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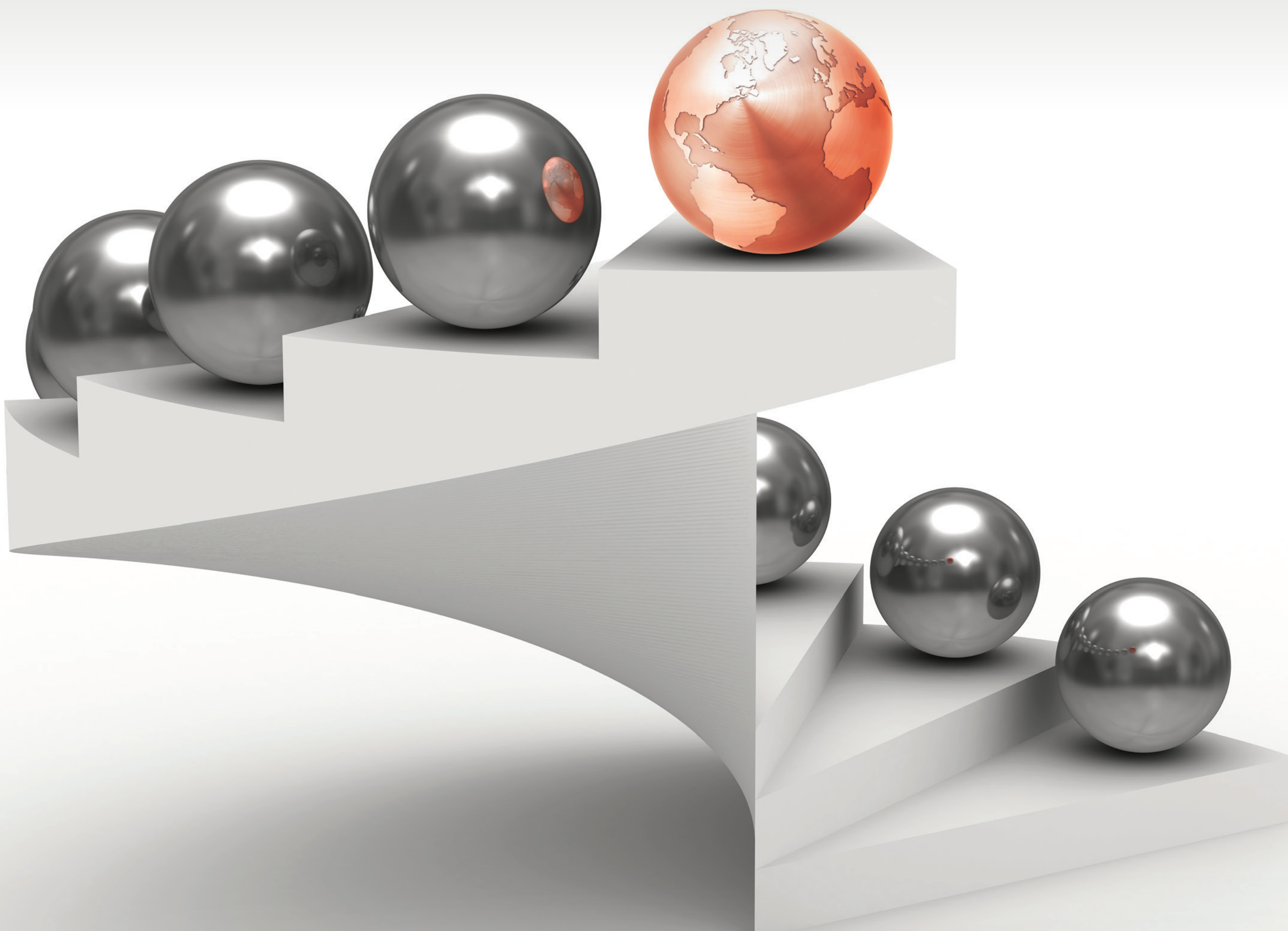
STRATEGIC MANAGEMENT 6e



Frank T. Rothaermel

McGraw Hill

Strategic Management

SIXTH EDITION

Strategic Management

Frank T. Rothaermel
Georgia Institute of Technology

McGraw Hill

STRATEGIC MANAGEMENT

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DEDICATION

To my eternal family for their love, support, and sacrifice: Kelleyn, Harris, Winston, Roman, Adelaide, Avery, and Ivy.

—Frank T. Rothaermel

CONTENTS IN BRIEF

Twelve full-length cases with auto-graded exercises are included in ***Connect.***

All of Frank T. Rothaermel's full-length cases are available through McGraw Hill Create: www.mcgrawhillcreate.com/rothaermel

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MINI**CASES** & FULL-LENGTH **CASES**

MINI**CASES** /

The twelve MiniCases correspond to their respective chapter number. These MiniCases are also available in Connect, with accompanying auto-graded exercises.

1 Whitney Wolfe Herd's Dating Strategy: From Tinder to Bumble
2 Microsoft: Satya Nadella hits Refresh
3 Robinhood: Democratizing Investing or Robbing Investors?
4 Dr. Dre's Core Competency: Coolness Factor
5 Sustaining Shared Value: The Rise and Fall of Toms Shoes
6 Warby Parker's Blue Ocean Strategy
7 Platform Strategy: How PayPal Solved the Chicken-or-Egg Problem
8 GE: Corporate Strategy Gone Bad
9 LVMH Acquires Tiffany: The American Jeweler Learns How to Speak French
10 Hollywood Goes Global
11 Chick-fil-A's Structure, Culture, and Control
12 Purdue Pharma and the Opioid Addiction Crisis

FULL-LENGTH **CASES** /

Twelve cases with auto-graded exercises are included in *Connect*. All of Frank T. Rothaermel's cases are available through McGraw Hill Create: www.mcgrawhillcreate.com/rothaermel

1 Peloton >>
2 Airbnb *
3 Rivian >>
4 Starbucks *
5 Best Buy *
6 Apple *
7 Tesla *
8 Uber >>
9 Disney *
10 Netflix *
11 McDonald's *
12 Nike

>> NEW TO THE SIXTH EDITION * REVISED AND UPDATED FOR THE SIXTH EDITION

PRIOR EDITION **CASES** /

Fifteen additional cases are included in *Connect*, in a standalone ebook. This combination of classic and contemporary cases provides even more options for instructors and students.

CHAPTER**CASES** & STRATEGY **HIGHLIGHTS**

CHAPTER**CASES** /

STRATEGY **HIGHLIGHTS** /

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ABOUT THE AUTHOR

Frank T. Rothaermel
Georgia Institute of Technology

Courtesy of Kelleyn Rothaermel

Frank T. Rothaermel, Ph.D., is a Professor of Strategy and Innovation, holds the Russell and Nancy McDonough Chair in the Scheller College of Business at the Georgia Institute of Technology (GT), and is an Alfred P. Sloan Industry Studies Fellow. He received a National Science Foundation (NSF) CAREER award, which "offers the National Science Foundation's most prestigious awards in support of those teacher-scholars who most effectively integrate research and education."[1] *Bloomberg Businessweek* named Frank one of Georgia Tech's Prominent Faculty, while *Poets & Quants* selected Frank as one of the "Favorite Business School Professors Teaching MBAs." He received the Theory-to-Practice Award from the Vienna Strategy Forum at the Vienna University of Economics and Business.

Frank is the author of a leading textbook—*Strategic Management* (6th edition, 2023), with translations into Greek, Korean, Mandarin, and Spanish. When launched, Frank's textbook won the McGraw Hill 1st Edition Award of the Year in Business and Economics. The 4th edition won the McGraw Hill Product of the Year Award in Business and Economics. Frank also authored over 50 case studies distributed by McGraw Hill Create (www.mcgrawhillcreate.com/rothaermel) and Harvard Business Publishing (HBP), with 23 achieving "bestseller" status among the cases distributed by HBP.

Frank's research interests lie in strategy, innovation, and entrepreneurship; he has published over 35 articles in leading academic journals such as the *Strategic Management Journal, Organization Science, Academy of Management Journal, Academy of Management Review,* and elsewhere. Using published papers in the top 1% based on citations, Thomson Reuters identified Frank as one of the "world's most influential scientific minds" and listed him among the top 100 scholars based on impact over more than a decade in economics and business. He is among the world's top 2% most-cited researchers, according to research conducted by the Meta-Research Innovation Center at Stanford University.

Frank has a wide range of executive education experience, including teaching in programs at GE Management Development Institute (Crotonville, New York), Georgia Institute of Technology, Georgetown University, ICN Business School (France), Politecnico di Milano (Italy), St. Gallen University (Switzerland), and the University of Washington. He received numerous teaching awards for excellence in the classroom, including the GT-wide Georgia Power Professor of Excellence award. To inform his research, Frank has conducted extensive fieldwork and executive training with a wide range of companies such as Amgen, Daimler, Eli Lilly, Equifax, GE Energy, GE Healthcare, Hyundai Heavy Industries (South Korea), Kimberly-Clark, Microsoft, McKesson, NCR, Turner (TBS), and UPS, among others.

Frank held visiting professorships at EBS University of Business and Law (Germany), Singapore Management University (Tommie Goh Professorship), and the University of St. Gallen (Switzerland). He is a member of the American Economic Association, the Academy of Management, and the Strategic Management Society.

Frank holds a Ph.D. in strategic management from the University of Washington, an MBA from the Marriott School of Management at Brigham Young University, and is Diplom-Volkswirt (M.Sc. equivalent) in economics from the University of Duisburg-Essen, Germany.

1. NSF CAREER Award description.

PREFACE

I'm pleased to introduce the new 6th edition of *Strategic Management*. Since January 2020, when the 5th edition published, the world has changed dramatically:

- The Covid-19 pandemic led to millions of deaths across the world. Governments shut down entire economies for periods of time. Working from home became the new normal. Governments spent trillions of dollars in fiscal stimuli and relief while central banks added substantial monetary expansions. Combined with disrupted supply chains, double-digit inflation not seen in decades ensued.
- The George Floyd killing (in 2020) sparked mass protests, leading to societies worldwide confronting a history of racial injustices.
- Russia invaded Ukraine, resulting in a significant supply-side shock to post-Covid economies still recovering, contributing to inflation, food shortages, and surges in oil, gas, and other commodity prices.
- Disenchantment with the economic system led to a shift from shareholder capitalism to stakeholder capitalism, with an emphasis on creating shared value.

Not only are we all affected by these significant events, but they also profoundly impact how strategic leaders run companies. As such, these dramatic events have a direct bearing on *Strategic Management*. I discuss these black swan events in detail and derive implications for strategy and competitive advantage. For instance, Chapter 5 has an entirely new focus by framing the discussion of competitive advantage in light of the shift toward creating shared value for all stakeholders.

What's New in the Sixth Edition?

I have revised and updated the new edition in the following ways, many of which were inspired by current events, recent developments in strategic management, and conversations and feedback from the many users, reviewers, and students of the prior editions.

OVERVIEW OF MAJOR CHANGES IN THE SIXTH EDITION

- The implications of the Covid-19 pandemic, the racial-justice movement, and the disenchantment with the capitalist system permeate the new 6th edition and capture the momentum toward stakeholder strategy to create shared value.

New Chapter:

- Chapter 5 has an entirely new focus by framing the discussion of competitive advantage in light of the shift toward creating shared value for all stakeholders, reflected in the new chapter title, "Shared Value and Competitive Advantage"

New ChapterCases:

- "Facebook becomes Meta" (Chapter 2)
- "Patagonia: A Pioneer in Creating Shared Value" (Chapter 5)

New Sections:

- "The Red Queen Effect in Business Competition" in Chapter 1, "What Is Strategy?"
- "Strategic Leadership at Meta's Facebook" in Chapter 2, "Strategic Leadership"
- "A Purpose-Driven Mission and Strategic Intent" in Chapter 2, "Strategic Leadership"

- "Strategic Leadership and the Future of Work" in Chapter 2, "Strategic Leadership"
- "Strategic Inflection Points" in Chapter 2, "Strategic Leadership"
- "Strategic Group Dynamics" in Chapter 3, "External Analysis: Industry Structure, Competitive Forces, and Strategic Groups"
- "The Four Industrial Revolutions" in Chapter 7, "Business Strategy: Innovation, Entrepreneurship, and Platforms"
- "Not All Industry Value Chain Stages Are Equally Profitable" in Chapter 8, "Corporate Strategy: Vertical Integration and Diversification"
- "Systemic Rivalry and Techno Cold War" in Chapter 10, "Global Strategy: Competing Around the World"
- "The Ambidextrous Organization: Balancing Trade-Offs" in Chapter 11, "Organizational Design: Structure, Culture, and Control"

New Exhibits:

- "The Interplay between Purpose-Driven Vision, Strategic Intent, and Core Competencies" in Chapter 2, "Strategic Leadership"
- "Strategic Inflection Point" in Chapter 2, "Strategic Leadership"
- "Strategic Groups and Mobility Barriers in U.S. Domestic Airline Industry, Including the Emergence of the Ultra-Low-Cost Strategic Subgroup" in Chapter 3, "External Analysis: Industry Structure, Competitive Forces, and Strategic Groups"
- "Four Industrial Revolutions from the 1780s to 2020s" in Chapter 7, "Business Strategy: Innovation, Entrepreneurship, and Platforms"
- "The Three Dimensions of Corporate-Level Strategy: Vertical Integration, Horizontal Diversification, and Geographic Scope" in Chapter 8, "Corporate Strategy: Vertical Integration and Diversification"
- "The Smiley Curve: Differential Profit Potential along the Industry Value Chain" in Chapter 8, "Corporate Strategy: Vertical Integration and Diversification"
- "The Short Head and the Long Tail" in Chapter 12, "Corporate Governance, Business Ethics, and Business Models"

Improvements to Content Flow:

- "Business Models: Strategy in Action" is now in Chapter 12, "Corporate Governance, Business Ethics, and Business Models," to reflect the role of business models in strategy implementation
- All new or updated and revised **Strategy Highlights** (two per chapter).

Cases:

- Nine (!) new out of 12 **MiniCases**, featuring successes and failures. Companies featured in the new MiniCases: Chick-fil-A, Dr. Dre (Beats Electronics), Microsoft, Purdue Pharma, Robinhood, Tiffany and LVMH, Tinder and Bumble, Toms Shoes, and Warby Parker.
  - All other MiniCases are revised and updated.
  - One MiniCase per chapter, tightly integrated with learning objectives.
  - Detailed and high-quality teaching notes are available in the **Connect Library.**
- Three new **full-length Cases:** Rivian, Peloton, and Uber
  - All other cases, including the most popular ones, such as Apple, Best Buy, Disney, McDonald's, Starbucks, and Tesla, are revised and updated.
    - Detailed and updated case teaching notes are available in the **Connect Library.**

IN DETAIL

CHAPTER 1

- A stronger emphasis on "Stakeholder Strategy and Competitive Advantage"
- New Section: "The Red Queen Effect in Business Competition"
- Revised and updated:
    - ChapterCase: "Tesla: The Trillion-Dollar Tech Titan"
    - Section: "Crafting and Implementing Strategy at Tesla"
    - Strategy Highlight: "Twitter Needs a Strategy?"

CHAPTER 2

- New ChapterCase: "Facebook Becomes Meta"
- New Sections:
    - "Strategic Leadership at Meta's Facebook"
    - "A Purpose-Driven Mission and Strategic Intent"
    - "Strategic Leadership and the Future of Work"
    - "Strategic Inflection Points"
- Revised and updated Strategy Highlight: "Teach for America: Inspiring Future Leaders"

CHAPTER 3

- Revised and updated:
    - ChapterCase: "Airbnb: Disrupting the Hotel Industry"
    - Strategy Highlight: "From League of Legends to Fortnite: The Rise of ESports"
- New Section:
    - "Strategic Group Dynamics"

CHAPTER 4

- Revised and updated ChapterCase: "Five Guys' Core Competency: 'Make the Best Burger, Don't Worry about Cost.'"
- New Strategy Highlight: "Yeti's Core Competency: Making Quality Cool"

CHAPTER 5

- New ChapterCase: "Patagonia: A Pioneer in Creating Shared Value"
- New A-head Section: "From Corporate Social Responsibility to Creating Shared Value"
- New Sections:
    - "Shareholder Capitalism"
    - "Shareholder Capitalism in Crisis?"
    - "Creating Shared Value"
- New Strategy Highlight: "BlackRock's $10 Trillion of Shared Value"

CHAPTER 6

- Revised and updated ChapterCase: "JetBlue Airways: En Route to a New Blue Ocean?"
- New Strategy Highlight: "How JC Penney Sailed into a Red Ocean"

CHAPTER 7

- Revised and updated ChapterCase: "Netflix: No Longer a Disruptor?"
- New Section: "The Four Industrial Revolutions"
- New Strategy Highlight: "How to Compete with Amazon.com? Easy: Use Shopify"
- Revised and updated Strategy Highlight: "Standards Battle: Which Automotive Technology Will Win?"

CHAPTER 8

- Revised and updated ChapterCase: "Amazon's Corporate Strategy"
- New Section: "Not All Industry Value Chain Stages Are Equally Profitable"
- Revised and updated Strategy Highlights:
  - "The Equity Alliance between Coca-Cola and Monster: A Troubled Engagement?"
  - "P&G Diversification Strategy: Turning the Tide?"

CHAPTER 9

- Revised and updated ChapterCase: "Little Lyft Gets Big Alliance Partners and Beats Uber in Going Public"
- Revised and updated Strategy Highlight: "Kraft Heinz: From Specializing in Hostile Takeovers to Eating Humble Pie"

CHAPTER 10

- Revised and updated ChapterCase: "IKEA: The World's Most Profitable Retailer"
- New Section: "Systemic Rivalry and Techno Cold War"
- New Strategy Highlight: "Squid Game: Netflix's Transnational Strategy"
- Revised and updated Strategy Highlight: "Walmart Retreats from Germany, and German Ultra-Low-Cost Grocers Invade the United States"
- Revised and updated section "Cost Reductions vs. Local Responsiveness," where the "Integration-Responsiveness Framework" is now the "Cost-Responsiveness Framework"

CHAPTER 11

- Revised and updated ChapterCase: "'A' is for Alphabet and 'G' is for Google"
- New Section: "The Ambidextrous Organization: Balancing Trade-Offs"
- Revised and updated Strategy Highlights:
  - "Zappos: Of Holacracy and (Not Much) Happiness"
  - "Sony vs. Apple: Whatever Happened to Sony?"

CHAPTER 12

- Revised and updated ChapterCase: "Theranos: Bad Blood"
- New A-head Section: "Business Models: Strategy in Action"
- New Section: "The Long Tail and Business Model Innovation"
- New Strategy Highlight: "Business Model Innovation: How Dollar Shave Club Disrupted Gillette"

PEDAGOGY

The market for strategy texts can be broadly separated into two overarching categories: traditional application-based and research-based. Traditional application-based strategy books represent the first-generation texts, with first editions published in the 1980s. The research-based strategy books represent the second-generation texts with first editions published in the 1990s. I wrote this text to address a needed new category—the third generation of strategy content that *combines* into one the student-accessible, application-oriented frameworks of the first-generation texts with the research-based frameworks of the second-generation texts. The market response to this unique approach to teaching and studying strategy continues to be overwhelmingly enthusiastic.

To facilitate an enjoyable and refreshing reading experience that enhances student learning and retention, I *synthesize* and *integrate* strategy frameworks, empirical research, and practical applications with current real-world examples. I also move iteratively between strategy concepts and real-world examples. This unique approach offers students a learning experience that combines rigor and relevance. As John Media of the University of Washington's School of Medicine and lifelong researcher on how the mind organizes information explains:

> How does one communicate meaning in such a fashion that learning is improved? A simple trick involves the liberal use of relevant real-world examples, thus peppering main learning points with meaningful experiences. . . . Numerous studies show this works. . . . The greater the number of examples . . . the more likely the students were to remember the information. It's best to use real-world situations familiar to the learner. . . . Examples work because they take advantage of the brain's natural predilection for pattern matching. Information is more readily processed if it can be immediately associated with information already present in the brain. We compare the two inputs, looking for similarities and differences as we encode the new information. Providing examples is the cognitive equivalent of adding more handles to the door. [The more handles one creates at the moment of learning, the more likely the information can be accessed at a later date.] Providing examples makes the information more elaborative, more complex, better encoded, and therefore better learned.[2]

Strategic Management brings conceptual frameworks to life via examples that cover products and services from companies with which students are familiar, such as Airbnb, Apple, Amazon, Chick-fil-A, Disney, Five Guys, IKEA, JetBlue, Lyft and Uber, Meta (Facebook), Netflix, Nike, Patagonia, Peloton, Robinhood, Rivian, Starbucks, Tinder and Bumble, Tesla, Toms Shoes, Warby Parker, and Yeti. Liberal use of such examples aids in making strategy relevant to students' lives and helps them internalize strategy concepts and frameworks. Integrating current examples with modern strategy thinking, I prepare students with the foundation they need to understand how companies gain and sustain competitive advantage. I also develop students' skills to become successful leaders capable of making well-reasoned strategic decisions in a turbulent 21st century.

My distinctive approach to teaching strategy offers students a unique learning experience that combines theory and practice and provides tight linkages between concepts and cases. In this new 6th edition, I build upon the unique strengths of this product and continue to add improvements based upon hundreds of insightful reviews and important feedback from professors, students, and working professionals. The hallmark features of this text continue to be:

- *Student engagement* via practical and relevant application of strategy concepts using a holistic **Analysis, Formulation, and Implementation (AFI) Strategy Framework**.

2. Medina, J. (2014), *Brain Rules: 12 Principles for Surviving and Thriving at Work, Home, and School* (Seattle: Pear Press), 139–140.

- *Synthesis and integration* of empirical research and practical applications combined with relevant strategy material to focus on "*What is important?"* for the student and *"Why is it important?"*
- *Strong emphasis on diversity, equity, and inclusion (DEI)* by featuring a wide range of strategic leaders from different backgrounds and fields, not just in business but also in entertainment, professional sports, and so forth.
- *Coverage of a wide array of organizations,* including for-profit public companies, private firms (including startups), and nonprofit organizations. All of them need a good strategy!
- *Global perspective*, with a focus on competing around the world, featuring many leading companies from Asia, Europe, Latin America, and North America. I was fortunate to study, live, and work across the globe, and I attempt to bring this cosmopolitan perspective to bear in this text.
- *Industry-leading digital delivery option* (Create), *adaptive learning system* (SmartBook), *activity-based applications* (ABAs or mini sims in Connect), and other *online assignment and assessment tools* (Connect).
- *Best-in-class Teaching Resources.*
- A *standalone module* on **How to Conduct a Case Analysis**.
- *High-quality* **Cases***,* well integrated with text chapters and standardized, *high-quality and detailed teaching notes;* there are three types of cases that come with this text:
  - **12 ChapterCases** begin and end each chapter, framing the chapter topic and content. Each ChapterCase has thought-provoking questions tailored to the specific chapter content to stimulate in-class discussions.
  - **12 MiniCases** in Part 4 of the book, with one MiniCase specifically matched to each chapter with accompanying discussion questions. All of the cases are based on original research, provide dynamic opportunities for students to apply strategy concepts by assigning them in conjunction with specific chapters, and can be used in various ways (as individual assignments, group work, and in class).
  - **27 full-length Cases** by Frank T. Rothaermel are included free of charge for students in **6th edition Connect**: 12 are new or fully updated; 15 are from previous editions.
- Over **50 full-length Cases** by Frank T. Rothaermel are available through McGraw Hill Create (www.mcgrawhillcreate.com/rothaermel).

I have taken great pride in authoring this text's case materials (some with co-authors). This additional touch is a differentiating feature from other offerings on the market and allows for strict quality control and seamless integration with chapter content. All case materials come with sets of questions to stimulate class discussion and provide guidance for written assignments. High-quality case teaching notes that more fully integrate content and cases are available to instructors in the **Connect Library** (Instructor Resources).

CONTENT DELIVERY

Connect, McGraw Hill's online assignment and assessment system, offers a wealth of content for both students and instructors. Assignable activities include the following:

- **SmartBook**, one of the first fully adaptive and individualized study tools, provides students with a personalized learning experience, allowing them to practice and challenge their understanding of core strategy concepts. It allows the instructor to set up all assignments before the semester, have them auto-released on preset dates, and receive auto-graded progress reports for each student and the entire class. Students love SmartBook because they learn at their own pace, and it helps them to study more efficiently by delivering an interactive reading experience through adaptive highlighting and review.

- **Application-Based Activities** (ABAs) are highly interactive mini simulations that challenge students to use problem-solving skills and apply their knowledge to realistic scenarios. Students are placed in specific roles in which they are required to apply multiple concepts and make data-informed decisions. They progress from understanding basic concepts to analyzing complex scenarios and solving problems.
- **Application Exercises** including animated video cases and on-location video cases, Mini-Case case analyses, interactive exercises, and new case exercises for all 12 full-length cases are available in Connect and require students to apply key concepts, thereby closing the knowing and doing gap, while providing instant feedback for the student and progress tracking for the instructor.
- **New Student Primer**, available in Connect, contains direct personal applications of strategy concepts to students' careers and lives, helping them to internalize the content. Included in the new Student Primer are the popular and completely revised myStrategy modules for each chapter, as well as Financial Ratio Reviews, which give students the opportunity to further hone their financial analysis skills. These review exercises cover each type of financial ratio (activity, leverage, liquidity, market, and profitability). As such, they provide students with a solid foundation for effective case analysis.

INSTRUCTOR RESOURCES

The **Instructor Resources** located in **Connect** provide the following teaching tools, all of which have been tested and updated with this edition:

- The **Teacher's Resource Manual (TRM)** includes thorough coverage of each chapter and guidance for integrating **Connect**—all in a single resource. Included in this newly combined TRM, which retains favorite features of the previous edition's Instructor's Manual, is the appropriate level of theory, framework, recent application, additional company examples not found in the textbook, teaching tips, PowerPoint references, critical discussion topics, answers to ChapterCase discussion questions, and a variety of exercises. In addition, all end-of-chapter discussion questions are now located in the TRM.
- The **PowerPoint (PPT)** slide decks, available in an accessible version for individuals with visual impairment, provide comprehensive lecture notes, video links, and additional company examples not found in the textbook. Options include instructor media-enhanced slides as well as notes with outside application examples. All slides can be edited by individual instructors to suit their needs.
- The **Test Bank** includes 100 to 150 questions per chapter, in a range of formats and with a greater-than-usual number of comprehension, critical-thinking, and application or scenario-based questions. Each question is tagged to learning objectives, Bloom's taxonomy levels, and AACSB compliance requirements. Many questions are new and written especially for this new edition.
- The **Video Guide** includes video links that relate to concepts from every chapter. The guide includes links to a wide range of sources, from Big Think to Stanford University's Entrepreneurship Corner; The McKinsey Quarterly to BBC and YouTube.

CREATE

- **Create**, McGraw Hill's custom-publishing tool, is where you access additional full-length cases (and Teaching Notes) beyond those included complimentary in Connect that accompany *Strategic Management* (http://www.mcgrawhillcreate.com/rothaermel). You can create customized course packages in print and/or digital form at a competitive price point.

- Through Create, you will be able to select from all author-written cases as well as instructor-written cases that match specifically with the new 6th edition. Create also contains cases from Harvard, Ivey, Darden, NACRA, and much more! You can assemble your own course, selecting the chapters, cases (multiple formats), and readings that will work best for you, or choose from several ready-to-go, author-recommended complete course solutions, which include chapters, cases, and readings, preloaded in Create. Among the preloaded solutions, you'll find options for undergraduate, MBA, accelerated, and other strategy courses.

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Any list of acknowledgments will always be incomplete, but I would like to thank some special people without whom this product would not have been possible. First and foremost, my wife, Kelleyn, and our children: Harris, Winston, Roman, Adelaide, Avery, and Ivy. Over the last few years, I have worked longer hours than when I was a graduate student to conduct the research and writing necessary for this text and accompanying case studies and other materials. I sincerely appreciate the sacrifice this has meant for my family.

The Georgia Institute of Technology provides a conducive intellectual environment and superb institutional support to make this project possible. I thank Russell and Nancy McDonough for generously funding the endowed chair I am honored to hold. I'm grateful to Dean Maryam Alavi and Senior Associate Deans Jonathan Clarke and Soumen Ghosh for providing the exceptional leadership that allows faculty to focus on research, teaching, and service. I would like to thank my colleagues at Georgia Tech—all of whom are not only great scholars but also fine individuals whom I'm fortunate to have as friends: Marco Ceccagnoli, Anne Fuller, Jonathan Giuliano, Stuart Graham, David Ku, Ashlee Li, Astrid Marinoni, John McIntyre, Alex Oettl, Aleksandra Rebeka, Eunhee Sohn, and Peter Thompson.

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I'm thankful for the contributions of great colleagues on various resources that accompany this new edition of *Strategic Management*:

- John Burr (Purdue University) on the *Video Guide.*
- Meredith Peabody (Northern Arizona University) and Carla Flores (Ball State University) on the revision of Connect, including the *Interactive Exercises*, *MiniCase Exercises*, and *Case Exercises*.
- Orhun Guldiken (Florida International University) on the accessible *PowerPoint* slide decks.
- Jennifer Sexton (Mississippi State University) on the *Teacher Resource Manual*.

Last but certainly not least, I wish to thank the reviewers and focus group attendees who shared their expertise with us, from the beginning when we developed the prospectus to the new teaching and learning package you hold in your hands. The reviewers have given us the greatest gift of all—the gift of time! These very special people are listed below.

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THANK YOU . . .

This text has gone through McGraw Hill Education's thorough development process. Over the course of several years, the project has benefited from numerous developmental focus groups, hundreds of reviews from instructors across the country, beta-testing, and market reviews of subsequent editions on various campuses in the U.S. and across the world. The author and McGraw Hill wish to thank the following people who shared their insights, constructive criticisms, and valuable suggestions throughout the development of this project. Your contributions have greatly improved this product:

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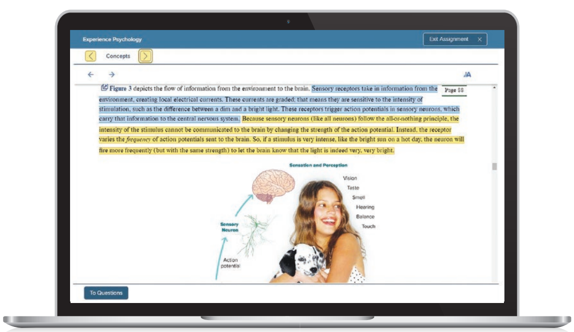

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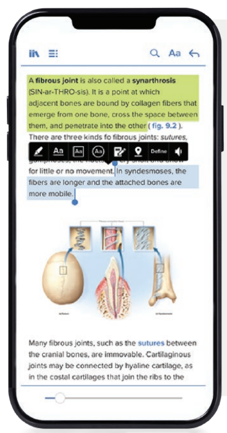

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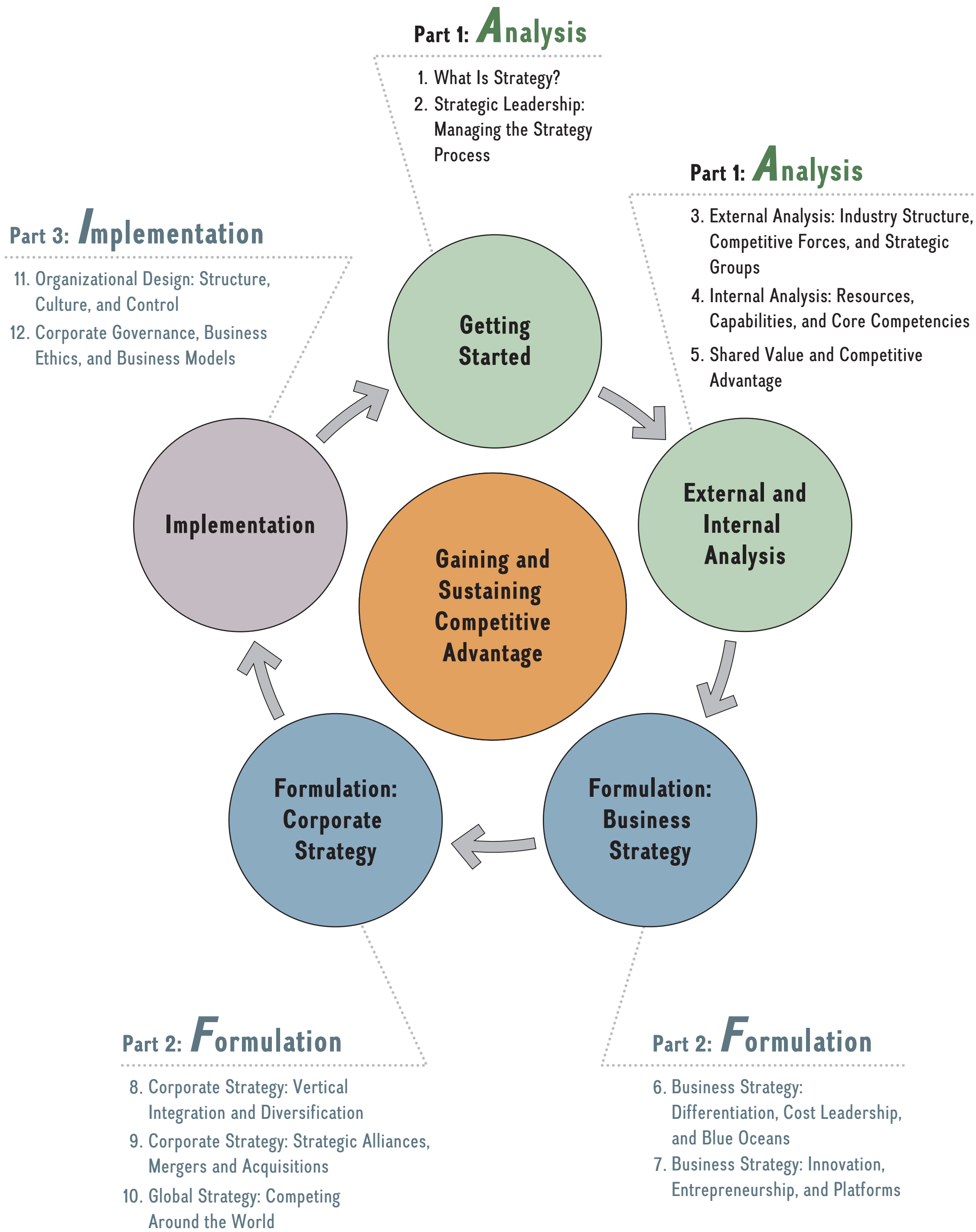
PART

1

Analysis

The AFI Strategy Framework



CHAPTER

1

What Is Strategy?

Chapter Outline

1.1 What Strategy Is: Gaining and Sustaining Competitive Advantage
Crafting and Implementing Strategy at Tesla
What Is Competitive Advantage?

1.2 Stakeholder Strategy and Competitive Advantage
Value Creation
Stakeholder Impact Analysis

1.3 The Analysis, Formulation, Implementation (AFI) Strategy Framework
Key Topics and Questions of the AFI Strategy Framework

1.4 Implications for Strategic Leaders

Learning Objectives

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

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

LO 1-3 Assess the relationship between stakeholder strategy and sustainable competitive advantage.

LO 1-4 Conduct a stakeholder impact analysis.

LO 1-5 Apply the Analysis, Formulation, Implementation (AFI) Strategy Framework.

Tesla: The Trillion-Dollar Tech Titan

Tesla, Inc., an American manufacturer of all-electric cars, had a market capitalization[1] of greater than $1 trillion in 2022, an appreciation of 50,000% over its initial public offering in 2010. Only five other tech companies—Alphabet, Amazon, Apple, Meta Platforms (formerly Facebook), and Microsoft—are in the elite trillion-dollar club.[2] A mere 18 years after its founding, Tesla is the youngest company to reach this important milestone. Moreover, the Austin, Texas–based electric vehicle company is almost twice as valuable as five major car companies combined: Ford, GM, Stellantis (formerly Fiat Chrysler), Toyota, and Volkswagen (VW).

Elon Musk introduced the Cybertruck in 2019, with mass production of the futuristic truck in 2023.

Frederic J. Brown/AFP/Getty Images

How did Tesla transform from a fledgling startup to a trillion-dollar tech titan? The answer: Tesla's strategy. In a 2006 blog entry, Elon Musk, Tesla's co-founder and chief executive officer (CEO), explained the startup's master plan:[3]

1. Build sports car.
2. Use that money to build an affordable car.
3. Use *that* money to build an even more affordable car.
4. While doing above, also provide zero-emission electric power generation options.

Did Tesla stick to its strategy? In 2008, Tesla introduced its first car: the Roadster, a $110,000 sports coupe with faster acceleration than a Porsche or a Ferrari. The Roadster served as a prototype to demonstrate that electric vehicles (EVs) can be more than mere golf carts. Tesla thus completed Step 1 of its master plan.

In Step 2, after selling 2,500 Roadsters, Tesla stopped producing them in 2012 to focus on its next car: the Model S, a four-door family sedan with an initial base price of $73,500. The Model S, which appeals to a somewhat broader market and thus allows for larger production runs to drive down unit costs, received an outstanding market reception. It was named the Motor Trend Car of the Year and received the highest score of any car ever tested by Consumer Reports (99/100). The refreshed Tesla Model S Plaid, introduced in 2022, is the world's fastest mass-production car; it accelerates from 0 mph to 60 mph in two seconds. Tesla has sold more than 300,000 Model S cars worldwide.

Tesla also completed Step 3 of its master plan. In 2016, it unveiled the Model 3, an all-electric compact luxury sedan with a starting price of $35,000. Many people who wanted the new Model 3 stood in line overnight, eagerly waiting for Tesla stores to open so they could pay their $1,000 deposit and secure a spot on the waiting list for a car they had never seen, let alone taken for a test drive. As a result of this consumer enthusiasm, Tesla received more than 500,000 preorders for the Model 3, for a total of $500 million in interest-free loans. Despite Tesla's initial difficulties in scaling up production, Model 3 deliveries began in 2017. In 2019, Tesla launched the Model Y, a compact SUV with the entry version starting at $39,000 (and a range of 230 miles) and the high-end performance version starting at $60,000 (and a range of 280 miles).

The two lower-priced Models 3 and Y were critical for Tesla to break into the mass market. In 2021, Tesla sold close to 1 million vehicles worldwide, with Models 3/Y accounting for 97% of sales. With upgrade options, the average selling price in 2021 was $54,000 for the Model 3 and $68,000 for the Model Y. Despite its higher price, the Model Y is the most popular Tesla vehicle globally, and Tesla continuously works on ramping up production volume to drive down costs further.

Step 4 of Musk's master plan for Tesla aims to provide zero-emission electric power generation options. To achieve this goal, Tesla acquired SolarCity, a solar energy company, for more than $2 billion in 2016. The integration of Tesla and SolarCity, which resulted in the first fully integrated clean-tech energy company that combines solar power, power storage, and transportation, marks the completion of Step 4 in Tesla's master plan.

In 2016, 10 years after creating Tesla's initial master plan, Elon Musk unveiled the second part of his strategy to continue the pursuit of Tesla's vision "to accelerate the advent of sustainable energy."[4] Again, CEO Musk detailed a set of stretch goals:

1. Create stunning solar roofs with seamlessly integrated battery storage.
2. Expand the EV product line to address all major segments.
3. Develop a self-driving capability that is 10 times safer than manual via massive fleet learning.
4. Enable your car to make money for you when you aren't using it.

In the updated strategy, Step 1 leverages the integration of SolarCity. Tesla is now a fully integrated sustainable energy company, combining energy generation and storage. It provides energy generation via solar roofs that look like regular roofing shingles but last longer and cost less, all things considered. Tesla also offers its Powerwall to residential consumers, making it possible to store solar energy captured on the roof of their house for later use. Energy generation therefore becomes decentralized. Thanks to the Powerwall, consumers can generate and use energy without being dependent on a utility company and can sell their excess energy to utility providers. Indeed, consumers can generate enough energy to power not only their Tesla cars but also their entire house. Should there be a power outage in the central utility grid, the Powerwall provides electricity to a home for one week.

In Step 2, Tesla is planning to expand the EV lineup to address all major market segments. Elon Musk excels in product development, and Tesla has introduced several new vehicles, including a futuristic pickup truck (the Cybertruck, with production in 2023) and a heavy-duty semitruck.

In Step 3, Tesla is developing its vehicles' self-driving capabilities. The goal is to make self-driving vehicles 10 times safer than cars driven manually, thus increasing the demand for fully autonomous cars. Many industry observers expect commercial trucks to be the first fully autonomous vehicles, especially on interstate highways. Self-driving large trucks can be on the road 24/7 and need to stop only to recharge their batteries.

Fully self-driving capabilities are required for Tesla to fulfill Step 4 of the new master plan: Turn your car into an income-generating asset. The idea is to offer an Uber-like service composed of Tesla vehicles but without drivers. On average, cars are in use for less than three hours a day. The idea is that your self-driving Tesla will be part of a shared vehicle fleet when you are not using it. This new business model drastically reduces the total cost of ownership of a Tesla vehicle. It also allows anyone to ride in a Tesla due to the sharing economy.[5]

Part II of this ChapterCase appears in Section 1.4.

Why is Tesla so successful? In contrast to Tesla's success, the big three U.S. automakers—Ford, GM, and Chrysler (now Stellantis)—struggled during the first decade of the 21st century, with both GM and Chrysler filing for bankruptcy protection.

Why are some companies successful while others fail? And what, as a strategic leader, can you do about it? These are the big questions that define strategic management. Answering these questions requires integrating the knowledge you've obtained in your studies of various business disciplines to understand what leads to superior performance and how you can help your organization achieve it.

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

Strategic management is the integrative management field that combines *analysis, formulation,* and *implementation* in the quest for competitive advantage. Mastery of strategic management enables you to view a firm or a nonprofit organization in its entirety. It also allows you to think like a general manager to help your organization achieve superior performance. The *AFI Strategy Framework* embodies this view of strategic management. It will guide our exploration of strategic management throughout this book.

In this chapter, we lay the groundwork for the study of strategic management. First, we introduce foundational ideas about strategy and competitive advantage. We move beyond thinking about competitive advantage solely as superior financial performance and introduce the concept of stakeholder strategy. Understanding stakeholder strategy allows us to appreciate the role of business in society more broadly. We then examine the components of the AFI framework and provide an overview of the entire strategic management process. We conclude this introductory chapter, as we conclude all other chapters in this text, with a section titled *Implications for Strategic Leaders,* which provides practical applications and considerations of the material developed in the chapter. Let's begin the exciting journey that ends with a deep understanding of strategic management and competitive advantage.

1.1 What Strategy Is: Gaining and Sustaining Competitive Advantage

LO 1-1

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

Strategy is a set of goal-directed and integrated actions a firm takes to gain and sustain superior performance *relative* to competitors.[6] Strategy is the outcome of the strategic management process. To achieve superior performance, companies compete for resources: New ventures compete for financial and human capital, existing companies compete for profitable growth, charities compete for donations, universities compete for the best students and professors, sports teams compete for championships, and celebrities compete for endorsements. As highlighted in the ChapterCase, Tesla, a new entrant in the automotive industry, is competing for customers with established U.S. companies such as GM and Ford, and with foreign automakers Toyota, Honda, Nissan, Hyundai, VW, Audi, Porsche, Mercedes, and BMW, among others.

A **good strategy** enables a firm to achieve superior performance and sustainable competitive advantage relative to its competitors in any competitive situation. A good strategy consists of three key elements that make up the strategic management process:

1. A *diagnosis* to identify the competitive challenge. Diagnosis includes analyzing the firm's external and internal environments (Part 1 of the AFI framework: *Analysis*).
2. A *guiding policy* to address the competitive challenge through strategy formulation. The guiding policy lays the foundation to craft a firm's corporate, business, and functional strategies (Part 2 of the AFI framework: *Formulation*).
3. A set of *coherent actions* to implement the firm's guiding policy (Part 3 of the AFI framework: *Implementation*).

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

good strategy Enables a firm to achieve superior performance and sustainable competitive advantage relative to its competitors. It is the outcome of a strategic management process that consists of three elements: (1) a diagnosis of the competitive challenge; (2) a guiding policy to address the competitive challenge; and (3) a set of coherent actions to implement a firm's guiding policy.

CRAFTING AND IMPLEMENTING STRATEGY AT TESLA

Let's revisit ChapterCase 1 to see whether Tesla pursues a good strategy. Tesla is performing quite well in terms of indicators such as stock appreciation, where it outperforms its competitors by a wide margin. The appreciation of Tesla stock after its initial public offering (IPO) points to investors' expectations of future growth. By other measures, such as generating profits, Tesla underperforms compared to established car companies. Early on, startups expect losses, especially if the business requires significant upfront investments such as building new manufacturing facilities and retooling existing factories, which Tesla was required to do. Since 2020, Tesla has been generating positive and increasing net income. What we can say at this point is that Tesla seems to be starting with a promising strategy and is in the process of achieving superior performance relative to its competitors. But can Tesla sustain this outstanding performance over time? Let's use the three elements of a good strategy to explore this question.

DIAGNOSIS OF THE COMPETITIVE CHALLENGE. A good strategy needs to start with a precise and critical diagnosis of the competitive challenge. Elon Musk, Tesla's co-founder and CEO, describes himself as an "engineer and entrepreneur who builds and operates companies to solve environmental, social, and economic challenges."[7] Tesla was founded with the vision to "accelerate the world's transition to sustainable transport."[8]

To accomplish this mission, Tesla must build zero-emission electric vehicles that are attractive and affordable. Beyond achieving a competitive advantage for Tesla, Musk is working hard to set a new standard in automotive technology. He hopes that zero-emission electric vehicles will one day replace gasoline-powered cars.

Tesla's competitive challenge is sizable. To succeed, it must use its new technology to manufacture attractive and affordable vehicles, which will compete with cars running on gasoline. To overcome "range anxiety,"[9] Tesla has installed a charging station network. At this point, mass-market EVs cannot drive as far on one charge as gasoline-powered cars with a tank of gas. Gas stations are pretty much on every corner in cities and every couple of miles on highways.[10]

A GUIDING POLICY. After diagnosing the competitive challenge, strategic leaders must formulate an effective guiding policy in response. The developed strategy needs to be consistent over the long term, and it is often backed up with strategic commitments. A *strategic commitment,* for instance, is a sizable investment or a change to an organization's incentive and reward system. Strategic commitments (such as Tesla's Gigafactories) are significant investments resulting in fundamental changes to the organization's structure. In general, strategic commitments are significant changes that are difficult and costly to reverse.

Without consistency in a firm's guiding policy, it can create confusion among employees about which priorities to address. An inconsistent policy, therefore, negatively impacts effective day-to-day decisions that support the overall strategy. Moreover, other stakeholders, including investors and customers, become frustrated if the firm does not have a consistent and coherent strategy over time.

Tesla's guiding policy is to build cost-competitive mass-market vehicles such as Models 3/Y. Its formulated strategy is consistent with its mission and the competitive challenge identified. This strategy required significant strategic commitments, as demonstrated by Tesla's $5 billion investment in a new lithium-ion battery plant in Nevada, the so-called Gigafactory or Giga Nevada. Batteries are the most critical component of electric vehicles. To build the battery manufacturing component of the Gigafactory, Tesla partnered with Panasonic of Japan, a world leader in battery technology.

To expand global production capacity rapidly and drive down costs, Tesla invested billions in several electric vehicle manufacturing plants across the globe. In 2019, it completed a production facility in Shanghai, China. Giga Shanghai is a vast factory, equal in size to the Tesla car manufacturing facility in Fremont, California, combined with its Gigafactory in Nevada. The goal is to produce batteries and cars on a large scale and in the same location. Large scale and co-location of critical tasks allow Tesla to further lower the price of Models 3/Y. The completion of Giga Shanghai in a record time of less than one year was a turning point for Tesla because the company was facing bankruptcy in 2018. The development and manufacturing costs of the luxury Models S/X were much higher than anticipated, leading to huge losses.

Giga Shanghai services the European market and the Chinese market, which is the largest electric vehicle market globally. The cost of Models 3/Y at Giga Shanghai is an estimated 40% lower than the costs when they are made in the United States, with no loss in quality. To further expand production capacity, in 2022 Tesla opened Giga Berlin, a $7 billion factory, and Giga Texas (near Austin), a $10 billion investment. Although such significant up-front investments frequently lead to early-year losses, they also represent a solid and credible commitment to becoming a viable competitor in the mass automobile market. Moreover, they deter entry by other potential newcomers to the EV industry.

COHERENT ACTIONS. Strategic leaders implement a guiding policy through coherent actions. Tesla's strategic leaders implement the formulated strategy with activities consistent with their diagnosis of the competitive challenge. To make a cost-competitive mass-market vehicle, Tesla must benefit from *economies of scale,* decreasing the cost per vehicle as output increases. To reap critical cost reductions, Tesla must ramp up its production volume. Tesla's retooling of its manufacturing facility in Fremont, California, to rely more heavily on cutting-edge robotics as well as its multibillion-dollar investment to secure an uninterrupted supply of lithium-ion batteries, exemplify actions coherent with Tesla's formulated strategy. So do its investments in Gigafactories in Austin, Berlin, and Shanghai.

Another set of coherent actions are those focused on Tesla's best-selling vehicles, Models 3/Y. In 2021, the EV maker doubled its production volume to close to 1 million cars compared to 2020. Thus, since 2015, Tesla has achieved a 20-fold increase in production volume from 50,000 cars built per year. Tesla's focus on Models 3/Y explains why they made up 97% of Tesla's vehicle deliveries in 2021. In addition, to ramp up production and drive down costs even further, Elon Musk announced, in 2022, that Tesla will not introduce any new vehicles for the time being. Moreover, he pushed back the mass production date for the much-anticipated Cybertruck to 2023.

At the same time, Tesla is expanding its network of charging stations across North America, Europe, and Asia. To fund this initiative and to avoid bottlenecks, Tesla announced that it will no longer provide new owners free use of the company's charging network. In addition, to accomplish the lofty goal of making zero-emission electric motors rather than internal combustion engines the new standard in automotive technology, Tesla decided to make some of its proprietary technology available to the public. Musk hopes that sharing Tesla's patents will expand the overall market size for electric vehicles as other manufacturers use Tesla's technology. This set of coherent actions shows that Tesla is dedicated to achieving its mission of accelerating the transition to sustainable transportation.

In review, to craft a good strategy, three steps are crucial in the strategic management process:

- A good strategy must define an organization's competitive challenge through a critical and honest assessment of the status quo.
- A good strategy provides a game plan for dealing with the competitive challenge identified. The firm needs a guiding policy that provides clear guidance for all employees.
- A good strategy requires effective implementation through a coherent and consistent set of actions.

Strategy Highlight 1.1 examines Twitter and asks whether the social media company has a strategy.

Strategy Highlight 1.1

Twitter Needs a Strategy

In late 2021, Jack Dorsey, Twitter's co-founder, was ousted as CEO for the second time. Dorsey had led Twitter from its founding in 2006 until 2008, and then returned as CEO for a second stint from 2015 until 2021. Despite its prominent role in public discourse, Twitter has failed to live up to expectations. In comparing normalized stock appreciation between Twitter's initial public offering (IPO) in 2013 and 2022, we see that Twitter's market cap increased by a mere 25%. Over the same period, the market cap of Meta (formerly Facebook) increased by over 620%. What went wrong? Despite churning through five CEOs in its short history, Twitter did not have a strategy!

Jack Dorsey co-founded Twitter in 2006. He served as CEO from 2006 to 2008 and 2015–2021.

Burston/Bloomberg/Getty Images

Twitter is an online news and social networking site that allows its users to send short messages ("tweets") of up to 280 characters to their followers. People who follow one another on Twitter can see tweets in each others' feeds. Users with the most followers include former President Barack Obama with 131 million, Justin Bieber (114 million), Katy Perry (109 million), and Rihanna (104 million). Many politicians, such as U.S. Senate and House Representatives and world leaders such as India's Prime Minister Narendra Modi (75 million followers), use Twitter to communicate directly with the public, allowing them to bypass traditional media outlets. While famous for its newsy and gossipy content, Twitter's cultural significance has resulted from its pivotal role during the Arab Spring (2010–2012), in the Black Lives Matter movement (founded in 2013), and in its real-time coverage of breaking news, such as the raid on Osama bin Laden's compound in Pakistan (2011) and the killing of George Floyd (2020).

To bolster the assertion that Twitter did not have a strategy, let's apply the three critical elements of a good strategy: *diagnose the competitive challenge, formulate a guiding policy,* and *implement a coherent set of actions.*

DIAGNOSIS OF THE COMPETITIVE CHALLENGE Twitter is a two-sided platform business, matching users with advertisers. Twitter's goal is to grow its user base and foster engagement. Capturing a large number of users and their attention allows Twitter to develop fine-grained profiles for each user, which in turn allows it to sell targeted advertising matched to each user's unique profile. Gaining market share in the digital ad space is critical for Twitter to drive future revenue growth, which is needed to fund continued innovation in product features and services. In 2022, the digital ad spending globally was a whopping $525 billion.

But compare Twitter's user base with that of another social media platform, Facebook. Twitter has 210 million daily users compared to Facebook's 2 billion daily users. Given Twitter's much smaller user base, advertisers view it as a niche application and thus channel the bulk of their digital ad dollars to three dominant digital ad platforms: Facebook (part of Meta Platforms), Google (part of Alphabet), and Amazon. These digital ad platforms allow advertisers to target their ads with great precision. The dominant ad platforms feed their artificial intelligence (AI) algorithms with data such as the user's location, browsing history, and demographic information (birth year, university affiliation, network of friends, interests, etc.) thus allowing for precisely targeted ads.

At the same time, Twitter also lost out on the digital ad bonanza during the Covid-19 pandemic. Advertisers poured billions into the digital ad space to reach consumers staying at home during the pandemic. Twitter fell further behind the digital ad giants and younger competitors in the digital ad space, such as Snap and TikTok. The newer entrants doubled their digital revenue during the pandemic.

A GUIDING POLICY Twitter's guiding policy is "to have the largest audience in the world,"[11] which is not a good strategy. Indeed, it is no strategy at all. Instead, it is a mere statement of desire.

COHERENT ACTIONS As Twitter attempts to attract more users, it encounters trade-offs that are hard, perhaps even impossible, to reconcile. Core users' needs differ from those of casual visitors or passive viewers. To narrow these gaps, Twitter has attempted to be everything to everybody, resulting in strategic confusion. One result was increased frustration among managers and engineers, which led to the turnover of key personnel. Low employee morale and inferior products and services resulted in a competitive disadvantage. Internal turmoil was further stoked by Jack Dorsey's personnel decisions, such as promoting close personal friends into important positions.

GOODBYE @JACK, HELLO @PARAGA Since the company's inception, Twitter's culture has been shaped by infighting and its leaders' public intrigues. Twitter insiders and analysts also charged that Jack Dorsey was "missing in action" as CEO because he focused on his fintech company Square (now Block) and spent little time on Twitter. Things came to a head when Dorsey announced shortly before the Covid-19 pandemic that he would move to Africa. The turmoil at Twitter led Elliott Management, an activist investor, to take a 9% stake in the company. Threatening an ugly proxy fight at the next shareholder meeting, Elliott presented Twitter's board of directors with a list of demands, including Dorsey giving up the CEO role and leaving Twitter.

Parag Agrawal became the CEO of Twitter in November 2021. At 37, A native of India, Agrawal is a computer engineer and scientist who graduated from the prestigious Indian Institute of Technology (IIT). He holds a master's and doctoral degrees from Stanford University. Before being appointed CEO, Agrawal served as Twitter's Chief Technology Officer. When Musk took over Twitter, he fired the company's top management team, including Parag Agrawal.

ZUMA Press, Inc./Alamy Stock Photo

Parag Agrawal, formerly Twitter's Chief Technology Officer, was appointed CEO in late 2021. Under his leadership, Twitter has successfully implemented several strategic initiatives. For example, Twitter decided to shut down its custom-built technology infrastructure (which regularly encountered security, reliability, and scaling issues) and moved its back-end computing needs to Amazon Web Services (AWS), the largest provider of cloud computing. Using AWS allows Twitter to be more innovative and to introduce new features and services faster. Jack Dorsey himself called Twitter "slow" and "not innovative."[12] Agrawal has also focused on fine-tuning Twitter's ad platform, allowing it to serve ads to its users with higher accuracy.

One thorny problem in growing its user base is that Twitter is a text-based SMS service, whereas newer competitors such as Instagram and TikTok are photo and video based. The vast majority of people are visual and not textual. Moreover, pictures and videos allow users to relax, which facilitates online shopping; Twitter is, by its nature, combative. However, Twitter is the forum where news breaks, is shaped, and is battled over, which means that new services will find it hard to dislodge Twitter.

While Twitter's impact on social and cultural life is tremendous, its ability to make money appears limited, given the nature of its product. One option for increasing revenue is to apply AI to Twitter's vast amount of real-time information, and license these data insights to stockbrokers, investment banks, hedge funds, media companies, other Fortune 500 companies, and governments. In 2021, revenues from licensing data to enterprise customers were less than 15% of Twitter's revenues. So, there appears to be room for growth.

Rather than limiting the company to the tactical changes Agrawal spearheaded, the new CEO needed a strategy! As Twitter's market cap continued to decline (from a peak of $62 billion in March 2021 down to $29 billion in early 2022—a loss of more than 50%), it became a takeover target.

Elon Musk felt the same way because he revealed (in spring 2022) that he had taken a 9% stake in Twitter, making him the single largest shareholder. Musk has been concerned with Twitter's commitment to free speech. After buying his stake in Twitter, Musk tweeted to his over 100 million followers: "Free speech is essential to a functioning democracy. Do you believe Twitter rigorously adheres to this principle?" He added in a follow-up tweet: "The consequences of this poll will be important. Please vote

(Continued)

carefully." More than 70% of his followers that responded to the poll voted no. A few weeks later, Musk made an offer to buy Twitter for $44 billion, taking the company private. He announced sweeping changes in strategy. The new Twitter owner wants less reliance on advertising. Rather, he wants to implement a subscription-based model. Musk also indicated that all human users should be verified and that bots, spam, and scams need to be removed more aggressively. He also advocated for less content moderation as he sees free speech as "the bedrock of a functioning democracy, and Twitter is the digital town square where matters vital to the future of humanity are debated."

In the summer of 2022, Musk announced that he would walk away from the deal to buy Twitter, arguing that the social message company has not been forthcoming enough in providing him with appropriate data to assess the problem of fake accounts and bots on the site. Twitter's board responded that they will insist that the agreement will be consummated. Twitter sued Musk to fulfill his commitment to acquiring Twitter at the price premium he originally offered. After some back-and-forth, the acquisition closed in the fall of 2022. Twitter became a private company owned by Elon Musk, who is implementing a new strategy. His first action at Twitter was to fire a slew of senior executives, including the CEO, Parag Agrawal.[13]

LO 1-2

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

WHAT IS COMPETITIVE ADVANTAGE?

A firm with superior performance relative to competitors in the same industry or the industry average has a **competitive advantage**.[14] Competitive advantage is always *relative,* not absolute. To assess competitive advantage, we compare firm performance to a *benchmark*—either the performance of other firms in the same industry or an industry average. Tesla's stock market valuation has increased much more in recent years than the market valuation of the major carmakers combined and thus has a competitive advantage, at least on this dimension.

A firm that can outperform its competitors or the industry average over a prolonged period has a **sustainable competitive advantage**. Apple, for example, has enjoyed a sustainable competitive advantage over Samsung in the smartphone industry since introducing the iPhone in 2007. Brands with smaller market share include HTC (Google Pixel phones), LG, and Motorola/Lenovo. Other phone makers, such as Microsoft (which purchased Nokia) and BlackBerry, have exited the smartphone market, while new entrants such as Oppo, Xiaomi, and ZTE of China are gaining traction.

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

Two distinct strategies form the basis for competitive advantage:

- A firm provides goods or services that consumers *value more* than its competitors' offerings, but at a *similar cost* (a *differentiation* strategy), or
- the firm furnishes goods and services *similar* to those of competitors but at a *lower cost* (a *cost leadership* strategy).

The rewards of superior value creation and capture are higher profitability and increased market share. For example, Elon Musk, who is motivated to address climate change, formed

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

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

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

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

Tesla to build electric vehicles with zero emissions. Sara Blakely, founder and CEO of Spanx, the global leader in the shapewear industry, is motivated to promote confidence in people. In creating Walmart, now the world's largest retailer, Sam Walton was driven to offer acceptable value at a lower cost than his competitors. Successful companies fill a need and provide a product, service, or experience that consumers want at a price they can afford while still making a profit. For Musk, Blakely, Walton, and numerous other entrepreneurs and businesspeople, creating shareholder value and making money is the *consequence* of being purpose-driven.[15]

The critical point here is that a good strategy delivers superior value while managing the costs of creating it or by offering similar value at a lower cost. Managers achieve these combinations of value and cost through *strategic positioning.* They stake out a unique position that allows the firm to provide value to customers while controlling costs. The larger the difference between value creation and cost, the greater the firm's *economic contribution* and the greater the likelihood of gaining a competitive advantage.

Strategic positioning requires *trade-offs,* however. Walmart has a clear strategic profile and serves a specific market segment as a low-cost retailer. Upscale retailer Nordstrom has also built a clear strategic profile, but it is almost the opposite of Walmart's: Nordstrom provides superior customer service to a high-end, luxury market segment. Although these companies are in the same industry, they are not direct competitors because their customer segments have very little overlap. Walmart and Nordstrom have chosen distinct but different strategic positions: cost leadership for Walmart, differentiation for Nordstrom. Their strategic leaders make conscious trade-offs that help each company strive for competitive advantage in the retail industry. Walmart provides acceptable service in a big-box retail outlet offering "everyday low prices," while Nordstrom offers a superior customer experience by hiring professional salespeople and offering a luxury setting.

Each retailer's clear strategic profile—which specifies its level of product differentiation, customer service, and cost structure—allows it to meet specific customer needs. The goal is to create value for customers (in this example, through lower prices or better service and selection). Even though Walmart and Nordstrom compete in the same industry, both can win if they achieve a clear strategic position through a well-executed competitive strategy. Strategy, therefore, is not a zero-sum game.

The key to a successful strategy is to combine activities to stake out a *unique strategic position* in an industry. Competitive advantage comes from performing different activities or performing the same activities differently from rivals. Ideally, consistent and coherent activities reinforce one another rather than create trade-offs. For instance, Walmart's strategic decisions work together to strengthen its position as a cost leader. Key components of Walmart's success include its big retail stores in rural locations, extremely high purchasing power, sophisticated IT systems, large regional distribution centers, low corporate overhead, decent base wages (well above the federal minimum) and salaries, employee profit-sharing, and a highly effective website (walmart.com) that provides an omnichannel experience (in-store/curbside pick-up or delivery).

Because precise strategic positioning requires trade-offs, strategy is as much about deciding what *not* to do as it is about deciding what to do.[16] Because resources are limited, decision-makers must carefully consider their strategic choices in the quest for competitive advantage. Trying to be everything to everybody will likely result in inferior performance.

As a striking example, the Sears department store chain was founded in 1886 and long hailed as an innovator. For instance, Sears pioneered its iconic mail-order catalog, which allowed customers in rural and remote areas of the United States to shop like city dwellers. The Sears catalog was an early version of Amazon.com, albeit with a smaller selection and slower delivery time. However, as time progressed and Sears failed to adapt to new competitive challenges, it lost its competitive advantage. In recent years, Sears did not have a clear strategic position and tried to be too many things for too many types of customers. Consequently, after more than 130 years in business, Sears filed for bankruptcy in 2018.

It is also important to note that operational effectiveness, marketing skills, and other functional expertise can strengthen a unique strategic position. However, those capabilities do not substitute for competitive strategy. Competing to be similar to but just a bit better than your competitor is likely a recipe for cutthroat competition and low profits. Let's examine this idea further with a quick thought experiment: If all firms in the same industry pursue a low-cost position through the application of competitive benchmarking, then all firms will have an identical cost structure. None could gain a competitive advantage. Everyone would be running faster, but nothing would change in relative strategic positions.

Red Queen effect
A situation in which everyone runs faster but there are no changes in relative strategic positions.

THE RED QUEEN EFFECT IN BUSINESS COMPETITION. The **Red Queen effect**[17] refers to a situation in which everyone runs faster but there are no changes in relative strategic positions. That is, studying and copying the competition results in unsuccessful efforts to gain a competitive advantage. The metaphor of the Red Queen comes from Lewis Carroll's novel *Through the Looking Glass*, in which the Red Queen informs Alice, "Here, you see, it takes all the running you can do, to keep in the same place. If you want to get somewhere else, you must run at least twice as fast as that!"[18]

Applying the idea of the Red Queen effect to business competition implies that when competitors copy one another, everyone will run faster, but their relative strategic positions may not change. The result is zero-sum competition in which a firm can gain market share only at a competitor's expense. As the Red Queen effect plays out, there is little value creation for customers because companies have no resources to invest in product and process improvements. Moreover, the least-efficient firms will be driven out of business, thus reducing customer choice.

To gain a deeper understanding of what strategy is, it is therefore helpful to think about what strategy is *not.*[19] Be on the lookout for the following red flags of what strategy is *not*:

Grandiose Statements Are Not Strategy. You may hear leaders say, "Our strategy is to win" or "We will be No. 1." Twitter, for example, declared its "ambition is to have the largest audience in the world."[20] These statements of desire, on their own, are not strategies. They provide little managerial guidance and often lead to goal conflict and confusion. Moreover, this type of wishful thinking frequently fails to address the economic fundamentals of *value creation* and *cost.* A compelling vision and mission *can* lay the foundation for crafting a good strategy; however, strategic actions and commitments based on economic fundamentals must address the competitive challenge identified.

A Failure to Face a Competitive Challenge Is Not Strategy. If a firm's leaders do not define a clear competitive challenge, employees have no way of assessing whether they are making progress in addressing it. For example, strategic leaders at the now-defunct video rental chain Blockbuster failed to address the competitive challenges posed by new players, including Netflix and Redbox. Likewise, Blackberry RIM did not address the competitive challenge posed by Apple's iPhone. Microsoft initially failed to address the shift to mobile computing pioneered by Google's Android and Apple's iOS.

Operational Effectiveness, Competitive Benchmarking, and Other Tactical Tools Are Not Strategy. People casually refer to a host of different policies and initiatives as "strategy": pricing strategy, internet strategy, alliance strategy, operations strategy, AI strategy, brand strategy, marketing strategy, HR strategy, China strategy, Covid-19 strategy, and so on. These elements may be a *necessary* part of a firm's functional and global initiatives to support its competitive strategy. However, they are *not sufficient* to achieve a competitive advantage. We reserve the term *strategy* for describing the firm's overall efforts to *gain and sustain a competitive advantage.*

1.2 Stakeholder Strategy and Competitive Advantage

LO 1-3

Assess the relationship between stakeholder strategy and sustainable competitive advantage.

VALUE CREATION

Companies with a good strategy generate value for society. When firms compete in their self-interest while obeying the law and acting ethically, they ultimately create value. **Value creation** occurs because companies with a good strategy can provide products or services to consumers at a price point that they can afford while keeping costs under control, thus making a profit at the same time. Both parties benefit from this trade as each captures a part of the value created. As a result, society is better off.[21]

value creation Occurs when companies with a good strategy are able to provide products or services to consumers at a price point that they can afford while keeping their costs in check, thus making a profit at the same time. Both parties benefit from this trade as each captures a part of the value created.

Thus value creation lays the foundation for the societal benefits that successful economies can provide: education, infrastructure, public safety, health care, clean water, and clean air, among others. Superior performance allows a firm to reinvest some of its profits and grow, providing more employment and career opportunities to the workforce. Google started as a research project in graduate school by Larry Page and Sergey Brin. Some 25 years later, it became one of the most valuable companies globally, with $2 trillion in market capitalization and 160,000 employees. Moreover, billions of people worldwide rely on Google for information gathering, a free service for the end user.[22]

In contrast, strategic failure can be expensive. Once a leading technology company, Hewlett-Packard was known for innovation that resulted in superior products. The "HP way of management" included lifetime employment, generous benefits, work/life balance, and freedom to explore ideas.[23] However, HP has not been able to address the competitive challenges of cloud and mobile computing, AI, and virtual and augmented reality, and HP's strategic mishaps destroyed significant shareholder value. The company also had to lay off tens of thousands of employees. Its customers no longer received the innovative products and services that made HP famous. The contrasting examples of Google and HP illustrate the relationship between individual firms, competitive advantage, and society. Successful firms ultimately create value for society.

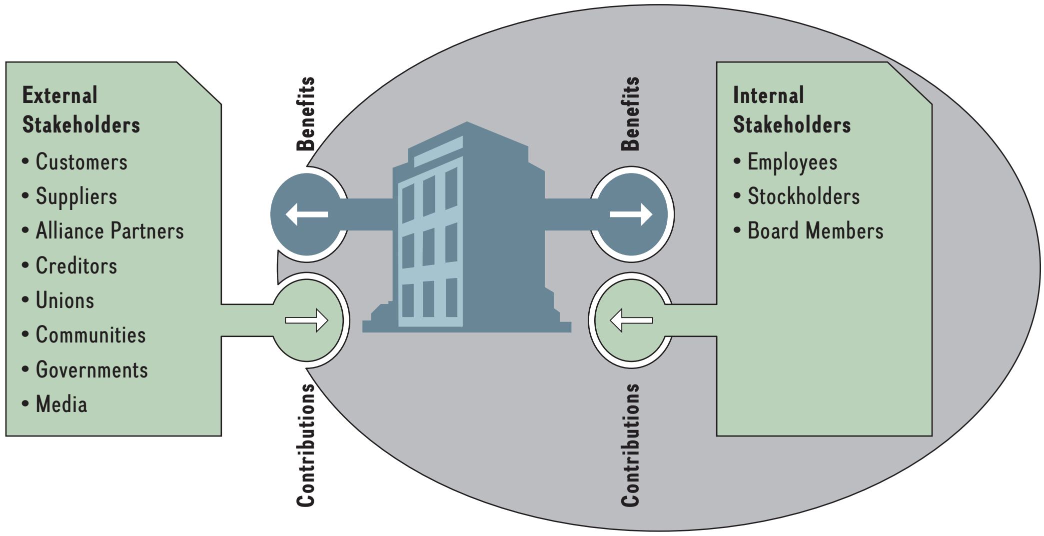
The goals of a good strategy are to create value and to capture some of it. Thus a good strategy creates a direct link between business and society. All organizations are embedded in a network of exchange relationships. Therefore, to manage a multifaceted and diverse set of relationships effectively, all organizations need a stakeholder strategy.[24]

STAKEHOLDER STRATEGY. **Stakeholders** are organizations, groups, and individuals that can affect or be affected by a firm's actions. They have a vested claim or interest in the firm's performance and continued survival.[25] Stakeholders make specific contributions to a firm, providing different types of benefits to various stakeholders:

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

- Shareholders provide capital with the expectation that they will receive a return on their investment in stock appreciation and dividend payments.
- Creditors such as debt holders provide financing for the firm.
- Employees contribute their time and talents to the firm, receiving wages and salaries in exchange.
- Communities furnish real estate, infrastructure, and public safety.

EXHIBIT 1.1 Internal and External Stakeholders in an Exchange Relationship with the Firm



In return for their various contributions, stakeholders expect companies to pay competitive salaries, provide health insurance, pay their fair share of taxes, provide safe employment, and not pollute the environment. The firm, therefore, is embedded in a *network of exchange relationships* with a diverse set of internal and external stakeholders. As shown in Exhibit 1.1, *internal stakeholders* include employees (executives, managers, and workers), stockholders, and board members. *External stakeholders* include customers, suppliers, alliance partners, creditors, unions, communities, governments at various levels, and the media. If any stakeholder withholds participation in the firm's exchange relationships, it can negatively affect firm performance.

stakeholder strategy An approach to strategy formulation that considers all of the company's stakeholders, not just its shareholders. A core tenet of stakeholder strategy is that a single-minded focus on shareholders exposes a firm to undue risks.

A core tenet of **stakeholder strategy** is that a single-minded focus on shareholders exposes a firm to undue risks. Putting shareholder interest above all else can undermine the company's economic performance and even threaten its very survival. Therefore, strategic leaders must understand the complex web of exchange relationships among different stakeholders. Based on that understanding, the firm can proactively shape the various associations to maximize the joint value created and manage the distribution of this larger pie fairly and transparently. Effective stakeholder management exemplifies how strategic leaders can improve the firm's performance, thereby enhancing its competitive advantage and increasing the likelihood of its continued survival.[26]

Strategy scholars have provided several arguments as to why effective stakeholder management can increase firm performance:[27]

- Satisfied stakeholders are more cooperative and thus more likely to reveal information that can further increase the firm's value creation or lower its costs.
- Increased trust lowers the costs of firms' business transactions.
- Effective management of the complex web of stakeholders can lead to greater organizational adaptability and flexibility.
- The likelihood of adverse outcomes can be reduced, creating more predictable and stable returns.
- Firms can build strong reputations that are rewarded by business partners, employees, and customers. Most strategic leaders care about the firm's public perception, and they

celebrate and publicize their inclusion in high-profile rankings such as *Fortune's* "World's Most Admired Companies," which is published annually.[28] In 2021, the top five companies in this ranking were Apple, Amazon, Microsoft, Disney, and Starbucks. Because of its continued innovation in products, services, and delivery, Apple has been ranked as the world's most admired company by *Fortune* for the past 14 years.

STAKEHOLDER IMPACT ANALYSIS

LO 1-4

Conduct a stakeholder impact analysis.

The critical challenge in the pursuit of stakeholder strategy is to effectively balance the needs of various stakeholders. Some of these needs may be in conflict. Strategic leaders need to ensure that their shareholders achieve their desired return on investments. At the same time, the firm needs to recognize and address the concerns of other stakeholders—employees, suppliers, customers, and communities—ethically and fairly so that they too are satisfied. Approaching stakeholder strategy in this manner sounds good in theory, but how can strategic leaders go about it in practice?

Stakeholder impact analysis provides a decision tool that helps strategic leaders recognize, prioritize, and address the needs of different stakeholders. It helps the firm achieve a competitive advantage while being a good corporate citizen. Stakeholder impact analysis takes strategic leaders through a five-step process to recognize and evaluate stakeholders' claims. Each step must pay attention to three crucial stakeholder attributes: *power, legitimacy,* and *urgency*.[29]

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

- A stakeholder has *power* over a company when it can get the firm to do something that it would not otherwise do.
- When a stakeholder's claim is perceived as legally valid or otherwise appropriate, that stakeholder has a *legitimate claim.*
- A stakeholder has an *urgent claim* when it requires a company's immediate attention and response.

Exhibit 1.2 depicts the five steps in stakeholder impact analysis and the corresponding critical question. Let's look at each step in detail.

EXHIBIT 1.2

Stakeholder Impact Analysis

STEP 1: IDENTIFY STAKEHOLDERS. In Step 1, strategic leaders ask, "Who are our stakeholders?" In this step, the strategic leaders focus on stakeholders that currently have or potentially can have a material effect on the company. This prioritization identifies the most powerful internal and external stakeholders and their needs. For public-stock companies, key stakeholders are the shareholders and other capital providers. If shareholders are not satisfied with investment returns, they will sell their stock, leading to a decrease in its market value. If this process continues, the company may become a takeover target or get stuck in a vicious cycle of continuous decline.

The second group of stakeholders includes customers, suppliers, and unions. Local communities and the media are also influential stakeholders that can affect the smooth operation of the firm. If their needs are not met, any of these groups can materially affect the firm's operations.

STEP 2: IDENTIFY STAKEHOLDERS' INTERESTS. In Step 2, strategic leaders ask, "What are our stakeholders' interests and claims?" Their goal is to specify and assess the interests and claims of the pertinent stakeholders using the power, legitimacy, and urgency criteria introduced earlier.

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

Even within stakeholder groups, there can be significant variation in the power of individual stakeholders. For example, public companies pay more attention to large investors than to millions of smaller, individual investors. *Shareholder activists* such as hedge funds and individuals such as Elliott Management, Bill Ackman (Pershing Square), Carl Icahn, Daniel Loeb (Third Point), and Nelson Peltz (Trian) buy equity stakes in corporations they view as underperforming. Then they pressure a company to change its strategy, for example through a media campaign and shareholder resolutions at annual meetings. Examples of activist activities include the takeover battle at Dell Computer (which founder Michael Dell subsequently took private before taking the company public again a few years later), the pressure on PepsiCo to spin off its Frito-Lay brand, and the pressure on Yahoo to sell itself to Verizon, which it did. Even top-performing companies are not immune to pressure from shareholder activists.[30] As a result of a sustained competitive advantage over the last decade, Apple became the first company to be valued above $1 trillion (in 2018), amassing $200 billion in cash in the process. Apple CEO Tim Cook faced significant pressure from Carl Icahn, who held roughly $4 billion worth of Apple stock, to buy back more of its shares and thus to raise Apple's share price further. Cook obliged, and Apple bought back a significant amount of stock, using its cash to bolster its share price.

Although individual and activist investors may claim the same legitimacy as stockholders, shareholder activists have more power over a firm. They can buy and sell a large number of shares at once or exercise block-voting rights in the *corporate governance process* (which we discuss in detail in Chapter 12). Shareholder activists frequently also demand seats on the company's board to influence its corporate governance and strategy more directly. For instance, Jack Dorsey's ouster as CEO of Twitter (Strategy Highlight 1.1) was initiated by activist investors Elliott Management and Silver Lake. Owning $2 billion combined in Twitter stock, the activist investors also each secured a seat on Twitter's board of directors and with it a direct influence over CEO appointments and the firm's strategy. These abilities make activist investors influential stakeholders with urgent and legitimate claims.

STEP 3: IDENTIFY OPPORTUNITIES AND THREATS. In Step 3, strategic leaders ask, "What opportunities and threats do our stakeholders present?"

Consumer boycotts, for example, can be a powerful threat or force affecting a company's behavior. For instance:

- BP faced a boycott for its role in the 2010 Gulf of Mexico oil spill, which resulted in environmental damage.
- Consumers boycotted Nestlé in response to its aggressive marketing of infant formula in developing countries. Specifically, boycotters noted that some of these countries lack dependable sources of clean water, which must be mixed with the formula; the polluted water led to high infant mortality. Boycotters also criticized the high price of the formula, which could consume up to 30% of a family's disposable income.
- PETA[31] called for a boycott of McDonald's due to alleged animal-rights abuses.

In the best-case scenario, strategic leaders transform such threats into opportunities. Sony Corp. of Japan did just that.[32] During one holiday season, the Dutch government blocked Sony's entire holiday-season shipment of PlayStation game systems, valued at roughly $500 million, into the European Union because of a small but legally unacceptable amount of toxic cadmium discovered in one of the system's cables. This incident led to an 18-month investigation in which Sony inspected over 6,000 supplier factories worldwide to track down the source of the problem. The findings allowed Sony to redesign and develop a cutting-edge supplier management system that adheres to stringent standards.

STEP 4: IDENTIFY SOCIAL RESPONSIBILITIES. In Step 4, strategic leaders ask, "What economic, legal, ethical, and philanthropic responsibilities do we have to our stakeholders?" To identify these responsibilities more effectively, scholars have advanced the notion of **corporate social responsibility (CSR)** to help firms recognize and meet society's expectations of the business enterprise.[33] According to the CSR perspective, strategic leaders need to realize that society grants shareholders the right and privilege to create a publicly traded company. Therefore, the firm owes something to the community.[34] CSR provides strategic leaders with a conceptual model that helps them identify society's expectations and guides strategic decision making. CSR has four components:

- Economic responsibilities
- Legal responsibilities
- Ethical responsibilities
- Philanthropic responsibilities[35]

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

Economic Responsibilities. According to the CSR perspective, a business enterprise is first and foremost an economic institution. Investors expect an adequate return for the risks they take. Creditors expect the firm to repay its debts with interest. Consumers expect safe products and services at reasonable prices and acceptable quality. Suppliers expect to be paid in full and on time. Governments expect the firm to pay its fair share of taxes and manage natural resources such as air and water. To meet all these expectations, firms must obey the law and act ethically in their quest to gain and sustain competitive advantage.

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

One far-reaching piece of U.S. legislation in terms of business impact is the Patient Protection and Affordable Care Act (PPACA), more commonly known as the Affordable Care Act (ACA, passed in 2010). One key provision of the ACA is that health insurance providers are not allowed to deny coverage based on preexisting medical conditions. As a consequence, health care premiums, whose cost is frequently shared by employers and employees, have been rising because the people insured are now less healthy as a group.[36]

Ethical Responsibilities. Legal responsibilities often define only the minimum acceptable standards for firm behavior. Frequently, strategic leaders are called upon to go beyond minimum legal requirements. The letter of the law cannot address or anticipate all possible business situations and newly emerging concerns, such as internet privacy or advances in artificial intelligence, DNA testing, genetic engineering, and stem cell research. A firm's ethical responsibilities, therefore, go beyond its legal responsibilities to reflect the full scope of stakeholders' expectations, norms, and values. Strategic leaders are called upon to do what society deems just and fair.

Consider a recent example. Starbucks received harsh criticism from multiple stakeholders (in 2018).[37] Calls to #BoycottStarbucks went viral on social media. The cause of the firestorm was the arrest of two Black men at one of its Philadelphia stores. Reports indicated that the two men had entered the Starbucks store and asked one of the employees to use the restroom. The employee refused permission because the men had not (yet) purchased anything. The men then sat down, stating they were meeting an associate for a business meeting and that they would order upon his arrival. Shortly after that, the two men were asked to leave the store. The store manager eventually called the police, who arrested them for alleged trespassing. A patron videotaped the entire scene and then posted it to Twitter; it has since been viewed more than 11 million times and retweeted more than 150,000 times. In the video, police officers are handcuffing the two men while a perplexed and upset bystander repeatedly asks the police, "But what did they do? What did they do? Someone tell me what they did."[38]

In response to the public outcry over the store's actions and the grave concerns expressed by stakeholders, Starbucks then-CEO Kevin Johnson issued a formal apology in which he expressed regret over the situation's "reprehensible outcome" and stated that the actions of the employees were "not representative of ... Starbucks' mission and values."[39] A few weeks after the incident, Starbucks closed its more than 8,000 U.S. stores for a full day and dedicated the day to diversity training for all employees. Closing its stores to provide training was not an action Starbucks was legally required to do, and it cost the company an enormous amount of money, but Starbucks felt ethically obligated to do so.[40]

Philanthropic Responsibilities. Philanthropic responsibilities are often subsumed under the idea of *corporate citizenship,* the idea that companies should voluntarily give back to society. Over the years, Microsoft's corporate philanthropy program has donated more than $3 billion in cash and software to people without access to computer technology.[41]

The pyramid in Exhibit 1.3 summarizes the four components of corporate social responsibility.[42] Economic responsibilities are the foundational building block, followed by legal,

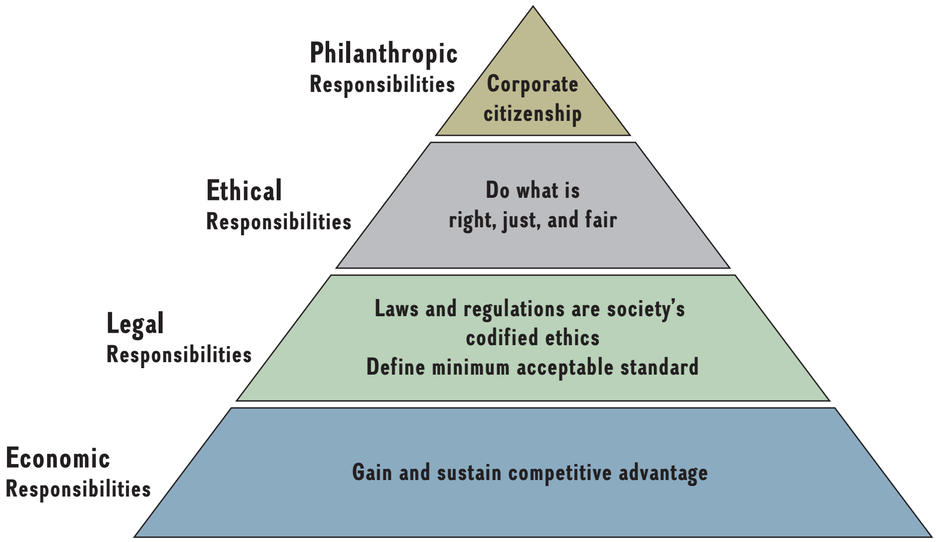


EXHIBIT 1.3

The Pyramid of Corporate Social Responsibility

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

ethical, and philanthropic responsibilities. Note that society and shareholders *require* economic and legal responsibilities. Ethical and philanthropic responsibilities result from a society's expectations of business. The pyramid symbolizes the need for firms to balance their social responsibilities carefully. Doing so ensures not only effective strategy implementation but also long-term viability.

STEP 5: ADDRESS STAKEHOLDER CONCERNS. Finally, in Step 5, the firm asks, "What should we do to effectively address the stakeholder concerns?" In this last step in stakeholder impact analysis, strategic leaders need to decide the appropriate course of action for the firm, given all of the preceding factors. Thinking about power, legitimacy, and urgency attributes helps firms prioritize the legitimate claims and address them accordingly.

Strategy Highlight 1.2 describes Merck's stakeholder strategy, which is anchored in ethical core values. It showcases how Merck considered and addressed various claims from a wide variety of stakeholders, among them the most disadvantaged patients who can't afford to pay for medications. It also explains a major misstep on Merck's part.

Strategy Highlight 1.2

Merck's Stakeholder Strategy

Merck's vision is to *preserve and improve human life*. The words of founder George W. Merck still form the basis of the company's values today: *We try to never forget that medicine is for the people. It is not for profits. The profits follow, and if we have remembered that, they have never failed to appear.*[43]

ENDING RIVER BLINDNESS Ray Vagelos, a former Merck scientist turned CEO, announced in 1987 that the company would donate, free of charge, its recently developed drug Mectizan to treat river blindness. For centuries, river blindness—a parasitic disease that causes blindness—plagued remote communities in Africa and other parts of the world. Merck's executives formed a novel private-public partnership, the Mectizan Donation Program (MDP), to distribute the drug in remote areas, where health services are often unavailable.

A 35-year-long effort, with some 120,000 communities served and more than 1 billion treatments administered,

(Continued)

effectively eradicated the disease. Kenneth Frazier, Merck's Executive Chairman, announced himself "humbled" by the result of the company's value-driven actions.[44]

Kenneth Frazier is the Executive Chairman of Merck and served as its CEO from 2011 to 2021. *Time* magazine included him in its list of the world's most influential people in 2018 and 2021.

Stephanie Keith/Getty Images

WITHDRAWING VIOXX The MDP marked a high point in the public's perception of Merck. In contrast, its stakeholder strategy for Vioxx had a disastrous effect. Vioxx is a painkiller that Merck developed to produce fewer gastrointestinal side effects than aspirin or ibuprofen. After the Food and Drug Administration (FDA) approved the new drug in 1999, Merck engaged in typical Big Pharma promotional practices, including:

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

Vioxx was a blockbuster, generating revenues of $2.5 billion a year by 2002 and growing fast.

When evidence began to appear that Vioxx caused heart attacks and strokes, critics alleged that Merck had suppressed evidence from early clinical trials about Vioxx's dangerous side effects. In 2004, Merck voluntarily recalled the drug. Merck's CEO at the time, Raymond Gilmartin, framed the situation in terms of knowledge learned *after* the initial release. He said he received a phone call from the head of research: "He told me that our long-term safety study of Vioxx was showing an increased risk of cardiovascular events compared to placebo, and the trial was being discontinued .... After analyzing the data further and consulting with outside experts, the Merck scientists recommended that we voluntarily withdraw the drug."[45]

The voluntary withdrawal reconfirmed Merck's core value that patients come before profits. Nonetheless, the Vioxx incident damaged Merck's reputation, and its stock fell almost 30%, eradicating $27 billion in market value almost overnight. Moreover, Merck has been hit by Vioxx-related lawsuits ever since, and legal liabilities have cost the company up to $30 billion thus far. Taken together, the value destruction of $57 billion was much greater than the estimated net present value of Merck's profits from continued sales of Vioxx.

In addition, some corporate social responsibility experts argue that Merck should have never put Vioxx on the market in the first place or that it should have at least provided up-front a clear assessment of the risks associated with it.[46]

LO 1-5

Apply the Analysis, Formulation, Implementation (AFI) Strategy Framework.

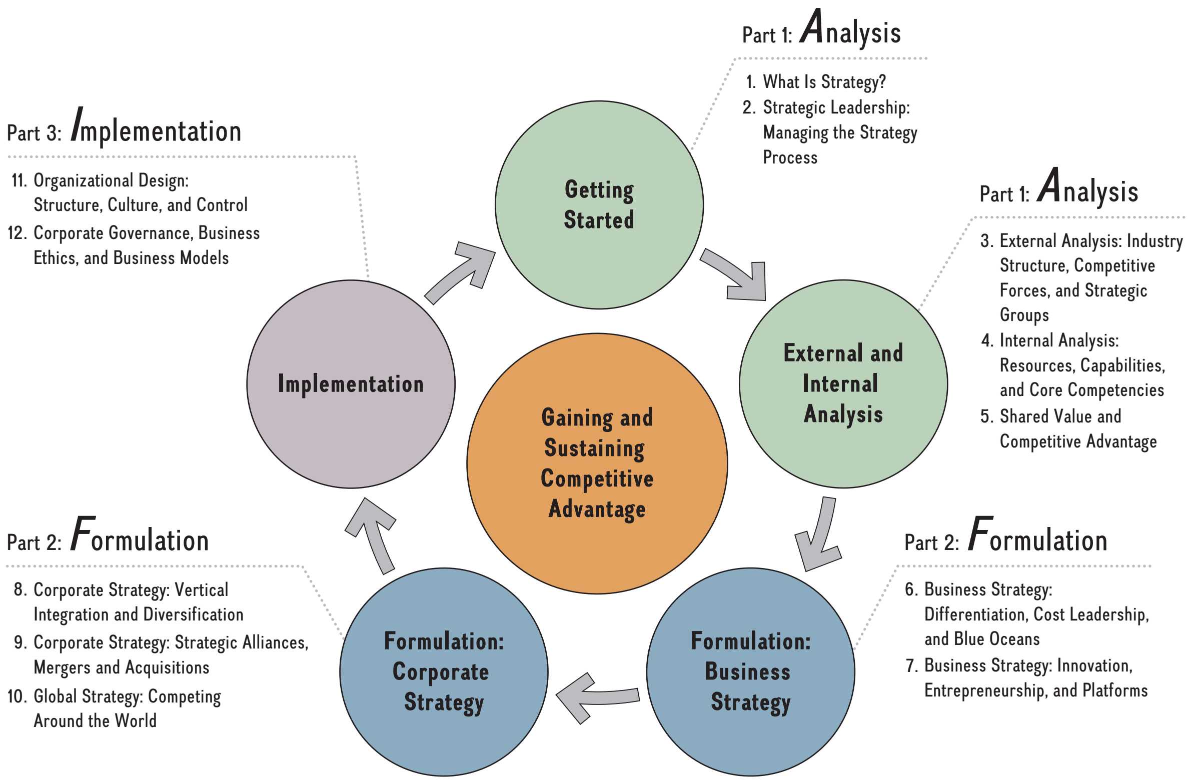
1.3 The Analysis, Formulation, Implementation (AFI) Strategy Framework

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

1. Analysis (A)
2. Formulation (F)
3. Implementation (I)

These three tasks are the pillars of research and knowledge of strategic management. Although we will study these tasks one at a time, they are highly interdependent and frequently occur simultaneously. Effective managers do not formulate a strategy without thinking about how to implement it. Likewise, while managers implement strategy, they also adjust to changing circumstances.

EXHIBIT 1.4 The Analysis, Formulation, Implementation (AFI) Strategy Framework



We've captured these interdependent relationships in the **Analysis, Formulation, Implementation (AFI) Strategy Framework** shown in Exhibit 1.4. This framework

1. Explains and predicts differences in firm performance.
2. Helps leaders formulate and implement a strategy that can result in superior performance.

Each broad strategy task raises specific topics and questions that managers must address. These questions and topics are listed in this section. They are also addressed in the specific chapters listed in Exhibit 1.4. Chapters 1 to 5 (Part 1) address questions related to analysis, Chapters 6 to 10 (Part 2) cover formulation, and Chapters 11 and 12 (Part 3) cover implementation.

Analysis, Formulation, Implementation (AFI) Strategy Framework A model that links three interdependent strategic management tasks—analyze, formulate, and implement—that, together, help managers plan and implement a strategy that can improve performance and result in competitive advantage.

KEY TOPICS AND QUESTIONS OF THE AFI STRATEGY FRAMEWORK

Analysis (A)

- **Strategic Leadership and the Strategy Process.** *What roles do strategic leaders play, and how do they help shape a firm's vision, mission, and values? How does strategy come about, and what process for creating strategy should strategic leaders put in place?* (Chapter 2)
- **External Analysis.** *What effects do forces in the external environment have on the firm's potential to gain and sustain a competitive advantage? How should the firm deal with them?* (Chapter 3)

- **Internal Analysis.** *How do internal resources, capabilities, and core competencies affect the firm's potential to gain and sustain a competitive advantage? How should the firm leverage them for competitive advantage?* (Chapter 4)
- **Shared Value and Competitive Advantage.** *How do we create shared value? What is the relationship between competitive advantage and firm performance?* (Chapter 5)

Formulation (F)

- **Business Strategy**. *How should the firm compete: cost leadership, differentiation, or value innovation?* (Chapters 6 and 7)
- **Corporate Strategy**. *Where should the firm compete in terms of industry, markets, and geography?* (Chapters 8 and 9)
- **Global Strategy.** *How and where should the firm compete: locally, regionally, nationally, or internationally?* (Chapter 10)

Implementation (I)

- **Organizational Design**. *How should the firm organize to translate the formulated strategy into action?* (Chapter 11)
- **Corporate Governance, Business Ethics, and Business Models.** *What type of corporate governance is most effective? How does the firm anchor strategic decisions in business ethics? Which business model should we use to execute strategy?* (Chapter 12)

The AFI Strategy Framework shown in Exhibit 1.4 is repeated at the beginning of each part of this text to help contextualize where we are in our study of the firm's quest to gain and sustain competitive advantage. In addition, the *AFI Strategic Management Process Map,* presented at the end of Chapter 1, illustrates the steps in the AFI framework in more detail. This strategic management process map highlights the key strategy concepts and frameworks we cover in each chapter. It also serves as a checklist for conducting a strategic management analysis.

We next turn to the *Implications for Strategic Leaders* to provide practical applications and considerations of the material discussed in this chapter.

1.4 Implications for Strategic Leaders

Strategy is the art and science of success and failure. The difference between success and failure lies in an organization's strategy. A good strategy is grounded in a strategic management process that defines the competitive challenge, provides a guiding policy, and is implemented by coherent actions. A good strategy enhances the chances of achieving a competitive advantage and superior performance. Strategic leaders appreciate the fact that competition is *everywhere.* Thus, they need a good strategy to deal with competition.

Strategic leaders are also mindful of the organization's internal and external *stakeholders* who have a vested claim or interest in the firm's performance and continued survival. Using a *stakeholder strategy approach* enables strategic leaders to manage a diverse set of stakeholders effectively in their quest to gain and sustain a competitive advantage.

Strategic leaders also realize that the principles of strategic management can be applied universally to all organizations. Strategy determines performance in organizations large and small, multinational Fortune 100 companies, and for-profit and nonprofit organizations; in the private sector and the public sector; and in developed economies as well as emerging economies. A good strategy is more likely to result when strategic leaders apply the three key tasks of the AFI Strategy Framework:

1. **A**nalysis of the external and internal environments
2. **F**ormulation of an appropriate business and corporate strategy
3. **I**mplementation of the formulated strategy through structure, culture, and controls

Keep in mind that strategic leaders are making decisions under conditions of uncertainty and complexity. They must carefully monitor and evaluate the progress toward key strategic objectives and make adjustments by fine-tuning any strategy as necessary. We discuss these topics in the next chapter, where we focus on strategic leaders and the strategic management process.

CHAPTERCASE 1 Part II

Despite Tesla's astronomical ascent, its market capitalization remains highly volatile, frequently fluctuating by hundreds of billions of dollars within a few days. Several factors explain why Tesla's future remains uncertain.

Transition to Electric Vehicles. Many observers wonder if and when a change to EVs will happen. In 2021, 14% of all new cars registered in Europe and 9% in China were EVs, but in the United States EVs made up a mere 4% of new car registrations. Consumers feel "range anxiety," worrying that EVs are limited in the number of miles they can be driven before requiring recharging. Moreover, EVs still sell at a premium over comparable internal combustion engine (ICE) cars, which are refilled easily at the many gas stations that dot the land.

Competition. Although Tesla enjoys a first-mover advantage, the legacy carmakers such as GM, Ford, and Volkswagen have committed billions of dollars to develop electric cars within the next decade. Tesla is also facing increasing competition from pure EV startups such as Rivian and Lucid in the United States and NIO, XPeng, and Li in China.

Global Scale. To continue to drive down the cost per car produced and to meet demand, which exceeds supply, Tesla must continue to ramp up its global scale. Tesla needs multiple factories across continents to make more than 1 million vehicles a year in each plant. In 2020, Tesla began producing cars at scale in Giga Shanghai, its most productive plant. In 2022, Tesla opened Gigafactories in Berlin, Germany, and Austin, Texas. Still, Tesla needs a much larger production footprint to meet global demand.

Moreover, given the supply chain interruptions in the wake of the Covid-19 pandemic, the productivity of the Gigafactories has been negatively affected. For instance, a limited supply of batteries and computer chips has caused production slowdowns. Finally, the geopolitical tensions between the United States and China may put Tesla in the crosshairs, with potentially adverse consequences.

Succession. Although Elon Musk is a visionary leader who can produce tremendous results, many observers note that Tesla has no succession plan. They wonder what will happen to the company if its temperamental leader becomes unable or unwilling to lead Tesla. Insiders confirm that Musk's true love is his space exploration and transportation company, SpaceX, and running Tesla is needed to "pay the bills." Finally, although Musk likes to be in charge, he does not want to be CEO. Indeed, he changed his official title at Tesla to "Techno King" in a filing with the Securities and Exchange Commission.

Questions

1. Do you agree with the assessment that Elon Musk and Tesla successfully fulfilled the first master plan published in 2006? To answer this question, apply the three-step process for crafting a good strategy explained in Section 1.1 (*diagnose the competitive challenge, develop a guiding policy, and implement a set of coherent actions*).

2. Apply again the three-step process for crafting a *good strategy* (see Section 1.1), this time to each element of the new master plan. On which steps of the new master plan has Tesla made the most progress? Which actions will be the most difficult to accomplish? Why?

3. Overall, does Tesla have a *good strategy?* Why or why not? How do you know? Explain.

4. Of the threats listed in Part II of the ChapterCase, which do you consider the most significant? How would you recommend that Musk and Tesla address each of these challenges?

TAKE-AWAY CONCEPTS

This chapter introduced the concept of *strategy* and the key role it plays in an organization's success or failure. We learned that a *good strategy* results from a strategic management process that defines the competitive challenge, provides a guiding policy, and is implemented by coherent actions. A good strategy improves the chances of achieving a competitive advantage and superior performance. It also examines the relationship between *stakeholder strategy* and *sustainable competitive advantage.* Finally, this chapter set the stage for further study of strategic management by introducing the *AFI Strategy Framework.*

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

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

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

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

LO 1-3 / Assess the relationship between stakeholder strategy and sustainable competitive advantage.

- *Stakeholders* are individuals or groups that have a claim on or interest in the firm's performance and continued survival. They make specific contributions for which they expect rewards in return.
- *Internal stakeholders* include stockholders, employees (for instance, executives, managers, and workers), and board members.
- *External stakeholders* include customers, suppliers, alliance partners, creditors, unions, communities, governments at various levels, and the media.
- The effective management of stakeholders is necessary to ensure the firm's continued survival and to sustain any competitive advantage. These goals are achieved through *stakeholder strategy.*

LO 1-4 / Conduct a stakeholder impact analysis.

- Stakeholder impact analysis considers the needs of different stakeholders, enabling the firm to perform optimally and to live up to the expectations of good citizenship.
- In a stakeholder impact analysis, managers pay particular attention to three important stakeholder attributes: power, legitimacy, and urgency.
- Stakeholder impact analysis is a five-step process that answers the following questions for the firm:
  1. Who are our stakeholders?
  2. What are our stakeholders' interests and claims?
  3. What opportunities and threats do our stakeholders present?
  4. What are our economic, legal, ethical, and philanthropic responsibilities to our stakeholders?
  5. What should we do to effectively address the stakeholder concerns?

LO 1-5 / Apply the Analysis, Formulation, Implementation (AFI) Strategy Framework.

- The Analysis, Formulation, Implementation (AFI) Strategy Framework (1) explains and predicts differences in firm performance, and (2) helps managers formulate and implement a strategy that can result in superior performance.
- Effectively managing the strategy process is the result of the following:
  1. Analysis (A)
  2. Formulation (F)
  3. Implementation (I)

KEY TERMS

Analysis, Formulation, Implementation (AFI) Strategy Framework *(p. 23)*
Competitive advantage *(p. 12)*
Competitive disadvantage *(p. 12)*
Competitive parity *(p. 12)*
Corporate social responsibility (CSR) *(p. 19)*
Good strategy *(p. 7)*
Red Queen effect *(p. 14)*
Stakeholder impact analysis *(p. 17)*
Stakeholder strategy *(p. 16)*
Stakeholders *(p. 15)*
Strategic management *(p. 6)*
Strategy *(p. 7)*
Sustainable competitive advantage *(p. 12)*
Value creation *(p. 15)*

ENDNOTES

1. Market capitalization (or, market cap) = Share price x Number of outstanding shares.

2. Globally, only one other firm (Saudi Aramco) is valued at more than $1 trillion.

3. Musk, E. (2006, Aug. 2), "The secret Tesla Motors Master Plan (just between you and me)," Tesla website, http://bit.ly/29Y1c3m.

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8. Tesla's mission statement. Tesla, Inc.

9. Range anxiety denotes the concern that an electric vehicle has insufficient range to reach its destination on a single charge. Tesla's cars can go some 250 miles per charge. The lower cost Nissan Leaf (~$30k) can go some 85 miles per charge, while GM's Chevy Bolt can

drive some 200 miles per charge, based on EPA estimates. The average American drives about 40 miles per day. http://www.fueleconomy.gov/

10. The discussion of Tesla throughout this chapter is based on Higgins, T. (2021), *Power Play: Tesla, Elon Musk, and the Bet of the Century* (New York: Doubleday); Tesla, Inc. annual reports (various years); Rothaermel, F.T. (2020), Tesla, Inc., McGraw-Hill Education Case Study MHE-FTR-067; Hoang, H., and F. T. Rothaermel (2016, Fall), "How to manage alliances strategically," *MIT Sloan Management Review*, 58(1): 69–76; Ramsey, M. (2016, Mar. 30), "A lot riding on Tesla's Model 3 unveiling," *The Wall Street Journal*; Ramsey, M., and C. Sweet (2016, Aug. 1), "Tesla and SolarCity agree to $2.6 billion deal," *The Wall Street Journal*; Pulliam, S., M. Ramsey, and I.J. Dugan (2016, Aug. 15), "Elon Musk sets ambitious goals at Tesla—and often falls short," *The Wall Street Journal*; and Ramsey, M. (2014, Jun. 12), "Tesla Motors offers open licenses to its patents," *The Wall Street Journal*.

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13. Sources: Bilton, N. (2013), *Hatching Twitter: A True Story of Money, Power, Friendship, and Betrayal* (London, UK: Sceptre); "Twitter in retweet," *The Economist* (2016, Sep. 17); "New models for new media," *The Economist* (2017, Feb. 16); Conger, K. (2018, Oct. 25), "Twitter posts another profit as user numbers drop," *The New York Times*; Thompson, B. (2021, Nov. 30), "Twitter has a new CEO; what about a new business model?" *Stratechery*; "Jack Dorsey goes Square—leaving Twitter at a time of his choosing," *The Economist* (2021, Dec. 4); Needleman, S., and W. Feuer (2022, Apr. 4), "Musk acquires 9% stake in Twitter, becoming its top stockholder," *The Wall Street Journal*; Thomas, L., A. Corse (2022, Oct. 28), "Elon Musk Twitter deal completed, CEO and CFO immediately fired," *The Wall Street Journal*; and Twitter, Inc. annual reports (various years).

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The Strategic Management Process Map

ANALYSIS

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CHAPTER

2 Strategic Leadership: Managing the Strategy Process

Chapter Outline

Learning Objectives

LO 2-1 Explain the role of strategic leaders and what they do.

LO 2-2 Outline how you can become a strategic leader.

LO 2-3 Compare and contrast the roles of corporate, business, and functional leaders in strategy formulation and implementation.

LO 2-4 Describe the roles of vision, mission, and values in a firm's strategy.

LO 2-5 Evaluate the strategic implications of product-oriented and customer-oriented vision statements.

LO 2-6 Justify why anchoring a firm in ethical core values is essential for long-term success.

LO 2-7 Evaluate top-down strategic planning, scenario planning, and strategy as planned emergence, identifying the pros and cons of each.

LO 2-8 Explain the causes of strategic dissonance and how to navigate strategic inflection points.

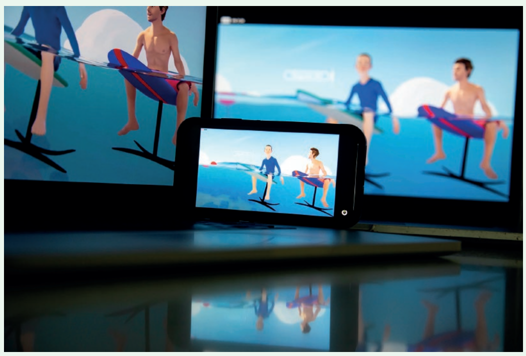
LO 2-9 Describe and evaluate the two distinct modes of decision making.

LO 2-10 Compare and contrast devil's advocacy and dialectic inquiry as frameworks to improve strategic decision making.

Facebook Becomes Meta

Mark Zuckerberg announced (in 2021) that Facebook would become Meta: "We're a company that focuses on connecting people. While most tech companies focus on how people interact with technology, we've always focused on building technology so people can interact with each other... Facebook is one of the most used technology products in the history of the world... The metaverse is the next frontier in connecting people, just like social networking was when we got started... To reflect who we are and the future we hope to build, I'm proud to share that our company is now Meta."[1]

But wait: What is the metaverse? Like past inspiration for tech entrepreneurs, the metaverse concept hails from science fiction. The *metaverse* refers to fully immersive, three-dimensional digital worlds beyond the analog physical world. Today, a person accesses the metaverse with virtual reality (VR) headsets like Meta's Oculus. Rather than looking at the internet on two-dimensional screens such as phones or laptops, in the metaverse you are *in* the internet. In the future, the metaverse will be where people work, shop, live, and have fun.



Mark Zuckerberg and his metaverse avatar.

Michael Nagle/Bloomberg/Getty Images

Critics of Facebook (now a subsidiary of Meta Platforms) were quick to highlight the timing of the rebranding. They view it as a ploy to distract the public from the intense scrutiny and criticism of the social media giant by regulators and lawmakers in the wake of the whistleblower leaks by Frances Haugen. The former Facebook engineer alleges that Facebook puts profits before its users' well-being. Indeed, Haugen suggested that the name change might provide a good opportunity for the social media company to install new leadership. "I think it is unlikely the company will change if [Mark Zuckerberg] remains the CEO," Haugen said. "Maybe it's a chance for someone else to take the reins. ... Facebook would be stronger with someone who was willing to focus on safety."[2]

On the one hand, Facebook becoming Meta is not unlike Alphabet being created out of Google to house a diversified set of businesses ranging from online search to YouTube to self-driving cars. Although Meta is best known for its flagship product, Facebook, which 3 billion people across the globe use, it is active in several different businesses. In addition to being the umbrella company overseeing such social apps as Facebook, Instagram, and WhatsApp, it owns Reality Labs, which produces augmented reality (AR) and VR hardware and software, including the Oculus line of headsets. Reality Labs also creates metaverse platforms such as Horizon Worlds, a VR online video game and game-creation platform.

On the other hand, the name Meta Platforms signals Mark Zuckerberg's strategic intent. To support the pivot toward the metaverse, Zuckerberg has made a strong strategic commitment by pledging to spend at least $10 billion per year to make his vision a reality. Zuckerberg sees the metaverse as the next technology frontier. He argues that the internet moved over time from text based in its early days to photos and then video. The next incarnation of the internet, he believes, will be fully immersive digital worlds. For many years, the Facebook app has been beholden to Apple and Google, which control the mobile internet because they established the two dominant operating systems that all phones run on: Apple's iOS and Google's Android. Zuckerberg wants to end Facebook's reliance on Apple and Google.

In the six months following Facebook's announcement that it would become Meta, it lost $550 billion in its stock market valuation, or 50% of its entire value. Meta faces three significant challenges that explain why investors question the company's future:

- Apple's App Tracking Transparency (ATT)
- Competition from TikTok
- Meta's product shift

APPLE'S APP TRACKING TRANSPARENCY (ATT)

Meta represents Zuckerberg's strategic pivot to create an operating system for the emerging metaverse. The repercussions of not having control over an operating system became painfully apparent when Apple introduced changes to how apps can collect data about users' mobile activity on iPhones. Apple's ATT initiative decreases Facebook's advertising effectiveness because its limits its ability to micro-target ads to iPhone users. As a result, companies shifted their digital ad spending to Google and Amazon. Apple's changes to enhance user privacy cost Meta more than $10 billion in revenue per year. Given the zero marginal cost of placing online ads, this $10 billion translates directly into lost profits—an amount equal to 25% of Meta's total profits.

COMPETITION FROM TIKTOK

Meta competes for people's time because its business model is based on user engagement to serve targeted ads. Mark Zuckerberg views TikTok as the most potent competitor that Facebook/Meta has ever faced. TikTok is a video-focused social media app owned by the Chinese tech company ByteDance. In just a few years, TikTok has gained over 2 billion users worldwide. Because of a superior algorithm for detecting user interests, TikTok is hugely popular, especially with a younger demographic. In the United States, 60% of TikTok users are under 24, while only 12% of Facebook users fall in the under-24 age category. Indeed, the average Facebook user in the United States is over 40 years old. Although TikTok's financial impact on Meta is less than that of Apple's ATT initiative, TikTok presents an existential threat to Facebook, especially if Facebook cannot win back younger users.

META'S PRODUCT SHIFT

In response to TikTok's threat, Meta is shifting away from maximizing total users for its social media apps and is focusing on young adults, ages 18 to 29. Meta plans to lean more fully into short-video content and make Reels (Meta's version of TikTok) more central to the user experience across its social media apps, including Facebook and Instagram. As with TikTok, Facebook and Instagram users will be served video content based on their interests; the videos will come not only from friends and people they follow but also from others they have no connection with. Instagram features Stories (Meta's version of Snapchat, where content disappears after 24 hours) more prominently, but Reels will also be much more central to the user experience in the future.

Meta Platforms' strategic pivot toward the metaverse represents a fundamentally new direction for the company. Such a drastic course correction at a time when its main product (Facebook) is still generating a tremendous amount of cash ($40 billion in annual profits) is possible because Meta Platforms is the only remaining tech company among the top five worldwide that is still led by its founder. (The other members of the top five are Amazon, Alphabet, Apple, and Microsoft.) Only a founder can muster the strategic leadership to focus on long-term existential risks rather than short-term financial risks.[3]

Part II of this ChapterCase appears in Section 2.5.

How do strategic leaders like Mark Zuckerberg guide their companies to gain and sustain a competitive advantage? How do they make strategic decisions? How do they formulate and implement their companies' strategies? How do they lead and motivate employees?

In Chapter 2, we move from thinking about *why* strategy is important to considering the role and activities of strategic leaders, specifically *how* they select, guide, and manage the strategy process across different levels in the organization. We begin by discussing the things a strategic leader must do to shape an organization's vision, mission, and values, which play an important role in anchoring a winning strategy. We then explore frameworks that strategic leaders use to develop strategy and maintain an effective strategic management process. Next, we delve deeper into strategic decision making, examining how biases, even those that strategic leaders and groups may not be consciously aware of, can impact leaders' ability to make rational decisions. Last, we summarize some of the most important practical insights in *Implications for Strategic Leaders*.

LO 2-1

Explain the role of strategic leaders and what they do.

2.1 Strategic Leadership

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

Executives whose vision and decisions enable their organizations to achieve competitive advantage demonstrate strategic leadership.[4] **Strategic leadership** refers to executives' use of power and influence to direct the activities of others when pursuing an organization's goals.[5] *Power* is the strategic leader's ability to influence other organizational members to do things, including things they would not do otherwise.[6] Strategic leaders can draw on *position power* based on their authority—for example, as chief executive officer (CEO). They can also draw on *informal power*, such as persuasion, to influence others when implementing strategy.

Although the effects of strategic leaders vary, they clearly matter to firm performance.[7] Think of successful business founders and their impact on the companies they built—Jeff Bezos at Amazon, Sara Blakely at Spanx, Arianna Huffington with her media and wellness businesses, Phil Knight at Nike, Jack Ma at Alibaba, Elon Musk at Tesla and SpaceX, Rihanna with Fenty Beauty, Oprah Winfrey with her media empire, and Whitney Wolfe with the dating apps Tinder and Bumble. Strategic leaders also shape and revitalize existing businesses. Examples include Mary Barra at GM, Rosalind Brewer at Walgreens Boots Alliance, Karen Lynch at CVS Health, Sundar Pichai at Google, Indra Nooyi at PepsiCo (left in 2018), Howard Schultz at Starbucks, and Satya Nadella at Microsoft.[8]

Indra Nooyi was PepsiCo CEO from 2006 to 2018. Nooyi is a transformational strategic leader who guided PepsiCo with a powerful vision of "performance with purpose." Under Nooyi's leadership, PepsiCo transformed into a company offering more healthy snack and beverage choices, and its revenues grew by 80%. Nooyi's 12-year tenure is more than double the length of the tenure of the average Fortune 500 CEO.

Alex Goodlett/Getty Images

At the other end of the spectrum, some CEOs have massively destroyed shareholder value: Ken Lay at Enron, John Sculley at Apple, Bernard Ebbers at WorldCom, Charles Prince at Citigroup, Richard Fuld at Lehman Brothers, Richard Wagoner at GM, Robert Nardelli at The Home Depot and later Chrysler, Martin Winterkorn at VW, and Ron Johnson at JCPenney, among many others.

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

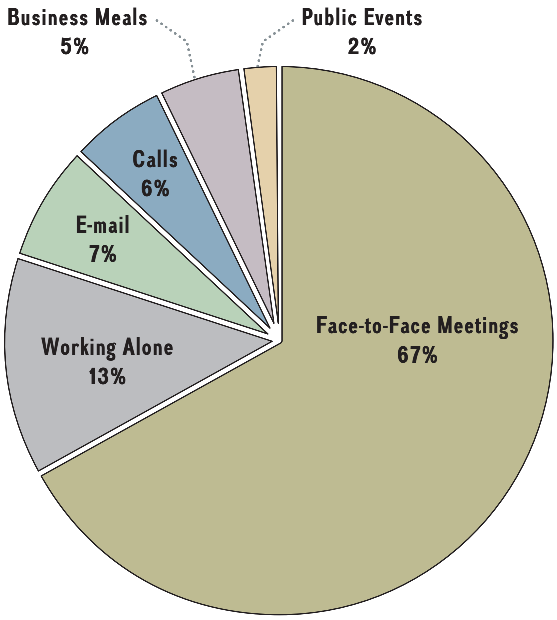
WHAT DO STRATEGIC LEADERS DO?

What do strategic leaders do that makes some more effective than others? In a study of more than 350 CEOs, strategy scholars found that strategic leaders spend, on average, 67% of their time in meetings, 13% of their time working alone, 7% on e-mail, 6% on phone calls, 5% at business meals, and 2% at public events such as ribbon-cutting for a new factory (Exhibit 2.1).[9] Other studies have also found that most managers prefer oral communication: CEOs spend most of their time "interacting—talking, cajoling, soothing, selling, listening and nodding—with a wide array of parties inside and outside the organization."[10]

One surprising finding is that CEOs prefer to spend their time in face-to-face meetings despite the advances in information technology (Skype videoconferencing has been available since 2003). CEOs consider face-to-face meetings most effective in getting their message across and obtaining the data and information they need. Face-to-face meetings also enable CEOs to pick up on rich nonverbal cues, such as facial expressions, body language, and mood, that are not apparent to them when they use e-mail or Skype.[11]

STRATEGIC LEADERSHIP AND THE FUTURE OF WORK. Although strategic leaders have a strong preference for face-to-face interactions, during the Covid-19 pandemic work needed to be performed outside the office, often from home. Face-to-face meetings were replaced with online sessions via Zoom and other videoconferencing technology. The pandemic created an interesting social experiment on the future of work, as companies experimented with how work should be conducted remotely and how strategic leaders can guide their organizations using technology. While some companies, such as Meta, Slack, and Twitter, have fully embraced remote work indefinitely, others have required their employees to return to the office. Those companies include Netflix and the Wall Street banks Goldman Sachs, JP Morgan, and Morgan Stanley.

EXHIBIT 2.1 How CEOs Spend Their Days



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

Meta gives employees the option to work remotely. Indeed, most of its strategic leaders no longer work from its headquarters in Menlo Park, California.[12] CEO Mark Zuckerberg spends most of the year working remotely so that he can be with his family. As he is known to company insiders, Zuck spends his time in Hawaii and other homes away from the company's headquarters. Naomi Gleit, Meta's head of product and one of its longest-tenured employees, works from New York. Adam Mosseri, the head of Meta's Instagram, works remotely from several locations, including Cape Cod, Hawaii, and Los Angeles. The company's chief marketing officer, Alex Schultz, works in the UK. Meta's company vice president of integrity, Guy Rosen, has moved to Israel. And Javier Olivan, chief operating officer (COO), works from his native Spain.

One motivation for encouraging remote work is Meta's desire to test its metaverse products, which Zuckerberg requires to be used for all virtual meetings. The requirement to use company products and services only, especially new ones that are in a beta version, is called *dogfooding.*[13] This dogfooding requirement forces all of Meta's strategic leaders to stress-test its products and services in a real-work setting and to initiate necessary improvements. Zuckerberg believes that requiring employees to use the company's metaverse products in combination with remote work increases employee productivity. He emphasizes that even a single-digit improvement in productivity (e.g., 4%) adds up quickly across over 80,000 Meta employees.[14]

In contrast, Netflix founder and co-CEO Reed Hastings views remote work as "a pure negative."[15] A disrupter to the video rental and traditional analog TV industries, Hastings has grown Netflix into the world's leading streaming service, with 225 million subscribers. Along the way, he has built a distinct corporate culture that some describe as cut-throat. Hastings believes that several critical elements of Netflix culture, including open and candid debate, suffer in a virtual working environment. He argues that not being able to meet face to face, especially internationally, is a significant detriment. James Gorman, Morgan Stanley's CEO, expressed his opinion about remote work with the sentiment, "If you can go to a restaurant in New York City, you can come into the office." He continued, "If you want to get paid New York rates, you work in New York. None of this, 'I'm in Colorado ... and getting paid like I'm sitting in New York City.'"[16]

Other leading investment banks such as Goldman Sachs and JP Morgan are also taking a hardline approach as they require all of their employees to work in the office. They argue that corporate culture is critical to the success of investment banks and that the intricacies of a successful career in a Wall Street firm must be acquired in person on the trading floor, where interns and new employees learn by being around more experienced traders. These strategic leaders also argue that being in the office fosters collaboration and idea generation, noting that employees working from home are less productive. When asked if he was concerned that the requirement to work in an office might prevent the bank from attracting the best talent, given that many tech companies are much more flexible in offering hybrid or fully remote work environments, Jamie Dimon, JP Morgan's CEO, retorted that the bank is not concerned because it receives 50,000 applications for 400 internship positions a year.[17]

What do employees think about how work should be organized? Surveying more than 300,000 workers across different industries in the United States, researchers found that employees prefer to work at least one day a week at home, up from two hours a week pre-pandemic. They provide five reasons for this stronger preference to work from home (WFH): better-than-expected productivity, improved WFH technologies, newly acquired employee skills to thrive in a WFH environment, less stigma associated with WFH, and lingering concerns about coronavirus infections in crowded social spaces. Based on employer data, the researchers estimate that WFH arrangements can boost productivity by up to 5% because of more optimized working arrangements.[18]

Because many firms use remote work only, especially in the technology sector, some younger employees may never work in an office setting. Specifically, members of Gen Z (defined as those born beginning in 1997) had to deal with two years of online education in high school and college. Gen Z is expected to make up one-third of the labor force by 2030. When surveyed, members of Gen Z overwhelmingly (almost 70%) said they would prefer working remotely for at least one-half of their time.

However, researchers have found adverse side effects of working remotely.[19] Working from home makes many employees feel lonely and anxious, and these effects are much more pronounced for younger workers. Spending so much time online prevented many college graduates from forming personal networks with their peers at university. These peer networks are critical for professional advancement throughout a career, but it is difficult to develop a bond between classmates who have never met in person. This problem continues when members of GenZ join the labor force. Working remotely prevents employees from forming social relationships with coworkers and superiors. Without social relationships, remote workers tend to lack peer support and mentorship. Remote workers often feel they do not know how their supervisors evaluate their work because they tend to receive less clear feedback than peers in the office. Indeed, given superiors' bias toward those who work near them, researchers have found that employees working remotely are often passed over for exciting assignments and promotions because they are "out of sight, out of mind."

STRATEGIC LEADERSHIP AT META'S FACEBOOK

To explain why some leaders create successful companies while many others fail, let's look at Meta Platforms (featured in the ChapterCase). Shortly before its rebranding as Meta, Facebook's market valuation crossed $1 trillion for the first time. It was only the fifth tech company to achieve this milestone. (The others were Apple, Alphabet, Amazon, and Microsoft.) How did Facebook become so successful?[20]

FACEBOOK'S STRATEGIC LEADERSHIP DUO. Facebook began as a startup in 2004 in the Harvard dorm room of then 19-year-old Mark Zuckerberg with the support of three college pals. At the time, Myspace was the leading social networking site, and News Corp. acquired it for $600 million (in 2005). Facebook lagged behind Myspace for several years in both investments and users, but it stayed alive thanks to cash injections from Microsoft, Yahoo, and a Russian investment group.

In 2008 Mark Zuckerberg made a critical hire: He persuaded Sheryl Sandberg to leave Google and join Facebook as the new second in command. When she left Google, Sandberg was vice president of global online sales and operations. She had joined the firm in 2001, leading a staff of 300 to develop the company's two online advertising programs, AdSense and AdWords. These two strategic initiatives continue to drive most of Google's revenues. Eric Schmidt, Google's CEO at the time, praised her as a superstar. Under her watch, Sandberg's group grew to 4,000 employees, or about a quarter of Google's workforce.

Zuckerberg is a computer hacker and product developer at heart. He opted to spend his energy on fulfilling his vision of Facebook—to turn it into a tool that would make the world "more open and connected."[21] He preferred coding to business deals and freely admitted that he did not have the skills to run a business successfully. Sandberg did. She brought with her all the business skills that Zuckerberg lacked. She had demonstrated her superb leadership capabilities at Google and was recognized for her prowess in sales, business development, public policy, and communications. Put simply, Zuckerberg saw his role as bringing in the users; he saw Sandberg's role as bringing in the money.

The Zuckerberg/Sandberg leadership duo turned out to be pure dynamite. It led to Facebook's exponential growth—from 100 million users in 2008 to 1 billion in 2012. Just five years later, in 2017, Facebook crossed the 2 billion users mark. And in 2020, it had 3 billion users out of an estimated 5 billion users online globally. Meta is today the largest social medial platform because 60% of the world's internet users are on the Facebook family of apps. By the time the company crossed the $1 trillion stock market valuation in 2021, Facebook's stock had appreciated by 1,200% since its initial public offering (IPO) in 2012, a mere nine years earlier.

In leading Meta's Facebook to become the most successful social network and one of the most valuable companies worldwide, Sheryl Sandberg has demonstrated effective strategic leadership. As chief operating officer (COO), Sandberg had tremendous position power because she was the second in command at Meta Platforms and reported only to CEO Mark Zuckerberg. Sandberg's business development skills are legendary: She transformed Facebook from a money-losing outfit into a titan of online advertising, with $120 billion in annual revenues and $40 billion in annual profits. When Sandberg started at Facebook, the tech startup has 500 employees. She grew the company to 80,000 employees.

Perhaps even more important, Sandberg designed and implemented Facebook's business model (how it makes money). Specifically, she attracted high-profile advertisers by demonstrating how Facebook can place precisely targeted and timed ads based on what it knows about each user, based on that person's social network. While Sandberg ran the company day to day, Zuckerberg dreams up new technological frontiers such as the metaverse.

After a super successful fourteen-year career at Meta Platforms, Sheryl Sandberg stepped down from running day-to-day operations as COO. She remains on the company's board of directors. Mark Zuckerberg was full of praise for Sandberg's accomplishments: "Sheryl architected our ads business, hired great people, forged our management culture, and taught me how to run a company. She created opportunities for millions of people around the world, and she deserves the credit for so much of what Meta is today."[22]

LO 2-2

Outline how you can become a strategic leader.

HOW DO YOU BECOME A STRATEGIC LEADER?

How did Sheryl Sandberg become such an effective and successful strategic leader?

Sandberg grew up in Florida and studied economics at Harvard University, where Larry Summers became her mentor and thesis advisor. Her thesis, entitled "How Economic Inequality Contributes to Spousal Abuse," and her founding of the Women in Economics and Government organization while she was an undergraduate, foreshadowed her interest in gender dynamics and advocacy for women in leadership. Her TED talk, "Why We Have Too Few Women Leaders," has been viewed more than 11 million times; and her book, *Lean In: Women, Work, and the Will to Lead,* was a bestseller. In both, Sandberg speaks about the low number of female leaders and how to overcome this situation. In *Lean In,* she expresses her vision for gender equality: "In the future, there will be no female leaders. There will just be leaders."[23]

Upon Sandberg's graduation in 1991, Summers recruited her to work as his research assistant at the World Bank, an international financial institution that provides loans to low-income countries. Two years later, Sandberg enrolled in the MBA program at Harvard Business School. After completing her MBA, she took a job with McKenzie, a strategy consulting firm. Her next stop was the federal government, where she was the Chief of Staff for Larry Summers, who was serving as U.S. Secretary of the Treasury under President Bill Clinton.

In 2001, Eric Schmidt, then Google's CEO, recruited Sandberg to join the fledgling online search startup. Google's successful IPO in 2004 owed much to Sandberg's astute leadership. In 2008, Sandberg joined Facebook as COO and second in command. Under Sandberg's strategic leadership, Facebook went public in 2012. In the same year, Sandberg was appointed to Facebook's board of directors, making her the first woman to join Meta's governing body. *Time* magazine included Sandberg in its annual list of the 100 Most Influential People, and *Forbes* magazine has named her the Most Powerful Woman in Tech multiple times in its annual ranking.

Sheryl Sandberg is one of the most influential businesspeople globally. She was the Chief Operating Officer (2008–2022) and remains a board member of Meta Platforms. She is also the founder of LeanIn.org, a nonprofit organization dedicated "to offering women the ongoing inspiration and support to help them achieve their goals." In her books Lean In and Option B, Sandberg shares deeply personal and professional experiences that have shaped her leadership style and how she overcame adversity and gender discrimination.

dpa picture alliance/Alamy Stock Photo

ARE STRATEGIC LEADERS BORN OR MADE? Are the skills necessary for becoming an ethical and effective strategic leader innate? Or can they be learned?

According to the **upper-echelons theory**, organizational outcomes, including strategic choices and performance levels, reflect the values of the top management team.[24] These are the individuals at the upper levels of an organization. According to the theory, strategic leaders interpret situations through the lens of their unique perspectives, which are shaped by their personal circumstances, values, and experiences. Their leadership actions reflect characteristics of their education and career experiences as filtered through personal interpretations of the situations they face. The upper-echelons theory favors the idea that effective strategic leadership results from innate abilities *and* learning.

In the bestseller *Good to Great,* Jim Collins explored over 1,000 *good* companies to find 11 *great* ones. He identified *great companies* as those that transitioned from average performance to sustained competitive advantage. He measured that transition as "cumulative stock returns of almost seven times the general market in the 15 years following their transition points."[25] A lot has happened since the book was published over two decades ago. As defined by Collins, only a few companies have sustained their *greatness*, including Kimberly-Clark and Walgreens. Some fell back to mediocrity; a few no longer exist in their earlier form. Competitive advantage is hard to achieve and even harder to sustain.

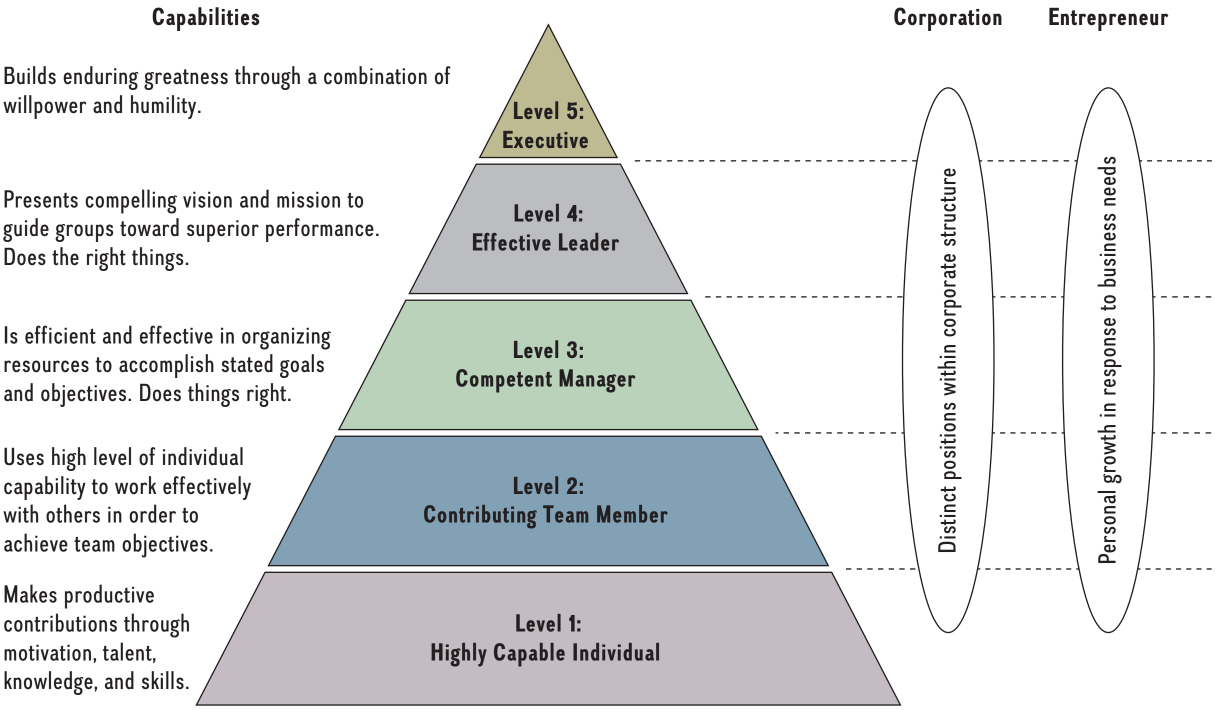
But Collins' book remains valuable for its thought-provoking observations. Studying these large corporations, Collins found consistent strategic leadership patterns among the top companies, as pictured in the **Level-5 leadership pyramid** in Exhibit 2.2. The pyramid is a conceptual framework that shows leadership progression through five distinct, sequential levels. Collins found that all the companies he identified as *great* were led by Level-5 executives.

According to the Level-5 leadership pyramid, effective strategic leaders go through a natural progression of five levels. Each level builds on the previous one; the individual can move to the next leadership level only after mastering the current level. On the left in Exhibit 2.2 are the capabilities associated with each level. But not all companies are Fortune 500 behemoths. On the right-hand side of Exhibit 2.2, we suggest that the model is also valuable to individuals who are looking to develop the capacity for greater professional success.

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

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

EXHIBIT 2.2 Strategic Leaders: The Level-5 Pyramid Adapted to Compare Corporations and Entrepreneurs



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

At Level 1, we find competent individuals who make productive contributions through motivation, talent, knowledge, and skills. These traits are necessary but not sufficient to move on to Level 2, where the individual attains the next level of strategic leadership by becoming an effective team player. As a contributing team member, the individual works effectively with others to achieve common objectives. In Level 3, the team player with a strong individual skill set turns into an effective manager who can organize the resources necessary to accomplish the organization's goals. Once these three levels are mastered, the effective professional can move to Level 4. At that level, effective professionals have learned to do the right things. They not only possess a strong individual skill set and are effective team players and managers, but they also know what actions are the right ones in any given situation to pursue an organization's strategy. At Level 5, the strategic leader builds enduring greatness by combining willpower and humility. A Level-5 executive works to help the organization succeed and others reach their full potential.

Sheryl Sandberg is a Level-5 executive: She has built enduring greatness at Meta through skill, willpower, and humility. Meta's CEO, Mark Zuckerberg, highly values Sandberg. He says,

> "She could go be the CEO of any company that she wanted, but I think the fact that she wants to get her hands dirty and work, and doesn't need to be the front person all the time, is the amazing thing about her. It's that low-ego element, where you can help the people around you and not need to be the face of all the stuff."[26]

In turn, Sandberg frequently quotes a definition of leadership she learned in business school: "Leadership is about making others better as a result of your presence and making sure that impact lasts in your absence." Sandberg encourages women to *lean in* to their careers and seek out leadership roles:

> "I hope you find true meaning, contentment, and passion in your life. I hope you navigate the difficult times and come out with greater strength and resolve. I hope you find whatever balance you seek with your eyes wide open. And I hope that you—yes, you—have the ambition to lean in to your career and run the world. Because the world needs you to change it."

LO 2-3

Compare and contrast the roles of corporate, business, and functional leaders in strategy formulation and implementation.

THE STRATEGY PROCESS ACROSS LEVELS: CORPORATE, BUSINESS, AND FUNCTIONAL LEADERS

According to the upper-echelons theory, strategic leaders determine a firm's ability to gain and sustain a competitive advantage through the strategies they pursue. Given the importance of such strategies, we need to understand how they are created. The *strategy process* consists of *strategy formulation* (which results from strategy analysis) and *strategy implementation.*

Strategy formulation concerns the choice of strategy in terms of *where and how to compete*, while **strategy implementation** involves the organization, coordination, and integration of *how work gets done.* In short, implementation concerns the *execution of strategy.* It is helpful to view strategy formulation and implementation across three distinct levels: corporate, business, and functional.

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

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

- *Corporate strategy* concerns the question of where to compete in industry, markets, and geography.
- *Business strategy* concerns the question of how to compete. Three generic business strategies are available: cost leadership, differentiation, and value innovation.
- *Functional strategy* concerns the question of how to implement a chosen business strategy. Different corporate and business strategies require different activities across the various functions.

Exhibit 2.3 shows the three areas of strategy formulation and implementation.

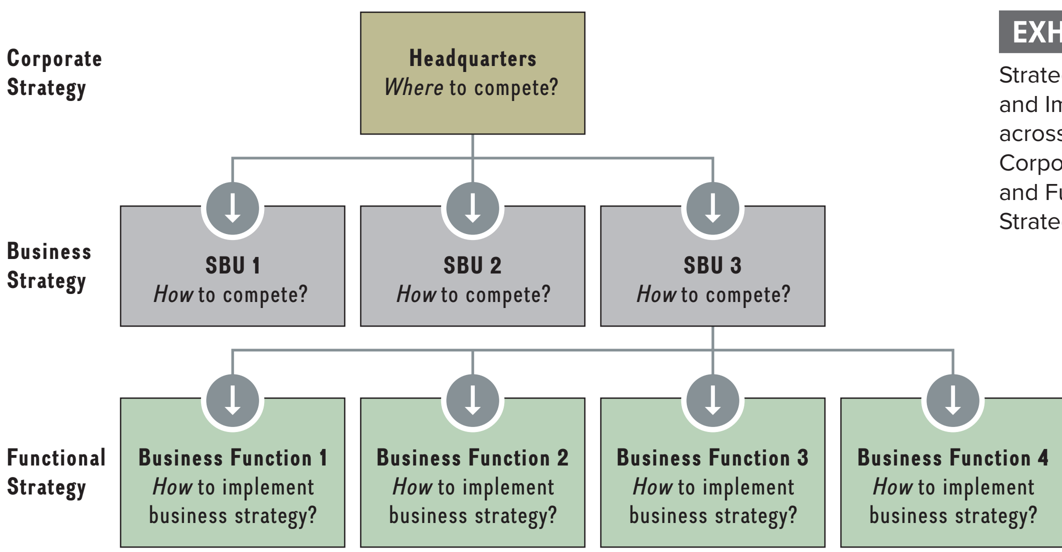


EXHIBIT 2.3

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

Roz Brewer is a trailblazer and role model. She is the first Black woman to become CEO of Walgreens Boots Alliance, group president and COO of Starbucks, CEO of Sam's Club, and a board member of Amazon.com. Brewer holds a degree in chemistry from Spelman College in Atlanta, Georgia, America's oldest private historically Black liberal arts college for women.

Phelan M. Ebenhack/AP Images

LEADING CORPORATE STRATEGY. Although we generally speak of the firm in an abstract form, individual employees make strategic decisions—whether at the corporate, business, or functional levels. *Corporate executives* at headquarters formulate corporate strategy. Corporate executives include Mary Barra (GM), Rosalind Brewer (Walgreens Boots Alliance), Thasunda Brown Duckett (TIAA), Satya Nadella (Microsoft), and Sundar Pichai (Alphabet). Corporate executives need to decide in which industries, markets, and geographies their companies should compete *(where to compete)*. They need to formulate a strategy that can create synergies across business units that may be quite different, and they determine the firm's boundaries by deciding whether to enter specific industries and markets and sell certain divisions. They are responsible for setting overarching strategic objectives and allocating scarce resources among different business divisions, monitoring performance, and making adjustments to the overall portfolio of businesses as needed. The objective of corporate-level strategy is to increase the overall company value to make it higher than the sum of the individual business units' value.

Rosalind Brewer (who goes by Roz) is the CEO of Walgreens Boots Alliance, a holding company for the retail pharmacy chains Walgreens (in the United States) and Boots (in the UK and elsewhere), as well as several pharmaceutical manufacturing and distribution companies. In her role, Brewer needs to devise a corporate strategy to compete with CVS Health, a diversified American healthcare company that owns CVS Pharmacy, a chain of retail pharmacies; CVS Caremark, a pharmacy benefits manager; and Aetna, a health insurance provider. Karen Lynch is the CEO of CVS Health. The company's revenues are $300 billion, making CVS the largest company run by a female CEO.

Karen Lynch is CEO of CVS Health, with $300 billion in annual revenues. CVS Health is the fourth-largest U.S. company. Only Walmart, Amazon, and Apple (in rank order) achieved higher sales (in 2021).

Courtesy of CVS Health

Returning to our ChapterCase on Meta Platforms, CEO Mark Zuckerberg determines Meta's corporate strategy. With some 80,000 employees, Meta is a far-flung internet firm—its various services are available in 200 languages, and it has offices in more than 35 countries.[27] Zuckerberg is responsible for the performance of the entire organization. He decides:

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

One example of Sandberg's effective strategic leadership during her tenure as second in command (2008-2022), was Facebook's turnaround (beginning in 2013) when it had little mobile presence. Part of the problem was the inferior quality of the mobile app. Zuckerberg had initially built Facebook for the desktop personal computer, not for mobile devices. Sandberg initiated a company-wide mobile-first strategic initiative focusing its engineers and marketers on mobile devices. The success of this turnaround strategy is stunning: Today, Facebook is an advertising powerhouse, generating over 80% of its $120 billion in revenues annually from mobile advertising.[28]

strategic business units (SBUs) Standalone divisions of a larger conglomerate, each with their own profit-and-loss responsibility.

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

While serving as president and CEO of Sam's Club (a strategic business unit of Walmart) from 2012 to 2017, Roz Brewer pursued a business strategy that achieved annual revenues of roughly $60 billion, approximately the same revenue as The Walt Disney Company. As CEO of Sam's Club, Brewer reported to Walmart's CEO, who, as a corporate executive, oversees all of Walmart's operations, with $600 billion in annual revenues and 12,000 stores globally.[29]

One interesting point to note here is that CEOs at SBUs decide, as part of their profit-and-loss responsibility, which business strategy to pursue. Roz Brewer pursued a somewhat different business strategy from Walmart's parent company. While Walmart stores follow a low-cost leadership strategy ("everyday low prices"), Brewer combined a low-cost approach with higher value added than would be found at regular Walmart stores. She formulated a value innovation business strategy for Sam's Club by offering higher quality products and brand names with bulk offerings and prescreening customers via required Sam's Club memberships to establish creditworthiness. (We discuss different business-level strategies in Chapter 6.)

In 2017, Brewer was appointed COO of Starbucks, the leading coffeehouse chain globally with $30 billion in annual revenues and 300,000 employees. Brewer was in charge of all Starbucks operations in the Americas (Canada, the United States, and Latin America) as well as the company's global supply chain, product innovation, and store development, which includes 34,000 stores globally. As second in command at Starbucks, Brewer reported directly (and only) to the Starbucks CEO. She also served as a director on Amazon's board, from 2019 to 2021. In 2021, she was appointed CEO of Walgreens Boots Alliance. Upon becoming CEO of Walgreens, Brewer stepped down from the Amazon board because Amazon also competes in health care. For example, it acquired the online pharmacy PillPack in 2018.

LEADING FUNCTIONAL STRATEGY. *Functional managers* are responsible for decisions and actions within a single functional area. Each strategic business unit has various business *functions,* such as accounting, human resources, procurement, product development, manufacturing, marketing, sales, and customer service. Functional-level strategies focus on improving a firm's value creation and cost structure in support of the business-level strategy. Most of the courses in business schools focus on particular business functions (e.g., finance, operations management, IT management). Similarly, most entry-level management positions are at the functional level.

For instance, a company that focuses on differentiation by providing a superior product and service such as Apple spends more on R&D, engineering, and software development. At the same time, it must also control costs. In contrast, a company that pursues a low-cost leadership strategy such as Motorola, which is owned by Lenovo of China and popular in emerging markets, must focus on designing phones that can be manufactured at a low cost. Motorola can achieve a low-cost position by focusing on procuring lower-cost inputs (previous-generation chips, plastic casings instead of metal, lower-grade glass for the screen) while still offering acceptable value. The decisions and actions that managers take at the functional level, therefore, aid in implementing the business-level strategy made at the level above (see Exhibit 2.3).

2.2 Vision, Mission, and Values

LO 2-4

Describe the roles of vision, mission, and values in a firm's strategy.

The first step in the strategic management process is to define an organization's vision, mission, and values by asking the following questions:

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

Strategic leaders must first define and articulate a *vision* for the enterprise because it identifies the organization's purpose and primary long-term objective. Strategic leaders need to begin with the end in mind.[30] Strategy formulation and implementation begin after a vision is articulated.

Transforming a vision into reality begins with formulating business and corporate strategies that enhance the company's chances of gaining and sustaining a competitive advantage. The strategy process ends with implementing the developed strategy to enable the organization to realize its vision. Formulating and implementing a strategy based on a purpose-driven vision is an iterative process that can be compared to designing and building a house. The builder needs an approved blueprint from the architect before construction can begin. The same holds for strategic success; it results from strategy formulation based on careful analysis before any implementation takes place. Let's examine this process in more detail.

A PURPOSE-DRIVEN VISION

vision A statement that captures an organization's purpose and aspiration. It spells out what the organization ultimately wants to accomplish.

A **vision** captures an organization's purpose and aspiration. It spells out what the organization ultimately wants to accomplish. An effective vision suffuses the organization with a sense of purpose and motivates employees at all levels to aim for the same target while leaving room for individual and team contributions. Employees in visionary companies tend to feel that they are part of something bigger than themselves. An inspiring vision provides a greater sense of purpose and helps employees find meaning in their work beyond mere monetary rewards. People have an intrinsic motivation to make the world a better place through their contributions.[31] In turn, this motivation, which inspires individual purpose, can lead to higher organizational performance.[32]

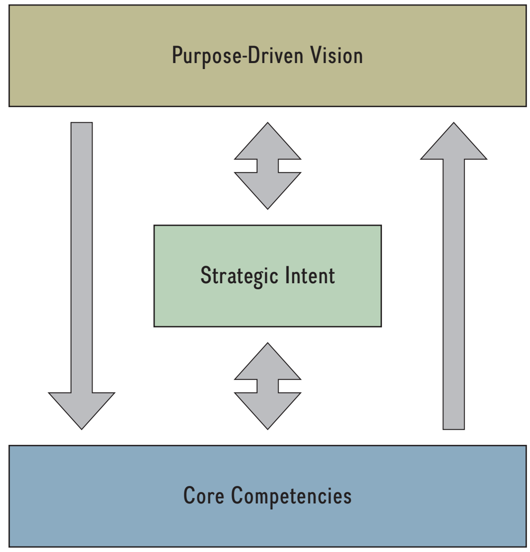
A firm's purpose-driven vision is expressed as a statement. The statement should be forward-looking and inspiring to ensure it provides meaning for employees in pursuit of the organization's ultimate goals. For example, Tesla's vision is *to accelerate the world's transition to sustainable transport.* Its goal is to provide affordable zero-emission mass-market cars that are the best in class. SpaceX is a spacecraft manufacturer and space transport services company whose inspirational vision is *to make human life multi-planetary.* To achieve this goal, SpaceX aims to make human travel to Mars not only possible but also affordable. Moreover, SpaceX also envisions a role for itself in helping to establish a self-sustainable human colony on Mars.[33]

strategic intent A stretch goal that pervades the entire organization with a sense of purpose.

STRATEGIC INTENT. Using a purpose-driven vision as the organization's foundation, strategic leaders must build core competencies to make the company's vision become reality. *Core competencies,* which result from the interplay of resources and capabilities, are activities in which the firm strives to be best. (For more in-depth coverage of core competencies, see Chapter 4.) Strategic leaders build the necessary core competencies by defining a **strategic intent**, which is a stretch goal that pervades the entire organization with a sense of purpose. This sense of purpose, in turn, helps in creating the required core competencies. Continuous learning, often over many years and frequently from failure, is critical in creating core competencies on which a competitive advantage can be based.[34]

Matching a firm's vision to its given level of internal resources and capabilities creates a static fit with the external environment. However, this approach focuses on maintaining the current situation (status quo), limits an organization's results, and curtails an organization's ability to achieve stretch goals. As a result, the organization is not able to accomplish a higher purpose such as making the world a better place by, for instance, addressing climate change and social injustices. In contrast, a clear strategic intent motivates and accelerates organizational learning across all levels to create and build the core competencies needed to make the vision a reality, even when the stretch goals seem initially out of reach. Seemingly impossible goals derived from a purpose-driven vision motivate employees and foster innovation. Exhibit 2.4 summarizes the interplay between a purpose-driven vision, strategic intent, and core competencies.

EXHIBIT 2.4 The Interplay between Purpose-Driven Vision, Strategic Intent, and Core Competencies



ChapterCase 2 highlights how Mark Zuckerberg proclaimed a new strategic intent by stating, "The metaverse is the next frontier in connecting people... To reflect who we are and the future we hope to build, I'm proud to share that our company is now Meta." Here, Zuckerberg lays out a strategic pivot to transform Facebook into Meta by sharing his vision that the future of the internet is the metaverse, where people are fully immersed in three-dimensional digital worlds rather than looking at the internet on the two-dimensional screen of a phone or laptop.

The purpose-driven vision for Meta's 80,000 employees is to build the resources and capabilities needed to make the metaverse a reality. Metamates, as Zuckerberg calls his employees, are motivated to create a new computing platform that will supersede existing standards, such as the Windows operating system in the PC world and the operating systems of Apple (iOS) and Google (Android) for mobile computing. To support his ambitious strategic intent, Zuckerberg is making credible strategic commitments by investing $10 billion per year, or about $1 for every $4 earned by Meta. To indicate how serious he is about creating the operating system for the metaverse, Zuckerberg has said that the $10 billion invested each year will increase substantially in the years to come.

Meta's strategic intent is quite ambitious because its realization is considered to be a decade away. In addition, it is not clear that Meta will be the winner in the metaverse; many companies are striving to compete successfully in the newly envisioned computing paradigm. Yet, one thing is clear: Zuckerberg is serious about his strategic intent and is investing a large chunk of the company's profits for years to come into achieving its purpose-driven mission to build the necessary core competencies to make the metaverse a reality. As noted earlier, a firm's purpose-driven vision is expressed as a forward-looking and inspiring statement that provides meaning for employees in pursuit of the organization's ultimate goals. Meta's vision statement meets these criteria: "The metaverse is the next frontier ... and the future we hope to build."

Firms need to back up their vision with *strategic commitments* in which the enterprise undertakes credible actions. Such commitments are costly, long-term oriented, and difficult to reverse—three criteria that characterize Mark Zuckerberg's commitment to building the dominant platform for the metaverse.[35] However noble the vision statement, to achieve competitive advantage companies must make strategic commitments informed by the economic fundamentals of value creation and value capture.

Strategy Highlight 2.1 shows how an inspiring purpose is at the heart of the Teach for America (TFA) vision statement. This statement effectively and clearly communicates not only TFA's strategic intent but also what it ultimately seeks to accomplish.

Strategy Highlight 2.1

Teach for America: Inspiring Future Leaders

The Teach for America (TFA) purpose-driven mission is educational equity. TFA is a nonprofit organization of future leaders that works to ensure that underserved youth receive an excellent education. TFA corps members spend two years teaching in economically disadvantaged communities across the United States. Although TFA initially targeted college seniors to join the organization, it now recruits both graduates and professionals to help achieve its vision: *One day, all children in this nation will have the opportunity to attain an excellent education.*

Wendy Kopp, founder of Teach for America.
Astrid Stawiarz/Getty Images

TFA began as a college senior thesis by 21-year-old Wendy Kopp in 1989. Kopp was convinced that young people seek meaning in their lives and that they can create meaning by making a positive contribution to society. With TFA, she changed the social perception of teaching, turning a seemingly unattractive, low-status job into a high-prestige, professional opportunity.

Kopp marketed her idea by disseminating and posting flyers in college dorms. In the first four months after creating TFA, she received more than 2,500 applications. During its first academic year (1990–91), TFA served five states and changed the lives of 36,000 students. In 2022, TFA had over 64,000 corps members and alumni, along with more than 9,000 school partnerships, and it impacted millions of students.

Being chosen for TFA is considered an honor. Of the total number of applications that TFA receives annually, approximately 15% are accepted; this is roughly equivalent to the admission rate of highly selective universities such as Northwestern, Cornell, and the University of California–Berkeley. Compared to the national average of people of color in teaching positions (20%), 53% of TFA corps members are people of color—a more accurate reflection of the population they teach. TFA corps members receive the same pay as other first-year teachers in their respective local school districts.

In an effort to eliminate educational inequity, Kopp deliberately enlists the nation's most promising future leaders. This decision to recruit only the best has had a hugely positive impact on students. Approximately 95% of all school principals working with TFA members say the TFA teachers have made significant strides with their students. Furthermore, a study commissioned by the U.S. Department of Education found that students who were taught by TFA corps members showed significantly higher achievement, especially in math and science.

Elisa Villanueva Beard is the CEO of Teach For America (TFA), a nonprofit organization dedicated to achieving educational equity by improving outcomes for low-income students. When she was part of a small Mexican-American student population at DePauw University, she struggled academically despite graduating at the top of her high school class in the Rio Grande Valley, a region spanning the border of Texas and Mexico. The area is one of the lowest-income regions in the United States. In 2020, she created a Diversity, Equity, and Inclusiveness (DEI) Office at Teach for America to create and implement systems and practices to enhance equity, inclusiveness, and belonging for all members of the TFA community.
Teach for America

TFA CEO Elisa Villanueva Beard was inspired to sign up for TFA when she was a student at DePauw University. What inspired her most, she says, was Wendy Kopp's "audacity to believe young people could make a profound difference in the face of intractable problems standing between the ideals of a nation I loved and a starkly disappointing reality; who were bound by a fierce belief that all children, from American Indian reservations in South Dakota to Oakland to the Rio Grande Valley to the Bronx, should have the opportunity to write their own stories and fulfill their true potential."[36]

Yet, despite its remarkable success, TFA finds itself wrestling with several challenges. First, applications have dropped since 2013, causing TFA's yearly cohort of corps members to drop from a high of almost 6,000 to a low of little less than 2,000 in 2022. Second, the short but intensive five-week summer boot camp intended to prepare new recruits for teaching in some of the toughest schools in the United States is increasingly criticized as insufficient.[37]

That vision statements can inspire and motivate employees in the nonprofit sector comes as no surprise. Who wouldn't find TFA's vision of wanting *to help children attain an excellent education* meaningful? Likewise, who wouldn't be moved by the promise *to always be there in times of need,* the vision of the American Red Cross? But can for-profit firms inspire and motivate as effectively as nonprofits do? The answer is yes. A truly meaningful and inspiring purpose-driven vision—whether for a nonprofit firm or a for-profit firm—makes employees feel that they are part of something bigger, which can be highly motivating.

When employees are motivated, firm financial performance tends to follow, but the success runs deeper than just higher profits. For example, visionary companies such as Patagonia provide aspirational ideas that are not merely financial: *At Patagonia, we appreciate that all life on Earth is under threat of extinction. We aim to use the resources we have—our business, our investments, our voice and our imaginations—to do something about it.* As such, they tend to outperform their competitors over the long run. The relationship between doing good and doing well also holds for publicly traded companies. Tracking the stock market performance of companies over several decades, strategy scholars found that visionary companies outperformed their peers by a wide margin.[38]

LO 2-5

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

VISION STATEMENTS AND COMPETITIVE ADVANTAGE. Do vision statements help firms gain and sustain competitive advantage? It depends. The effectiveness of vision statements differs by type. *Customer-oriented* vision statements allow companies to adapt to changing environments because they focus employees on thinking about how best to solve a problem for consumers. In contrast, *product-oriented* vision statements often constrain this ability.[39]

Clayton Christensen, an American academic and business consultant, shares how a customer focus helped a fast food chain increase sales of milkshakes. The company approached Christensen after it had made several changes to its milkshake offerings based on extensive customer feedback, but sales failed to improve. Rather than asking customers what kind of milkshake they wanted, Christensen approached the problem in a different way. He observed customer behavior and then asked customers, "What job were you trying to do that caused you to hire that milkshake?"[40] He wanted to know what problem the customers were trying to solve. Surprisingly, he found that roughly half of the shakes were purchased in the morning because customers wanted an easy breakfast in the car and a diversion on long commutes. Based on the insights gained from this *problem-solving perspective,* the company expanded its shake offerings to include healthier options with fruit chunks. It also provided a prepaid dispensing machine to speed up the drive-through and thus improve customers' morning commute. The lesson is clear: A customer focus made finding a solution much easier.

We could say that, before hiring Christensen, the restaurant company had a product orientation that prevented its executives from seeing unmet customer needs. Product-oriented vision statements focus employees on improving existing products and services without considering the underlying customer problems to be solved. But the environment is ever changing and sometimes seems chaotic. The increased strategic flexibility afforded by customer-oriented vision statements can provide a basis on which companies can build competitive advantage.[41] Let's look at both types of vision statements in more detail.

PRODUCT-ORIENTED VISION STATEMENTS. A *product-oriented vision* defines a business in terms of a good or service provided. Product-oriented visions tend to force managers to take a more myopic view of the competitive landscape. Companies that define themselves based on product-oriented statements (e.g., "We are in the typewriter business") tend to be less flexible and thus more likely to fail. The lack of an inspiring needs-based vision can cause the long-range problem of failing to adapt to a changing environment.

Consider the strategic decisions of U.S. railroad companies. Railroads are in the business of moving goods and people from point A to point B by rail. When they started in the 1850s, their short-distance competition was the horse or horse-drawn carriage. There was little long-distance competition (e.g., ship canals or good roads) to cover the United States from coast to coast. Because of their monopoly, especially in long-distance travel, the railroad companies were initially extremely profitable. Not surprisingly, the early U.S. railroad companies saw their vision as being in the railroad business, clearly a product-based definition.

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

However, the railroad companies seem to be learning some lessons: CSX Railroad is now redefining itself as a green-transportation alternative. It claims it can move 1 ton of freight 423 miles on 1 gallon of fuel. However, its vision remains product oriented: *to be the safest, most progressive North American railroad.*

CUSTOMER-ORIENTED VISION STATEMENTS. *A customer-oriented vision* defines a business in terms of providing solutions to customer needs—for example, "We provide solutions to professional communication needs." Companies with a customer-oriented vision can more easily adapt to changing environments. Exhibit 2.5 provides examples of companies with customer-oriented vision statements.

Customer-oriented visions identify a critical need but do not explain how to meet that need. Why? Customer needs may change, and the *means* of meeting those needs may change. The future is unknowable, and innovation is likely to provide new ways to meet needs that we cannot fathom today.[42]

For example, consider the need to transmit information over long distances. Communication needs have persisted throughout the millennia, but the technology to solve this problem has changed drastically over time.[43] During the reign of Julius Caesar, moving

EXHIBIT 2.5

Companies with Customer-Oriented Vision Statements

Amazon: To be Earth's most customer-centric company, where customers can find and discover anything they might want to buy online.
Better World Books: To harness the power of capitalism to bring literacy and opportunity to people around the world.
Facebook (a subsidiary of Meta Platforms): To make the world more open and connected.
Fenty Beauty by Rihanna: To include women everywhere.
Google (a subsidiary of Alphabet): To organize the world's information and make it universally accessible and useful.
IKEA: To create a better everyday life for the many people.
Nike: To bring inspiration and innovation to every athlete* in the world. (*If you have a body, you are an athlete.)
Shopify: Make commerce better for everyone.
SpaceX: To make human life multi-planetary.
TED: Spread ideas.
Rivian: To keep the world adventurous forever.
Tesla: To accelerate the world's transition to sustainable energy.
Walmart: To be the best retailer in the hearts and minds of consumers and employees.
Warby Parker: To offer designer eyewear at a revolutionary price, while leading the way for socially conscious businesses.

information over long distances required papyrus, ink, a chariot, a horse, and a driver. During Abraham Lincoln's time, the telegraph was used for short messages while railroads handled larger documents. When Franklin Delano Roosevelt was president, an airplane transported letters over long distances. Today, we use connected mobile devices to move information over long distances at the speed of light. The problem to be solved—moving information over long distances—has remained the same, but the technology employed to do this job has changed drastically. Christensen recommended that strategic leaders think hard about how the means of getting a job done have changed over time and ask themselves, "Is there an even better way to get this job done?"

An organization's vision must be flexible to allow for change and adaptation. Consider how Ford Motor Co. has addressed the problem of personal mobility over the past 100 years. Before Ford entered the market for automobiles in the early 1900s, people traveled long distances by horse-drawn buggy, horseback, boat, or train. But Henry Ford had a different idea. In fact, he famously said, "If I had listened to my customers, I would have built a better horse and buggy."[44] Instead, his original vision was *to make the automobile accessible to every American.* He succeeded, and the automobile dramatically changed how mobility was achieved.

Fast-forward to today: Ford Motor Co.'s vision is *to provide personal mobility for people around the world.* Note that this vision does not even mention the automobile. By focusing on the consumer need for personal mobility, Ford is leaving the door open for many different ways of fulfilling that need. For the past decade, Ford has offered mainly traditional cars and trucks with gas-powered internal combustion engines, with some hybrid electric vehicles in its lineup. Over the same time period, it has invested billions of dollars in electrification and autonomy. Two of its electric vehicles, the Mustang Mach E and the Ford F-150 Lightning, have not only received outstanding reviews by industry experts but are also in high demand.

In addition, over the next decade, with increasing autonomy and electrification, cars and trucks are less likely to be owned personally. Instead, rides will be provided on demand by ride-hailing services such as Lyft, which Ford has formed a strategic alliance with. Further into the future, perhaps Ford will get into the business of individual flying devices. Throughout all of these changes, its vision will still be relevant and will compel its strategic leaders to engage in future markets. In contrast, a product-oriented vision focused, for instance, on making the best gasoline-powered cars and trucks, would greatly constrain Ford's strategic flexibility and lead to inferior performance as the external environment continues to move toward electrification and autonomy. To speed this transition along, Ford has invested over $1 billion in Rivian, an electric vehicle startup with a focus on all-terrain SUVs and pickup trucks.

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

In the internet age, though, the standalone PC as the end-product has become less important. Customers want to stream videos and share selfies and other pictures online. These activities consume a tremendous amount of computing power. To reflect this shift, Intel changed its vision (in 1999) to focus on being *the preeminent building-block supplier to the internet economy.* Although its product-oriented vision statements did not impede its performance or competitive advantage, Intel fully made the shift to a customer-oriented vision in 2008: *to delight our customers, employees, and shareholders by relentlessly delivering the platform and technology advancements that become essential to the way we work and live.* This shift was reflected in the hugely successful "Intel Inside" advertising campaign in the 1990s that made Intel a household name worldwide. Today, more than a decade later, Intel maintains its 2008 vision statement.

Intel accomplished superior firm performance over decades through continuous adaptations to changing market realities, but its formal vision statement lagged behind the firm's strategic transformations. That is, Intel regularly changed its vision statement *after* it had accomplished each successful transformation.[45] So, in Intel's case, vision statements and firm performance were clearly not related. Today, Intel faces new challenges as it struggles to maintain leadership in mobile computing, where Apple, Arm, Nvidia, and Qualcomm are leading competitors.

It is interesting to note that many customer-oriented visions also change over time. When Tesla was founded in 2003, its vision was *to accelerate the world's transition to sustainable transport.* Over the last decade or so, Tesla completed several steps of its initial master plan (as detailed in ChapterCase 1), including providing zero-emission electric power–generation options (Step 4) through the acquisition of SolarCity. Tesla therefore no longer views itself as a car company but instead as a fully integrated clean-tech company. To capture this ambition more accurately Tesla changed its vision, which is now *to accelerate the world's transition to sustainable energy.* To reposition Tesla as an integrated clean-tech energy company, Tesla changed its official name from Tesla Motors to simply Tesla, Inc. (in 2017).

Empirical research shows that vision statements and firm performance are associated with each other.[46] A positive relationship between a vision statement and firm performance is more likely to exist when:

- The vision is customer oriented.
- Internal stakeholders are invested in defining a purpose-driven vision.
- Organizational structures such as compensation systems align with the firm's vision.

In summary, a purpose-driven vision statement focused on solving problems can lay the foundation upon which to craft a strategy that can create a competitive advantage.

MISSION

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

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

- A vision defines what an organization wants *to be*, and what it wants to accomplish ultimately. A vision begins with the infinitive form of a verb (starting with *to)*. As discussed in Strategy Highlight 2.1, TFA wants all children in the nation to have the opportunity *to attain an excellent education*.
- A mission describes what an organization does and *how* it proposes to accomplish its vision. The mission is often introduced with the preposition *by*. Thus, we can write the following mission statement for TFA: *TFA wants to give all children in the nation the opportunity to attain an excellent education by enlisting, developing, and mobilizing as many as possible of our nation's most promising future leaders to grow and strengthen the movement for educational equity and excellence*.

LO 2-6

Justify why anchoring a firm in ethical core values is essential for long-term success.

VALUES

A powerful vision and mission statement are not enough. An organization's values also need to be clearly articulated in the strategy process. A **core values statement** matters because it helps employees understand the company culture, offering bedrock principles that employees at all levels can use to manage complexity and resolve conflict. Such statements can provide the organization's employees with a moral compass.

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

Organizational core values are the ethical standards and norms that govern individuals' behavior within a firm or organization. Strong ethical values and norms have two important functions. First, they underlie the vision statement and provide stability to the strategy, laying the groundwork for long-term success. Second, once the company is pursuing its vision and mission in its quest for competitive advantage, they serve as guardrails to keep the company on track.

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

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

The values espoused by a company answer the question, *How do we accomplish our goals?* They help individuals make choices that are both ethical and effective in advancing the company's goals. For instance, Teach for America (TFA) has a set of core values that focus on transformational change through team-based leadership, diversity, respect, and humility. These values guide TFA corps members in their day-to-day decision making, aiding each corps member in making ethical and value-based decisions in teaching environments that can often be challenging and stressful.

One last point about organizational values: Organizational core values must be lived with integrity, especially by the top management team. Without the commitment and involvement of strategic leaders, any statement of values is merely a public relations exercise. Employees tend to follow the values practiced by their leaders. They closely observe top managers' day-to-day decisions and quickly decide whether those leaders are merely paying lip service to the company's stated values. Unethical behavior by strategic leaders is like a virus that spreads quickly throughout an entire organization.

As an example, consider Volkswagen (VW), one of the largest carmakers by volume worldwide. One of its long-time marketing slogans, *Truth in Engineering,* did not prevent the forced resignation of VW CEO Martin Winterkorn as a consequence of an emissions cheating scandal dubbed Dieselgate (in 2015). Then, Winterkorn was indicted on fraud and conspiracy charges (in 2018). What happened? VW had illegally installed so-called "defeat devices" in some 11 million vehicles. When programmed and installed, these devices limited emissions when the vehicle was on a test stand. In addition, they disabled emissions control when the vehicle was in daily driving mode on public roads. These defeat devices helped VW diesel cars pass stringent emissions tests, even though in reality they were emitting up to 40 times the allowed level of pollutants. In the end, Volkswagen paid more than $22 billion in fines and damaged its stellar reputation. As is generally the case with illegal corporate activity, the fines were much higher than the cost of equipping the diesel engines with the appropriate pollution controls.[47]

As the VW example demonstrates, it is imperative that strategic leaders set the example of ethical behavior by living their firm's core values. Strategic leaders have a strong influence in setting their organization's vision, mission, and values—the first step of the *strategic management process.*

LO 2-7

Evaluate top-down strategic planning, scenario planning, and strategy as planned emergence, identifying the pros and cons of each.

2.3 The Strategic Management Process

An effective **strategic management process** lays the foundation for sustainable competitive advantage. In the section Strategic Leadership, we gained insight into the corporate, business, and functional levels of strategy. Here we turn to the process or method by which strategic leaders formulate and implement strategy. When setting the strategy process, strategic leaders rely on three approaches:

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

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

This order reflects the sequence of development of these approaches over time. Thus, we begin with strategic planning, followed by scenario planning, and then strategy as planned emergence. The first two are relatively formal, top-down planning approaches. The third begins with a strategic plan but offers a less formal and less stylized approach. Each approach has its strengths and weaknesses, depending on the circumstances in which it is employed.

TOP-DOWN STRATEGIC PLANNING

The prosperous decades after World War II resulted in tremendous growth of corporations. As company executives needed a way to manage ever more complex firms more effectively, they began to use strategic planning.[48] **Top-down strategic planning**, derived from military strategy, is a rational process through which executives attempt to program future success.[49] In this approach, all strategic intelligence and decision-making responsibilities are concentrated in the office of the CEO. Much like a military general, the CEO leads the company strategically through competitive battles.

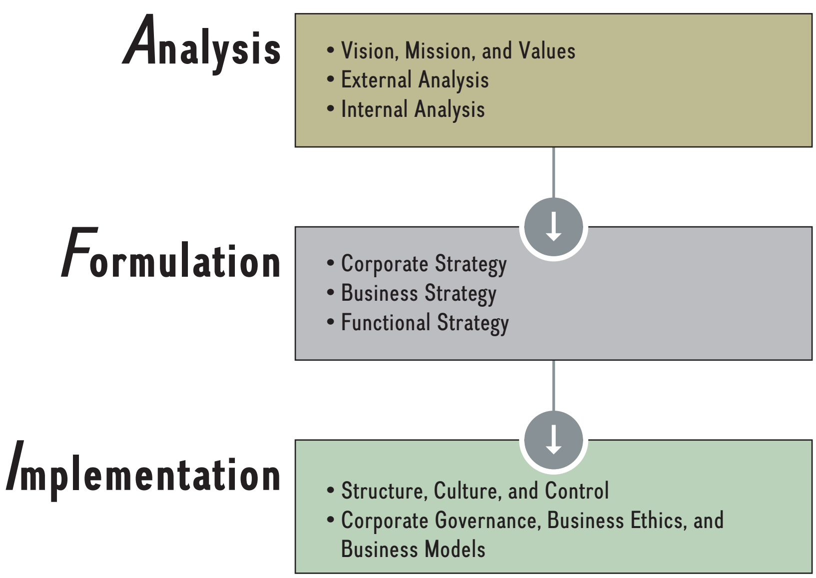
top-down strategic planning A rational, data-driven strategy process through which top management attempts to program future success.

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

Top-down strategic planning rests on the assumption that we can predict the future from the past. This approach works reasonably well when the environment does not change much, but it has some major shortcomings. Specifically, the formulation of strategy is separate from implementation, and thinking about strategy is separate from doing it. Information flows one way only: from the top down. In addition, we simply cannot know the future. Unforeseen events can make even the most scientifically developed and formalized plans obsolete. Moreover, strategic leaders' visions of the future can be downright wrong.

Sometimes strategic leaders impose their visions onto a company's strategy, structure, and culture from the top down to create a desired future state. Under its co-founder and

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



long-time CEO Steve Jobs, Apple was one of the few successful tech companies using a top-down strategic planning process.[50] Jobs felt that he knew best what the next big thing should be. Under his top-down, autocratic leadership, Apple did not engage in market research because Jobs firmly believed that "people don't know what they want until you show it to them."[51] In his well-researched, 700-page biography of Steve Jobs, Walter Isaacson presents Jobs' lessons in strategic leadership in 14 memorable aphorisms, including *push for perfection*, *tolerate only "A" players*, and *bend reality*.[52]

The traditional top-down strategy process served Apple well in its journey to becoming the world's first company to be valued at $3 trillion. Under Tim Cook, Jobs' successor as CEO, Apple's strategy process has become more flexible. The company is trying to incorporate the possibilities of different future scenarios and bottom-up strategic initiatives.[53]

SCENARIO PLANNING

Given that the only constant is change, should managers even try to strategically plan for the future? The answer is yes—but they also need to expect that unpredictable events will happen. Strategic planning in a fast-changing environment happens in a fashion similar to the way a fire department plans for a fire.[54] There is no way to know in advance where and when the next emergency will arise; nor can we know its magnitude in advance. Nonetheless, fire chiefs always consider the "what-if" scenarios, and they put in place contingency plans that address a wide range of emergencies and their different dimensions.

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

When engaging in **scenario planning,** managers also ask what-if questions. Like top-down strategic planning, scenario planning starts with a top-down approach to the strategy process. Top management envisions different scenarios to anticipate plausible futures and to derive strategic responses. For example, new laws might restrict carbon emissions or expand employee health care. Demographic shifts may alter the ethnic diversity of a nation, and changing tastes or economic conditions will affect consumer behavior. Technological advances may provide completely new products, processes, and services. How will any of these changes affect a firm, and how should it respond?

Scenario planning takes place at both the corporate and business levels of strategy. Typical scenario planning considers both optimistic and pessimistic futures. Managers then formulate strategic plans they could activate and implement if the envisioned optimistic or pessimistic scenarios begin to appear. For instance, strategy executives at UPS identified a number of issues as critical to shaping its future competitive scenarios: (1) artificial intelligence (AI), (2) being the target of a terrorist attack or having a security breach or IT system disruption, (3) large swings in energy prices, including gasoline, diesel, and jet fuel, and interruptions in the supply of these commodities, (4) fluctuations in exchange rates or interest rates, and (5) climate change.[55]

To model the scenario-planning approach, place the elements in the Analysis, Formulation, Implementation (AFI) Strategy Framework in a continuous feedback loop, where analysis leads to formulation, then to implementation, and then back to analysis. The goal is to create a number of detailed and executable strategic plans. These plans allow the strategic management process to be more flexible and more effective than the more static strategic planning approach with one master plan.

Exhibit 2.7 elaborates on this simple feedback loop to show the dynamic and iterative method of scenario planning. In the *analysis stage,* managers brainstorm to identify possible future scenarios. Input from several levels within the organization and from different functional areas such as R&D, manufacturing, and marketing and sales is critical. For example, UPS executives considered how they would compete if the price of a barrel of oil was $35,

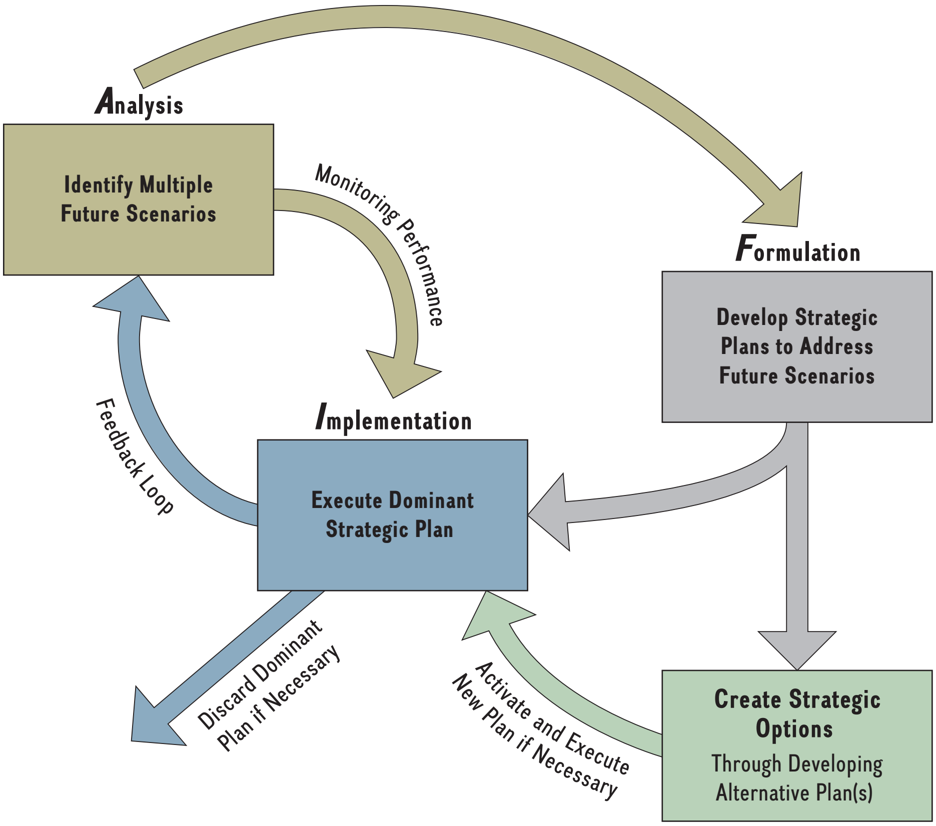


EXHIBIT 2.7

Scenario Planning within the AFI Strategy Framework

$100, or even $200. Strategic leaders may also attach probabilities (highly likely versus unlikely, or 85% likely versus 2% likely) to different future states.

It is imperative to consider negative scenarios carefully. For example, exporters such as Boeing, Harley-Davidson, and John Deere need to analyze how shifts in exchange rates will affect their profit margins. They might go through an exercise to derive different strategic plans based on large exchange-rate fluctuations of the U.S. dollar against major foreign currencies such as the euro, Japanese yen, or Chinese yuan. What would happen if the euro depreciated to below $1 per euro, or if the Chinese yuan depreciated rather than appreciated? How would Disney compete if the dollar were to appreciate so much as to make visits by foreign tourists to its California and Florida theme parks prohibitively expensive? Companies might also consider the implications of tariffs levied as the result of a trade war between the United States and another country, or the likely results of pandemic restrictions and disrupted supply chains.

BLACK SWANS AND SCENARIO PLANNING. The metaphor of a black swan describes the *high impact of a highly improbable event.* In the past, most people assumed that all swans are white, so when they first encountered black swans, they were surprised.[56] Strategic leaders need to consider how **black swan events** might affect their strategic planning. In the UPS scenario planning exercise, a terrorist attack and/or a complete security breach of its IT system are examples of possible black swan events. Looking at highly improbable but high-impact events allows UPS executives to be less surprised and more prepared if those events do occur.

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

Bernd Wolter/Shutterstock

Some examples of black swan events include the 9/11 terrorist attacks, the British exit from the European Union (Brexit), the European refugee and migrant crises (in 2015 in the wake of the Syrian civil war and in 2022 after Russia's invasion of Ukraine), and the Covid-19 pandemic. Although these events were highly improbable and thus unexpected, they all had a profound impact.

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

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

Even so, this was not the end of the story for BP, which was found to have committed "gross negligence" (reckless and extreme behavior) by a federal court. In addition, BP racked up another $8.5 billion in additional fines and other environmental costs. BP's total tab for the Gulf of Mexico disaster was $56 billion! After the exit of Tony Hayward, BP's new CEO, Bob Dudley, sold about $40 billion of the company's assets, turning BP into a smaller company that aims to become more profitable.

What should strategy leaders do about possible future black swan events and other unexpected circumstances? In the *formulation stage* of scenario planning, management teams develop different strategic plans to address possible future scenarios. Engaging in this what-if exercise forces managers to develop detailed contingency plans before events occur. Each plan relies on an entire set of analytical tools, which we will introduce in upcoming chapters. They capture the firm's internal and external environments when answering several key questions:

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

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

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

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

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

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

Critics of top-down and scenario planning argue that *strategic planning* is not the same as *strategic thinking.*[57] In fact, they argue that strategic planning processes are often too regimented and confining, and the processes lack the flexibility needed for quick and effective response.

Leaders engaged in a more formalized approach to the strategy process may succumb to an *illusion of control*, which refers to managers' inclination to overestimate their ability to control events.[58] Hard numbers in a strategic plan can convey a false sense of security. According to critics of strategic planning, for a strategy to be successful, it should be based on an inspiring and purpose-driven vision and not on hard data alone. They advise strategic leaders to focus on all types of information sources, including soft sources that can generate new insights, such as personal experience, deep domain expertise, or the insights of frontline employees. The important work, they argue, is to synthesize all available input from different internal and external sources into an overall strategic vision that guides the firm's strategy (as discussed in the section Vision, Mission, and Values).

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

Consider online retailing. In 1990, it was nonexistent. Today, almost all internet users have purchased goods and services online. As a total of all sales, online retailing was 16% in 2022 and is expected to double by 2030.[59] Given the success of Amazon as the world's leading online retailer, bricks-and-mortar companies such as Best Buy, The Home Depot, and even Walmart have all been forced to respond and adjust their strategies. Others, such as Kmart, Radio Shack, and even the once-venerable Sears, filed for Chapter 11 bankruptcy (a provision of the U.S. bankruptcy code that allows reorganization and restructuring of debts owed), while Circuit City, Borders, and others went out of business altogether (liquidation bankruptcy). Alibaba is emerging as the leading internet-based wholesaler connecting manufacturers in China to retailers in the West, as well as a direct online retailer.[60] Similarly, the ride-hailing services Uber, Lyft, Didi, and Grab are disrupting the existing taxi and limousine businesses in many metropolitan areas around the world. Having been protected by decades of regulations, existing taxi and limo services are scrambling to deal with the unforeseen competition. Many try to use the courts or legislative system to block the new entrants, alleging that ride-sharing services violate safety and other regulations. Another new *sharing economy* venture, Airbnb, is facing a similar situation. Airbnb is an online platform that allows users to list and rent lodging in residential properties.

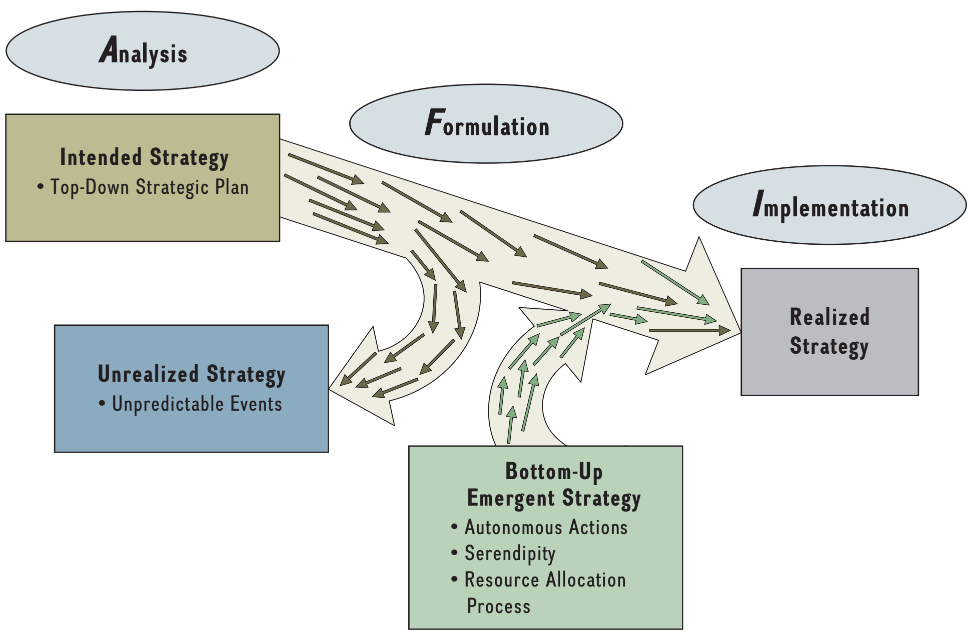
strategy as planned emergence Strategy process in which organizational structure and systems allow bottom-up strategic initiatives to emerge and be evaluated and coordinated by top management. Strategic initiatives can bubble up from deep within the organization through autonomous actions, serendipity, and resource allocation process.

The critics of more formalized approaches to strategic planning, most notably Henry Mintzberg, propose a third approach to the strategic management process. In contrast to the two top-down strategy processes discussed already, the third approach is a less formal and less stylized approach to strategy development.

To reflect the reality that strategy can be planned *or* emerge from the bottom up, Exhibit 2.8 shows a more integrative approach to managing the strategy process, one in which a firm's realized strategy is a combination of top-down strategic intent and bottom-up emergent strategies. Please note that even in **strategy as planned emergence**, the overall strategy process still unfolds along the AFI framework of analysis, formulation, and implementation. In strategy as planned emergence, organizational structure and systems allow bottom-up strategic initiatives to emerge and be evaluated and coordinated by top management.[61]

EXHIBIT 2.8

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



Amazon Prime Air is a planned future service that will deliver packages up to five pounds in 30 minutes or less using small drones. This strategic initiative was conceived and invented by a lower-level engineer at Amazon.

Johannes Schmitt-Tegge/dpa/Alamy Stock Photo

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

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

A strategic initiative is a key feature of the planned emergence model. A **strategic initiative** is any activity that a firm pursues to explore and develop new products and processes, new markets, or new ventures. Strategic initiatives can come from anywhere. They can emerge as a response to external trends or come from internal sources. In other words, strategic initiatives can be the result of top-down planning by executives, or they can emerge through a *bottom-up process* (or both). Many high-tech companies employ the planned emergence approach to formulate strategy. For example, Amazon Prime Air, the delivery-by-drone project at Amazon, was conceived and invented by a lower-level engineer at the company. Even relatively junior employees can come up with strategic initiatives that can make major contributions if the strategy process is sufficiently open and flexible.[62]

The arrows in Exhibit 2.8 represent different strategic initiatives. In particular, strategic initiatives can bubble up from deep within a firm through

- Autonomous actions.
- Serendipity.
- The resource-allocation process (RAP).[63]

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

Functional managers such as Diana, the Starbucks store manager featured in Strategy Highlight 2.2, are much closer to the company's final products, services, and customers than are the more removed corporate- or business-level managers. They also receive much more direct customer feedback. As a result, functional managers may start strategic initiatives based on autonomous actions that can influence the direction of the company. To be successful, these emergent strategies must be supported by top-level executives who believe that those strategies fit with the firm's vision and mission. That is, *internal champions* are often needed for autonomous actions to be successful. Diana's autonomous actions might not have succeeded or might have gotten her in trouble if she did not garner the support of a senior Starbucks executive who championed her initiative.

Although emergent strategies can arise in the most unusual circumstances, it is important to emphasize the role of top management teams. In the strategy-as-planned-emergence approach, executives need to decide which bottom-up initiatives to pursue and which to shut down. This critical decision is made on the basis of whether the strategic initiative fits with the company's vision and mission, and whether it provides an opportunity worth exploiting. Executives therefore play a critical role in the potential success or failure of emergent strategies because they determine how limited resources are allocated. After initial resistance, as

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

realized strategy Combination of intended and emergent strategy.

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

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

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

Strategy Highlight 2.2

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

M. Unal Ozmen/Shutterstock

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

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

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

You've probably guessed by now that we're talking about the Starbucks Frappuccino, which is now a multibillion-dollar product for Starbucks. At one point, this iced drink brought in more than 20% of Starbucks' total revenues, which stood at $30 billion in 2022.[64]

detailed in Strategy Highlight 2.2, the Starbucks executive team around CEO Howard Schultz fully supported the Frappuccino strategic initiative, providing the resources and personnel to help it succeed.

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

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

There are dozens of examples where serendipity had a major influence on the course of business and entire industries. The discovery of 3M's Post-it Notes and Pfizer's Viagra (first intended as a drug to treat hypertension) are well known. Less well known is the discovery of potato chips.[65] The story goes that in the summer of 1853, George Crum was working as a cook at the Moon Lake Lodge resort in Saratoga Springs, New York. A grumpy patron ordered the Moon resort's signature fried potatoes. These potatoes were served in thick slices and eaten with a fork as in the French tradition. When the patron received the fries, he immediately returned them to the kitchen, asking for them to be cut thinner. Crum prepared a second plate in order to please the patron, but this attempt was returned as well. The third plate was prepared by an annoyed Crum who, trying to mock the patron, sliced the potatoes sidewise as thin as he could and fried them. Instead of being offended, the patron was ecstatic with the new fries, and suddenly other patrons wanted to try them as well. Crum later opened his own restaurant and offered the famous "Saratoga Chips," which some customers took home as a snack to be eaten later. Today, PepsiCo's line of Frito-Lay potato chips is a multibillion-dollar business.

How do strategic leaders create a work environment in which autonomous actions and serendipity can flourish? One approach is to provide time and resources for employees to pursue other interests. For example, Google, the online search and advertising subsidiary of Alphabet, organizes the work of its engineers according to a 70-20-10 rule. The majority of the engineers' work time (70%) is focused on its main business (search and ads).[66] Google also allows its engineers to spend one day a week (20%) on ideas of their own choosing, and the remainder (10%) on total wild cards such as Project Tapestry, which focuses on the electric power grid with the goal of transitioning the current infrastructure to a resilient, zero-emission electricity system by developing computational tools that create a complete and dynamic picture of the grid, whether one nanosecond from now or ten years into the future.[67] Google reports that half of its new products and services, including Gmail, Google Maps, and Google News, have come from the 20% rule.[68] With the restructuring of Google into a corporation with multiple strategic business units, engineers spending their 10% time on total wild cards now do so within Google X, the company's research and development unit.[69]

RESOURCE-ALLOCATION PROCESS. A firm's **resource-allocation process (RAP)** determines the way it allocates its resources and can be critical in shaping its realized strategy.[70] Emergent strategies can result from a firm's RAP.[71] Intel Corp. illustrates this idea.[72] Intel was created to produce DRAM (dynamic random-access memory) chips. From the start, producing these chips was the firm's top-down strategic plan, and initially it worked well. Japanese competitors brought better-quality chips to the market at lower cost in the 1980s, threatening Intel's position and making its top-down strategic plan obsolete. However, Intel was able to pursue a strategic transformation because of the way it set up its RAP. In a sense, Intel was using functional-level managers to drive business and corporate strategy in a bottom-up fashion. Specifically, during this time, Intel had only a few fabrication plants (called "fabs") to produce silicon-based products. It would have taken several years and billions of dollars to build additional capacity and bring new fabs online.

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

With constrained capacity, Intel implemented the production-decision rule *to maximize margin-per-wafer start.* Each time functional managers initiated a new production run, they were to consider the profit margins for DRAM chips and for microprocessors, the "brains" of personal computers. The operations managers then could produce *whichever product* delivered the higher margin. By following this simple rule, frontline managers shifted Intel's production capacity away from the lower-margin DRAM business to the higher-margin microprocessor business. The firm's focus on microprocessors emerged from the bottom up, based on resource allocation. Indeed, by the time top management finally approved the de facto strategic switch, the company's market share in DRAM had dwindled to less than 3%.[73]

Here is another example: In the wake of the Covid-19 pandemic, car manufacturers noticed a positive side effect of their resource-allocation rule of maximizing profitability in production runs. Semiconductors were in short supply because orders had been canceled during the pandemic as economies were shut down. Given their limited supply of chips, carmakers stopped producing smaller vehicles, which have lower profit margins. Instead, they focused their RAP on making luxury cars, SUVs, and trucks. Although they produced many fewer cars, their profitability went up.[74]

Exhibit 2.9 compares and contrasts the three different approaches to the strategic management process: top-down strategic planning, scenario planning, and strategy as planned emergence.

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

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

(*continued*)

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

2.4 Strategic Decision Making

LO 2-8

Explain the causes of strategic dissonance and how to navigate strategic inflection points.

STRATEGIC INFLECTION POINTS

When discussing strategic intent, we noted that firms often fail to create inspiring stretch goals but rather focus on aligning strategy and action to meet the demands of the current situation. Although successful alignment between strategy and execution can bring a temporary advantage, it is unlikely to last, especially in a fast-moving environment. When a firm competes in a high-velocity environment such as technology, bioscience, or fashion, a static fit leads to a strategic misfit because the firm's actions are likely to lag behind competitive realities. In other words, the competitive environment is changing faster than the firm.

For instance, Microsoft was late in responding to the shift away from PC-based computing to mobile devices, and it lost the standards battle to Apple (iOS) and Google (Android). Blackberry RIM and Nokia, former market leaders in cell phones, were late in recognizing that the iPhone drastically altered the notion of what a phone is and what it can do. The Coca-Cola Company was late in understanding the market shift away from carbonated sodas to healthier options such as bottled water. Traditional retailers initially did not recognize the threat of ecommerce. The legacy carmakers were late in comprehending the industry shift to electrification and autonomy. The old-line media companies and Hollywood studios initially dismissed the shift to streaming on demand. And the list goes on.

strategic dissonance Occurs when a firm's static fit no longer matches competitive realities.

strategic inflection point A turning point in determining the future of company; the moment when the fundamentals of a business and its industry are about to change.

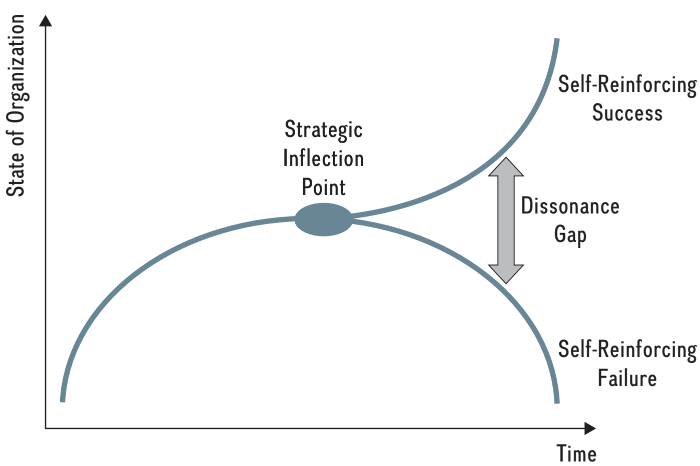
When a firm's static fit no longer matches competitive realities, **strategic dissonance** emerges.[75] Strategic dissonance is present when a firm's current strategy no longer provides the expected outcomes. Here, old models of competing for advantage no longer work and strategic leaders often experience *cognitive dissonance* between the contradictory beliefs they hold in their minds and the evidence on the ground. Cognitive dissonance results when strategic leaders attempt to make sense of the tension between their mental models and new facts and data. They firmly believe they know how to run the business because they have been successful in the past, but current realities no longer square with their beliefs.

The onset of strategic dissonance indicates that the firm is at a critical junction where dramatic changes are about to occur. A **strategic inflection point** is a turning point in determining the company's future. It is the moment when the fundamentals of a business and its industry are about to change. The decisions that leaders take when traversing a strategic inflection point are critical because they decide whether the firm will capitalize on the opportunity that a strategic inflection point provides to create forward momentum, or if the firm has started to decline.

Addressing strategic inflection points is a difficult leadership challenge because they require fundamental changes to the firm's strategy. Formulating and implementing a new strategy at a strategic inflection point is made even more challenging by the fact that company leaders are often late in comprehending that their cognitive dissonance is not due to faulty information about reality. Instead, it results because their belief system is no longer a good fit with the new circumstances. Addressing strategic dissonance, therefore, requires leaders to adapt their theory of how to compete, often in radical ways.

Another difficulty in successfully navigating a strategic inflection point is the fact that financial results often lag and the company does not feel a negative impact until much after a strategic inflection point. For instance, Microsoft was hugely profitable for a decade or so after mobile operating systems began gaining traction in the market. The optimal time to address a strategic inflection point is when strategic dissonance first emerges. At that point, the firm is still on top of its game and has the resources to address this fundamental challenge. Once a firm starts to decline, resources become scarce, morale drops, and failure results from a self-reinforcing downward spiral.

EXHIBIT 2.10 Strategic Inflection Point



Source: Author's creation based on Burgelman, R.A., and A.S. Grove (1996), Strategic dissonance, *California Management Review* 38(2): 8-28.

Exhibit 2.10 captures this discussion. The vertical axis denotes the state of the organization, with high indicating success. The horizontal axis indicates time. Because environments are always dynamic, all organizations will encounter a strategic inflection point. The more the convictions of strategic leaders deviate from reality, the larger the *dissonance gap*. The greater the dissonance gap, the more difficult it is to change course. If strategic leaders are able to make fundamental strategy changes early on, there is a high likelihood that the organization will experience self-reinforcing success by going from strength to strength. If the firm fails to navigate a strategic inflection point, the result will be self-reinforcing failure.

In ChapterCase 2, we noted that Mark Zuckerberg initiated a strategic pivot of

Facebook toward the metaverse, along with a rebranding of the company as Meta. While some critics saw this pivot as a PR ploy to distract the public from the negative coverage the company was experiencing following the revelations in the leaked "Facebook files," a more likely explanation is that Zuckerberg realized that the computing industry is experiencing a strategic inflection, with the metaverse as the next frontier. Because Meta is the only large tech company still led by its founder, Zuckerberg was able to declare a strategic pivot toward the metaverse at a time when the old Facebook was still on top of its game in terms of profitability. A founder, rather than a hired executive, is much more likely to initiate such a consequential transition when the company is still strong. In addition, a founder has the freedom to prioritize existential risks over financial ones, even when shareholders revolt and the value of the company drops by more than 50% (or some $550 billion) in the few months after the strategic pivot is announced. A founder also has the prerogative to spend tens of billions of dollars a year on funding projects rather than buying back shares or paying out dividends to keep investors happy.

Zuckerberg is willing to make huge strategic commitments so that his company will become a leader in the metaverse. Ideally, he wants Meta to establish a new standard for computing in the metaverse. Creating the dominant operating system of the metaverse will allow Zuckerberg to control the rules of the game. Other companies, such as Apple or Google, will no longer be able to lock out his company's social media apps as they did with their restrictions on how much information Facebook can gather from phone users. Zuckerberg's strategic pivot is a huge bet, but it may result in Meta becoming the dominant computing platform in the metaverse.

TWO DISTINCT MODES OF DECISION MAKING

LO 2-9

Describe and evaluate the two distinct modes of decision making.

Although we like to believe that we make rational decisions informed by data and facts, especially in business, the truth is that human beings are fallible and our decision making is fraught with cognitive limitations and biases. Herbert Simon, a Nobel Laureate in economics, developed the **theory of bounded rationality**, which posits that rather than optimizing when we are faced with decisions, we tend to "satisfice"—a portmanteau of the two words *satisfy* and *suffice*.[76] Simon asserts that cognitive limitations prevent us from appropriately processing and evaluating each piece of information that we encounter.

theory of bounded rationality When individuals face decisions, their rationality is confined by cognitive limitations and the time available to make a decision. Thus, individuals tend to "satisfice" rather than to optimize.

cognitive limitations Constraints such as time or the brain's inability to process large amounts of data that prevent us from appropriately processing and evaluating each piece of information we encounter.

Cognitive limitations tend to lead us to choose the "good enough option" that satisfies our immediate needs, rather than to search for an optimal solution, perhaps because we do not have all the information we need to arrive at an optimal decision. However, it can be argued that online search engines such as Google, and AI assistants such as Apple's Siri and Amazon's Alexa, now give us access to a wealth of information—perhaps too much information. Indeed, today's strategic leaders generally face the issue of *too much* information rather than *too little* information. In making decisions, they experience *information overload*, especially when faced with constraints such as time. This combination of conditions results in *a wealth of information but a scarcity of attention,* which hinders their ability to make optimal decisions. One of the strengths of strategy frameworks is that they allow managers to cut through a lot of the noise and to focus on the signal—that is, the most important pieces of information.

Strategic decisions are frequently made using simple heuristics and rules of thumb rather than based entirely on rational thinking. In other words, decision makers often use tacit (or implicit) knowledge rather than explicit knowledge. Thus, by gaining professional experience and by viewing the complex and uncertain world through the lens of theory and frameworks, managers can become better equipped and faster at making sound strategic decisions.

EXHIBIT 2.11 Two Distinct Modes of Decision Making

System 1	System 2
Fast	Slow
Unconscious	Conscious
Automatic	Effortful
Everyday, Snap Decisions	Complex, Analytical Decisions
Error Prone, Higher Likelihood of Biases	Reliable, Lower Likelihood of Biases

Source: Author's creation based on Kahneman, D. (2011), *Thinking, Fast and Slow* (New York: Farrar, Straus and Giroux).

In his popular book *Thinking, Fast and Slow,* Daniel Kahneman, also a Nobel Laureate in economics, describes the research in **behavioral economics** that he and his late collaborator Amos Tversky spent decades conducting.[77] They posit that our decision making is governed by two different systems. **System 1** is the brain's default mode. It is the gut reaction we experience when we see something beautiful, and it is the confidence we feel while driving down a stretch of highway that we've driven along a thousand times before. The highway is so familiar that we feel as though we can drive it on autopilot. We like System 1, and we use it most of the time because it is fast, which leads to "snap judgments."[78] It is efficient and automatic, and therefore it requires little if any attentional energy.

In contrast, **System 2** is logical, analytical, and deliberate. Because logical and analytical thinking consumes much more of our brain's energy, this system of decision making tends to be slower. Making decisions is a challenge because the brain is already energy hungry. While it comprises only 2% of our body weight, it consumes over 20% of our energy. Exhibit 2.11 compares some of the key characteristics of System 1 and System 2.

We tend to rely on System 1 when we are tired or annoyed. For example, assume your goal is to lose 15 pounds. It is the end of a long day and you are exhausted and hungry. You stop at the market intending to pick up a few healthy items for dinner. Instead, you find yourself wandering to the frozen-food aisle and reaching for a pint of Häagen-Dazs ice cream. In this situation, you are activating System 1 precisely because you're exhausted. The brain energy required to keep System 1 in check, and to activate System 2, has already been spent as you moved throughout the course of your day working, studying, or both. Had System 2 been in charge, you would have opted for a salad, or some other healthy option, instead of a pint of ice cream.

COGNITIVE BIASES AND DECISION MAKING

Along with cognitive limitations, human beings are prone to **cognitive biases**, which lead to systematic errors in decision making and interfere with rational thinking. Many of our cognitive biases result from System 1–governed thinking. Research in behavioral economics has identified a host of cognitive biases that can lead to systematic errors in decision making: illusion of control, escalating commitment, confirmation bias, reason by analogy, representativeness, and groupthink.[79] In the following sections we explain the most common biases that can affect strategic leaders' thinking. Creating awareness of the sources of the systematic

behavioral economics A field of study that blends research findings from psychology with economics to provide valuable insights showing when and why individuals do not act like rational decision makers, as assumed in neoclassical economics.

System 1 One of two distinct modes of thinking used in decision making. It is our default mode because it is automatic, fast, and efficient, requiring little energy or attention. System 1 is prone to cognitive biases that can lead to systematic errors in our decision making.

System 2 One of two distinct modes of thinking used in decision making that applies rationality and relies on analytical and logical reasoning. Thus, it is an effortful, slow, and deliberate way of thinking.

cognitive biases Obstacles in thinking that lead to systematic errors in our decision making and interfere with our rational thinking.

errors that can negatively impact strategic decision making allows managers to put some safeguards in place for overcoming them and, thus, make better, more rational decisions.

ILLUSION OF CONTROL. One of the more common biases (mentioned briefly earlier in this chapter) is the **illusion of control,** which is the tendency to overestimate our ability to control events.[80] Put simply, the illusion of control is the belief that you control things that you do not. Successful individuals such as CEOs and other top-level executives are highly prone to the illusion of control because they tend to attribute their success to their own abilities.

illusion of control A cognitive bias that highlights people's tendency to overestimate their ability to control events.

We can see an example of the illusion of control in the relationship between air traffic controllers and pilots.[81] Some air traffic controllers observed that after they complimented pilots with phrases such as "nice landing," the next time these same pilots landed an aircraft in the same airport, the landing was not as good. Conversely, when air traffic controllers expressed that the landings were not good (e.g., "You really missed the mark on that one"), the next set of landings was better. Based on these observations, the air traffic controllers formed the mistaken belief that their comments influenced the quality of the landings. They hypothesized that complimenting pilots for good landings would result in pilot complacency and therefore lead to subsequent poor landings. They also hypothesized that criticizing seemingly complacent pilots for sloppy landings would result in pilot improvement and therefore lead to subsequent better landings.

Although this reasoning made perfect sense to the air traffic controllers and resulted in their providing mostly negative feedback to pilots, a more likely explanation is simply that a *regression to the mean* is taking place. If we assume a normal (bell-shaped) distribution and the landing under consideration was perfect (thus in the far right tail of the distribution), then the probability that the pilots' next landing will not be as perfect is nearly 100%. Conversely, if the pilot team put down a sloppy landing (far left tail of the distribution), then the likelihood that the next landing will be better is close to 100% also. In sum, the air traffic controllers were under the illusion that they could directly influence the quality of the pilots' landings. In actuality, they were observing the regression-to-the-mean phenomenon.

In The Strategic Management Process section, we highlighted that managers who implement a formalized, top-down strategy process frequently succumb to the illusion of control. Why? They tend to rely on hard data from the past to forecast the future success of their organization. Such thinking is flawed because the past often does not predict the future. The only constant is change. When facing strategic inflection points, therefore, leaders are susceptible to the illusion of control.

ESCALATING COMMITMENT. An **escalating commitment** is another common cognitive bias. It occurs when decision makers continue to support and invest in a project despite receiving feedback that it is unlikely to succeed. Typically, significant time and financial resources have already been committed to the project.[82] Rather than ignoring the prior resources already spent (that is, the *sunk costs*) and shut the project down, which would be the rational decision, the strategic decision makers commit more and more resources to a failing course of action ("doubling down"). The most rational approach would be to ignore the sunk costs and consider any future decisions with a clean-slate approach. Although this approach may seem a bit counterintuitive, it is the most rational approach when making strategic decisions. Nonetheless, managers may be reluctant to use this approach because of *loss aversion;* they feel that they need to "recover" the investments already made.

escalating commitment A cognitive bias in which an individual or a group faces increasingly negative feedback regarding the likely outcome from a decision, but nevertheless continues to invest resources and time in that decision, often exceeding the earlier commitments.

An *escalating commitment to a failing course of action* is often observed in R&D projects. For example, Motorola spent billions of dollars and many years engineering its Iridium project in the hopes that it would eventually be successful.[83] Iridium was an ill-fated, satellite-based telephone system that Motorola attempted to commercialize in the 1990s. Despite clear evidence that an Earth-based cellular telephone network was going to be much more successful because it was less expensive to deploy and more affordable for the end consumer, Motorola continued investing billions of dollars in its Iridium project for more than a decade. For the project to work, several dozen satellites needed to be launched into space at an exorbitant expense. And even though Motorola executives knew early on that satellite-based telephone systems would not work in buildings and cars—two things that most businesspeople rely on—Motorola kept on spending. Clearly, Motorola's strategic decision makers fell prey to escalating commitment; although it was apparent that the project was failing commercially, executives persisted in "throwing good money after bad." Failing to consider the *opportunity costs* of the investment (that is, the value of the next-best alternative use), Motorola executives wasted scarce R&D dollars that could have been put to use much more effectively elsewhere.

confirmation bias A cognitive bias in which individuals tend to search for and interpret information in a way that supports their prior beliefs. Regardless of facts and data presented, individuals will stick with their prior hypothesis.

CONFIRMATION BIAS. **Confirmation bias**, also called *prior hypothesis bias,* is the tendency of individuals to search for information that confirms their existing beliefs. When confronted with evidence that contradicts these beliefs, they either ignore the evidence or interpret it such that it supports their beliefs. People tend to cling, in particular, to their prior beliefs about a relationship between two variables (e.g., market share is the key to profitability) or how the world works in general.

Confirmation bias can occur when earlier experience appears to support a prior hypothesis. For example, strategic decision makers at Intel might have believed that the key to continued success is to develop yet another faster chip for personal computers (PCs) using the same x86 architecture as in the past. This prior hypothesis is based on the observation that this incremental innovation strategy was successful for 30 years (starting with the 8086 chip in 1978 and continuing through the Intel Atom chip in 2008). However, while the strategic managers at Intel clung to their prior hypothesis of how to sustain a competitive advantage, the external environment shifted away from personal computing to mobile computing—a change for which Intel was ill prepared. Consequently, it lost out to ARM, Nvidia, and other mobile chip makers and is now playing catch-up.

reason by analogy A cognitive bias in which individuals use simple analogies to make sense out of complex problems.

REASON BY ANALOGY. **Reason by analogy** is the tendency to use simple analogies to make sense out of complex problems. Analogies allow us to examine and compare a complex problem to something familiar, even though the two objects or ideas might actually be very different from each other. This is the primary drawback of reason by analogy: What appears to be similar on the surface may actually be very different on a deeper level.

For example, Walmart executives' decision making was affected by reason by analogy when they first entered the Canadian market in 1994. Walmart attempted to use the same cost-leadership strategy that was so successful in the United States (opening large supercenters in rural areas, implementing sophisticated IT systems, and hiring minimum-wage employees, for instance). Walmart's managers looked at Canada and saw an opportunity in the country's rural areas, believing the regions strongly resembled the rural areas in the United States. They saw other similarities, too: English is spoken in both countries, and Canada is a major trading partner of the United States. Yet, despite these similarities and perceived advantages, Walmart struggled in the Canadian market and lost money. Walmart executives discovered the hard way that the Canadian market is quite different from the U.S. market in such key areas as customers, preferences, and culture.

representativeness A cognitive bias in which conclusions are based on small samples, or even from one memorable case or anecdote.

REPRESENTATIVENESS. **Representativeness** is the cognitive bias of drawing conclusions based on small samples, or even from one memorable case or anecdote. Relying on this simple heuristic violates the *law of large numbers*, which states that a large enough sample is necessary to calculate a value that is close enough to the expected value that would be observed across all possible observations.

Many internet entrepreneurs and venture capitalists succumbed to a representativeness bias during the internet boom in the 1990s. They saw the early success of Amazon, eBay, and Yahoo and decided that they, too, could build a successful online business. Most of these entrepreneurial ventures failed in the dot-com crash of 2001, which destroyed billions in venture capital investments. Today a similar phenomenon is being observed in the app economy, in which many young entrepreneurs are directing their energies. Their reasoning based on representativeness bias goes as follows: "We will be the Uber of X, where X is any other category than ride-hailing" or "We will be the Airbnb of Y, where Y is any other category than hospitality services."

Cognitive biases creep in because Uber's experiences cannot be generalized to other markets. Specifically, Uber is an idiosyncratic service offered in an industry that was ripe for disruption at a particular point in time. Hiring a ride from point A to point B is a well-established commoditized service with high purchasing frequency and a true on-demand component. In addition, fortunate timing leads to "winner-take-all" or at least "winner-take-most" of the available market such as a large metropolitan area. All of these characteristics are idiosyncratic to Uber's success and are less likely to be present in markets where entrepreneurs are trying to apply Uber's business model to a different service. Beyond idiosyncracies, which highlight the problem of representativeness, simply exporting Uber's business model to other potential services may also be prone to another related bias discussed: reason by analogy.

GROUPTHINK. The cognitive limitations discussed so far tend to afflict individuals. One important cognitive bias that can affect entire teams is **groupthink,** the situation in which opinions coalesce around a leader and individuals do not critically evaluate and challenge that leader's opinions and assumptions.[84] We have seen groupthink occur in military history. For instance, in 1812, Napoleon Bonaparte's commanders endorsed his idea to invade Russia, convinced that his strategy was well thought out. The commanders' unquestioned conformity to Napoleon's beliefs led to disastrous consequences. Their groupthink, combined with Napoleon's hubris, led to one of the most devastating military defeats in history.[85] Napoleon began his campaign with almost 700,000 soldiers (the largest army ever amassed at that point in history), but only about 20,000 lived to return home.

groupthink A situation in which opinions coalesce around a leader without individuals critically evaluating and challenging that leader's opinions and assumptions.

In business, strong leaders tend to set the culture of their organizations. This process is reinforced by leaders' preference to recruit, retain, and promote employees who subscribe to the same values, which, in turn, attracts more people with similar values to the organization.[86] Although this process strengthens an organization's culture and makes it more distinct, it also creates a more homogeneous organization, making its employees vulnerable to groupthink.

Groupthink frequently comes into play when executives consider major strategic decisions such as takeovers. For example, in 2015 General Electric (GE) paid close to $20 billion to acquire Alstom, a French industrial conglomerate.[87] Then-CEO Jeffrey Immelt and his team of hand-selected lieutenants were certain that acquiring Alstom was needed to transform the flagging GE. They further convinced themselves that they could integrate Alstom into GE and manage the combined entity successfully. Their thinking went along these lines: Because GE produces the world's best business leaders who can manage any situation, who other than GE could pull off this acquisition successfully?

Despite many red flags, such as the apparent overpayment for the target and massive regulatory pushback, as well as subsequent deep concessions by GE, Immelt pushed the acquisition through.[88] (Persisting in the face of contradictory data and massive pushback also suggests an *escalating commitment to a failing course of action* by GE senior leaders.) Just three years later, GE had to write off more than $20 billion in assets from its Power

Division, most of it caused by the failed Alstom acquisition. After a 16-year tenure as CEO, Jeffrey Immelt was replaced. His successor, John Flannery (another GE insider), lasted 14 months on the job before he too was fired. GE, once the most valuable company in the United States with $600 billion in market capitalization in mid-2000 (equivalent to $1 trillion in 2022, inflation adjusted), was valued at a mere $48 billion in 2020. GE had lost 90% of its market value, or more than $550 billion.

In sum, cohesive, nondiverse groups are highly susceptible to groupthink, which can lead to flawed decision making with potentially disastrous consequences.

LO 2-10

Compare and contrast devil's advocacy and dialectic inquiry as frameworks to improve strategic decision making.

HOW TO IMPROVE STRATEGIC DECISION MAKING

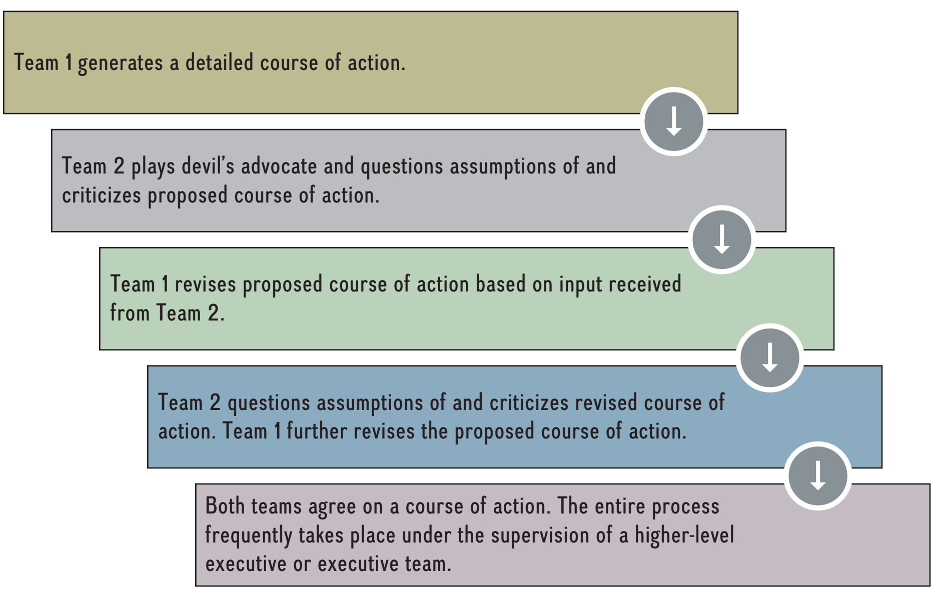
How can strategic leaders ensure that they base their decisions on relevant and critical information, while overcoming groupthink and the cognitive biases that can affect all of us? Two techniques have proven effective at improving strategic decision making: *devil's advocacy* and *dialectic inquiry*.[89]

devil's advocacy
Technique that can help to improve strategic decision making; a key element is that of a separate team or individual carefully scrutinizing a proposed course of action by questioning and critiquing underlying assumptions and highlighting potential downsides.

Devil's Advocacy. The **devil's advocacy** decision framework begins with one team generating a detailed course of action. Next, a second team plays devil's advocate and challenges the proposal generated by Team 1. Team 2 questions the underlying assumptions made in the proposal and highlights anything that might go wrong in the proposed course of action, thus illuminating potential downsides. In a third step, Team 1 then revises its initial proposal based on the input and suggestions received from the devil's advocate (that is, Team 2). This process is then repeated one more time. In the final step, both teams agree on a course of action. The entire process frequently takes place under the supervision of a higher-level executive or executive team. Exhibit 2.12 summarizes the devil's advocacy framework to enhance strategic decision making.

Amazon uses the devil's advocacy approach when making strategic decisions. Founder and long-time CEO Jeff Bezos banned all PowerPoint presentations and requires each manager to write a "narrative memo" no longer than six pages to which others are expected to respond as devil's advocates. These written exchanges become the documents referenced when Amazon's management teams meet to make decisions.[90]

EXHIBIT 2.12
How to Use a Devil's Advocate to Improve Strategic Decision Making



Dialectic Inquiry. In contrast to the devil's advocacy decision framework, which begins with a team generating one detailed course of action, in the **dialectic inquiry** framework two teams each generate a detailed course of action. In Step 1, Team 1 generates a detailed course of action (*thesis*) and Team 2 responds to Team 1 by generating a second, alternate detailed course of action (*antithesis*). In Step 2, a debate in front of higher-level executives takes place where both *thesis* and *antithesis* are presented and discussed. In the final step, the executive team synthesizes both proposals into a compromise plan of action and decides whether to adopt either proposal or neither of them.

Exhibit 2.13 summarizes the dialectic inquiry framework as another option to enhance strategic decision making.

EXHIBIT 2.13 How to Use Dialectic Inquiry to Improve Strategic Decision Making

Step 1: Thesis and Antithesis	
Team 1 generates a detailed course of action (Thesis)	Team 2 generates a detailed but alternative course of action (Antithesis)

↓

Step 2: Debate	
Team 1 presents proposal to higher-level executive team	Team 2 presents alternative proposal to higher-level executive team

↓

Step 3: Synthesis
Higher-level executive team takes one of three courses of action: adopts neither Team 1's nor Team 2's proposal, adopts either proposal, or adopts a synthesis (some combination of both proposals)

2.5 Implications for Strategic Leaders

Executives whose vision and decisions enable their organizations to achieve competitive advantage demonstrate *strategic leadership.* Effective strategic leaders use position, informal power, and influence to direct the activities of others when implementing the organization's strategy. To gain and sustain a competitive advantage, strategic leaders need to put an effective *strategic management process* in place. An important first step in crafting an effective strategic management process is to articulate an inspiring and purpose-driven vision and mission backed up by ethical core values. *Customer-oriented* or *problem-defining* vision statements are often correlated with firm success over long periods of time because they allow firms strategic flexibility to meet changing customer needs and exploit external opportunities.

Another important implication of our discussion is that all employees should feel invested in and inspired by the firm's purpose and vision. Companies use different tactics to achieve such commitment. Some firms annually invite all employees to review and revise the statement of firm values; others ask employees to rank themselves, their departments, and management on success relative to the vision and mission. Belief in a company's vision and mission motivates its employees.

Strategic leaders, moreover, need to design a process that supports strategy formulation and implementation. They have three options in their strategic toolkit: top-down strategic planning, scenario planning, and strategy as planned emergence. Each of these options has its strengths and weaknesses (see Exhibit 2.9). Strategic leaders also need to consider the rate of change and firm size, two factors that affect the effectiveness of a chosen strategy process. The rate of change, internally and externally, can suggest the more useful planning approach. In a slow-moving and stable environment, top-down strategic planning might be the most effective. In a fast-moving and changeable environment, strategy as planned emergence might be the most effective. Larger firms tend to use either a top-down strategic planning process or scenario planning. Smaller firms may find it easier to implement strategy as planned emergence when feedback loops are short and they have the ability to respond quickly.

dialectic inquiry
Technique that can help to improve strategic decision making; key element is that two teams each generate a detailed but alternate plan of action (thesis and anti-thesis). The goal, if feasible, is to achieve a synthesis between the two plans.

For instance, a nuclear power provider such as Framatome in France, which supplies over 75% of the country's energy with the long-term backing of the state, might do well using a top-down strategy approach. Consider the issue of disaster planning. Nuclear accidents, while rare, have tremendous impact as witnessed in Chernobyl, former USSR (now Ukraine), and Fukushima, Japan, so power providers need to be prepared. Nuclear accidents are *black swans,* low-probability events with high impact. Framatome might use scenario planning to prepare for such a black swan event. Contrast this environment with fast-moving environments. Internet-based companies such as Airbnb, Alibaba, Alphabet, Amazon, Microsoft, Uber, and Zoom tend to use strategy as planned emergence. In this process, every employee plays a strategic role. When a firm uses top-down planning or scenario planning, lower-level employees focus mainly on strategy implementation. As the examples in this chapter have shown, however, *any employee,* even at the entry level, can have great ideas that might become *strategic initiatives* with the potential to transform companies.

Over time, all businesses will experience *strategic inflection points.* A strategic inflection point is the moment when the fundamentals of a business are about to change. The decisions that strategic leaders take when navigating strategic inflection points are critical because they decide whether the firm will capitalize on the opportunity provided or if the firm has started its decline.

Even the best-designed strategic management process will fail if strategic leaders are unable to use the information at their disposal. But, our *rationality is bounded.* That is, although many of us attempt to be rational, we are unable to process a vast amount of information in real time. Individuals are not (yet) cyborgs, after all. Furthermore, every individual, even the most astute strategic leader, is susceptible to a host of *cognitive biases* that lead to systematic errors in our decision making. Thus, it is imperative that strategic leaders put in place safeguards, such as *devil's advocacy* and *dialectic inquiry,* to improve strategic decision making.

The conclusion of our discussion of the strategic management process marks the end of the "getting started" portion of the Analysis, Formulation, Implementation (AFI) Strategy Framework (see Exhibit 1.4). The next three chapters cover the *analysis* part of the framework. In Chapter 3, we begin by studying external analysis before studying internal analysis (Chapter 4) and shared value and competitive advantage (Chapter 5).

CHAPTER**CASE 2** Part II

The Zuckerberg/Sandberg leadership duo has created the most successful social network ever. When Sheryl Sandberg joined Facebook in 2008, her main priority was to develop a business model from which Facebook (a subsidiary of Meta Platforms) could make money. In short, her task was to build a big advertising business. Sandberg relied on the same playbook that she had used so successfully at Alphabet's Google. The first step was to create a large user base—Mark Zuckerberg and his team of computer scientists excelled in this area.

Facebook's focus on user growth began shortly before its initial public offering in 2012. In a fateful meeting of top executives and lead product developers, Sandberg showed that revenues were flat and user growth was slowing considerably. For a social media company to grow, she said, it must pursue a business model that provides free services to the end-user but charges advertisers for placing online ads. Sandberg admonished the lead product developers, saying "things had to change" and "we have to do something."[91] As one of the software engineers present at the meeting recalls,

Ex-Facebook product manager and whistleblower Frances Haugen severely criticized the social media company and its leadership in her testimony before the U.S. Congress.

Lenin Nolly/SOPA Images via ZUMA Press Wire/Alamy Stock Photo

"We needed to pull out all of the stops and experiment way more aggressively with user engagement with the goal to make money."[92] The marching orders were clear: Drive exponential growth and user engagement while keeping costs down. Software engineers and product developers quickly learned that polarizing news and microtargeting were key to increasing user engagement and driving future growth.

The second step was to gather as much personal data as possible from Facebook's users, friends, and activities on the open web. Facebook excelled in this area as well. It purchased additional personal data from data brokers and consumer credit reporting companies. From these data, Facebook gathered a wide range of personal information: what each person buys, where each lives, where each works, how much money each makes, each person's traffic patterns, family activities, likes and dislikes, movies watched, restaurants dined at, and much more. Most people are unaware that so many personal data are being collected.

The third step was to place microtargeted ads using a proprietary algorithm. Facebook managed to collect a breadth of fine-grained and high-quality user data, the best in the industry. It uses these data to develop unique profiles. Advertisers relied on these profiles to place their microtargeted ads. For access to these accurate individual profiles, advertisers ranging from consumer product companies to presidential campaigns were willing to pay a premium price. Facebook's business model of offering free services to end users while allowing advertisers to place finely targeted ads is hugely profitable. Indeed, almost all of Meta's profits (97% of $120 billion) come from ads.

Nonetheless, Meta's Facebook appears to be in a deep crisis and is struggling to maintain its reputation. It has lost users' trust and legitimacy among many stakeholders, including the media, politicians, and regulators in the United States and Europe. Demands to regulate the social media platform more closely are gathering steam. User engagement has fallen, and the company's valuation dropped by $550 billion in the first six months after Facebook rebranded itself as Meta.

What led to this crisis? First and foremost, user privacy has become a growing concern. Facebook has long been criticized for alleged lax handling of user information and an opaque privacy policy. In 2018, a whistleblower revealed that Cambridge Analytica, a political consulting firm, used Facebook data from millions of users and their friends without their consent to create microtargeted political advertising campaigns during the 2016 U.S. presidential election.

Second, Facebook is more of a news organization than a social network, which has become a major issue in the era of fake news and misinformation concerning vaccinations and other politically charged topics. Roughly two-thirds of Americans of all ages (and a higher percentage of youth) get their news and other information from social media sites. Critics, therefore, want Facebook to demonstrate a greater degree of editorial oversight, similar to the oversight provided by traditional publishers. Facebook maintains that it is agnostic on news content and points to existing U.S. law (Section 230 of the Communications Decency Act), which states that internet firms are not liable for the content published on their platform.

Third, even early investors of Facebook allege that Zuckerberg and Sandberg responded too slowly to the various crises they were facing: Russian meddling in U.S. elections, unauthorized use of personal data by third parties, and Facebook's abdication of any responsibility for the content posted on its platform.

Fourth, *The Wall Street Journal* published a multipart series (in 2021) entitled "The Facebook Files," based on internal documents released by whistleblower Frances Haugen, a former Facebook engineer. The leaked documents show that Facebook had undertaken detailed research studies to understand the effects of its services on users. Research results indicate that the company's strategic leaders (including Zuckerberg and Sandberg) were fully aware of several adverse effects of its products on users.

Specifically, the research indicated that Instagram is harmful to some young users. In particular, negative body image issues due to social comparisons affected one in three teenage girls. The reports also document that the network's algorithms serve harmful content to its youngest users, including posts celebrating anorexia and self-harm. The leaked documents also shed light on many other problems, including the exemption of high-profile users such as politicians and celebrities from community rules of what can and cannot be posted, the promotion of anger-inducing content leading to further divisions even among family and friends, and the spreading of misinformation.

Finally, Meta's strategic leaders are being criticized for prioritizing exponential growth over user safety. Critics allege that Meta's executives failed to consider the potential downsides of creating an information platform for 3 billion people. Many have equated the social network to "a digital nation-state" profiting from "surveillance capitalism."

As a result of these various crises, Sheryl Sandberg stepped down as Meta's second in command (in 2022), while remaining on the board of directors. Critics now fear that things could get much worse if Zuckerberg's vision of the metaverse comes true—if Meta succeeds in providing fully immersive user experiences and its operating system defines the rules of the metaverse.[93]

Questions

1. What challenges (as detailed in ChapterCase2 Part I and Part II) is Meta Platforms facing? How should Mark Zuckerberg deal with each of them? List the challenges and make specific recommendations for addressing them.
2. Compare and contrast the strategic leadership of Mark Zuckerberg and Sheryl Sandberg (who stepped down as Meta's COO in 2022, while remaining on the board of directors). Which qualities of each strategic leader stand out to you, and why? Where would you place each individual on the Level-5 pyramid for strategic leaders (see Exhibit 2.2), and why? Is either of them an effective strategic leader? Explain your answers.
3. Given an alleged leadership crisis at Meta Platforms, should Mark Zuckerberg be replaced? Why or why not? Explain your answers.
4. When Mark Zuckerberg announced that Facebook is now Meta, U.S. Representative Alexandria Ocasio-Cortez (@AOC) reacted on Twitter, saying: "Meta as in, 'we are a cancer to democracy metastasizing into a global surveillance and propaganda machine for boosting authoritarian regimes and destroying civil society ... for profit!'" Do you agree or disagree with her assessment? Explain.

TAKE-AWAY CONCEPTS

This chapter examined the role strategic leaders play, delineated different processes to create strategy, and outlined the different cognitive biases that can negatively impact strategic decision making and what managers can do to improve decision making. We summarize the discussion in the following learning objectives and related take-away concepts.

LO 2-1 / Explain the role of strategic leaders and what they do.

- Executives whose vision and decisions enable their organizations to achieve competitive advantage demonstrate strategic leadership.
- Strategic leaders use formal and informal power to influence the behavior of other organizational members to do things, including things they would not do otherwise.
- Strategic leaders can have a strong (positive or negative) performance impact on the organizations they lead.

LO 2-2 / Outline how you can become a strategic leader.

- To become an effective strategic leader, you need to develop skills to move sequentially through five leadership levels: highly capable individual, contributing team member, competent manager, effective leader, and executive (see Exhibit 2.2).
- The Level-5 strategic leadership pyramid applies to both distinct corporate positions and personal growth.

LO 2-3 / Compare and contrast the roles of corporate, business, and functional managers in strategy formulation and implementation.

- *Corporate executives* must provide answers to the question of *where to compete,* whether in industries, markets, or geographies, and *how to create synergies* among different business units.
- *General managers* in strategic business units must answer the strategic question of *how to compete* in

order to achieve superior performance. They must manage and align the firm's different functional areas for competitive advantage.

- *Functional managers* are responsible for *implementing business strategy* within a single functional area.

LO 2-4 / Describe the roles of vision, mission, and values in a firm's strategy.

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

LO 2-5 / Evaluate the strategic implications of product-oriented and customer-oriented vision statements.

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

LO 2-6 / Justify why anchoring a firm in ethical core values is essential for long-term success.

- Ethical core values underlie the vision statement to ensure the stability of the strategy and thus lay the groundwork for long-term success.
- Ethical core values are the guardrails that help keep the company on track when pursuing its mission and its quest for competitive advantage.

LO 2-7 / Evaluate top-down strategic planning, scenario planning, and strategy as planned emergence, identifying the pros and cons of each.

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

LO 2-8 / Explain the causes of strategic dissonance and how to navigate strategic inflection points.

- When a firm's static fit no longer matches competitive realities, strategic dissonance emerges.
- Strategic dissonance is present when a firm's current strategy no longer provides the expected outcomes.
- A strategic inflection point is the moment when the fundamentals of a business and its industry are about to change.
- The decisions that leaders take when traversing a strategic inflection point are critical because they decide whether the firm will capitalize on the opportunity that a strategic inflection point provides to create forward momentum, or if the firm has started to decline.

LO 2-9 / Describe and evaluate the two distinct modes of decision making.

- When faced with decisions, individuals tend to satisfice rather than optimize due to cognitive limitations.
- Our decision making is governed by two distinct ways of thinking: System 1 and System 2.
- System 1 is our default mode of thinking because it is automatic, fast, and efficient, requiring little energy or attention. System 1 is prone to cognitive biases that can lead to snap judgments and systematic errors in decision making.
- System 2 is based on attempting to apply rationality to our decision making by relying on analytical and logical reasoning. It is an effortful, slow, and deliberate way of thinking.
- In addition to facing cognitive limitations, humans are prone to a host of cognitive biases, which can lead to systematic errors in decision making.

LO 2-10 / Compare and contrast devil's advocacy and dialectic inquiry as frameworks to improve strategic decision making.

- Devil's advocacy and dialectic inquiry are two techniques to improve strategic decision making.
- Devil's advocacy can help to improve strategic decision making. A key element of this technique is a separate team or individual carefully scrutinizing a proposed course of action by questioning and critiquing underlying assumptions and highlighting potential downsides.
- Dialectic inquiry can also help to improve strategic decision making; the key element is that two teams generate detailed but alternate plans of action (thesis and antithesis). The goal, if feasible, is to achieve a synthesis between the two plans.

KEY TERMS

Autonomous actions *(p. 59)*
Behavioral economics *(p. 66)*
Black swan events *(p. 55)*
Cognitive biases *(p. 66)*
Cognitive limitations *(p. 65)*
Confirmation bias *(p. 68)*
Core values statement *(p. 51)*
Devil's advocacy *(p. 70)*
Dialectic inquiry *(p. 71)*
Dominant strategic plan *(p. 57)*
Emergent strategy *(p. 59)*
Escalating commitment *(p. 67)*
Groupthink *(p. 69)*
Illusion of control *(p. 67)*
Intended strategy *(p. 59)*
Level-5 leadership pyramid *(p. 39)*
Mission *(p. 51)*
Organizational core values *(p. 51)*
Realized strategy *(p. 59)*
Reason by analogy *(p. 68)*
Representativeness *(p. 68)*
Resource-allocation process (RAP) *(p. 61)*
Scenario planning *(p. 54)*
Serendipity *(p. 60)*
Strategy as planned emergence *(p. 58)*
Strategic business unit (SBU) *(p. 42)*
Strategic dissonance *(p. 64)*
Strategic inflection point *(p. 64)*
Strategic initiative *(p. 59)*
Strategic intent *(p. 44)*
Strategic leadership *(p. 34)*
Strategic management process *(p. 52)*
Strategy formulation *(p. 41)*
Strategy implementation *(p. 41)*
System 1 *(p. 66)*
System 2 *(p. 66)*
Theory of bounded rationality *(p. 65)*
Top-down strategic planning *(p. 53)*
Upper-echelons theory *(p. 39)*
Vision *(p. 44)*

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CHAPTER 3

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

Chapter Outline

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

3.2 Industry Structure and Firm Strategy: The Five Forces Model
Industry vs. Firm Effects in Determining Firm Performance
Competition in the Five Forces Model
The Threat of Entry
The Power of Suppliers
The Power of Buyers
The Threat of Substitutes
Rivalry among Existing Competitors
Applying the Five Forces Model to the U.S. Airline Industry
A Sixth Force: The Strategic Role of Complements

3.3 Changes over Time: Entry Choices and Industry Dynamics
Entry Choices
Industry Dynamics

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

3.5 Implications for Strategic Leaders

Learning Objectives

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

LO 3-2 Differentiate between firm effects and industry effects in determining firm performance.

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

LO 3-4 Examine how competitive industry structure shapes rivalry among competitors.

LO 3-5 Describe the strategic role of complements in creating positive-sum co-opetition.

LO 3-6 Explain the five choices required for market entry.

LO 3-7 Appraise the role of industry dynamics and industry convergence in shaping the firm's external environment.

LO 3-8 Generate a strategic group model to reveal performance differences between clusters of firms in the same industry.

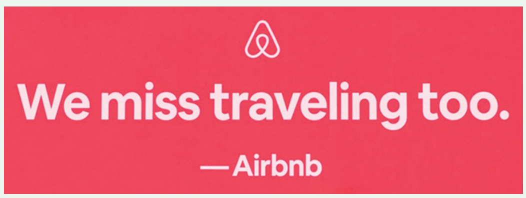
CHAPTERCASE 3 Part I

Airbnb's Pandemic Pivot

Not too long ago, it would have seemed impossible for a startup to disrupt the entire hospitality industry. The business had been long dominated by giants such as Marriott and Hilton, which took decades to become successful global brands. Yet in 2022, Airbnb had 4 million hosts in over 100,000 cities in some 220 countries offering guest stays in almost every region across the globe. Guests can make reservations for low-budget spare rooms or entire islands and castles. With its asset-light approach based on its platform strategy, Airbnb can offer more accommodations than the three biggest hotel chains combined: Marriott, Hilton, and Intercontinental. And just like global hotel chains, Airbnb uses sophisticated pricing and reservation systems for guests to find, reserve, and pay for rooms to meet their travel needs.

In 2008, Airbnb was a fledgling startup on a shoestring budget. Today, it is a multibillion-dollar company that competes globally. The company, for instance, reached a significant milestone (in 2021) with 1 billion guest arrivals. Airbnb's success is even more stunning given the high entry barriers traditionally protecting incumbent firms. How did Airbnb disrupt the global hospitality industry?

Brian Chesky and Joe Gebbia, the founders of Airbnb, were roommates in San Francisco (in 2007) struggling to make rent payments. Both were industrial designers, people who shape the form and function of everything from coffee cups to office furniture to airplane interiors. On a whim, they decided to send an e-mail to the distribution list for an upcoming industrial design conference in their hometown: "If you're heading out to the [industrial design conference] in San Francisco next week and have yet to make accommodations, well, consider networking in your jam-jams. That's right. For an affordable alternative to hotels in the city, imagine yourself in a fellow design industry person's home, fresh awake from a snooze on the ol' air mattress, chatting about the day's upcoming events over Pop Tarts and OJ."[1]



Airbnb's strategic pivot turned the Covid-19 pandemic into an opportunity. A massive amount of real-time user data from the company's website allowed CEO Chesky to quickly notice emerging travel trends. Guests searched for local travel accommodations with remote working capabilities. As city dwellers left the crowded apartment buildings, they also booked longer stays. With ads like the one shown here, Airbnb encourages its users to think beyond renting accommodations for pandemic-related work arrangements but consider leisure travel again as Covid-restrictions have eased around the globe.

Source: Airbnb, Inc.

Three people took them up on the offer, and the two roommates made some money to subsidize their rent payments. But, more importantly, Chesky and Gebbia felt that they had stumbled upon a new business idea: Help people rent out their spare rooms. They then brought on computer scientist Nathan Blecharczyk, one of Gebbia's former roommates, to create a website where hosts and guests could meet and transact. The three co-founders named their site AirBedandBreakfast.com, later shortened to Airbnb. The three entrepreneurs tested their new site at the 2008 South by Southwest (SXSW) conference, which celebrates the convergence of the tech, film, and music industries. SXSW also serves as an informal launch pad for new ventures. Twitter, for example, was unveiled at SXSW just a year earlier to great fanfare. However, Airbnb's launch at SXSW flopped. The conference organizers had exclusive contracts with local hotels, which the Airbnb founders did not know. As a result, the conference organizers didn't drive any traffic to Airbnb's site.

Undiscouraged, Airbnb decided to take advantage of the anticipated shortage of hotel rooms in Denver, Colorado, at the Democratic National Convention (DNC) in 2008. After all local hotels were booked, the founders prepared media releases with pithy titles such as "Grassroots Housing for Grassroots Campaign." This messaging resonated with Obama supporters. As a result of their shrewd guerrilla marketing,[2] both *The New York Times* and *The Wall Street Journal* wrote effusively about Airbnb. The newly designed Airbnb website facilitated about 100 rentals during the DNC. Soon after the event, however, website traffic to Airbnb's site fell back to zero. To generate some cash to continue their venture, Chesky and Gebbia decided to become cereal entrepreneurs, creating "Obama-O's: The breakfast of change" and "Cap'n McCains: A maverick in every bite," featuring illustrated images of the 2008 presidential candidates on 1,000 cereal boxes. After sending samples to their press contacts and the subsequent media coverage, the limited-edition cereal sold out quickly, providing Chesky and Gebbia with additional revenue to continue marketing Airbnb.

The fledgling venture's big break came in 2009. Y Combinator, a startup accelerator that has spawned famous tech companies such as Dropbox, Stripe, and Twitch.tv, offered Airbnb one of the few coveted spots in its program. In exchange for equity in the new venture, startup accelerators provide office space, mentoring, and networking opportunities with venture capitalists looking to fund the next "big thing." A year later, Airbnb received funding from Sequoia Capital, one of the most prestigious venture capital (VC) firms in Silicon Valley. The VC firm had already provided early-stage funding to then startups Apple, Google, Oracle, PayPal, YouTube, and WhatsApp. Although it was not a first mover in the peer-to-peer rental space, Airbnb, with Y Combinator's support, was the first to figure out that a sleek website design composed of professional photos of available rentals makes a huge difference. In addition, Airbnb developed a seamless transaction experience between hosts and guests and was able to earn a little over 10% on each transaction conducted on its site. The timing of these wins was fortuitous. The 2008–10 global financial crisis was in full swing, and people were looking for low-cost accommodations while hosts were trying to pay rent or mortgages to keep their homes.

Resilience and agility have been a part of Airbnb's DNA since its initial startup during the challenging external environment of a global financial crisis. These capabilities served them well as they pivoted in response to the Covid-19 pandemic. A vast stream of user data from its site allowed CEO Chesky to quickly notice emerging travel trends, such as local travel and remote working. He also noted that guests booked trips closer to home (but not in metropolitan areas such as big cities) and with longer durations. Airbnb closely studied how consumer behaviors were evolving and became convinced that the lines between travel, leisure, and living were blurring. Applying artificial intelligence to the vast amounts of data generated on its website allowed Airbnb to pivot during the pandemic. Meanwhile, many traditional hotels were closed or operated at much lower capacity because of pandemic restrictions.

As the pandemic spread, Airbnb quickly realized that guests were willing to pay a premium for long-term rentals with fast internet connections in desirable suburbs, rural areas, and vacation locales such as Boise (Idaho), Lake Tahoe (California), Martha's Vineyard (Massachusetts), Maui (Hawaii), Palm Beach (Florida), and San Antonio (Texas). Airbnb's superfast pivot in response to the pandemic was possible only because it uses an asset-light approach. Airbnb can match changing guest preferences (demand) with hosts (supply) on its two-sided platform in real time. In addition, given the dynamic nature of its algorithm, Airbnb can feature hosts on its site that can best address current booking needs.

Airbnb was valued at a whopping $114 billion in early 2022, making it one of the world's most valuable startups. Even more stunning, Airbnb's valuation is almost double that of long-time market leader Marriott, which stood at $59 billion.[3]

Part II of this ChapterCase appears in Section 3.5.

How can an internet startup based on the idea of home sharing disrupt the global hospitality industry, long dominated by corporate giants such as Marriott, Hilton, and Intercontinental? One reason is that Airbnb, now the world's largest accommodation provider, owns no real estate. Using a disruptive business model, Airbnb was able to circumvent high entry barriers into the hospitality industry, a traditionally capital-intensive and slow-moving business. With an asset-light approach afforded by its platform strategy, Airbnb quickly achieved global scale. In addition, and perhaps even more importantly, Airbnb can respond to trends in the external environment in real time.

Just like DoorDash, Amazon, or Facebook (now part of Meta Platforms), Airbnb provides an online platform for sellers (hosts) and buyers (renters) to connect and transact (we'll examine "platform strategy" in depth in Chapter 7). While traditional hotel chains need years of planning and millions of dollars in real estate investments to add additional capacity (finding properties, building hotels, staffing and running them, and so on), Airbnb's inventory is unlimited as long as it can sign up hosts with spare rooms to rent. Even more importantly, Airbnb does not need to deploy millions of dollars in capital to acquire and manage physical assets or manage a large cadre of employees. For example, Marriott has over 120,000 employees, while Airbnb's headcount is less than 6,000 (only 5% of Marriott's). Thus, Airbnb can grow faster and respond quickly to changing circumstances affecting the demand for and supply of accommodations. Airbnb's agility allows it to react in a fine-grained manner even down to rapidly changing local conditions. The competitive intensity in the hospitality industry is likely to increase, especially in high-traffic metropolitan cities such as New York, Paris, Dubai, Shanghai, and Seoul.

In this chapter, we present a set of frameworks to analyze the firm's *external environment*—the industry in which the firm operates and the competitive forces surrounding the firm. We move from a more macro perspective to a more micro understanding of how the external environment affects a firm's quest for competitive advantage. We begin with the PESTEL framework, which allows firms to scan, monitor, and evaluate changes and trends in their macroenvironment. Next, we study Porter's five forces model of competition, which helps firms determine an industry's profit potential. Depending on the firm's strategic position, these forces can affect its performance for good or ill. After covering firms' choices when considering entry into an industry, we move from a static analysis of a firm's industry environment to a dynamic understanding of how industries and competition change over time. We then discuss how to think through entry choices after an attractive industry is identified, and we introduce the strategic group model for understanding performance differences among clusters of firms in the same industry. Finally, we offer practical *Implications for Strategic Leaders.*

3.1 The PESTEL Framework

LO 3-1

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

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

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

- **P**olitical
- **E**conomic
- **S**ociocultural
- **T**echnological
- **E**cological
- **L**egal

Together these segments form the acronym PESTEL.

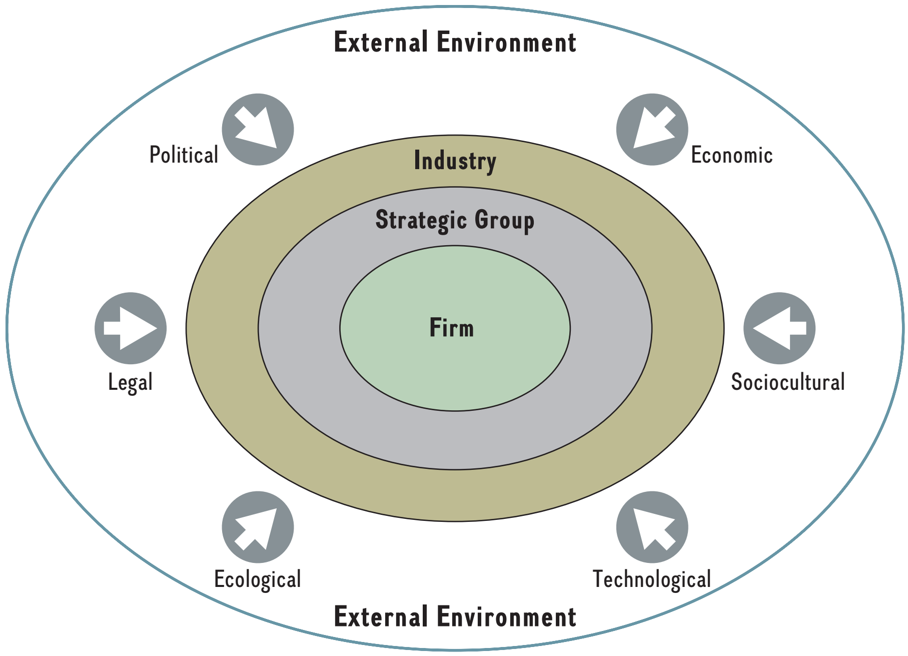
PESTEL model A framework that categorizes and analyzes an important set of external factors (political, economic, sociocultural, technological, ecological, and legal) that might impinge upon a firm. These factors can create both opportunities and threats for the firm.

POLITICAL FACTORS

Political factors result from the pressure that various groups such as government bodies, nongovernmental organizations (NGOs), and social movements can exert to influence the decisions and behavior of firms.[4] Examples of NGOs include the American Civil Liberties Union (ACLU), Amnesty International, Greenpeace, and the National Rifle Association (NRA). Influential social movements include Black Lives Matter (BLM) and #MeToo.

EXHIBIT 3.1

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



Political pressure is an expression of certain groups' expectations, and it happens before any legal changes occur. Because political pressure often results in legal changes, political factors and legal factors are closely related.

For instance, in the wake of the 1965 civil rights legislation outlawing racial discrimination, gay rights activists organized demonstrations in many of the largest U.S. cities. After five decades of campaigning by gay rights groups, the U.S. Supreme Court in 2015 decided that the Fourteenth Amendment requires all states to allow same-sex marriages and recognize same-sex marriages performed in other states. Here, political pressure resulted in a legal ruling that significantly impacts businesses. For example, it is illegal for a company to exclude a same-sex spouse from health benefits as an employee's dependent if the same benefits are available to an opposite-sex spouse.

Although political factors are in the firm's general environment, where firms traditionally wield less influence, companies nevertheless work hard to shape and influence this realm. They do so by pursuing a **nonmarket strategy** in which they seek to obtain more favorable outcomes for the firm through such activities as lobbying, public relations, contributions, and litigation.[5] For example, in 2021 Amazon and Meta Platforms both spent more than $20 million to lobby Congress and the federal government. That same year, the Pharmaceutical Research & Manufacturers of America, an industry association, shelled out over $30 million to support its nonmarket strategy.

nonmarket strategy Strategic leaders' activities outside market exchanges (in which firms sell products or provide services) to influence a firm's general environment through such activities as lobbying, public relations, contributions, and litigation that will lead to favorable outcomes for the firm.

ECONOMIC FACTORS

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

- Growth rates
- Employment level
- Interest rates

- Price stability (inflation and deflation)
- Currency exchange rates

GROWTH RATES. The overall economic *growth rate* measures the change in the value of goods and services produced by a nation's economy. Strategic leaders look to the *real growth rate,* which adjusts for inflation. This real growth rate indicates whether business activity is expanding or contracting—that is, the economy's position in the *business cycle*. During periods of economic expansion, consumer and business demand is rising, and competition among firms frequently decreases. Businesses expand operations to satisfy demand and are more likely to be profitable. The reverse is generally true for recessionary periods. However, certain companies that focus on low-cost solutions may benefit from economic contractions because demand for their products or services rises in such times. Consumer expenditures on luxury products are often the first to be cut during recessionary periods. For instance, you might switch from a \$5 venti latte at Starbucks to a \$1 alternative from McDonald's.

Occasionally, boom periods can overheat the economy and lead to speculative asset bubbles. For example, in the early 2000s, the United States experienced an asset bubble in real estate.[6] Easy credit, made possible by the availability of subprime mortgages and other more exotic financial instruments such as credit default swaps,[7] fueled an unprecedented demand for housing. Real estate, rather than stocks, became the investment vehicle of choice for many Americans, who were propelled by the common belief that house prices can only go up. When the housing bubble burst, the deep economic recession of 2008–09 began, impacting in some way nearly all businesses in the United States and worldwide.

EMPLOYMENT LEVEL. Growth rates directly affect the *employment level.* In boom times, unemployment tends to be low, and skilled human capital becomes scarce and more expensive. As the price of labor rises, firms are incentivized to invest more in capital goods such as cutting-edge equipment or artificial intelligence (AI).[8] In economic downturns, unemployment rises. As more people search for employment, skilled human capital is more abundant and wages usually fall.

INTEREST RATES. Another key macroeconomic variable that strategic leaders track is *real interest rates*—the amount that creditors earn for lending their money and the amount that debtors pay to use that money, adjusted for inflation. To respond to the severe economic impact of the Covid-19 pandemic as economies worldwide "shut down" for a period, central banks kept interest rates near zero or even negative, as in Europe.

Keeping interest rates low spurs investments by businesses and spending by consumers. When interest rates are low, firms can easily borrow money to finance growth. Borrowing at lower rates reduces the cost of capital and enhances a firm's competitiveness. Low-interest rates also have a direct bearing on consumer demand. When credit is cheap because interest rates are low, consumers buy homes, condos, automobiles, computers, smartphones, and vacations on credit; in turn, all of this demand fuels economic growth. These effects reverse when real interest rates are rising. Consumer demand slows, credit is harder to come by, and firms find it more costly to borrow money to support operations, deferring some investments they would have made if cheaper financing were available.

PRICE STABILITY. *Price stability*—little or no change in the prices of goods and services—is rare because economic growth is dynamic and needs to be matched with adequate monetary supply. Indeed, many central banks do not consider price stability desirable. Instead, they target an inflation rate of 2% per year. Why not 0%? The reasons include measurement errors in gross domestic product (GDP) growth along with the central bank's need for flexibility, in that central banks may take certain measures to avoid deflation or cut interest rates to stimulate growth. Businesses have a strong preference for planning certainty, but the central bank's actions are not guaranteed. Although they typically aim for 2% annual inflation over time, the rate is sometimes significantly higher. Strategic leaders therefore know that they need to address changing price levels over time.

inflation A general and sustained increase in the overall price level for goods and services in an economy.

Inflation is a general and sustained increase in the overall price level for goods and services in an economy.[9] The overall price level is the key variable here, not the price of a single good or service (such as the price for an iPhone or a Netflix subscription). Inflation frequently results from *too much money chasing too few goods and services.*[10] In the wake of the Covid-19 pandemic, many economies saw inflation reach its highest level in decades. Price levels rose because central banks kept interest rates near zero, and governments spent trillions of dollars to help businesses and citizens cope with economic shutdowns. Simultaneously, supply-chain bottlenecks resulted in shortages of key components such as semiconductors, further reducing the supply of some goods and thus driving up prices.

Inflation has several pernicious effects. It hampers economic growth and reduces the purchasing power of individuals and businesses. For example, if the annual inflation rate is 9% (as was the case in the United States in 2022) and wages increase by 4%, then workers experience a 5% decrease in their real compensation. Inflation has the most negative effect on the lowest earners in an economy because they must spend a larger share of their income on necessities such as food, rent, utilities, and transportation.

Deflation is a sustained decrease in the overall price level. A sudden and pronounced drop in demand can initiate a cycle of deflation, forcing sellers to lower prices to motivate buyers. Deflation is a severe threat to economic growth because it distorts expectations about the future.[11] For example, when overall price levels start falling, companies will not invest in new production capacity or innovation because they expect a further decline in prices. Because of persistent deflation, economic growth in Japan has been significantly lower than it would have been if the central bank had achieved the inflation target of 2%.

CURRENCY EXCHANGE RATES. The *currency exchange rate* determines how many dollars one must pay for a unit of foreign currency. It is a critical variable for any company buying or selling products and services across national borders, and strategic leaders need to fully appreciate the power of varying currency exchange rates to assess their effects on firm performance.

For example, if the U.S. dollar appreciates against the euro and increases in real value, firms need more euros to buy 1 dollar. An appreciating dollar makes U.S. exports such as Boeing aircraft, Intel chips, and John Deere tractors more expensive for European buyers and reduces demand for U.S. exports overall. This process reverses when the dollar depreciates (decreases in real value) against the euro. In this scenario, it will take more dollars to buy 1 euro. European imports such as French wines, LVMH luxury accessories, and Porsche automobiles become more expensive for U.S. buyers. European vacations will also be more costly for U.S. consumers if the dollar depreciates in relation to the euro.

Similarly, if the Chinese yuan appreciates, Chinese goods imported into the United States become relatively more expensive. At the same time, Chinese purchasing power increases, allowing Chinese businesses to purchase more U.S. goods such as soybeans, aircraft, and vehicles. The reverse holds if the Chinese yuan depreciates.

SOCIOCULTURAL FACTORS

Sociocultural factors capture a society's cultures, norms, and values. Because sociocultural factors are constantly in flux and differ across groups, strategic leaders need to closely monitor such trends and consider the implications for firm strategy. For example, in recent years, a growing number of U.S. consumers have become more health conscious about what they eat. This trend led to a boom for businesses such as Chipotle, Subway, and Whole Foods. At the same time, traditional fast food companies such as McDonald's and Burger King, along with grocery chains such as Albertsons, Kroger, and Walmart, scrambled to provide healthier choices in their product offerings.

Demographic trends are critical sociocultural factors. These trends capture population characteristics related to age, gender, family size, ethnicity, sexual orientation, religion, and socioeconomic class. Like other sociocultural factors, demographic trends present opportunities and threats. Firms that adjust to demographic changes can gain a competitive advantage, while firms that do not may experience negative performance implications.

For instance, recent U.S. census data reveal that 59 million Americans (18.1% of the total population) are Hispanic.[12] They are now the largest minority group in the United States and growing fast. On average, Hispanic people are younger, and their incomes climb quickly. Companies are trying to benefit from this opportunity. For example, MundoFox and ESPN Deportes (specializing in soccer) have joined Univision and NBC's Telemundo in the Spanish-language television market. In the United States, Univision is now the fifth most popular network overall, just behind the four major English-language networks (ABC, NBC, CBS, and Fox). Likewise, advertisers pour dollars into the Spanish-language networks to promote their products and services.[13]

TECHNOLOGICAL FACTORS

Technological factors capture the application of knowledge to create new processes and products. Significant innovations in *process technology* include lean manufacturing, Six Sigma quality, genetic engineering, artificial intelligence (AI), and quantum computing. The nanotechnology revolution, which is just beginning, promises significant upheaval for many industries as it produces innovative new products ranging from tiny medical devices to new-age materials for earthquake-resistant buildings.[14] Other *product innovations* include drones, wearable devices such as virtual reality (VR) headsets, and high-performing electric cars. Recent high-profile product innovations include the development of Covid-19 vaccines by BioNTech and Moderna. These biotech ventures used a process innovation (mRNA) to generate a product innovation (a new type of vaccine).

Continued advances in AI and machine learning promise to fundamentally alter how we work and live.[15] Many of us are familiar with early AI applications such as Amazon's Alexa, Apple's Siri, and Google's Assistant, and the future will bring much more significant changes, including autonomous driving and the internet of things. The transportation industry sees early signs of disruption as a result of autonomous vehicles and trucks, which can drive themselves from coast to coast, 24/7, with no breaks needed except for stops to recharge or exchange battery packs. Fully autonomous vehicles, which are already on the road, will be commonplace in the not-too-distant future. The internet of things will connect all sorts of devices such as vehicles, airplanes, home appliances, computers, manufacturing facilities, and power grids, allowing them to exchange data and permitting companies to manage systems more holistically and more intelligently. In addition, the internet of things reduces energy consumption and can notify users that a system requires maintenance long before it breaks down.

Given the importance of a firm's innovation strategy in terms of building and sustaining competitive advantage, we discuss the effect of technological factors in greater detail in Chapter 7.

Strategy Highlight 3.1 details how the once-mighty video rental chain Blockbuster fell when it failed to pay sufficient attention to the PESTEL factors.

Strategy Highlight 3.1

Blockbuster's Bust

Blockbuster was not only a pioneer in the video rental business, but it was also the undisputed industry leader from the mid-1980s to the early 2000s. At one point, Blockbuster opened a new store every 17 hours. At its peak, it had a total of 9,000 stores across the United States, and it earned $6 billion in annual revenue. Blockbuster was a mainstay of U.S. culture and an essential element of family movie night. But in 2010, the once-mighty Blockbuster filed for bankruptcy. What went wrong?

The video rental chain Blockbuster went out of business because it failed to clearly define the competitive challenge posed by technological changes in the industry.

Adwo/Shutterstock

Blockbuster was unable to respond effectively to technological changes in the industry. The first wave of disruption hit the TV industry in the 1980s and 1990s when cable networks started offering hundreds of channels, challenging the cozy oligopoly of the three old-line broadcast networks ABC, CBS, and NBC. With the arrival of the cable networks, Blockbuster's fortunes began to dim, as reflected in a double-digit decline in its market valuation. Unable to address the technological challenge posed by cable network content as a substitute for video rentals, Blockbuster's creator and owner, Wayne Huizenga, sold the company to the media conglomerate Viacom in 1994.

By the late 1990s and early 2000s, Blockbuster was challenged more directly by low-cost substitutes such as Netflix's mail-order DVD service and Redbox's automated DVD rental kiosks. In 1997, annoyed at paying more than $40 in late fees for a Blockbuster video, Reed Hastings decided to start Netflix—an online, subscription-based business model that offered consumers DVD rentals. However, when the dot-com bubble burst in 2000, Netflix almost went bankrupt. Hastings approached Blockbuster and proposed selling Netflix to it for a mere $50 million and rebranding the chain as Blockbuster.com. The idea was that Netflix would become Blockbuster's online branch. Blockbuster turned Netflix down, thinking it was a small niche business at best.

Netflix managed to stay afloat. Its convenient and low-cost option for at-home viewing via higher-quality DVD technology (compared to lower-quality VHS tapes) attracted more subscribers, allowing the firm to weather the dot-com crash. To fund future growth, Netflix went public in 2002 at a valuation of $310 million. Just a year later, Netflix surpassed 1 million subscribers. After seeing Netflix's success, Blockbuster began to mimic its online subscription model. However, unlike Netflix, which did not charge late fees given Reed Hastings' aversion to penalizing customers, Blockbuster continued to do so. The firm relied on late fees because they were, unfortunately, one of the most profitable aspects of its business model.

Technological progress continued at a rapid clip. The next wave of technological disruption hit the home media industry in the mid-2000s. The ability to stream content directly onto many devices, such as laptops, tablets, smartphones, and internet-connected TVs, turned almost any screen into a personal media conduit. The prevalence of high-speed internet connections combined with advances in mobile devices changed the way people consume entertainment. The days when people needed to go to a bricks-and-mortar store to rent a videotape or DVD were gone. With on-demand video streaming, consumers could choose from a nearly unlimited inventory of movies while lounging on the couch. In the end, Blockbuster's attempts to change were too little, too late. In 2010, the once-mighty Blockbuster filed for bankruptcy. Netflix's market capitalization peaked at $300 billion (in late 2021), with over 200 million subscribers worldwide in 2022.[16]

ECOLOGICAL FACTORS

Ecological factors concern broad environmental issues such as the natural environment, climate change, and sustainable economic growth. Organizations and the natural environment coexist in an interdependent relationship. Managing these relationships responsibly and sustainably influences the continued existence of human societies and the organizations we create. Strategic leaders can no longer separate the natural and the business worlds; they are inextricably linked.[17]

Many companies contribute to the pollution of air, water, and land and the depletion of the world's natural resources. One infamous example that comes readily to mind is the BP oil spill in the Gulf of Mexico (in 2010). The spill destroyed fauna and flora along the U.S. shoreline from Texas to Florida. It led to a drop in fish and wildlife populations, triggered a severe decline in the fishery and tourism industries, and threatened the livelihood of thousands of people. It also cost BP more than $50 billion and one-half of its market value.

Greta Thunberg is a Swedish environmental activist who challenges world leaders to take immediate and drastic action to combat climate change. She stepped into the public limelight by successfully organizing multicity school climate strikes via social media, with a million or more students protesting in several cities across the globe. In 2019, she became the youngest person ever selected as *Time* magazine's "Person of the Year." That same year, *Forbes* included Thunberg in its list of "The World's Most Powerful Women." Thunberg has also been nominated for the Nobel Peace Prize in multiple years.

Sarah Silbiger/Getty Images

While the BP oil spill is one high-profile incident, much more significant and persistent causes of climate change and pollution are the externalities that businesses cause. These externalities include emitting greenhouse gases, releasing untreated wastewater, and contaminating the air without paying for the damage caused. **Externalities** occur when the production or consumption of goods and services imposes costs on or provides benefits to others, but the prices of the goods and services do not capture these costs and benefits. *Negative externalities* such as air pollution impose a cost on society. *Positive externalities* such as the beautiful design of an environmentally friendly office building benefit employees and the community. In our current system, finding (and paying for) remedies for negative externalities is generally left to governments and society. Indeed, if business leaders focus on maximizing shareholder value, they have an incentive *not to pay* to fix the negative externalities they cause unless they are legally required to do so.[18]

externalities Occurs when the production or consumption of goods and services imposes costs on or provides benefits to others, but the prices of the goods and services do not capture these costs and benefits.

At the same time, ecological factors such as climate change can provide business opportunities. As documented in ChapterCase 1, Tesla addresses environmental concerns regarding the carbon emissions of gasoline-powered cars by building zero-emission battery-powered vehicles. To generate the needed energy to charge the batteries sustainably, Tesla acquired SolarCity to provide integrated, clean-tech energy services for its customers, including decentralized solar power generation and storage via its Powerwall.

LEGAL FACTORS

Legal factors capture the official outcomes of political processes as manifested in laws, mandates, regulations, and court decisions, all of which can directly impact a firm's profit potential. Regulatory changes tend to affect entire industries. Many industries in the United States have been deregulated over the past few decades, including airlines, telecom, energy, and trucking.

As noted earlier, legal factors often coexist with or result from a political will. Governments can directly affect firm performance by exerting political pressure and legal sanctions, including court rulings and industry regulations. Consider how the European Commission, the EU's executive branch, applies political and legal pressure on U.S. tech companies. European Commission targets include Apple, Alphabet, Amazon, Meta, and Microsoft—the five largest U.S. tech companies—and startups such as Uber and Airbnb. Europe's policymakers seek to retain control over essential industries, including transportation and the internet, to ensure that profits earned in Europe by Silicon Valley firms are taxed locally. The European

The Waymo autonomous vehicle, which gives people the opportunity to be driven rather than to drive, may mark another step in the revolution of personal transportation. If Waymo, Tesla, and Cruise (a subsidiary of GM) realize their vision, then autonomous cars will chauffeur people from place to place. Traditional automakers such as GM, Ford, and VW are also investing tremendous sums in developing autonomous vehicles. However, as the industry embraces electrification and autonomy, it is unclear who the leading players will be. In addition, an important question remains unanswered: Will individuals still want to own a car, or will they prefer to catch a ride in an autonomous vehicle for a per-ride usage fee ("pay as you go")? Autonomous vehicles offer many benefits: Their pay-as-you-go model does not require a large upfront payment, unlike the purchase or lease of a car. In addition, vehicle ownership has many other costs, including car registration, insurance, and maintenance. Indeed, for cars with an internal combustion engine, the cost of gasoline frequently exceeds the cost of the vehicle over its lifetime.

Sundry Photography/Shutterstock

Parliament even proposed legislation to break up Alphabet, which it views as a digital monopoly. This proposal would require Alphabet to offer search services independently as a standalone company from its other online services, including Gmail and Drive, Google's cloud-based file storage and synchronization service.

The EU's wariness extends beyond tax revenue: It has much stronger legal requirements and cultural expectations concerning data privacy. For instance, in 2018 the EU implemented the General Data Protection Regulation (GDPR), which gives individuals wide-reaching control over their data and secured protection of these data. Personal data comprise any information related to a person, such as a name, home address, e-mail address, phone number, location details, photos, videos, social media postings, and computer IP addresses. GDPR grants all EU residents far-reaching rights concerning their data, including the right to access, the right to be forgotten (that is, not to show up in search results), the right to data portability across providers, and the right to be notified promptly of any data breaches that compromise personal data. To continue doing business in Europe, all U.S. companies, including Alphabet and Meta, had to change their policies to comply with the GDPR. Overall, the data protection and privacy regulations that internet companies face in the EU are more stringent than those in the United States. But several U.S. states, including California, Colorado, and Virginia, have enacted similar privacy and data-protection laws.

THE PESTEL FRAMEWORK—CAVEATS. The PESTEL model provides a relatively straightforward way to *scan, monitor,* and *evaluate* the critical external factors and trends that might influence firm performance. Such factors create both opportunities and threats. The PESTEL forces influence firm performance, both positively and negatively.

However, the PESTEL framework is a *static model*, taking a snapshot of many moving parts at a given point in time. This shortcoming implies that the dynamics behind different forces in a firm's external environment are harder to capture. For this reason, questions such as "Which PESTEL factors have the greatest velocity right now?" and "How fast is each factor changing?" are harder to answer. Nonetheless, a PESTEL analysis can help strategic leaders recognize external factors and turn threats into opportunities.

3.2 Industry Structure and Firm Strategy: The Five Forces Model

LO 3-2

Differentiate between firm effects and industry effects in determining firm performance.

INDUSTRY VS. FIRM EFFECTS IN DETERMINING FIRM PERFORMANCE

Firm performance is determined primarily by two factors: industry effects and firm effects. **Industry effects** are the result of the underlying economic structure of the industry and its impact on firm performance. The structure of an industry is determined by elements common to all industries, such as entry and exit barriers, number and size of companies, and types of products and services offered. The industry structure, in turn, determines the profit potential of an industry, which affects firm performance. **Firm effects** attribute firm

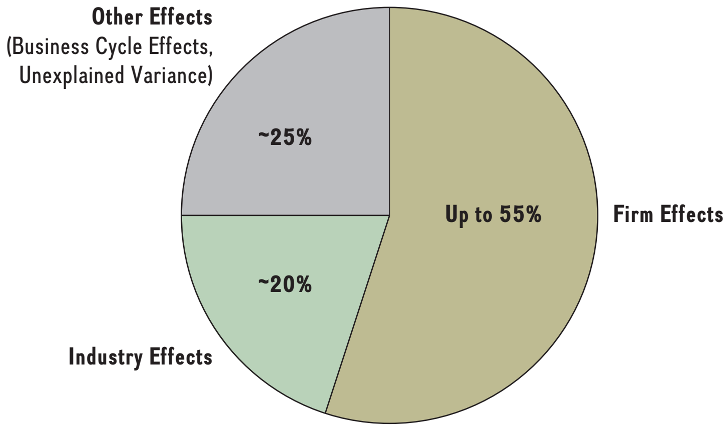
industry effects Firm performance attributed to the structure of the industry in which the firm competes.

firm effects Firm performance attributed to the actions strategic leaders take.

performance directly to strategic leaders' actions. *Corporate strategy* addresses the question of which industries to compete in, while *business strategy* provides an answer to the question of how to compete in a chosen industry.

In a series of empirical studies, academic researchers have shown that industry effects explain roughly 20% of overall firm performance, while firm effects (i.e., specific managerial actions) explain about 55%. In Chapter 4, we go inside the firm to understand why firms within the same industry differ and how such differences can lead to competitive advantage. For now, the critical point is that external and internal factors combined explain roughly 75% of overall firm performance. Business cycles and other effects are responsible for the remaining 25%.[19] Exhibit 3.2 shows these findings.

EXHIBIT 3.2 Industry, Firm, and Other Effects Explaining Firm Performance



To better understand how external factors affect firm strategy and performance and what strategic leaders can do about them, we look closely in this chapter at an industry's underlying structure. As such, we now move one step closer to the firm (in the center of Exhibit 3.1) and examine the industry in which it competes.

An **industry** is a group of incumbent firms with more or less the same set of suppliers and buyers. Firms competing in the same industry tend to offer similar products or services to meet specific customer needs. Although the PESTEL framework allows us to scan, monitor, and evaluate the external environment to identify opportunities and threats, **industry analysis** provides a more rigorous basis not only for identifying an industry's profit potential (that is, the level of profitability that can be expected for the *average* firm) but also for identifying implications for one firm's strategic position within an industry. A firm's **strategic position** is based on creating value for customers *(V)* while containing the cost *(C)*. Competitive advantage flows to the firm that creates as large a gap as possible between the value of its product or service and the cost required to produce it *(V – C)*.

industry A group of incumbent firms with more or less the same set of suppliers and buyers.

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

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

COMPETITION IN THE FIVE FORCES MODEL

LO 3-3

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

Michael Porter developed the highly influential **five forces model** to help strategic leaders understand the profit potential of different industries and position their respective firms to gain and sustain competitive advantage.[20] By combining theory from industrial organization economics with detailed case studies, Porter derived two key insights that form the basis of the five forces model:

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

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

COMPETITION BROADLY DEFINED. As noted, Porter's model more broadly defines competition to include other industry forces: buyers, suppliers, potential new entry of other firms, and the threat of substitutes. Strategy addresses the question of how to deal with competition. In the five forces model, all of the forces are viewed as potential competition attempting to extract value from the industry. Specifically, competition is the struggle among these forces to capture as much of the economic value created in an industry as possible. Therefore, a firm's strategic leaders must be concerned not only with the intensity of rivalry among direct competitors (e.g., Nike vs. Under Armour, The Home Depot vs. Lowe's, Merck vs. Pfizer) but also with the strength of the other competitive forces that are attempting to extract part or all of the economic value that the firm creates.

Recall that firms create economic value by expanding as much as possible the gap between the perceived value *(V)* of the firm's product or service and the cost *(C)* to produce it. *Economic value* thus equals $V - C$. To succeed, creating value is not enough. Firms must also *capture* a significant share of the value created to gain and sustain a competitive advantage. In this sense, strategy is about *creating* and *capturing value.* When faced with competition in this broader sense, strategy requires a firm to position itself in an industry to enhance its chances of achieving superior performance.

INDUSTRY PROFIT POTENTIAL. The five forces model enables strategic leaders to understand the firm's industry environment and shape firm strategy. As a rule of thumb, *the stronger the five forces, the lower the industry's profit potential,* making the industry less attractive for competitors. The reverse is also true. *The weaker the five forces, the greater the industry's profit potential,* making the industry more attractive. Therefore, in existing firms competing for advantage in an established industry, strategic leaders should position the company in a way that relaxes the constraints of strong forces and leverages weak forces. A carefully crafted strategic position is needed to improve the firm's ability to achieve and sustain a competitive advantage.

As Exhibit 3.3 shows, Porter's model identifies five fundamental competitive forces that strategic leaders need to consider when analyzing the industry environment and formulating a competitive strategy:

1. Threat of entry
2. Power of suppliers
3. Power of buyers
4. Threat of substitutes
5. Rivalry among existing competitors

THE THREAT OF ENTRY

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

The **threat of entry** describes the risk of potential competitors entering the industry. Potential new entry makes an industry less attractive in two significant ways:

1. *It reduces the industry's overall profit potential.* Faced with the threat of additional capacity coming into an industry, incumbent firms may lower their prices to make entry appear less attractive to potential new competitors. Lower prices will reduce the industry's overall profit potential, especially in industries with slow or no overall growth in demand. Consider the market for new microwave ovens. Demand consists of the replacement rate for older models and the demand created by new households. Because this market grows slowly, if at all, any additional entry will likely lead to excess capacity and lower prices overall.

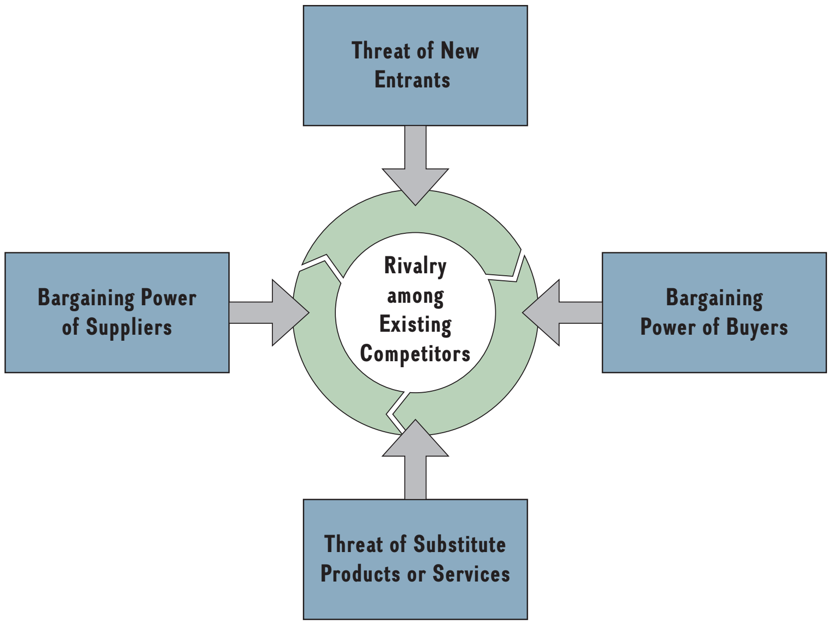


EXHIBIT 3.3

Porter's Five Forces Model

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

2. *It increases spending by incumbent firms.* The threat of entry by additional competitors may force incumbent firms to spend more to satisfy their existing customers. This spending reduces an industry's profit potential primarily if firms cannot raise prices.

Consider how Starbucks has chosen to upgrade and refresh its stores and service offerings constantly. Starbucks has over 15,000 U.S. stores and more than 17,000 international locations. By raising the value of its offering in the eyes of consumers, it slows others from entering the industry or rapidly expanding. Increasing customer value allows Starbucks to keep at bay smaller regional competitors, such as Peet's Coffee & Tea, which has fewer than 200 stores mainly on the West Coast, and smaller national chains, such as Caribou Coffee, with 415 stores.

Internationally, China accounts for 25% of total Starbucks revenues, and Starbucks' China-based revenue grows by double digits each year. To keep domestic competitors such as Luckin Coffee at bay, Starbucks has opened more than 5,400 stores in China. Starbucks coffeehouses are some of the nicest stores in China, providing complimentary high-speed internet access to their customers. Constantly refreshing the Starbucks experience increases costs, but Starbucks is willing to accept a lower profit margin to grow its market share and deter entry.

Of course, the more profitable an industry, the more attractive it is to new competitors. However, several significant barriers exist that can reduce that threat to existing firms. **Entry barriers**, which are advantageous for incumbent firms, are obstacles that discourage or prevent entry into an industry. Incumbent firms can benefit from several types of entry barriers:

entry barriers Obstacles that discourage or prevent entry into an industry.

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

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

We reviewed the critical relationship between scale and production cost at Tesla in ChapterCase 1. New entrants into the automotive industry need large-scale production to be efficient. Tesla leveraged new technology to circumvent the formidable entry barrier of large-scale production. Reaching sufficient manufacturing scale to be cost-competitive is critical for Tesla as it moves more into the mass market.

To benefit from economies of scale, Tesla introduced new vehicle models over time. It started with an expensive Roadster ($110,000). The small production run of merely 2,500 Roadsters proved that electric vehicles (EVs) could outperform the best gasoline-powered cars. The first step toward mass production was the Model S and Model X, an expensive luxury sedan ($73,500) and SUV ($80,000), respectively. However, Tesla did not achieve mass production and thus lower costs per car until it introduced the Model 3/Y (compact sedan and SUV). Despite achieving *minimum efficient scale* or MES (the output range needed to drive down the per-unit cost to the lowest point possible) for the Model 3/Y, the production cost of $36,000 was still too high to allow Tesla to penetrate the mass market. Tesla aims to introduce a $25,000 EV, which it has dubbed "Model 2."

network effects The positive impacts that one user of a product or service has on other users of that product or service.

NETWORK EFFECTS. **Network effects** refer to the positive impacts that one user of a product or service has on other users of that product or service. When network effects are present, the value of the product or service increases with the number of users. An increase in the value of a product or service as a function of its users is a *positive externality.* The threat of potential entry is reduced when network effects are present.

Featured in ChapterCase 3, Brian Chesky, Airbnb's CEO, argues that the online marketplace for lodging benefits from global network effects thanks to listings in over 100,000 cities around the globe at many different price points, combined with an inventory of 6 million homes and apartments. This global network effect grows even stronger as more and more guests use the service and become hosts themselves. Given the importance of network effects in the digital economy, we will discuss them in Chapter 7.

CUSTOMER SWITCHING COSTS. *Switching costs* are the costs that a customer incurs when changing to the products, services, and/or brands offered by a different vendor. Customer switching costs are primarily monetary—for example, retraining employees costs money—but they can also be psychological, as when a customer is attached to a certain brand but changes reluctantly to a new brand. Changing vendors may require the customer to alter product specifications and modify existing processes. Although switching costs are one-time sunk costs, they can be significant and thus they present a formidable barrier to entry. Incumbent firms therefore seek to raise the switching costs for their customers. The higher the switching costs, the lower the threat of entry.

For example, a firm that has used a customer relationship management (CRM) system from Salesforce.com for many years will incur high switching costs if it implements a new CRM system from a new entrant into the industry. Potential new entrants are aware of any significant switching costs and are less likely to enter the industry because existing customers will switch only if they expect to receive positive *net* benefits. For this reason, the new product needs to offer a high level of additional value or significant cost savings so that it not only outperforms any existing product but also makes up for the customer switching costs. High customer switching costs not only deter entry but also reduce customer churn among existing firms in the industry, thereby also contributing to lower competitive rivalry.

CAPITAL REQUIREMENTS. *Capital requirements* are the "entry ticket price" into a new industry. How much capital is required to compete in a particular industry, and which companies are willing and able to make such investments? Related to economies of scale, capital requirements may encompass investments to set up plants with dedicated machinery, run a production process, and cover startup losses. The higher the capital requirements to enter an industry, the lower the threat of entry.

As we saw in Chapter 1, Tesla has built a network of Gigafactories across the globe, producing battery packs and manufacturing EVs. Each production facility costs up to $10 billion. This global network of expensive production facilities reduces that threat of new entrants in the EV segment of the automotive industry. The significant capital outlays required to become a viable player in the EV mass market explains why only a few deep-pocketed legacy carmakers, such as GM, Ford, and Volkswagen, have committed billions of dollars to enter this industry segment.

In general, the threat of entry is high when capital requirements are low in comparison to the expected returns. However, if an industry is attractive enough, efficient capital markets are likely to provide the necessary funding to enter an industry. Unlike proprietary technology and industry-specific know-how, capital is a *fungible* resource that can be relatively easily acquired when attractive returns seem likely. Several pureplay EV startups (e.g., Rivian and Lucid Motors in the United States) have attempted to secure sufficient capital to mass-produce EVs.[21]

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

Brand Loyalty. *Brand loyalty,* an essential concept in marketing, captures a consumer's emotional attachment and feelings toward a specific brand. Brand loyalty translates into repeat purchases of the brand's products and services. Brand-loyal customers are often the company's best advertising, talking up the brand through "word of mouth" on social media. They are also more likely to overlook deficiencies in their favorite brand's products and services. At the same time, they tend to discount competitors' offerings.

For instance, Tesla's loyal customers strengthen the firm's competitive position and reduce the threat of entry into the all-electric car segment, at least by other startup companies.[22] Unlike GM or Ford, which spend billions each year on advertising, Tesla doesn't have a large marketing budget. Instead, it relies on word of mouth. Like Apple in its early days, Tesla has its own "cool factor," evidenced by its beautifully designed, top-notch quality cars. When *Consumer Reports* tested the Model S, the usually understated magazine concluded, "The Tesla Model S is the best car we ever tested."[23] In addition, many Tesla owners feel an emotional connection to the company because they sincerely believe in the company's vision "to accelerate the world's transition to sustainable energy."

However, Tesla's customers are also aware of the company's shortcomings. Many vocal customers complain that Tesla's delivery experience and customer service are not up to par, even though Tesla styles itself as a luxury car brand and charges a premium price. And, although Tesla has a reputation for launching innovative and paradigm-defining vehicles, many Tesla owners and observers consider its customer service inferior, especially when compared to other luxury brands such as Porsche. Clearly, Tesla's customer service bandwidth and capabilities have yet to catch up with its vehicle production and delivery volume. Tesla's brand loyalty may be affected negatively if the company cannot quickly address the perception of inferior customer service.

Proprietary Technology. *Proprietary technology* is any process, method, device, or system that firms use to solve problems when providing products and services. Because it can underpin a firm's competitive advantage, proprietary technology is fiercely guarded with trade secrets, patents, and trademarks. Although it is useful in any competitive situation, proprietary technology is particularly beneficial for incumbent firms. It deters new entry because it is often developed through years of experience in a particular industry.

For example, financial institutions such as Morgan Stanley (an investment bank) and Bridgewater (a hedge fund) spent years and millions of dollars in AI research to develop proprietary algorithms to help inform decisions. SpaceX, founded in 2002, is an aerospace manufacturer and provider of space transportation. Over the past 20 years, SpaceX developed proprietary materials that are both space resistant and low cost. Given this huge head start in materials science, SpaceX's proprietary technology presents significant entry barriers for potential new entrants.

Preferential Access. Preferential access to raw materials, critical components, and distribution channels can bestow absolute cost advantages. For example, the lithium-ion batteries that are so critical to all-electric vehicles are not only the vehicles' most expensive component, but they are also in short supply. Thanks to its new battery Gigafactories, Tesla can eliminate its dependence on the few worldwide suppliers of lithium-ion batteries and enjoys an absolute cost advantage.[24] Tesla's independence from suppliers should further reduce the threat of new entrants in the all-electric vehicle segment, assuming that no radical technological changes are expected in battery-cell technology in the next few years.

Favorable Locations. Favorable locations, such as the locations of Tesla's Gigafactories near Austin, Texas, and Shanghai, China, provide advantages that other locales cannot match easily. These benefits include proximity to the company's main markets, access to skilled and lower-cost engineering talent and assembly workers, proximity to world-class universities, favorable tax and other incentives, overall more business-friendly locations with less red tape and bureaucracy, and a lower cost of living in a desirable place. Although Tesla still uses its original California manufacturing facility to produce Models S/X (which account for less than 5% of its total vehicle production), Tesla moved its headquarters from Fremont, California, to the more business-friendly Austin, Texas.

Cumulative Learning and Experience. Finally, incumbent firms often benefit from cumulative learning and experience effects over long periods. Tesla has accumulated 15 years of experience in designing and building high-performance all-electric vehicles of superior quality and design. Indeed, many industry experts view Tesla as being at least five years ahead of the legacy carmakers because Tesla designs its vehicles to be purely electric right from the start.

In contrast, the old-line carmakers often use existing car platforms and convert them into hybrid or electric cars. Attempting to obtain such deep design, engineering, and manufacturing knowledge within a shorter time frame is often costly, if not impossible, due to *time compression diseconomies.* That is, costs often increase exponentially when companies attempt to build a new competence in a shorter amount of time than it usually takes. Time compression diseconomies are determined by cumulative learning experience and constitute formidable barriers to entry.

GOVERNMENT POLICY. Government policies frequently restrict or prevent new entrants. To protect millions of small vendors and wholesalers, India did not until recently allow foreign retailers such as Walmart or IKEA to own stores and compete with domestic companies. China frequently requires foreign companies to enter joint ventures with domestic companies and to share their technology.

In contrast, deregulation in airlines, telecommunications, and trucking has generated significant new entry. With new entry comes increased competition that frequently results in lower prices, better quality, more innovation, and more choices for consumers. Therefore, the threat of entry is high when restrictive government policies do not exist or when industries are deregulated.

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

There are several scenarios in which potential new entrants should expect a vigorous and robust response beyond price competition by incumbent firms. If the current competitors have deep pockets, unused excess capacity, reputational clout with industry suppliers and buyers, a history of strong retaliation during earlier entry attempts, and heavy investments in resources specific to the core industry and ill-suited for redeployment in alternative uses, then they are likely to press these advantages. In addition, if industry growth is slow or stagnant, incumbents are more likely to retaliate against new entrants to protect their market share, often initiating a price war to drive out the new entrants. In contrast, the threat of entry is high when new entrants expect that incumbents will not or cannot retaliate.

Although several pureplay EV startups such as Rivian and Lucid Motors in the United States and NIO, Xpeng, or Li Auto in China are attempting to enter the industry, it is far from guaranteed that they will morph into large, mass-producing automobile manufacturers with a global presence. Although the EV market is growing rapidly, retaliation by the legacy carmakers and Tesla can be expected. As the automobile market transitions from gasoline cars to EVs, the legacy carmakers attempt to protect their market share in the overall industry by aggressively introducing many EV models. Moreover, the old-line car manufacturers benefit from large-scale manufacturing capabilities, which, in combination with their deep pockets, allows them to price their new EVs near or even below cost. Even Tesla, which endeavors to accelerate the transition to sustainable transport and energy, continues to introduce new models in different market segments; it has announced several lineup additions, including a more affordable compact car, the Cybertruck (a futuristic-looking full-size truck), and a commercial semitruck. Tesla's latest product announcements raise the threat of retaliation that new competitors might incur if they enter specific segments of the EV market.

THE POWER OF SUPPLIERS

Suppliers with strong bargaining power can exert pressure on an industry's profit potential. Powerful suppliers reduce a firm's ability to obtain superior performance for two reasons:

1. Powerful suppliers can raise the cost of production by demanding higher prices for their inputs or by reducing the quality of input factors or service level delivered.
2. Powerful suppliers threaten firms because they reduce the industry's profit potential by capturing part of the economic value created.

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

- The supplier's industry is more concentrated than the industry it sells to.
- Suppliers do not depend heavily on the industry for much of their revenues.
- Incumbent firms face high switching costs when changing suppliers.
- Suppliers offer products that are differentiated.
- There are no readily available substitutes for the suppliers' products or services.
- Suppliers can credibly threaten to forward-integrate into the industry (that is, move into the buyer's industry).

THE POWER OF BUYERS

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

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

FACTORS THAT INCREASE BUYER POWER. The power of buyers is high when:

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

Niloo138/123RF

Walmart is perhaps the most potent example of tremendous buyer power. It is not only the largest retailer worldwide (with 12,000 stores and 2 million employees), but it is also one of the largest companies in the world, with $575 billion in revenues in 2022. One of the few large big-box global retail chains, Walmart frequently purchases large quantities from its suppliers. It leverages its buyer power by exerting tremendous pressure on its suppliers to lower prices and increase quality—or risk losing access to coveted shelf space at the world's largest retailer. Walmart's buyer power is so strong that many suppliers co-locate offices next to Walmart's headquarters in Bentonville, Arkansas, because such proximity enables Walmart's strategic leaders to test the suppliers' latest products and negotiate prices.

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

Buyers are also powerful when they can credibly threaten backward integration. *Backward integration* occurs when a buyer moves upstream in the industry value chain into the seller's business. Walmart has exercised the threat of backward integration by producing several private-label brands such as Equate health and beauty items, Ol'Roy dog food, and Parent's Choice baby products.

Powerful buyers can extract a significant amount of the value created in the industry, leaving little or nothing for producers. In addition, strategic leaders need to be aware of situations when buyers are especially price sensitive. Buyers are price sensitive when:

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

CONTEXT-DEPENDENCIES ON BUYER POWER. It is essential to note that the relative strengths of the five forces that shape competition are context-dependent. For example, the Mexican multinational CEMEX, one of the world's leading cement producers, faces different buyer power in the United States than it does domestically. In the United States, cement buyers consist of a few large and powerful construction companies that account for a significant percentage of CEMEX's revenue. The result is razor-thin margins for CEMEX on its U.S. sales.

In contrast, the vast majority of CEMEX customers in its Mexican home market are small, individual customers facing a few large suppliers, with CEMEX being the biggest. CEMEX earns high profit margins in its home market. With the same undifferentiated product, CEMEX competes in two different industry scenarios with varying levels of buyer strength.

THE THREAT OF SUBSTITUTES

Substitutes are the threat that products or services available from *outside the given industry* will come close to meeting the needs of current customers.[25] For example, many software products are substitutes for professional services, at least at the lower end. Tax preparation software such as Intuit's TurboTax is a substitute for professional services offered by H&R Block and others. LegalZoom, an online legal documentation service, is a threat to professional law firms. Other examples of substitutes are energy drinks versus coffee, videoconferencing versus business travel, e-mail versus express mail, gasoline versus biofuel, and wireless telephone services versus internet-enabled voice and video apps such as Zoom, FaceTime (Apple), WhatsApp (Facebook), and WeChat (Tencent).

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

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

PRICE/PERFORMANCE TRADE-OFF. The threat of substitutes is high when they offer a low-cost alternative that provides a similar or equivalent product or service performance.

For instance, renting a small number of movies on DVD per month is a low-budget alternative to signing up for a streaming service that charges a monthly subscription fee. The rented movie on a DVD provides an equivalent viewer experience, albeit less convenient. But, more importantly, it has a much lower cost, and consumers only pay for movies they choose to watch.

The movie rental company Redbox uses 40,000 kiosks in the United States to make movie rentals available for $2. Redbox is a low-cost alternative to subscriptions to streaming services such as Netflix ($10/month) and Disney+ ($11/month) for people who watch a few movies a month. However, Redbox is a direct competitor to Netflix's DVD rental business, where plans cost $10 a month (for one DVD out at a time).

LOW SWITCHING COSTS. In addition to offering a lower price, substitutes may become more attractive by offering a higher value proposition.[26] In Spain, some 6 million people travel annually between Madrid and Barcelona, which are roughly 400 miles apart. The trip by car or train used to take most of the day, and 90% of travelers chose to fly, creating a highly profitable business for local airlines. This situation changed with the introduction of the Alta Velocidad Española (AVE), an ultramodern high-speed train. Considering the total time involved, high-speed trains are faster than short-haul flights. Passengers travel in greater comfort than airline passengers and commute from one city center to the next, with only a short walk or cab ride to their final destinations. The rapid shift away from air travel to trains was facilitated by nonexistent switching costs. Indeed, given the greater convenience and lower cost, customers had an incentive to choose the high-speed train rather than airplane travel.

The AVE example highlights the two fundamental insights provided by Porter's five forces framework:

- Competition must be defined more broadly to go beyond direct industry competitors.
- Any of the five forces on its own, if sufficiently strong, can extract industry profitability.

In the AVE example, rather than defining competition narrowly as the firm's closest competitors, airline executives in Spain must look beyond other airlines and consider substitute offerings such as high-speed trains. The threat of substitutes limits the airline industry's profit potential. With the arrival of AVE, the airlines' monopoly on fast transportation between Madrid and Barcelona vanished, along with the airlines' high profits. In this case, the substantial threat of substitutes increased the rivalry among existing competitors in the Spanish air transportation industry.

LO 3-4

Examine how competitive industry structure shapes rivalry among competitors.

RIVALRY AMONG EXISTING COMPETITORS

Rivalry among existing competitors describes the intensity with which companies in the same industry jockey for market share and profitability. This rivalry can range from genteel to cutthroat. The other four forces—the threat of entry, the power of buyers and suppliers, and the threat of substitutes—all exert pressure on this rivalry, as indicated by the arrows pointing toward the center in Exhibit 3.3. *The stronger the forces, the stronger the expected competitive intensity, limiting the industry's profit potential.*

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

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

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

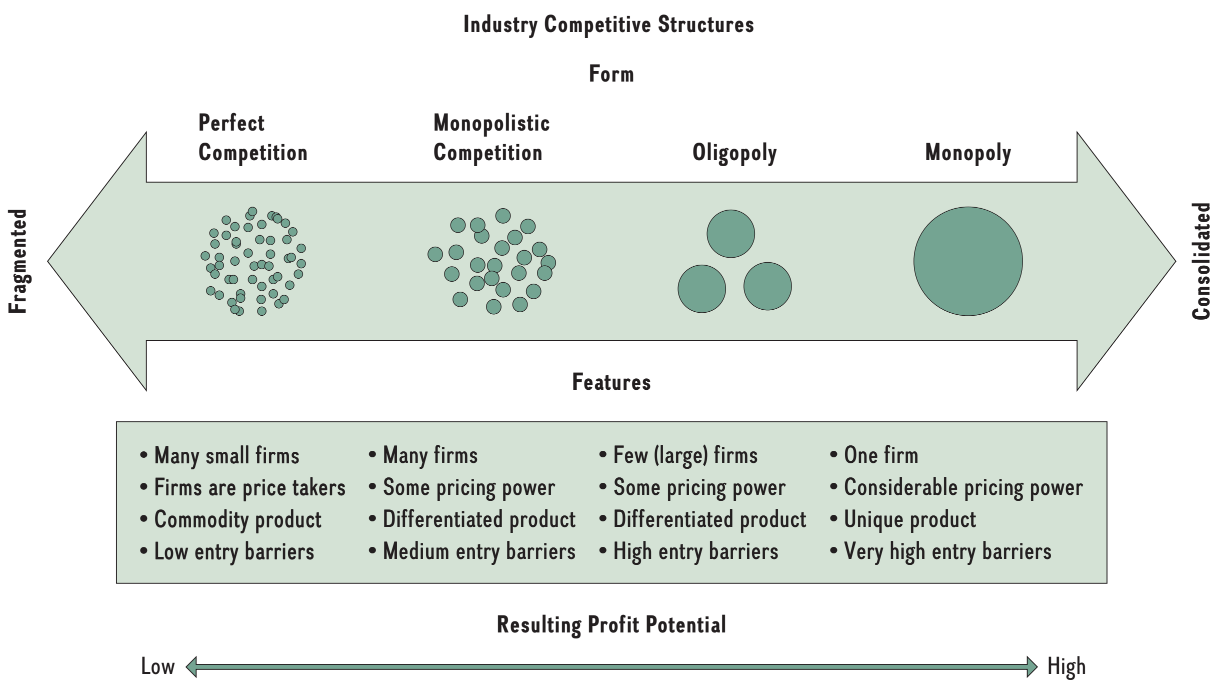
COMPETITIVE INDUSTRY STRUCTURE. The **competitive industry structure** refers to elements and features common to all industries. These features are:

- The number and size of a firm's competitors.
- The firm's degree of pricing power.
- The type of product or service (commodity or differentiated product).
- The height of entry barriers.[27]

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

Exhibit 3.4 shows different industry types along a continuum from fragmented structures to consolidated structures. At one extreme, a *fragmented industry* consists of many small firms and generates low profitability. At the other end of the continuum, a *consolidated*

EXHIBIT 3.4 Industry Competitive Structures along the Continuum from Fragmented to Consolidated



industry is dominated by a few firms, or even just one firm, and has the potential to be highly profitable. The four main competitive industry structures are:

1. Perfect competition.
2. Monopolistic competition.
3. Oligopoly.
4. Monopoly.

Perfect Competition. A *perfectly competitive* industry is fragmented. It is characterized by many small firms, a commodity product, ease of entry, and little or no ability for each firm to raise its prices. The firms competing in a perfectly competitive industry are approximately similar in size and resources. Consumers make purchasing decisions solely on price because the commodity product offerings are more or less identical. The resulting performance of the industry shows low profitability.

Under the conditions of perfect competition, firms have difficulty achieving even a temporary competitive advantage. Any advantage erodes quickly because all firms are assumed to have access to the same information, technology, resources, and capabilities. In addition, there are no barriers to resource mobility, and thus firms cannot create a moat around their advantage. Therefore, firms under perfect competition can at best achieve only competitive parity. Although perfect competition is rare in its pure form, markets for commodities such as natural gas, copper, and iron tend to approach this industry structure.

Modern high-tech industries are also not immune to the perils of perfect competition. Many internet entrepreneurs have learned that it is difficult to beat the forces of perfect competition. Fueled by eager venture capitalists, about 100 online pet supply stores such as pets.com, petopia.com, and pet-store.com had sprung up at the height of the internet bubble (by 2000).[28] Cutthroat competition ensued, with online retailers selling products below cost. When many small firms offer a commodity product in an industry that is easy to enter, no one can increase prices and generate profits.

To make matters worse for the online pet-supply retailers, category-killers such as PetSmart and Petco were expanding rapidly, opening some 2,000 bricks-and-mortar stores in the United States and Canada. The ensuing price competition led to an industry shakeout, leaving online retailers in the dust. Looking at the competitive industry structures depicted in Exhibit 3.4, we might have predicted that online pet-supply stores were unlikely to be profitable.

Monopolistic Competition. A *monopolistically competitive* industry has many firms, a differentiated product, some obstacles to entry, and the ability to raise prices for a relatively unique product while retaining customers. In this industry structure, firms offer products or services with unique features. Thus, although products between competitors tend to be similar, they are by no means identical. Consequently, firms selling a product with unique features tend to have some ability to raise prices. When a firm can differentiate its product or service offerings, it carves out a niche in the market with some degree of monopoly power over pricing, thus the name "monopolistic competition." Firms frequently communicate the degree of product differentiation through advertising.

The computer hardware industry is one example of monopolistic competition. Many firms compete in this industry, and even the largest (Acer, Apple, ASUS, Dell, HP, Lenovo, and Microsoft) have less than 20% market share. Nonetheless, firms in this industry differentiate their product offerings to some extent. While it is well known that Apple charges a premium price for a perceived better user experience, other players in this industry also stake out unique positions to some extent. Lenovo, for instance, has a strong position in the high end of the laptop market because it creates products to meet the needs of professionals with significant computing needs, such as engineers and scientists. Microsoft, in contrast, targets its Surface line of tablets and PCs toward individuals with a productivity focus, such as students and professionals on many levels. Dell competes on price, providing acceptable everyday and professional computing solutions at a low cost.

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

In an oligopoly, the competing firms are *interdependent.* With only a few large competitors in the mix, the actions of one firm influence the behaviors of the others. Therefore, each competitor in an oligopoly must consider the other competitors' strategic actions. Oligopoly is often analyzed using *game theory,* which attempts to predict strategic behaviors by assuming that the moves and reactions of competitors can be anticipated.[29] Due to their strategic interdependence, companies in an oligopolistic industry have an incentive to coordinate their strategic actions to maximize joint performance. Although explicit coordination such as price-fixing is illegal in the United States, tacit coordination such as "an unspoken understanding" is not.

The express-delivery industry is an example of an oligopoly. The main competitors in this space are FedEx and UPS. Any strategic decision made by FedEx (e.g., to expand delivery services to ground delivery of larger-size packages) directly affects UPS; likewise, any decision made by UPS (e.g., to guarantee next-day delivery before 8:00 a.m.) directly affects FedEx. Other examples of oligopolies include the soft drink industry (Coca-Cola vs. Pepsi), airframe manufacturing business (Boeing vs. Airbus), home-improvement retailing (The Home Depot vs. Lowe's), toys and games (Hasbro vs. Mattel), and detergents (P&G vs. Unilever).[30] These examples of different company pairings represent a duopoly in each industry. Duopoly means "two firms competing." A duopoly is an oligopoly type in which two firms have dominant or exclusive control over a market.

Companies in an oligopoly tend to have some pricing power based on differentiating their product or service offerings from those of their competitors. *Non-price competition* is therefore the preferred mode of competition. Firms compete by offering unique product features or services rather than competing based on price. When one firm in an oligopoly cuts prices to take market share from a competitor, the competitor typically will respond in kind and cut prices. This process initiates a price war, which can be extremely detrimental to overall industry profitability.

In the early years of the soft drink industry, for example, whenever PepsiCo lowered prices, Coca-Cola followed suit. These actions resulted in reduced profitability for both companies. In recent decades, Coca-Cola and PepsiCo have repeatedly demonstrated that they have learned this lesson. They have shifted the basis of competition from price cutting to new product introductions and lifestyle advertising. Any price adjustments are merely short-term promotions. By leveraging innovation and advertising, Coca-Cola and PepsiCo have moved to non-price competition, allowing them to charge higher prices and improve industry and company profitability.[31]

Oligopolies tend to have no more than a few large firms that are interdependent. For instance, in the delivery express industry, the largest global companies are DHL, FedEx, and UPS. The international delivery express industry, therefore, is an oligopoly. In many economies, including the United States, oligopoly is the most common industry structure.

Monopoly. An industry is a *monopoly* when there is only one, often large firm supplying the market. The firm may offer a unique product, and the barriers to entry tend to be high or insurmountable. Because a monopolist has considerable pricing power, firm and thus industry profit tend to be high. The one firm is the industry.

In some instances, the government grants one firm the right to be the sole supplier of a product or service. Governments grant monopoly rights to incentivize a company to engage in a venture that would not be profitable if the industry had more than one supplier. These monopolies are called *natural monopolies.* For instance, public utilities incur huge fixed costs to build plants and supply a particular geographic area. Thus public utilities providing water, gas, and electricity to businesses and homes are frequently monopolists. Georgia Power is the only electricity supplier for over 2.5 million customers in the southeastern United States. Philadelphia Gas Works is the sole supplier of natural gas in Philadelphia, serving some 500,000 customers. The governments involved believe the market would not supply these products or services without these natural monopolies. The situation in which a market does not provide a specific product or service is called *market failure.* In the past few decades, more and more natural monopolies in the United States have been deregulated, including airlines, telecommunications, railroads, trucking, and ocean transportation. This deregulation has led to the emergence of competition, which frequently leads to lower prices, better service, and more innovation.

Of great interest to strategists are the so-called *near monopolies*. These firms have accrued significant market power, for example, by owning valuable patents or proprietary technology. In the process, they are changing the industry structure in their favor, generally from monopolistic competition or oligopoly to near monopoly. These near monopolists have accomplished product differentiation to such a degree that they are in a class by themselves, just like a monopolist. For example, the European Union views Google with its 90% market share in online search as a *digital monopoly.*[32] This position is enviable in terms of Google's ability to extract profits by leveraging its data to provide targeted online advertising and other customized services, with the caveat that Google must steer clear of monopolistic behavior, which may attract antitrust regulators and lead to legal repercussions.

INDUSTRY GROWTH. Industry growth directly affects the intensity of rivalry among competitors. During periods of high growth, consumer demand rises, and price competition among firms frequently decreases. Because the pie is expanding *(positive-sum competition)*, rivals are focused on capturing a larger piece of an increasing pie rather than taking market share and profitability away from one another.

For example, knee replacement is a fast-growing segment in the medical products industry. In the United States, robust demand is driven by the need for knee replacements for an aging and heavy population. The leading competitors are Zimmer Biomet, DePuy, and Stryker, with a significant share held by Smith & Nephew. Competition in this market is based primarily on innovative design, improved implant materials, and differentiated products such as gender solutions and a range of high-flex knees. The competitors avoid price competition and focus on differentiation that allows premium pricing. Interestingly, as a result of improvements to materials and procedures, younger patients increasingly choose an early surgical intervention.

Rivalry among competitors becomes fierce during slow or negative industry growth (*zero-sum competition* in a given market size and *negative-sum competition* in a shrinking market). Price discounts, frequent new product releases with minor modifications, intense promotional campaigns, and fast retaliation by rivals are all tactics indicative of an industry with slow or negative growth. Competition is fierce because opponents can gain only at the expense of others; therefore, companies focus on taking business away from one another. Attempts by McDonald's, Burger King, and Wendy's to steal customers from one another include frequent discounting tactics such as dollar menus. Such competitive tactics indicate cutthroat competition and a low-profit potential in the traditional hamburger fast food industry.

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

STRATEGIC COMMITMENTS. If firms make strategic commitments to compete in an industry, rivalry among competitors is likely to become more intense. **Strategic commitments** are decisions that are costly, have a long-term impact, and are difficult to reverse (e.g., spending billions of dollars building a new high-tech factory). In contrast, *tactical decisions* are short-term and can be easily reversed (e.g., a marketing campaign). Strategic commitments to a specific industry can stem from large, fixed-cost requirements and from noneconomic considerations.[33]

strategic commitments Decisions that are costly, have a long-term impact, and are difficult to reverse. Contrast with tactical decisions, which are short-term and can be easily reversed.

exit barriers The obstacles that interfere with a firm's ability to leave an industry.

EXIT BARRIERS. The rivalry among existing competitors is also a function of an industry's **exit barriers**, the obstacles that interfere with a firm's ability to leave an industry. Exit barriers are created by both economic factors and social factors. They include fixed costs that must be paid regardless of whether the company is operating in the industry or not. For example, a company exiting an industry may still have contractual obligations to employees, such as health care, retirement benefits, and severance pay. Social factors include elements such as emotional attachments to specific geographic locations. In Michigan, entire communities depend on GM, Ford, and Chrysler (renamed Stellantis). If any carmaker exits the industry, communities will suffer. Other social and economic factors include ripple effects through the supply chain. When one major player in an industry shuts down, its suppliers are adversely impacted.

An industry with low exit barriers is more attractive because it allows underperforming firms to exit more easily. Such exits reduce competitive pressure on the remaining firms because excess capacity is removed. In contrast, an industry with high exit barriers has reduced profit potential because excess capacity often remains much longer than economically justifiable.

The Five Forces Competitive Analysis Checklist. The key takeaway from the five forces model is that the stronger the forces, the lower the industry's ability to earn above-average profits and the lower the firm's ability to gain and sustain a competitive advantage. Conversely, the weaker the forces, the greater the industry's ability to earn above-average profits and the greater the firm's ability to gain and sustain competitive advantage. Therefore, a company's strategic leaders need to craft a strategic position that leverages weak forces into opportunities and mitigates strong forces that are potential threats to the firm's ability to gain and sustain a competitive advantage.

Exhibit 3.5 provides a checklist that you can apply to any industry when assessing the underlying competitive forces that shape strategy.

EXHIBIT 3.5

The Five Forces Competitive Analysis Checklist

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

The threat of entry is high when:

✓ The minimum efficient scale to compete in an industry is low.
✓ Network effects are not present.
✓ Customer switching costs are low.
✓ Capital requirements are low.
✓ Incumbents do not possess:
  - Brand loyalty.
  - Proprietary technology.
  - Preferential access to raw materials.
  - Preferential access to distribution channels.
  - Favorable geographic locations.
  - Cumulative learning and experience effects.

✓ Restrictive government regulations do not exist.
✓ New entrants expect that incumbents will not or cannot retaliate.

The power of suppliers is high when:

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

The power of buyers is high when:

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

The threat of substitutes is high when:

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

The rivalry among existing competitors is high when:

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

APPLYING THE FIVE FORCES MODEL TO THE U.S. AIRLINE INDUSTRY

Applying the five forces model to the U.S. domestic airline industry provides a neat examination of the competitive forces shaping strategy.[34]

THREAT OF ENTRY. *Entry barriers* in the airline industry are relatively low, resulting in new airlines popping up occasionally. To enter the industry on a small scale and serve a few select cities, a prospective new entrant needs only a couple of airplanes, which can be rented; a few pilots and crew members; some routes connecting city pairs; and gate access in airports. Despite the notoriously low profitability of the airline industry, Virgin America entered the U.S. market in 2007. Virgin America is the brainchild of Sir Richard Branson, founder, and chairman of the Virgin Group, a UK conglomerate of hundreds of companies using the Virgin brand, including the international airline Virgin Atlantic. Virgin America's business strategy was to offer low-cost service between major metropolitan cities on the American East Coast and West Coast. Virgin America failed and was acquired by Alaska Airlines in 2016.

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

Let's discuss one important supplier group to this industry: Boeing and Airbus, the makers of large commercial jets. Airframe manufacturers are powerful suppliers to airlines because their industry is much more concentrated (only two firms) than the industry it sells to. Compared to two airframe suppliers, there are hundreds of commercial airlines worldwide. Given the trend of large airlines merging to create even larger mega-airlines, however, increasing buyer power may eventually balance out this situation a bit. Nonetheless, the airlines face nontrivial switching costs when changing suppliers because pilots and crew need to be retrained to fly new aircraft, maintenance capabilities need to be expanded, and some routes may need to be reconfigured due to differences in aircraft range and passenger capacity.

Moreover, although some aircraft can be used as substitutes, Boeing and Airbus offer differentiated products. This fact becomes more evident when we consider some of the more recent models from each company. Boeing introduced the 787 Dreamliner to capture long-distance point-to-point travel (close to an 8,000-mile range, sufficient to fly nonstop from Los Angeles to Sydney). In contrast, Airbus introduced the A-380 Superjumbo to focus on high-volume transportation (close to 900 passengers) between major airport hubs (e.g., Tokyo's Haneda Airport and Singapore's Changi Airport).

For people who are considering long-distance travel, there are no readily available substitutes for commercial airliners, a fact that strengthens supplier power. Thus, the supplier power of commercial aircraft manufacturers is quite significant. Formidable supplier power puts Boeing and Airbus in a strong position to extract profits from the airline industry, thus reducing the profit potential of the airlines.

Although the supplier power of Boeing and Airbus is strong, several factors moderate their bargaining positions. First, the suppliers of commercial airliners depend heavily on robust demand by commercial airlines for their revenues. Given the lower-than-expected demand for the A-380, for instance, Airbus stopped producing the Superjumbo in 2021.[35] Now, Airbus focuses on its newer and smaller A-350 model, a versatile and fuel-efficient airplane designed to be deployed on high-traffic point-to-point routes. It is thus a direct competitor to Boeing's 787 (which encountered problems with faulty batteries and improper manufacturing of some fuselage parts, and was grounded for some time by regulators). As the recent strategic moves by Airbus and Boeing show, even a *duopoly* in the airframe manufacturing business is not immune to changes in customer demand (power of buyers).

Second, Boeing and Airbus are unlikely to threaten forward integration and become commercial airlines themselves. Third, Bombardier of Canada and Embraer of Brazil, both manufacturers of smaller commercial airframes, have begun to increase size of the jets they offer, and their products now compete with some of the U.S.-produced smaller planes, such as the Boeing 737 and Airbus A-320. Finally, industry structures are not static but can change over time. Several of the remaining large domestic U.S. airlines have merged (Delta and Northwest, United and Continental, and American and U.S. Airways), which changed the industry structure in their favor. There are now fewer airlines, but they are larger. Their larger size increases their buyer power, which we turn to next.

POWER OF BUYERS. Large corporate customers contract with airlines to serve all of their employees' travel needs; such *powerful buyers* further reduce profit margins for air carriers. To make matters worse, consumers primarily make purchase decisions based on price because air travel is viewed as a commodity with little or no differentiation across domestic U.S. carriers. In inflation-adjusted dollars, ticket prices have been falling since industry deregulation in 1978. Thanks to internet travel sites such as Orbitz, Travelocity, and Kayak, price comparisons are effortless. Consumers benefit from cutthroat price competition between carriers and capture significant value. Low switching costs and nearly perfect real-time information combine to strengthen buyer power.

THREAT OF SUBSTITUTES. To make matters worse for the U.S. airline industry, *substitutes* are readily available: Customers can drive a car or use the train or bus if airline ticket prices are too high. For example, the route between Atlanta and Orlando (roughly 400 miles) used to be one of Delta's busiest and most profitable. Given the increasing security requirements at airports and other factors, more people now prefer to drive.

Summary. In terms of generating profit potential in the U.S. airline industry, the competitive forces are quite unfavorable: low entry barriers, high supplier power, high buyer power combined with low customer switching costs, and the availability of low-cost substitutes. This hostile environment leads to intense rivalry among existing airlines and low overall industry profit potential.

RIVALRY AMONG EXISTING COMPETITORS. As a consequence of the powerful industry forces discussed, the *nature of rivalry* among airlines has become extremely intense. Moreover, the required strategic commitments combined with exit barriers further increase the competitive intensity in the U.S. domestic airline industry.

Strategic Commitments. Significant strategic commitments are required to compete in the U.S. airline industry, which uses a hub-and-spoke system to provide domestic and international coverage. The major U.S.-based airlines—Delta, United, and American—incur high fixed costs to maintain the network of routes that affords global coverage, frequently in conjunction with foreign partner airlines. These fixed costs in aircraft, gate leases, hangars, maintenance facilities, baggage facilities, and ground transportation all accrue before the airlines sell any tickets.

High fixed costs create tremendous pressure to fill empty seats. Like an unbooked hotel room, an airline seat on a specific flight is perishable. Empty airline seats are often filled through price cutting. Given similar high fixed costs, other airlines respond in kind.

Eventually, a vicious cycle of price cutting ensues, driving average industry profitability to zero or even negative numbers (with the companies losing money). Given their strategic commitments, airlines are unlikely to exit an industry. Excess capacity remains, further depressing industry profitability.

In other cases, strategic commitments to a specific industry may result from more political than economic considerations. The U.S. domestic airlines received a federal government bailout of more than $60 billion to avoid bankruptcies during the Covid-19 pandemic. Policy decision-makers justified the bailouts by arguing that travel is an essential service. Given these political considerations and large-scale strategic commitments, none of the major U.S. airlines exited the industry even if they lost large sums of money during the pandemic.

Exit Barriers. The U.S. domestic airline industry is characterized by high exit barriers, which further reduce the industry's overall profit potential. All the large U.S. airlines (American, Delta, and United) have filed for bankruptcy at one point. Due to a unique feature of U.S. Chapter 11 bankruptcy law, companies may continue to operate and reorganize while being temporarily shielded from their creditors and other obligations. As a result, excess capacity is often not removed from the industry. Exit barriers thus lead to excess capacity, which in turn puts pressure on prices and reduces industry profit potential.

CONCLUSION. Although many of the U.S. mega-airlines have lost billions of dollars over the past few decades and continue to struggle to generate consistent profitability, other players in the industry have been quite profitable because they were able to extract some of the economic value created. The surprising conclusion, therefore, is that while the mega-airlines frequently struggle to achieve consistent profitability over time, the other players in the industry—such as the suppliers of airframes and aircraft engines, aircraft maintenance companies, IT companies providing in-flight Wi-Fi and entertainment as well as reservation and logistics services, caterers, airports, and so on—are quite profitable, all extracting significant value from the air transportation industry. Customers also are better off, as ticket prices have decreased and travel choices have increased.

A closer look at the U.S. domestic airline industry shows how the five forces framework is a powerful and versatile tool for analyzing industries. The five forces model allows strategic leaders to analyze all players using a wider industry lens, enabling a deeper understanding of an industry's profit potential. Moreover, a five forces analysis provides the basis for how a firm should position itself to gain and sustain a competitive advantage. We will take up the topic of competitive positioning in Chapter 6 when studying business-level strategy in much more detail.

A SIXTH FORCE: THE STRATEGIC ROLE OF COMPLEMENTS

LO 3-5

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

The value of the five forces model for explaining the profit potential of an industry can be further enhanced if one also considers the availability of complements.[36]

A **complement** is a product, service, or competency that adds value to the original product offering when the two are used in tandem.[37] Complements increase demand for the primary product, thereby enhancing the profit potential for the industry and the firm. A company is a **complementor** to your company if customers value your product or service

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

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

offering more when they can combine it with the other company's product or service.[38] Firms may choose to provide the complements themselves or work with another company to accomplish this.

CO-OPETITION. For example, in the smartphone industry, Alphabet's Google complements Samsung, the Korean high-tech company. Samsung's smartphones are more valuable when they come with Google's Android mobile operating system installed. At the same time, Google and Samsung are increasingly becoming competitors. With Google's acquisition of Motorola Mobility, the online search company launched its smartphones and Chromebooks. This development illustrates the process of **co-opetition**, which is cooperation by competitors to achieve a strategic objective. Samsung and Google cooperate as complementors to compete against Apple's strong position in the mobile device industry. While Google retained Motorola's patents for development in its future phones and to defend itself against competitors such as Samsung and Apple, Alphabet (Google's parent company) sold the manufacturing arm of Motorola to Lenovo, a Chinese maker of computers and mobile devices.

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

Google acquired HTC's smartphone engineering group in 2017. The Taiwanese smartphone maker developed the Google Pixel phone. With this acquisition, Google is committing to handset manufacturing. In contrast, Google's Motorola deal was more motivated by intellectual property considerations. Integrating HTC's smartphone unit within Google enables engineers to integrate hardware and software more tightly to provide a better user experience. Tighter integration allows Google to differentiate its high-end Pixel phones from the competition, especially Apple's iPhones and Samsung's Galaxy phones. So, although Google and Samsung are still cooperating in mobile operating system software, they are increasingly competing in the phone market.

LO 3-6

Explain the five choices required for market entry.

3.3 Changes over Time: Entry Choices and Industry Dynamics

ENTRY CHOICES

One of the key insights of the five forces model is that the more profitable an industry, the more attractive it becomes to competitors. Let's assume a firm's strategic leaders are aware of potential barriers to entry (discussed earlier), but they nonetheless contemplate potential market entry because the industry profitability is high and thus quite attractive. Exhibit 3.6 illustrates an integrative model that can guide the entry choices that strategic leaders must make. Rather than considering firm entry as a discrete event (i.e., simple yes or no decision) or a discrete event composed of five parts, this model suggests that the entry choices that firms make constitute a strategic process unfolding over time.

Specifically, to increase the probability of successful entry, strategic leaders need to consider the following five questions:[39]

1. *Who are the players?* Building on Porter's insight that competition must be viewed in a broader sense beyond direct competitors, the *who* question allows strategic leaders not only to identify direct competitors but also to focus on customers and suppliers that can extract some of the value created in the industry. Strategic leaders also need to align the incentives of other external and internal stakeholders such as employees, regulators, and

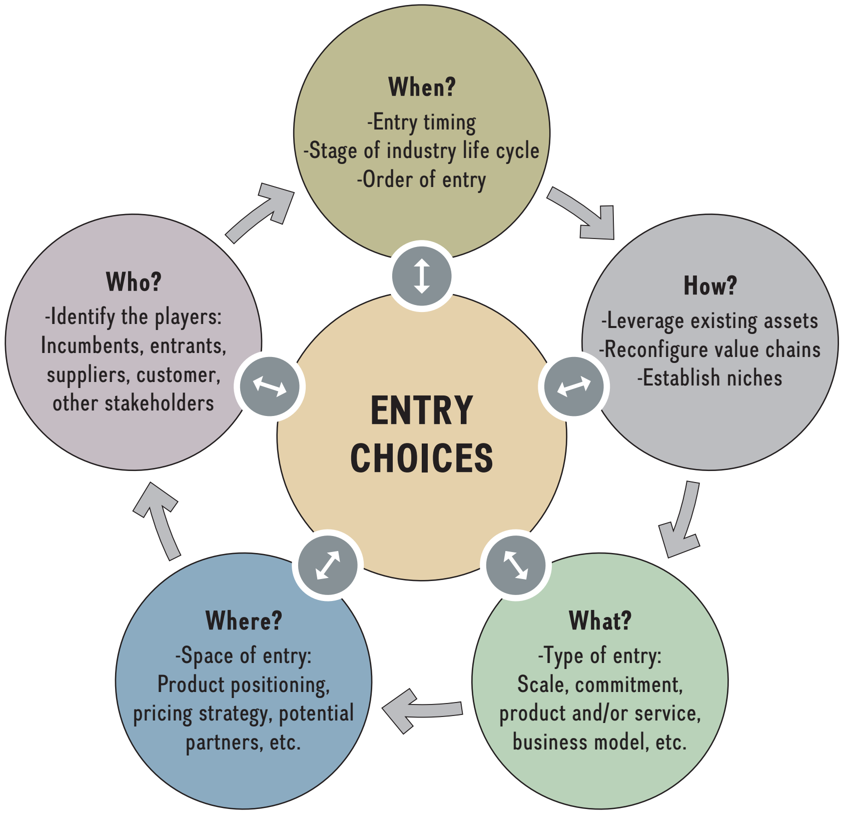


EXHIBIT 3.6

An Integrative Model of Entry Choices

Source: Author's adaptation from M.A., Zachary, P.T. Gianiodis, G. Tyge Payne, and G.D. Markman (2014), "Entry timing: enduring lessons and future directions," *Journal of Management* 41: 1409; and Bryce, D.J., and J.H. Dyer (2007, May), "Strategies to crack well-guarded markets," *Harvard Business Review:* 84–92.

communities (see discussion of stakeholder strategy in Chapter 1) to improve their chances of successful entry.

2. *When to enter?* This question concerns the *timing of entry.* Given that our perspective is that of a firm considering entry into an *existing* industry, any first-mover advantages are bygones. Nonetheless, potential new entrants need to consider at which stage of the industry life cycle (introduction, growth, shakeout, maturity, or decline) they should enter. We take a deep dive into the industry life cycle and how it unfolds in Chapter 7.
3. *How to enter?* One of the challenges that strategic leaders face is that often the most attractive industries in terms of profitability are also the hardest to break into because they are protected by entry barriers. The *how to enter* question goes to the heart of this problem.
   - One option is to *leverage existing assets*—that is, to combine the resources and capabilities that firms already possess, and if necessary blend them with partner resources through strategic alliances. Although Circuit City went bankrupt as an electronics retailer, losing out to Best Buy and Amazon, a few years earlier it recombined its existing expertise in big-box retailing, including optimization of supply and demand in specific geographic areas, to create CarMax, now the largest used-car dealer in the United States and a Fortune 500 company.

- Another option is to *reconfigure value chains.* This approach allowed Skype and Zoom to enter the market for video calls and videoconferencing by combining value chains differently and using a different technology, Voice over Internet Protocol (VoIP), to circumvent entry barriers. Reconfiguring the value chain by using new technology to bypass traditional entry barriers into the telecommunications industry enabled Skype and Zoom to compete with incumbent telecom companies such as AT&T, T-Mobile, and Verizon.
- The third option is to *establish a niche* in an existing industry, and then use this beachhead to grow. The Austrian maker of Red Bull used this approach when entering the U.S. soft drink market, long dominated by Coca-Cola and PepsiCo. Red Bull's energy drink is offered in a small 8.4-ounce (250-ml) can, but its price is several times that of Coke or Pepsi. Red Bull's smaller cans allowed retailers to stock them in small spaces, such as near the checkout counter. In addition, Red Bull initially used many nontraditional outlets as points of sale, such as bars and nightclubs. This approach created a loyal following that helped Red Bull expand its entry into the mainstream carbonated beverage industry in the United States and elsewhere. Today, energy drinks are one of the fastest-growing segments in this industry.

4. *What type of entry?* The *what* question refers to the type of entry in terms of product market (e.g., smartphones), value chain activity (e.g., R&D for smartphone chips or manufacturing of smartphones), geography (e.g., domestic and/or international), and type of business model (e.g., subsidizing smartphones when providing services). Depending on the market under consideration for entry, firms may face unique competitive and institutional challenges. For example, discount carrier Spirit Airlines' unbundling of its services, which entails charging customers separately for elements such as checked luggage, assigned seating, carry-on items, and other in-flight perks such as drinks, met considerable backlash in 2007 when introduced. Yet this strategic initiative marked the starting point of Spirit Airlines' strategic positioning as an *ultra-low-cost carrier.* Unbundling air travel into its different components allows Spirit to lower the prices for the (stand-alone) airfare. Lower ticket prices have created more customer demand, and Spirit Airlines has added many attractive routes and entered geographic markets in which it was not able to compete previously.
5. *Where to enter?* After the firm has decided on the type of entry, the *where* to enter question requires managers to attend to the more fine-tuned aspects of entry, such as product positioning (high end vs. low end), pricing strategy, and potential partners.

LO 3-7

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

INDUSTRY DYNAMICS

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

Industry structures are not stable over time. Rather, they are dynamic. Because a consolidated industry tends to be more profitable than a fragmented one (see Exhibit 3.4), firms have a tendency to change the industry structure in their favor, making it more consolidated through horizontal mergers and acquisitions. Having fewer competitors generally equates to higher industry profitability. Industry incumbents therefore have an incentive to reduce the number of competitors in the industry. With fewer but larger competitors, incumbent firms can more effectively mitigate the threat of strong competitive forces, such as supplier or buyer power.

The U.S. domestic airline industry has witnessed several large horizontal mergers between competitors, including Delta and Northwest, United and Continental, Southwest and AirTran, and American and U.S. Airways. These mergers have allowed the remaining carriers to enjoy a more benign industry structure and to retire some of the excess capacity in the industry as the merged airlines consolidated their networks of routes. The merger activity in the airline industry provides one example of how firms can proactively reshape industry structure in their favor. A more consolidated airline industry is likely to lead to higher ticket prices and fewer choices for customers, but more profit for the airlines.

Sometimes consolidated industry structures break up and become more fragmented. This fragmentation generally happens when there are external shocks to an industry such as deregulation, new legislation, technological innovation, or globalization. For example, the widespread use of the internet moved the stock brokerage business from an oligopoly controlled by full-service firms such as Merrill Lynch and Morgan Stanley to monopolistic competition with many generic online brokers such as TD Ameritrade, Charles Schwab, E-Trade, and Scottrade.

Robinhood Markets, founded with the mission to "provide everyone with access to the financial markets, not just the wealthy,"[40] initiated the next round of innovation by introducing commission-free trading. Most of the other brokerage firms, especially all the firms that had entered the industry in the wave just before Robinhood, followed suit and now offer commission-free trades. Copying the innovative move of a new entrant indicates a high level of competitiveness in an industry where individual investors face low switching costs between providers. Many consumers view stock brokerage services as a non-differentiated commodity, and price is often the deciding factor.

Another dynamic to be considered is **industry convergence**, the process whereby formerly unrelated industries begin to satisfy the same customer need. Industry convergence is often brought on by technological advances. For years, many players in the media industries have been converging due to technological progress in AI, telecommunications, and digital media. Media convergence unites computing, communications, and content, thereby causing significant upheaval across previously distinct industries. Content providers in industries such as newspapers, magazines, TV, movies, radio, and music are all scrambling to adapt. Many standalone print newspapers are closing up shop, while others are trying to figure out how to offer online news content for which consumers are willing to pay.[41] Internet companies such as Alphabet (owner of Google), Meta (with its Facebook and Instagram apps), LinkedIn (owned by Microsoft), Snap, Spotify, and Twitter are changing the industry structure by constantly morphing their capabilities and forcing old-line media companies such as Disney, News Corp., The New York Times Company, and WarnerMedia (part of Discovery), to adapt. A wide variety of mobile devices, including smartphones, tablets, and e-readers, provide a new form of instant and global, 24/7, 365-day content delivery that is making older forms of media obsolete.

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

The convergence of different technologies can also lead to the emergence of entirely new industries. Strategy Highlight 3.2 documents the recent rise of the esports industry.

Strategy Highlight 3.2

From League of Legends to Fortnite: The Rise of Esports

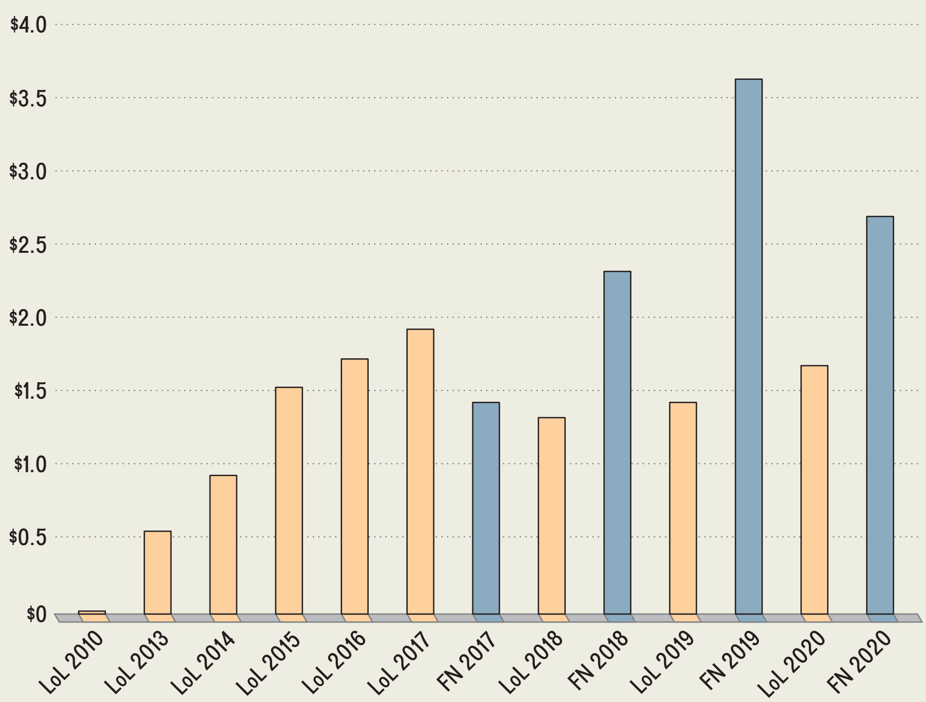
League of Legends (LoL), the famous multiplayer online battle arena game developed and launched in 2009 by Riot Games of Los Angeles, went from a small niche game to a billion-dollar business, sparking the explosive growth of the esports industry. Although online games have been around for a while, Riot Games accelerated esports' acceptance into the mainstream culture.

Within two years of its launch, LoL managed to accrue 1.4 million daily players and 3.5 million monthly average users (MAU). Since then, it has garnered 130 million MAU and made more than $12 billion in revenues. The explosive growth and global popularity of LoL did not go unnoticed: In 2011, the Chinese tech company Tencent (also the owner of WeChat, the world's largest social media and mobile payment app, with some 1 billion daily users) bought Riot Games for $400 million. LoL was the world's most popular video game for nearly a decade—until Fortnite took over. Exhibit 3.7 shows the annual revenues of LoL and Fortnite over time.

LoL is free to download and free to play. Game updates released by Riot Games are also free. How has Riot Games made so much money using a freemium business model? Its business model relies on four key tactics: in-game and ancillary transactions, live in-person events, livestreaming, and merchandise sales.

In-game and ancillary transactions are the first source of revenue. Riot Games makes the bulk of its money by selling "champions" (the avatars that fight in the battles and their "skins" (which change the appearance of the champions) to its extensive user base. It offers more than 150 champions with some 1,300 skins and other

EXHIBIT 3.7 League of Legends and Fortnite Annual Revenues (in $bn)



Source: Author's depiction of publicly available data.

accessories, such as name changes. Each champion has unique abilities, and you unlock more abilities as you play and win. LoL accepts two types of currency: Blue Essence, which are points that can be earned through playing (by accomplishing specific missions in a game, for instance), and Riot Points, which can be purchased with real money through a credit card, Paypal, or a prepaid card. Because each match consists of two teams comprising five players, the possible permutations of champions and skins can add up to the billions, and all encounters are unique. Furthermore, the LoL in-game store is digital, which means its inventory is potentially unlimited. Players receive personalized recommendations based on their selected champions and other individual characteristics.

Live esport events are the second source of revenue. One key differentiator between LoL and previous esports games is its competitive focus. Riot Games hosts a League Championship Series (LCS), attracting vast audiences and significant media and sponsorship attention. It controls all aspects of the LCS, including the music, the broadcasting, and the decisions about where to run LoL tournaments, which are hosted in several global locations. Top professional players can earn millions of dollars a year (in prize money, sponsorship, and streaming fees), and thousands of players have gone professional, with many of them making $150,000 a year. The LCS events are hugely popular and fill venues with tens of thousands of attendees, who are often dressed in cosplay outfits as characters from LoL, a movie, a book, or another video game. In addition to providing a unique experience for their visitors, live events help to build a community of like-minded gamers.

Livestreamed esport events delivered via the video platform Twitch.tv (nicknamed "the ESPN of Esports," a subsidiary of Amazon) are the third source of revenue. These events often have corporate sponsorships ranging from computer hardware companies (e.g., Intel, Razer, Logitech) to energy-drink firms (e.g., Red Bull, Monster, 5-Hour Energy). LoL has a significant sponsorship deal with Mastercard, a global financial institution best known for its credit cards. Sales of LoL-specific merchandise, such as hoodies, T-shirts, and hats, represent the final source of revenue.

The constant evolution of LoL keeps gamers challenged, creative, and engaged. Many of them can be found in online communities in Reddit and Discord discussing their strategy with other players, thus further expanding the gaming community and its global reach. Most of the world's ranked players are from the United States, China, South Korea, Germany, France, and Sweden (in rank order). The demographics of the players are highly sought after by advertisers because most players are between the ages of 15 and 35, a notoriously difficult audience to reach. Yet, the player base is highly skewed by gender: 85% of the players are male. With virtually no barriers to entry, Riot Games managed to create a new industry and build a colossal gamer base that continues to grow exponentially.

However, during LoL's rise to success, Riot Games found itself contending with competitors such as Minecraft (which Microsoft bought for $2.5 billion in 2014) and Dota 2. Nonetheless, LoL dominated its competitors until the fall of 2017, when Epic Games (partly owned by Tencent) released Fortnite. Fortnite is a battle royale game—a multiplayer online game that continues until only one survivor is standing. Fortnite took off quickly because the game, unlike LoL, was available on all consoles and mobile devices ("cross-platform play"). In contrast, LoL is played on laptops and desktops only. It cannot be played on mobile devices or game consoles such as Xbox or PlayStation. While both LoL and Fortnite are free to download and play, Fortnite is less challenging to play than LoL, making it especially attractive for beginning gamers.

Within the first few months of its launch, Fortnite brought in $1.5 billion in revenues. In its first complete year of existence (2018), Fortnite had $2.4 billion in revenues, and it has brought in over $10 billion since its launch (see Exhibit 3.7). Simultaneously, LoL's revenues declined, indicating that some gamers have moved from LoL to Fortnite. Although Riot Games created the new billion-dollar esports industry, Fortnite appeared to gain a competitive advantage, and LoL may be losing its edge and appeal.

The competitive esports landscape is constantly evolving. Apple removed Fortnite from the app store in 2020 because Epic Games implemented an in-app payment system, bypassing Apple's system. Alphabet's Google followed Apple's move by banning Fortnite from its play store. Apple and Google's actions mean that Fortnite can no longer be played on mobile devices. Epic sued Apple but lost in court. Epic was ruled to be in breach of contract.[42]

LO 3-8

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

3.4 Performance Differences within the Same Industry: Strategic Groups

In further analyzing the firm's external environment to explain performance differences, we now move to firms *within the same industry.* As noted earlier in the chapter, a firm occupies a place within a **strategic group**, a set of companies that pursue a similar strategy within a specific industry, in the quest for competitive advantage (see Exhibit 3.1).[43] Strategic groups differ from one another along important dimensions such as expenditures on research and development, technology, product differentiation, product and service offerings, market segments, distribution channels, and customer service.

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

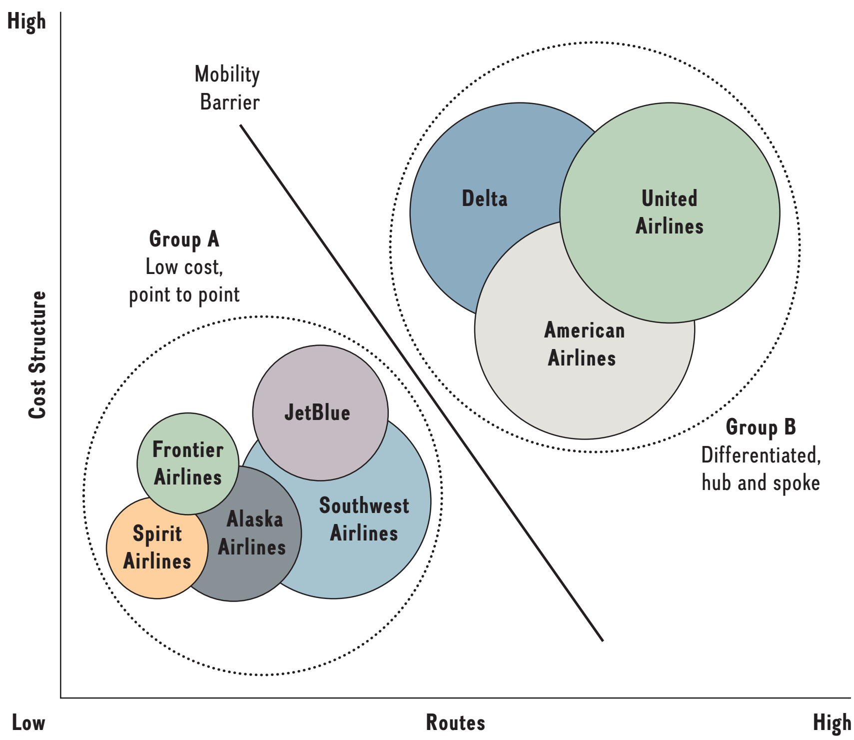
strategic group model A framework that explains differences in firm performance within the same industry.

To explain differences in firm performance within the same industry, the **strategic group model** clusters different firms into groups based on a few key strategic dimensions.[44] Even within the same industry, firm performance differs depending on strategic group membership. Some strategic groups tend to be more profitable than others. This difference implies that firm performance is determined not only by the industry to which the firm belongs but also by its strategic group membership.

The distinct differences across strategic groups reflect the business strategies that firms pursue. Firms in the same strategic group tend to follow a similar strategy. Therefore, companies in the same strategic group are direct competitors. The rivalry among firms *within* the same strategic group is generally more intense than the rivalry *among* strategic groups: *Intra-group rivalry exceeds inter-group rivalry.* The number of different business strategies pursued within an industry determines the number of strategic groups in that industry. In most industries, strategic groups can be identified along a fairly small number of dimensions. In many instances, an industry has two strategic groups based on two different business strategies: One pursues a low-cost strategy, and the other pursues a differentiation strategy (Exhibit 3.8). We discuss each of these generic business strategies in detail in Chapter 6.

EXHIBIT 3.8

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



THE STRATEGIC GROUP MODEL

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

- Identifying the most important strategic dimensions, such as expenditures on research and development, technology, product differentiation, product and service offerings, cost structure, market segments, distribution channels, and customer service. These dimensions are strategic commitments based on managerial actions that are costly and difficult to reverse.
- Choosing two key dimensions for the horizontal and vertical axes, which expose important differences among the competitors.
- Graphing the firms in the strategic group, indicating each firm's market share by the size of the bubble with which it is represented.[45]

Continuing with the example used in our earlier application of the five forces model in determining industry profit potential, the U.S. domestic airline industry provides an illustrative example for the application of the strategic group model. Exhibit 3.8 maps companies active in this industry. The two strategic dimensions on the axes are cost structure and routes. As a result of this mapping, two strategic groups become apparent, as indicated by the dashed circles: Group A, low-cost, point-to-point airlines (Alaska Airlines, Frontier Airlines, JetBlue, Southwest Airlines, and Spirit Airlines), and Group B, differentiated airlines using a hub-and-spoke system (American, Delta, and United). The low-cost, point-to-point airlines are clustered in the lower-left corner because they tend to have a lower cost structure and generally serve fewer routes due to their point-to-point operating system.

The differentiated airlines in Group B, offering full services using a hub-and-spoke route system, comprise the so-called legacy carriers. They are clustered in the upper-right corner because of their generally higher cost structures. Using the hub-and-spoke system, the legacy carriers usually offer many more routes and many more destinations than the point-to-point low-cost carriers. For example, Delta's main hub is in Atlanta, Georgia.[46] If you were to fly from Seattle, Washington, to Miami, Florida, you would likely stop to change planes in Delta's Atlanta hub on your way.

The strategic group mapping in Exhibit 3.8 provides additional insights:

- **Competitive rivalry is strongest between firms in the same strategic group.** The closer firms are on the strategic group map, the more directly and intensely they compete with one another. After a wave of mergers, the remaining mega-airlines—American, Delta, and United—are competing head to head, not only in the U.S. domestic market but also globally. They tend to monitor one another's strategic actions closely. Although Delta faces secondary competition from low-cost carriers such as Southwest Airlines (SWA) on some domestic routes, its primary competitive rivals remain the other legacy carriers, which compete more on providing seamless global services within their respective airline alliances (SkyTeam for Delta, Oneworld for American, and Star Alliance for United) than on low-cost airfares for particular city pairs in the United States. Nonetheless, when Delta faces direct competition from SWA on a particular domestic route (say from Atlanta to Chicago), both tend to offer similar low-cost fares.
- **The external environment affects strategic groups differently.** During times of economic downturn, for example, low-cost airlines tend to take market share away from legacy carriers. Moreover, given their generally higher cost structure, the legacy carriers are often unable to stay profitable during recessions, at least on domestic routes. These outcomes imply that external factors such as recessions or high oil prices favor the companies in the low-cost strategic group. In contrast, given governmental restrictions on

international air travel, the few airlines that are able to compete globally usually make a tidy profit in this specific industry segment.

- **The five competitive forces affect strategic groups differently.** *Barriers to entry,* for example, are higher in the hub-and-spoke (differentiated) airline group than in the point-to-point (low-cost) airline group. Following deregulation, many airlines entered the industry, but all of these new players used the point-to-point system. Because hub-and-spoke airlines can offer worldwide service and are protected by regulation to some extent from foreign competition, they often face weaker *buyer power,* especially from business travelers. While the hub-and-spoke airlines compete head-on with the point-to-point airlines when they are flying the same or similar routes, the *threat of substitutes* is stronger for the point-to-point airlines because they tend to be regionally focused and compete with the viable substitutes of car, train, or bus travel. The threat of *supplier power* tends to be stronger for the airlines in the point-to-point, low-cost strategic group because they are much smaller and thus have weaker negotiation power when acquiring new aircraft, for example. For this reason, these airlines frequently purchase used aircraft from legacy carriers. This brief application of the five forces model leads us to conclude that rivalry among existing competitors in the low-cost, point-to-point strategic group is likely to be more intense than the rivalry within the differentiated, hub-and-spoke strategic group.
- **Some strategic groups are more profitable than others.** Historically, airlines clustered in the lower-left corner tended to be more profitable in the U.S. domestic market. Why? They create similar, or even higher, value for their customers in terms of on-time departure and arrival, safety, and fewer bags lost while keeping their cost structure well below that of the legacy carriers. The point-to-point airlines have generally lower costs than the legacy carriers because they turn their airplanes around faster, fly them longer, use fewer and older airplane models, focus on high-yield city pairs, and tie pay to company performance, among many other activities that support their low-cost business model. The point-to-point airlines are able to offer their services at lower prices to consumers because of a lower cost structure and at a higher perceived value, thus creating the basis for a competitive advantage.

MOBILITY BARRIERS

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

Mobility barriers are industry-specific factors that separate one strategic group from another.[47] Although some strategic groups tend to be more profitable and therefore more attractive than others, *mobility barriers* restrict the movement between groups. The dimensions of a strategic group are determined by mobility barriers, which are a result of prior strategic commitments. Managerial decisions are strategic commitments when they are costly and not easily reversed. Strategic commitments include the firm's underlying cost structure and its business model (point to point vs. hub and spoke).

The two groups identified in Exhibit 3.8 are separated by a specific mobility barrier: the fact that offering international routes necessitates the hub-and-spoke model. Frequently, the international routes tend to be the remaining profitable routes left for the legacy carriers. However, the Persian Gulf region carriers, in particular Emirates, Etihad Airways, and Qatar Airways, are beginning to threaten this profit sanctuary.[48]

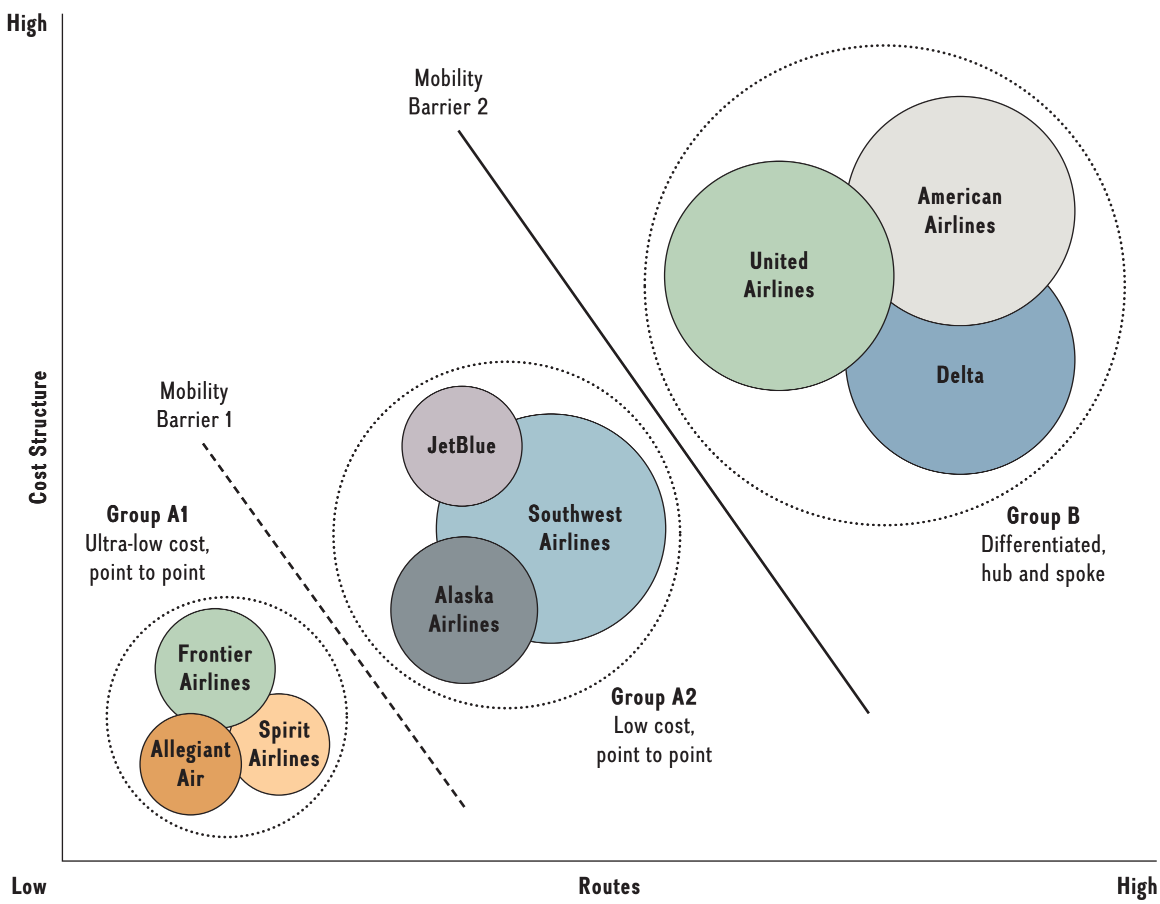
This mobility barrier implies that if carriers in the lower-left cluster wanted to compete globally, they would likely need to change their point-to-point operating model to a hub-and-spoke model. Or they could select a few profitable international routes and service them with long-range aircraft such as Boeing 787s or Airbus A-350s. Adding international service to the low-cost model, however, would require managerial commitments resulting in significant capital investments and a likely departure from a business model that is functioning well. This mobility barrier is reinforced by additional hurdles, such as the difficulty of securing landing slots at international airports around the world.

Despite its continued use of a point-to-point operating system, SWA experienced these and many other challenges when it began offering international flights to selected resort destinations such as Aruba, Cabo San Lucas, Cancun, the Bahamas, and Jamaica. In addition to changing its reservation system, SWA needed to secure passports for crew members, train its people in cultural awareness, learn how to read instructions in foreign languages, and perform drills in swimming pools on how to evacuate passengers onto life rafts. All of these additional requirements resulted in a somewhat higher cost for SWA in servicing international routes.[49]

STRATEGIC GROUP DYNAMICS

Although the strategic group map depicted in Exhibit 3.8 emerged in the decades following the deregulation of the U.S. domestic airline industry, firm positioning and strategy do not remain unchanged. In recent years, the low-cost, point-to-point strategic group (Group A) depicted in Exhibit 3.8 broke apart into two subgroups–the traditional low-cost point-to-point group (A2) and a new ultra-low-cost point-to-point group (A1) (Exhibit 3.9).

EXHIBIT 3.9 Strategic Groups and Mobility Barriers in U.S. Domestic Airline Industry, including the Emergence of the Ultra-Low-Cost Strategic Subgroup



Airlines in Group A1 are no-frills budget airlines that minimize operating costs. These discount carriers can achieve ultra-low costs by unbundling their services, as discussed earlier in the description of Spirit Airlines. Budget airlines focus on rock-bottom ticket prices and charge extra for amenities such as carry-on baggage. Airlines in Group A1 frequently have a regional footprint rather than a national footprint. As a result, they can obtain favorable conditions for their main regional airports. For instance, Frontier Airlines' central hub is in Denver, Colorado, while Spirit Airlines' main airport is Fort Lauderdale, Florida. Allegiant Air is a more recent entrant into the ultra-low-cost group, with some 100 aircraft and its main airport in Las Vegas.

It is important to note certain unique features in Exhibit 3.9. Specifically, one strategic group has split into two subgroups (A1 and A2). Moreover, the mobility barrier between subgroups A1 and A2 is merely dashed (Mobility Barrier 1), indicating a more effortless movement between groups. For instance, Frontier Airlines bid to acquire Spirit Airlines (in 2022). This acquisition would combine Frontier's focus on the West Coast with Spirit's presence on the East Cost. The combined airline would have a national footprint. A greater number of routes, requiring slots at more expensive airports and a mix of different airplanes, will likely result in a higher cost structure as the operating complexity increases. Consequently, a combined Frontier-Spirit Airline might well move back into Group A2.

In sum, strategic groups are dynamic. Firms can carve out a more robust strategic profile along crucial dimensions, resulting in new strategic (sub)groups. Membership in different strategic (sub)groups has distinct competitive implications.

3.5 Implications for Strategic Leaders

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

Exhibit 3.1 identifies external factors based on the *proximity* of these external factors, gradually moving from the general environment to the task environment. The next layer to understand is the industry. Applying Porter's five forces model allows strategic leaders to understand an industry's profit potential, which helps them determine how to carve out a strategic position that makes gaining and sustaining a competitive advantage more likely. Follow these steps to apply the five forces model:[50]

1. **Define the relevant industry.** In the five forces model, industry boundaries are specified by identifying a group of incumbent companies that face more or less the same suppliers and buyers. This group of competitors is likely to be an industry if it faces the same entry barriers and a similar threat from substitutes. In this model, therefore, an industry is defined by commonality and overlap in the five forces that shape competition.
2. **Identify the key players in each of the five forces and attempt to group them into different categories.** This step aids in assessing the relative strength of each force. For example, although the makers of jet engines (GE, Rolls-Royce, Pratt & Whitney) and local

catering services are all suppliers to airlines, their strengths vary widely. Segmenting different players within each force allows you to assess each force at a fine-grained level.

3. **Determine the underlying drivers of each force.** Which forces are strong, which forces are weak, and why? Continuing with the airline example, the supplier power of jet engine manufacturers is strong because they supply a mission-critical, highly differentiated product for airlines. Moreover, there are only a few suppliers of jet engines worldwide and no viable substitutes.
4. **Assess the overall industry structure.** What is the industry's profit potential, and which forces directly influence that potential? Not all forces are likely to have an equal effect. Focus on the most important forces that drive industry profitability.

The final step in industry analysis is to draw a strategic group map. This exercise allows you to unearth and explain *performance differences within an industry.* When analyzing a firm's external environment, you need to apply the three frameworks introduced in this chapter (PESTEL, Porter's five forces, and strategic group mapping). The external environment can determine up to roughly one-half of the performance differences across firms (see Exhibit 3.2).

Although working with the different models discussed in this chapter is an important step in the strategic management process, be aware that these models are not without shortcomings. First, all the models presented are *static.* They provide a snapshot of what is actually a moving target, and they do not allow for consideration of industry dynamics even though changes in the external environment can appear suddenly, for example, through black swan events (see Chapter 2). Industries can be revolutionized by innovation. Strategic groups can break apart or become obsolete as a result of deregulation or technological progress. To overcome the crucial shortcoming of static frameworks, strategic leaders must conduct external analyses at different points in time to gain a sense of the underlying *dynamics.* The frequency with which these tools need to be applied is a function of the industry's rate of change. For example, the mobile app industry is changing extremely fast, while the railroad industry operates in a less volatile environment.

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

CHAPTER**CASE 3** Part II

Even though Airbnb is one of the most valuable startups globally and offers more accommodations than the three largest hotel chains (Marriott, Hilton, and Intercontinental) combined, not all has been smooth sailing. External environmental factors discussed in this chapter present significant challenges for Airbnb. Economic, political, and legal factors required tremendous agility from the company as it went public during a global pandemic.

Although early recognition of changing travel trends helped Airbnb prevent disaster during widespread pandemic lockdowns, the pandemic's impact was non-trivial. As part of its Covid-19 pivot, Airbnb laid off a quarter of its workforce in its first round of layoffs ever. In addition, CEO Chesky cut all noncore expenditures (such as generous employee perks) and investments in future growth areas such as Airbnb Experiences, which provide a more in-depth and personalized adventure by fully immersing guests in the host's unique world and expertise. These experiences include making sushi with a famous chef, creating graffiti art, and participating in an exploratory tour of an exciting destination. Airbnb Experiences are an essential part of Chesky's stated ambition to transform Airbnb into a fully vertically integrated travel company. Experiences help to vertically integrate the company by providing tourist offerings as part of the travel destination purchase options, ensuring that money spent at the destination remains with Airbnb and hosts. More guests leave a five-star review after a stay if they have participated in an experience. Despite the lower investment in Experiences during the pandemic, Airbnb remains optimistic that Experiences will be an area of growth over the next five years.

As part of the pandemic pivot, CEO Chesky also needed to delay the long-anticipated initial public offering (IPO). In December 2020, with the Nasdaq Composite[51] up almost 60% from the pandemic low in March that year, he finally took the company public. At the IPO, Airbnb's valuation was $47 billion. By early 2022, Airbnb's market cap stood at $114 billion, an appreciation of almost 60%. Yet, in the same month that Airbnb went public, it reported a record loss of $4 billion, making its total loss in 2020 higher than its losses in the previous four years combined.

Since Airbnb began operations, it has faced evolving regulatory issues that affect the short-term rental and home-sharing business. City councils, homeowners, and homeowners' associations have proposed or enacted regulations to hamstring Airbnb. Such rules find their manifestations in local ordinances, lease agreements, insurance policies, and/or mortgage agreements to limit hosts' ability to share their spaces using Airbnb and other short-term rental platforms. For example, some condo homeowner associations in popular U.S. cities limit how many units can be used for short-term rentals, if any. In Europe, a group of mayors representing 22 cities (including Amsterdam, Barcelona, and London) has met with the European Commission (the executive branch of the European Union) to seek increased regulatory control over short-term rental platforms. As a result of these moves, Airbnb and its hosts are at risk of incurring significant penalties.

In addition, established companies with superior brand recognition launched retaliatory competitive moves in response to Airbnb's disruption of the industry. Competitors are beginning to adopt elements of Airbnb's business model. Numerous competing companies now offer homes for booking online, and Airbnb hosts frequently offer their properties on multiple platforms. Moreover, Google's ability to promote its travel and vacation rental ads more prominently in search results negatively affects Airbnb's traffic. Success breeds imitation: Airbnb's list of competitors is growing to include online travel agencies, search engines such as Google, category-focused metasearch sites (such as Kayak, Tripadvisor, and Trivago), hotel chains, and Chinese short-term rental companies (such as Tujia).

Yet despite all these challenges, Airbnb's pandemic pivot paid off. In 2021, the company reported record revenues. Growth in bookings was strongest for overnight stays in non-urban areas. And, as work from home becomes the new normal for many, Airbnb's guests are staying longer. Indeed, long-term stays of 28 nights or more are its fastest-growing segment, already accounting for 20% of all nights booked.[52]

Questions

1. Why do PESTEL factors have such a substantial impact on the future of a business? Identify key PESTEL factors for Airbnb, and explain why they can have a significant impact (positive or negative) on the firm's business.
   a. What activities might Airbnb include in a nonmarket strategy to respond to and shape its regulatory environment?
   b. How can awareness of PESTEL factors guide the internal actions that a firm decides to undertake? How might strategic leaders learn from Airbnb's example?
2. How could an internet startup disrupt the hospitality industry long dominated by Marriott and Hilton, which took decades to become successful worldwide chains? Explain using the Entry Choices framework (see Section 3.3).
3. Evaluate the actions that Airbnb took in response to the global pandemic. Would you have recommended other activities? If so, which specific activities would you have recommended? If not, why not?

TAKE-AWAY CONCEPTS

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

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

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

LO 3-2 / Differentiate between firm effects and industry effects in determining firm performance.

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

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

- The profit potential of an industry is a function of the five forces that shape competition: (1) threat of entry, (2) power of suppliers, (3) power of buyers, (4) threat of substitutes, and (5) rivalry among existing competitors.
- The stronger a competitive force, the greater the threat it represents. The weaker the competitive force, the greater the opportunity it presents.
- A firm can shape an industry's structure in its favor through its strategy.

LO 3-4 / Examine how competitive industry structure shapes rivalry among competitors.

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

LO 3-5 / Describe the strategic role of complements in creating positive-sum co-opetition.

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

LO 3-6 / Explain the five choices required for market entry.

- The more profitable an industry, the more attractive it becomes to competitors, who must consider the *who*, *when*, *how*, *what*, and *where* of entry.
- The five choices constitute more than parts of a single decision point; their consideration forms a strategic process unfolding over time. Each choice involves multiple decisions including many dimensions.
- *Who* includes questions about the full range of stakeholders, and not just competitors; *when*, questions about the industry life cycle; *how*, about overcoming barriers to entry; *what*, about options regarding product market, value chain, geography, and business model; and *where*, about product positioning, pricing strategy, and potential partners.

LO 3-7 / Appraise the role of industry dynamics and industry convergence in shaping the firm's external environment.

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

LO 3-8 / Generate a strategic group model to reveal performance differences between clusters of firms in the same industry.

- A strategic group is a set of firms within a specific industry that pursue a similar strategy in their quest for competitive advantage.
- Generally, there are two strategic groups in an industry based on two different business strategies: one pursues a low-cost strategy and the other pursues a differentiation strategy. Existing strategic groups may break into subgroups defined by the new strategic positioning of the break-away cluster of firms.
- Rivalry among firms of the same strategic group is more intense than the rivalry between strategic groups: Intra-group rivalry exceeds inter-group rivalry.
- Strategic groups are affected differently by the external environment and the five competitive forces.
- Some strategic groups are more profitable than others.
- Movement between strategic groups is restricted by mobility barriers, which are industry-specific factors that separate one strategic group from another. Movement between strategic subgroups can be achieved more easily.

KEY TERMS

Competitive industry structure *(p. 101)*
Complement *(p. 109)*
Complementor *(p. 109)*
Co-opetition *(p. 110)*
Entry barriers *(p. 93)*
Exit barriers *(p. 105)*
Externalities *(p. 89)*
Firm effects *(p. 90)*
Five forces model *(p. 91)*
Industry *(p. 91)*
Industry analysis *(p. 91)*
Industry convergence *(p. 113)*
Industry effects *(p. 90)*
Inflation *(p. 86)*
Mobility barriers *(p. 118)*
Network effects *(p. 94)*
Nonmarket strategy *(p. 84)*
PESTEL model *(p. 83)*
Strategic commitments *(p. 105)*
Strategic group *(p. 116)*
Strategic group model *(p. 116)*
Strategic position *(p. 91)*
Threat of entry *(p. 92)*

ENDNOTES

1. As quoted in Parker, G.G., M.W. Van Alstyne, S.P. Choudary (2016), *Platform Revolution: How Networked Markets Are Transforming the Economy—And How to Make Them Work for You* (New York: Norton).

2. Guerrilla marketing is a tactic in which a company uses unconventional interactions and surprises to promote its product or service. It is often a low-cost advertisement campaign used by startups to generate "buzz," or awareness of a new product or service.

3. Sources: Pressler, J. (2014, Sep. 23), "The dumbest person in your building is passing out keys to your front door!," *New York Magazine*; "New York deflates Airbnb," *The Economist* (2016, Oct. 27); Parker, G.G., M.W. Van Alstyne, S.P. Choudary (2016), *Platform Revolution: How Networked Markets Are Transforming the Economy—And How to Make Them Work for You* (New York: Norton); Stone, B. (2017), *The Upstarts: How Uber, Airbnb, and the Killer Companies of the New Silicon Valley Are Changing the World* (New York: Little, Brown and Co.); Austin, S., C. Canipe, and S. Slobin (2015, Feb. 18), "The billion-dollar startup club," *The Wall Street Journal* (updated Jan. 2017); Tabarrok, A. (2017, Jan. 30), "How Uber and Airbnb won," *The Wall Street Journal*; "Interview with Brian Chesky, co-founder and CEO Airbnb." (34:24 min) Code 2018 Recode, https://youtu.be/nc90n-6dQRo?t=1 Stoll, J.D. (2020, Jan. 18), "Airbnb's new compensation plan asks shareholders to share with other stakeholders," *The Wall Street Journal*; Winkler, R (2020, May 6), "Airbnb to lay off quarter of workforce," *The Wall Street Journal*; "Business this week," *The Economist* (2022, Feb. 19); Rana, P. (2021, Feb. 26), "Airbnb posts steep losses in first earnings report after going public," *The Wall Street Journal*; Airbnb, Inc. Q3 2021 Earnings Call. Nov. 04, 2021; and Airbnb Annual Reports (various years).

4. Becker, G.S. (1983), "A theory of competition among pressure groups for political influence," *The Quarterly Journal of Economics* 98(3): 371-400. For a detailed treatise on how institutions shape the economic climate and with it firm performance, see: North, D.C. (1990), *Institutions, Institutional Change, and Economic Performance* (New York: Random House).

5. De Figueireo, R.J.P., and G. Edwards (2007), "Does private money buy public policy? Campaign contributions and regulatory outcomes in telecommunications," *Journal of Economics and Management Strategy* 16: 547–576; and Hillman, A.J., G.D. Keim, and D. Schuler (2004), "Corporate political activity: A review and research agenda," *Journal of Management* 30: 837-857.

6. Lowenstein, R. (2010), *The End of Wall Street* (New York: Penguin Press).

7. A credit default swap (CDS) is a financial derivative contract used, for instance, by lenders to shift the credit risks of mortgages to a third party in exchange for a premium.

8. Brynjolfsson, E., and A. McAfee (2014), *The Second Machine Age: Work, Progress, and Prosperity in a Time of Brilliant Technologies* (New York: Norton).

9. Engemann, K.M. (2019, Jan. 16), *The Fed's Inflation Target: Why 2 Percent?*, Federal Reserve Bank of St. Louis.

10. "Professor Emeritus Milton Friedman dies at 94," University of Chicago press release (2006, Nov. 16). The link between money supply and inflation is captured in the quantitative theory of money, which links money supply directly to inflation by formulating an equation of exchange. The identity states: $MV = Py$, where M is the money supply, V is the velocity of money (i.e., the speed at which money circulates through the economy relative to the money supply), P is the price level, and y is real gross domestic product (GDP). See for a discussion and a graphic showing a close correlation between money supply and inflation since 1960 to today: Hanke, S.H., and N. Hanlon (2022, Feb. 24), "Powell is wrong. Printing money causes inflation," *The Wall Street Journal.*

11. Lucas, R. (1972), "Expectations and the neutrality of money," *Journal of Economic Theory* 4: 103–124.

12. The U.S. Census Bureau defines Hispanic or Latino as "a person of Cuban, Mexican, Puerto Rican, South or Central American, or other Spanish culture or origin regardless of race." Source: https://bit.ly/3HXqqeG

13. U.S. Census Bureau (2017, Jul. 1), "Population estimates," www.census.gov/quickfacts/fact/table/US/PST045217; "Media companies are piling into the Hispanic market. But will it pay off?" *The Economist* (2012, Dec. 15).

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15. See for example: Brynjolfsson, E., and A. McAfee (2014). *The Second Machine Age: Work, Progress, and Prosperity in a Time of Brilliant Technologies* (New York: W. W. Norton & Co.); and McAfee, A., and E. Brynjolfsson (2017). *Machine, Platform, Crowd: Harnessing Our Digital Future,* 1st ed., Kindle edition (New York: W. W. Norton & Co.).

16. For an in-depth discussion of technological changes in the media industry, see: Rothaermel, F.T., and A. Guenther (2018), Netflix, Inc., case study MH0043, http://create.mheducation.com; and Sandomirjune, R. (1991, Jun. 9), "Entrepreneurs: Wayne Huizenga's growth complex," *The New York Times Magazine*; "Blockbuster files for bankruptcy," *The Economist* (2010, Sep. 23); Gandel, S. (2010, Oct. 17), "How Blockbuster failed at failing," *Time*; Satel, G. (2014, Sep. 5), "A look back at why Blockbuster really failed and why it didn't have to," *Forbes*; Schmidt, S. (2017, Apr. 26), "Blockbuster has survived in the most curious of places—Alaska," *The Washington Post;* and Netflix Inc annual reports (various years).

17. Academy of Management, ONE Division, 2013 domain statement; Anderson, R.C. (2009), *Confessions of a Radical Industrialist: Profits, People, Purpose—Doing Business by Respecting the Earth* (New York: St. Martin's Press); and Esty, D.C., and A.S. Winston (2009), *Green to Gold: How Smart Companies Use Environmental Strategy to Innovate, Create Value, and Build Competitive Advantage,* revised and updated (Hoboken, NJ: John Wiley & Sons).

18. Henderson, R. (2020), *Reimagining Capitalism in a World on Fire* (New York: Public Affairs).

19. This interesting debate unfolds in the following articles, among others: Misangyi, V.F., H. Elms, T. Greckhamer, and J.A. Lepine (2006), "A new perspective on a fundamental debate: A multilevel approach to industry, corporate, and business unit effects," *Strategic Management Journal* 27: 571–590; Hawawini, G., V. Subramanian, and P. Verdin (2003), "Is performance driven by industry- or firm-specific factors? A new look at the evidence," *Strategic Management Journal* 24: 1–16; McGahan, A.M., and M.E. Porter (1997), "How much does industry matter, really?" *Strategic Management Journal* 18: 15–30; Rumelt, R.P. (1991), "How much does industry matter?" *Strategic Management Journal* 12: 167–185; and Hansen, G.S., and B. Wernerfelt (1989), "Determinants of firm performance: The relative importance of economic and organizational factors," *Strategic Management Journal* 10: 399–411.

20. The discussion in this section is based on: Magretta, J. (2012), *Understanding Michael Porter: The Essential Guide to Competition and Strategy* (Boston: Harvard Business Review Press); Porter, M.E. (2008, Jan.), "The five competitive forces that shape strategy," *Harvard Business Review*; Porter, M.E. (1980), *Competitive Strategy: Techniques for Analyzing Industries and Competitors* (New York: Free Press); and Porter, M.E. (1979, Mar.-Apr.), "How competitive forces shape strategy," *Harvard Business Review*: 137–145.

21. The term pureplay denotes a company that focuses exclusively on a particular product or service in order to obtain a large market share.

22. Walsh, T. (2014, Sep. 2), "The cult of Tesla Motors Inc: Why this automaker has the most loyal customers," *The Motley Fool*.

23. "Tesla Model S road test," *Consumer Reports*, www.consumerreports.org/cro/tesla/model-s/road-test.htm.

24. Wang, U. (2013, Nov. 5), "Tesla considers building the world's biggest lithium-ion battery factory," *Forbes*.

25. Whether a product is a substitute (complement) can be estimated by the cross-elasticity of demand. The cross-elasticity estimates the percentage change in the quantity demanded of good X resulting from a 1 percent change in the price of good Y. If the cross-elasticity of demand is greater (less) than zero, the products are substitutes (complements). For a detailed discussion, see: Allen, W.B., K. Weigelt, N. Doherty, and E. Mansfield (2009), *Managerial Economics Theory, Application, and Cases,* 7th ed. (New York: Norton).

26. This example, as with some others in the section on the five forces, is drawn from: Magretta, J. (2012), *Understanding Michael Porter: The Essential Guide to Competition and Strategy* (Boston: Harvard Business Review Press).

27. Because the threat of entry is one of the five forces explicitly recognized in Porter's model, we discuss barriers to entry when introducing the threat of entry above. The competitive industry structure framework is frequently referred to as the structure-conduct-performance (SCP) model. For a detailed discussion, see: Allen, W.B., K. Weigelt, N. Doherty, and E. Mansfield (2009), *Managerial Economics Theory, Application, and Cases,* 7th ed. (New York: Norton); Carlton, D.W., and J.M. Perloff (2000), *Modern Industrial Organization,* 3rd ed. (Reading, MA: Addison-Wesley); Scherer, F.M., and D. Ross (1990), *Industrial Market Structure and Economic Performance,* 3rd ed. (Boston: Houghton Mifflin); and Bain, J.S. (1968), *Industrial Organization* (New York: John Wiley & Sons).

28. Besanko, D., E. Dranove, M. Hanley, and S. Schaefer (2010), *The Economics of Strategy,* 5th ed. (Hoboken, NJ: John Wiley & Sons).

29. Dixit, A., S. Skeath, and D.H. Reiley (2009), *Games of Strategy,* 3rd ed. (New York: Norton).

30. When there are only two main competitors, it's called a *duopoly* and is a special case of oligopoly.

31. Yoffie, D.B., and R. Kim (2011, Jun.), "Coca-Cola in 2011: In search of a new model," Harvard Business School Case 711–504 (revised Aug. 2012). See also: Yoffie, D.B., and Y. Wang (2002, Jan.), "Cola wars continue: Coke and Pepsi in the twenty-first century," Harvard Business School Case 702–442 (revised Jan. 2004, et seq).

32. "Trustbusting in the internet age: Should digital monopolies be broken up?" *The Economist* (2014, Nov. 29); and "Internet monopolies: Everybody wants to rule the world," *The Economist* (2014, Nov. 29).

33. See: Chang, S-J., and B. Wu (2013), "Institutional barriers and industry dynamics," *Strategic Management Journal* 35: 1103–1123. Discussion of this new and insightful research offers an opportunity to link the PESTEL analysis to the five forces analysis. The study focuses on the competitive interaction between incumbents and new entrants as a driver of industry evolution. It investigates the impact of institutional characteristics (political, legal, and sociocultural norms in PESTEL analysis) unique to China on productivity and exit hazards of incumbents versus new entrants. China's environment created a divergence between productivity and survival that shaped industry evolution. It also offers an illustration of the role that liability of newness plays in new entrant survival.

34. This example is drawn from: Porter, M.E. (2008), "The five competitive forces that shape strategy," *An Interview with Michael E. Porter: The Five Competitive Forces that Shape Strategy,* Harvard BusinessPublishing video; "Everyone else in the travel business makes money off airlines," *The Economist* (2012, Aug. 25); "How airline ticket prices fell 50% in 30 years (and nobody noticed)," *The Atlantic* (2013, Feb. 28); U.S. gallon of jet fuel prices; author's interviews with Delta Air Lines executives.

35. Wall, R. (2019, Feb. 14), "Airbus to retire the A380, the superjumbo that never quite took off," *The Wall Street Journal*.

36. Brandenburger, A.M., and B. Nalebuff (1996), *Co-opetition* (New York: Currency Doubleday); and Grove, A.S. (1999), *Only the Paranoid Survive* (New York: Time Warner).

37. Milgrom, P., and J. Roberts (1995), "Complementarities and fit strategy, structure, and organizational change in manufacturing," *Journal of Accounting and Economics* 19(2-3): 179–208; and Brandenburger, A.M., and B. Nalebuff (1996), *Co-opetition* (New York: Currency Doubleday).

38. In this recent treatise, Porter also highlights positive-sum competition. See: Porter, M.E. (2008, Jan.), "The five competitive forces that shape strategy," *Harvard Business Review*.

39. This discussion is based on: Zachary, M.A., P.T. Gianiodis, G. Tyge Payne, and G.D. Markman (2014), "Entry timing: Enduring lessons and future directions," *Journal of Management* 41: 1388–1415; and Bryce, D.J., and J.H. Dyer (2007, May), "Strategies to crack well-guarded markets," *Harvard Business Review*: 84-92. I also gratefully acknowledge the additional input received by Professors Zachary, Gianiodis, Tyge Payne, and Markman.

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41. "Reading between the lines," *The Economist* (2009, Mar. 26); and "New York Times is near web charges," *The Wall Street Journal* (2010, Jan. 19).

42. Chokshi, N. (2018, Aug. 27), "What you might not know about Esports, soon to be a $1 billion industry," *The New York Times*; Grey, A. (2018, Jul. 3), "The explosive growth of eSports," *World Economic Forum*; Fisher, S.D. (2014, Jan.-Feb.), "The rise of eSports: League of Legends article series," white paper, Foster Pepper PLLC; Segal, D. (2014, Oct. 10), "Behind League of Legends, Esports' main attraction," *The New York Times*; Needleman, S.E. (2020, Aug. 14), "'Fortnite' kicked off Apple and Google app stores after Epic games moves to bypass fees," *The Wall Street Journal*; Higgins (2021, Dec. 8), "Apple wins delay in monopoly case, allowing app store rules to stay for now," *The Wall Street Journal*; some data drawn from statista.com and "How much money does League of Legends make?" www.youtube.com/watch?v=1ug-YKLwkaA.

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45. In Exhibit 3.8, United Airlines is the biggest bubble because it merged with Continental in 2010, creating the largest airline in the United States. Delta is the second-biggest airline in the United States after merging with Northwest Airlines in 2008.

46. American's hub is at Dallas-Fort Worth; Continental's is at Newark, New Jersey; United's is at Chicago; and U.S. Airways' is at Charlotte, North Carolina.

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49. Carey, S. (2014, Oct. 14), "Steep learning curve for Southwest Airlines as it flies overseas," *The Wall Street Journal*.

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52. Sources: Stone, B. (2017), *The Upstarts: How Uber, Airbnb, and the Killer Companies of the New Silicon Valley Are Changing the World* (New York: Little, Brown and Co.); "New York deflates Airbnb," *The Economist* (2016, Oct. 27); Austin, S., C. Canipe, and S. Slobin (2015, Feb. 18), "The billion dollar startup club," *The Wall Street Journal* (updated Jan. 2017); Parker, G.G., M.W. Van Alstyne, S.P. Choudary (2016), *Platform Revolution: How Networked Markets Are Transforming the Economy—And How to Make Them Work for You* (New York: Norton); Pressler, J. (2014, Sep. 23), "The dumbest person in your building is passing out keys to your front door!"; Tabarrok, A. (2017, Jan. 30), "How Uber and Airbnb won," *The Wall Street Journal*; "Interview with Brian Chesky, co-founder and CEO Airbnb." (34:24 min) Code 2018 Recode, https://youtu.be/nc90n-6dQRo?t=1; Stoll, J.D. (2020, Jan 18), "Airbnb's new compensation plan asks shareholders to share with other stakeholders," *The Wall Street Journal*; Winkler, R (2020, May 6), "Airbnb to lay off quarter of workforce," *The Wall Street Journal*; "Business this week," *The Economist* (2022, Feb. 19); Rana, P. (2021, Feb 26), "Airbnb posts steep losses in first earnings Report after going public," *The Wall Street Journal*; Airbnb, Inc. Q3 2021 Earnings Call. 04 Nov 2021; and Airbnb Annual Reports (various years).

CHAPTER

4

Internal Analysis: Resources, Capabilities, and Core Competencies

Chapter Outline

Learning Objectives

LO 4-1 Explain why and how internal firm differences are the root of competitive advantage.

LO 4-2 Differentiate among a firm's core competencies, resources, capabilities, and activities.

LO 4-3 Compare and contrast tangible and intangible resources.

LO 4-4 Evaluate the two critical assumptions about the nature of resources in the resource-based view.

LO 4-5 Apply the VRIO framework to assess the competitive implications of a firm's resources.

LO 4-6 Evaluate different conditions that allow a firm to sustain a competitive advantage.

LO 4-7 Outline how dynamic capabilities can help a firm sustain a competitive advantage.

LO 4-8 Apply a value chain analysis to understand which of the firm's activities in transforming inputs into outputs generate differentiation and which drive costs.

LO 4-9 Identify competitive advantage as residing in a network of distinct activities.

LO 4-10 Conduct a SWOT analysis to generate insights from external and internal analysis and to derive strategic implications.

CHAPTERCASE 4 Part I

Five Guys' Core Competency: "Make the Best Burger. Don't Worry about Cost."

Jerry Murrell, the founder of Five Guys Burgers and Fries, grew up in northern Michigan. He attended a Catholic high school and did so poorly academically that one of the nuns told him, "If you don't study, you'll be flipping burgers."[1] Little did she know that this prophecy would become a reality. Today, Five Guys is the fastest-growing restaurant chain in the United States, with 1,700 locations worldwide and estimated revenues of $2 billion. And Jerry Murrell's net worth is hundreds of millions of dollars. How did all of this come about?

In the 1980s, while looking for entrepreneurial opportunities in the Washington, D.C., area, Jerry Murrell was selling insurance. He and his family often visited nearby Ocean City, Maryland. The boardwalk was filled with fast food vendors—many of them selling fries—but only one always had a long line in front of it: Thrashers. While reading the text on the potato bags, Murrell noticed that the potatoes came from Rick Miles in Rigby, Idaho. The Thrashers encounter brought back memories of Push' Em Up Tony, a hamburger stand in Murrell's Michigan hometown. People from all over town drove to Tony's for burgers. Murrell has always loved burgers and fries, so while observing Thrashers in action and recalling good times at Push' Em Up Tony, he came up with an idea: Open a stand that offers only hamburgers *and* fries. Keep it simple—and it might work.

Murrell excitedly shared his idea with his wife, Janie, but she was not impressed and told him he'd be better off keeping his day job. Her reaction left him undeterred. He sought funding from banks for his new venture, but they all thought he was foolish for wanting to compete against such multinational fast food giants as McDonald's and Burger King. Still determined and with one last option to explore, Murrell asked his two older sons, who were both in high school at the time, whether they wanted to go to college. When both boys said they'd do something else instead, Murrell took their college fund and used it to open the first Five Guys store in Arlington, Virginia, in 1986.

Murrell named the hamburger joint after himself and his four sons at the time (a fifth son arrived later). From the get-go, he chose not to put a lot of money into the business. Instead, he opted to find an out-of-the-way place where the rent was low and to focus on making the best burgers and fries. He reasoned that if people started buying the Five Guys' product and *kept* buying it, he would know that its burgers and fries were good. Murrell also decided not to spend any money on marketing, figuring that his customers would be his best salespeople. To the Murrells' surprise, their little hole-in-the-wall offering takeout-only burgers and fries became instantly popular and profitable.

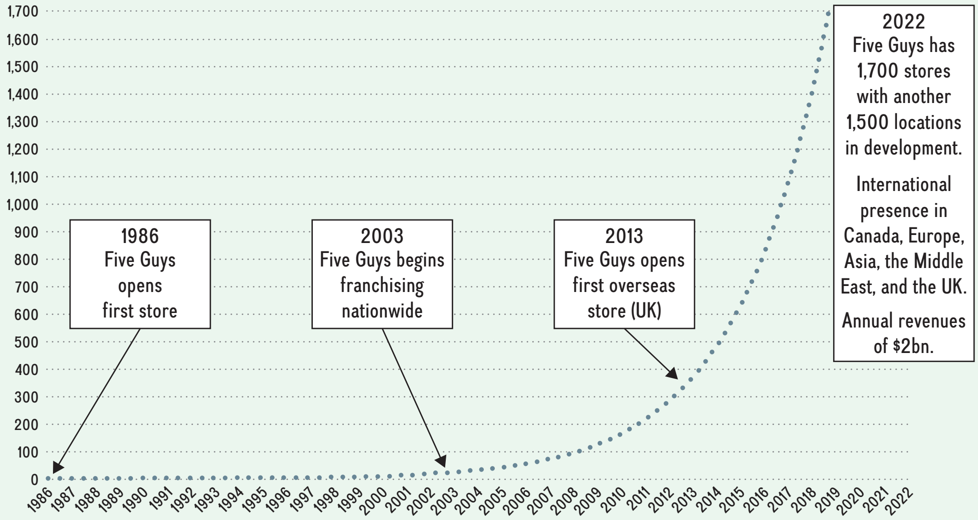
For the next few years, Five Guys focused on the nuts and bolts of the hamburger business. The Murrells obsessed about every detail: store layout and design, the quality of the buns and never-frozen beef, how to fry the potatoes, and where to source the potatoes from. They eventually settled on Rick Miles in Idaho, the Thrashers supplier. Murrell even had his sons conduct a blind taste test of 16 varieties of mayonnaise to find the perfect one. The winner was the most expensive brand, supplied by only one vendor, who was notorious for being difficult to deal with. But Five Guys went with that vendor, keeping in mind Jerry Murrell's mantra: "Make the best burger. Don't worry about cost."

Five Guys makes burgers to order and customizes them with up to 15 fresh toppings, including grilled mushrooms, green peppers, and jalapeños, at no extra charge. This focus on making the best burgers and fries has resulted in a higher cost structure than typical in the fast-casual restaurant segment, which includes Shake Shack and Smashburger. Additionally, Five Guys' prices are based on actual ingredient costs plus margin; therefore, the prices are not only several times higher than what you would pay for a fast food burger, but they also fluctuate with the cost of inputs. Not once did the Murrells compromise on the quality of their product to keep prices low or even consistent—not even when a hurricane destroyed most of the tomato crop in Florida, causing prices for this ingredient to increase almost threefold.

It took the Murrells 17 years to perfect their recipe for success. During that time, they had only five stores in the Washington, D.C., area, all owned and operated by the family. Then Jerry Murrell's sons suggested franchising the business. Initially opposed to the idea, Jerry changed his mind and gave the go-ahead after reading *Franchising for Dummies* by Wendy's founder Dave Thomas.

As Exhibit 4.1 shows, by 2003 Five Guys was ready for prime time. Within just 18 months, all regional franchises

EXHIBIT 4.1 Five Guys' Growth in Number of Stores, 1986–2022



Source: Author's depiction of publicly available data (fitted trend line).

in the United States had sold out. By 2010, Five Guys started moving beyond the United States, first to Canada and then to the United Kingdom in 2013. Starting in 2015, Five Guys' international expansion picked up speed with store openings in France, Germany, Ireland, Kuwait, Saudi Arabia, Singapore, Spain, and the United Arab Emirates. In 2021, the burger restaurant made its debut in the Australian market. The Covid-19 pandemic did little to slow Five Guys' growth globally.

Jerry and Janie Murrell are now retired, but their five sons and their grandchildren are involved in Five Guys' leadership positions. Despite being a global, multibillion-dollar enterprise, Five Guys is still owned and operated by the Murrell family. And the nun who taught Jerry in high school was right: He ended up flipping burgers for the rest of his life.[2]

Part II of this ChapterCase appears in Section 4.6.

One of the key messages of this chapter is that a firm's ability to gain and sustain competitive advantage is the result of *core competencies*—unique strengths embedded deep within a firm. Core competencies allow a firm to differentiate its products and services from those of its rivals, creating higher value for the customer or offering products and services of comparable value at a lower cost.

How did Five Guys become so successful in a highly competitive industry dominated by fast food giants such as McDonald's and Burger King, as well as direct competitors claiming to be "better burger" joints such as Smashburger, BurgerFi, and Shake Shack? By some estimates, Five Guys captured 50% of the market share in the "better burger" segment.[3] How did Five Guys achieve a loyal following despite its higher menu prices and longer wait times? In short, how did Five Guys gain and sustain a competitive advantage in this highly competitive industry? The answer to all these questions is found in Five Guys' core competency: delivering a customized, made-to-order burger and hand-cut fries using only the highest-quality ingredients.

To better understand why and how differences *within* firms are at the root of competitive advantage, we begin this chapter by shifting the focus from an outward-looking external analysis to an inward-looking internal analysis of the firm. After closely examining a firm's *core competencies,* we introduce the *resource-based view* of the firm to provide an analytical model that allows us to assess resources, capabilities, and competencies and their potential for creating a sustainable competitive advantage. We also discuss the *dynamic capabilities perspective.* This model emphasizes a firm's ability to modify and leverage its resource base to gain and sustain a competitive advantage in a constantly changing environment. Next, we focus on *value chain analysis* to better understand a firm's internal activities when transforming inputs into outputs. We then take a closer look at *strategic activity systems.* Here, a firm's competitive advantage resides in a network of interconnected and reinforcing activities. We conclude with *Implications for Strategic Leaders,* highlighting how to use a *SWOT analysis* to obtain strategic insights from combining external analysis with internal analysis.

4.1 From External to Internal Analysis

LO 4-1

Explain why and how internal firm differences are the root of competitive advantage.

In this chapter, we use analytical tools to explain why differences in firm performance exist even within the *same* industry. For example, why does Five Guys outperform McDonald's, Burger King, In-N-Out Burger, Smashburger, and others in the (hamburger) restaurant industry? Because these companies compete in the same sector of an industry and face similar external opportunities and threats, the sources of some of the observable performance differences must be found *inside the firm.* In Chapter 3, when discussing industry and firm effects and their relationship to superior performance, we noted that up to 55% of the overall performance differences are explained by firm-specific effects (see Exhibit 3.2). Looking *inside* the firm to analyze its resources, capabilities, and core competencies allows us to understand its strengths and weaknesses. Linking these insights from a firm's internal analysis to the insights from an external analysis enables managers to determine their strategic options. Ideally, strategic leaders want to leverage their firms' internal strengths to exploit external opportunities and mitigate internal weaknesses and external threats.

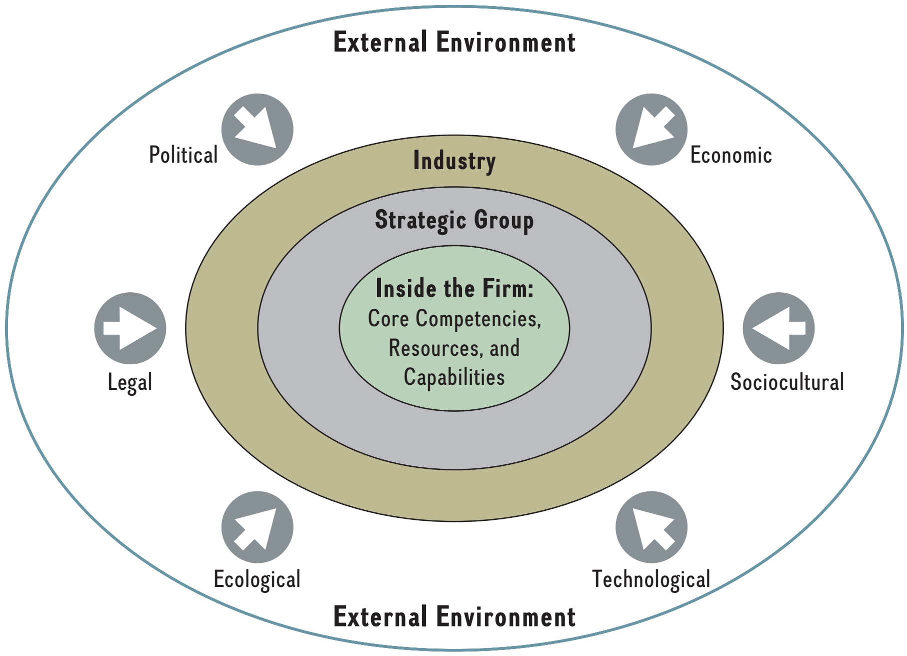
Exhibit 4.2 depicts how and why we move from the firm's external environment to its internal environment. To formulate and implement a strategy that enhances the firm's chances of gaining and sustaining a competitive advantage, the firm must have specific resources and capabilities that combine to form core competencies. The best firms conscientiously identify their core competencies, resources, and capabilities in their quest for superior performance. Strategic leaders determine how to manage and develop internal strengths to respond to the challenges and opportunities in the firm's external environment. In particular, strategic leaders evaluate and develop internal strengths in the context of external PESTEL forces and competition within their industry by applying the five forces model and the strategic group map (see Chapter 3).

The firm's response must be dynamic. Rather than creating a one-time and thus a static fit, strategic leaders must ensure that the firm's internal strengths change with its external environment *dynamically*. The goal should be to develop resources, capabilities, and competencies that create a *strategic fit* with the firm's environment. **Strategic fit** occurs when an organization matches its internal resources and capabilities to the external environment, exploiting external opportunities while mitigating external threats and internal weaknesses. The rest of this chapter provides a deeper understanding of the *sources* of competitive advantage within a firm and how firms change to maintain strategic fit.

strategic fit Occurs when an organization matches its internal resources and capabilities to the external environment, exploiting external opportunities while mitigating external threats and internal weaknesses.

EXHIBIT 4.2

Inside the Firm: Competitive Advantage Based on Core Competencies, Resources, and Capabilities



LO 4-2

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

4.2 Core Competencies

Products and services make up the *visible* side of competition, but residing deep within the firm lies a diverse set of *invisible* elements around which companies compete; these are the core competencies. **Core competencies** are unique strengths embedded deep within a firm (see Exhibit 4.2). Core competencies allow a firm to differentiate its products and services from its rivals', creating higher value for the customer or offering products and services of comparable value at a lower cost. Core competencies find their expression in the structures, processes, and routines that strategic leaders put in place. The critical point here is that competitive advantage is frequently the result of a firm's core competencies.[4]

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

Consider Five Guys, featured in the ChapterCase, as an example of a company with a clearly defined core competency: a superior ability to deliver fresh, customized hamburgers and hand-cut fries using only the highest-quality ingredients. By doing things differently than its rivals, Five Guys built and honed its core competency over a long period.

LEVERAGING CORE COMPETENCIES REQUIRES FOCUS ON WHAT TO DO AND WHAT *NOT* TO DO

Strategy is as much about deciding to do things *differently* from competitors as it is about choosing *not* to do certain things at all. Indeed, deciding what not to do is often critical in gaining a competitive advantage because it allows the firm to leverage its competency. Trying to do too many things dilutes focus and limits the potency of a firm's core competency. Jerry Murrell was clear and consistent about what Five Guys would do and what it would *not* do from the start.

What did Five Guys decide to do? Five Guys sources only the highest-quality ingredients, including fresh, never frozen ground beef for its burgers; freshly baked buns from local bakeries; potatoes from Idaho; and tomatoes from Florida. Five Guys differentiates itself from its competitors by offering a wide range of free toppings from classics like ketchup and lettuce to specialties like grilled mushrooms, jalapeños, and green peppers. Some of Five Guys' ingredients cost four times what other chains pay for similar ingredients. Its fries are hand cut from potatoes grown in Idaho north of the 42nd parallel and cooked in pure peanut oil. Five Guys keeps its store designs simple, functional, and consistent: Its iconic red and white tiles are often seen in shopping and strip malls, where many of its stores are located.

What did Five Guys decide NOT to do? Early on, Jerry Murrell made some important strategic decisions about what *not* to do, including no menu bloat, no drive-throughs, no delivery, no WiFi, no place to hang out, and no marketing. It would *not,* for instance, expand its menu and offer up to 125 items, as McDonald's did over the years. Instead, it kept its menu simple: burgers, fries, and hot dogs. This simplicity allowed each Five Guys team to deliver on its core competency: custom, made-to-order, high-quality burgers for each of its patrons. Five Guys took almost 30 years to add milkshakes to its menu. This new and popular item is available with free mix-in flavors such as classic chocolate, vanilla, strawberry, Oreo, and flavors unique to Five Guys, such as bacon.

In addition, Five Guys does *not* have drive-throughs. Because its food, unlike fast food, is made to order, drive-through wait times would be too long. Although food delivery via apps such as Uber Eats, Grubhub, and DoorDash is now commonplace, in the 1980s when Five Guys started selling burgers and fries, restaurants often delivered their food, especially large orders. However, Jerry Murrell decreed that Five Guys would never offer food delivery, regardless of who asks for it—not even when an admiral from the Pentagon requested a special lunch delivery for 25 people. (Jerry Murrell declined politely.) The next day Five Guys hung up a 22-foot-long banner that read "ABSOLUTELY NO DELIVERY." Business from the Pentagon picked up after that. Even former President Barack Obama had to wait in line.

As part of its heritage as a takeout-only place, Five Guys does *not* encourage its patrons to linger. For instance, it does not offer free WiFi, and while the seating is functional, it isn't that comfortable. Five Guys focuses on getting the customer in and out expediently and efficiently to increase throughput,[5] especially during peak lunch hours.

Five Guys also does *not* spend money on marketing. Murrell believes that happy customers are the best salespeople for the company because they will share their experiences with their friends. Such word-of-mouth publicity is even more potent now with the prevalence of social media. Over the years, local press has provided free advertising, showering Five Guys with hundreds of glowing reviews. Many of these reviews are framed and hanging on the bathroom walls of its stores. Much of its early fame can also be attributed to Zagat, one of the most important restaurant guides in the United States.

Together, these multiple and varied activities reinforce Five Guys' core competency, which enables it to differentiate its product offerings, create higher perceived value for its customers, and command premium prices for its products. It is important to note that before expanding geographically, the Murrells spent nearly two decades perfecting the core competency in their five northern Virginia stores. These stores were staffed and operated by family members. When the company started to franchise, Five Guys needed to maintain delivery of the core competency in multiple stores across the United States. To do so, Five Guys replicated its unique structure, processes, and routines, including its diverse set of strategic activities, orchestrating a supply chain that sourced only fresh, quality ingredients. Replicating so many activities with a perishable product is no small feat considering that core competencies and underlying knowledge often do not travel easily across geographic distances.[6]

Thus, as much as competition is about products and services, it is also about developing, nurturing, honing, and leveraging core competencies. And a good strategy is as much deciding what to do as it is choosing what not to do.

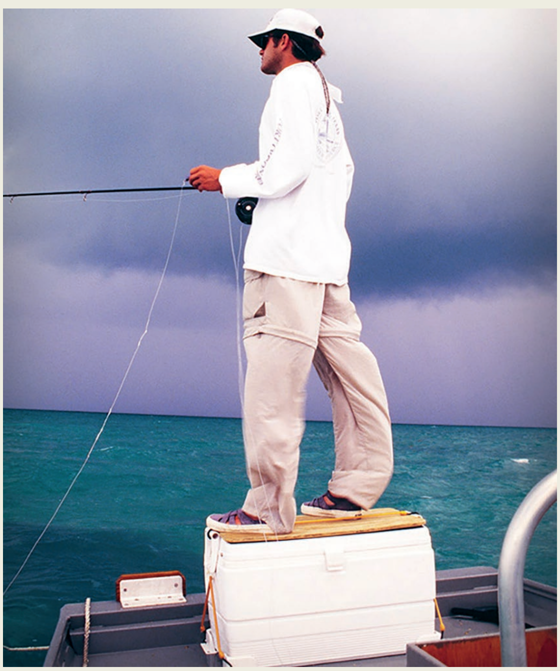
Strategy Highlight 4.1 illustrates how Yeti created a cult following and a mass-market success by clearly defining, developing, and honing a few critical core competencies.

Strategy Highlight **4.1**

Yeti's Core Competency: Making Quality Cool

Who is willing to pay several hundred dollars for a cooler? It turns out that a lot of people are. In 2022, Yeti, an all-American manufacturer specializing in outdoor lifestyle products such as coolers, drinkware, and accessories, had sales of $1.5 billion and generated $215 million in net income.

Natives of Driftwood, Texas, a community of fewer than 150 people, Roy and Ryan Seider have been avid outdoors people all their lives. Their father introduced them to hunting and fishing at an early age. In 2006, the brothers founded Yeti due to their frustration with available coolers, which didn't meet their needs. For instance, they had to reinforce a cooler with plywood so the lid wouldn't cave in when used as a casting platform during a fishing trip (see photo). This eureka moment gave them the idea to make the perfect cooler they wanted for outdoor activities. Using a technique called rotational molding, they added a thick insulation layer to their new cooler, making it nearly indestructible and allowing it to store ice for days even in a scorching desert. Thus, Yeti was born. The only problem was that Yeti coolers retailed for $250 to $1,300, more than 10 times the price of ordinary coolers.



One of the Seider brothers stands on a rigged-up cooler with plywood reinforcement that prevents the lid from caving in when the cooler is used as a casting platform during a fishing trip.

Courtesy of Yeti Coolers, LLC

When Yeti went public in 2018, many analysts were skeptical that consumers would be willing to pay the hefty price tag of the company's products. By that time, Yeti had already amassed a cultlike following as a niche supplier to hardcore outdoor enthusiasts. Indeed, Yeti's products are so desirable that they regularly appear on lists of hard-to-find holiday gifts, and Yeti's expensive coolers are a favorite target of thieves, who have cut cable-secured coolers off boats and pickup trucks. How did Yeti build such a coveted brand and turn a plastic cooler into a status symbol? The answer comes down to Yeti's core competencies: superior quality and performance combined with a coolness factor.

Yeti's success stems from its focus on producing high-quality outdoor gear that works and lasts. Before Yeti, none of the available products on the market met the needs of serious outdoors people. The Seider brothers designed and constructed a virtually indestructible cooler with exceptional ice retention, which changed consumers' perceptions of how coolers can perform even in extreme conditions. Any Yeti cooler component that is breakable can be easily replaced, thus prolonging the life and value of each cooler.

Thanks to their high performance, Yeti's state-of-the-art coolers quickly became a staple in fishing and hunting communities, mainly in the southern United States. The Interagency Grizzly Bear Committee, a group that seeks to protect the habitats of grizzly bears, even awarded the coolers a seal of approval for their bear resistance.

However, although Yeti thrived on grassroots marketing in the fishing and hunting communities as consumers bragged about their bear-proof coolers to their friends, it remained a niche supplier to hunters and anglers during its early years.

Yeti expanded into the mainstream market in 2014 by introducing high-performance drinkware. Using a quality-forward design process similar to that used for its coolers, Yeti created durable tumblers and bottles that were attractive not only to passionate outdoors people but also to status-conscious urban dwellers. The new product line turbocharged Yeti's revenues from $150 million in 2014 to $900 million just before the Covid-19 pandemic hit. As more Americans began spending time in the great outdoors to escape Covid-19, Yeti's sales grew even further, reaching over $1 billion in 2020. Some Yeti products have even become collectors' items, fueled by Yeti's release of limited-edition products and its customization options. The limited-edition products are often resold at multiples of their original retail price.

Yeti products represent a way of life—freedom, individualism, and ruggedness—and thus have a built-in coolness factor. To promote its brand, Yeti creates super-high-quality cinematic videos featuring well-known brand ambassadors, capturing their epic adventures: flying, freediving, crossing a desert, skiing down an entire mountain range. Yeti's advertising establishes an emotional connection with consumers through these inspirational stories.

Yeti has also received free promotional endorsements from a number of celebrities. In his number-one country chart song "Buy Me a Boat," Chris Janson mentions Yeti. A-list celebrities including Kim Kardashian, Matt Damon, and Reese Witherspoon have all posted photos of themselves on social media using Yeti products. However, Yeti does not actively employ modern-day influencers to market its products. Instead, it leverages its network of roughly 130 brand ambassadors to establish and maintain its products' emotional appeal to consumers. Its advertisements feature the epic adventures of outdoor enthusiasts such as rugged fishers, brave hunters, hardy kayakers, and expert rodeo wranglers, showcasing the resiliency of not only Yeti users but also Yeti products.

By turning a cooler—a conventional and cheap commodity product—into a highly differentiated status symbol, Yeti has been able to command a premium price for its product. In the process, Yeti revitalized stale categories and built an authentic lifestyle brand. In addition, Yeti's reputation and popularity have allowed the company to outperform traditional players in the outdoor and recreation market, such as Igloo, Coleman, and Hydro Flask. However, success attracts attention and competition. Many imitator products focusing on quality with a lower price point have sprung up to take a bite out of Yeti's revenue.[7]

For an overview of the core competencies of different companies and specific examples, see Exhibit 4.3.

EXHIBIT 4.3 Company Examples of Core Competencies

Company	Core Competencies	Examples
Amazon	• Superior IT and AI capabilities. • Superior customer service. • Diversification across different industries.	• Online retailing: Largest selection of items online. Full vertical integration, from warehouse to delivery. • Amazon Prime: Paid subscription service including free delivery, video and music streaming, and other digital benefits such as free e-books. • Online advertising: Fastest-growing digital ad company (along with Alphabet's Google and Meta's Facebook); captures two-thirds of all digital ad dollars. • Cloud computing: Largest provider through Amazon Web Services (AWS).

(Continued)

Company	Core Competencies	Examples
Apple	• Superior industrial design in the integration of hardware and software. • Superior marketing and retailing experience. • Establishment and maintenance of a digital ecosystem.	• Innovative and category-defining mobile devices and software services that take the user's experience to a new level. • A global ecosystem of 2 billion users of products and services (e.g., iPhone, iPad, Apple Watch, App Store, Apple Care, Apple Pay, and iCloud Services) that reinforce one another.
Coca-Cola Co.	• Superior marketing and distribution.	• A diverse lineup of beverages that leverage one of the world's most recognized brands (based on its original "secret formula"). • Global availability of products.
ExxonMobil	• Superiority in discovering and extracting fossil-fuel-based energy sources globally.	• Focus on oil and gas (fossil fuels only, not renewables).
Facebook (a subsidiary of Meta Platforms)	• Superior IT and AI capabilities to provide reliable social network services on a large scale (globally). • Superior algorithms to offer targeted online ads.	• Over 3.5 billion social media users worldwide. • News feed, photos, messenger, timeline, graph search, and stories. • Online advertising.
Five Guys	• Superiority in providing fresh, customized hamburgers and hand-cut fries using the highest-quality ingredients.	• Hamburgers and fries.
Google (a subsidiary of Alphabet)	• Superior AI capability that results in best-in-class and proprietary algorithms based on vast amounts of data collected online. • Establishment and maintenance of mobile operating system software.	• Online search. • Online advertising. • Cloud-based services (e.g., Gmail, Docs, Drive, maps, storage). • Android, which powers over 70% of smartphones globally.
IKEA	• Superiority in designing modern functional home furnishings at low cost. • Superior retail experience.	• Fully furnished room setups, practical tools for all rooms, do-it-yourself.
McKinsey	• Superiority in developing practice-relevant strategic knowledge, insights, and frameworks.	• Management consulting; in particular, strategy consulting provided to clients in business and government.
Microsoft	• Best-in-class productivity software and business applications, delivered on any platform and device.	• Office 365, Teams. • Cloud storage and computing.
Netflix	• Superior AI that predicts which shows will be most successful when licensing and creating original content. • Superior AI to create best-in-class personalized recommendation algorithm.	• Streaming media (including proprietary) content.

Company	Core Competencies	Examples
Tesla	• Superior software and engineering expertise in designing high-performance, high-efficiency battery packs, electric motors, and power trains. • Superior expertise in decentralized power storage and management based on renewable (solar) energy. • Vertically integrated car manufacturer and clean-tech company.	• Category-defining electric vehicles (e.g., Model S, Model X, Model 3, Model Y, and Cybertruck). • Renewable energy generation and storage (e.g., Powerwall, solar roof tiles, and complete rooftop solar systems).
Uber	• Superior mobile-app-based transportation and logistics expertise focused on cities, but on a global scale.	• Uber, UberX, UberLUX, UberSUV, Uber Eats.

RESOURCES AND CAPABILITIES

Because core competencies are critical to gaining and sustaining competitive advantage, it is crucial to understand how they are created. Companies develop core competencies through the interplay of resources and capabilities. Exhibit 4.4 shows this relationship. **Resources** are any assets such as cash, buildings, machinery, or intellectual property that a firm can draw on when crafting and executing a strategy. Resources can be either tangible or intangible. **Capabilities** are the organizational and managerial skills necessary to orchestrate a diverse set of resources and deploy them strategically. Capabilities are, by nature, intangible. They find their expression in a company's structure, routines, and culture.

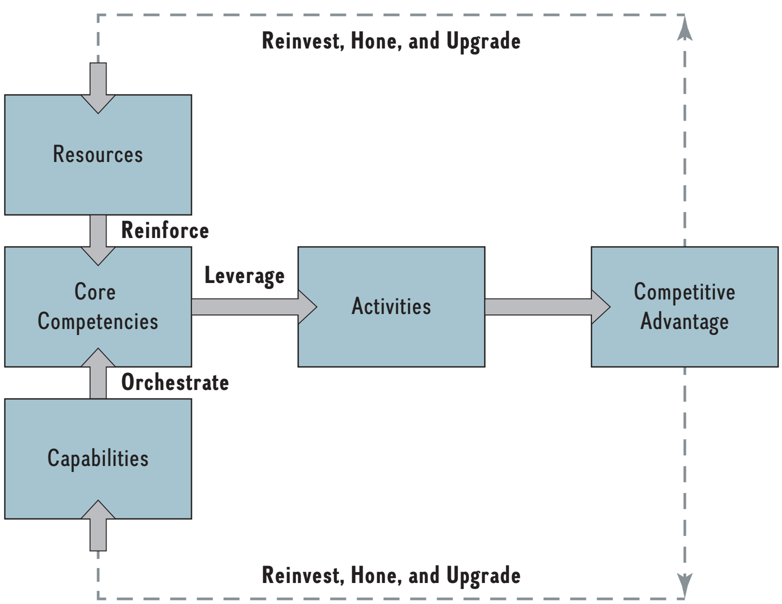
As Exhibit 4.4 shows, a firm's core competencies are manifested in its activities, lead to competitive advantage, and result in superior firm performance. **Activities** are distinct and fine-grained business processes such as taking orders, delivering products, or invoicing

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

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

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

EXHIBIT 4.4 Linking Core Competencies, Resources, Capabilities, and Activities to Competitive Advantage



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

We should make two more observations about Exhibit 4.4 before we move on:

1. Core competencies that are not continuously nourished will lose their ability to yield a competitive advantage.
2. When analyzing a company's success in the market, it can be too easy to focus on the more *visible* manifestations of core competencies such as superior products or services. These are the outward demonstrations of core competencies, but it is even more important to understand the *invisible* part of core competencies.

Core competencies that are not continuously nourished will lose their ability to yield a competitive advantage. As an example, consider the consumer electronics industry. For some years, Best Buy outperformed Circuit City based on its strengths in employee development, exclusive branding, and customer-centricity (segmenting customers based on demographic, attitudinal, and value tiers, and configuring stores to serve the needs of the customer segments in that region). Although Best Buy outperformed Circuit City (which filed for bankruptcy in 2009), more recently Best Buy has not honed and upgraded its core competencies sufficiently to compete effectively against Amazon, the world's largest online retailer. Amazon does not have the overhead expenses associated with maintaining buildings or a human sales force; therefore, it has a lower cost structure and thus can undercut in-store retailers on price. When a firm does not continually upgrade or improve core competencies, its competitors are more likely to develop equivalent or superior skills, as Amazon did. This insight allows us to explain differences between firms in the same industry and competitive dynamics over time. It also helps us identify the strategy that firms use to gain and sustain a competitive advantage and weather an adverse external environment.

Companies need to look beyond the visible manifestations of core competencies such as superior products or services. In the next section, we introduce tools to clarify the more opaque aspects of a firm's core competencies. We start by looking at both tangible resources and intangible resources.

LO 4-3

Compare and contrast tangible and intangible resources.

4.3 The Resource-Based View

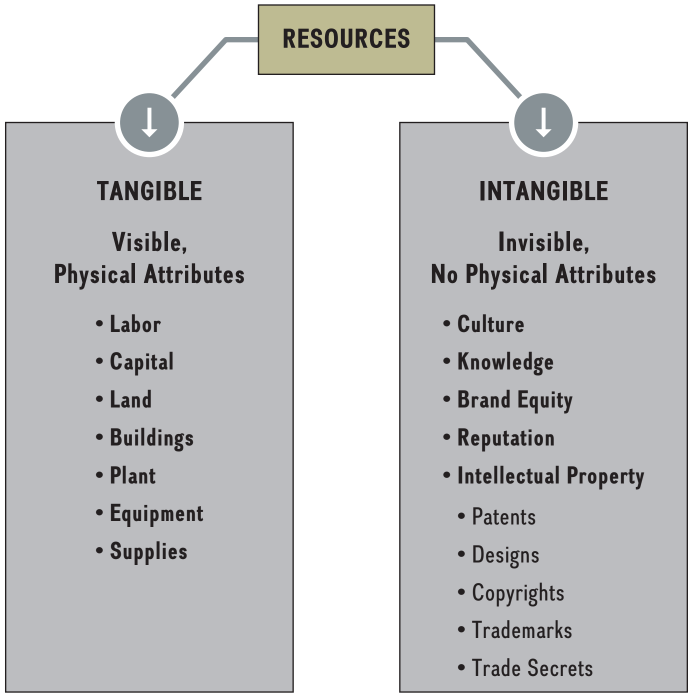
To gain a deeper understanding of how the interplay between resources and capabilities creates core competencies that drive firm activities leading to competitive advantage, we turn to the **resource-based view** of the firm. This model systematically aids in identifying core competencies.[8] As its name suggests, this model sees resources as key to superior firm performance. As Exhibit 4.5 illustrates, resources fall broadly into two categories: tangible and intangible. **Tangible resources** have physical attributes and are visible. Examples of tangible

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

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

resources are labor, capital, land, buildings, plant, equipment, and supplies. **Intangible resources** have no physical attributes and thus are invisible. Intangible resources include firm culture, knowledge, brand equity, reputation, and intellectual property.

EXHIBIT 4.5 Tangible and Intangible Resources



Consider Alphabet, a holding company overseeing diverse activities, with Google its most prominent subsidiary. Alphabet's tangible resources, valued at $85 billion, include its headquarters (The Googleplex) in Mountain View, California, a vast campus across four pieces of land near the edge of San Francisco Bay, and numerous clusters of computer servers across the globe.[9] The Google brand, an intangible resource, is valued at $460 billion—more than five times higher than Alphabet's tangible assets.[10]

Alphabet's headquarters exemplifies both tangible and intangible resources. The Googleplex is composed of parcels of land containing futuristic buildings. Both the land and the buildings are tangible resources. However, the *company's location* in the heart of Silicon Valley is an *intangible* resource that provides the company with several benefits. Two benefits are (1) access to a valuable network of contacts, including a number of college graduates and a large and tech-savvy workforce, and (2) knowledge spillovers from numerous nearby universities. These intangible resources add to Google's technical and managerial capabilities.[11]

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

Another benefit of being located in Silicon Valley is access to venture capital firms. Silicon Valley has the highest concentration of venture capital firms in the United States. Venture capitalists tend to prefer local investments because the more local they are, the more closely they can be monitored. The proximity of venture capitalists to the companies they fund provides mutual benefit.[12] In fact, initial funding for Google came from the well-known venture capital firms Sequoia Capital and Kleiner Perkins, both located in Silicon Valley.

Competitive advantage is more likely to spring from intangible resources than from tangible resources. Tangible assets, such as buildings or computer servers, can be bought on the open market by anyone who has the necessary cash. However, a brand name must be built, often over long periods. It took mainstay firms such as Apple, Microsoft, Visa, McDonald's, and MasterCard—five of the global Top 10 most valuable brands—many years to build their value and earn brand recognition in the marketplace. Newer companies accomplished their enormous brand valuation more quickly, mainly because of their superior core competencies and global reach and scale. These companies include Google (founded in 1998 and part of Alphabet; brand value of over $460 billion), Amazon (founded in 1994; brand value of over $685 billion), Facebook (founded in 2004 and part of Meta; brand value of over $225 billion), and the Chinese technology companies Tencent (founded in 1998; brand value of $240 billion) and Alibaba (founded in 1999; brand value of some $200 billion).[13]

LO 4-4

Evaluate the two critical assumptions about the nature of resources in the resource-based view.

RESOURCE HETEROGENEITY AND RESOURCE IMMOBILITY

In the resource-based view (RBV), a firm is a *unique bundle* of resources, capabilities, and competencies. The RBV defines resources broadly. According to the RBV, a **resource** is any asset, capability, or competency that a firm can draw upon when formulating and implementing strategy.[14] The usefulness of the resource-based view to explain and predict competitive advantage rests on two critical assumptions about the nature of resources:

1. Resource heterogeneity
2. Resource immobility[15]

RESOURCE HETEROGENEITY. The first critical assumption—**resource heterogeneity**—comes from the insight that bundles of resources differ across firms. This insight requires us to look more critically at the resources of firms competing in the same industry or even the same strategic group because each bundle is unique to some extent. For example, Southwest Airlines (SWA) and Alaska Airlines (ASA) both compete in the same strategic group (low-cost, point-to-point airlines; see Exhibit 3.8), but they draw on different resource bundles. SWA's employee productivity tends to be higher than ASA's because the two companies differ in their human and organizational resources. At SWA, job descriptions are informal, and employees pitch in to "get the job done." Pilots may help load luggage to ensure an on-time departure; flight attendants clean airplanes to prepare them for on-time departure. Employees pitching in as needed allows SWA to keep its planes flying for longer and to lower its cost structure. SWA then passes these savings on to passengers in the form of lower ticket prices.

RESOURCE IMMOBILITY. The second critical assumption—**resource immobility**—rests on the insight that resources tend to be "sticky" and don't move easily from firm to firm. Because of that stickiness, the resource differences between firms are difficult to replicate and therefore can last a long time. For example, SWA has enjoyed a sustained competitive advantage, outperforming its competitors over several decades. That resource difference is not due to a lack of imitation attempts. Continental and Delta attempted to copy SWA with their Continental Lite and Song airline offerings. However, neither airline succeeded in imitating the resource bundles and firm capabilities that make SWA unique.

Together, resource heterogeneity and resource immobility mean that resource bundles differ across firms, and such differences can persist for long periods. These two assumptions about resources are critical to explaining superior firm performance in the resource-based model.

Note, by the way, that the critical assumptions of the resource-based model are fundamentally different from those describing a firm in the perfectly competitive industry structure introduced in Chapter 3. In perfect competition, all firms have access to the *same* resources and capabilities, ensuring that one firm's advantage will be short-lived. When resources are freely available and mobile, competitors can quickly acquire the same resources that the current market leader utilizes. Although some commodity markets

resource In the resource-based view of the firm, any asset, capability, or competency that a firm can draw upon when formulating and implementing strategy.

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

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

approach perfect competition, most other markets include firms whose resource endowments differ. Therefore, the resource-based view delivers useful insights about formulating a strategy that will enhance the firm's chances of gaining a competitive advantage.

THE VRIO FRAMEWORK

LO 4-5

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

In the resource-based view of the firm, specific *resources attributes* are essential to superior firm performance.[16] For a resource to be the basis of competitive advantage, it must be:

Valuable.

Rare, and costly to

Imitate. And, the firm itself must be

Organized to capture the value of the resource.

Following the lead of Jay Barney, one of the pioneers of the resource-based view of the firm, we call this model the **VRIO framework**.[17] According to this model, a firm can gain and sustain a competitive advantage only when it has resources that satisfy all of the VRIO criteria. Remember that resources in the VRIO framework are broadly defined to include any assets, capabilities, and competencies that a firm can draw upon when formulating and implementing strategy. The presentation of the VRIO model summarizes our discussion thus far.

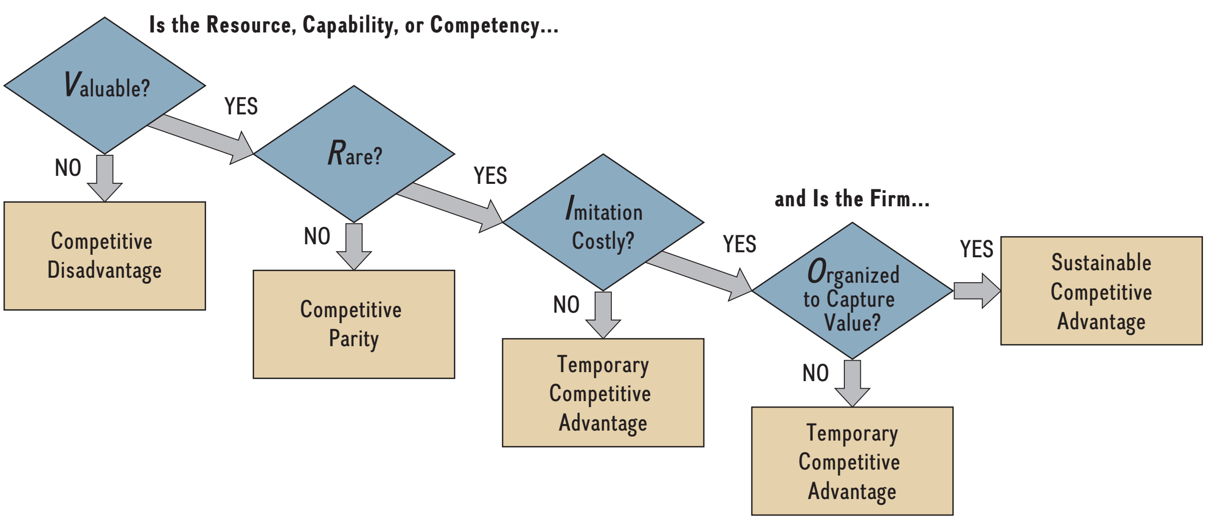
VRIO framework A theoretical framework that explains and predicts firm-level competitive advantage.

Exhibit 4.6 captures the VRIO framework in action. You can use this decision tree to decide if the resource, capability, or competency under consideration fulfills the VRIO requirements. As you study the discussion of each VRIO attribute, you will notice that they need to accumulate to lead to sustainable competitive advantage. For the resource in question to be a core competency that underpins a firm's sustainable competitive advantage, you must be able to answer "Yes" to all four of the attributes listed in the decision tree.

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

VALUABLE. A **valuable resource** enables the firm to exploit an external opportunity or offset an external threat and positively affects the firm's competitive advantage. In particular, a valuable resource allows a firm to increase its economic value creation *(V – C)*. Revenues

EXHIBIT 4.6 Applying the VRIO Framework to Reveal Competitive Advantage



rise if a firm can increase the perceived value *(V)* of its product or service in the eyes of consumers by offering superior design and adding attractive features (assuming costs are not increasing). Production costs *(C)* fall if the firm can put in place an efficient manufacturing process and tight supply chain management (assuming the perceived value is not decreasing).

Five Guys' superior ability to deliver fresh, customized hamburgers and hand-cut fries using the highest-quality ingredients is valuable because it enables the firm to command a premium price due to its perceived higher value creation. However, value creation on its own is not enough. Although Five Guys has succeeded in driving up the perceived value of its offerings, it also needs to control costs to ensure that this valuable resource can lay the foundation for a competitive advantage.

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

RARE. A resource is **rare** if only one or a few firms possess it. If the resource is common, the result is perfect competition in which no firm can maintain a competitive advantage (see the discussion in Chapter 3). A valuable but not rare resource can lead to competitive parity at best. A firm is on the path to competitive *advantage* only if it possesses a valuable resource that is also rare.

When founded in 1986, Five Guys' superior ability to deliver made-to-order hamburgers from the freshest ingredients and hand-cut fries made from the best potatoes was undoubtedly rare. So was its restaurant concept. Five Guys is neither a fast food place nor a traditional sit-down establishment. It offers a limited menu, no drive-through option, and a self-service format—and none of this has changed since the company's earliest days. Five Guys manages to charge premium prices that are much higher than those charged by its fast food competitors. Today, eateries like Five Guys are called fast-casual restaurants, a term that didn't enter the dining vernacular until the 2000s, despite well-known Five Guys competitors such as Chipotle Mexican Grill (founded in 1993) coming onto the scene earlier.

To further underscore the idea that Five Guys was rare on multiple fronts, note that its more direct competitors and imitators in the "better burger" segment—Shake Shack (founded in 2004), Smashburger (founded in 2007), and Burger Fi (founded in 2011)—were not launched until much later. The head start of almost 20 years gave Five Guys the ability to perfect its core competencies over a long period of time before it decided to franchise (see Exhibit 4.1). Five Guys enjoyed a first-mover advantage because it *created* the "better burger" segment. It locked in the best store locations and perhaps, more importantly, the best suppliers (e.g., Rick Miles of Rigby, Idaho, is Five Guys' sole supplier of potatoes).

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

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

For more than 35 years, Five Guys has consistently delivered fresh, made-to-order premium burgers and fries. As a result, Five Guys enjoys a cultlike following among its customers, along with a 50% market share in the "better burger" segment. Five Guys spent almost 20 years refining, honing, upgrading, and perfecting its core competency before franchising nationally. Perfecting its core competencies enabled Five Guys to more easily duplicate its core competency in different geographic areas as it franchised throughout the United States and beyond.

Although Five Guys' business model ("make the best burger") may seem simple, it is by no means simplistic. Coordinating a multilayered supply chain of a relatively large number of high-quality, fresh ingredients is a complex undertaking. For example, ensuring no food-borne illnesses requires strict adherence to established food-handling protocols and best practices in every one of its 1,700 stores. In addition, much of Five Guys' business was built around Jerry Murrell's gut feeling—something that cannot be imitated. In fact, Murrell himself cannot explain the reasoning behind his many "strategic hunches" over the years.[18]

Unlike Five Guys, imitators such as Shake Shack, Smashburger, and Burger Fi franchised almost immediately after launching. The Five Guys imitators rushed because of their relatively late entry into the market and their attempt to compete nationwide with Five Guys. In doing so, the imitators discovered that it is pretty costly to imitate Five Guys' core competency. Moreover, given that most of these chains franchised more or less immediately, they were unable to perfect their core competency before expanding. Together, the combination of the three resource attributes *($V + R + I$)* has allowed Five Guys to enjoy a competitive advantage (see Exhibit 4.6).

Direct Imitation. A firm that enjoys a competitive advantage attracts significant attention from its competitors, which will attempt to negate a firm's resource advantage by directly imitating the resource in question *(direct imitation)* or by working around it to provide a comparable product or service *(substitution)*.

We usually see direct imitation when firms have difficulty protecting their competitive advantage and a competitor wants to copy or imitate a valuable and rare resource. (We discuss barriers to imitation later.) Direct imitation can be swift and successful if intellectual property (IP) protection such as patents or trademarks can be easily circumvented.

Tiffany & Co. has developed a core competency: elegant jewelry design and craftsmanship delivered through a superior customer experience. This experience is valuable, rare, and costly for competitors to imitate. The company vigorously protects its trademarks, including its Tiffany Blue Box, but it never trademarked the so-called Tiffany setting for diamond rings. Many jewelers now use this setting, and the term " Tiffany setting" has been co-opted for advertising by other retailers (including Costco), claiming it is a generic term commonly used in the jewelry industry.

Lucas Oleniuk/Toronto Star/ Getty Images

Crocs, the inventor of the iconic plastic clog, fell victim to direct imitation. Launched as spa shoes at the Fort Lauderdale, Florida, boat show, Crocs experienced explosive growth, selling millions of pairs each year. To protect its unique shoe design, the firm secured several patents. However, thanks to Crocs' explosive growth, numerous cheap imitators have sprung up to copy the colorful and comfortable plastic clog. Despite Crocs' patents and celebrity endorsements, other firms copied the shoe and bit strongly into Crocs' profits.

This example illustrates that competitive advantage cannot be sustained if the underlying capability can easily be replicated and therefore *directly imitated.* Competitors created molds to mimic the original Crocs shoe's shape, look, and feel. Indeed, any competitive advantage in a fashion-driven industry will be short-lived if the company fails to continuously innovate or build strong brand recognition that prevents direct imitation.

Although Crocs provides an interesting example in the business-to-consumer (B2C) space, the business-to-business (B2B) market is about 10 times larger, given that purchases consist of much more expensive items such as sophisticated and advanced equipment. The commercialization of the CAT scanner provides a classic example. Based on internal research, the British conglomerate EMI developed and launched the computed axial tomography (CAT) scanner. This technology, for which EMI received several patents, takes three-dimensional pictures of the human body and is considered the most important breakthrough in radiology since the discovery of X-rays. The invention of the CAT scanner also paved the way for follow-up innovations such as nuclear magnetic resonance imaging (MRI). Direct imitation through a workaround allowed a second mover, General Electric (GE), to mitigate the innovator's advantage and to gain and even sustain a competitive advantage.[19] Despite its initial success, EMI lost out quickly to GE.

How can an innovator with a patent-protected technology lose out to a follower? GE was able to reverse-engineer EMI's CAT scanner to produce a model that worked around EMI's patents. Moreover, GE leveraged necessary *complementary resources* such as financing, manufacturing, distribution, marketing, and after-sales support. While EMI possessed a valuable and rare resource, it could not protect itself from GE's direct imitation.

Five Guys' imitators in the "better burger" segment were all founded after Five Guys started to franchise in 2003, which gave Five Guys almost a 20-year lead in perfecting its core competency. In addition, within 18 months of beginning to franchise, Five Guys sold out the U.S. territory, and its franchisees had locked down most of the best locations. Given the Five Guys competitors' entry into the marketplace, it is clear that they perceived the fast-casual burger segment as highly profitable, and they embarked on a direct imitation attempt. However, first-mover advantages in combination with perfected core competency made such direct imitation attempts more difficult, and Five Guys has been able to sustain its competitive advantage.

Substitution. The second avenue of imitation for a firm's valuable and rare resource is *substitution.* Imitation via substitution is often accomplished through *strategic equivalence.* Take the example of Jeff Bezos launching and developing Amazon.[20] Before Amazon's inception, the retail book industry was dominated by a few large chains and many independent bookstores. As the internet was emerging in the 1990s, Bezos was looking for options in online retail. He zeroed in on books because of their non-differentiated commodity nature and ease of shipping. In purchasing a printed book online, customers knew exactly what they would be sent because the products were identical whether they were sold online or in a brick-and-mortar store. The only difference was the mode of transaction and delivery. Removing the worry that they would receive an inferior product made potential customers more likely to try this new way of shopping.

The emergence of the internet allowed Bezos to develop a new distribution system that negated the need for retail stores and thus high real estate costs. Bezos' unique business model of ecommerce substituted for the traditional fragmented supply chain in book retailing and allowed Amazon to offer lower prices because of its lower operating costs. In other words, Amazon uses a strategic equivalent substitute to satisfy a customer need previously met by brick-and-mortar retail stores.

Combining Imitation and Substitution. In some instances, firms can combine direct imitation and substitution when attempting to mitigate a rival's competitive advantage. With its Galaxy line of smartphones, Samsung has successfully imitated the look and feel of Apple's iPhones. Samsung's Galaxy smartphones use Google's Android operating system and apps from Google Play Store as an alternative to Apple's iOS and App Store. Samsung's success in this space is based on a combination of *direct imitation* (look and feel) and *substitution* (using Google's mobile operating system and app store).[21]

Amazon started competing in the high-end grocery market by acquiring the brick-and-mortar Whole Foods (in 2017). As we will see in ChapterCase 8, Amazon's entry into high-end groceries involves both imitation and substitution.

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

ORGANIZED TO CAPTURE VALUE. The final criterion of whether a rare, valuable, and costly-to-imitate resource can form the basis of a sustainable competitive advantage depends on the firm's internal structure. To fully exploit the competitive potential of its resources, capabilities, and competencies, a firm must be **organized to capture value**—that is, it must have in place an effective organizational structure and coordinating systems. We will study organizational design in detail in Chapter 11.

Before Apple or Microsoft had a significant share of the personal computer market, Xerox's Palo Alto Research Center (PARC) invented and developed an early word-processing application, the graphical user interface (GUI), the Ethernet, the mouse as a pointing device, and even the first personal computer. These technology breakthroughs laid the foundation of the personal computing industry.[22] Xerox's invention competency built through a unique combination of resources and capabilities was valuable, rare, and costly to imitate with the potential to create a competitive advantage.

However, due to a lack of organization, Xerox failed to appreciate and exploit PARC's many breakthroughs in computing software and hardware. Why? The innovations did not fit within Xerox's business focus at the time. Under pressure in its core business from Japanese low-cost competitors, Xerox's top management was busy pursuing innovations in the photocopier business. Xerox did not organize to appreciate the competitive potential of the valuable, rare, and inimitable resources generated at PARC. Such organizational problems were exacerbated by geography: Xerox headquarters is on the East Coast in Norwalk, Connecticut, across the country from PARC on the West Coast in Palo Alto, California.[23] Nor did it help that development engineers at Xerox headquarters disdained the scientists engaging in basic research at PARC. In the meantime, both Apple and Microsoft developed operating systems, GUIs, and application software. Indeed, both Steve Jobs (co-founder of Apple) and Bill Gates (co-founder of Microsoft) took one look at Xerox's inventions during tours of the facility and immediately recognized the potential of PARC's inventions.[24] And, as the adage goes, the rest is history.

Suppose a firm is not effectively organized to exploit the competitive potential of a valuable, rare, and costly-to-imitate (VRI) resource. In that case, the best-case scenario is a temporary competitive advantage (see Exhibit 4.6). In the case of Xerox, where the strategic leaders were not supportive of the resource, even a temporary competitive advantage would not have been realized even though the resource met the VRI requirements.

In summary, for a firm to gain and sustain a competitive advantage, its resources and capabilities need to interact in such a way as to create unique core competencies (see Exhibit 4.4). Ultimately, though, only a few competencies may turn out to be the *specific* core competencies that fulfill the VRIO requirements.[25] A company cannot do everything equally well and must carve out a unique strategic position for itself, making necessary trade-offs.[26] Strategy Highlight 4.2 provides an application of the VRIO framework.

Strategy Highlight **4.2**

Applying VRIO: The Rise and Fall of Groupon

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

Groupon became one of the most successful internet startups, reaching over 260 million subscribers and serving more than 500,000 merchants in about 50 countries. Indeed, Groupon's success attracted a $6 billion buyout offer by Google in early 2011, which Mason declined. Then, in November 2011, Groupon held a successful initial public offering (IPO), valued at more than $16 billion with a share price over $26. But a year later, Groupon's share price had fallen 90% to just $2.63, resulting in a market cap of less than $1.8 billion. In early 2013, Mason posted a

(Continued)

letter for Groupon employees on the web, arguing that it would leak anyway. He stated, "After four and a half intense and wonderful years as CEO of Groupon, I've decided that I'd like to spend more time with my family. Just kidding—I was fired today."

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

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

Also, note that the ability to imitate a rare and valuable resource is directly linked to entry barriers, one of the five forces in Porter's model—specifically, *threat of new entrants*. This relationship allows us to link internal analysis using the resource-based view with external analysis using the five forces model, which also predicts low industry profit potential given low or no barriers to entry.

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

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

Once imitated, Groupon's competency to facilitate local commerce using an internet platform was neither valuable nor rare. As the VRIO model would have predicted, Groupon's competitive advantage as a first mover was temporary at best (see Exhibit 4.6).[27]

LO 4-6

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

ISOLATING MECHANISMS: HOW TO SUSTAIN A COMPETITIVE ADVANTAGE

Although VRIO resources can lay the foundation of competitive advantage, no competitive advantage can be sustained indefinitely.[28] Several conditions can potentially protect a successful firm by making it more difficult for competitors to imitate the resources, capabilities, and competencies that underlie its competitive advantage. Those conditions include *barriers* *to imitation,* which are examples of **isolating mechanisms** that prevent rivals from competing away the advantage a firm may enjoy. In the business world, isolating mechanisms are often referred to as a *moat to protect competitive advantage.* They include the following:[29]

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

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

Each isolating mechanism is directly related to one of the criteria in the resource-based view used to assess the basis of competitive advantage: costly (or difficult) to imitate. If one, or any combination, of these isolating mechanisms is present, a firm may strengthen its basis for competitive advantage, increasing its chance of sustaining that advantage over a longer period.

BETTER EXPECTATIONS OF FUTURE RESOURCE VALUE. Better expectations of the future value of a resource allow a firm to gain a competitive advantage. If these better expectations can be systematically repeated over time, they can help a firm develop a *sustainable* competitive advantage. For example, firms can sometimes acquire resources at a low cost. This acquisition can lay the foundation for a competitive advantage later when the purchaser's expectations about the future value of the resource turn out to be more accurate than competitors' expectations.

Let's discuss how the concept of better expectations of future resource value works in the case of Aaliyah, a real estate developer looking to purchase land. Aaliyah must decide when and where to buy land for future development. Suppose she buys a parcel of land for a low cost in an undeveloped rural area 40 miles north of San Antonio, Texas. She believes that the value of the land will increase substantially in the future due to natural population growth. If the land does indeed grow in value, her firm may gain a competitive advantage. Now assume that several years later an interstate highway gets built near this land. Thanks to the highway, suburban growth explodes. New neighborhoods and shopping centers are built. Aaliyah's firm now decides to develop the property she purchased. Specifically, it decides to create high-end office and apartment buildings to accommodate the suburban growth. Thus, the value creation resulting from the purchase of the land ends up far exceeding its initial cost. Having better expectations of the land's future value allows Aaliyah's firm to gain a competitive advantage over other real estate developers in the area.

Other developers could have purchased the particular parcel of land that Aaliyah bought. But if they decided to do so only after the highway's construction was announced, they would have had to pay a much higher price for the land (and land adjacent to it). Why? To reflect the new reality of being located near an interstate highway, the price of the land would have increased. The expectations of the future value of the land would have adjusted upward. This increase in the cost of the land to reflect its future value, in turn, would have negated any potential for competitive advantage.

In short, Aaliyah developed better expectations of the future value of the resource than her competitors did. If she can repeat these better expectations over time more or less systematically, then her firm will likely gain a sustainable competitive advantage. Otherwise, her decision to purchase this particular piece of land may just be considered a stroke of luck. Although luck can play a role in gaining an initial competitive advantage, it is not a basis for sustaining one.

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

PATH DEPENDENCE. **Path dependence** describes a process in which the options in a current situation are limited by decisions made in the past.[30] Often, early events—sometimes even random ones—significantly affect outcomes.

The U.S. carpet industry provides an example of path dependence.[31] Roughly 85% of all carpets sold in the United States and almost one-half of all carpets sold worldwide come from carpet mills located within 65 miles of one city: Dalton, Georgia. Although the U.S. manufacturing sector has suffered in recent decades, the carpet industry has flourished. Companies not located near Dalton face a disadvantage because they cannot readily access the required know-how, skilled labor, suppliers, and low-cost infrastructure that are needed to be competitive.

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

Path dependence also rests on the notion that time cannot be compressed at will. Although management can compress resources such as labor and R&D into a shorter period, the push will not be as effective as when a firm spreads out its effort and investments over a longer period. Trying to achieve the same outcome in less time, even with higher investments, tends to lead to inferior results due to *time compression diseconomies*.[32]

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

Companies not only feel the nudge of forces in their environment but can also push back. The California mandate on zero emissions, for example, did not stand.[33] Several stakeholders, including the car and oil companies, fought it through lawsuits and other actions. CARB ultimately gave in to the pressure and abandoned its zero-emissions mandate. GM recalled and destroyed its EV1 electric vehicles when the mandate was revoked and terminated its EV program. This decision turned out to be a strategic error that would haunt GM a decade or so later. Although GM was the leader among car companies in EVs in the mid-1990s, it did not have a competitive model to counter the Toyota Prius when its sales took off in the early 2000s. The Chevy Volt, a plug-in hybrid that was GM's first major vehicle to compete with the Prius, was delayed by over a decade because GM had to start its EV program basically from scratch. While GM sold about 50,000 Chevy Volts worldwide, Toyota sold about 10 million Prius cars. Moreover, when Nissan introduced its all-electric Leaf in 2010, GM did not have an all-electric vehicle in its lineup. Meanwhile, Nissan sold over 500,000 Leafs worldwide.

Due to an inadequate product lineup during the early 2000s, GM's U.S. market share dropped below 20% in 2009 (from over 50% a few decades earlier). That same year it filed for bankruptcy. GM subsequently reorganized under Chapter 11 of the U.S. bankruptcy law and relisted on the New York Stock Exchange in 2010.

Collaborating with LG Corp. of Korea, GM introduced the Chevy Bolt, an all-electric vehicle, in 2017.[34] Although some of its features, such as a 230-mile range on a single charge, appear attractive, GM's electric car does not sell well. In 2021, for instance, GM sold a mere 22,000 Chevy Bolts, while Tesla (featured in ChapterCase 1) sold over 40 times as many Model 3/Ys. In the same year, GM announced that it would invest $35 billion into electrification and autonomy over the next few years.

One important take-away here is that once the train of new capability development has left the station, it is hard to jump back on because of path dependence. Moreover, firms cannot compress time at will. Indeed, learning and improvements must occur over time, and existing competencies must constantly be nourished and upgraded.

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

CAUSAL AMBIGUITY. **Causal ambiguity** describes a situation in which the cause and effect of a phenomenon are not readily apparent. To formulate and implement a strategy that enhances a firm's chances of gaining and sustaining a competitive advantage, strategic leaders need to have a hypothesis or theory of how to compete. A *hypothesis* is a specific statement that proposes a relationship, such as a relationship between resources and competitive advantage. A *theory* is a more generalized explanation of what causes what, and why. Strategic leaders need to have a good understanding about what causes superior or inferior performance, and why. However, comprehending and explaining the underlying reasons for observed phenomena is far from trivial.

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

Everyone can see that Apple has launched several hugely successful innovative products, including the iPhone and Apple Watch. These products, combined with Apple's hugely popular App Store, led to a decade of sustainable competitive advantage. These successes stem from Apple's set of *V, R, I,* and *O* core competencies, which support its ability to continue offering a variety of innovative products and to create an ecosystem of products and services.

However, gaining a deep understanding of exactly *why* Apple has been so successful is difficult. Even Apple's strategic leaders may not be able to pinpoint the source of their success. Is it the visionary role that the late Steve Jobs played? Is it the rare skills of Apple's uniquely talented design team around Jonathan Ive (who left Apple in 2019)? Is it the timing of the company's product introductions? Is it Apple CEO Tim Cook, who adds superior organizational skills and puts all the pieces together when running the day-to-day operations? Or is it a combination of these factors? If the link between cause and effect is ambiguous for Apple's strategic leaders, then it is that much more difficult for others seeking to copy a valuable resource, capability, or competency.

SOCIAL COMPLEXITY. **Social complexity** describes situations in which different social and business systems interact. There is frequently no causal ambiguity about how *individual* systems such as supply chain management or new product development work in isolation. They are often managed through standardized business processes such as Six Sigma or ISO 9000. Social complexity emerges when two or more such systems are *combined.* Copying the emerging complex social systems is difficult for competitors because neither direct imitation nor substitution is valid. The interactions between different systems create too many possible permutations for a system to be understood with any

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

Thasunda Brown Duckett is CEO of the Teachers Insurance and Annuity Association of America (TIAA), a Fortune 100 financial services firm that manages about $1.5 trillion in assets, serves more than 15,000 institutions, and employs some 20,000 employees.

Leon Bennett/WireImage/Getty Images

accuracy. The resulting social complexity makes copying these systems difficult and perhaps even impossible, resulting in a valuable, rare, and costly-to-imitate resource that the firm is organized to exploit.

Think about it this way: A group of three people has three relationships, connecting every person directly with one another. Adding a fourth person to this group *doubles* the number of direct connections to six. Introducing a fifth person increases the number of relationships to 10.[35] This example gives you some idea of how complexity might increase when combining different systems with many other parts.

Some firms manage thousands of employees from all walks of life. Their interactions within the firm's processes, procedures, and norms make up its culture. Although an observer may conclude that Zappos' culture, which focuses on autonomous teams in a flat hierarchy to provide superior customer service, might be the basis for its competitive advantage, engaging in reverse social engineering to crack Zappos' success code might be much more difficult. Moreover, an informal, decentralized organizational culture that works for an online retailer such as Zappos (which is owned by Amazon) might wreak havoc at a Fortune 100 financial services firm such as TIAA, led by CEO Thasunda Brown Duckett. Financial service firms use a centralized, top-down approach because of various regulatory constraints and legal obligations.

In summary, one must understand competitive advantage within its organizational and industry context. Looking at individual elements of success without considering social complexity is a recipe for inferior performance or worse.

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

INTELLECTUAL PROPERTY PROTECTION. **Intellectual property (IP) protection** is a critical intangible resource that can help sustain a competitive advantage. There are five primary forms of IP protection:[36]

- Patents
- Designs
- Copyrights
- Trademarks
- Trade secrets

IP protection intends to prevent others from copying legally protected products or services. In many knowledge-intensive industries that are characterized by high research and development (R&D) costs, such as smartphones and pharmaceuticals, IP protection provides not only an incentive to make these risky and often large-scale investments in the first place but also a strong isolating mechanism that is critical to a firm's ability to capture the returns to investment. Although the initial investment to create the first version of a new product or service is quite high in many knowledge-intensive industries, the *marginal cost* (i.e., the cost to produce the next unit) after the initial invention is quite low.

For example, Microsoft spends billions of dollars to develop a new version of its Windows operating system. Once completed, the following "copy" costs close to zero because it is just software code distributed online in digital form. Similarly, the costs of developing a new prescription drug, a process that often takes more than a decade, are estimated to be over $2.5 billion.[37] Rewards to IP-protected products or services can be high. For example, while under patent protection, Pfizer's Lipitor, the world's best-selling drug, accumulated over $125 billion in sales.[38]

IP protection can make direct imitation attempts difficult or even outright illegal. Dr. Dre (featured in MiniCase 4) attracted significant attention and support from other artists in the music industry when he sued Napster, an early online music file-sharing service, and helped shut it down (in 2001) because of copyright infringements.

IP protection does not last forever, however. Once the protection has expired, the invention can be used by others. Patents usually expire 20 years after filing with the U.S. Patent and Trademark Office. In the next few years, patents protecting roughly $100 billion in sales of proprietary drugs in the pharmaceutical industry will expire. When that happens, producers of generics (medicines that contain the same active ingredients as the original patent-protected formulation), such as Teva Pharmaceutical Industries of Israel, enter the market, and prices fall drastically. Pfizer's patent on Lipitor expired in 2011. One year later, of the 55 million prescriptions for cholesterol-lowering statins, 45 million (or more than 80%) were generics.[39] Drug prices fall by 20% to 80% when generic formulations become available.[40]

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

4.4 The Dynamic Capabilities Perspective

CORE RIGIDITIES

A firm's external environment is rarely stable (as discussed in Chapter 3). Indeed, in many industries the pace of change is ferocious. Firms that fail to adapt their core competencies to a changing external environment lose their competitive advantage and may go out of business.

We've seen the relentless pace of change in consumer electronics retailing in the United States. Former market leader Circuit City's core competencies were efficient logistics and superior customer service, but the firm neglected to upgrade and hone them over time. Consequently, Best Buy and online retailer Amazon outflanked it, and it went bankrupt. Best Buy encountered the same difficulties competing against Amazon just a few years later. Core competencies might form the basis for a competitive advantage at one point, but as the environment changes the same core competencies may turn into *core rigidities,* hindering the firm's ability to change.[41]

A core competency can turn into a **core rigidity** if a firm relies too long on the competency without honing, refining, and upgrading it as the environment changes.[42] Over time, the original core competency is no longer a good fit with the external environment, and it turns from an asset into a liability. Reinvesting, honing, and upgrading resources and capabilities are crucial to sustaining any competitive advantage to prevent competencies from turning into core rigidities (see Exhibit 4.4). This ability to hone and upgrade lies at the heart of the dynamic capabilities perspective. We defined *capabilities* as the organizational and managerial skills necessary to orchestrate diverse resources and deploy them strategically. Capabilities are by nature intangible. They find their expression in a company's structure, routines, and culture.

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

LO 4-7

Outline how dynamic capabilities can help a firm sustain a competitive advantage.

DYNAMIC CAPABILITIES

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

Dynamic capabilities describe a firm's ability to create, deploy, modify, reconfigure, upgrade, and leverage its resources over time in its quest for competitive advantage.[43] For a firm to maintain its competitive edge, the fit between its internal strengths and the external environment must be dynamic. Rather than focusing on a static fit at one point in time, a firm must change its internal resource base as the external environment changes. Its goal should be to develop resources, capabilities, and competencies that create a *strategic fit* with the firm's ever-changing environment. Dynamic capabilities are essential for moving beyond a short-lived advantage and creating sustained competitive advantage.

In addition to allowing firms to adapt to changing market conditions, dynamic capabilities enable firms to *create market changes* that can strengthen their strategic position. The market changes implemented by proactive firms introduce altered circumstances that can have a major effect on more reactive rivals. For example, Apple's dynamic capabilities allowed it to redefine the markets for mobile devices, computing, music, smartphones, and media content. Through its iPod and App Store, Apple generated environmental change in the music market to which Sony and others had to respond. With its iPhone, Apple redefined the smartphone market, creating environmental change that forced a response by competitors such as Samsung, BlackBerry, and Nokia. Apple's introduction of the iPad redefined the media and tablet computing market, forcing action by Amazon and Microsoft. The Apple Watch is shaping the market for computer wearables. Dynamic capabilities are especially important for surviving and competing in markets that shift quickly and constantly, such as the high-tech space in which Amazon, Apple, Alphabet, and Microsoft compete.

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

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

RESOURCE STOCKS AND RESOURCE FLOWS

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

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

One way to think about developing dynamic capabilities and other intangible resources is to distinguish between resource stocks and resource flows.[44] **Resource stocks** refer to the firm's current level of intangible resources. **Resource flows** are the firm's level of investments to maintain or build an intangible resource. A helpful metaphor to explain the differences between resource stocks and resource flows is a bathtub filled with water (Exhibit 4.7).[45] The amount of water in the bathtub indicates a company's level of specific *intangible resource stocks*—such as its dynamic capabilities, new product development, engineering expertise, innovation capability, or reputation for quality.[46]

Intangible resource stocks are built through investments over time. In Exhibit 4.7, these investments are represented by the four faucets from which water flows into the tub. Each faucet represents a different investment flow. Investments in building an innovation capability, for example, differ from investments made in marketing expertise. Each investment decision carries an opportunity cost that captures the loss of the next-best investment option. For example, a dollar invested in R&D cannot be invested in marketing, and vice versa. Because corporate budgets are limited, wise decisions about investing in dynamic

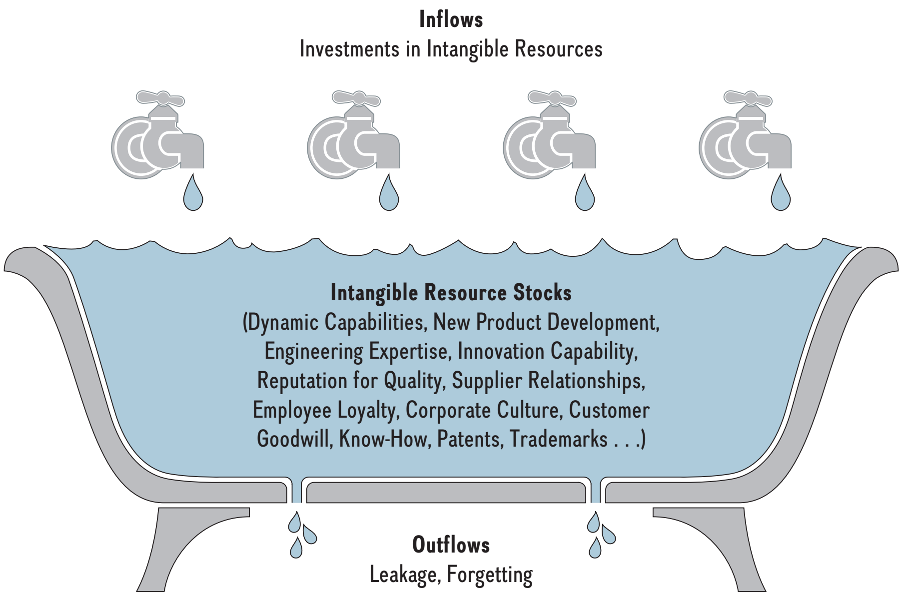


EXHIBIT 4.7

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

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

capabilities are critical. How fast a firm can build its intangible resources—how fast the tub fills—depends on how much water comes out of the faucets and how long the faucets are left open. Intangible resources are built through continuous investments and experience over time. Organizational learning interacts in a feedback loop with investment decisions to build intangible resource stocks over time.

IBM, for instance, demonstrated its expertise in artificial intelligence (AI) when its Deep Blue computer beat reigning chess champion Garry Kasparov (in 1997). To take advantage of business opportunities, IBM continued to invest billions to build a deep capability in cognitive computing to apply AI to everyday problems. IBM again showcased its advancing capabilities when it created Watson, a supercomputer capable of answering questions posed in natural language. Watson competed against all-time *Jeopardy!* quiz-show champion Ken Jennings and won. Subsequently, Watson demonstrated its skill in many professional areas where deep domain expertise is needed for making decisions in more or less real time: a wealth manager making investments, a doctor working with a cancer patient, an attorney working on a complex case, and even a chef in a five-star restaurant creating a new recipe.

Deep Mind (which Google acquired for $650 million in 2014) took the power of AI to the next level when its program, AlphaGo, beat the reigning Go champion, Lee Sedol of South Korea in 2016. Go, the ancient Chinese board game, is much more complex than chess. In contrast to chess, which has a finite number of moves, Go requires a higher level of intuition and feeling about an opponent's next moves because the number of possible moves is infinite. AlphaGo improved over time by using *machine learning*, a machine's capability to imitate intelligent human behavior. Machine learning algorithms allow AlphaGo to play against itself millions of times, improving its algorithms incrementally. AlphaGo's win over the reigning Go grandmaster surprised experts because the possibility of an AI program beating a top-ranked Go professional was seen as years off into the future.

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

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

LO 4-8

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

4.5 The Firm Value Chain and Strategic Activity Systems

FIRM VALUE CHAIN

There are two types of value chains. *Industry value chains* are *vertical value chains* because they depict the transformation of raw materials into finished goods and services along distinct stages in a specific industry. Each stage of the vertical value chain typically represents a distinct *industry* in which a number of different firms are competing. *Firm value chains* are *horizontal value chains* depicting the areas in which a firm is active, ranging from basic research to after-sales support and customer service. Horizontal firm value chains intersect with industry value chains in each stage of transforming raw materials into finished goods and services.

For instance, Intel, one of the leading semiconductor chip manufacturers globally, sources raw materials such as silicon, copper, aluminum, and various plastics from different suppliers. Intel's suppliers are active in different industries, including mining, smelting, and petroleum. Intel's firm value chain begins with research and development in designing cutting-edge semiconductors, which it manufactures in its fabs.[47] Intel sells its chips to computer manufacturers such as Dell, HP, and Microsoft, and carmakers such as GM and Ford. In this chapter, we focus on the horizontal firm value chains. We discuss vertical industry value chains in Chapter 8 when studying corporate strategy.

value chain The internal activities a firm engages in when transforming inputs into outputs; each activity adds incremental value.

A firm's **value chain** describes its internal activities when transforming inputs into outputs.[48] Each action the firm performs along the *horizontal* chain adds incremental value as raw materials and other inputs are transformed into components that are assembled into finished products or services for the end consumer. Each activity the firm performs along the *horizontal* value chain also adds incremental costs. A careful analysis of the value chain allows strategic leaders to obtain a more detailed and fine-grained understanding of how the firm's *economic value creation* ($V - C$) breaks down into distinct activities that help determine the perceived value (V) and the costs (C) to create it. The value chain concept can be applied to any firm—manufacturing, high-tech, or service.

DISTINCT ACTIVITIES. A firm's core competencies are deployed through its activities (see Exhibit 4.4). Therefore, a firm's activities are one of the vital internal drivers of performance differences across firms. *Activities* are distinct actions that enable firms to add incremental value at each step in the value chain by transforming inputs into goods and services. Managing a supply chain, running the computer system, and providing customer support are examples of specific firm activities. Activities are narrower than functional areas such as marketing because each functional area comprises a set of distinct activities.

Five Guys' Activities. Five Guys' core competency is offering a simple menu of fresh, high-quality burgers and fries and a great customer experience. To command a premium price for these products and service, Five Guys needs to engage in a number of distinct activities. Though it may seem simple, the ability to implement diverse sets of distinct activities every day across multiple geographic locations is no small feat.

The activities begin with sourcing ingredients. From the start, the Murrell sons have always selected only the best ingredients *without* knowing their cost. They viewed cost as distracting them from identifying and choosing only the freshest, tastiest, highest-quality toppings and condiments. For example, the mayonnaise they selected after a blind taste test turned out to be the most expensive brand on the market. A notoriously tricky vendor sold it, but they stuck with him because he offered the best mayonnaise. In addition, sourcing locally is also important to the Five Guys brand. The 15 free toppings that Five Guys offers are locally sourced whenever possible. Likewise, the fresh-baked buns are local as well, in that they come from bakeries that Five Guys built near their stores to guarantee their freshness.

In most chain restaurants, fries are a simple side dish. At Five Guys, though, fries are a specialty made with great care. According to founder Jerry Murrell, fries might look like the easiest item to make, but they are actually the hardest. Unlike other fast food chains that dump dehydrated frozen fries into hot oil, Five Guys hand-cuts Idaho potatoes that are grown north of the 42nd parallel and then soaks them in water to rinse off the starch. Soaking prevents the potatoes from absorbing the pure peanut oil as they are cooked, which gives them their unique Five Guys texture and taste.

Obsessing about every detail does not end at the supply chain. The Murrell family also obsesses over the layout of each store, particularly the cooking area. Unlike other hamburger chains, which use the same grill for their meat and buns, Five Guys uses a dedicated grill for its burgers and a separate toaster for its buns. Although this approach requires additional equipment and thus increases cost and operational complexity, it allows for perfectly grilled burgers and perfectly toasted buns. All these activities contribute to Five Guys' higher perceived value among customers, allowing the firm to charge premium prices for its offerings using a simple cost-plus-margin formula.

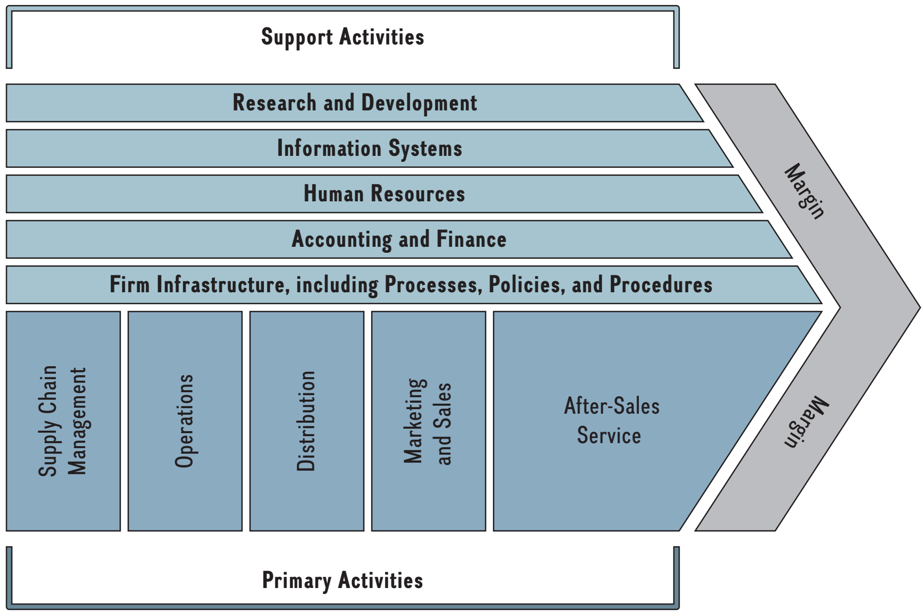
Each activity that Five Guys engages in focuses on delivering premium burgers and fries. Maintaining this focus if the company were to franchise weighed heavily on Jerry Murrell's mind. He worried that the different activities needed to deliver what Five Guys stood for could not be duplicated away from the five original stores in the Washington, D.C., area. In particular, he worried that if the activities could not be copied exactly, then neither could the quality of the product nor the customer experience. The result might be a diminished brand and a loss of Five Guys' hard-earned reputation. It is not surprising, then, that Five Guys waited as long as it did to franchise. It felt it needed to develop the perfect system for its specific activities before expanding beyond its home area. When Five Guys opened its store in Richmond, Virginia, a mere 100 miles from its first store in Arlington, Jerry Murrell couldn't sleep for weeks, despite knowing he had the perfect system in place.[49] Today, the set of distinct activities set forth by Murrell is implemented in every locale of Five Guys' 1,700 stores worldwide.

GENERIC FIRM VALUE CHAIN. Exhibit 4.8 shows a generic firm value chain and how the transformation process from inputs to outputs comprises a set of distinct activities. When these activities generate value greater than their costs, the firm obtains a profit margin—as long as the market price also exceeds those costs.

A generic firm value chain needs to be modified to capture the activities of a specific business. Retail chain American Eagle Outfitters, for example, needs to identify suitable

EXHIBIT 4.8

A Generic Value Chain: Primary and Support Activities



store locations, build or rent stores, purchase goods and supplies, manage distribution and store inventories, operate stores both in the brick-and-mortar world and online, hire and motivate a sales force, create payment systems, engage in promotions, and ensure after-sales services, including returns. A maker of semiconductor chips such as Intel needs to engage in R&D, design and engineer semiconductor chips and their production processes, purchase silicon and other ingredients, set up and staff chip fabrication plants, control quality and throughput, engage in marketing and sales, and provide after-sales customer support.

primary activities
Firm activities that add value directly by transforming inputs into outputs as the firm moves a product or service horizontally along the internal value chain.

support activities
Firm activities that add value indirectly, but are necessary to sustain primary activities.

PRIMARY AND SUPPORT ACTIVITIES. As Exhibit 4.8 illustrates, the value chain is divided into primary and support activities. The **primary activities** add value directly as the firm transforms inputs into outputs—from raw materials through production phases to sales and marketing and finally customer service. Following are the primary activities:

- Supply chain management
- Operations
- Distribution
- Marketing and sales
- After-sales service

In contrast, **support activities** add value indirectly. Following are the support activities:

- Research and development (R&D)
- Information systems
- Human resources
- Accounting and finance
- Firm infrastructure, including processes, policies, and procedures

To help a firm achieve a competitive advantage, each distinct activity performed needs to either add incremental value to the product or service offering or lower its relative cost.

Discrete and specific firm activities are therefore the basic units of developing a competitive advantage. They are the drivers of the firm's relative costs and the level of differentiation that the firm can provide to its customers. While the resource-based view of the firm helps identify the integrated set of resources and capabilities that are the building blocks of core competencies, the value chain perspective enables strategic leaders to see how competitive advantage flows from the firm's distinct set of activities. Why? A firm's core competency is generally found in a network linking different but distinct activities, each contributing to the firm's strategic position as either a low-cost leader or differentiator.

STRATEGIC ACTIVITY SYSTEMS

LO 4-9

Identify competitive advantage as residing in a network of distinct activities.

A **strategic activity system** views a firm as a network of interconnected activities that can be the foundation of its competitive advantage.[50] A strategic activity system is socially complex and causally ambiguous. Although one can easily observe one or more elements of a strategic activity system, the capabilities necessary to orchestrate and manage a network of distinct activities within the entire system cannot be so easily observed. For this reason, a strategic activity system is difficult to imitate in its entirety, and this difficulty enhances a firm's possibility of developing a sustainable competitive advantage based on a set of distinct but interconnected activities.

strategic activity system The conceptualization of a firm as a network of interconnected activities.

Let's assume that Firm A's strategic activity system, which lays the foundation of its competitive advantage, consists of 25 interconnected activities. Attracted by Firm A's competitive advantage, competitor Firm B closely monitors this activity system and begins to copy it through direct imitation. It turns out that Firm B is very good at copying, managing to achieve a 90% accuracy rate. Will Firm B be able to negate Firm A's competitive advantage as a result? Far from it. Recall that Firm A's activity system comprises 25 interconnected activities. Because each of these activities is copied with just 90% accuracy, Firm B's ability to copy the *entire* system accurately is $0.9 \times 0.9 \times 0.9 \ldots$, repeated 25 times, or $0.9^{25} = 0.07$. In other words, Firm B will only be able to imitate Firm A with a total accuracy rate of 7%. This example demonstrates that using imitation as a path to competitive advantage is extremely difficult because quickly compounding probabilities render copying an entire activity system futile.

RESPONDING TO CHANGING ENVIRONMENTS. A firm's strategic activity systems need to evolve over time if the firm is to sustain a competitive advantage. Failure to create a dynamic strategic fit generally leads to a competitive disadvantage because the external environment changes and a firm's competitors get better at developing their own activity systems and capabilities. Therefore, strategic leaders need to adapt their firm's activity system by upgrading value-creating activities in response to changing environments. To gain and sustain competitive advantage, strategic leaders may add new activities, remove no-longer-relevant activities, and upgrade activities that have become stale or obsolete. Each of these adjustments will require changes to the resources and capabilities involved and will reconfigure the entire strategic activity system.

Consider The Vanguard Group, one of the world's largest investment management companies.[51] It serves individual investors, financial professionals, and institutional investors such as state retirement funds. Vanguard's mission is to help clients reach their financial goals by being their highest-value provider of investment products and services.[52] Since its founding in 1929, Vanguard has emphasized low-cost investing and quality service for its clients. Vanguard's average expense ratio (fees as a percentage of total net assets paid by investors) is generally the lowest in the industry.[53] The Vanguard Group also is a pioneer in passive index-fund investing. Rather than picking individual stocks and trading frequently as done in traditional money management, a mutual fund tracks the performance of an index (such as the Standard & Poor's 500), discourages active trading, and encourages long-term investing.

To sustain a competitive advantage, Vanguard's strategic activity system needs to evolve as the company grows and market conditions and competitors change. Let's examine how The Vanguard Group's strategic activity developed over 25 years, from 1997 to 2022.

EVOLVING A SYSTEM OVER TIME. In 1997, The Vanguard Group managed less than $500 billion of assets. It pursued its mission of becoming the highest-value provider of investment products and services through its unique set of interconnected activities depicted in Exhibit 4.9. The six larger ovals depict Vanguard's strategic core activities: strict cost control, direct distribution, low expenses with savings passed on to clients, a broad array of mutual funds, efficient investment management approach, and straightforward client communication and education. These six strategic themes were supported by clusters of tightly linked activities (smaller circles), further reinforcing the strategic activity network.

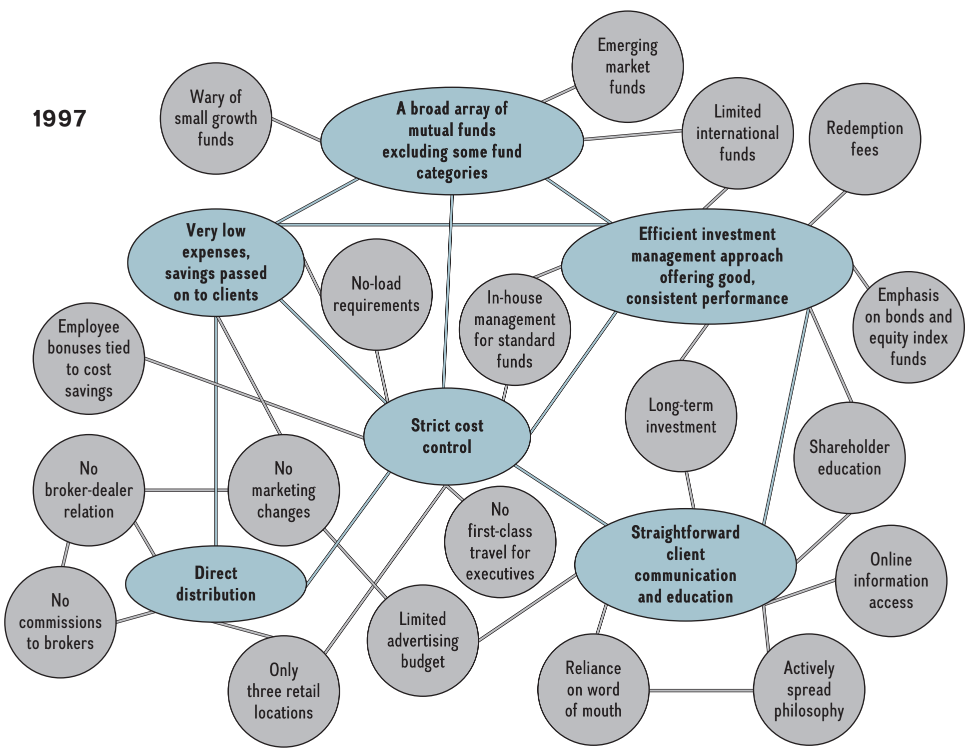
The needs of Vanguard's customers, however, have changed since 1997. Exhibit 4.10 shows Vanguard's strategic activity system 25 years later (in 2022). By that time, The Vanguard Group had grown by more than 15 times, from a mere $500 billion (in 1997) to more than $8 trillion (in 2022) of assets under management.[54]

The large ovals in Exhibit 4.10 depict Vanguard's strategic core activities that help it realize its strategic position as the low-cost leader in the industry. Note, though, that the system evolved as Vanguard's strategic leaders added a new core activity—customer segmentation—to the six core activities already in place in 1997 and still in place today. Vanguard's managers implemented the customer-segmentation core activity, along with two new support

EXHIBIT 4.9

The Vanguard Group's Activity System in 1997

Source: Author's adaptation from N. Siggelkow (2002), "Evolution toward fit," *Administrative Science Quarterly* 47: 146.



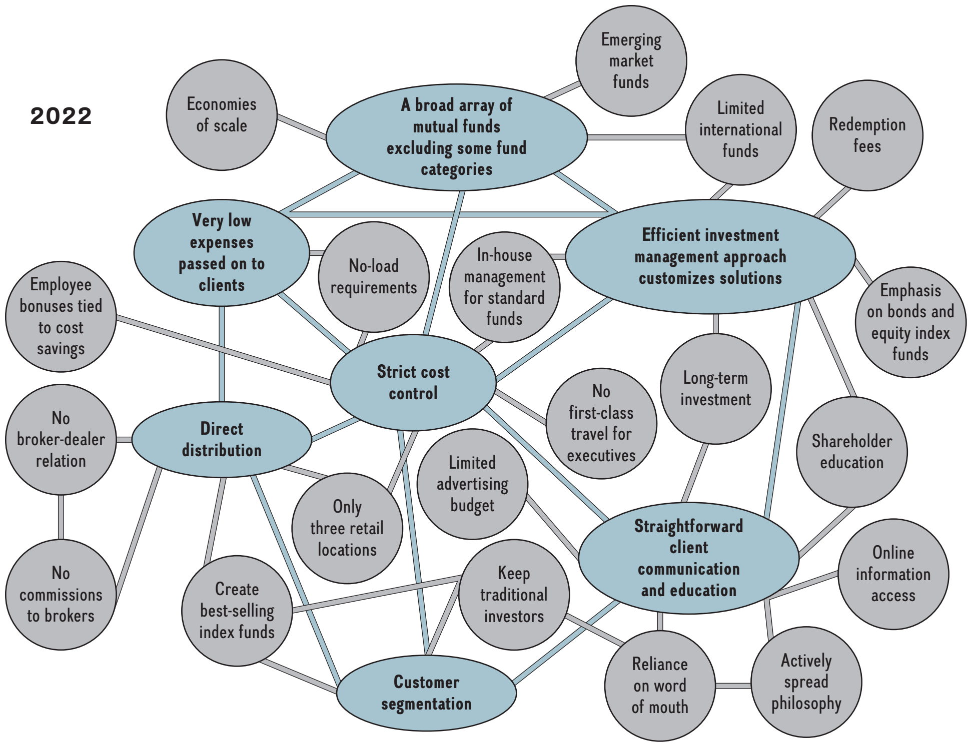


EXHIBIT 4.10

The Vanguard Group's Activity System in 2022

activities, to address a new customer need that it could not meet with its older configuration. Specifically, its 1997 activity system did not allow Vanguard to continue providing quality service targeted at different customer segments at the lowest possible cost. The new activity-system configuration allows Vanguard to customize its service offerings: It separates its more traditional customers, who invest for the long term, from more active investors, who trade more often but are attracted to Vanguard funds by the firm's high performance and low cost. The strategic challenge for Vanguard's strategic leaders was to address the inherent trade-off between increasing customization and controlling cost.

The new core activity "customer segmentation" that Vanguard added to its strategic activity system was developed with great care to ensure that it fits well with its existing core activities and further reinforces its activity network. For example, the new support activity "create best-selling index funds" also relies on direct distribution. It is consistent with and further reinforces Vanguard's low-cost leadership position. The "create best-selling index funds" activity is balanced out by the second new support activity "keep traditional investors" in an attempt to address the tradeoff between customer segmentation and the traditional core investors that prefer passive investments over a long period of time.

As a result of achieving its "best-selling" goal, Vanguard is now the world's second-largest investment management company, just behind BlackRock, with over \$10 trillion of assets under management. Vanguard's large size allows it to benefit from economies of scale (e.g., cost savings accomplished through a larger number of customers served and a greater amount of assets managed), further driving down cost. By lowering its cost structure, Vanguard can offer more customized services without raising its overall cost. Despite increased customization, Vanguard still has one of the lowest expense ratios in the industry. Even in a changing environment, the firm continues to pursue its strategy of offering low-cost investing combined with quality service. If firms add activities that don't fit their strategic positioning (e.g., if Vanguard added local retail offices in shopping malls, thereby increasing operating costs), they create "strategic misfits" that will likely erode their competitive advantage.

Overall, The Vanguard Group's core competency of providing low-cost investing and quality service for its clients is accomplished through a unique set of interconnected primary and support activities, including strict cost control, direct distribution, low expenses with savings passed on to clients, a broad array of mutual funds, an efficient investment management approach, and straightforward client communication and education.

In summary, a firm's competitive advantage can result from its unique network of activities. However, a static fit with the current environment is insufficient; instead, a firm's unique network of activities must evolve to take advantage of new opportunities and mitigate emerging threats. Strategic leaders can identify critical activities by benchmarking the competition and using activity-based accounting, which identifies specific activities in an organization and then assigns costs to each activity based on estimates of all resources consumed. In Chapter 5, we look more closely at assessing competitive advantage.

4.6 Implications for Strategic Leaders

We've reached a significant point: We can now combine the external analysis from Chapter 3 with internal analysis. Together the two allow leaders to begin formulating a strategy that matches a firm's internal resources and capabilities to the demands of the external industry environment. Ideally, strategic leaders want to leverage their firm's internal strengths to exploit external opportunities while mitigating internal weaknesses and external threats. Both types of analysis in tandem allow managers to formulate a strategy tailored to their company, creating a unique fit between the company's internal resources and the external environment. Such a *strategic fit* increases the likelihood of a firm gaining a competitive advantage. If a firm achieves a *dynamic* strategic fit, it is likely to *sustain* its edge over time.

LO 4-10

Conduct a SWOT analysis to generate insights from external and internal analysis and to derive strategic implications.

USING SWOT ANALYSIS TO GENERATE INSIGHTS FROM EXTERNAL AND INTERNAL ANALYSIS

We synthesize insights from an internal analysis of the company's *strengths* and *weaknesses* with those from an analysis of external *opportunities* and *threats* using the **SWOT analysis**. Internal strengths (*S*) and weaknesses (*W*) concern resources, capabilities, and competencies. Whether they are strengths or weaknesses can be determined by applying the VRIO framework. A resource is a weakness if it is not valuable, in which case the resource does not allow the firm to exploit an external opportunity or offset an external threat. In contrast, a resource is a strength and a core competency if it is valuable, rare, and costly to imitate, and the firm is organized to capture at least part of the economic value created.

SWOT analysis Application of a framework that allows strategic leaders to synthesize insights obtained from an internal analysis of the company's strengths and weaknesses (*S* and *W*) with those from an analysis of external opportunities and threats (*O* and *T*) to derive strategic implications.

External opportunities (*O*) and threats (*T*) are in the firm's general environment and can be captured by PESTEL and Porter's five forces analyses (discussed in Chapter 3). An attractive industry as determined by the five forces, for example, presents an external opportunity for firms not yet active in this industry. In contrast, stricter regulation might represent an external threat. For example, more regulation of financial institutions might represent an external threat to banks.

A SWOT analysis allows strategic leaders to evaluate a firm's current situation and future prospects by simultaneously considering internal and external factors. The SWOT analysis encourages strategic leaders to scan the internal and external environments, looking for any factors that might affect the firm's current or future competitive advantage. The focus is on internal and external factors that can affect—positively or negatively—the firm's ability to

		External to Firm	
		Opportunities	**Threats**
Internal to Firm	**Strengths**	*How can the firm use internal strengths to take advantage of external opportunities?*	*How can the firm use internal strengths to reduce the likelihood and impact of external threats?*
	Weaknesses	*How can the firm overcome internal weaknesses that prevent it from taking advantage of external opportunities?*	*How can the firm overcome internal weaknesses that will make external threats a reality?*

EXHIBIT 4.11

Strategic Questions within the SWOT Matrix

gain and sustain a competitive advantage. To facilitate a SWOT analysis, managers use a set of strategic questions that link the firm's internal environment to its external environment, as shown in Exhibit 4.11. In this SWOT matrix, the horizontal axis is divided into factors that are *external to the firm* (the focus of Chapter 3) and the vertical axis into elements that are *internal to the firm* (the focus of this chapter).

To conduct a SWOT analysis, strategic leaders start by gathering information to link internal factors *(strengths* and *weaknesses)* to external factors *(opportunities* and *threats).* Next, they use the SWOT matrix shown in Exhibit 4.11 to develop *strategic alternatives* for the firm. Developing strategic alternatives is a four-step (but not necessarily linear) process:

1. **Focus on the *Strengths-Opportunities* quadrant (top left)** to derive "offensive" alternatives by using an internal strength to exploit an external opportunity.
2. **Focus on the *Weaknesses-Threats* quadrant (bottom right)** to derive "defensive" alternatives by eliminating or minimizing an internal weakness to mitigate an external threat.
3. **Focus on the *Strengths-Threats* quadrant (top right)** to use an internal strength to minimize the effect of an external threat.
4. **Focus on the *Weaknesses-Opportunities* quadrant (bottom left)** to shore up an internal weakness to improve its ability to take advantage of an external opportunity.

Strategic leaders carefully evaluate the pros and cons of each strategic alternative to select one or more alternatives to implement. They need to carefully explain their decision rationale, including why they rejected the other strategic alternatives.

SWOT ANALYSIS CAVEATS. Although the SWOT analysis is a widely used management framework, a word of caution is in order. A problem with this framework is that a strength can also be a weakness and an opportunity can also be a threat. Earlier in this chapter, we discussed the location of Alphabet's headquarters in Silicon Valley and near several universities as a key resource for the firm. Most people would consider this a strength for the firm. However, California has a high cost of living and is routinely ranked among the worst states in terms of "ease of doing business." In addition, this area of California is along major earthquake fault lines and is more prone to natural disasters than many other parts of the country. So is the location a strength or a weakness? The answer is "It depends."

Now consider this question: Is climate change an opportunity for car manufacturers, or is it a threat? If governments enact higher gasoline taxes and make driving more expensive, it can be a threat. However, if carmakers respond to government regulations with increased innovation and the development of low- or zero-emission engines and more fuel-efficient cars such as hybrid or electric vehicles, they may create more demand for new cars and achieve higher sales.

To make the SWOT analysis an effective management tool, strategic leaders must first conduct a thorough external and internal analysis, as laid out in Chapter 3 and here in Chapter 4. This sequential process grounds the analysis in rigorous theoretical frameworks before strategic leaders use SWOT to synthesize the results from the external and internal analyses to derive a set of strategic options.

We now have the toolkit we need to conduct a complete strategic analysis of a firm's internal and external environments. In the next chapter, we focus on creating shared value and competitive advantage. That chapter will complete Part 1, on strategy analysis, in the AFI framework (see Exhibit 1.4).

CHAPTERCASE 4 Part II

To stand out in a saturated burger market dominated by such giants as McDonald's and Burger King, Five Guys pursues a differentiation strategy that helps it create a higher perceived value among its customers. One key differentiating feature is its product: Each Five Guys burger is made from never-frozen ground beef nestled inside a toasted, freshly baked bun. Each burger is made to order and can be customized with any of 15 toppings—all of which can be added free of charge. Its fries are hand-cut and sourced from Idaho potatoes grown north of the 42nd parallel and cooked in pure peanut oil. Another key feature is Five Guys' streamlined menu: burgers, fries, and hot dogs—no salads, no wraps, no desserts.

High(est) quality and consistency are extremely important to Five Guys. To ensure these standards are met, it conducts two third-party audits in each of its 1,700 stores weekly to ensure the food is always fresh and the stores are always clean. The money that Five Guys does not spend on marketing is, instead, spent on its staff: Bonuses are awarded to the teams that score the highest on these audits. Each week a winning team receives a bonus of about $1,000, which is then split among the team's five or six members. About 200 teams make the cut and receive the bonus. Five Guys' strategy for motivating its staff with bonuses also differentiates it from its competitors, which tend to pay only hourly wages, often on the lower end.

Although Five Guys' food tastes great and provides emotional comfort to many of its patrons, in recent years Five Guys has landed on the list of U.S. chain restaurants that offer the most unhealthy meals. A standard bacon cheeseburger has close to 1,000 calories and a large order of fries has about 1,500. As a consequence, Five Guys' food offerings have been criticized by watchdogs such as the Center for Science in the Public Interest. With the recent focus on healthy eating, many restaurant chains such as Chipotle have started offering healthier options, including low-calorie meals with fresh produce.

Five Guys' commitment to the delivery of quality foods using fresh ingredients, a simple menu, and classic flavors has allowed it to thrive for more than 35 years in a highly competitive market, with 1,700 stores as of 2022 and another 1,500 locations in development. With all the regional Five Guys franchises in the United States sold out, the company is focusing on international expansion.[55]

Questions

1. Why is Five Guys so successful? Describe Five Guys' core competency, then explain how the company built it and why it is essential to the company's success.
2. Five Guys' success led to imitation attempts by more recent entries in the fast-casual "better burger" segment of the restaurant industry such as BurgerFi, Shake Shack, and Smashburger. Do you think these new entrants are competitive threats to Five Guys? Why or why not? If you think they are a competitive threat, what should Five Guys do about the threat, if anything? Explain.
3. Do you think a trend toward more healthy eating is a threat to Five Guys? If so, what could the company do about it? For example, should the company change its menu to include healthier choices, or should it continue with what made Five Guys so successful? Explain, using Exhibit 4.11 to guide your response.
4. Do you think Five Guys will be as successful outside the United States as it has been in its home market? Why or why not?

TAKE-AWAY CONCEPTS

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

LO 4-1 / Explain why and how internal firm differences are the root of competitive advantage.

- Because companies that compete in the same industry face similar external opportunities and threats, the source of the observable performance difference must be found inside the firm.
- Looking inside a firm to analyze its resources, capabilities, and core competencies allows strategic leaders to understand the firm's strengths and weaknesses.
- Linking the insights from a firm's external analysis to the insights from an internal analysis allows managers to determine their strategic options.
- Strategic leaders should aim to leverage their firms' internal strengths to exploit external opportunities and to mitigate internal weaknesses and external threats.
- *Strategic fit* allows a firm to exploit external opportunities while mitigating external threats.

LO 4-2 / Differentiate among a firm's core competencies, resources, capabilities, and activities.

- *Core competencies* are unique, deeply embedded, firm-specific strengths that allow companies to differentiate their products and services and thus create more value for customers than their rivals, or offer products and services of acceptable value at lower cost.
- *Resources* are any assets that a company can draw on when crafting and executing strategy.
- *Capabilities* are the organizational and managerial skills necessary to orchestrate a diverse set of resources to deploy them strategically.
- *Activities* are distinct and fine-grained business processes that enable firms to add incremental value by transforming inputs into goods and services.

LO 4-3 / Compare and contrast tangible and intangible resources.

- *Tangible resources* have physical attributes and are visible.
- *Intangible resources* have no physical attributes and are invisible.
- Competitive advantage is more likely to be based on intangible resources.

LO 4-4 / Evaluate the two critical assumptions about the nature of resources in the resource-based view.

- The first critical assumption—*resource heterogeneity*—is that bundles of resources, capabilities, and competencies differ across firms. The resource bundles of firms competing in the same industry (or even the same strategic group) are unique to some extent and thus differ from one another.
- The second critical assumption—*resource immobility*—is that resources tend to be "sticky" and don't move easily from firm to firm. Because of that stickiness, the resource differences that exist between firms are difficult to replicate and therefore can last a long time.

LO 4-5 / Apply the VRIO framework to assess the competitive implications of a firm's resources.

- For a firm's resource to be the basis of a competitive advantage, it must have VRIO attributes: *valuable (V), rare (R),* and *costly to imitate (I).* The firm must also be able to *organize (O) in order to capture the value of the resource.*
- A resource is valuable (V) if it allows the firm to take advantage of an external opportunity and/or neutralize an external threat. A valuable resource enables a firm to increase its economic value creation ($V - C$).
- A resource is rare (R) if the number of firms that possess it is smaller than the number of firms necessary to reach a state of perfect competition.
- A resource is costly to imitate (I) if firms that do not possess the resource are unable to develop or buy the resource at a comparable cost.

- The firm is organized (*O*) to capture the value of the resource if it has an effective organizational structure, processes, and systems in place to fully exploit the competitive potential.

LO 4-6 / Evaluate different conditions that allow a firm to sustain a competitive advantage.

- Several conditions make it costly for competitors to imitate the resources, capabilities, or competencies that underlie a firm's competitive advantage: (1) *better expectations of future resource value,* (2) *path dependence,* (3) *causal ambiguity,* (4) *social complexity,* and (5) *intellectual property (IP) protection*.
- These *barriers to imitation* are isolating mechanisms because they prevent rivals from competing away the advantage a firm may enjoy.

LO 4-7 / Outline how dynamic capabilities can help a firm sustain a competitive advantage.

- To sustain a competitive advantage, any fit between a firm's internal strengths and the external environment must be dynamic.
- *Dynamic capabilities* allow a firm to create, deploy, modify, reconfigure, and/or upgrade its resource base to gain and sustain competitive advantage in a constantly changing environment.

LO 4-8 / Apply a value chain analysis to understand which of the firm's activities in transforming inputs into outputs generate differentiation and which drive costs.

- The value chain describes the internal activities a firm engages in when transforming inputs into outputs.
- Each activity the firm performs along the horizontal chain adds incremental value and incremental costs.
- A careful analysis of the value chain allows managers to obtain a more detailed and fine-grained understanding of how the firm's economic value creation breaks down into a distinct set of activities that helps determine perceived value and the costs to create it.
- When a firm's set of distinct activities is able to generate value greater than the costs to create it, the firm obtains a profit margin (assuming the market price the firm is able to command exceeds the costs of value creation).

LO 4-9 / Identify competitive advantage as residing in a network of distinct activities.

- A strategic activity system conceives of a firm as a network of interconnected firm activities.
- A network of primary and supporting firm activities can create a strategic fit that can lead to a competitive advantage.
- To sustain a competitive advantage, firms need to hone, fine-tune, and upgrade their strategic activity systems over time, in response to changes in the external environment and to competitors' moves.

LO 4-10 / Conduct a SWOT analysis to generate insights from external and internal analysis and to derive strategic implications.

- Formulating a strategy that increases the chances of gaining and sustaining a competitive advantage is based on synthesizing insights obtained from an internal analysis of the company's strengths (*S*) and weaknesses (*W*) with those from an analysis of external opportunities (*O*) and threats (*T*).
- The strategic implications of a SWOT analysis should help the firm leverage its internal strengths, exploit external opportunities, and mitigate internal weaknesses and external threats.

KEY TERMS

ENDNOTES

1. Raz, G. (2017, Jun. 5). "How I built this," *NPR,* www.npr.org/2017/08/07/531097687/five-guys-jerry-murrell.

2. Sources: Five Guys Media Fact Sheet (2021), https://www.fiveguys.com/-/media/public-site/files/media-fact-sheets/five-guys-media-fact-sheet-web.ashx; Raz, G. (2017, Jun. 5), "How I built this," NPR, www.npr.org/2017/08/07/531097687/five-guys-jerry-murrell; Jargon, J. (2017, May 31), "Diners are finding $13 burgers hard to swallow," *The Wall Street Journal;* Olmsted, L. (2013, Oct. 10), "Great American bites: Why burger lovers flock to Five Guys," *USA Today;* Egan, T. (2013, Mar. 21), "Burgers, fries and lies," *The New York Times*; Burke, M. (2012, Jul. 18), "Five Guys Burgers: America's fastest growing restaurant chain," *Forbes*; Welch, L. (2010, Apr. 1), "How I did it: Jerry Murrell, Five Guys burgers and fries," *Inc. Magazine.*

3. The discussion of Five Guys here and elsewhere in the chapter is based on the following sources: Five Guys Media Fact Sheet (2021), https://www.fsheets/five-guysiveguys.com/-/media/public-site/files/media-fact–media-fact-sheet-web.ashx; Raz, G. (2017, Jun. 5), "How I built this," NPR, www.npr.org/2017/08/07/531097687/five-guys-jerry-murrell; Jargon, J. (2017, May 31), "Diners are finding $13 burgers hard to swallow," *The Wall Street Journal*; Olmsted, L. (2013, Oct. 10), "Great American bites: Why burger lovers flock to Five Guys," USA Today; Egan, T. (2013, Mar. 21), "Burgers, fries and lies," *The New York Times*; Burke, M. (2012, Jul. 18), "Five Guys Burgers: America's fastest growing restaurant chain," *Forbes*; Welch, L. (2010, Apr. 1), "How I did it: Jerry Murrell, Five Guys burgers and fries," I*nc. Magazine*.

4. Prahalad, C.K., and G. Hamel (1990, May–Jun.), "The core competence of the corporation," *Harvard Business Review*.

5. Throughput denotes the amount of material or items passing through a system or process. In this case, it is the number of customers served per store during a certain time interval, i.e., lunch time from 11 am to 1 pm.

6. For a discussion of core competencies and capabilities as well as their replication and transfer over time and space, see: Dosi, G., R.R. Nelson, and S.G. Winter, Eds. (2001), *The Nature and Dynamics of Organizational Capabilities,* rev. ed. (Oxford, UK: Oxford University Press); Helfat, C.E., and M.B. Lieberman (2002), "The birth of capabilities: Market entry and the importance of pre-history," *Industrial and Corporate Change* 11(4): 725–760; and Sorenson, O., and J.B. Sørensen (2001), "Finding the right mix: Franchising, organizational learning, and chain performance," *Strategic Management Journal* 22(6–7): 713–724.

7. This Strategy Highlight was prepared by Frank T. Rothaermel with Veronica Bian, who provided superb research assistance. Sources: Saporito, B. (2016, Feb.), "How 2 brothers turned a $300 cooler into a $450 million cult brand," *Inc. Magazine;* Clarke, J. (2016, Aug. 31), "Yeti coolers are hot! No really, people are stealing them," *The Wall Street Journal;* Jarzemsky, M. (2016, Sep. 24), "Yeti: How a $67 million investment became a $3.3 billion windfall," *The Wall Street Journal*; Satran, R. (2022, Jan. 22), "Yeti's billion-dollar strategy: No celebrities, no pandering," *The Wall Street Journal;* Yeti Holdings, Inc., "Annual Report" (multiple years), Securities and Exchange Commission (sec.gov). "How Yeti became a billion dollar business," CNBC Make It, video at https://www.youtube.com/watch?v=0FJgKXovKh4 (12:11 min).

8. This discussion is based on: Amit, R., and P.J.H. Schoemaker (1993), "Strategic assets and organizational rent," *Strategic Management Journal* 14: 33–46; Peteraf, M. (1993), "The cornerstones of competitive advantage," *Strategic Management Journal* 14: 179–191; Barney, J. (1991), "Firm resources and sustained competitive advantage," *Journal of Management* 17: 99–120; and Wernerfelt, B. (1984), "A resource-based view of the firm," *Strategic Management Journal* 5: 171–180.

9. Tangible resources are listed under "Property and Equipment" in the Consolidated Balance Sheet, see Alphabet Annual Report, 2021. https://www.sec.gov/

10. "BrandZ Top 100 Most Valuable Global Brands 2021" report by The Kantar Group, https://bit.ly/3CbxLGk

11. For a discussion on the benefits of being located in a technology cluster, see: Rothaermel, F.T., and D. Ku (2008), "Intercluster innovation differentials: The role of research universities," *IEEE Transactions on Engineering Management* 55: 9–22; and Saxenian, A.L. (1994), *Regional Advantage: Culture and Competition in Silicon Valley and Route 128* (Cambridge, MA: Harvard University Press).

12. Stuart, T., and O. Sorenson (2003), "The geography of opportunity: Spatial heterogeneity in founding rates and the performance of biotechnology firms," *Research Policy* 32: 229–253.

13. " BrandZ Top 100 Most Valuable Global Brands 2021" report by The Kantar Group, https://bit.ly/3CbxLGk

14. Barney, J. (1991), "Firm resources and sustained competitive advantage," *Journal of Management* 17: 99–120.

15. This discussion is based on: Amit, R., and P.J.H. Schoemaker (1993), "Strategic assets and organizational rent," *Strategic Management Journal* 14: 33–46; Barney, J. (1991), "Firm resources and sustained competitive advantage," *Journal of Management* **17**: 99–120; Peteraf, M. (1993), "The cornerstones of competitive advantage," *Strategic Management Journal* 14: 179–191; and Wernerfelt, B. (1984), "A resource-based view of the firm," *Strategic Management Journal* 5: 171–180.

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CHAPTER

5

Shared Value and Competitive Advantage

Chapter Outline

5.1 From Corporate Social Responsibility to Creating Shared Value
Shareholder Capitalism
Shareholder Capitalism in Crisis?
Stakeholder Capitalism and Shared Value

5.2 Competitive Advantage
Accounting Metrics
Shareholder Value Creation
Economic Value Creation
The Balanced Scorecard
The Triple Bottom Line

5.3 Implications for Strategic Leaders

Learning Objectives

LO 5-1 Compare and contrast shareholder capitalism and stakeholder capitalism while highlighting the strengths and weaknesses of each.

LO 5-2 Explain the shift in emphasis from corporate social responsibility (CSR) to creating shared value (CSV).

LO 5-3 Appraise accounting metrics and shareholder value creation as measures of competitive advantage.

LO 5-4 Link economic value creation to different sources of competitive advantage.

LO 5-5 Apply a balanced scorecard to assess and evaluate competitive advantage.

LO 5-6 Apply a triple bottom line to assess and evaluate competitive advantage.

Patagonia: A Pioneer in Creating Shared Value

At Patagonia, making a profit is not the goal, because the Zen master would say profits happen "when you do everything else right."[1]

It has become fashionable for executives to extol their companies' environmental, social, and governance (ESG) credentials. Almost 200 CEOs of some of the best-known companies globally, such as 3M, Accenture, Alphabet, Amazon, Apple, Disney, Coca-Cola, ExxonMobil, and General Motors, signed a statement by the Business Roundtable (in 2019) that "the purpose of a corporation is to promote an economy that serves all Americans."[2] In this declaration, the CEOs endorse stakeholder capitalism by committing to delivering value for customers, investing in employees by fostering diversity and inclusion, dealing fairly and ethically with suppliers, supporting local communities, and (mentioned last) creating long-term shareholder value.

For 50 years, Patagonia has been a pioneer in pursuing a stakeholder strategy to create shared value. Patagonia's storied history demonstrates that doing good by creating value for its diverse stakeholders has also resulted in doing well in terms of profits. Patagonia was founded with the purpose-driven mission "to save our home planet."[3] Founder Yvon Chouinard explains Patagonia's mission: "Who are businesses really responsible to? Their customers? Shareholders? Employees? We would argue that it's none of the above. Fundamentally, businesses are responsible to their resource base. Without a healthy environment, there are no shareholders, no employees, no customers, and no business."[4] How did this California-based outdoor clothing company achieve a sustainable competitive advantage while doing right by all of its stakeholders, not just its investors and owners?

In his business memoir, *Let My People Go Surfing,* Yvon Chouinard describes the discussion he had with climbing friends turned employees about how to name the new company: "We didn't want our clothes to be associated only with mountain climbing; we had a vision of a greater future than that. The name Patagonia soon came up in our discussions. To most people (in 1973), Patagonia was a name like Timbuktu or Shangri-La—far-off, interesting, not quite on the map. Patagonia brings to mind, as we once wrote in a catalog introduction, 'romantic visions of glaciers tumbling into fjords, jagged windswept peaks, gauchos and condors.' Our intent was to make clothing for those rugged southern Andes/Cape Horn conditions. It's been a good name for us, and it can be pronounced in every language."

Spec: image of Mount Fitz Roy[5]

Niv Koren/Shutterstock

Yvon Chouinard, the renowned mountaineer and environmentalist who founded and owns Patagonia, never desired to be a businessperson. He had always considered businesspeople "greaseballs."[6] He believes that corporations are the source of all evil because their ever-increasing desire to maximize profit is harmful to Mother Nature—something very dear to Chouinard's heart. Growing up, Chouinard was always exploring the great outdoors, engaging in outdoor activities from fishing to surfing to wandering around forests. Some of the outings of the Southern California Falconry Club, of which Chouinard was a member, required rock climbing to observe falcons and their nests close up. Chouinard fell in love with rock climbing instantly, and over time, his rock-climbing adventures became increasingly intense. With it arose the need for better and more durable equipment.

At age 18 (in 1957), Yvon started forging reusable steel pitons, climbing hardware designed to protect rock climbers from falling. Pitons are metal spikes driven into the rock that the climber can fasten to a rope with a carabiner or directly use as a climbing aid to hold or step on. These reusable pitons proved to be a better alternative to cheaper European pitons designed as one-time-use products. Chouinard also disliked the European pitons because they littered once-pristine mountain faces. At heart, Yvon is a craftsperson who enjoys making things for himself, items he wants to use in his varied outdoor adventures. Chouinard took to selling his hard-steel pitons to avid climbers so that he could spend more time outdoors and avoid traditional employment. His first marketing flyer warned customers not to expect any deliveries during the climbing season.

To meet the growing demand for his steel pitons and the other innovative climbing gear that he created, Yvon entered a partnership with Tom and Doreen Frost (in 1964) to form Chouinard Equipment Ltd. By 1970, their fledgling startup had become the largest supplier of climbing hardware in the United States. At that point, Chouinard feared that the company was becoming one of those "sources of evil" like other traditional companies that he despised. To correct his course, Yvon decided to put protecting the environment at the center of his business. As climbing became more popular, climbers gravitated to the same routes. On one ascent, Yvon was revolted by the disfigurement of a previously pristine rock face, which now had cracks caused by the repeated hammering in and removal of pitons. Chouinard decided to redesign his steel pitons, which were the company's primary revenue source. He invented aluminum chocks, a more rock-friendly alternative. In 1972, Chouinard Equipment released its first catalog. It contained an extensive essay emphasizing the importance of transitioning from pitons to chocks to promote "clean climbing," which means climbing without leaving a trace of having been there. When the catalog went out, roughly 70% of the business was pitons; nine months later, it was 70% chocks.

In the following years, the company's mail catalogs came to be known for showcasing new products, communicating matter-of-fact descriptions of them, and expounding on its do-good philosophy. All the while, Yvon dedicated himself to making equipment to use on his outdoor adventures. These adventures ranged from white-water kayaking and fly fishing to mountain climbing, and they spanned the globe from Russia's Siberia to South America's Patagonia. The company's design philosophy of making items that outdoor enthusiasts would want to use was born of Yvon's penchant for tinkering with any item that could be used in the great outdoors. To this day, Patagonia's research and development follows Chouinard's original philosophy by designing products built for performance.

Chouinard Equipment's first foray into apparel came in 1970 when climbers showed interest in a colorful, durable rugby shirt Yvon had purchased on a climbing trip in Scotland. The company started ordering rugby shirts from the UK and making other apparel products in-house. While the company continued to dominate the climbing hardware market, demand for its new apparel business took off. Due to liability concerns, Chouinard Equipment Ltd. was shut down in 1989.

Yvon Chouinard and his spouse Malinda became the sole owners of a new apparel company, Patagonia, Inc. In naming the new company Patagonia, Inc., Chouinard communicated that its clothing is suitable for the conditions in that beautiful but rugged southern Andes region, whose iconic mountain peaks inspired the company's name and logo. The company grew so fast that it made the *Inc.* magazine list of the fastest-growing privately held companies. At this point, Chouinard realized that he had become something he never considered himself to be—a businessperson. He also knew that he would not conduct "business as usual" like the other "greaseballs." Not wanting his company to be included again on *Inc.* magazine's list, Chouinard purposefully refocused Patagonia on sustainable growth. Indeed, since its founding Patagonia Inc. has done business differently, and it has been a pioneer in many ESG practices that are common today. For example, Patagonia:

- Donates 1% of its top-line revenues ("Earth tax") to environmental causes.
- Offers flexible work hours. Its employees can go for a run, play beach volleyball, sit outside and visit with friends, or go surfing if the conditions are right (thus the title of his "business book" bestseller *Let My People Go Surfing*).
- Provides an onsite child care center. Patagonia was one of the first companies in the United States to sponsor onsite child care.
- Sponsors ski and climbing trips for employees.
- Serves healthy, organic food in its cafeteria.
- Has no private offices for employees, including for the founder and CEO.
- Has no dress code.
- Strives towards carbon neutrality through the use of renewable energy and recycling.

In 2012, Patagonia became the first California company to be certified as a benefit corporation ("B Corp"). A benefit cooperation must have an explicit ESG mission and is legally required to follow a stakeholder approach. Implementing an ESG mission requires the strategic leaders of a B Corp to consider the needs and interests of its employees, its shareholders, the community, and the environment.

By 2022, Patagonia had estimated annual sales of $1 billion and more demand than it can meet or wants to meet. For instance, Patagonia's iconic vests are a standard uniform in many corporate offices, and companies, especially Wall Street banks, love to buy Patagonia vests for their employees and co-brand them with their company's logo. However, Patagonia refuses to sell to any corporate customer that is not a B Corp or does not commit a portion of its revenues to "save the planet."

Patagonia remained privately owned for 50 years by Yvon and Malinda Chouinard, whose estimated net wealth was $1.2 billion, mostly tied up in the company. But in late 2022, the Chouinards decided to donate Patagonia to a purpose-designed trust and nonprofit company, rather than going public or selling the company. This unique legal arrangement allows Patagonia, Inc. to remain a private, for-profit company. But all of its profits must be given away each year to combat climate change. Patagonia, Inc.'s annual profits are estimated to be $100 million.[7]

Part II of this ChapterCase appears in Section 5.3.

Rather than focusing on shareholders, the 200 high-profile CEOs who signed the Business Roundtable's declaration publicly committed to *stakeholder capitalism,* in which a corporation's purpose is to promote "an economy that serves all Americans." The implication is that leaders must pursue a strategy that meets the needs of all its stakeholders, including customers, employees, suppliers, local communities, and shareholders.

What caused the shift from the importance of shareholders to a focus on stakeholders? Why was Patagonia able to achieve a sustainable competitive advantage over decades despite (or because of) the unorthodox business practices introduced by founder Yvon Chouinard? This chapter shows how an understanding of the firm's purpose has moved from corporate social responsibility to creating shared value. To understand this shift, we must first understand shareholder capitalism and its challenges. Building on our discussion of stakeholder strategy in Chapter 1, we examine stakeholder capitalism and its implications for achieving a competitive advantage. Because gaining and sustaining competitive advantage is the defining challenge in strategy, we devote the remainder of the chapter to deepening our understanding of the multifaceted nature of competitive advantage. As with each chapter, we conclude the chapter with practical *Implications for Strategic Leaders.*

5.1 From Corporate Social Responsibility to Creating Shared Value

LO 5-1

Compare and contrast shareholder capitalism and stakeholder capitalism while highlighting the strengths and weaknesses of each.

By choosing to keep Patagonia, Inc. private, founder Yvon Chouinard has been able to pursue a stakeholder strategy with a focus on **environmental, social, and governance (ESG) criteria**. ESG criteria are a set of standards beyond mere financial results on which companies are evaluated. Helping to address climate change, among other sustainability goals, is part of the *environmental* dimension. The *social* aspect focuses on areas such as diversity, equity, inclusion, health and safety, and human rights. The *governance* characteristic captures business ethics, legal compliance, board independence, transparency, and shareholder democracy.

environmental, social, and governance (ESG) criteria A set of standards beyond mere financial results on which companies are evaluated.

A system in which one share equals one vote is key to shareholder democracy. However, many tech companies such as Alphabet (owner of Google) and Meta Platforms (formerly Facebook) have governance structures in which founders have supermajority voting rights. At Meta, for instance, Mark Zuckerberg holds Class B shares that give him ten votes for every share, while regular investors hold Class A shares that carry one vote per share. Despite Mark Zuckerberg owning less than 13% of all shares in Meta, he controls roughly 60% of all voting shares. Thus, Zuckerberg is unchallenged at Meta Platforms, and this position allows him to make huge "bet the company" moves, such as the pivot toward the metaverse (or to pursue ESG goals, if he so chooses). For more details, see ChapterCase 2.

Similarly, Chouinard's idea of creating Patagonia "to save our home planet" led to his unwavering pursuit of ESG objectives that seemed quite unorthodox a few decades ago but are now becoming mainstream. While keeping a company private requires continued cash flow or borrowing to keep operations running, it also allows founders as the owners of the company to pursue ESG goals as they please. The drawback is that a private company might suffer from a shortage of cash when it faces a downturn. For example, Patagonia was on the verge of bankruptcy in the early 1990s when the business expanded too fast and the economy entered a recession. Yvon Chouinard had to make the difficult decision to lay off 20% of Patagonia's workforce, which he considers his family. From that point forward, he vowed to grow Patagonia more slowly and to keep it debt-free so that it can withstand the future ups and downs of the business cycle and the apparel industry.

In addition, growing a private business is more challenging because equity markets provide access to large sums of capital. One could argue that a larger company following ESG principles could have a stronger impact on society than a small, niche business. For example, Nike's sales are roughly 50 times larger than Patagonia's, meaning that Nike's pursuit of any ESG goal could have a much larger impact than Patagonia's pursuit of the same goal.

Importantly, the choice of staying private or going public depends on the industry. While a clothing brand like Patagonia may decide to stay private and keep the business relatively small and sustainable, electric vehicle startups must go public because car manufacturing requires huge sums of capital upfront to scale production before any profits can be reaped. Some startups choose to go public to allow early investors and founders to cash in on the success of the venture. Early providers of funding such as venture capitalists require companies to pursue an initial public offering (IPO), in which a private company becomes a public company by selling shares in the company on a stock exchange.

To comprehend the shifting landscape and to derive implications for strategic leaders, we begin by studying shareholder capitalism before highlighting some of its challenges and the criticisms leveled against it. We then examine stakeholder capitalism with its goal of creating shared value (CSV).

SHAREHOLDER CAPITALISM

shareholder capitalism An economic system in which the investors who own shares in a public company are the providers of risk capital and therefore the company's legal owners.

Shareholder capitalism is an economic system in which the investors who own shares in a public company are the providers of risk capital and the company's legal owners. In this traditional understanding of a publicly traded company, shareholders are the stakeholder group with the most legitimate and dominant claim on the company's profits. A key proponent of shareholder capitalism is the Nobel laureate Milton Friedman. Over the past 50 years, Friedman's notion about the purpose of the firm in a free-market capitalist system has been hugely influential. Friedman sees the firm's economic responsibility as its primary objective, as captured in his famous quote:

> What does it mean to say that the corporate executive has a "social responsibility" in his capacity as businessman? If this statement is not pure rhetoric, it must mean that he is to act in some way that is not in the interest of his employers... There is one and only one social responsibility of business–to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.[8]

The duty of executives, therefore, is to maximize shareholder value. According to Friedman, this focus on maximizing profits also increases societal welfare. This conclusion rests on three fundamental assumptions:[9]

1. Free markets are perfectly efficient.
2. Individual freedom should be the primary goal of society.
3. Managers are agents of shareholders.

Free markets are perfectly efficient. In his popular PBS broadcast series *Free to Choose,* Friedman used an everyday item–a pencil–to explain the beauty and efficiency of free markets:[10]

> Look at this lead pencil. There's not a single person in the world who could make this pencil. Remarkable statement? Not at all. The wood from which it is made, for all I know, comes from a tree that was cut down in the state of Washington. To cut down that tree, it took a saw. To make the saw, it took steel. To make steel, it took iron ore. This black center–we call it lead but it's really graphite, compressed graphite–I'm not sure where it comes from, but I think it comes from some mines in South America. This red top up here, this eraser, a bit of rubber,

> probably comes from Malaya, where the rubber tree isn't even native! It was imported from South America by some businessmen with the help of the British government. This brass ferrule? I haven't the slightest idea where it came from. Or the yellow paint! Or the paint that made the black lines. Or the glue that holds it together. Literally thousands of people cooperated to make this pencil. People who don't speak the same language, who practice different religions, who might hate one another if they ever met! When you go down to the store and buy this pencil, you are in effect trading a few minutes of your time for a few seconds of the time of all those thousands of people. What brought them together and induced them to cooperate to make this pencil? There was no commissar sending ... out orders from some central office. It was the magic of the price system: the impersonal operation of prices that brought them together and got them to cooperate, to make this pencil, so you could have it for a trifling sum.
>
> That is why the operation of the free market is so essential. Not only to promote productive efficiency, but even more to foster harmony and peace among the peoples of the world.

In Chapter 8 we use a more modern item—a cell phone—to illuminate the benefits of a division of labor and specialization across industries and geography. The takeaway point remains the same, however: Competitive markets are efficient in allocating resources and in providing information about their value via the price mechanism. In contrast, economic systems that rely on central, command-and-control planning (such as the former Soviet Union or present-day Venezuela and North Korea) are much less efficient and thus result in a significantly lower standard of living.

Individual freedom should be the primary goal of society. In the United States, a company is considered a person ("corporate personhood") in that it enjoys some of the same legal rights and responsibilities that human beings do. Indeed, in most countries corporations are "legal persons" that can sign contracts, be sued or sue in a court of law, and be required to pay taxes. Although individual freedom is one of the most laudable aims of society, when companies are granted too much freedom, the result can be negative externalities such as environmental degradation and climate change. Public policymakers enact legislation and regulation in an attempt to address such negative externalities.

Managers are agents of shareholders. In publicly traded companies, shareholders own the enterprise but hired managers run the day-to-day business. This arrangement creates the *principal-agent problem.* The foremost duty of managers is to act in the best interest of their shareholders, who, on average, want them to maximize the returns on their investment. Stockowners prefer to use their own money to support ESG causes of their own choosing, and they do not like managers to make decisions about the money they do not own or spend it on ESG goals that shareholders don't agree with. We discuss the principal-agent problem in more depth in Chapters 8 and 12.

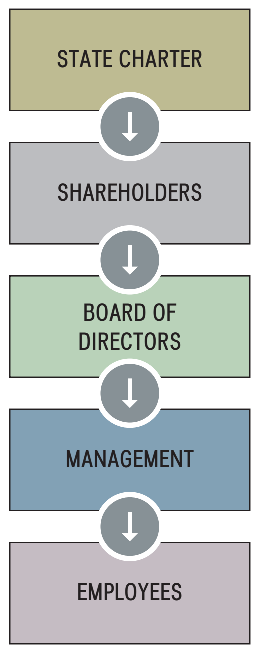
THE PUBLIC STOCK COMPANY. The *public stock company* is an important institutional arrangement in modern, free market economies. It provides goods and services as well as employment; it pays taxes and increases the standard of living. An implicit contract based on trust exists between society and the public stock company. Society grants the right to incorporation, and in turn it expects companies to be good citizens by adding value to society.

To fund future growth, companies frequently need to go public. Recent initial public offerings include Airbnb (hospitality), Rivian and Lucid (all-electric car makers), Robinhood (retail investing), and the mobile transportation companies Didi (China), Grab (Singapore), Lyft, and Uber.

Exhibit 5.1 depicts the levels of hierarchy within a public stock company. The state or society grants a charter of incorporation to the company's shareholders—its legal owners,

EXHIBIT 5.1

The Public Stock Company: Hierarchy of Authority



who own stock in the company. The shareholders appoint a board of directors to govern and oversee the firm's management. The managers hire, supervise, and coordinate employees to manufacture products and provide services.

The public stock company has four characteristics that make it an attractive corporate form:[11]

1. **Limited liability for investors.** This characteristic means that the shareholders who provide the risk capital are liable only for the capital specifically invested, and not for other investments they may have made or for their personal wealth. While they can earn money on their investment, they cannot lose an amount that is larger than that investment. Limited liability encourages investments by the wider public and entrepreneurial risk-taking.
2. **Transferability of investor ownership** through the trading of shares of stock on exchanges such as the New York Stock Exchange (NYSE), NASDAQ,[12] or exchanges in other countries. Each share represents only a minute fraction of ownership in a company, thus easing transferability.
3. **Legal personality.** The law regards a non-living entity such as a for-profit firm as similar to a person, with legal rights and obligations. Legal personality allows a firm's continuation beyond its founders' lifetime or involvement in the company.
4. **Separation of legal ownership and management control.**[13] In publicly traded companies, the stockholders (the principals, represented by the board of directors) are the legal owners of the company, and they delegate decision-making authority to professional managers (the agents).

The public stock company has been a major contributor to value creation since its inception as a new organizational form more than a hundred years ago. By the 1990s, however, as some of the side effects of industrial activity in capitalist systems—such as pollution and income inequality—became more apparent, the notions of stakeholder strategy and corporate social responsibility gained traction.

SHAREHOLDER CAPITALISM IN CRISIS?

Since the start of the new millennium, significant shocks to free market capitalism have led to more critical scrutiny of the relationship between value creation and societal well-being.[14] The implicit trust relationship between the corporate world and society at large has deteriorated because of several notable crises:

- One of the first crises of the 21st century occurred when the accounting scandals at Enron, Arthur Andersen, WorldCom, Tyco, Adelphia, and others came to light. Those events led to bankruptcies, large-scale job loss, and the destruction of billions of dollars in shareholder value and employees' retirement savings. As a result, the public's trust in business and free market capitalism began to erode.
- Another major event occurred in 2008 with the global financial crisis, which shook the entire capitalist system to its core.[15] A real estate bubble had developed in the United States, fueled by cheap credit and the availability of subprime mortgages. When that bubble burst, many entities faced financial duress or bankruptcy, including investors holding securities based on those mortgages and the financial institutions that had sold the securities. Several investment banks such as Lehman Brothers filed for bankruptcy, while others, including Merrill Lynch, were acquired at fire-sale prices. Home foreclosures skyrocketed as a large number of borrowers defaulted on their mortgages. House prices in the United States plummeted by roughly 30%. The United States plunged into a deep recession. The Dow Jones Industrial Average (DJIA) lost about half its market value in

the process. The impact of the global financial crisis was worldwide. The freezing of capital markets during the global financial crisis triggered a debt crisis in Europe. Some European countries (notably Greece) defaulted on government debt; other countries could repay their debts only with the assistance of other, more solvent European countries. This severe financial crisis not only put Europe's common currency, the euro, at risk but also led to a prolonged and deep recession in Europe. In the wake of the global financial crisis, the Occupy Wall Street protest was born out of dissatisfaction with the capitalist system. The key drivers behind the protest movement are income disparity, questionable corporate ethics, corporate influence on governments, and ecological sustainability.

- Disenchanted with the European Union (a political and economic union of 27 European countries), voters in the United Kingdom decided to leave the EU (in 2016). The withdrawal from the EU has been dubbed Brexit (short for "British exit"). After protracted "divorce negations" between the EU and Great Britain, the UK left the EU in 2020.
- After the George Floyd killing (in 2020), large racial-justice protests ensued, with an estimated 15 to 26 million people participating in demonstrations across the United States, likely making the protest movement the largest in U.S. history.[16] The mass demonstrations also highlighted income inequality and the fact that the economy is not working for all Americans, an issue the Business Roundtable promised to address.

In addition, trust in business has been shattered by widespread perceptions of unethical or immoral behavior by businesses, particularly in the pharma industry. For example, Purdue Pharma is implicated in causing the drug overdose epidemic by its single-minded focus on profit maximization. The misuse of and addiction to prescription pain relievers such as Purdue Pharma's OxyContin kills some 80,000 people a year (see **MiniCase 12**).[17]

Turing Pharmaceutical provides another example of how things can go awry when shareholder maximization is the only goal.[18] Turing's CEO Martin Shkreli announced (in 2015) that the company would raise the price of its drug Daraprim from $13.50 to $750 a pill–a more than 5,500% increase. The drug is used to prevent complications from AIDS, and it costs about $1 to produce. Although Daraprim was a generic drug at the time, Shkreli knew that it would take the FDA five years (until 2020) to approve other manufacturers to make the drug. Facing no competition in the market, Shkreli decided to price the drug according to what the market could bear. When the price change was announced, the condemnation in the media was swift. Although he was vilified and accosted in public, a defiant Shkreli said:

> No one wants to say it, no one's proud of it, but this is a capitalist society, capitalist system and capitalist rules, and my investors expect me to maximize profits, not to minimize them, or go half, or go 70%, but to go to 100% of the profit curve that we're all taught in MBA class.[19]

As a consequence of the several black swan events and behaviors by Martin Shkreli and other CEOs, strategy scholars argue that many public companies have defined value creation too narrowly in terms of financial performance.[20] They believe that executives' exclusive pursuit of profit maximization can have negative consequences for society at large and that the focus on shareholder primacy has contributed to the loss of trust in corporations as a vehicle for value creation and societal welfare. They believe that stakeholder capitalism with a focus on creating shared value can remedy some of the shortcomings inherent in shareholder capitalism.

STAKEHOLDER CAPITALISM AND SHARED VALUE

The Greek philosopher Heraclitus is credited with the saying that the only constant in life is change. The understanding of a firm's purpose has evolved because specific ideas reflect the particular time and place in which they originated.[21] Thus, our understanding of the firm has shifted from the primary focus on profit maximization to corporate social responsibility and more recently to a focus on creating shared value.

Summing up the challenges capitalism faces in her book *Reimagining Capitalism in a World on Fire,* the strategy scholar Rebecca Henderson identifies three defining problems of our time:[22]

Climate Change. If left unchecked, climate change will likely result in melting glaciers and warming oceans, rising sea levels, flooding, storms, heatwaves, wildfires, and more frequent and intense droughts. All of these have detrimental effects on humans, animals, plants, and the entire ecological system on which life depends.

tragedy of the commons A problem that arises when individuals, companies, or nations pursue their own self-interest without considering the well-being of society or the global community.

Climate change is a classic **tragedy of the commons** problem. The tragedy of the commons problem arises when individuals, companies, or nations pursue their own self-interest without considering the well-being of society or the global community. The problem results in overconsumption (e.g., overfishing in oceans) or underinvestment (e.g., pollution abatement). Climate change is a global problem, and addressing it requires global coordination. Because the interests of individual nation-states are not aligned, a tragedy of the commons problem complicates the mitigation of climate change.

Economic Inequality. Wealth distribution is becoming more skewed. The 50 richest people in the world own more wealth than the poorer half of humanity combined. In the United States, the ratio of CEO compensation to average worker compensation grew from 61:1 in 1989 to 351:1 in 2020.[23] Billions of people across the globe are not having their basic needs met in terms of access to education, health, and a decent job. To make matters worse, advances in artificial intelligence (AI) and robotics threaten to replace millions of jobs.

Beleaguered Institutions. The institutions that historically provided structure to a free market capitalist system have lost credibility and legitimacy. For instance, global and domestic health authorities made several embarrassing blunders during the Covid-19 pandemic. Mistakes included the slow and incompetent initial response to the pandemic, with delayed manufacture and distribution of testing kits and personal protective equipment, such as N-95 masks, costing the lives of (too) many people across the globe. Other blunders included draconian measures such as prolonged closures of day care facilities and elementary schools without any discernible effect on stopping the spread of the virus. The once-hidden costs of prolonged isolation during the pandemic, such as increased rates of teenage depression and suicide, have now become apparent.[24]

In addition, in many democracies election outcomes are questioned. Peaceful transfers of power are no longer guaranteed. Even courts that are supposed to be independent arbiters in applying the law face massive political pressure. Across the world, democracies seem to be weakening as populists gain power, and authoritarian regimes delight in showcasing the dysfunctions in liberal democracies. At a micro level, families, local communities, and the faith traditions that provided the glue of our shared humanity are being attacked and are disintegrating.

CREATING SHARED VALUE. To address these significant challenges, business scholars have put forth the notion of *creating shared value (CSV).* In their seminal *Harvard Business Review* article, Michael Porter and Mark Kramer define shared value as

> policies and operating practices that enhance the competitiveness of a company while simultaneously advancing the economic and social conditions in the communities in which it operates. Shared value creation focuses on identifying and expanding the connections between societal and economic progress.[25]

Unlike Milton Friedman, they argue that strategic leaders should not concentrate exclusively on increasing firm profits. Instead, effective strategists should focus on creating shared value, which involves creating economic value for shareholders while also creating social value by addressing society's needs and challenges. In other words, strategic leaders need to reestablish the critical relationship between superior firm performance and societal progress. This dual viewpoint allows companies to gain and sustain a competitive advantage and reshape capitalism and its relationship to society. Patagonia, Inc., featured in ChapterCase 5, is an example of a company creating shared value.

shared value creation framework Framework proposing that strategic leaders maintain a dual focus on shareholder value creation and value creation for society.

The **shared value creation framework** proposes that strategic leaders maintain a dual focus on shareholder value creation and value creation for society. It recognizes that markets are defined not only by economic needs but also by societal needs. It advances the perspective that negative externalities such as pollution, wasted energy, and costly accidents can have negative internal effects, not only in lost reputation but also on the bottom line. Rather than pitting economic and societal needs against each other, Porter and Kramer suggest that the two can work together to create a larger pie. The shared value creation framework seeks to enhance a firm's competitiveness by identifying connections between economic and social needs and then creating a competitive advantage by addressing these business opportunities. It is critical for strategic leaders to rediscover and reestablish the important relationship between superior firm performance and societal progress, which will allow companies to gain and sustain a competitive advantage and reshape capitalism and its relationship to society.

For example, GE has strengthened its competitiveness by creating a profitable business with its "green" Ecomagination initiative. Ecomagination is GE's strategic initiative to provide cleaner and more efficient energy sources, provide abundant sources of clean water anywhere in the world, and reduce emissions.[26] Jeffrey Immelt, GE's former CEO, often said, "Green is green,"[27] meaning that addressing ecological needs offers the potential for GE to gain and sustain a competitive advantage. By applying strategic innovation, GE is providing solutions for some tough environmental challenges while driving company growth. Ecomagination solutions and products allow GE to increase the perceived value it creates for its customers while lowering costs to produce and deliver green products and services. Ecomagination allows GE to eliminate the trade-off between increasing value creation and lowering costs, enhancing GE's contribution to shared value creation.

GE's Ecomagination products and services create value for society in terms of reducing emissions and lowering energy consumption, among other benefits. By 2020, renewables, including nuclear power, became the second most prevalent electricity source in the United States, after natural gas.[28] In its sustainability report, GE states, "Investing in clean energy has proven good for business, job creation, the economy, and the world."[29] As part of its reorganization, GE has created a standalone division called Renewable Energy, which had $16 billion in revenues in 2020.[30]

To ensure that strategic leaders can reconnect economic needs and societal needs, Porter recommends that they focus on three things within the shared value creation framework:[31]

1. **Expand the customer base to bring in *nonconsumers*** such as those at the *bottom of the pyramid*—the largest but lowest income socioeconomic group of the world's population. The base of the pyramid in the global economy can provide significant business opportunities, which—if satisfied—could improve the living standard of the people living below the poverty line around the world. For example, Muhammad Yunus, Nobel Peace Prize winner, founded Grameen Bank in Bangladesh to provide small loans (termed *microcredit)* to impoverished villagers, who used the funding for entrepreneurial ventures that would help them climb out of poverty. Other businesses have also found profitable opportunities at the base of the pyramid. In India, Arvind Ltd. offers jeans in a ready-to-make

kit that costs only a fraction of the high-end Levi's. The Tata group sells its Nano car for around 150,000 rupees (about $2,500), enabling more families in India to move from mopeds to cars.

2. **Expand traditional internal firm value chains to include more nontraditional partners** such as *nongovernmental organizations* (NGOs). NGOs are nonprofit organizations that pursue a particular cause in the public interest and are independent of any government. Habitat for Humanity and Greenpeace are examples of NGOs.
3. **Focus on creating new regional clusters** such as Silicon Valley in the United States; Electronic City in Bangalore, India; and Chilecon Valley in Santiago, Chile.

In line with *stakeholder theory* (discussed in Chapter 1), proponents of the CSV approach argue that these strategic actions lead to a larger pie of revenues and profits that can be distributed more fairly among a company's stakeholders.

Strategy Highlight 5.1 shows how BlackRock, the world's largest investment management corporation, uses its power to endorse a focus on stakeholder capitalism and ESG goals in its portfolio companies.

Strategy Highlight **5.1**

BlackRock's $10 Trillion of Shared Value

"Society is demanding that companies, both public and private, serve a social purpose. To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society." —Larry Fink, CEO of BlackRock, Inc.[32]

BlackRock, Inc. is the world's largest investment management corporation with $10 trillion of assets under management, equivalent to 10% of the world's GDP. BlackRock manages money for pension funds, endowments (such as for universities), governments, companies, and wealthy individuals. It is one of the top three shareholders in more than 80% of the companies in the S&P 500, a stock market index of the leading publicly traded companies in the United States.[33] The list of the companies in the S&P 500 reads like a "Who's Who" of the business world. It includes tech companies such as Alphabet, Amazon, Apple, Meta, Microsoft, and Tesla and more old-line businesses such as Anheuser-Busch, Boeing, Exxon, GM, MGM Resorts (gambling), and Philip Morris (the maker of Marlboro cigarettes). As such, few people in the world wield more power than Larry Fink, CEO of BlackRock. And he is on a mission to push companies to embrace environmental, social, and governance (ESG) issues. Addressing climate change and social justice are at the top of Fink's agenda.

Fink is not shy about wielding his firm's power to induce desired outcomes in the companies in which

Larry Fink, CEO of BlackRock, Inc. is one of the most powerful businesspeople globally because his company manages $10 trillion in assets. BlackRock is one of the three largest shareholders in over 80% of the companies in the S&P 500, a stock market index of the leading publicly traded companies listed in the United States. Fink uses his power to induce companies to pursue ESG goals. He is especially concerned about climate change and social justice.

Kristoffer Tripplaar/Alamy Stock Photo

BlackRock has invested. In his annual letter to CEOs (in 2018), Fink endorsed the shift toward stakeholder capitalism, a management approach in which a company must benefit all its stakeholders, including shareholders, employees, customers, and the communities in which it operates. He stated that "BlackRock can choose to sell the securities of a company if we are doubtful about its strategic direction or long-term growth," emphasizing his belief that corporations should align their missions with the principles of creating shared value (CSV). In his 2020 letter to CEOs, Fink further pressed company leaders to recognize the importance of pursuing a sustainability-forward purpose. He also required BlackRock's portfolio companies to disclose their carbon emissions and climate risks. Fink's letters capture the zeitgeist ("spirit of the times") well because strategic leaders have begun to recognize the importance of incorporating ESG goals into their corporate agenda. In addition, employees and customers are increasingly calling on enterprises to address social and environmental issues.

Given BlackRock's power, it is not surprising that Larry Fink has been shaking up things in many old-line businesses. In 2021, BlackRock engineered the election of three climate-focused board members to ExxonMobil's board of directors. Relying on BlackRock's proxies on Exxon's board (which come from the ESG-focused investment firm Engine No. 1, a BlackRock collaborator), Fink expects the old-line fossil fuel company to move toward a carbon-neutral and clean-energy future. Put simply, BlackRock is requiring a strategic pivot by Exxon, which traditionally focused only on fossil fuels. Exxon's core competency is discovering and extracting oil and gas globally, not in renewable energy.

Not everyone agrees with Larry Fink's approach. One criticism levied against ESG activism is that many of the ESG issues that companies attempt to solve should be addressed through the political process because they concern public policy issues. Critics argue that CEOs such as Fink do not have a legitimate mandate and that capitalism may show up in areas of social and public life where it has no place.[34] Therefore, they argue that capitalism should stay in its lane and focus on providing goods and services efficiently. Powerful asset managers and CEOs should not force companies to pursue ESG goals but allow firms to pursue their own strategy, especially if that strategy entails increasing profits while providing the products and services that customers want.

Indeed, not all investors for which BlackRock manages money are happy with Larry Fink's approach. They argue that ESG issues should be decided in the democratic process and not by CEOs, who are not elected and have no democratic legitimacy. The democratic process is unbiased in terms of how many shares of a company an individual owns; each person has one vote at the ballot box. However, a firm like BlackRock has a million times more influence than the average person, thereby disenfranchising most individuals.

Critics also call out the paradox BlackRock creates by encouraging companies to pursue BlackRock's purpose and follow BlackRock's ESG agenda. For example, Exxon's commitment to being the world's premier oil and gas company is thwarted by BlackRock's sustainability agenda. Returns-focused investors believe that BlackRock's actions are not in their favor, that Exxon has no expertise, and therefore no business, in renewable energy. These critics say that they prefer using their own money to support their chosen causes and not have Larry Fink decide on their behalf. The critics conclude that public policy and social issues should be decided in the democratic process and not by powerful individuals.

In response to the critics who label his approach as woke, Fink wrote (in his 2022 letter) that "stakeholder capitalism is not about politics ... *it is capitalism*." Fink emphasizes that long-term value creation and profitability can be achieved only through active engagement with internal and external stakeholders. Despite opposition, Fink stands by his strategic decision to embed stakeholder capitalism and ESG values into BlackRock's strategy. He also plans to launch a "Center for Stakeholder Capitalism" to better educate strategic leaders about creating shared value.[35]

LO 5-2

Explain the shift in emphasis from corporate social responsibility (CSR) to creating shared value (CSV).

FROM CORPORATE SOCIAL RESPONSIBILITY (CSR) TO CREATING SHARED VALUE (CSV). Creating shared value (CSV) differs markedly from corporate social responsibility (CSR), discussed in Chapter 1. Exhibit 5.2 shows how the thinking about the firm's purpose has evolved in the last few decades. As shown in the pyramid of corporate social responsibility (Exhibit 1.3), a business is first and foremost an economic institution, and its primary goal aligns with Friedman's idea of profit maximization as the firm's purpose. However, CSR goes a step further. It suggests that firms that do well ("make profits") should also do good by engaging in corporate philanthropy ("doing good," "giving back," and "being a good citizen").

The CSV framework takes value creation to the next level. In the CSV framework, value creation is focused from the beginning on both economic benefits and societal benefits. For example, a purpose-driven company attempting to create shared value will price in externalities such as pollution to more accurately reflect the actual cost of its products and services. Rather than focusing on good citizenship and philanthropy as advocated in the CSR approach, leaders who are committed to CSV think holistically about joint economic and societal value creation when crafting strategy. Rather than adding a CSR component as an afterthought, which often comes across as a public-relations exercise, companies that follow the CSV approach think about how to create shared value as an integral part of the firm's competitive strategy from the beginning, as informed by a purpose-driven mission. While CSR is externally focused to address pressures that arise, such as addressing child labor in the supply chain, CSV is internally focused and derives from deeply held beliefs such as Patagonia's purpose "to save our home planet."

A CSR perspective leads to tinkering with isolated components as needed, such as starting a fair trade initiative. In contrast, the CSV approach is baked in from the beginning, as when a company designs a closed-loop supply chain to provide higher quality products at a lower cost while also reducing its environmental impact. CSR initiatives are often abolished when budgets are tight or public opinions shift, while a CSV approach is identity defining for an organization.

For instance, Patagonia decided (in 1994) to make its cotton sportswear 100% organic after seeing the environmental impact of cotton farmed on an industrial scale using huge amounts of pesticides. This strategic decision meant developing an entire organic cotton supply chain from scratch and incurring significantly higher costs for a critical input. Yet, Patagonia's customers embraced the new organic cotton and were happy to pay a premium price. Today, organic cotton is used widely in the apparel industry, thanks to Patagonia's pioneering work. Exhibit 5.2 summarizes this discussion and shows the shift from CSR to CSV.

EXHIBIT 5.2 From Corporate Social Responsibility (CSR) to Creating Shared Value (CSV)

Corporate Social Responsibility (CSR)	→	Creating Shared Value (CSV)
Value creation: Competitive advantage is fundamental and the top priority, which allows "doing good"		**Value creation:** Focus is on creating economic and societal benefits relative to cost, which includes all externalities (such as pricing in pollution)
Focus: Citizenship and philanthropy		**Focus:** Joint company, community, and societal value creation
Action: Reactive to external pressures		**Action:** Proactive and integral to the firm's competitive strategy (where and how to compete)
Agenda: Determined by external "public relations (PR) benefits" and personal preferences of firm leaders		**Agenda:** Determined internally based on the firm's vision and values (company specific)
Impact: Limited by CSR budget and shifting preferences over time as external pressures vary		**Impact:** Motivates internal and external stakeholders by realigning the entire company budget around creating shared value
Example: Fair trade purchasing		**Example:** Transforming the entire supply chain to increase quality and lower costs while also eliminating or reducing the environmental footprint (i.e., solving trade-offs)

Source: Author's adaptation from Porter, M.E., and M.R. Kramer (2011, Jan.-Feb.), "Creating shared value" *Harvard Business Review*.

5.2 Competitive Advantage

The goal of a strategy is to *gain and sustain a competitive advantage.* But what is a competitive advantage? And how do we know when a firm has achieved it? It is easy to compare two firms and identify the better performer as the one with a competitive advantage. But such a simple comparison has its limitations. How does it help us to understand how and why a firm has a competitive advantage? How can we measure that advantage? How can we understand competitive advantage in the context of an entire industry and the ever-changing external environment? What strategic implications for managerial actions can we derive from our assessments? These questions may seem simple, but their answers are not. Strategy researchers have debated them intensely for the past few decades.[36]

To address these key questions, we will develop a *multidimensional perspective* for assessing competitive advantage. We begin by focusing on the three standard performance dimensions:[37]

1. Accounting metrics
2. Shareholder value
3. Economic value

These three performance dimensions generally correlate, particularly over time. Accounting profitability and economic value creation tend to be reflected in the firm's stock price, which in part determines the stock's market valuation.

ACCOUNTING METRICS

LO 5-3

Appraise accounting metrics and shareholder value creation as measures of competitive advantage.

As we discussed in Chapter 1, *strategy* is a set of goal-directed actions that a firm takes to gain and sustain a competitive advantage. Using accounting data to assess competitive advantage and firm performance is standard managerial practice. When measuring accounting profitability to assess competitive advantage, managers use financial data and ratios derived from publicly available accounting data such as income statements and balance sheets.[38] Because *competitive advantage* is defined as superior performance *relative* to other competitors in the same industry or to the industry average, a firm's strategic leaders must be able to accomplish two critical tasks:

1. Assess their firm's performance accurately.
2. Compare and benchmark their firm's performance to other competitors in the same industry or against the industry average.

Standardized financial metrics found in publicly available income statements and balance sheets allow a firm to accomplish both of these tasks. By law, public companies are required to release these data in compliance with generally accepted accounting principles (GAAP) set by the Financial Accounting Standards Board (FASB) and as audited by certified public accountants. Publicly traded firms are required to file a Form 10-K (or "annual report") each year with the U.S. Securities and Exchange Commission (SEC), a federal regulatory agency. The 10-K reports are the primary source of companies' accounting data available to the public. The fairly stringent requirements applied to accounting data that are audited and publicly released enhance the data's usefulness for comparative analysis.

Accounting data enable managers to conduct direct performance comparisons between different companies. Some of the profitability ratios most commonly used in strategic management are *return on invested capital (ROIC), return on equity (ROE), return on assets (ROA),* and *return on revenue (ROR).* In the "How to Conduct a Case Analysis" module in Part 4, you will find a complete presentation of accounting measures and financial ratios, how they are calculated, and a brief description of their strategic characteristics.

LIMITATIONS OF ACCOUNTING DATA. Although accounting data tend to be readily available and can easily be transformed into financial ratios to assess and evaluate competitive performance, they also have some important limitations:

- *Accounting data are historical and thus backward-looking.* Accounting profitability ratios show us only the outcomes from past decisions, and the past is no guarantee of future performance. There is also a significant time delay before accounting data become publicly available. Some strategists liken making decisions based on accounting data to driving a car by looking in the rearview mirror.[39] Although financial strength certainly helps, past performance is no guarantee that a company is prepared for market disruption.
- *Accounting data do not consider off–balance-sheet items.* Off–balance-sheet items, such as pension obligations (quite large in some U.S. companies) or operating leases in the retail industry, can be significant factors in assessing firm performance. For example, one retailer may own all its stores, which would properly be included in the firm's assets; a second retailer may lease all its stores, which would *not* be listed as assets. All else being equal, the second retailer's ROA would be higher. Strategists address this shortcoming by adjusting accounting data to obtain an *equivalent* economic capital base so that they can compare companies with different capital structures.
- *Accounting data focus mainly on tangible assets, which are no longer a company's most important assets.*[40] This limitation of accounting data is nicely captured in the adage, "Not everything that can be counted counts. Not everything that counts can be counted."[41] Capturing the value of intangible assets with standard accounting data is difficult and prone to errors, and perhaps even outright unfeasible. Accounting metrics require that a dollar value must be assigned to each asset and that value must be amortized over time. Amortization, in turn, necessitates that the value of intangible assets such as intellectual property and brand value must be gradually reduced over time (just like factory machinery that wears out). Yet it is quite difficult to predict the future value of intangibles. The value can drop to zero quickly when innovation makes the asset obsolete, or the value can rise exponentially over time as in the case of Google's search algorithm or Apple's installed base of more than 1 billion users on the iOS platform. In addition, standard accounting data do not capture many key intangible assets (e.g., "reputation for quality service" or "nimble and innovative culture"). Yet, the most competitively important assets in today's knowledge-based economies tend to be intangibles such as innovation, quality, and customer experience, which are not included in a firm's balance sheet. For example, Apple's core competency in designing beautiful and user-friendly mobile devices embedded within a large ecosystem of various services, such as iCloud and ApplePay, is not a balance-sheet item, but it is nonetheless a critical foundation in its quest for competitive advantage.

INTANGIBLES AND THE VALUE OF FIRMS. Intangible assets that are not captured in accounting data have become much more important in firms' stock market valuations over the last few decades. Exhibit 5.3 shows the average firm's book value (accounting data capturing the firm's actual costs of assets minus depreciation) as a portion of a firm's total stock market valuation (number of outstanding shares times share price). The firm's book value captures the historical cost of a firm's assets (i.e., tangible assets), whereas market valuation is based on future expectations for a firm's growth potential and performance. For the firms in the S&P 500 (the 500 largest publicly traded companies by market capitalization in the U.S. stock market, as determined by Standard & Poor's, a rating agency), the importance of a firm's book value has declined dramatically over time. This decline mirrors a commensurate increase in the importance of intangibles that contribute to growth potential and yet are not captured in a firm's accounting data.

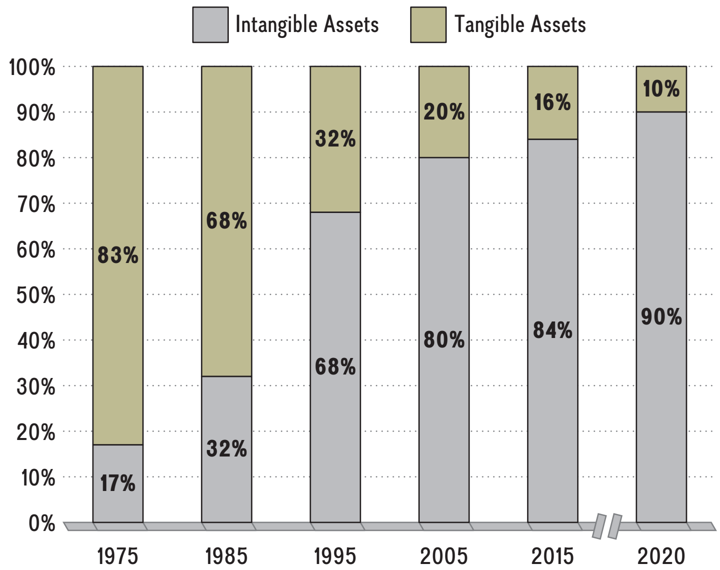


EXHIBIT 5.3

The Importance of Intangible Assets to Firms' Stock Market Valuations, 1975-2020

Source: Author's analysis and depiction of data from Compustat, 1975–2020.

Let's study Exhibit 5.3 more closely. The vertical axis indicates that tangible assets (book value) and intangible assets (not captured in accounting data such as book value) add up to 100% of the stock market valuation for the average firm in the S&P 500. In 1975 more than 80% of a firm's stock market valuation was, on average, based on its book value and less than 20% was based on the market's expectations concerning the firm's future performance. By 2005, this relationship reversed, with firms' valuations based only 20% on assets captured by accounting data. Fast forward to 2020, and we see that almost all of a firm's valuation (90%) is based on intangibles. This trend explains why, in 2022, Amazon ($1.5 trillion) is valued 15 times as much as Boeing ($100 billion), and why Alphabet, Google's parent company ($1.7 trillion), is valued almost 30 times more than GM ($58 billion).

The important takeaway is that intangibles such as intellectual property and brand value that are not captured in firms' accounting data have become much more important to a firm's competitive advantage. Further highlighting the value of intangibles and future expected growth, the five most valuable companies globally are all tech companies: Alphabet, Amazon, Apple, Meta, and Microsoft. Intangibles therefore need to take center stage when formulating strategy.

What does this discussion tell us about accounting profitability? Key financial ratios are a good starting point and are useful in certain assessments. But accounting data have major limitations, especially their inability to account for the value of intangibles, which are a key force in today's economy. We next turn to *shareholder value creation,* a second traditional way to measure and assess competitive advantage. It attempts to overcome the shortcomings of a backward-looking internal focus on mostly tangible assets.

SHAREHOLDER VALUE CREATION

Shareholders—individuals or organizations that own one or more shares of stock in a public company—are the legal owners of public companies. From the shareholders' perspective, the measure of competitive advantage that matters most is the return on their **risk capital**,[42] which is the money they provide in return for an equity share. They cannot recover this money if the firm goes bankrupt. For example, the shareholders of Lehman Brothers, a global financial services firm, lost their entire investment of about $40 billion when the firm declared bankruptcy (in 2008) during the global financial crisis.

shareholders Individuals or organizations that own one or more shares of stock in a public company.

risk capital The money provided by shareholders in exchange for an equity share in a company; it cannot be recovered if the firm goes bankrupt.

total return to shareholders Return on risk capital that includes stock price appreciation plus dividends received over a specific period.

efficient-market hypothesis The idea that all available information about a firm's past, current state, and expected future performance is embedded in the market price of the firm's stock.

market capitalization A firm performance metric that captures the total dollar market value of a company's total outstanding shares at any given point in time.

Investors are primarily interested in a company's **total return to shareholders**, which is the return on risk capital, including stock price appreciation plus dividends received over a specific period. Unlike accounting data, total return to shareholders is an *external* and *forward-looking* performance metric. It indicates how the stock market views all available public information about a firm's past, current state, and expected future performance, with most of the weight on future growth expectations. The weight on future expectations also explains, in part, why intangibles are becoming more important in an economy where many firms benefit from positive returns to scale.

The idea that all available information about a firm's past, current state, and expected future performance is embedded in the market price of the firm's stock is called the **efficient-market hypothesis**.[43] According to this perspective, a firm's share price provides an objective performance indicator. When assessing and evaluating competitive advantage, a comparison of rival firms' share price development or market capitalization provides a helpful yardstick when used over the long term. **Market capitalization** (or market cap) captures the total dollar market value of a company's outstanding shares at any given point in time (*Market cap = Number of outstanding shares × Share price*). For example, if a company has 50 million shares outstanding, and each share is traded at $200, the market capitalization is $10 billion (50,000,000 × $200 = $10,000,000,000, or $10 billion).[44]

An important question arises with regard to a firm's net profits. Should they be distributed to the shareholders, or should they benefit other stakeholders such as employees? In the shareholder perspective, a firm's profitability above and beyond what needs to be invested in the business to remain competitive belongs to the shareholders. Thus, any net profits should be returned to the legal owners of the company through stock buybacks (which increase the share price) or dividends. Meanwhile, employees argue that net profits should be invested in increasing employee wages and benefits.

Upon starting his third stint as CEO of Starbucks in 2022, Howard Schultz faced this dilemma. Much to the disappointment of shareholders, he reversed the company's decision to buy back stock in the billions. Instead, he decided to reinvest the net profits into cafés, customers, and employees rather than return it to stockholders. Embracing shareholder capitalism, CEO Schultz declared to an approving audience of Starbucks employees: "I am not in business, as a shareholder of Starbucks, to make every single decision based on the stock price for the quarter. Those days, ladies and gentlemen, are over."[45]

BENCHMARK METRICS. All public companies in the United States are required to report total return to shareholders annually in the statements they file with the Securities and Exchange Commission (SEC). In addition, they must also provide benchmarks, usually one comparison to the industry average and another to a broader market index that is relevant for more diversified firms.[46] Because competitive advantage is defined in relative terms, these benchmarks allow us to assess whether a firm has a competitive advantage.

In its annual reports, Microsoft, for example, compares its performance to two stock indices: the NASDAQ computer index and the S&P 500. The computer index includes over 400 high-tech companies traded on the NASDAQ, including Apple, Adobe, Alphabet, Intel, and Oracle. It provides a comparison of Microsoft to the computer industry—broadly defined. The S&P 500 allows Microsoft to offer a comparison to the wider stock market beyond the computer industry. In its 2021 annual report, Microsoft showed that it *outperformed* the S&P 500 since 2016 and the NASDAQ computer index in 2018.

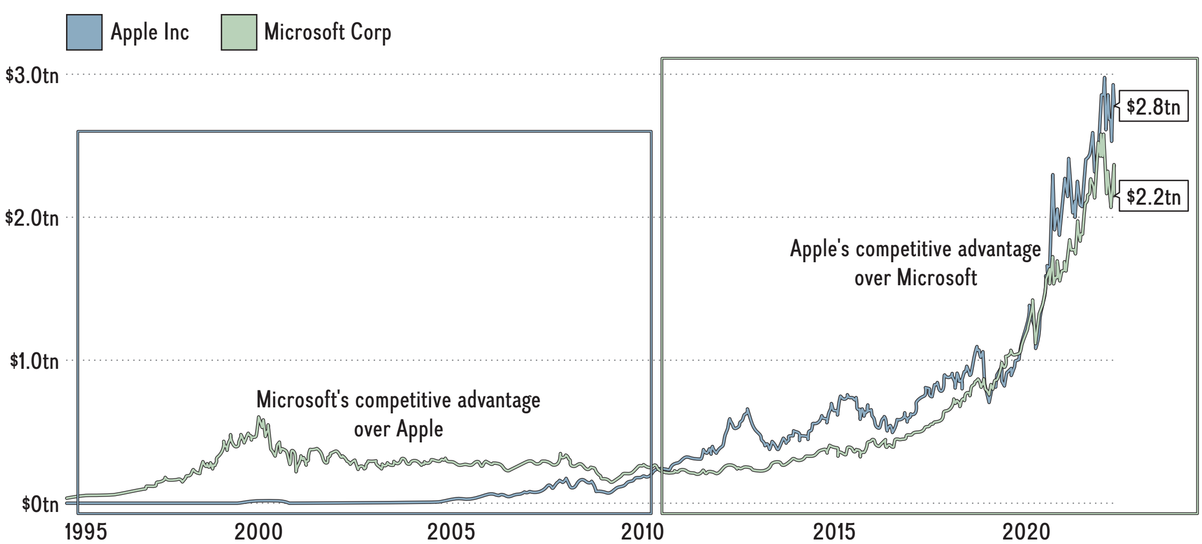
GROWTH-RATE PREDICTIONS. Effective strategies to grow the business can increase a firm's profitability and its stock price.[47] Indeed, investors and Wall Street analysts expect continuous growth. A firm's stock price generally increases only if the firm's rate of growth exceeds investors' expectations. Why? Investors discount into the present value of the firm's stock price whatever growth rate they foresee in the future. If a low-growth business like Comcast (in cable TV) is expected to grow 2% each year but realizes 4% growth, then its stock price will appreciate (increase). In contrast, if a fast-growing business like Apple in mobile computing is expected to grow by 10% annually but delivers "only" 8% growth, then its stock price will fall.

Investors also adjust their expectations over time. Because the business in the slow-growth industry (in our example earlier, Comcast) surprised them by delivering higher than expected growth, they adjust their expectations upward. The next year, they expect the firm to again deliver 4% growth, all else equal. On the other hand, if the industry average is 10% growth a year in the high-tech business (Apple), then the firm that delivered 8% growth will be expected to deliver at least the industry average growth rate. If it does not deliver that 10% growth, its stock will be further discounted.

STOCK MARKET VALUATIONS. Considering stock market valuations (*Share price × Number of outstanding shares*) over the long term provides a useful metric to assess competitive advantage. Exhibit 5.4 shows the stock market valuations for Apple and Microsoft from 1990 until 2022. Microsoft was the most valuable company worldwide (in December 1999 with close to $600 billion in market cap, which is over $1 trillion today, inflation-adjusted), but its market valuation dropped in the following decade. The valuation declined because Microsoft struggled with the transition from desktop to mobile and cloud-based computing. The left box in Exhibit 5.4 shows Microsoft's competitive advantage from 1995 until about 2010, when the Windows operating system dominated the personal computing world. In 2007, Apple introduced the iPhone, and it has supercharged its stock market valuation since that time. In 2020, Apple became the first company to reach a market cap of $3 trillion.

In 2014, Microsoft appointed Satya Nadella as CEO, and he led an astonishing turnaround at the software giant. Nadella is moving Microsoft away from its Windows-only business model to compete more effectively in a "mobile first, cloud first world."[48] Nadella's strategic initiative is starting to bear fruit as investors appear to be pleased with how well Microsoft is performing in future growth areas such as cloud computing. As Exhibit 5.4 shows, since Nadella took the helm at Microsoft in 2014, the company's market cap has been increasing at a steep clip, even overtaking Apple briefly in 2020, before falling back a bit.

EXHIBIT 5.4 Stock Market Valuations of Apple and Microsoft (in $ trillions), 1995–2022



Source: Author's depiction of publicly available data.

LIMITATIONS OF SHAREHOLDER VALUE CREATION. Although measuring firm performance through total return to shareholders and firm market capitalization has many advantages, it has its shortcomings. Specifically:

- *Stock prices can be highly volatile, making it difficult to assess firm performance, particularly in the short term.* This volatility, combined with external factors and investor sentiment, implies that *total return to shareholders* is a better measure of firm performance and competitive advantage over the long term (as shown in Exhibit 5.4).
- *Overall macroeconomic factors such as economic growth or contraction, the unemployment rate, and interest and exchange rates all have a direct bearing on stock prices.* It can be difficult to ascertain the extent to which a stock price is influenced by external macroeconomic factors (as discussed in Chapter 3) rather than by the firm's strategy. (See also Exhibit 3.2 highlighting firm, industry, and other effects in overall firm performance.)
- *Stock prices frequently reflect investors' psychological mood, which can at times be irrational.* Stock prices can overshoot expectations based on economic fundamentals in periods like the internet boom, during which former Federal Reserve Chairman Alan Greenspan famously described investors' buoyant sentiments as "irrational exuberance."[49] Similarly, stock prices can undershoot expectations during busts like the 2008–2009 global financial crisis, in which investors' sentiment was described as "irrational gloom."[50]

LO 5-4

Link economic value creation to different sources of competitive advantage.

ECONOMIC VALUE CREATION

The relationship between *economic value creation* and competitive advantage is fundamental in strategic management. It provides the foundation on which to formulate a firm's competitive strategy for cost leadership or differentiation (discussed in detail in Chapter 6). For now, suffice it to say that a firm has a competitive advantage when it creates more *economic value* than rival firms do.

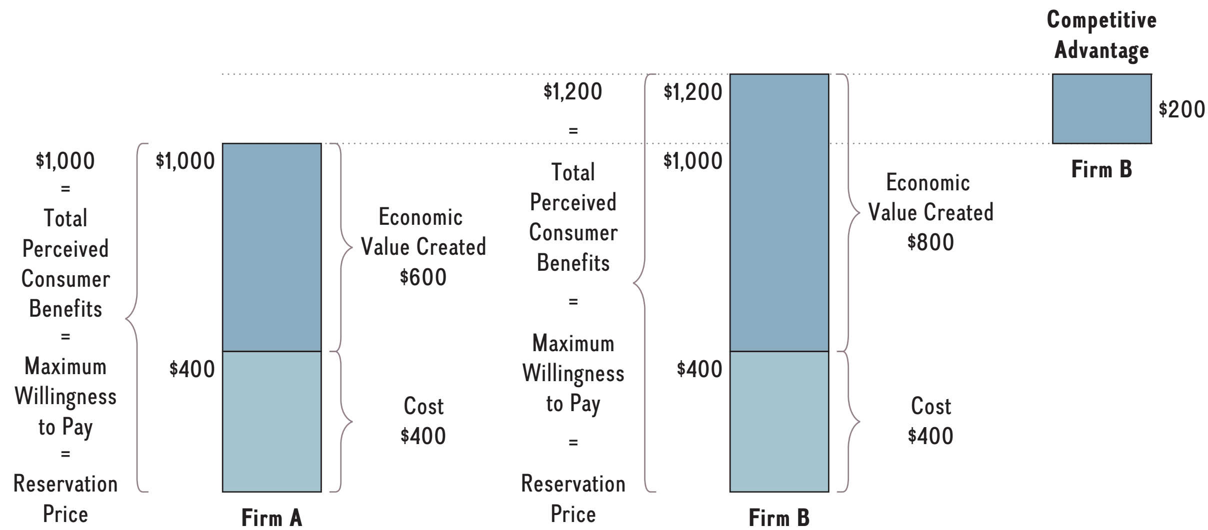
economic value created Difference between value (V) and cost (C), or ($V - C$).

reservation price The maximum price a consumer is willing to pay for a product or service based on the total perceived consumer benefits.

Economic value created is the difference between a buyer's willingness to pay for a product or service and the firm's total cost to produce it. Let's say a consumer is considering buying a new laptop and has a budget of $1,200. The consumer has narrowed the choices to Model 1 by Firm A and Model 2 by Firm B. Because of owing a laptop by Firm A before, the consumer is familiar with its models. The consumer values Model 1 at a **reservation price** of $1,000, which is the maximum this consumer is willing to pay for it. Model 1 is comparable to a more or less generic, run-of-the-mill laptop. In contrast, the consumer values Model 2 by Firm B at $1,200 because it has a somewhat higher performance, is more user friendly, and has a greater coolness factor. Given that the value of Model 2 by Firm B at $200 is more than the value of Model 1 by Firm A, the consumer purchases Model 2, paying as much as the reservation price allows.

IMPLICATIONS FOR FIRM-LEVEL COMPETITIVE ADVANTAGE. Let's now move from individual considerations to the overall laptop market in order to derive implications for firm-level competitive advantage. To simplify this illustration, we will assume that Firm A and Firm B are the only firms competing in the laptop market. Assuming that both firms produce their respective models at the same total unit cost ($400), and the market at large has preferences similar to that of our consumer, then Firm B will have a competitive advantage. Why? As Exhibit 5.5 depicts, even though the total unit costs for both firms is the same, Firm B's laptop is perceived as providing more utility than Firm A's laptop, which implies that Firm B creates more economic value ($1,200 – $400 = $800) than Firm A ($1,000 – $400 = $600). Thus, Firm B has a competitive advantage over Firm A because Firm B's *total perceived consumer benefits* are greater than Firm A's, while the firms have the

EXHIBIT 5.5 Firm B's Competitive Advantage: Same Cost as Firm A but Firm B Creates More Economic Value

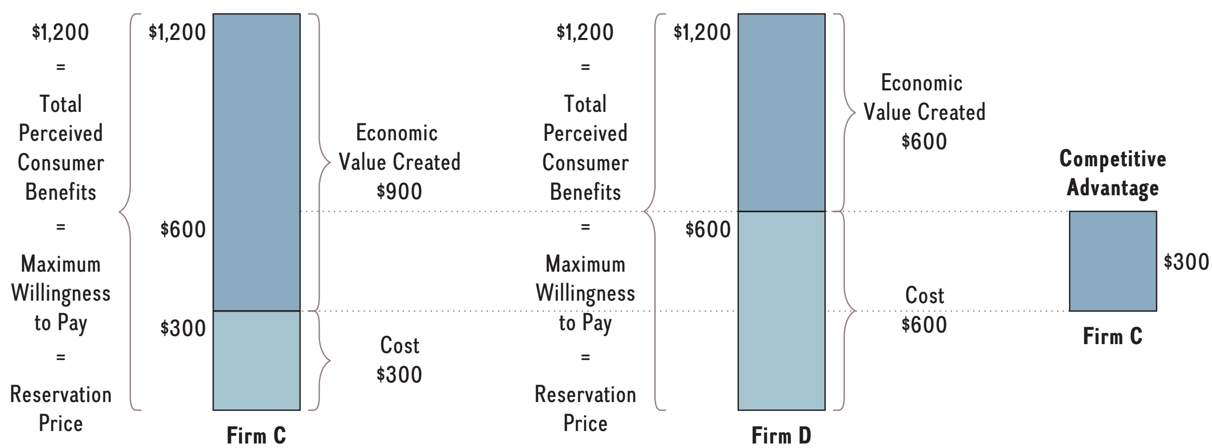


same cost. The amount of *total perceived consumer benefits* equals the *maximum willingness to pay,* or the *reservation price.* In short, Firm B's advantage is based on superior *differentiation* leading to higher perceived value. Further, the competitive advantage can be quantified: It is $200 (or $1,200 – $1,000) per laptop sold for Firm B over Firm A (see Exhibit 5.5).

Exhibit 5.5 shows that Firm B's competitive advantage is based on greater economic value creation because of superior product differentiation. In addition, a firm can achieve competitive advantage through a second avenue. Specifically, competitive advantage can also result from a relative *cost advantage* over rivals, assuming both firms can create the same total perceived consumer benefits.

Now let's introduce two new firms to our hypothetical laptop market. Exhibit 5.6 shows how Firm C and Firm D each offer a model that has the same perceived consumer benefits ($1,200). Firm C, however, creates greater economic value ($900, or $1,200 – $300) than

EXHIBIT 5.6 Firm C's Competitive Advantage: Same Total Perceived Consumer Benefits as Firm D but Firm C Creates More Economic Value



Firm D does ($600, or $1,200 – $600). Why? Firm C's total unit cost ($300) is lower than Firm D's ($600). Firm C has a relative cost advantage over Firm D, even though both of their products provide the same total perceived consumer benefits ($1,200). Furthermore, Firm C has a competitive advantage over Firm D in the amount of $300 for each laptop sold. Here, the source of Firm C's competitive advantage is a relative cost advantage over its rival, Firm D, while perceived consumer benefits are the same.

So far we have discussed situations in which products are priced at the maximum that a consumer might be willing to pay. But markets generally don't work like that. More often, the economic value created is shared between the producer and the consumer. That is, most of the time consumers are able to purchase the product at a price point below the maximum they are willing to spend. Both the seller and the buyer benefit.

VALUE, PRICE, AND COST. To calculate competitive advantage, we need three values, which will help us to further explain *total perceived consumer benefits* and *economic value created* in more detail:

1. Value (V)
2. Price (P)
3. Cost (C)

value The dollar amount (V) a consumer attaches to a good or service; the consumer's maximum willingness to pay; also called *reservation price*.

Value is the dollar amount (V) a consumer attaches to a good or service. Value captures a consumer's willingness to pay and is determined by the perceived benefits that a good or service provides to the buyer. The cost (C) to produce the good or service matters little to the consumer, but it matters a great deal to the producer (supplier) of the good or service because it has a direct bearing on the profit margin.

Let's return to our laptop example from Exhibit 5.5, in which Firm A and Firm B sold their laptops at different prices ($1,000 and $1,200, respectively) even though their total unit costs were the same ($400). In each case, the price did not exceed the consumer's maximum willingness to pay for the particular offering. Subtracting the costs, we found that Firm A created an economic value of $600 while Firm B created an economic value of $800, thus achieving a competitive advantage. In most market transactions, however, some of the economic value created benefits the consumer as well.

producer surplus Another term for profit, the difference between price charged (P) and the cost to produce (C), or ($P – C$); also called *profit*.

profit Difference between price charged (P) and the cost to produce (C), or ($P – C$); also called *producer surplus*.

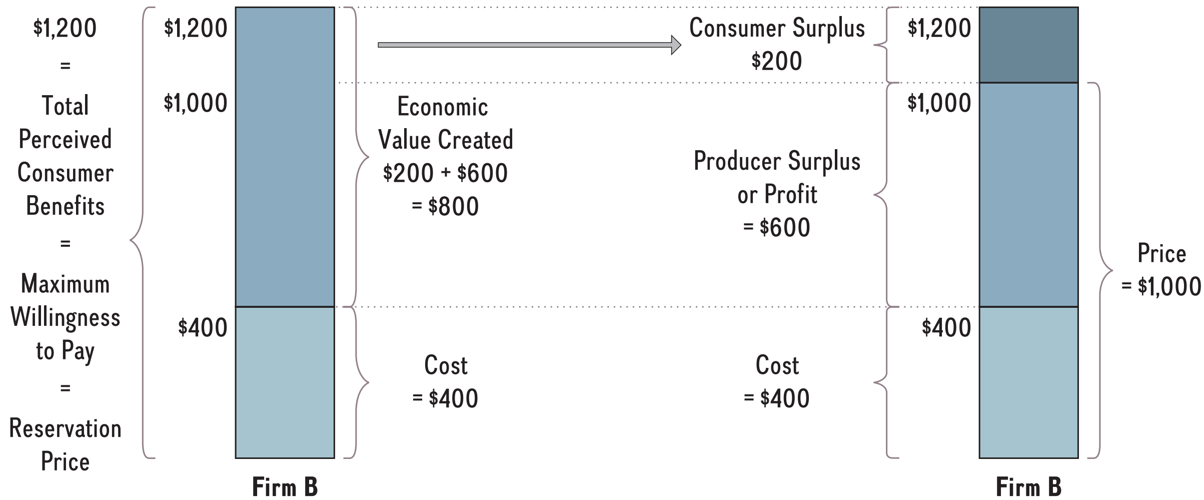
consumer surplus Difference between the value a consumer attaches to a good or service (V) and what he or she paid for it (P), or ($V – P$).

The Role of Consumer Surplus and Producer Surplus. Again, let's revisit the example depicted in Exhibit 5.5. The consumer's preference was to buy the laptop from Firm B, which they would have done because they preferred this laptop and could afford it given their reservation price. Let's assume Firm B's laptop is actually on sale for $1,000 (everything else remains constant). Assume the consumer again chooses to purchase Firm B's laptop rather than Firm A's (which they considered inferior). In this case, some of the economic value created by Firm B goes to the consumer. On a formula basis, total perceived value of Firm B's laptop ($1,200) splits into *economic value created* ($V – C$ = $800) plus *total unit cost* (C = $400), or: $V = (V – C) + C$.

The difference between the price charged (P) and the cost to produce (C) is the **producer surplus**, or simply **profit**. In the laptop example in Exhibit 5.7, if the price charged is $1,000, the profit is $P – C$ = $1,000 – $400 = $600. The firm captures this amount as profit per unit sold. Consumers capture the difference between what they would have been willing to pay (V) and what they actually paid (P), called **consumer surplus**. In our example, the consumer surplus is $V – P$ = $1,200 – $1,000, or $200. *Economic value creation* therefore equals *consumer surplus* plus *firm profit,* or $(V – C) = (V – P) + (P – C)$. In the laptop example from Exhibit 5.5:

Economic value created ($1,200 – $400) = Consumer surplus ($1,200 – $1,000) + Producer surplus ($1,000 – $400) = $200 + $600 = $800.

EXHIBIT 5.7 The Role of Consumer Surplus and Producer Surplus (Profit)



The Relationship between Consumer Surplus and Producer Surplus. The relationship between consumer surplus and producer surplus is the reason trade happens: Both transacting parties capture *some* of the overall value created. Note, though, that the distribution of the value created between parties need not be equal to make trade worthwhile. In the example illustrated in Exhibit 5.7, the consumer surplus is $200, while profit per unit sold is $600.

In cases where firms offer highly innovative products or services, the relationship can be even more skewed. The entry-level model of the Apple Watch retailed for $349 when it was introduced in 2015. It sold well, with Apple selling twice as many Apple Watches as iPhones in each device's first year.[51] An analysis by an independent engineering team revealed that Apple's total cost in terms of materials and labor for the Apple Watch was no more than $84.[52] Thus, Apple's profit for each watch sold was an estimated $265, with a profit margin of 315%.

The economic value creation framework shows that strategy is about:

1. Creating economic value.
2. Capturing as much of it as possible.

As a counterexample to Apple, consider Amazon. It is creating a large amount of value for its customers, but it is not capturing much of that value (at this point). Amazon has had two decades of negative net income as it attempts to build a stronger position in a variety of businesses. With its online retail business, Amazon is creating significant value for its customers (especially its Prime members) and for third-party sellers that use its platform, but Amazon is comfortable with taking minor or no profit. Why? At this point, Amazon cares more about its *installed base of its users,* because Amazon wants to accrue as many customers as possible to benefit from network effects and to lock out competing retail platforms.

Consumers have also benefited from Amazon's acquisition of Whole Foods. Even at the high end, the grocery industry has thin margins. Before Amazon acquired it, Whole Foods had been under stockholder pressure to *increase* margins by lowering *costs* for better shareholder returns. Now Whole Foods under Amazon has become the grocery industry's worst nightmare: It can deliver negative margins, but stockholders still applaud. Even if Amazon had no plans to reap synergies between its in-store and online tactics, Whole Foods has now become supercompetitive with its ability to lower prices.[53] Indeed, on its first day after closing the acquisition of Whole Foods, Amazon dropped prices at its new grocery chain by more than 30% on some 100 grocery staples.

In this case, Amazon's customers are capturing the value that Amazon is creating. Following the mindset of Amazon founder Jeff Bezos, Andy Jassy, Amazon's CEO since 2021, is focused on long-term performance rather than short-term profitability. Amazon's investors don't seem to mind the company's long-term orientation, because Amazon's market cap reached almost $2 trillion (in 2021), making it one of the most valuable companies on the planet. Again, future expectations of growth and the potential of intangible assets explain the high stock market valuation.

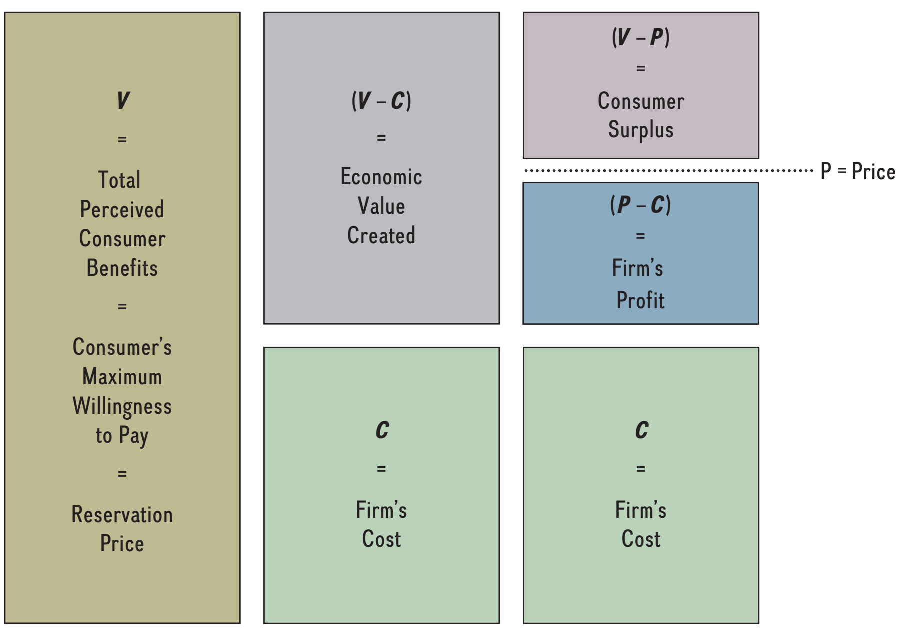
Competitive Advantage and Economic Value Created. Exhibit 5.8 illustrates how the components of economic value creation fit together conceptually. On the left side of the exhibit, V represents the total perceived consumer benefits, as captured in the consumer's maximum willingness to pay. In the lower part of the center bar, C is the cost to produce the product or service (the unit cost). It follows that the difference between the consumers' maximum willingness to pay and the firm's cost ($V - C$) is the economic value created. The price of the product or service (P) is indicated by the dashed line. The economic value created ($V - C$), as shown in Exhibit 5.8, is split between producer and consumer: ($V - P$) is the value the consumer captures *(consumer surplus),* and ($P - C$) is the value the producer captures *(producer surplus* or *profit).*

Competitive advantage goes to the firm that achieves the largest economic value created, which is the difference between V, the consumer's willingness to pay, and C, the cost to produce the good or service. The reason is that a large difference between V and C gives the firm two distinct pricing options: (1) It can charge higher prices to reflect the higher value and thus increase its profitability, or (2) it can charge the same price as competitors and thus gain market share. The strategic objective is to maximize $V - C$, or the economic value created.

Applying the notion of *economic value creation* also has direct implications for firm financial performance. Revenues are a function of the value created for consumers and the price

EXHIBIT 5.8

Competitive Advantage and Economic Value Created: The Role of Value, Cost, and Price



of the good or service, which together determine the volume of goods sold. In this perspective, profit (Π) is defined as total revenues (TR) minus total costs (TC):

$$\Pi = TR - TC, \text{ where } TR = P \times Q, \text{ or } \textit{price} \text{ times } \textit{quantity sold}$$

Total costs include both fixed and variable costs. *Fixed costs* are independent of consumer demand—for example, the cost of capital to build computer manufacturing plants or an online retail presence to take direct orders. *Variable costs* change with the level of consumer demand—for instance, components such as different types of display screens, microprocessors, hard drives, and keyboards.

Rather than merely relying on historical costs (a limitation of taking the perspective of *accounting profitability*, introduced earlier), in the *economic value creation* perspective *all costs,* including *opportunity costs,* must be considered. **Opportunity costs** capture the value of the best forgone alternative use of the resources employed.

opportunity costs The value of the best forgone alternative use of the resources employed.

Entrepreneurs, for example, face two types of opportunity costs: (1) forgone wages they could be earning if they were employed elsewhere and (2) the cost of capital they invested in their business, which could instead be invested in, say, the stock market or U.S. Treasury bonds.

Let's consider a hypothetical example. At the end of the year, the entrepreneurs consider their business over the last 12 months. They made an *accounting profit* of \$90,000, calculated as total revenues minus expenses, which include all historical costs but not opportunity costs. But they also realize they have forgone \$70,000 in salary they could have earned as an employee at another firm. In addition, they know that they could have earned \$30,000 in interest if they had bought U.S. Treasury bills with a 4% return instead of investing \$750,000 in their business. The opportunity cost of being an entrepreneur was \$100,000 (\$70,000 + \$30,000). Therefore, when considering all costs, including opportunity costs, they actually experienced an economic loss of \$10,000 (\$100,000 – \$90,000). When evaluating their future options, they should stay in business only if they value their independence as an entrepreneur more than \$10,000 per year, or if they think business will be better next year.

LIMITATIONS OF ECONOMIC VALUE CREATION. The economic value creation perspective gives us one useful way to assess competitive advantage. This approach is conceptually quite powerful, and it lies at the center of many strategic management frameworks such as the generic business strategies (which we discuss in the next chapter). However, it falls somewhat short when managers are called upon to operationalize competitive advantage. When the need for "hard numbers" arises, managers and analysts frequently rely on firm financials such as *accounting profitability* or *shareholder value creation* to measure firm performance. The economic value creation framework also has the following limitations:

- *Determining the value of a good in the eyes of consumers is not a simple task.* One way to tackle this problem is to look at consumers' purchasing habits for their revealed preferences, which indicate how much each consumer is willing to pay for a product or service. In the earlier example, the value (V) the consumer placed on the laptop—the highest price they were willing to pay, or the reservation price—was \$1,200. If the firm is able to charge the reservation price ($P = \$1{,}200$), it captures all the economic value created ($V - C = \$800$) as producer surplus or profit ($P - C = \$800$).
- *The value of a good in the eyes of consumers changes based on income, preferences, time, and other factors.* If your income is high, you are likely to place a higher value on some goods (e.g., business-class air travel) and a lower value on other goods (e.g., Greyhound bus travel). In regard to preferences, you may place a higher value on a ticket for a

Beyoncé concert than on one for the New York Philharmonic (or vice versa). As an example of time value, you place a higher value on an airline ticket that will get you to an important business meeting tomorrow than on one for a planned trip to take place eight weeks from now.

- *To measure firm-level competitive advantage, we must estimate the economic value created for all products and services offered by the firm.* This estimation may be a relatively easy task if the firm offers only a few products or services. It is much more complicated for diversified firms such as Amazon or Siemens (an engineering company) that offer hundreds or even thousands of different products and services across many industries and geographies. Although the performance of individual strategic business units (SBUs) can be assessed along the dimensions described here, it is more difficult to make this assessment at the corporate level (more on this in our discussion of diversification strategy in Chapter 8).

balanced scorecard Strategy implementation tool that harnesses multiple internal and external performance metrics in order to balance financial and strategic goals.

We've now completed our consideration of the three standard dimensions for measuring competitive advantage—accounting profitability, shareholder value, and economic value. Although each provides unique insights for assessing competitive advantage, all of them are more or less one-dimensional metrics. Focusing on just one performance metric when assessing competitive advantage can lead to significant problems, because each metric has its shortcomings, as explained earlier. We now turn to two more conceptual and qualitative frameworks—the balanced scorecard and the triple bottom line—that attempt to provide a more holistic perspective on firm performance.

LO 5-5

Apply a balanced scorecard to assess and evaluate competitive advantage.

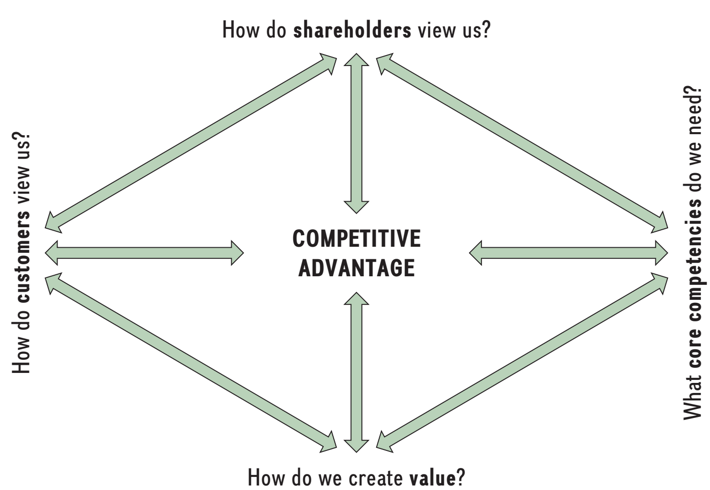
THE BALANCED SCORECARD

Just as airplane pilots rely on a number of instruments to provide constant information about key variables—such as altitude, airspeed, fuel, position of other aircraft in the vicinity, and destination—to ensure a safe flight, so should strategic leaders rely on multiple yardsticks to more accurately assess company performance in an integrative way. The **balanced scorecard** is a framework to help managers achieve their strategic objectives more effectively.[54] This approach harnesses multiple internal and external performance metrics in order to balance financial goals and strategic goals.

Exhibit 5.9 depicts the balanced-scorecard framework. Strategic leaders using the balanced scorecard develop appropriate metrics to assess strategic objectives by answering four

EXHIBIT 5.9

Balanced-Scorecard Approach to Creating and Sustaining Competitive Advantage



key questions.[55] Brainstorming answers to these questions ideally results in measures that give managers a quick and comprehensive view of the firm's current state. The four key questions are:

1. *How do customers view us?* The customer's perspective concerning the company's products and services links directly to its revenues and profits. Consumers decide their reservation price for a product or service based on how they view it. If customers view the company's offering favorably, they are willing to pay more for it, enhancing its competitive advantage (assuming production costs are well below the asking price). Managers track customer perception to identify areas for improvement, with a focus on speed, quality, service, and cost. In the air-express industry, for example, managers learned from their customers that many don't really need next-day delivery for most of their documents and packages; rather what they really cared about was the ability to track the shipments. This discovery led to the development of steeply discounted second-day delivery by UPS and FedEx, combined with sophisticated real-time online tracking tools.
2. *How do we create value?* Answering this question challenges managers to develop strategic objectives that ensure future competitiveness, innovation, and organizational learning. The answer focuses on the business processes and structures that allow a firm to create economic value. One useful metric is the percentage of revenues obtained from new product introductions. For example, 3M requires that 30% of revenues must come from products introduced within the past four years.[56] A second metric, aimed at assessing a firm's external learning and collaboration capability, is to stipulate that a certain percentage of new products must originate from outside the firm's boundaries.[57] Through its Connect + Develop program, the consumer products company Procter & Gamble has raised the percentage of new products that originated (at least partly) from outside P&G to 35%, up from 15%.[58]
3. *What core competencies do we need?* This question focuses strategic leaders to identify the internal core competencies needed to achieve their objectives and the accompanying business processes that support, hone, and leverage those competencies. Honda's core competency is designing and manufacturing small but powerful and highly reliable engines. Its business model is to find places to put its engines. Beginning with motorcycles in 1948, Honda nurtured this core competency over many decades and is leveraging it to reach stretch goals in the design, development, and manufacture of small airplanes. Today, consumers still value reliable, gas-powered engines made by Honda. If consumers start to value electric motors more because of zero emissions, lower maintenance costs, and higher performance metrics, among other possible reasons, the value of Honda's engine competency will decrease. If this happens, then Tesla's core competency in designing and building high-powered battery packs and electric drivetrains will become more valuable. In turn, Tesla (featured in ChapterCase 1) might then be able to leverage this core competency into a strong strategic position in the broad automotive and mobility industry.
4. *How do shareholders view us?* The final perspective in the balanced scorecard is the shareholders' view of financial performance (as discussed earlier). Some of the measures in this area rely on accounting data such as cash flow, operating income, *ROIC, ROE,* and, of course, total returns to shareholders. Understanding the shareholders' view of value creation leads managers to a more future-oriented evaluation.

By relying on both an internal and an external view of the firm, the balanced scorecard combines the strengths provided by the individual approaches to assessing competitive advantage discussed earlier: accounting profitability, shareholder value creation, and economic value creation.

ADVANTAGES OF THE BALANCED SCORECARD. The balanced-scorecard approach is popular in managerial practice because it has several advantages. Specifically, the balanced scorecard allows strategic leaders to:

- Communicate and link the strategic vision to responsible parties within the organization.
- Translate the vision into measurable operational goals.
- Design and plan business processes.
- Implement feedback and organizational learning to modify and adapt strategic goals when necessary.

The balanced scorecard can accommodate both short-term and long-term performance metrics. It provides a concise report that tracks chosen metrics and measures and compares them to target values. This approach allows strategic leaders to assess past performance, identify areas for improvement, and position the company for future growth. Including a broader perspective than financials allows managers and executives a more balanced view of organizational performance—hence its name. In a sense, the balanced scorecard is a broad diagnostic tool. It complements the common financial metrics with operational measures on customer satisfaction, internal processes, and the company's innovation and improvement activities.

As an example of how to implement the balanced-scorecard approach, let's discuss FMC Corp., a chemical manufacturer employing some 5,000 people in different SBUs and earning over $3 billion in annual revenues.[59] To achieve its vision of becoming "the customer's most valued supplier," FMC's strategic leaders initially had focused solely on financial metrics, such as return on invested capital (ROIC), as performance measures. FMC is a multibusiness corporation with several standalone profit-and-loss strategic business units; its overall performance was the result of both overperforming and underperforming units. FMC's managers had tried several approaches to enhance performance, but those approaches were ineffective. Perhaps even more significant, short-term thinking by general managers was a major obstacle in FMC's attempt to implement an effective business strategy.

In an attempt to improve its performance, FMC's CEO decided to adopt a balanced-scorecard approach. This approach enabled the managers to view FMC's challenges and shortcomings from a holistic, company perspective, which was especially helpful to the general managers of different business units. In particular, the balanced scorecard allowed general managers to focus on market position, customer service, and product introductions that could generate long-term value. Using the framework depicted in Exhibit 5.9, strategic leaders had to answer tough follow-up questions such as: How do we become the customer's most valued supplier, and how can my division create this value for the customer? How do we become more externally focused? What are my division's core competencies and contributions to the company goals? What are my division's weaknesses?

Implementing a balanced scorecard allowed FMC's managers to align their different perspectives to create a more focused corporation overall. General managers now review progress along the chosen metrics every month, and corporate executives do so on a quarterly basis. Implementing a balanced-scorecard approach is not a onetime effort. Rather, it requires continuous tracking of metrics and updating of strategic objectives, if needed. It is an ongoing process, feeding performance back into the strategy process to assess its effectiveness (see Chapter 2).

DISADVANTAGES OF THE BALANCED SCORECARD. Though widely implemented by many businesses, the balanced scorecard is not without its critics.[60] It is important to note that the balanced scorecard is a tool for strategy *implementation,* not for strategy *formulation.*

It is up to a firm's leaders to formulate a strategy that will enhance the firm's chances of gaining and sustaining a competitive advantage. In addition, the balanced-scorecard approach provides only limited guidance about which metrics to choose. Different situations call for different metrics. All three of the approaches to measuring competitive advantage—accounting profitability, shareholder value creation, and economic value creation—in addition to other quantitative and qualitative measures can be helpful when using a balanced-scorecard approach.

When implementing a balanced scorecard, managers need to be aware that a failure to achieve competitive advantage is not so much a reflection of a poor framework but instead a strategic failure. The balanced scorecard is only as good as the skills of the managers who use it. Those managers must first devise a strategy that enhances the odds of achieving competitive advantage. Second, they must accurately translate the strategy into objectives that they can measure and manage within the balanced-scorecard approach.[61]

Once the metrics have been selected, the balanced scorecard tracks chosen metrics and measures and compares them to target values. It does not, however, provide much insight into how metrics that deviate from the set goals can be put back on track.[62]

THE TRIPLE BOTTOM LINE

LO 5-6

Apply a triple bottom line to assess and evaluate competitive advantage.

Today, strategic leaders are frequently asked to maintain and improve not only the firm's economic performance but also its social and ecological performance. When serving as CEO of PepsiCo, Indra Nooyi responded by declaring the company's vision to be *Performance with Purpose* defined by goals in the social dimension (*human sustainability* to combat obesity by making its products healthier, and the *whole person at work* to achieve work/life balance) and the ecological dimension (*environmental sustainability* in regard to clean water, energy, recycling, and so on), in addition to firm financial performance. Strategy Highlight 5.2 discusses Indra Nooyi's strategic initiative in detail.

Strategy Highlight **5.2**

PepsiCo's Indra Nooyi: Performance with Purpose

"Performance with Purpose is not how we spend the money we make; it's how we make the money," said Indra Nooyi while PepsiCo CEO.[63]

In the 120-year history of PepsiCo, Indra Nooyi was the first, and so far only, female chief executive officer to run the multinational food, snack, and beverage company. As CEO of PepsiCo from 2006 to 2018, Nooyi was one of the world's most powerful business leaders. A native of Chennai, India, Nooyi holds multiple degrees: bachelor's degrees in physics, chemistry, and mathematics from Madras Christian College; an MBA from the Indian Institute of Management; and a master's degree in public and private management from Yale University. Before joining PepsiCo in 1994, Nooyi worked for Johnson & Johnson, Boston Consulting Group, Motorola, and ABB. For the past several years, she has been a regular in the *Forbes* list of the Top 20 most powerful women. However, she is not your typical Fortune 500 CEO: She is well known for walking around the office barefoot and singing—a remnant from her days in an all-girls rock band in high school.

Indra Nooyi, chief executive officer of PepsiCo from 2006 to 2018, captured her strategic leadership with the mantra "Performance with Purpose."
Monica Schipper/Contributor/Getty Images

Nooyi shook things up at PepsiCo, a company with roughly $65 billion in annual reve-

(Continued)

nues in 2018, over $160 billion in stock market valuation, close to 270,000 employees worldwide, and business interests in more than 200 countries. She took the lead role in spinning off Taco Bell, Pizza Hut, and KFC in 1997. Later, she masterminded the acquisitions of Tropicana in 1998 and Quaker Oats, including Gatorade, in 2001. When she became CEO in 2006, Nooyi declared PepsiCo's vision to be Performance with Purpose:

> Performance with Purpose means delivering sustainable growth by investing in a healthier future for people and our planet.... We will continue to build a portfolio of enjoyable and healthier foods and beverages, find innovative ways to reduce the use of energy, water, and packaging, and provide a great workplace for our associates.... Because a healthier future for all people and our planet means a more successful future for PepsiCo. This is our promise.[64]

Nooyi's Performance with Purpose has three dimensions:

1. **Human sustainability.** PepsiCo's strategic intent is to make its product portfolio healthier to combat obesity by reducing sugar, sodium, and saturated fat content in certain key brands. It wants to reduce the salt and fat in its "fun foods" such as Frito-Lay and Doritos brands, and to include healthy choices such as Quaker Oats products and Tropicana fruit juices in its lineup. Nooyi was convinced that if food and beverage companies did not make their products healthier, they would face stricter regulation and lawsuits, as tobacco companies did. Nooyi's goal was to increase PepsiCo's revenues for nutritious foods substantially, as detailed in her 2025 Performance with Purpose agenda.
2. **Environmental sustainability.** PepsiCo instituted various initiatives to ensure that its operations don't harm the natural environment. The company has programs in place to reduce water and energy use, increase recycling, and promote sustainable agriculture. The goal is to transform PepsiCo into a company with a net-zero impact on the environment. Nooyi believes that young people will not patronize or want to work for a company that does not have a strategy that also addresses ecological sustainability.
3. **The whole person at work.** PepsiCo wants to create a corporate culture in which employees do not "just make a living, but also have a life," Nooyi said.[65] She argued that this type of culture allows employees to unleash both their mental energies and their emotional energies.

PepsiCo's vision of Performance with Purpose acknowledges the importance of the corporate social responsibility and stakeholder strategy. Nooyi was convinced that companies have a duty to society to "do better by doing better."[66] She subscribed to a triple-bottom-line approach to competitive advantage, which considers not only economic but also social and environmental performance. As CEO, Nooyi declared that the true profits of an enterprise are not just "revenues minus costs" but rather "revenues minus costs minus costs to society." Problems such as pollution or the increased cost of health care to combat obesity impose costs on society that companies typically do not bear (externalities). As Nooyi saw it, the time when corporations can just pass on their externalities to society is nearing an end.

Although PepsiCo's revenues have remained more or less flat over the past few years, investors see significant future growth potential. Over the five years between 2013 and 2018, PepsiCo under Nooyi outperformed Coca-Cola Co. by a relatively wide margin. During this period, PepsiCo's normalized stock appreciation was 66%, while Coca-Cola's was 25%; thus, PepsiCo outperformed archrival Coca-Cola by 41 percentage points. With better than expected financial results in her last five years as CEO, Nooyi stands vindicated after years of criticism. Despite opposition, she stuck by her strategic mantra for PepsiCo—Performance with Purpose.[67]

Being proactive along noneconomic dimensions can make good business sense. For example, in anticipation of coming industry requirements for "extended producer responsibility," which requires the seller of a product to take it back for recycling at the end of its life, the German carmaker BMW was proactive. It not only lined up the leading car-recycling companies but also started to redesign its cars using a modular approach. The modular parts allow for quick car disassembly and reuse of components in the after-sales market (so-called refurbished or rebuilt auto parts).[68]

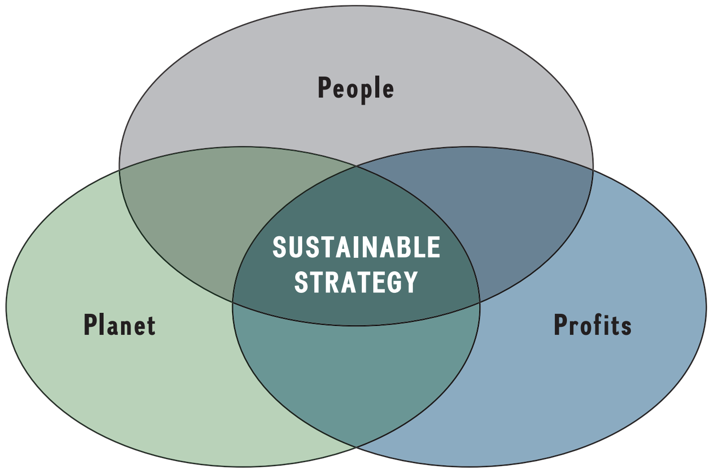


EXHIBIT 5.10

Sustainable Strategy: A Focus on the Triple Bottom Line

The simultaneous pursuit of performance along social, economic, and ecological dimensions provides a basis for a triple-bottom-line strategy.

Three dimensions—*economic, social, and ecological*—make up the **triple bottom line**, which is fundamental to a sustainable strategy. These three dimensions are also called the three Ps: *profits, people,* and *planet*:

triple bottom line Combination of economic, social, and ecological concerns—or profits, people, and planet—that can lead to a sustainable strategy.

- **Profits.** The *economic dimension* captures the necessity of businesses to be profitable to survive.
- **People.** The *social dimension* emphasizes the people aspect (such as PepsiCo's initiative of the *whole person at work).*
- **Planet.** The *ecological dimension* emphasizes the relationship between business and the natural environment.

As the intersection of the three ovals (*profits, people,* and *planet*) in Exhibit 5.10 suggests, achieving positive results in all three areas can lead to a **sustainable strategy**, which is a strategy that can be pursued over time without detrimental effects on people or the planet.

sustainable strategy A strategy along the economic, social, and ecological dimensions that can be pursued over time without detrimental effects on people or the planet.

Like the balanced scorecard, the triple bottom line takes a more integrative and holistic view in assessing a company's performance.[69] Using a triple-bottom-line approach, strategic leaders audit their company's fulfillment of its social and ecological obligations to stakeholders such as employees, customers, suppliers, and communities as conscientiously as they track its financial performance.[70] In this sense, the triple-bottom-line framework is related to *stakeholder capitalism,* an approach to understanding a firm as embedded in a network of internal and external constituencies that each make contributions and expect consideration in return. (See the discussion earlier in this chapter and in Chapter 1.)

5.3 Implications for Strategic Leaders

An effective strategic leader needs to understand the strengths and weaknesses of shareholder capitalism and stakeholder capitalism. Shareholder capitalism is increasingly under attack as firms encounter stronger demands to address environmental, social, and governance (ESG) issues. Over the last two decades, a shift has taken place from corporate social responsibility (CSR)—that is, doing good as an afterthought after having done well—to creating shared value (CSV), where ESG principles are baked into the strategy formulation from the start, beginning with a purpose-driven mission.

Strategy is about gaining and sustaining a competitive advantage. We studied how to measure and assess competitive advantage using three traditional approaches: accounting profitability, shareholder value creation, and economic value creation. We then introduced

EXHIBIT 5.11 How to Measure and Assess Competitive Advantage

Competitive advantage is reflected in superior firm performance.
• Competitive advantage is assessed *relative* to a benchmark, either competitors or the industry average.
• Competitive advantage is a multifaceted concept.
• Competitive advantage can be measured by accounting profit, shareholder value, or economic value.
• The balanced-scorecard approach harnesses multiple internal and external performance dimensions to balance a firm's financial and strategic goals.
• More recently, competitive advantage has been linked to a firm's triple bottom line, the ability to maintain performance in the economic, social, and ecological contexts (profits, people, planet) to achieve a sustainable strategy.

two conceptual frameworks that help us understand competitive advantage in a more holistic fashion: the balanced scorecard and the triple bottom line.

Exhibit 5.11 summarizes how to measure and assess competitive advantage.

Several implications for strategic leaders emerge from our discussion of competitive advantage and firm performance:

- No *best* strategy exists—only *better* ones (better in comparison with others). We must interpret any performance metric relative to those of competitors and the industry average. Actual performance can be judged only in comparison to other contenders in the field or the industry average, not on an absolute basis.
- The goal of strategic management is to integrate and align each business function and activity to obtain superior performance at the business unit and corporate levels. Therefore, competitive advantage is best measured by criteria that reflect *overall business unit performance* rather than the performance of specific departments. For example, although the functional managers in the marketing department may (and should) care greatly about the success or failure of their recent ad campaign, *general* managers care most about the performance implications of the ad campaign at the business-unit level for which they have profit-and-loss responsibility. Metrics that aggregate upward and reflect overall firm and corporate performance are most useful to assess the effectiveness of a firm's competitive strategy.
- Both *quantitative and qualitative* performance dimensions matter in judging the effectiveness of a firm's strategy. Those who focus on only one metric risk being blindsided by poor performance on another. Strategic leaders need to rely on a more holistic perspective when assessing firm performance, measuring different dimensions over different time periods.

This concludes our discussion of competitive advantage and firm performance, and it completes Part 1—strategy analysis—of the AFI framework. In Part 2, we turn our attention to the next step in the AFI framework—strategy formulation. In Chapters 6 and 7, we focus on business strategy: How should the firm compete (cost leadership, differentiation, or value innovation)? In Chapters 8 and 9, we study corporate strategy: Where should the firm compete (industry, markets, and geography)? Chapter 10 looks at global strategy: How and where (locally, regionally, nationally, and/or internationally) should the firm compete around the world?

CHAPTERCASE 5 Part II

Over time, Patagonia has morphed into a diversified conglomerate active in many different areas. The holding company overseeing Patagonia's various ventures is Patagonia Works, a certified B Corporation. Patagonia Works includes the well-known Patagonia, Inc. (apparel), Patagonia Provisions (food), Patagonia Media (books, films, and multimedia projects), and other investments. Patagonia Media and Chouinard's angel investments in ESG startups aim to nurture young ESG companies and teach them Patagonia's philosophy. According to Chouinard, his company "exists to challenge conventional wisdom and present a new style of responsible business."[71]

Like many iconic founders, Yvon Chouinard created Patagonia to reflect his convictions and unorthodox approach to business. At age 18, he started making pitons to have better climbing equipment. A self-described "dirtbag," Chouinard began selling pitons to avoid working and to spend as much time as possible in the great outdoors. As his equipment business took off, Chouinard became a reluctant businessperson. To manage his employees, Chouinard uses his "MBA skills." In using this term, he is making fun of business school education because, for him, the MBA theory of management means "management by absence." He spends months, often most of the year, away from the company pursuing extreme outdoor expeditions in far-flung places such as Tibet to test equipment and develop new ideas. To this day, Chouinard does not own a computer (he has never used one). He does not own a cell phone, either. If employees want to talk to him, they must leave a note on the Etch A Sketch drawing toy that sits on his office desk.

As many other strong-willed founders have done, Chouinard set Patagonia's initial strategy, structure, and culture and transformed his vision of what a business could be ("to save our home planet") into reality. He defined and shaped Patagonia's unique culture through this type of founder imprinting. The culture that founders initially imprint is reinforced by their strong preference to recruit, retain, and promote employees who subscribe to the same values. In turn, more people with similar values are attracted to that organization. In his business memoir *Let My People Go Surfing*, Chouinard explains how he hired his climbing buddies as employees and says that they became like family. People at Patagonia have complete autonomy regarding when and how to work. They can come and go as long as projects get done.

Ryan Gellert, Patagonia's CEO since 2020, is continuing with its purpose-driven mission to use business to combat climate change. As a private company, Patagonia has always had a significant public profile, but Gellert is leaning into the company's activism by calling out other companies that do not combat climate change, stating that there is "a special place in hell"[72] for businesspeople who do not join in addressing the environmental challenge.

Questions

1. Strong founder imprinting, like that at Patagonia, can result in cohesive groups of employees holding similar beliefs. As a result, the corporate culture becomes more potent and unique. Yet, strong cultures can have a negative side effect: groupthink, the situation in which opinions coalesce around a leader and individuals do not critically evaluate and challenge that leader's views and assumptions. Cohesive, non-diverse groups are highly susceptible to groupthink, which can lead to poor decision making with potentially harmful consequences. Is groupthink a risk to Patagonia? Why or why not?
2. Yvon Chouinard has had a tremendous influence on Patagonia over decades, initially by setting its strategy and culture. Chouinard was born in 1938. Many companies such as Walmart, Microsoft, Apple, and Dell experienced great difficulty after their iconic founders departed. Do you think Patagonia may face a similar crisis when Chouinard is no longer involved with Patagonia? Why or why not? Explain.
3. Strategy is as much deciding what to do as it is about choosing what not to do. Chouinard decided to keep Patagonia private for almost 50 years, and then to donate the company to a trust. Being a private company limits growth (as mentioned, Nike is some 50 times larger than Patagonia). Should Patagonia have gone public to maximize the impact of its mission "to save our planet"? In other words, could a larger Patagonia have made a more significant difference in achieving its purpose-driven mission? Would a publicly traded Patagonia company have allowed more people to buy into and support the company's vision by purchasing the company's shares? What are the pros and cons of Patagonia being public? Which would you support—remaining private (as part of the trust set up by Yvon Chouinard) or being public? Explain.
4. On a more philosophical note, do you think businesses should pursue ESG goals such as combating climate change? Or should companies attempt to be as efficient as possible in providing products and services, focus on their core business, and return profits to owners who then can pursue ESG goals independently? One criticism levied against ESG activism is that many of the problems that companies attempt to solve should be

left in the public domain and addressed through the political process because they concern social and environmental policy issues. Critics argue that companies do not have a legitimate democratic mandate and that capitalism may show up in areas of social and public life where it has no place.[73] Other criticisms focus on the fact that businesses are not efficient in solving problems outside their expertise and that many companies pursue "greenwashing"[74] as a public relations technique. What do you think? Explain.

TAKE-AWAY CONCEPTS

In this chapter, we compared and contrasted shareholder capitalism and stakeholder capitalism. We emphasized the shift from corporate social responsibility (CSR) to creating shared value (CSV) in the last two decades.

We then studied three traditional approaches for assessing and measuring firm performance and competitive advantage, as well as two conceptual frameworks designed to provide a more holistic and qualitative perspective on firm performance.

LO 5-1 / Compare and contrast shareholder capitalism and stakeholder capitalism while highlighting the strengths and weaknesses of each.

- Shareholder capitalism is an economic system in which the investors who own shares, as the providers of risk capital, are the legal owners of public companies.
- As legal owners, shareholders therefore have the most legitimate and dominant claim on profits, among all stakeholders.
- The idea that companies that focus on maximizing profits also increase societal welfare rests on three fundamental assumptions: (1) free markets are perfectly efficient, (2) individual freedom should be the primary goal of a society, and (3) managers are agents of shareholders.
- The public stock company enjoys four characteristics that make it an attractive corporate form: (1) limited liability for investors, (2) transferability of investor ownership, (3) legal personality, and (4) separation of legal ownership and management control.
- Over the past two decades, shareholder capitalism has come under fire due to a number of crises.
- Stakeholder capitalism is a management approach in which a company must benefit all its stakeholders, including shareholders, employees, customers, and the communities in which it operates.
- Frequently, the interests of various stakeholders such as shareholders and employees stand in conflict.

LO 5-2 / Explain the shift in emphasis from corporate social responsibility (CSR) to creating shared value (CSV).

- Three defining problems of our time led to the rise of stakeholder capitalism: (1) climate change, (2) economic inequality, and (3) beleaguered institutions.
- The shared value creation framework proposes that strategic leaders maintain a dual focus on shareholder value creation and value creation for society.
- In the corporate social responsibility perspective (CSR), firms that do well ("make profits") should do good by engaging in corporate philanthropy. Providing societal benefits is an afterthought ("a responsibility"), assuming the firm can afford it.
- In the creating shared value (CSV) framework, the question of how to create value is focused from the beginning on both economic and societal benefits.
- CSR is externally focused to address pressures that arise, such as the issue of child labor in the supply chain, while CSV is internally focused and derives from a deeper purpose.

LO 5-3 / Appraise accounting metrics and shareholder value creation as measures of competitive advantage.

- To measure competitive advantage, we must be able to (1) accurately assess firm performance, and (2) compare and benchmark the firm's performance to other competitors in the same industry or the industry average.

- To measure accounting profitability, we use standard metrics derived from publicly available accounting data.
- Commonly used profitability metrics in strategic management are return on assets (ROA), return on equity (ROE), return on invested capital (ROIC), and return on revenue (ROR). See the key financial ratios in five tables in "How to Conduct a Case Analysis."
- Accounting data are historical and thus backward-looking. They focus mainly on tangible assets and do not consider intangibles that are hard or impossible to measure and quantify, such as innovation competency.
- Investors are primarily interested in total return to shareholders, which includes stock price appreciation plus dividends received over a specific period.
- Total return to shareholders is an external performance metric. It indicates how the market views all publicly available information about a firm's past, current state, and expected future performance.
- Applying a shareholders' perspective, key metrics to measure and assess competitive advantage are the return on (risk) capital and market capitalization.
- Stock prices can be highly volatile, which makes it difficult to assess firm performance. Overall macroeconomic factors have a direct bearing on stock prices. Also, stock prices frequently reflect the psychological mood of the investors, which can at times be irrational.
- Shareholder value creation is a better measure of competitive advantage over the *long term* due to the "noise" introduced by market volatility, external factors, and investor sentiment.

LO 5-4 / Link economic value creation to different sources of competitive advantage.

- The relationship between economic value creation and competitive advantage is fundamental in strategic management. It provides the foundation upon which to formulate a firm's competitive strategy of cost leadership or differentiation.
- Three components are critical to evaluating any good or service: value (V), price (P), and cost (C). Cost includes opportunity costs.
- Economic value created is the difference between a buyer's willingness to pay for a good or service and the firm's cost to produce it ($V - C$).
- A firm has a competitive advantage when it is able to create more economic value than its rivals. The source of competitive advantage can stem from higher perceived value creation (assuming equal cost) or lower cost (assuming equal value creation).

LO 5-5 / Apply a balanced scorecard to assess and evaluate competitive advantage.

- The balanced-scorecard approach attempts to provide a more integrative view of competitive advantage.
- Its goal is to harness multiple internal and external performance dimensions to balance financial and strategic goals.
- Managers develop strategic objectives for the balanced scorecard by answering four key questions: (1) How do customers view us? (2) How do we create value? (3) What core competencies do we need? (4) How do shareholders view us?

LO 5-6 / Apply a triple bottom line to assess and evaluate competitive advantage.

- Noneconomic factors can have a significant impact on a firm's financial performance, reputation, and customer goodwill.
- Managers are frequently asked to maintain and improve not only the firm's economic performance but also its social and ecological performance.
- Three dimensions—economic, social, and ecological, also known as *profits, people,* and *planet*—make up the triple bottom line. Achieving positive results in all three areas can lead to a sustainable strategy that can endure over time.
- A sustainable strategy produces not only positive financial results but also positive results along the social and ecological dimensions.
- Using a triple-bottom-line approach, managers audit their company's fulfillment of its social and ecological obligations to stakeholders (such as employees, customers, suppliers, and communities) as seriously as they track its financial performance.
- The triple-bottom-line framework is related to stakeholder theory, an approach to understanding a firm as embedded in a network of internal and external constituencies that each make contributions and expect consideration in return.

KEY TERMS

Balanced scorecard *(p. 192)*
Consumer surplus *(p. 188)*
Economic value created *(p. 186)*
Efficient-market hypothesis *(p. 184)*
Environmental, social, and governance (ESG) criteria *(p. 171)*
Market capitalization *(p. 184)*
Opportunity costs *(p. 191)*
Producer surplus *(p. 188)*
Profit *(p. 188)*
Reservation price *(p. 186)*
Risk capital *(p. 183)*
Shareholders *(p. 183)*
Shared value creation framework *(p. 177)*
Shareholder capitalism *(p. 172)*
Sustainable strategy *(p. 197)*
Total return to shareholders *(p. 184)*
Triple bottom line *(p. 197)*
Tragedy of the commons *(p. 176)*
Value *(p. 188)*

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PART

2

Formulation

The AFI Strategy Framework

Part 1: Analysis

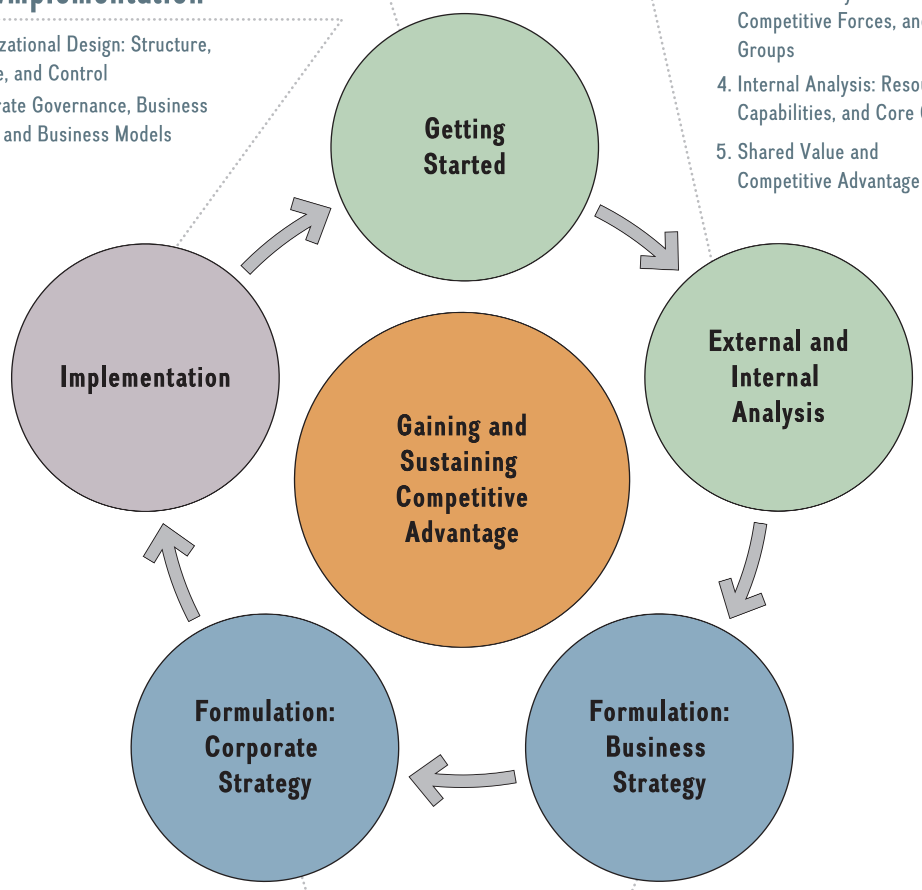
1. What Is Strategy?
2. Strategic Leadership: Managing the Strategy Process

Part 1: Analysis

3. External Analysis: Industry Structure, Competitive Forces, and Strategic Groups
4. Internal Analysis: Resources, Capabilities, and Core Competencies
5. Shared Value and Competitive Advantage

Part 3: Implementation

11. Organizational Design: Structure, Culture, and Control
12. Corporate Governance, Business Ethics, and Business Models



Part 2: Formulation

8. Corporate Strategy: Vertical Integration and Diversification
9. Corporate Strategy: Strategic Alliances, Mergers, and Acquisitions
10. Global Strategy: Competing Around the World

Part 2: Formulation

6. Business Strategy: Differentiation, Cost Leadership, and Blue Oceans
7. Business Strategy: Innovation, Entrepreneurship, and Platforms

CHAPTER

6

Business Strategy: Differentiation, Cost Leadership, and Blue Oceans

Chapter Outline

Learning Objectives

LO 6-1 Define business-level strategy and describe how it determines a firm's strategic position.

LO 6-2 Examine the relationship between value drivers and differentiation strategy.

LO 6-3 Examine the relationship between cost drivers and cost-leadership strategy.

LO 6-4 Assess the benefits and risks of differentiation and cost-leadership strategies vis-à-vis the five forces that shape competition.

LO 6-5 Evaluate value and cost drivers that may allow a firm to pursue a blue ocean strategy.

LO 6-6 Assess the risks of a blue ocean strategy, and explain why it is difficult to succeed at value innovation.

JetBlue Airways: En Route to a New Blue Ocean?

JetBlue is the sixth-largest airline in the United States (in 2022), following the "big four" (American, Delta, Southwest, and United) and Alaska Airlines, which beat out JetBlue in acquiring Virgin America (in 2016). Recovering nicely post-pandemic, JetBlue offers more than 900 daily flights to over 100 destinations in the United States and over 25 countries. The New York-based airline employs 21,000 crew members and services 40 million customers annually.

When JetBlue took to the skies in 2000, founder David Neeleman set out to pursue a blue ocean competitive strategy, which combines differentiation and cost-leadership activities. To reconcile the inherent trade-offs in these two distinct strategic positions, it used value innovation. How did Neeleman implement this strategy, and where did his ideas come from?

In an attempt to differentiate its service offering, JetBlue provides its Mint luxury experience, which includes a lie-flat bed up to 6 feet 8 inches long, a high-resolution personal screen, and free in-flight high-speed Wi-Fi, on many domestic U.S. routes. Other U.S. competitors offer such amenities only on a few selected routes.

Carlos Yudica/123RF

At the age of 25, the young entrepreneur founded Morris Air, a charter air service that was later purchased by Southwest Airlines (SWA) in 1993. Morris Air was a low-fare airline that pioneered many cost-saving practices that later became standard in the industry, such as e-ticketing. After a stint as an airline executive for SWA, Neeleman went on to launch JetBlue. His strategy was to provide air travel at even lower costs than SWA. At the same time, he wanted to offer more and better service and amenities than those offered by such legacy carriers as American, Delta, and United. According to JetBlue's Customer Bill of Rights, its purpose-driven vision is to bring humanity back to air travel.

To implement a blue ocean strategy, JetBlue focused on lowering operating costs while driving up perceived customer value in its service offerings. Specifically, it copied and improved on many of SWA's cost-reducing activities. It used just one type of airplane (the Airbus A-320) to lower the costs of aircraft maintenance and pilot and crew training (but has since expanded its fleet). It also specialized in transcontinental flights connecting the East Coast (from its home base in New York) to the West Coast (e.g., Los Angeles). This point-to-point model focuses on directly connecting fewer but more highly trafficked city pairs, and it differs from American, Delta, and United's hub-and-spoke system, which connects many different locations via layovers at airport hubs. JetBlue's point-to-point model has allowed it to lower costs by flying longer distances and transporting more passengers per flight than SWA. As a consequence, JetBlue's cost per available seat-mile (an important performance metric in the airline industry) is one of the lowest in the United States.

To enhance its differential appeal, JetBlue drove up its perceived value by implementing its mantra: combining *high-touch*—to enhance the customer experience—and *high-tech*—to drive down costs. JetBlue also had a highly functional website for making reservations and planning other travel-related services. But because research showed that roughly one-third of customers prefer speaking to live reservation agents, it decided to add live agents. All of these agents were U.S.-based, work-from-home employees rather than outsourced workers, per the industry best practice.

To further enhance its value for customers, JetBlue added to its fleet high-end, 100-seat Embraer regional jets. Equipped with leather seats, free movie and television programming via DirecTV, and XM Satellite Radio, each Embraer jet is staffed with friendly and attentive on-board service attendants. Additional amenities included its Mint class, a luxury version of first-class travel featuring small private suites with lie-flat beds of up to 6 feet 8 inches long, a high-resolution personal viewing screen offering a large library of free and on-demand movies, live and rerun TV, and free in-flight high-speed Wi-Fi ("Fly-Fi"). JetBlue also offered personal check-in and early boarding, free bag check and priority bag retrieval after flight, and complimentary gourmet food and alcoholic beverages in flight.

In its early years, pursuing a blue ocean strategy by combining a cost-leadership position with a differentiation strategy resulted in a competitive advantage. JetBlue used value innovation to drive up perceived customer value while lowering operating costs. This approach can work when an airline is small and connects a few highly profitable city routes. However, it is quite difficult to implement because it involves simultaneous execution of cost-leadership and differentiation activities, which are two very distinct strategic positions. Pursuing them simultaneously results in trade-offs that work against each other. For instance, higher perceived customer value (e.g., providing leather seats and free Wi-Fi throughout the aircraft) comes with higher costs. These trade-offs eventually caught up with JetBlue.

Between 2007 and 2015, the airline faced several high-profile mishaps, including emergency landings and erratic pilot and crew behaviors. Following the "snowmageddon" (in 2007), when JetBlue was forced to cancel about 1,600 flights and passengers were stranded on full airplanes for up to nine hours on the tarmac, the board removed founder Neeleman as CEO and replaced him with David Barger, formerly JetBlue's chief operating officer. These public relations nightmares compounded the fundamental difficulty of resolving the need to limit costs while providing superior customer service and in-flight amenities. Ultimately, Barger was unable to overcome JetBlue's competitive disadvantage. By 2014, the airline was lagging the Dow Jones U.S. Airline Index by more than 115 percentage points.

JetBlue's board replaced Barger, appointing Robin Hayes as the new CEO (in 2015). Hayes, who had been with British Airways for almost 20 years, attempted to sharpen JetBlue's strategic profile, doubling down on its blue ocean strategy. He focused on lowering operating costs while increasing perceived value creation. To drive down costs, he decided to add more seats to each plane, reducing legroom in coach (now on par with the legacy carriers). In addition to identifying other cost-savings opportunities, mainly in aircraft maintenance and crew scheduling, Hayes expanded JetBlue's Mint class service to many more flights, providing a product that customers loved and some other airlines lacked. JetBlue also added to its fleet a new airplane, the Airbus A-321, which scores significantly higher in customer satisfaction surveys than the older A-320.

In an attempt to turn around JetBlue, CEO Hayes made some more aggressive moves. In 2020, JetBlue announced a strategic alliance with American Airlines to jointly market their flights at the three New York airports and in Boston, link their loyalty programs, and deepen cooperation on transcontinental flights. In 2021, the U.S. Department of Justice filed an antitrust suit challenging the JetBlue/American tie-up. In 2022, JetBlue agreed to buy ultra-low-cost carrier Spirit Airlines for $3.8 billion to thwart Frontier Airlines (also an ultra-low-cost carrier). Given the antitrust scrutiny that JetBlue is facing, it is not clear that the merger will be approved by the regulatory authorities.

Meanwhile, JetBlue's performance has gone from bad to worse. Pre-Covid-19 pandemic, in 2019, JetBlue ranked last in the annual WSJ survey of U.S. airlines in terms of delays. Post pandemic, in 2022, JetBlue ranked dead last in overall performance among all of the U.S. domestic airlines surveyed, based on objective data such as on-time arrival, tarmac and flight delays, canceled flights, involuntary bumping of passengers, mishandled bags, and numerous other customer complaints.[1]

Part II of this ChapterCase appears in Section 6.6.

The chaptercase illustrates how JetBlue ran into trouble by pursuing two different business strategies at the same time—a *cost-leadership* strategy focused on low cost and a *differentiation* strategy focused on delivering unique features and service. Although the idea of combining different business strategies seems appealing, it is quite difficult to execute a cost-leadership position and differentiation position concurrently. Pursuing them simultaneously results in trade-offs that work against each other. Providing higher perceived customer value tends to generate higher costs.

Strategic leaders need to avoid being *stuck in the middle* between distinct business strategies. In this situation, strategic leaders fail to carve out a clear *strategic position.* In their attempt to be everything to everybody, their firms end up being neither a low-cost leader nor a differentiator (thus the phrase *stuck in the middle*). This common strategic failure contributed to JetBlue's sustained competitive disadvantage over the past few years. A clear strategic position—either as differentiator *or* low-cost leader—is more likely to form the basis for competitive advantage. Although quite attractive at first glance, a *blue ocean strategy* is difficult to implement because of the trade-offs between the two distinct strategic positions (low-cost leadership and differentiation), unless the firm is successful in *value innovation* that allows it to reconcile these inherent trade-offs (discussed in detail later).

This chapter, the first in Part 2 on strategy *formulation,* takes a close look at business-level strategy, frequently called *competitive strategy.* It deals with *how* to compete for advantage. Based on the analysis of the external and internal environments (presented in Part 1), the second step in the *AFI Strategy Framework* is to formulate a business strategy that enhances the firm's chances of achieving a competitive advantage.

We begin our discussion of strategy formulation by defining *business-level strategy, strategic position,* and *generic business strategies.* We then look at two key generic business strategies: *differentiation* and *cost leadership.* We pay special attention to value and cost drivers that managers can use to carve out a clear strategic profile. Next, we relate the two business-level strategies to the external environment—in particular, to the five forces—to highlight their respective benefits and risks. We then examine *blue ocean strategy,* which uses *value innovation* to combine a differentiation position and a cost-leadership strategic position. We also look at changes in competitive positioning over time before concluding with practical *Implications for Strategic Leaders.*

6.1 Business-Level Strategy: How to Compete for Advantage

LO 6-1

Define business-level strategy and describe how it determines a firm's strategic position.

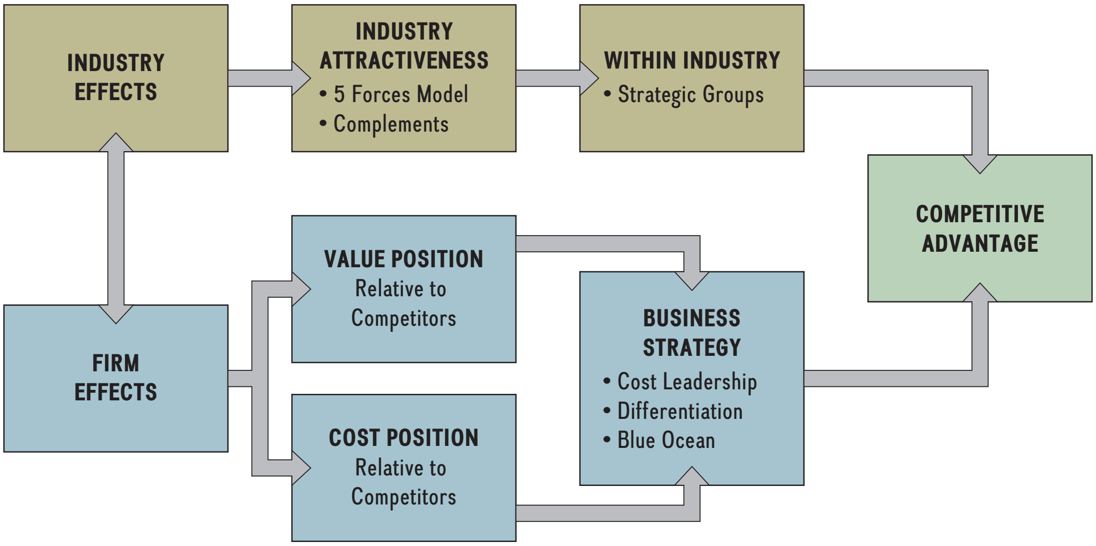
Business-level strategy details the goal-directed actions that managers take in their quest for competitive advantage when competing in a single product market.[2] It may involve a single product or a group of similar products that use the same distribution channel. It concerns the broad question, "How should we compete?" To formulate an appropriate business-level strategy, strategic leaders must answer the who, what, why, and how questions of competition:

- *Who* are the customer segments we will serve?
- *What* customer needs, wishes, and desires will we satisfy?
- *Why* do we want to satisfy them?
- *How* will we satisfy them?[3]

business-level strategy The goal-directed actions managers take in their quest for competitive advantage when competing in a single product market.

To formulate an effective business strategy, executives need to keep in mind that competitive advantage is determined jointly by *industry* effects and *firm* effects. As shown in Exhibit 6.1, one route to competitive advantage is shaped by *industry effects,* while a second route is determined by *firm effects.* Recall from Chapter 3 that an industry's profit potential can be assessed using the five forces framework plus the availability of complements. Managers need to be certain that the business strategy is aligned with the five forces that shape competition. They can evaluate performance differences among clusters of firms in the same industry by conducting a strategic-group analysis. The concepts introduced in Chapter 4 are key in understanding firm effects because they allow us to look inside firms and explain why they differ based on their resources, capabilities, and competencies. It is also important to note that industry and firm effects are not independent. Instead, they are *interdependent,* as shown by the two-pointed arrow connecting industry effects and firm effects in Exhibit 6.1. At the firm level, performance is determined by value and cost positions *relative* to competitors. This is the firm's *strategic position,* which we discuss next.

EXHIBIT 6.1 Industry and Firm Effects Jointly Determine Competitive Advantage



STRATEGIC POSITION

We noted in Chapter 5 that competitive advantage is based on the difference between the *perceived value* a firm is able to create for consumers (V), captured by how much consumers are willing to pay for a product or service, and the total cost (C) the firm incurs to create that value. The greater the *economic value created* ($V - C$), the greater is a firm's potential for competitive advantage. To answer the business-level strategy question of how to compete, managers have two primary competitive levers at their disposal: value (V) and cost (C).

A firm's business-level strategy determines its *strategic position*—its strategic profile based on value creation and cost—in a specific product market. A firm attempts to stake out a valuable and unique position that meets customer needs while simultaneously creating as large a gap as possible between the value the firm's product creates and the cost required to produce it. Higher value creation tends to require higher cost. To achieve a desired strategic position, executives must make **strategic trade-offs**—choices between a cost position *or* value position. They must address the tension between value creation and the pressure to keep cost in check so as not to erode the firm's economic value creation and profit margin.

strategic trade-offs
Choices between a cost position or value position. Such choices are necessary because higher value creation tends to generate higher cost.

As shown in ChapterCase 6, JetBlue experienced a competitive disadvantage for a number of years because it was unable to effectively address the strategic trade-offs inherent in pursuing a cost-leadership strategy *and* differentiation strategy at the same time. A business strategy is more likely to lead to a competitive advantage if a firm has a clear strategic profile, either as differentiator *or* a low-cost leader. In contrast, a *blue ocean strategy* is successful only if the firm can implement some type of value innovation that reconciles the inherent trade-off between value creation and underlying costs.

differentiation strategy
Generic business strategy that seeks to create higher value for customers than the value that competitors create, while containing costs.

GENERIC BUSINESS STRATEGIES

There are two fundamentally different generic business strategies—*differentiation* and *cost leadership*. A **differentiation strategy** seeks to create higher value for customers than the value that competitors create. Firms that follow a differentiation strategy attempt to deliver products or services with unique features while keeping costs at the same or similar levels, allowing them to charge higher prices to their customers. In contrast, a **cost-leadership strategy** seeks to create the same or similar value for customers by delivering products or services at a lower cost than competitors, enabling the firm to offer lower prices to its customers.

cost-leadership strategy Generic business strategy that seeks to create the same or similar value for customers at a lower cost.

These two business strategies are called *generic strategies* because they can be used by any organization—manufacturing or service, large or small, for-profit or nonprofit, public or private, domestic or foreign—in the quest for competitive advantage, independent of industry context. Differentiation and cost leadership require distinct strategic positions, and they increase a firm's chances of gaining and sustaining a competitive advantage.[4] Because value creation and cost tend to be positively correlated, important trade-offs exist between value creation and low cost. A business strategy is therefore more likely to lead to a competitive advantage if it allows a firm to either *perform similar activities differently* than its rivals or *perform different activities* that result in creating more value or offering similar products or services at lower cost.[5]

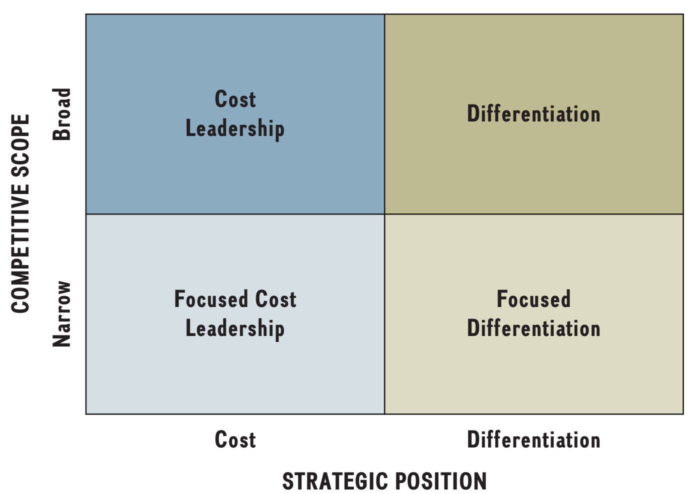
When considering different business strategies, strategic leaders must define the **scope of competition**—whether to pursue a specific, narrow part of the market or go after the broader market.[6] The automobile industry provides an example of the *scope of competition.* Alfred P. Sloan, longtime president and CEO of GM, defined the carmaker's mission as providing a car for every purse and purpose. GM was one of the first companies to implement a multidivisional structure to separate the brands into strategic business units, allowing each brand to create its unique strategic position (with its own profit and loss responsibility) within the broad automotive market. For example, GM's product lineup ranges from the low-cost-positioned Chevy brand to the differentiated Cadillac brand. Chevy pursues a broad cost-leadership strategy, while Cadillac pursues a broad differentiation strategy. These two different business strategies are integrated at the GM corporate level. (We continue our discussion of *corporate strategy* in Chapters 8 and 9.)

scope of competition The size—narrow or broad—of the market in which a firm chooses to compete.

In contrast, Tesla, the maker of all-electric cars (featured in ChapterCase 1), offers a highly differentiated product and pursues only a small market segment. At this point, it uses a *focused differentiation strategy.* Specifically, Tesla focuses on environmentally conscious consumers who want to drive a high-performance car and who are willing to pay a premium price. Tesla is broadening its competitive scope with its Models 3/Y, which are available at a lower price point than Tesla's Model S sedan and Model X sport-utility crossover. GM's competitive scope is broad—with a focus on the mass automotive market—while Tesla's competitive scope is narrow—with a focus on all-electric luxury cars.

We can now combine the dimensions describing a firm's strategic position (*differentiation versus cost*) with the scope of competition *(narrow versus broad).* As shown in Exhibit 6.2, by doing so we get the two major broad business strategies *(cost leadership* and *differentiation),* shown as the top two boxes in the matrix, and the *focused* version of each, shown as the bottom two boxes in the matrix. The focused versions of the two business strategies—

EXHIBIT 6.2 Strategic Position and Competitive Scope: Generic Business Strategies



Source: Based on M.E. Porter (1980), *Competitive Strategy. Techniques for Analyzing Industries and Competitors* (New York: Free Press).

focused cost-leadership strategy Same as the cost-leadership strategy except with a narrow focus on a niche market.

focused differentiation strategy Same as the differentiation strategy except with a narrow focus on a niche market.

focused cost-leadership strategy and **focused differentiation strategy**—are essentially the same as the broad generic strategies *except* that the competitive scope is narrower. For example, the manufacturing company BIC pursues a focused cost-leadership strategy, designing and producing disposable pens at a low cost, while Mont Blanc pursues a focused differentiation strategy, offering exquisite pens—which it calls "writing instruments"—some of them priced at several hundred dollars.

As discussed in ChapterCase 6, JetBlue attempts to combine a focused cost-leadership position with a focused differentiation position. Although it was initially successful, for the last several years JetBlue has been consistently outperformed by airlines that do not attempt to straddle different strategic positions but rather have clear strategic profiles as either differentiators or low-cost leaders. For example, Southwest Airlines competes clearly as a broad cost leader (and would be placed squarely in the upper-left quadrant of Exhibit 6.2). The legacy carriers—Delta, American, and United—all compete as broad differentiators (and would be placed in the upper-right quadrant). Regionally, we find smaller airlines that have clear strategic positions as ultra-low-cost carriers, such as Allegiant Air, Frontier Airlines, and Spirit Airlines. These smaller airlines would be placed in the lower-left quadrant of Exhibit 6.2 because they are pursuing a focused cost-leadership strategy. Based on a clear strategic position, these airlines have outperformed JetBlue over several years. JetBlue appears to be stuck between different strategic positions as it tries to combine a focused cost-leadership position with focused differentiation. As it grew, the problems inherent in attempting to combine different strategic positions also grew—and became more severe because of JetBlue's attempt to also straddle the (broad) cost-leadership position with the (broad) differentiation position.

stuck in the middle Strategic position that is not clearly defined as low cost or differentiation; results from attempts to straddle different strategic positions and leads to inferior performance results.

In essence, JetBlue was trying to be everything to everybody. Being **stuck in the middle** of different strategic positions is a recipe for inferior performance and competitive disadvantage—and this is exactly what JetBlue experienced when it underperformed the Dow Jones Airlines Index, lagging behind the big four airlines (American, Delta, Southwest, and United) as well as smaller airlines such as Alaska Airlines, Allegiant Air, and Spirit.

LO 6-2

Examine the relationship between value drivers and differentiation strategy.

6.2 Differentiation Strategy: Understanding Value Drivers

The goal of a differentiation strategy is to add unique features that will increase the perceived value of goods and services in the minds of consumers so they are willing to pay a higher price. Ideally, a firm following a differentiation strategy aims to achieve in the minds of consumers a level of value creation that its competitors cannot easily match. The focus of competition in a differentiation strategy tends to be on unique product features, services, new product launches, and on marketing and promotion rather than price.

Several competitors in the bottled-water industry provide a prime example of pursuing a successful differentiation strategy.[7] As more and more consumers shift from carbonated soft drinks to healthier choices, the industry for bottled water is booming—growing about 10% per year. In the United States, the per-person consumption of bottled water surpassed that of carbonated soft drinks for the first time in 2016. Such a fast-growing industry provides ample opportunity for differentiation. The industry is split into two broad segments depending on the sales price. Bottled water with a sticker price of $1.50 or less per 32 ounces (close to 1 liter) is considered lower end, while those with a higher price tag are seen as luxury items. For example, PepsiCo's Aquafina and Coca-Cola's Dasani are considered lower-end products. They are sold at competitive prices, often in bulk at big-box retailers such as Walmart. On the premium end, PepsiCo introduced Lifewtr with a splashy ad during Super Bowl LI (in 2017), while Jennifer Aniston markets Smartwater, Coca-Cola's premium water.

The idea of selling premium water is not new. Evian (owned by Danone, a French consumer products company) and S.Pellegrino (owned by Nestlé of Switzerland) have long focused on differentiating their products by emphasizing the uniqueness of their respective natural sources. Evian hails from the French Alps while Pellegrino comes from San Pellegrino Terme in Italy's Lombardy region. Recent entrants into the luxury segment for bottled water have taken the differentiation of their products to new heights. Some purveyors, such as Svalbardi, are able to charge super-premium prices. At upscale retailer Harrods in London, a bottle of Svalbardi costs \$110 for 25 ounces; the water, sold in a heavy glass bottle, hails from Norwegian icebergs some 4,000 years old.

Anythings/Shutterstock

Ordering premium bottled water in the United States to accompany lunch has become a status symbol. Indeed, many restaurants now feature water lists in addition to the more traditional wine selection. Energy waters enhanced with minerals and vitamins are the fastest-growing segment. Although flavored waters make up less than 5% of the overall market for bottled water, they rack up 15% of total revenues. And these revenues are substantial: The market for bottled water globally is over \$200 billion and continues to grow fast. Although a free substitute can be had from most taps in industrialized countries, the success of many luxury brands in the bottled-water industry shows the power of a well-formulated and well-executed differentiation strategy.

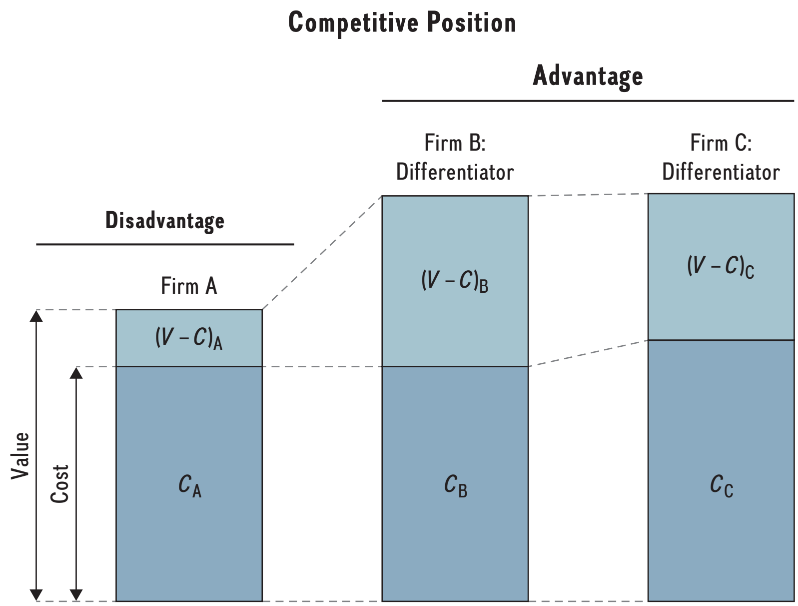
A company that uses a differentiation strategy can achieve a competitive advantage as long as its economic value created $(V - C)$ is greater than that of its competitors. Firm A in Exhibit 6.3 produces a generic commodity. Firm B and Firm C represent two efforts at differentiation. Firm B not only offers greater value than Firm A but also maintains *cost parity,* meaning it has the same costs as Firm A. Even if a firm fails to achieve cost parity (which is often the case because higher value creation tends to go along with higher costs in terms of higher quality raw materials, research and development, and employee training to provide superior customer service), it can still gain a competitive advantage if its economic value creation exceeds that of its competitors. Firm C represents just such a competitive advantage. For the approach shown *either* in Firm B or Firm C, economic value creation, $(V - C)_B$ or $(V - C)_C$, is greater than that of Firm A $(V - C)_A$. Both Firm B and Firm C, therefore, achieve a competitive advantage because they have a higher value gap over Firm A $[(V - C)_B > (V - C)_A$, and $(V - C)_C > (V - C)_A]$, which allows them to charge a premium price, reflecting their higher value creation. To complete the relative comparison, although both companies pursue a differentiation strategy, Firm B also has a competitive advantage over Firm C because although both offer identical value, Firm B has lower costs, thus $(V - C)_B > (V - C)_C$.

Increased value creation is a defining feature of a differentiation strategy, but managers must also control costs. Rising costs reduce economic value created and erode profit margins. Indeed, if cost rises too much as the firm attempts to create more perceived value for customers, its value gap shrinks, negating any differentiation advantage. JetBlue could not maintain its initial competitive advantage partly because it was unable to keep its costs down sufficiently. JetBlue's current management team put measures in place to lower the airline's cost structure. For example, JetBlue now charges fees for checked bags, and it reduced leg space to increase passenger capacity on each of its planes. These cost-saving initiatives should increase its economic value creation.

EXHIBIT 6.3

Differentiation Strategy: Achieving Competitive Advantage

Pursuing a differentiation strategy, firms that successfully differentiate their product can enjoy a competitive advantage, assuming they are able to control costs. Firm A's product is seen as a generic commodity with no unique brand value. Firm B has the same cost structure as Firm A but creates more economic value and thus has a competitive advantage over both Firm A and Firm C because $(V - C)_B > (V - C)_C > (V - C)_A$. Although Firm C has higher costs than Firm A and B, it still generates a higher economic value than Firm A.



Although a differentiation strategy is generally associated with premium pricing, strategic leaders have an important second pricing option. When a firm is able to offer a differentiated product or service and can control its costs at the same time, it is able to gain market share from other firms in the industry by charging a similar price but offering more perceived value. In leveraging its differentiated appeal of superior customer service and quality, for example, Marriott offers a line of different hotels: its flagship Marriott full-service business hotel equipped to host large conferences; Residence Inn for extended stay; Marriott Courtyard for business travelers; and Marriott Fairfield Inn for inexpensive leisure and family travel.[8] Although these hotels are roughly comparable to their competitors in price, they generally offer a higher perceived value. With this line of different hotels, Marriott can benefit from economies of scale and scope, and thus keep its cost structure in check. *Economies of scale* are decreases in cost per unit as output increases (more on this topic in the next section when we discuss cost-leadership strategy). **Economies of scope** are the savings that come from producing two (or more) outputs at less cost than producing each output individually, despite using the same resources and technology. A larger difference between cost and value allows Marriott to achieve greater economic value than its competitors, and to gain market share and achieve superior performance.

economies of scope Savings that come from producing two (or more) outputs at less cost than producing each output individually, despite using the same resources and technology.

Managers can adjust a number of different levers to improve a firm's strategic position. These levers either increase perceived value or decrease costs. Here, we will study the most salient *value drivers* that strategic leaders have at their disposal (we look at cost drivers in the next section).[9] They include the following:

- Product features
- Customer service
- Complements

These value drivers are related to a firm's expertise in, and organization of, different internal value chain activities. Although they are the most important value drivers, no such list can be complete. Applying the concepts introduced in this chapter should allow strategic leaders to identify other important value and cost drivers unique to their business.

When attempting to increase the perceived value of the firm's product or service offerings, managers must remember that the different value drivers contribute to competitive advantage *only if* their increase in value creation (ΔV) exceeds the increase in costs (ΔC). The condition of $\Delta V > \Delta C$ must be fulfilled if a differentiation strategy is to strengthen a firm's strategic position and thus enhance its competitive advantage.

PRODUCT FEATURES

One of the obvious but most important levers that strategic leaders can adjust is product features, thereby increasing the perceived value of the product or service offering. Adding unique product attributes allows firms to turn commodity products into differentiated products commanding a premium price. Strong R&D capabilities are often needed to create superior product features. In the kitchen-utensil industry, OXO follows a differentiation strategy, highlighting product features. Adhering to its philosophy of making products that are easy to use for the largest variety of possible users,[10] OXO differentiates its kitchen utensils through its patent-protected ergonomically designed soft black rubber grips.

CUSTOMER SERVICE

Managers can increase the perceived value of their firms' product or service offerings by focusing on customer service. For example, the online retailer Zappos earned a reputation for superior customer service by offering free shipping both ways: to the customer and for returns.[11] Although several online retailers now offer free shipping both ways, Zappos has done so since its inception in 1999, long before more recent imitators. Perhaps more important, Zappos makes the return process hassle free by providing a link to a prepaid shipping label. All the customer needs to do is drop the box off at a nearby UPS store, all free of charge. Zappos' strategic leaders didn't view free shipping both ways as an additional expense but rather as part of the marketing budget. Moreover, Zappos does not outsource its customer service, and its associates do not use predetermined scripts. They are instead encouraged to build a relationship of trust with each individual customer. Indeed, it is quite fun to interact with Zappos customer service reps. There seemed to be a good return on investment as word spread through the online shopping community. Competitors took notice, too; Amazon bought Zappos for over $1 billion.[12]

Trader Joe's has some 530 stores, about half of them in California and the rest in 42 other states and Washington, DC. The chain is known for good products, value for money, and great customer service. As just one example, stores stock local products as requested by their communities.[13]

QualityHD/Shutterstock

COMPLEMENTS

When studying industry analysis in Chapter 3, we identified the availability of complements as an important force determining an industry's profit potential. When consumed in tandem with a product or service, complements add value. Finding complements, therefore, is an important task for strategic leaders in their quest to enhance the value of their offerings.

A prime example of complements is smartphones and cellular services. A smartphone without a service plan is much less useful than one with a data plan. Traditionally, the providers of smartphones such as Apple and Samsung did not provide wireless services.

AT&T and Verizon are by far the two largest service providers in the United States, jointly holding some 75% of the market share. To enhance the attractiveness of their phone and service bundles, phone makers and service providers frequently sign exclusive deals. When the iPhone was first released, for instance, service was exclusively offered by AT&T. Thus, if you wanted an iPhone, you had to sign up for a two-year service contract with AT&T.

Google, a division of Alphabet, decided to offer the important complements of smartphones and in-house wireless services to attract more customers.[14] Google offers high-end phones such as the Pixel 8 with pro cameras and cutting-edge, built-in artificial intelligence (via its Google Assistant) at competitive prices. It combines this offering with discounted high-speed wireless services via Google Fi, a complementary service. Working in conjunction with smaller wireless service providers such as T-Mobile, the number-three provider in the United States, Google provides seamless wireless services by stitching together a nationwide network of services based on available free Wi-Fi hotspots (such as at Starbucks) and cellular networks offered by T-Mobile. This network not only enables wide coverage but also reduces data usage significantly because Google phones automatically switch to free Wi-Fi networks wherever they are available. In addition, rather than paying for a predetermined amount of data each month, users of Google Fi pay for data use as they go. In contrast, AT&T and Verizon decrease your network speed from 5G to 2G (which isn't enough speed to use the Uber app) after you exceed the package for which you've prepaid.

Project Fi is intended to drive more demand for Google's phones. The strategy seems to be working; recent models have broken Google sales records. Stronger demand for Google's phones locks more users into the Google ecosystem. Here, complementary product and service offerings not only reinforce demand for one another but also create a situation in which network externalities can arise. As more users sign up for Google Fi, the company is able to offer faster and more reliable services by investing more into the latest technology, such as 5G, thereby making its network and its Google phones more attractive to more users.

In summary, by choosing the differentiation strategy as the strategic position for a product, managers focus their attention on adding value to the product through unique features that respond to customer preferences, customer service during and after the sale, and effective marketing that communicates the value of the product's features. Although this positioning involves increased costs (for example, higher quality inputs or innovative research and development activities), customers are generally willing to pay a premium price for the product or service that satisfies their needs and preferences. In the next section, we discuss how strategic leaders formulate a cost-leadership strategy.

LO 6-3

Examine the relationship between cost drivers and cost-leadership strategy.

6.3 Cost-Leadership Strategy: Understanding Cost Drivers

The goal of a cost-leadership strategy is to reduce the firm's cost below that of its competitors while offering adequate value. As its name implies, the *cost leader* focuses its attention and resources on reducing the cost to manufacture a product and on lowering the operating cost to deliver a service in order to offer lower prices to its customers. The cost leader attempts to optimize all of its value chain activities to achieve a low-cost position. Although staking out the lowest-cost position in the industry is the overriding strategic objective, a cost leader still needs to offer products and services of acceptable value. As an example, both GM and the Korean car manufacturer Kia offer some models that compete directly with one another, yet Kia's cars tend to be produced at lower cost while providing a similar value proposition.

A cost leader can achieve a competitive advantage as long as its economic value created $(V - C)$ is greater than its competitors'. Firm A in Exhibit 6.4 produces a product with a cost structure vulnerable to competition. Firms B and C show two different approaches to cost leadership. Firm B achieves a competitive advantage over Firm A because Firm B not only has lower cost than Firm A but also achieves *differentiation parity* (meaning it creates the same value as Firm A). As a result, Firm B's economic value creation, $(V - C)_B$, is greater than that of Firm A, $(V - C)_A$. For example, as the low-cost leader, Walmart took market share from Kmart, which subsequently filed for bankruptcy.

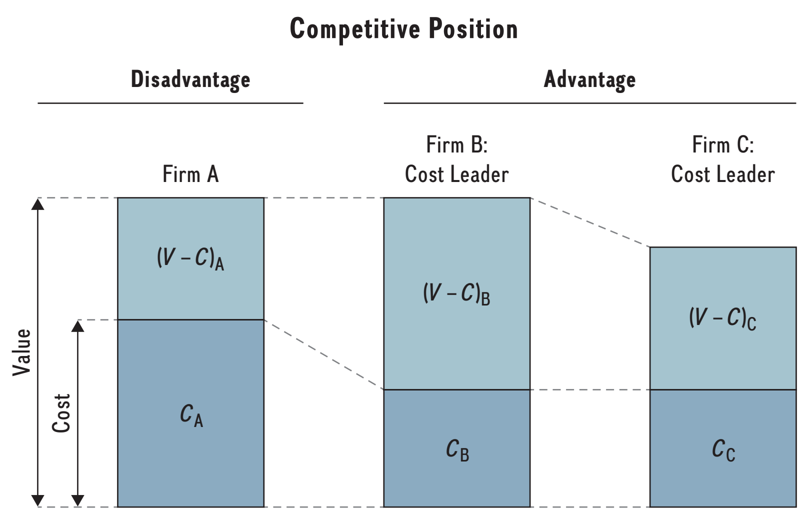
What happens if a firm fails to create differentiation parity? Such parity is often hard to achieve because value creation tends to go along with higher costs, and Firm B's strategy focuses on lower costs. A firm can still gain a competitive advantage as long as its economic value creation exceeds that of its competitors. Firm C represents this approach to cost leadership. With lower value provided (no differentiation parity) but also lower cost, Firm C's economic value creation, $(V - C)_C$, still is greater than that of Firm A, $(V - C)_A$.

In both approaches to cost leadership in Exhibit 6.4, Firm B's economic value creation is greater than that of Firm A and Firm C. Nonetheless, both Firm B and Firm C achieve a competitive advantage over Firm A. Either one can charge prices similar to its competitors and benefit from a greater profit margin per unit, or it can charge lower prices than its competition and gain higher profits from higher volume. Both variations of a cost-leadership strategy can result in a competitive advantage. Although Firm B has a competitive advantage over both firms A and C, Firm C has a competitive advantage over Firm A.

Although companies that are successful at cost leadership must excel at controlling costs, that doesn't mean that they can neglect value creation. For example, Kia signals the quality of its cars with a five-year, 60,000-mile warranty, one of the more generous warranties in the industry. Walmart offers products of acceptable quality, including many brand-name products.

EXHIBIT 6.4 Cost-Leadership Strategy: Achieving Competitive Advantage

Pursuing a cost-leadership strategy, firms that can keep their cost at the lowest point in the industry while offering acceptable value are able to gain a competitive advantage. Firm A has not managed to take advantage of possible cost savings and thus experiences a competitive disadvantage. Firm B's offering has the same perceived value as Firm A's offering but through more effective cost containment creates more economic value (over both Firm A and Firm C because $(V - C)_B > (V - C)_C > (V - C)_A$. The offering from Firm C has a lower perceived value than that of Firm A and Firm B and has the same reduced product cost that Firm B does; as a result, Firm C generates higher economic value than Firm A.



The most important *cost drivers* that strategic leaders can manipulate to keep their costs low are:

- Cost of input factors.
- Economies of scale.
- Learning-curve effects.
- Experience-curve effects.

However, this list is only a starting point; managers may also consider other cost drivers, depending on the situation.

COST OF INPUT FACTORS

One of the most basic advantages a firm can have over its rivals is access to lower-cost input factors such as raw materials, capital, labor, and IT services. In the market for international long-distance travel, a potent competitive threat facing U.S. legacy carriers (American, Delta, and United) comes from three airlines located in the Persian Gulf states: Emirates, Etihad, and Qatar. These airlines achieve a competitive advantage over their U.S. counterparts thanks to lower-cost inputs—specifically, raw materials (access to cheaper fuel), capital (interest-free government loans), and labor—and fewer regulations (for example, regarding nighttime take-offs and landings, or adding new runways and building luxury airports with swimming pools and other amenities).[15] To benefit from lower-cost IT services, the Gulf carriers outsource to India some value chain activities such as booking and online customer service. Together, these distinct cost advantages across several key input factors add up to create a greater economic value creation for the Gulf carriers vis-à-vis U.S. competitors, providing the basis for a competitive advantage.

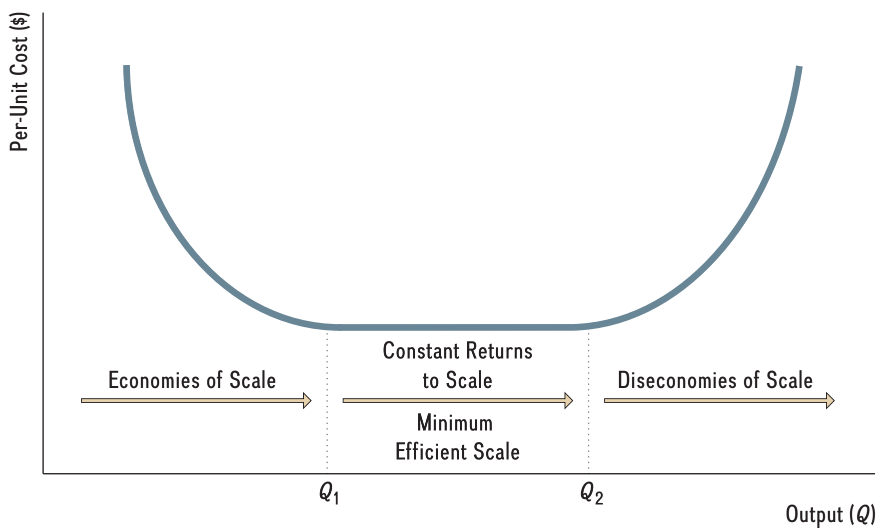
economies of scale Decreases in cost per unit as output increases.

ECONOMIES OF SCALE

Firms with greater market share might be in a position to reap **economies of scale**, decreases in cost per unit as output increases. This relationship between unit cost and output is depicted on the left-hand side of Exhibit 6.5: Cost per unit falls as output increases up to

EXHIBIT 6.5

Economies of Scale, Minimum Efficient Scale, and Diseconomies of Scale



point Q_1. A firm whose output is closer to Q_1 has a cost advantage over other firms with less output. In this sense, bigger is better.

In the airframe-manufacturing industry, for example, achieving economies of scale and learning is critical for cost-competitiveness. The market for commercial airplanes is often not large enough to allow more than one competitor to reach sufficient scale to drive down unit cost. For example, Boeing chose not to compete with Airbus in the market for superjumbo jets; rather, it decided to focus on a smaller, fuel-efficient airplane (the 787 Dreamliner, priced at roughly $250 million) that allows for long-distance, point-to-point connections. By 2022, it had built 1,000 Dreamliners and had another 1,500 orders for the new airplane.[16] Boeing can expect to reap significant economies of scale and learning, which will lower per-unit cost. At the same time, Airbus delivered over 250 A-380 superjumbos (sticker price: $450 million).[17] If both companies had chosen to compete head-on in each market segment, the resulting per-unit cost for each airplane would have been much higher because neither could have achieved significant economies of scale. (Overall their market share split is roughly 50-50.)

What causes per-unit cost to drop as output increases (up to point Q_1 in Exhibit 6.5)? Economies of scale allow firms to:

- Spread their fixed costs over a larger output.
- Employ specialized systems and equipment.
- Take advantage of certain physical properties.

SPREADING FIXED COSTS OVER LARGER OUTPUT. Larger output allows firms to spread their fixed costs over more units, which explains why gains in market share are often critical in driving down per-unit cost. This relationship is even more pronounced in many high-tech industries because most of the cost occurs before a single product or service is sold. As an example, consider operating systems software. Microsoft spends over $10 billion a year on research and development (R&D).[18] For a few years prior to the release of Windows 11 in 2021, a good part of the R&D billions was spent on developing it. This R&D expense was a fixed cost that Microsoft had to incur before a single copy of Windows 11 was sold. However, once the initial version of the new software was completed, the marginal cost of each additional copy was basically zero. Given that Microsoft dominates the operating system market for personal computers (PCs) with more than 90% market share, it expects to sell several hundred million copies of Windows 11, thereby spreading its huge fixed cost of development over a large number of users. Microsoft's huge installed base of Windows operating systems throughout the world allows it to capture a large profit margin for each copy of Windows sold, after recouping its initial investment. Microsoft's Windows 11 also drives sales for complementary products such as the ubiquitous Microsoft Office Suite, which includes Word, Excel, PowerPoint, Outlook, and other programs.

EMPLOYING SPECIALIZED SYSTEMS AND EQUIPMENT. Larger output also allows firms to invest in more specialized systems and equipment, such as enterprise resource planning (ERP) software or manufacturing robots. Tesla employs cutting-edge robotics in its manufacturing plants to drive down costs while producing cars of high quality at large scale. Tesla manufactures the Models 3/Y in its brand-new, super-large-scale Gigafactories in Austin (Texas), Berlin (Germany), and Shanghai (China). High demand combined with large production runs will further drive down per-unit cost as economies of scale kick in.

TAKING ADVANTAGE OF CERTAIN PHYSICAL PROPERTIES. Economies of scale also occur because of certain physical properties. One such property is the *cube-square rule:* The volume of a body such as a pipe or a tank increases disproportionately more than its surface. This principle makes big-box retail stores such as Walmart or The Home Depot cheaper to build and run. They can also stock much more merchandise and handle inventory more efficiently, making it difficult for department stores and small retailers to compete on cost and selection.

minimum efficient scale (MES) Output range needed to bring down the cost per unit as much as possible, allowing a firm to stake out the lowest-cost position that is achievable through economies of scale.

Look again at Exhibit 6.5. The output range between Q_1 and Q_2 is considered the **minimum efficient scale (MES)** to be cost-competitive. Between Q_1 and Q_2, the returns to scale are constant. The MES is the output range needed to bring the cost per unit down as much as possible, allowing a firm to stake out the lowest-cost position achievable through economies of scale. With more than 10 million Prius cars sold worldwide since the introduction of the Prius in 1997, Toyota has been able to reach the MES part of the per-unit cost curve, allowing the company to reduce total costs, offer the car at a relatively low price, and still make a profit.

The concept of MES applies not only to manufacturing processes but also to managerial tasks such as how to organize work. Due to investments in specialized technology and equipment (e.g., electric arc furnaces), Nucor is able to reach MES with much smaller batches of steel than larger, fully vertically integrated steel companies that use older technology. Nucor's optimal plant size is about 500 people. In contrast, larger integrated steelmakers such as U.S. Steel often employ thousands of workers per plant.[19] Of course, MES depends on the specific industry: The average per-unit cost curve, depicted conceptually in Exhibit 6.5, is a reflection of the underlying production function, which is determined by technology and other input factors.

diseconomies of scale Increases in cost per unit when output increases.

Benefits to scale cannot go on indefinitely, though. Bigger is not always better; in fact, sometimes bigger is worse. Beyond Q_2 in Exhibit 6.5, firms experience **diseconomies of scale**—increases in cost as output increases. As firms get too big, the complexity of managing and coordinating the production process raises costs, negating any benefits to scale. Large firms also tend to become overly bureaucratic, with too many layers of hierarchy. They grow inflexible and slow in decision making. To avoid problems associated with diseconomies of scale, Gore Associates, maker of GORE-TEX fabric, Glide dental floss, and many other innovative products, breaks up its company into smaller units. Gore Associates found that employing about 150 people per plant allows it to avoid diseconomies of scale. It uses a simple decision rule:[20] "We put 150 parking spaces in the lot, and when people start parking on the grass, we know it's time to build a new plant."[21]

Finally, there are physical limits to scale. Airbus pushed the envelope with its A-380 aircraft, which can hold more than 850 passengers and can fly 9,520 miles (from Newark, New Jersey, to Singapore, for instance). Its goal was to drive down the cost of the average seat-mile flown (CASM, a standard cost metric in the airline industry). However, the A-380 superjumbo did not allow airlines to operate at a minimum efficient scale and thus failed to deliver the lowest cost per unit (CASM) possible. Rather, it turned out that the A-380 was simply too large to be efficient, thus causing *diseconomies of scale*. For example, boarding and embarking procedures needed to be completely revamped and streamlined to accommodate more than 850 people in a timely and safe manner. Given the huge size of the airliner, boarding and deplaning required multiple levels at airport terminals. Airports around the world also needed to be retrofitted with longer and wider runways to allow the superjumbo to take off and land. As demand for the superjumbo declined in recent years, Airbus ceased production of the A-380 (in 2021).[22]

In summary: *Scale economies* are critical to driving down a firm's cost and strengthening a cost-leadership position. Although strategic leaders need to increase output to operate at a minimum efficient scale (between Q_1 and Q_2 in Exhibit 6.5), they also need to be watchful not to drive scale beyond Q_2, where they would encounter diseconomies. If the firm's output range is less than Q_1 or more than Q_2, the firm is at a cost disadvantage; reaching an output level between Q_1 and Q_2 is optimal in terms of driving down costs. Monitoring the firm's cost structure closely over different output ranges allows managers to fine-tune operations and benefit from economies of scale.

LEARNING CURVE

Do learning curves go up or down? Many people tend to see learning as an uphill battle and therefore assume the learning curve goes up. But if we consider productivity, learning curves go down as people learn how to be more efficient and it takes less and less time to produce the same output. In other words, learning by doing drives down cost. As individuals and teams engage repeatedly in an activity, whether writing computer code, developing new medicines, or building submarines, they learn from their cumulative experience.[23] *Learning curves* were first documented in aircraft manufacturing as the United States ramped up production in the 1930s, before its entry into World War II.[24] Every time production was doubled, the per-unit cost dropped by a predictable and constant rate (approximately 20%).[25]

It is not surprising that a learning curve was first observed in aircraft manufacturing. A modern commercial aircraft is highly complex and can contain more than 5 million parts, compared with a few thousand for a car. The more complex the underlying process to manufacture a product or deliver a service, the more learning effects we can expect. As cumulative output increases, managers learn how to optimize the process, and workers improve their performance through repetition and specialization.

TESLA'S LEARNING CURVE. Tesla's production of its Model S vehicle provides a more recent example, as depicted in Exhibit 6.6. The horizontal axis shows cumulative output in units and the vertical axis shows per-unit cost in thousands of dollars.[26]

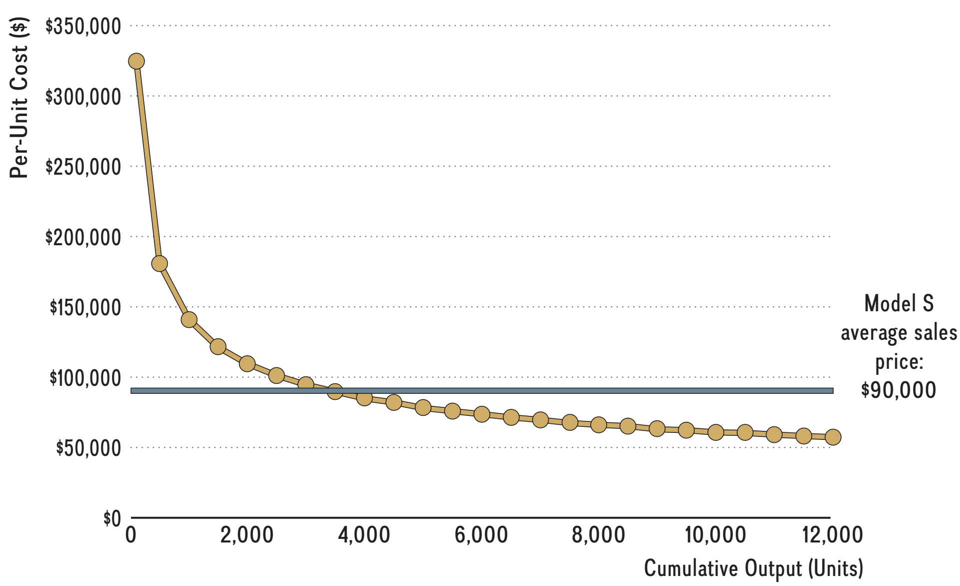


EXHIBIT 6.6

Tesla's Learning Curve Producing the Model S

Source: Author's depiction of functional relationship estimated in J. Dyer and H. Gregersen (2016, Aug. 24), "Tesla's innovations are transforming the auto industry," *Forbes*.

Featured in ChapterCase 1, Tesla is the California-based designer and manufacturer of all-electric cars. It has a market valuation of roughly $1 trillion, which is higher than the combined value of the old-line carmakers. At this point, demand for Tesla's all-electric cars exceeds its supply. The company faces production limitations as it tries to satisfy its global demand. Tesla's learning curve, therefore, is critical in justifying the stock market's lofty valuation, because as production volume increases, production cost per car falls, and the company becomes profitable. The vast majority of cars that Tesla is selling (95%) are Models S/Y. Each model has its own learning curve because Tesla uses fully dedicated production lines for each model, with no switchovers. To illuminate, let's look more closely at the learning curve underlying Tesla's Model S, which was critical in terms of mainstream market acceptance for Tesla cars.

Based on a careful analysis of production reports for the Model S between 2012 and 2014,[27] Exhibit 6.6 shows how Tesla was able to drive down the unit cost for each car as production volume ramped up. Initially, Tesla lost a significant amount of money on each Model S sold because of high upfront R&D spending to develop the futuristic self-driving car. When Tesla produced only 1,000 Model S vehicles, unit cost was $140,000. As production volume of the Model S reached some 12,000 units per year (in 2014), unit cost fell to about $57,000. Although those costs were still high, Tesla was able to start making money on each car, because the average selling price for a Model S was about $90,000.

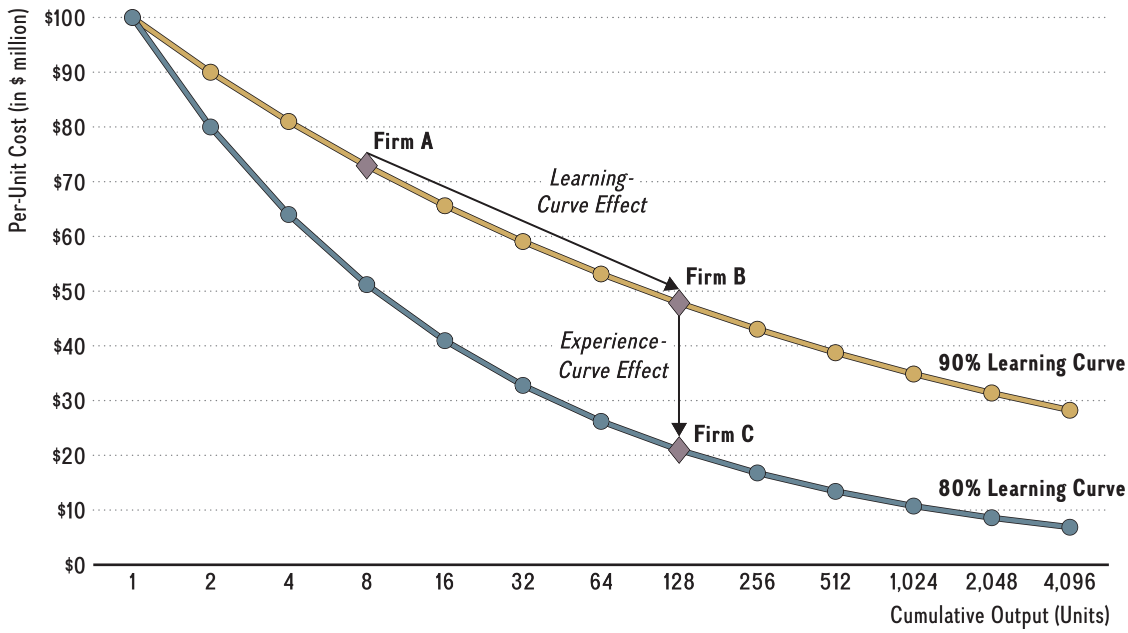
The relationship between production volume and per-unit cost for Tesla (depicted in Exhibit 6.6) suggests an 80% learning curve. In an 80% learning curve, per-unit cost drops 20% every time output doubles. Assuming that a similar relationship holds for production of the Model 3, per-unit cost would fall to $16,000 per Model 3 with a cumulative production volume of 400,000 (which is the number of preorders Tesla received within one week of announcing this new vehicle). Although the Model 3 base price is pegged at $35,000, the estimated average selling price is more like $50,000 given additional features and the expiration of a $7,500 federal tax credit for electric vehicles in the United States. (The credit expires when a manufacturer hits 200,000 units.) Riding down an 80% learning curve, Tesla makes a profit of an estimated $34,000 per Model 3, which would translate to a cumulative profit for Tesla of more than $13.5 billion for the Model 3 preorders alone. As Tesla is reducing the price for the Model 3, the expected profits would decline accordingly. This back-of-the-envelope calculation shows some of the rationale behind Tesla's market capitalization exceeding that of GM and Ford.

In addition to highlighting the power of the learning curve in driving down per-unit costs, this example indicates how critical cost containment is in gaining a competitive advantage when pursuing a differentiation strategy, as Tesla does.

DIFFERENCES IN LEARNING CURVES. Let's now compare different learning curves and explore their implications for competitive advantage. The steeper the learning curve, the more learning has occurred. As cumulative output increases, firms move down the learning curve, achieving lower per-unit costs. Exhibit 6.7 depicts two different learning curves: a 90% learning curve and an 80% learning curve. In a 90% learning curve, per-unit cost drops 10% every time output doubles. The steeper 80% learning curve indicates a 20% drop every time output doubles (as in the previous Tesla example).

Technology and Learning Curves. The learning-curve effect is driven by increasing cumulative output within the existing technology over time. Thus the only difference between two points on the same learning curve is the size of the cumulative output. The underlying technology remains the same. The speed of learning determines the slope of the learning curve,

EXHIBIT 6.7 Gaining Competitive Advantage by Leveraging Learning- and Experience-Curve Effects



or how steep the learning curve is (e.g., an 80% learning curve is steeper than a 90% learning curve because costs decrease by 20% versus a mere 10% each time output doubles). *Economies of learning* allow movement down a *given* learning curve based on current production technology.

By moving further down a given learning curve than its competitors, a firm can gain a competitive advantage. Exhibit 6.7 shows that Firm B is further down the 90% learning curve than Firm A. Firm B leverages *economies of learning* due to larger cumulative output to gain an advantage over Firm A. The only variable that has changed is cumulative output; the technology underlying the 90% learning curve remained the same.

Let's continue with the example of manufacturing airframes. As shown in Exhibit 6.7, Firm A produces eight aircraft and reaches a per-unit cost of $73 million per aircraft.[28] Firm B produces 128 aircraft using the same technology as Firm A (because both firms are on the same 90% learning curve), but given a much larger cumulative output, its per-unit cost falls to only $48 million. Thus, Firm B has a clear competitive advantage over Firm A, assuming similar or identical quality in output. We will discuss Firm C when we formally introduce the impact of changes in technology and process innovation.

Learning curves are a robust phenomenon observed in many industries, not only in manufacturing processes but also in the management of strategic alliances (partnerships between firms), franchising, and health care.[29] For example, physicians who perform only a small number of cardiac surgeries per year can have a patient mortality rate five times higher than physicians who perform the same surgery more frequently.[30] Strategy Highlight 6.1 features Dr. Devi Shetty of India, who reaped huge benefits by applying learning-curve principles to open-heart surgery, driving down cost while improving quality at the same time.

Strategy Highlight 6.1

Dr. Shetty: "The Henry Ford of Heart Surgery"

Namas Bhojani

Open-heart surgeries are complex medical procedures that are loaded with risk. Although well-trained surgeons using high-tech equipment are able to reduce mortality rates, costs for cardiac surgeries in the United States have climbed. Difficult heart surgeries can cost $100,000 or more. Dr. Devi Shetty, a heart surgeon in India, has driven down the costs to an average of $2,000 per heart surgery while delivering equal or better outcomes in terms of quality.

Dr. Shetty's goal is to be "the Henry Ford of heart surgery." Like the American industrialist who applied the learning curve to drive down the cost of an automobile to make it affordable, so Dr. Shetty is reducing the costs of health care and making some of the most complex medical procedures affordable to the world's most economically disadvantaged. A native of Mangalore, India, Dr. Shetty was trained as a heart surgeon at Guy's Hospital in London, one of Europe's best medical facilities. He first came to fame in the 1990s when he successfully conducted an open-heart bypass surgery on Mother Teresa after she suffered a heart attack.

Dr. Shetty believes that the key to driving down costs in health care is not product innovation but rather process innovation. He was able to drive down the cost of complex medical procedures from $100,000 to $2,000 not by doing one big thing but rather by focusing on doing a thousand small things. He is applying the concept of the learning curve to make a complex procedure routine and comparatively inexpensive. Part of the Narayana Health group, Dr. Shetty's hospital in Bangalore, India, performs so many cardiac procedures per year that doctors are able to get a great deal of experience quickly, which allows them to specialize in one or two complex procedures. The Narayana surgeons perform two or three procedures a day for six days a week, compared to U.S. surgeons who perform one or two procedures a day for five days a week. The difference adds up. Some of Dr. Shetty's surgeons perform more specialized procedures by the time they are in their 30s than their U.S. counterparts will perform throughout their entire careers. This volume of experience allows the cardiac surgeons to move down the learning curve quickly, because the more heart surgeries they perform, the more their skills improve. With this skill level, surgical teams develop robust standard operating procedures and processes, and team members become experts at their specific tasks.

This expertise improves outcomes while the learning-curve effects of performing the same procedures over time also drive down cost (see Exhibit 6.7). Other factors provide additional cost savings. For example, Dr. Shetty pays his cardiac surgeons the going rate in India, between $110,000 and $250,000 a year, depending on experience. Their U.S. counterparts earn two to three times the average Indian salary.

Dr. Shetty's health group also reduces costs through economies of scale. Because the group's surgeons perform thousands of heart surgeries a year, high fixed costs such as the purchase of expensive medical equipment can be spread over a much larger volume. The Narayana hospital in Bangalore has 1,000 beds (many times larger than the average U.S. hospital, which has 160 beds) and some 20 operating rooms that stay busy pretty much around the clock. This scale allows the Narayana heart clinic to cost-effectively employ specialized high-tech equipment. The large size of Dr. Shetty's hospital also gives it significant buying power, which drives down the costs of the latest high-tech equipment from vendors such as GE and Siemens. Wherever possible, Dr. Shetty sources lower-cost inputs such as sutures locally, rather than from the more expensive companies such as Johnson & Johnson. Further, the Narayana heart clinic shares common services, such as laboratories and blood bank and more mundane services such as catering, with the 1,400-bed cancer clinic next door. Together, all of these small changes result in significant cost savings and create a reinforcing system of low-cost value chain activities.

While many worry that high volume compromises quality, the data suggest the opposite: Narayana Health's medical outcomes in terms of mortality rate are equal to or even lower than those of the best hospitals in the United States. The American College of Cardiology frequently sends surgeons and administrators to visit the Narayana heart clinic. The College concluded that the clinic provides high-tech and high-quality care at low cost. Dr. Shetty now brings top-notch care at low cost to the masses in India. Narayana Health runs a chain of over 30 hospitals in 20 locations throughout India and performs some 100,000 heart surgeries a year.

Dr. Shetty is also bringing his high-quality, low-cost health care solutions closer to American patients. In 2014, his group opened the doors to Health City Cayman Islands, a fully accredited cardiac and cardiothoracic surgery clinic, a bit over one hour from Miami by air.[31]

Learning effects differ from economies of scale (discussed earlier) in two key ways:

- **Differences in timing.** Learning effects occur *over time* as output accumulates, while economies of scale are captured at *one point in time* when output increases. The improvements in Tesla's production costs, discussed earlier, resulted from some 12,000 units in cumulative output, but it took two years to reach this volume (see Exhibit 6.6). Although learning can decline or flatten (see Exhibit 6.7), there are no *diseconomies to learning* (unlike *diseconomies to scale* in Exhibit 6.5).
- **Differences in complexity.** In some production processes (e.g., the manufacture of steel rods), effects from economies of scale can be quite significant while learning effects are minimal. In contrast, in some professions (brain surgery or the practice of estate law), learning effects can be substantial while economies of scale are minimal.

Managers need to understand such differences to calibrate their business-level strategy. If a firm's cost advantage is due to economies of scale, a strategic leader should worry less about employee turnover (and a potential loss in learning) and more about drops in production runs. In contrast, if the firm's low-cost position is based on complex learning, a strategic leader should be much more concerned if a key employee (e.g., a star engineer) were to leave the company.

EXPERIENCE CURVE

In the *learning curve* just discussed, we assumed that the underlying technology remained constant while only cumulative output increased. In contrast, in the *experience curve* we change the underlying technology while holding cumulative output constant.[32]

Technology and Experience Curves. In general, technology and production processes do not stay constant. *Process innovation*—a new method or technology to produce an existing product—may initiate a new and steeper curve. Assume that Firm C, on the same learning curve as Firm B, implements a new production process, such as lean manufacturing. In doing so, Firm C initiates an entirely new and steeper learning curve. Exhibit 6.7 shows this *experience-curve effect* based on a process innovation. Firm C jumps down to the 80% learning curve, reflecting the new and lower-cost production process. Although Firm B and Firm C produce the same cumulative output (each making 128 aircraft), the per-unit cost differs. Because it is positioned on the less-steep 90% learning curve, Firm B has a per-unit cost of $48 million for each airplane.[33] In contrast, Firm C, which is positioned on the steeper 80% learning curve because of process innovation, has a per-unit cost of only $21 million per aircraft, which is less than half of Firm B's per-unit cost.

Firm C has a competitive advantage over Firm B based on lower cost per unit (assuming similar quality).

The takeaway is: Learning by doing allows a firm to move down a given learning curve and thereby lower its per-unit costs, while experience-curve effects based on process innovation allow a firm to drive down its per-unit costs by leapfrogging to a steeper learning curve.

Recall from Strategy Highlight 6.1 how Dr. Shetty leveraged learning-curve effects to save lives while driving down costs. One could argue that his Narayana Health group not only moved down a given learning curve using best industry practice but also jumped down to a new and steeper learning curve through process innovation. Dr. Shetty sums up his business strategy based on cost leadership: "Japanese companies reinvented the process of making cars (by introducing lean manufacturing). That's what we're doing in health care. What health care needs is process innovation, not product innovation."[34]

In a cost-leadership strategy, managers must focus on lowering the costs of production while maintaining a level of quality acceptable to the customer. By sharing the benefits of lower costs with consumers, cost leaders appeal to bargain-conscious buyers, whose main criterion is price. By reducing costs in value chain activities, managers aim for the lowest-cost position in the industry. They strive to offer lower prices than their competitors and thus to increase sales. Cost leaders such as Walmart ("Every Day Low Prices") can be quite profitable by pursuing this strategic position over time.

LO 6-4

Assess the benefits and risks of differentiation and cost-leadership strategies vis-à-vis the five forces that shape competition.

6.4 Business-Level Strategy and the Five Forces: Benefits and Risks

The business-level strategies introduced in this chapter allow firms to carve out strong strategic positions that enhance the likelihood of gaining and sustaining competitive advantage. The five forces model introduced in Chapter 3 helps strategic leaders assess the forces—threat of entry, power of suppliers, power of buyers, threat of substitutes, and rivalry among existing competitors—that make some industries more attractive than others. With this understanding of industry dynamics, managers use one of the generic business-level strategies to protect themselves against the forces that drive down profitability.[35] Exhibit 6.8 details the relationship between competitive positioning and the five forces. It highlights the benefits and risks of differentiation and cost-leadership business strategies, which we discuss next.

DIFFERENTIATION STRATEGY: BENEFITS AND RISKS

A differentiation strategy is defined by establishing a strategic position that creates higher perceived value while controlling costs. The successful differentiator stakes out a unique strategic position, where it can benefit from imperfect competition (as discussed in Chapter 3) and command a premium price. A well-executed differentiation strategy reduces rivalry among competitors.

A successful differentiation strategy is likely to be based on unique or specialized features of the product, an effective marketing campaign, and on intangible resources such as a reputation for innovation, quality, and customer service. To gain market share, a rival needs to improve the product features and build a similar or more effective reputation. The threat of entry is reduced: Competitors will find such intangible advantages time consuming and costly, and maybe impossible, to imitate. If the source of the differential appeal is intangible rather than tangible (e.g., reputation rather than observable product and service features), a differentiator is even more likely to sustain its advantage.

EXHIBIT 6.8 Competitive Positioning and the Five Forces: Benefits and Risks of Differentiation and Cost-Leadership Business Strategies

Competitive Force	Differentiation		Cost Leadership	
	Benefits	**Risks**	**Benefits**	**Risks**
Threat of entry	• Protection against entry due to intangible resources such as a reputation for innovation, quality, or customer service	• Erosion of margins • Replacement	• Protection against entry due to economies of scale	• Erosion of margins • Replacement
Power of suppliers	• Protection against increase in input prices, which can be passed on to customers	• Erosion of margins	• Protection against increase in input prices, which can be absorbed	• Erosion of margins
Power of buyers	• Protection against decrease in sales prices, because well-differentiated products or services are not perfect imitations	• Erosion of margins	• Protection against decrease in sales prices, which can be absorbed	• Erosion of margins
Threat of substitutes	• Protection against substitute products due to differential appeal	• Replacement, especially when faced with innovation	• Protection against substitute products through further lowering of prices	• Replacement, especially when faced with innovation
Rivalry among existing competitors	• Protection against competitors if product or service has enough differential appeal to command premium price	• Focus of competition shifts to price • Increasing differentiation of product features that do not create value but raise costs • Increasing differentiation to raise costs above acceptable threshold	• Protection against price wars because lowest-cost firm will win	• Focus of competition shifts to non-price attributes • Lowering costs to drive value creation below acceptable threshold

Source: Based on M.E. Porter (2008, January), "The five competitive forces that shape strategy," *Harvard Business Review*; and M.E. Porter (1980), *Competitive Strategy: Techniques for Analyzing Industries and Competitors* (New York: Free Press).

Moreover, if the differentiator is able to create a significant difference between perceived value and current market prices, the differentiator will not be so threatened by increases in input prices due to powerful suppliers. Although an increase in input factors could erode margins, a differentiator is likely able to pass on price increases to its customers as long as its value creation exceeds the price charged. Because a successful differentiator creates perceived value in the minds of consumers and builds customer loyalty, powerful buyers demanding price decreases are unlikely to emerge. A strong differentiated position also reduces the threat of substitutes, because the unique features of the product have been created to appeal to customer preferences, keeping customers loyal to the product. For example, by providing superior quality beverages and other food items combined with a great customer experience and a global presence, Starbucks has built a strong differentiated appeal. It has cultivated a loyal following of customers who reward it with repeat business.

The viability of a differentiation strategy is severely undermined when the focus of competition shifts to price rather than value-creating features. This can happen when differentiated products become commoditized and an acceptable standard of quality has emerged across rival firms. For example, although the iPhone was a highly differentiated product when it was introduced in 2007, touch-based screens and other once-innovative features are now standard in smartphones. Indeed, Android-based smartphones hold more than 72% of market share globally, while Apple's iOS phones hold 28%.[36] Several companies, including Google, Samsung, and LG of South Korea, and low-cost leader Xiaomi of China, are attempting to challenge Apple's ability to extract significant profits from the smartphone industry based on its iPhone franchise. A differentiator also needs to be careful not to overshoot its differentiated appeal by adding product features that raise costs but not perceived value in the minds of consumers. For example, any additional increase in screen resolution beyond Apple's retina display cannot be detected by the human eye at a normal viewing distance, so it makes no sense for Apple to continue improving its displays. Finally, a differentiator needs to be vigilant that its costs of providing uniqueness do not rise above the customer's willingness to pay.

COST-LEADERSHIP STRATEGY: BENEFITS AND RISKS

A cost-leadership strategy is defined by obtaining the lowest-cost position in the industry while offering acceptable value. The cost leader is protected from other competitors because it has the lowest cost. If a price war ensues, the low-cost leader will be the last firm standing; all other firms will be driven out as margins evaporate. Because reaping economies of scale is critical to reaching a low-cost position, the cost leader is likely to have a large market share, which in turn reduces the threat of entry.

A cost leader is also fairly well isolated from powerful suppliers' threats to increase input prices, because it is more able to absorb price increases by accepting lower profit margins. Likewise, a cost leader can absorb powerful buyers' demands for price reductions. Should substitutes emerge, the low-cost leader can try to fend them off by further lowering its prices to reinstall relative value with respect to the substitute. For example, Walmart tends to be fairly isolated from all of these threats. Its cost structure combined with its large volume allows it to work with suppliers to keep prices low, to the extent that suppliers are often the party that experiences a profit-margin squeeze.

Although a cost-leadership strategy provides some protection against the five forces, it also carries some risks. If a new entrant with relevant expertise enters the market, the low-cost leader's margins may erode due to loss in market share while it attempts to learn new capabilities. For example, Walmart faces challenges to its cost leadership. Dollar General stores and other smaller low-cost retail chains have drawn customers who prefer a smaller format than the big box of Walmart. The risk of replacement is particularly pertinent if a potent substitute emerges due to an innovation. Leveraging ecommerce, Amazon has become a potent substitute and thus a powerful threat to many bricks-and-mortar retail outlets, including Barnes & Noble, Best Buy, The Home Depot, and even Walmart. Powerful suppliers and buyers may be able to reduce margins so much that the low-cost leader could have difficulty covering the cost of capital and lose the potential for a competitive advantage.

The low-cost leader also needs to stay vigilant to keep its cost the lowest in the industry. Over time, competitors can beat the cost leader by more effectively implementing the same business strategy. Although keeping its cost the lowest in the industry is imperative, the cost leader must not forget that it needs to create an acceptable level of value. If continuously lowering costs leads to a value proposition that falls below an acceptable threshold, the low-cost leader's market share will evaporate. Finally, the low-cost leader faces significant difficulties when the focus of competition shifts from price to non-price attributes.

We have seen the usefulness of the five forces model in industry analysis. None of the business-level strategies depicted in Exhibit 6.2 (cost leadership, differentiation, and focused variations thereof) is inherently superior. The success of each depends on context and relies on two factors:

- How well the strategy leverages the firm's internal strengths while mitigating its weaknesses
- How well the strategy helps the firm exploit external opportunities while avoiding external threats

There is no single correct business strategy for a specific industry. The best strategy is one that attempts to maximize economic value creation and is effectively implemented.

blue ocean strategy Business-level strategy that successfully combines differentiation and cost-leadership activities using value innovation to reconcile the inherent trade-offs.

blue oceans Untapped market space that is ripe for the creation of additional demand and the resulting opportunities for highly profitable growth.

red oceans The known market space of existing industries, where the rivalry among existing firms is cutthroat because the market space is crowded and competition is a zero-sum game.

6.5 Blue Ocean Strategy: Combining Differentiation and Cost Leadership

So far we've seen that firms can create more economic value and the likelihood of gaining and sustaining competitive advantage in one of two ways—either by increasing perceived consumer value (while containing costs) or by lowering costs (while offering acceptable value). Should strategic leaders try to do both at the same time? In general the answer is *no.* To do so, they would need to integrate two different strategic positions: differentiation *and* low cost.[37] Unless they are able to reconcile the conflicting requirements of each generic strategy, managers should not pursue this complex strategy because of the inherent trade-offs in these different strategic positions.

To meet this challenge, strategy scholars W. Chan Kim and Renée Mauborgne advanced the notion of a **blue ocean strategy**, which is a business-level strategy that successfully combines differentiation and cost-leadership activities by using value innovation to reconcile the inherent trade-offs in those two distinct strategic positions.[38] They use the metaphor of an ocean to denote market spaces. **Blue oceans** represent untapped market space, the creation of additional demand, and the resulting opportunities for highly profitable growth. In contrast, **red oceans** are the known market space of existing industries. In red oceans the rivalry among existing firms is cutthroat because the market space is crowded and competition is a zero-sum game. Products become commodities, and competition is focused mainly on price. Any gain in market share comes at the expense of other competitors in the same industry, turning the oceans bloody red.

A blue ocean strategy allows a firm to offer a differentiated product or service at low cost. As one example of a blue ocean strategy, consider the grocery chain Trader Joe's. Trader Joe's had much lower costs than Whole Foods (prior to the latter's 2017 acquisition by Amazon) for the same market of shoppers desiring high-value and health-conscious foods. In addition, Trader Joe's scores

Strategic leaders may use *value innovation* to move to blue oceans—that is, to new and uncontested market spaces. Shown here is the famous "blue hole" just off the coast of Belize.

Mlenny/Getty Images

exceptionally well in customer service and other areas. When a blue ocean strategy is successfully formulated and implemented, investments in differentiation and low cost are not substitutes but rather complements, providing important positive spillover effects. A successfully implemented blue ocean strategy gives firms two pricing options: First, the firm can charge a higher price than the cost leader, reflecting its higher value creation and thus generating greater profit margins. Second, the firm can lower its price below that of the differentiator because of its lower-cost structure. If the firm offers lower prices than the differentiator, it can gain market share and make up the loss in margin through increased sales.

LO 6-5

Evaluate value and cost drivers that may allow a firm to pursue a blue ocean strategy.

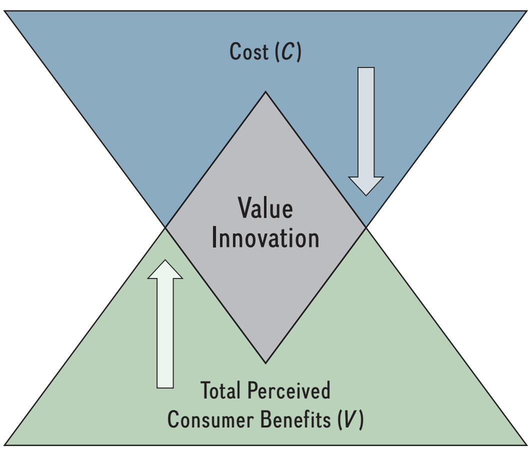
VALUE INNOVATION

value innovation The simultaneous pursuit of differentiation and low cost in a way that creates a leap in value for both the firm and the consumers; considered a cornerstone of blue ocean strategy.

For a blue ocean strategy to succeed, managers must resolve trade-offs between the two generic strategic positions: low cost and differentiation.[39] They do so through **value innovation**, aligning innovation with total perceived consumer benefits, price, and cost (also see the discussion in Chapter 5 on *economic value creation*). Instead of attempting to outcompete rivals by offering better features or lower costs, successful value innovation makes competition irrelevant by providing a leap in value creation, thereby opening new and uncontested market spaces.

Successful value innovation requires that a firm's strategic moves lower its costs and increase the perceived value for buyers (Exhibit 6.9). Lowering costs is achieved primarily by eliminating and reducing the taken-for-granted factors on which the firm's industry rivals compete. Perceived buyer value is increased by raising existing key success factors and by creating new elements that the industry has not offered previously. To initiate a strategic move that allows a firm to open a new and uncontested market space through value innovation, strategic leaders must answer four key questions when formulating a blue ocean business strategy.[40] In terms of achieving successful value innovation, note that the first two questions focus on lowering costs, and the second two questions focus on increasing perceived consumer benefits:

EXHIBIT 6.9 Value Innovation Accomplished through Simultaneously Pursuing Differentiation ($V\uparrow$) and Low Cost ($C\downarrow$)



Source: Author's adaptation from C.W. Kim and R. Mauborgne (2005), *Blue Ocean Strategy: How to Create Uncontested Market Space and Make Competition Irrelevant* (Boston: Harvard Business School Publishing).

Value Innovation—Lower Costs

1. *Eliminate.* Which of the factors that the industry takes for granted should be eliminated?
2. *Reduce.* Which of the factors should be reduced well below the industry's standard?

Value Innovation—Increase Perceived Consumer Benefits

1. *Raise.* Which of the factors should be raised well above the industry's standard?
2. *Create.* Which factors should be created that the industry has never offered?

The international furniture retailer IKEA, for example, has used value innovation based on this *eliminate-reduce-raise-create* framework to initiate its own blue ocean and to achieve a sustainable competitive advantage.[41]

ELIMINATE (TO LOWER COSTS). IKEA eliminated several taken-for-granted competitive elements, including salespeople, expensive but small retail outlets in prime urban locations and shopping malls, a long wait after ordering furniture, and after-sales service. Instead, IKEA displays its products in a warehouse-like setting, thus reducing inventory cost. Customers serve themselves and then transport the furniture for assembly to their homes in IKEA's signature flat-packs. IKEA also uses the big-box concept of locating supersized stores near major metropolitan areas (refer to the discussion of "Taking Advantage of Certain Physical Properties" under "Economies of Scale" in Section 6.3).

Each IKEA store has a large self-service warehouse section, further driving down its cost.
Tooykrub/Shutterstock

REDUCE (TO LOWER COSTS). Because of its do-it-yourself business model regarding furniture selection, delivery, and assembly, IKEA drastically reduced the need for staff in its megastores. Strolling through an IKEA store, you encounter few employees. IKEA also reduced several other taken-for-granted competitive elements, including 25-year warranties on high-end custom furniture, high degree of customization in selecting options such as different fabrics and patterns, and use of expensive materials such as leather or hardwoods.

RAISE (TO INCREASE PERCEIVED CONSUMER BENEFITS). IKEA raised several competitive elements. Specifically, it offers tens of thousands of home furnishing items in each of its big-box stores (which take up 320,000 square feet, roughly the equivalent of six football fields) versus a few hundred in traditional furniture stores. It also offers more than furniture, including a range of accessories such as placemats, laptop stands, and much more; each store has hundreds of rooms fully decorated with all sorts of IKEA items, each with a detailed tag explaining the item. Moreover, rather than sourcing its furniture from wholesalers or other furniture makers, IKEA manufactures all of its furniture at fully dedicated suppliers, thus tightly controlling the design, quality, functionality, and cost of each product.

IKEA also raised the customer experience by laying out its stores in such a way that customers can see and touch basically all of its products, including dishware, bedding, and furniture.

CREATE (TO INCREASE CONSUMER BENEFITS). IKEA created a new way for people to shop for furniture. Customers stroll along a predetermined path winding through the fully furnished showrooms. They can compare, test, and touch all the things in the showroom. The price tag on each item contains other important information, including type of material and weight. Once an item is selected, the customer notes the item number (the store provides a pencil and paper). The tag also indicates the location in the warehouse where the customer can pick up the item in IKEA's signature flat-packs. After paying, the customer transports the products and assembles the furniture. The customer has 90 days to return items for a full refund.

In traditional furniture shopping, customers visit a small retail outlet where salespeople swarm them. After a purchase, the customer generally has to wait a few weeks before the furniture is shipped because many furniture makers do not produce items, such as expensive leather sofas, until they are paid for in advance. Finely crafted couches and chairs cost thousands of dollars (compared to IKEA's fabric couches, which retail for $399). When shopping at a traditional furniture store, the customer also pays for delivery of the furniture.

IKEA also created a new approach to pricing its products. Rather than using a "cost plus margin approach" like traditional furniture stores when pricing items, IKEA begins with the retail price first. For example, it sets the price for an office chair at $150, and then IKEA's designers figure out how to meet this goal, which includes a profit margin. They need to consider the chair from start to finish, thinking not only about design but also about raw materials and the way the product will be displayed and transported. Only then will products go into production.

In addition, IKEA created several other new competitive elements that allow it to offer more value to its customers. For example, IKEA stores provide onsite child care, house a cafeteria serving delicious food options including Swedish delicacies such as smoked salmon at low prices, and offer convenient and ample parking, often in garages under the store, from which escalators bring customers directly into the showrooms.

By implementing these key steps to achieving value innovation—eliminate, reduce, raise, and create—IKEA orchestrates different internal value chain activities to reconcile the tension between differentiation and cost leadership to create a unique market space. IKEA uses innovation in multiple dimensions—in furniture design, engineering, and store design—to solve the trade-offs between value creation and production cost. An IKEA executive highlights the difficulty of achieving value innovation as follows: "Designing beautiful-but-expensive products is easy. Designing beautiful products that are inexpensive and functional is a huge challenge."[42] IKEA leverages its deep design and engineering expertise to offer furniture that is stylish and functional and that can be easily assembled by the consumer. In this way, IKEA can pursue a blue ocean strategy based on value innovation to increase the perceived value of its products, while simultaneously lowering its cost and offering competitive prices. It opened a new market serving a younger demographic than traditional furniture stores. When young people around the world move into their own apartment or house, they frequently furnish it with products from IKEA.

LO 6-6

Assess the risks of a blue ocean strategy, and explain why it is difficult to succeed at value innovation.

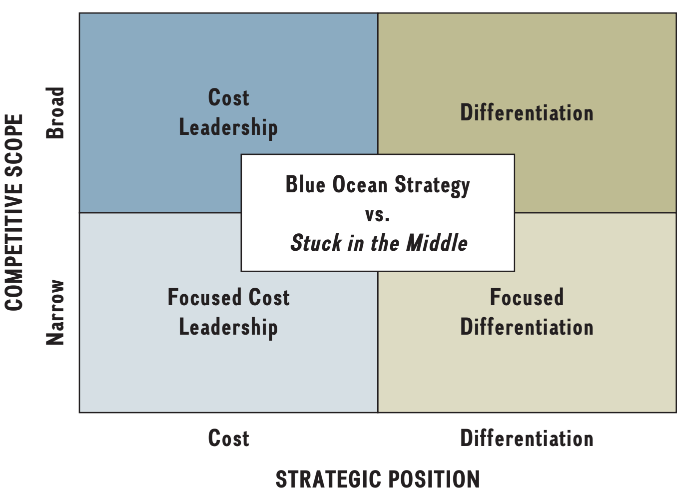
BLUE OCEAN STRATEGY GONE BAD: "STUCK IN THE MIDDLE"

Although appealing in a theoretical sense, a blue ocean strategy can be quite difficult to translate into reality. Differentiation and cost leadership are distinct strategic positions that require important trade-offs.[43] A blue ocean strategy is difficult to implement because it requires the reconciliation of fundamentally different strategic positions—differentiation and low cost—which in turn require distinct internal value chain activities (see Chapter 4) that allow the firm to increase value *and* lower cost at the same time.

Exhibit 6.10 suggests how a successfully formulated blue ocean strategy based on *value innovation* combines both a differentiation position and a low-cost position. It also shows the consequence of a blue ocean strategy gone bad—the firm ends up being *stuck in the middle*, meaning it has neither a clear differentiation nor a clear cost-leadership profile. Being stuck in the middle leads to inferior performance and a resulting competitive disadvantage.

Strategy Highlight 6.2 shows how JCPenney was attempting to implement a blue ocean strategy, but instead ended up in a red ocean of cutthroat competition.

EXHIBIT 6.10 Value Innovation vs. *Stuck in the Middle*



Strategy Highlight **6.2**

How JCPenney Sailed into a Red Ocean

JCPenney was once one of the top department stores in the United States, with more than 2,000 locations at its peak. Indeed, the retailer was so ubiquitous in the suburbs that one could not imagine a shopping mall without a JCPenney. Generations of America's children were mesmerized by its annual holiday catalog. As recently as 2007, JCPenney had enjoyed a market valuation of $18 billion. A little more than a decade later, JCPenney filed for bankruptcy. What went wrong?

Of course, all retailers, including JCPenney, face the same threat, Amazon, which has become synonymous with online shopping. Unlike Walmart, Target, and Best Buy, which have become more competitive in recent years, JCPenney sped up its demise with a bad business strategy. Under former CEO Ron Johnson, JCPenney learned the hard way how difficult it is to change a strategic position. When hired as JCPenney's CEO in 2011, Johnson was hailed as a star executive. JCPenney had poached him from Apple, where he had created and led Apple's retail stores since 2000. Apple's stores are the most successful retail stores globally in terms of sales per square foot. Not even luxury jewelers achieve higher sales per square foot. This poaching didn't come cheap: JCPenney paid Ron Johnson close to $53 million in total compensation in 2011, even though he didn't join the company until November of that year.

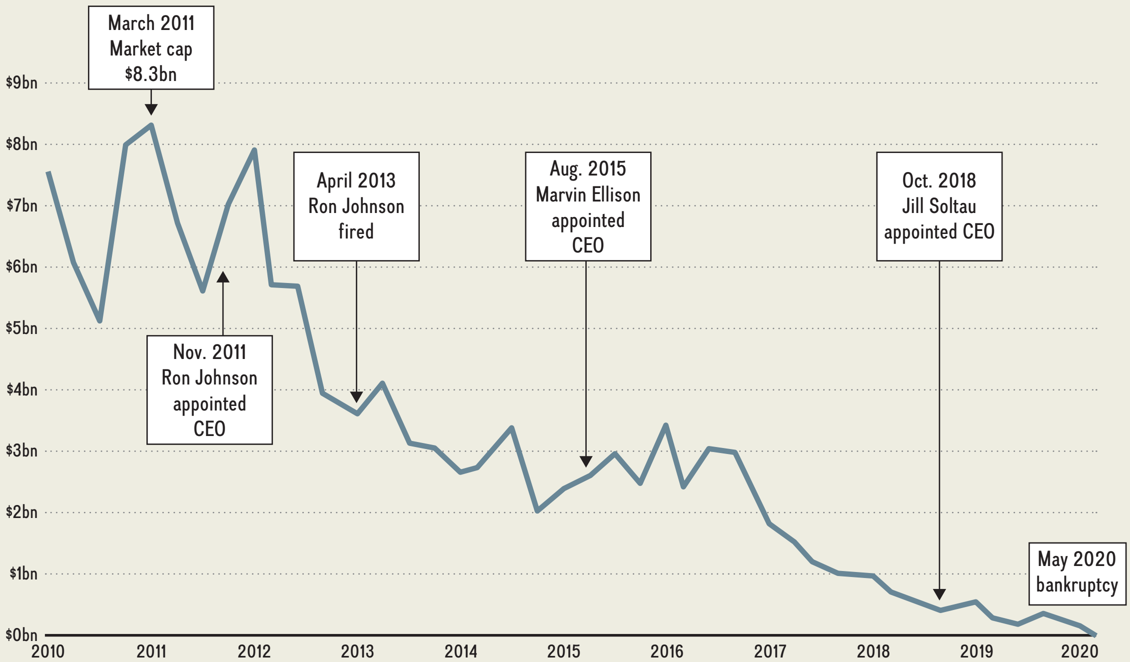
Once onboard with JCPenney, Johnson immediately began to change the company's strategic position from a cost-leadership strategy to a blue ocean strategy, attempting to combine its traditional cost-leadership position with a differentiation position. Specifically, he tried to reposition the department store more toward the high end by providing an improved customer experience and more exclusive merchandise through in-store boutiques. Johnson ordered the removal of all clearance racks with steeply discounted merchandise, once common in JCPenney stores. He also did away with JCPenney's long-standing practice of mailing discount coupons to its customers. Rather than following industry best practice by testing the more drastic strategic moves in a small number of selected stores, Johnson implemented them in all 1,800 stores simultaneously. When one executive raised the issue of pretesting, Johnson bristled and responded, "We didn't test at Apple."[44] Under his leadership, JCPenney also got embroiled in a legal battle with Macy's because of Johnson's attempt to lure away homemaking maven Martha Stewart and her exclusive merchandise collection.

The envisioned blue ocean strategy failed badly, and JCPenney ended up stuck in the middle. Within 12 months, with Johnson at the helm,

Marvin Ellison holds an undergraduate degree from the University of Memphis and an MBA from Emory University. He was JCPenney's CEO from 2015 to 2018. Although Ellison was able to recover some of the company's lost profitability, he could not turn the retailer's fortunes around given unfavorable external conditions. In 2018, he was appointed CEO of home improvement chain Lowe's, where he has had a terrific run. When he joined in 2018, the market cap stood at $78 billion. Under his leadership, Lowe's market cap grew by 125% to over $170 billion in 2022, and it has outperformed The Home Depot since 2020.

MediaPunch/REX/Shutterstock

EXHIBIT 6.11 JCPenney's Market Cap and CEO Leadership, 2010–2020 (in $ bn)



Source: Author's depiction of publicly available data.

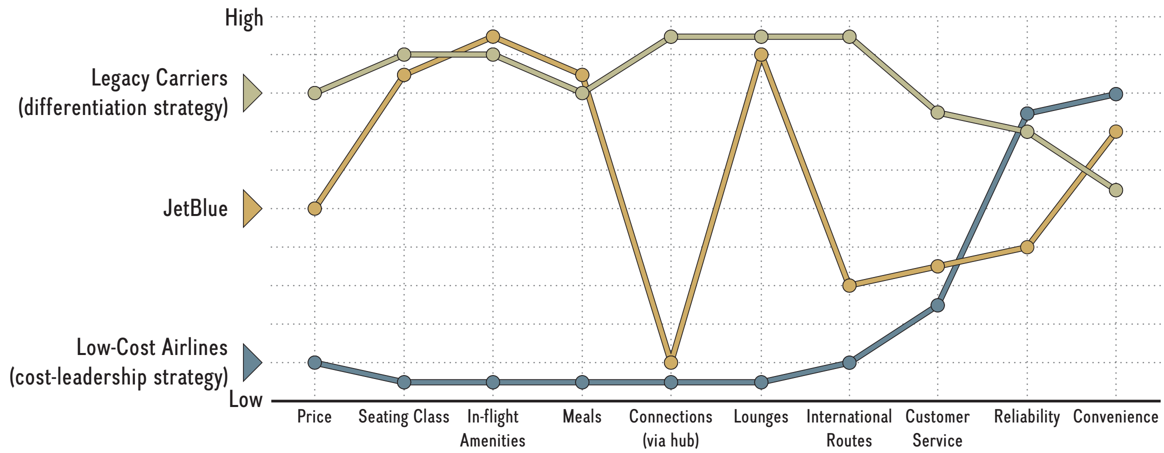
JCPenney's sales dropped by 25%. Such a significant drop in sales is a landslide in a hypercompetitive industry such as retailing where every single percent of market share counts. Things went from bad to worse. In 2013, JCPenney's stock performed so poorly it was dropped from the S&P 500 index. Less than 18 months into his new job, Johnson was fired. JCPenney had lost over roughly half of its market valuation (or $3.5 billion) under Johnson's leadership. Johnson's attempted overhaul of JCPenney also left the company burdened with more than $4 billion in debt.

Under Johnson's leadership, JCPenney failed at its attempted blue ocean strategy and instead sailed deeper into the red ocean of bloody competition. As we've seen, attempting a blue ocean strategy is perilous because of the inherent trade-offs in the underlying generic business strategies of cost leadership and differentiation. Myron Ullman, Johnson's predecessor, was brought out of retirement as a temporary replacement. Exhibit 6.11 shows JCPenney's stock market valuation and CEO appointments over time.

In 2015 the board appointed Marvin Ellison as CEO, charging him with turning around the 120-year-old iconic retail store. With a strong background in operations management and leadership skills honed at The Home Depot, he focused on lowering JCPenney's cost structure while increasing the perceived value offered to its customers. In an attempt to stem losses, in 2017 JCPenney closed some 140 retail stores across the United States out of a total of 1,000 remaining stores. Marvin Ellison was lured back into the home improvement industry when he was appointed CEO of Lowe's in 2018.

In 2018, the board appointed Jill Soltau as CEO of JCPenney. She was previously the CEO of Jo-Ann Stores, a fabric-and-craft retailer. Soltau retained McKinsey, a strategy consulting firm, to help with the turnaround. It failed because JCPenney was unable to address the external threat of ecommerce, which eroded its profits. To make matters worse, the Covid-19 pandemic closed its retail stores. JCPenney did not recover. After being in business for almost 120 years and a staple of American life, JCPenney filed for bankruptcy in 2020.[45]

EXHIBIT 6.12 Strategy Canvas of JetBlue vs. Low-Cost Airlines and Legacy Carriers



THE STRATEGY CANVAS. The **value curve** is the basic component of the **strategy canvas**. It graphically depicts a firm's relative performance across different competitive factors in an industry. A strong value curve has a clear focus and divergence from the competition. It can suggest what strategy is being followed or should be undertaken.

Exhibit 6.12 plots the strategic profiles or value curves for three kinds of competitors in the U.S. airline industry. On the left-hand side, starting at the top and descending in underlying cost structure, are the legacy carriers (for example, Delta), followed by JetBlue, and then finally low-cost airlines such as Southwest Airlines (SWA). The exhibit also shows the different strategic positions (differentiator, stuck in the middle, and low-cost leader) and traces the value curves as each group ranks high or low on a variety of parameters. JetBlue is stuck in the middle (as discussed in the ChapterCase). Low-cost airlines follow a cost-leadership strategy.

Legacy carriers tend to score fairly high on most competitive elements in the airline industry, including different seating class choices (such as business class, economy comfort, basic economy, and so on); in-flight amenities such as Wi-Fi, personal video console to view movies or play games, and complimentary drinks and meals; coast-to-coast coverage via connecting hubs; plush airport lounges; international routes and global coverage; high customer service; and high reliability in terms of safety and on-time departures and arrivals. As expected when a firm is pursuing a generic differentiation strategy, all these scores along the different competitive elements in an industry correspond to a relative higher cost structure.

In contrast, the low-cost airlines tend to hover near the bottom of the strategy canvas, with low scores for a number of competitive factors in the industry: no assigned seating, no in-flight amenities, no drinks or meals, no airport lounges, few if any international routes, and a low to intermediate level of customer service. A relatively lower cost structure goes along with a generic low-cost leadership strategy.

value curve Horizontal connection of the points of each value on the strategy canvas that helps strategic leaders diagnose and determine courses of action.

strategy canvas Graphical depiction of a company's relative performance vis-à-vis its competitors across the industry's key success factors

This strategy canvas also reveals key strategic insights. Look at the few competitive elements where the value curves of the differentiator and low-cost leader diverge. Interestingly, some cost leaders (e.g., SWA) score much higher than some differentiators (e.g., United Airlines) in terms of reliability and convenience, offering frequent point-to-point connections to conveniently located airports, often in or near city centers. This key divergence between the two strategies explains why generic cost leaders have frequently outperformed generic differentiators in the U.S. airline industry. Overall, both value curves show a consistent pattern representative of a more or less clear strategic profile as either differentiator or low-cost leader.

Now look at JetBlue's value curve. Unlike the differentiation or low-cost value curves, which are relatively consistent, the JetBlue value curve follows a zigzag pattern. JetBlue attempts to achieve parity with or even outcompete differentiators in the U.S. airline industry along competitive factors such as different seating classes (e.g., the high-end Mint offering discussed in the ChapterCase), higher level of in-flight amenities, higher-quality beverages and meals, and plush airport lounges. However, JetBlue looks more like a low-cost leader in terms of providing only a few connections via hubs domestically and a low number of international routes, and it recently has had a poor record of customer service, mainly because of some high-profile missteps as documented in the ChapterCase. JetBlue's reliability is mediocre, but it does provide a larger number of convenient point-to-point flights than a differentiator such as Delta (but fewer point-to-point flights than a low-cost leader such as SWA).

A value curve that zigzags across the strategy canvas indicates a lack of effectiveness in its strategic profile. The curve visually represents how JetBlue is stuck in the middle and as a consequence has experienced inferior performance and thus a sustained competitive disadvantage vis-à-vis airlines with a stronger strategy profile such as SWA and Delta.

6.6 Implications for Strategic Leaders

Formulating a business strategy is never easy, even when only a handful of strategic options are available (i.e., low cost or differentiation, broad or narrow, or blue ocean). The best strategic leaders work hard to make sure they understand their firm and their industry, and the opportunities they reveal. They work even harder to fine-tune strategy formulation and execution. When well-formulated and implemented, a business strategy enhances a firm's chances of obtaining superior performance. Strategic positioning requires making important trade-offs (think Walmart versus Supreme in clothing).

In rare instances, a few exceptional firms are able to change the competitive landscape by opening previously unknown areas of competition. Doing so requires the firm reconcile the significant trade-offs between increasing value and lowering costs by pursuing both business strategies (differentiation and low cost) simultaneously. Blue ocean strategy tends to be successful only if a firm is able to rely on a value innovation that allows it to reconcile the trade-offs. Toyota, for example, initiated a new market space with its introduction of lean manufacturing, delivering cars of higher quality and value at lower cost. This value innovation gave Toyota a competitive advantage for a decade or more, until its new process technology diffused widely. In contrast, while JetBlue was successful initially in pursuing a blue ocean strategy, its strategic profile became less clearly defined as the company grew, and it ended up stuck in the middle with a competitive disadvantage.

CHAPTER**CASE 6** Part II

In 2022, the "big four" airlines (American, Delta, SWA, and United) controlled 80% of the U.S. domestic market, so the industry is fairly concentrated. JetBlue had 5.3% market share and close to $6 billion in annual revenues.

Early in its history JetBlue Airways achieved a competitive advantage based on *value innovation.* It was able to drive up perceived customer value while lowering costs, which allowed it to carve out a strong strategic position and move into a non-contested market space. No other competitors in the U.S. domestic airline industry were able to provide such value innovation at that point in time. Rather than directly competing with other airlines, JetBlue created a blue ocean.

Although JetBlue was able to create an initial competitive advantage, it was unable to sustain that advantage. Because JetBlue failed to reconcile the strategic trade-offs inherent in combining differentiation and cost leadership, it was unable to continue its blue ocean strategy, and it experienced a sustained competitive disadvantage, frequently lagging the Dow Jones U.S. Airlines Index.

JetBlue's leadership team is attempting to reverse this trend; it has made changes to improve the airline's flagging profitability. It is putting strategic initiatives in place to lower costs while also trying to further increase its value offering. To lower operating costs, JetBlue decided to start charging $35 for the first checked bag and $45 for the second. It also removed the additional legroom for which it was famous in the industry.

To drive up perceived customer value, JetBlue has added to its fleet more than 60 new airplanes (Airbus A-321), which significantly improve the in-flight experience and thus customer satisfaction. Although JetBlue already flies internationally, serving destinations in Central and South America as well as the Caribbean, CEO Robin Hayes has added London as the first European destination and is considering adding more flights to continental Europe. Flying non-stop to cities in Europe is now possible for JetBlue with its addition of the new Airbus A-321 to its fleet. Flying longer, non-stop routes drives down costs. Moreover, international routes tend to be much more profitable than domestic routes because of less competition, at least for the time being.

Questions

1. Despite its initial success, why was JetBlue unable to sustain a blue ocean strategy?
2. *The Wall Street Journal* asked JetBlue's chief commercial officer, Marty St. George, "What is the biggest marketing challenge JetBlue faces?" His response: "We are flying in a space where our competitors are moving toward commoditization. We have taken a position that air travel is not a commodity but a services business. We want to stand out, but it's hard to break through to customers with that message."[46]
   a. Given St. George's statement, which strategic position is JetBlue trying to accomplish: differentiator, cost leader, or blue ocean strategy?-Explain.
   b. Which strategic moves has the team around CEO Robin Hayes put in place, and why? Explain whether they focus on value creation, operating costs, or both simultaneously. Do these moves correspond to St. George's understanding of JetBlue's strategic position? Why or why not? Explain.
3. Consider JetBlue's value curve in Exhibit 6.12. Why is JetBlue experiencing a competitive disadvantage? What recommendations would you offer JetBlue to strengthen its strategic profile? Be specific.
4. JetBlue CEO Robin Hayes is contemplating adding international routes, connecting the U.S. East Coast to more European destinations. Would this additional international expansion put more pressure on JetBlue's current business strategy? Would it require a shift in JetBlue's strategic profile? If a strategic repositioning is needed, in which direction should JetBlue pivot? Explain.

TAKE-AWAY CONCEPTS

This chapter discussed two generic business-level strategies: *differentiation* and *cost leadership.* Companies can use various tactics to drive one or the other of these strategies, either narrowly or broadly. A *blue ocean strategy* attempts to find a competitive advantage by creating a new competitive area via value innovation. When successful, a blue ocean strategy reconciles the trade-offs between the two generic business strategies.

LO 6-1 / Define business-level strategy and describe how it determines a firm's strategic position.

- Business-level strategy determines a firm's strategic position in its quest for competitive advantage when competing in a single industry or product market.
- Strategic positioning requires that managers address strategic trade-offs that arise between value and cost, because higher value tends to correspond with higher cost.
- Differentiation and cost leadership are distinct strategic positions.
- In addition to selecting an appropriate strategic position, managers must also define the scope of competition—whether to pursue a specific market niche or go after the broader market.

LO 6-2 / Examine the relationship between value drivers and differentiation strategy.

- The goal of a differentiation strategy is to increase the perceived value of goods and services so that customers will pay a higher price for additional features.
- In a differentiation strategy, the focus of competition is on value-enhancing attributes and features, along with cost control.
- Some of the unique value drivers that managers can manipulate are product features, customer service, customization, and complements.
- Value drivers contribute to competitive advantage only if their increase in value creation (ΔV) exceeds the increase in costs (ΔC), or $\Delta V > \Delta C$.

LO 6-3 / Examine the relationship between cost drivers and cost-leadership strategy.

- The goal of a cost-leadership strategy is to reduce the firm's cost below that of its competitors.
- In a cost-leadership strategy, the focus of competition is achieving the lowest possible cost position, which allows the firm to offer a lower price than competitors while providing acceptable value.
- Some of the unique cost drivers that managers can manipulate are the cost of input factors, economies of scale, and learning- and experience-curve effects.
- No matter how low the price, the product or service will not sell if it does not have an acceptable value proposition.

LO 6-4 / Assess the benefits and risks of differentiation and cost-leadership strategies vis-à-vis the five forces that shape competition.

- The five forces model helps managers use generic business strategies to protect themselves against the industry forces that drive down profitability.
- Differentiation and cost-leadership strategies allow firms to carve out strong strategic positions, not only to protect themselves against the five forces but also to benefit from them in their quest for competitive advantage.
- Exhibit 6.8 details the benefits and risks of each business strategy.

LO 6-5 / Evaluate value and cost drivers that may allow a firm to pursue a blue ocean strategy.

- To address the trade-offs between differentiation and cost leadership at the business level, managers must employ value innovation, a process that will lead them to align the proposed business strategy with total perceived consumer benefits, price, and cost.
- Lowering a firm's costs is primarily achieved by eliminating and reducing the taken-for-granted factors on which the firm's industry rivals compete.
- Increasing perceived buyer value is primarily achieved by raising existing key success factors and by creating new elements that the industry has not yet offered.
- Strategic leaders track their opportunities and risks for lowering a firm's costs and increasing perceived value vis-à-vis their competitors by use of a strategy canvas, which plots industry factors among competitors (see Exhibit 6.12).

LO 6-6 / Assess the risks of a blue ocean strategy, and explain why it is difficult to succeed at value innovation.

- A successful blue ocean strategy requires the trade-offs between differentiation and low cost to be reconciled.
- A blue ocean strategy often is difficult because the two distinct strategic positions require internal value chain activities that are fundamentally different.
- When firms fail to resolve strategic trade-offs between differentiation and cost, they end up "stuck in the middle." They succeed at neither business strategy, and they end up at a competitive disadvantage.

KEY TERMS

Blue oceans *(p. 231)*
Blue ocean strategy *(p. 231)*
Business-level strategy *(p. 211)*
Cost-leadership strategy *(p. 213)*
Differentiation strategy *(p. 212)*
Diseconomies of scale *(p. 222)*
Economies of scale *(p. 220)*
Economies of scope *(p. 216)*
Focused cost-leadership strategy *(p. 214)*
Focused differentiation strategy *(p. 214)*
Minimum efficient scale (MES) *(p. 222)*
Red oceans *(p. 231)*
Scope of competition *(p. 213)*
Strategic trade-offs *(p. 212)*
Strategy canvas *(p. 237)*
Stuck in the middle *(p. 214)*
Value curve *(p. 237)*
Value innovation *(p. 232)*

ENDNOTES

1. Sources: Sindreu, J. (2022, Apr. 6), "JetBlue-Spirit deal goes one complication too far," *The Wall Street Journal*; Sider, A. (2022, Apr. 5), "JetBlue offers to buy Spirit in all-cash deal," *The Wall Street Journal*; McCartney, S. (2022, Jan. 28), "The best and worst U.S. airlines of 2018," *The Wall Street Journal*; Kendall, B., and A. Sider (2021, Sep. 22), "Justice Department files antitrust suit challenging American-JetBlue alliance," *The Wall Street Journal*; Cameron, D., and A. Sider (2020, Jul. 20), "American targets New York expansion with JetBlue pact," *The Wall Street Journal*; McCartney, S. (2019, Jan. 16), "The best and worst U.S. airlines of 2018," *The Wall Street Journal*; McCartney, S. (2018, Jan. 10), "The best and worst U.S. airlines of 2017," *The Wall Street Journal*; McCartney, S. (2017, Mar. 8), "Discount business class? Thank JetBlue," *The Wall Street Journal*; Carey, S. (2016, Dec. 16), "JetBlue unveils cost-cutting plan worth up to $300 million by 2020," *The Wall Street Journal*; Carey, S. (2016, Jul. 26), "JetBlue considers foray into Europe," *The Wall Street Journal*; Carey, S. (2016, Apr. 12), "JetBlue to expand its high-end service, dubbed Mint, to more routes," *The Wall Street Journal*; Nicas, J. (2015, Mar. 27), "Pilot sues JetBlue for allegedly letting him fly while mentally unfit," *The Wall Street Journal*; Mayerowitz, S. (2015, Feb. 16), "JetBlue's CEO vies to please passengers, stocks," *The Associated Press*; Vranica, S. (2015, Feb. 22), "JetBlue's plan to repair its brand," *The Wall Street Journal*; Harris, R.L. (2015, Feb. 11), "On JetBlue, passengers can use ApplePay," *The New York Times*; Rosenbloom, S. (2015, Jan. 22), "Flying deluxe domestic coast-to-coast for around $1,000," *The New York Times*; Nicas, J. (2014, Nov. 19), "JetBlue to add bag fees, reduce legroom," *The Wall Street Journal*; Gardiner, S. (2010, Aug. 10), "Flight attendant grabs two beers, slides down the emergency chute," *The Wall Street Journal*; Miranda, C.A. (2007, Feb. 21), "Can JetBlue weather the storm?" *Time*; Bailey, J. (2007, Feb. 19), "JetBlue's C.E.O. is 'mortified' after fliers are stranded," *The New York Times*; Zeller, T. (2007, Feb. 16), "Held hostage on the tarmac: Time for a passenger bill of rights?" *The New York Times*; Bryce, D.J., and J.H. Dyer (2007, May), "Strategies to crack well-guarded markets," *Harvard Business Review*; Kim, C.W., and R. Mauborgne (2005), *Blue Ocean Strategy: How to Create Uncontested Market Space and Make Competition Irrelevant* (Boston: Harvard Business School Publishing); Friedman, T. (2005), *The World Is Flat: A Brief History of the Twenty-First Century* (New York: Farrar, Strauss and Giroux); and Neeleman, D. (2003, Apr. 30), "Entrepreneurial thought leaders lecture," Stanford Technology Ventures Program; some data drawn from statista.com and JetBlue Fact Sheets and Annual reports (various years).

2. This discussion is based on: Porter, M.E. (2008, Jan.), "The five competitive forces that shape strategy," *Harvard Business Review*; Porter, M.E. (1996, Nov.–Dec.), "What is strategy?" *Harvard Business Review*; Porter, M.E. (1985), *Competitive Advantage: Creating* and *Sustaining Superior Performance* (New York: Free Press); and Porter, M.E. (1980), *Competitive Strategy: Techniques for Analyzing Industries and Competitors* (New York: Free Press).

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5. Porter, M.E. (1996, Nov.–Dec.), "What is strategy?" *Harvard Business Review*.

6. To decide if and how to divide the market, you can apply the market segmentation techniques you have acquired in your marketing and microeconomics classes.

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9. The interested reader is referred to the strategy, marketing, and economics literatures. A good start in the strategy literature is the classic work of M.E. Porter: Porter, M.E. (1980), *Competitive Strategy: Techniques for Analyzing Industries and Competitors* (New York: Free Press); Porter, M.E. (1985), *Competitive Advantage: Creating and Sustaining Superior Performance* (New York: Free Press); and Porter, M.E. (2008, Jan.), "The five competitive forces that shape strategy," *Harvard Business Review*.

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26. The Tesla example draws on: Dyer, J., and H. Gregersen (2016, Aug. 24), "Tesla's innovations are transforming the auto industry," *Forbes*; Higgins T. (2017, Apr. 10), "How Tesla topped GM as most valuable U.S. automaker," *The Wall Street Journal Tech Talk*; "Tesla increases deliveries of electric cars," *The Economist* (2017, Apr. 6); Tesla Annual Report (various years); and GM Annual Report (various years).

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Units	Per-Unit Cost ($)
100	$324,464
500	$180,901
1,000	$140,659
1,500	$121,407
2,000	$109,369
2,500	$100,859
3,000	$94,400
3,500	$89,263
4,000	$85,039
4,500	$81,480
5,000	$78,422
5,500	$75,756
6,000	$73,400
6,500	$71,298
7,000	$69,406
7,500	$67,689
8,000	$66,122
8,500	$64,683
9,000	$63,354
9,500	$62,123
10,000	$60,977
10,500	$59,907
11,000	$58,903
11,500	$57,961
12,000	$57,072

28. The exact data for learning curves depicted in Exhibit 6.7 are depicted below. A simplifying assumption is that the manufacturing of one aircraft costs $100 million, from there the two different learning curves set in. Noteworthy, that while making only one aircraft costs $100 million, when manufacturing over 4,000 aircraft the expected per-unit cost falls to only $28 million (assuming a 90 percent learning curve) and only $7 million (assuming an 80 percent learning curve). Data underlying Exhibit 6.7

Learning Curves		
	Per-Unit Cost*	
Units	90%	80%
1	$100	$100
2	90	80
4	81	64
8	73	51
16	66	41
32	59	33
64	53	26
128	48	21
256	43	17
512	39	13
1,024	35	11
2,048	31	9
4,096	28	7

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32. Boston Consulting Group (1972), *Perspectives on Experience* (Boston: Boston Consulting Group).

33. See data presented in Endnote 28.

34. Anand, G. (2009, Nov. 25), "The Henry Ford of heart surgery," *The Wall Street Journal.*

35. This discussion is based on: Porter, M.E. (1979, Mar.–Apr.), "How competitive forces shape strategy," *Harvard Business Review*: 137–145; Porter, M.E. (1980), *Competitive Strategy: Techniques for Analyzing Industries and Competitors* (New York: Free Press); and Porter, M.E. (2008, Jan.), "The five competitive forces that shape strategy," *Harvard Business Review*.

36. As of Q1 2022, the exact market share for Google's Android was 71.7% and for Apple's iOS was 27.57%, thus together they hold 99.3% of the entire mobile operating system market globally. Data drawn from https://gs.statcounter.com/os-market-share/mobile/worldwide.

37. This discussion is based on: Kim, C.W., and R. Mauborgne (2017), *Blue Ocean Shift: Beyond Competing—Proven Steps to Inspire Confidence and Seize New Growth* (New York: Hachette); Kim, C.W., and R. Mauborgne (2005), *Blue Ocean Strategy: How to Create Uncontested Market Space and Make Competition Irrelevant* (Boston: Harvard Business School Publishing); Miller, A., and G.G. Dess (1993), "Assessing Porter's model in terms of its generalizability, accuracy, and simplicity," *Journal of Management Studies* 30: 553–585; and Hill, C.W.L. (1988), "Differentiation versus low cost or differentiation and low cost: A contingency framework," *Academy of Management Review* 13: 401–412.

38. Kim, C.W., and R. Mauborgne (2005), *Blue Ocean Strategy: How to Create Uncontested Market Space and Make Competition Irrelevant* (Boston: Harvard Business School Publishing); Miller, A., and G.G. Dess (1993), "Assessing Porter's model in terms of its generalizability, accuracy, and simplicity," *Journal of Management Studies* 30: 553–585; and Hill, C.W.L. (1988), "Differentiation versus low cost or differentiation and low cost: A contingency framework," *Academy of Management Review* 13: 401–412.

39. Kim, C.W., and R. Mauborgne (2005), *Blue Ocean Strategy: How to Create Uncontested Market Space and Make Competition Irrelevant* (Boston: Harvard Business School Publishing); Miller, A., and G.G. Dess (1993), "Assessing Porter's model in terms of its generalizability, accuracy, and simplicity," *Journal of Management Studies* 30: 553–585; and Hill, C.W.L. (1988), "Differentiation versus low cost or differentiation and low cost: A contingency framework," *Academy of Management Review* 13: 401–412.

40. Kim, C.W., and R. Mauborgne (2005), *Blue Ocean Strategy: How to Create Uncontested Market Space and Make Competition Irrelevant* (Boston: Harvard Business School Publishing); Miller, A., and G.G. Dess (1993), "Assessing Porter's model in terms of its generalizability, accuracy, and simplicity," *Journal of Management Studies* 30: 553–585; and Hill, C.W.L. (1988), "Differentiation versus low cost or differentiation and low cost: A contingency framework," *Academy of Management Review* 13: 401–412.

41. The IKEA example is drawn from: "IKEA: How the Swedish retailer became a global cult brand," *Bloomberg Businessweek* (2005, Nov. 14); Edmonds, M. (2008, Jul. 8), "How IKEA works," http://money.howstuffworks.com/; and www.ikea.com.

42. "IKEA: How the Swedish retailer became a global cult brand," *Bloomberg Businessweek* (2005, Nov. 14).

43. This discussion is based on: Porter, M.E. (1980), *Competitive Strategy: Techniques for Analyzing Industries and Competitors* (New York: Free Press); and Porter, M.E. (1996, Nov.–Dec.), "What is strategy?" *Harvard Business Review*: 61–78.

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46. Marty St. George, who spent over 13 years with JetBlue Airways in 2019. Vranica S. (2015, Feb. 22), "JetBlue's plan to repair its brand," *The Wall Street Journal.*

CHAPTER

7

Business Strategy: Innovation, Entrepreneurship, and Platforms

Chapter Outline

Learning Objectives

LO 7-1 Outline the four-step innovation process from idea to imitation.

LO 7-2 Outline the four stages of industrial revolutions and derive implications for expected changes in the future.

LO 7-3 Apply strategic management concepts to entrepreneurship and innovation.

LO 7-4 Describe the competitive implications of different stages in the industry life cycle.

LO 7-5 Derive strategic implications of the crossing-the-chasm framework.

LO 7-6 Categorize different types of innovations in the markets-and-technology framework.

LO 7-7 Explain why and how platform businesses can outperform pipeline businesses.

CHAPTERCASE 7 Part I

Netflix: No Longer a Disruptor?

Netflix was one of the big winners during the Covid pandemic, when millions of people were stuck at home. By 2022, Netflix had 220 million subscribers worldwide, with 75 million subscribers in the United States and Canada. At its peak, Netflix's market cap was over $300 billion, and its stock had appreciated more than 95,000% since Netflix went public (in 2002). In comparison, the tech-heavy NASDAQ-100 index grew by "only" 1,200% in the same period. By continuing to innovate on many dimensions, Netflix was able to disrupt TV broadcasting and gain a competitive advantage. How did Netflix do so?

Netflix started as an online shop renting DVDs delivered through the U.S. mail. Annoyed by paying late fees for a Blockbuster video, Reed Hastings started Netflix in 1997 to offer online DVD rentals. Next, Netflix rolled out a monthly subscription model (in 1999), with unlimited rentals for a single monthly rate (and no late fees). At the time, the commercial internet was in its infancy. Streaming content was only a distant dream in the era of dial-up internet, but Netflix got a head start by turning from the dwindling VHS format to DVDs, which were just becoming popular. DVDs were cheaper and easier to mail than clunky VHS tapes. Netflix sent rental DVDs in distinctive red envelopes with preprinted return envelopes. No late fees were charged, but Netflix would not send new rentals until the current rental was returned.

Even with its innovative business model, Netflix got off to a slow start. By 2000, it had only about 300,000 subscribers, and it was losing money. To keep his business alive, Hastings approached Blockbuster, at the time the largest bricks-and-mortar video rental chain with 8,000 stores in the United States. He proposed selling Blockbuster 49% of Netflix and rebranding it as Blockbuster.com. The idea was that Netflix would become Blockbuster's online presence. The dot-com bubble had just burst, and Blockbuster turned Netflix down cold. Netflix also tried to sell itself to Amazon.com, but a deal never materialized.

Netflix survived the dot-com bust. By 2002 it was profitable, and it went public. Blockbuster began online rentals in 2004. By this time, Netflix had built its subscriber base to almost 4 million and developed a strong brand identity. Meanwhile, Blockbuster lost 75% of its market value between 2003 and 2005. From there it went from bad to worse, and in 2010 the once-mighty Blockbuster filed for bankruptcy. In the meantime, Amazon.com built out its own streaming service, available free to members of its Prime program.

The sci-fi horror drama *Stranger Things* is one of Netflix's most popular original TV series. In a small town, a young boy suddenly vanishes under mysterious circumstances. The boy's mother is on a desperate quest to find him, and the townspeople begin to uncover ever stranger things such as a secret government lab, portals to another world, and sinister monsters.

Pictorial Press Ltd/Alamy Stock Photo

Netflix began streaming content over the internet in 2007, and it was at the forefront of the streaming video-on-demand wave, which disrupted the linear cable TV industry. It adjusted quickly to consumers' new options for receiving content, making streaming available on mobile phones, tablets, game consoles, and new devices dedicated to internet content streaming, such as Roku, Kindle TV, Google Chromecast, and smart TVs. At the same time, Americans were signing up for high-speed broadband internet connections, making streaming content a much more enjoyable experience. The market for internet-connected, large, high-definition flat-screen TVs also began to take off. Within just two years, Netflix subscriptions (then priced at $7.99 per month) jumped to 12 million.

Nonetheless, old-line media executives continued to dismiss Netflix as a threat. In 2010, Time Warner CEO Jeff Bewkes snubbed Netflix, saying, "It's a little bit like, is the Albanian army going to take over the world? I don't think so."[1] Even Reed Hastings said that Netflix provided "rerun TV." But behind their bravado, the broadcast networks were waking up to the Netflix threat. They stopped distributing content to Netflix and instead made it available through Hulu, an online streaming service jointly owned by Disney and NBCUniversal. In 2011, Hulu began offering original content that was not available on broadcast or cable television. The networks saw Hulu's streaming model, with its lower cost structure, as a way to test new ideas for TV series with minimal financial risk. As the old-line media companies realized the threat posed by Netflix, they raised their licensing fees to prohibitively high levels or refused to license content to Netflix. In response, Netflix announced a move to create original content.

Netflix devoted significant resources to producing high-quality, original content. With this pivot, it added content creation to its business activities, and it morphed into an integrated media content company that distributes its content to consumers via streaming. As a result of significant resource investments combined with a deep analysis of viewer data, Netflix has had a string of highly successful original TV series, including *House of Cards, The Crown, Ozark, Stranger Things, 13 Reasons Why, Tiger King, The Queen's Gambit,* and *Bridgerton.* Some of these shows were tremendous hits and received many Emmys and Golden Globes.

In 2022, Netflix spent $18 billion on content, more than any Hollywood studio. Only Disney spends more on content development ($30 billion), but this spending takes place across its multiple media assets (e.g., Disney+, ESPN+, and Hulu, majority-owned by Disney). These enormous sums are not surprising given that the cost of creating high-quality original content has skyrocketed. For instance, the hugely successful HBO series *Game of Thrones* cost some $10 million for each hour of content.

Despite its success and its innovations, Netflix faces challenges. By the spring of 2022, it was losing subscribers, and its market cap had fallen by more than 75% from its peak: a loss of more than $220 billion in value. Is Netflix no longer an innovative disruptor? Has its innovation machine stalled?[2]

Part II of this ChapterCase appears in Section 7.6.

Innovation—the successful introduction of a new product, process, or business model—is a powerful driver in the competitive process. The ChapterCase provides an example of how innovations in technology and business models in the TV industry can make existing competitors obsolete, and how they allowed Netflix to gain a competitive advantage.

Innovation allows firms to redefine the marketplace in their favor and achieve a competitive advantage.[3] Successful innovation allows a company to introduce change that requires a response from other firms, and continued innovation enables a firm to be proactive, rather than reactive and passive, in terms of sustaining a competitive advantage over time. To highlight innovation as a powerful competitive weapon when formulating business strategy, in this chapter we focus on innovation and the related topic of entrepreneurship. We begin by detailing how competition is a process driven by continuous innovation. Next, we discuss strategic and social entrepreneurship. We then take a deep dive into the industry life cycle, which helps strategic managers formulate a more dynamic business strategy as an industry changes over time. We also introduce the crossing-the-chasm framework, highlighting the difficulties in transitioning through different stages of the industry life cycle. We then move into a detailed discussion of different types of innovation using the markets-and-technology framework, and then we present insights on how to compete in two-sided markets with platform strategy. As with every chapter, we conclude with practice-oriented *Implications for Strategic Leaders.*

7.1 Competition Driven by Innovation

Competition is a process driven by the "perennial gale of creative destruction," in the words of famed economist Joseph Schumpeter.[4] Firms must be able to innovate while also fending off competitors' imitation attempts. Many firms have dominated an early wave of innovation only to be challenged and destroyed by the next wave. A successful strategy requires both an effective offense and a hard-to-crack defense. The continuous waves of change in market leadership in the TV industry demonstrate the potency of innovation as a competitive weapon: It can simultaneously create and destroy value. Here, we note two recent waves of disruption.

Disruption Wave 1. The disruption of broadcasting by cable content providers played out in the 1980s and 1990s, upsetting a handful of old-line networks with cable's dozens and then hundreds of channels. The traditional television networks (ABC, CBS, and NBC) struggled to maintain viewers and advertising revenues as cable and satellite providers offer many more channels in addition to innovative programming. As the disruption played out, the traditional broadcasters lost out to cable networks.

Disruption Wave 2. Cable television subscriptions in the United States peaked at 70 million in 2000. The current wave of disruption started in the 2000s, as consumers began bypassing old-line cable content providers for direct online streaming. The cable and satellite providers that were the disruptors during Wave 1 are now being disrupted. They are losing subscribers as people "cut the cord" (i.e., cancel their subscription) or never sign up in the first place. Since 2000, the number of U.S. households subscribing to cable has fallen by 80% to 15 million. At the same time, the U.S. population has increased from 282 million people (in 2000) to 332 million (in 2022), an increase of 18%. Today, most consumers prefer to stream customized content on a multitude of devices. In this wave of creative destruction, cable TV has lost out to streaming services. And the traditional TV networks continue to struggle.

NETFLIX'S CONTINUED INNOVATION

Innovation can be the basis for gaining a competitive advantage, while continued innovation can lead to sustainable competitive advantage. As illustrated in the ChapterCase, innovation is the bedrock of Netflix's business strategy. Netflix entered the video rental industry by way of an innovative business model: offering DVDs via mail as a subscription service. Using big data analytics, Netflix also introduced a number of other innovations in the video rental business. One of Netflix's more ingenious moves was to have each user build a queue of movies they wanted to watch next. An algorithm allowed Netflix to predict future demand for specific movies fairly accurately. Another Netflix innovation was its "personalized recommendation engine," which predicts what each subscriber might want to watch next on the basis of a quick rating survey, the subscriber's viewing history, and the movies that users with a similar profile have watched and enjoyed.

Based on Netflix's proprietary learning algorithm powered by artificial intelligence (AI), the recommendations improve over time as the user's preferences become more clear. This improvement allowed Netflix to steer users away from hit movies (where wait times for DVD rentals were long because the company only had a limited number in its library) to lesser-known titles in its catalog. The ability to bring in the *long tail* of demand delighted not only viewers, who then enjoyed lesser-known but often critically acclaimed films, but also movie studios, which could now make additional money on movies that would otherwise not be in demand. The **long tail** is a business model in which companies can obtain a large part of their revenues by selling a small number of units from among almost unlimited choices.[5] Moreover, unlike other players in the media industry, Netflix was fast to catch the wave of content streaming via the internet, thus benefitting from a *first-mover advantage.*

long tail A business model in which companies can obtain a large part of their revenues by selling a small number of units from among almost unlimited choices.

THE SPEED OF INNOVATION

As the adage goes, change is the only constant—and the rate of technological change has accelerated dramatically over the past hundred years. Changing technologies spawn new industries, while other industries die. This rate of change makes innovation a powerful strategic weapon to gain and sustain a competitive advantage.

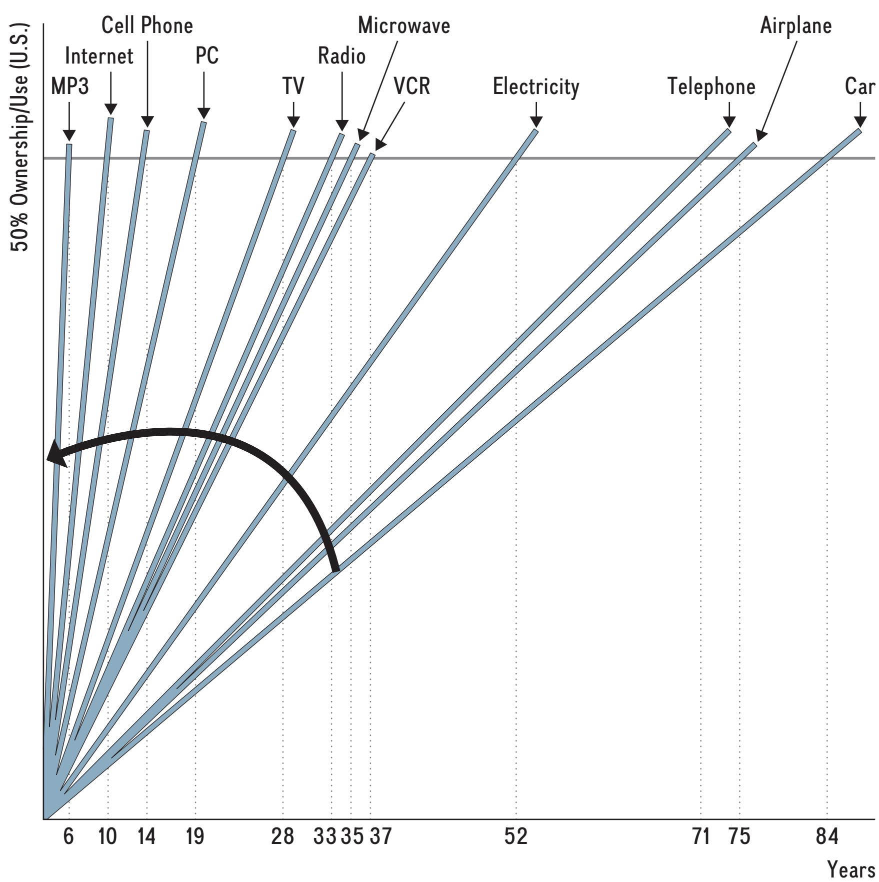
Exhibit 7.1 shows how many years it took for different technological innovations to reach 50% of the U.S. population (either through ownership or usage). For example, it took 84 years for half of the U.S. population to own a car, but only 28 years for half the population to own a TV. The pace of the adoption rate of recent innovations continues to accelerate. It took 19 years for the PC to reach 50% ownership, but only 6 years for MP3 players to accomplish the same diffusion rate.

What factors explain increasingly rapid technological diffusion and adoption? Earlier innovations such as the car, airplane, telephone, and use of electricity provided the necessary infrastructure for newer innovations to diffuse more rapidly. Another reason is the emergence of new business models that make innovations more accessible. For example, Dell's direct-to-consumer distribution system improved access to low-cost PCs, and Walmart's low-price, high-volume model used a sophisticated IT logistics system to fuel explosive growth. In addition, satellite and cable distribution systems facilitated the ability of mass media such as radio and TV to deliver advertising and information to a wider audience. The speed of technological diffusion has accelerated further with the emergence of the internet, social networking sites, and viral messaging. Amazon continues to drive increased convenience, higher efficiency, and lower costs in retailing and other services such as cloud computing. The accelerating speed of technological change has significant implications for the competitive process and firm strategy. We will now look closely at the innovation process unleashed by technological changes.

EXHIBIT 7.1

Accelerating Speed of Technological Change

Source: Depiction of data from the U.S. Census Bureau, the Consumer Electronics Association, *Forbes,* and the National Cable and Telecommunications Association.



THE INNOVATION PROCESS

LO 7-1

Outline the four-step innovation process from idea to imitation.

Broadly viewed, innovation describes the discovery, development, and transformation of new knowledge in a four-step process captured in the *four I's: idea, invention, innovation,* and *imitation* (Exhibit 7.2).[6]

IDEA. The innovation process begins with an *idea.* The idea is often presented in terms of abstract concepts or as findings derived from basic research. Basic research is conducted to discover new knowledge and is often published in academic journals. Research may be done to enhance the fundamental understanding of nature, without any commercial application or benefit in mind. In the long run, however, basic research is often transformed into applied research with commercial applications. For example, wireless communication technology today is built on the fundamental scientific breakthroughs Albert Einstein accomplished over 100 years ago in his research on the nature of light.[7]

INVENTION. In the next step of the innovation process, **invention** transforms an idea into a new product or process, or it modifies and recombines existing products or processes. The practical application of basic knowledge in a particular area frequently results in new technology. If an invention is *useful, novel,* and *non-obvious* as assessed by the U.S. Patent and Trademark Office, it can be patented.[8] A **patent**, which is a form of *intellectual property*, gives the inventor exclusive rights to benefit from commercializing a technology for a specified time period in exchange for public disclosure of the underlying idea (see also the discussion of *isolating mechanisms* in Chapter 4). For instance, many pharmaceutical drugs are patent protected. In the United States, the time period for the right to exclude others from the use of the technology is 20 years from the filing date of a patent application. Exclusive rights often translate into a *temporary monopoly position* until the patent expires.

Strategically, however, patents are a *double-edged sword.* On the one hand, patents provide a temporary monopoly as they bestow exclusive rights on the patent owner to use a novel technology for a specific time period. Thus, patents may form the basis for a competitive advantage. Because patents require full disclosure of the underlying technology and know-how so that others can use them freely once the patent protection has expired, many firms find it strategically beneficial *not* to patent their technology. Instead they use **trade secrets**, valuable proprietary information that is not in the public domain and that the firm makes every effort to keep secret. Perhaps the most famous example of a trade secret is the

invention The transformation of an idea into a new product or process, or the modification and recombination of existing ones.

patent A form of *intellectual property* that gives the inventor exclusive rights to benefit from commercializing a technology for a specified time period in exchange for public disclosure of the underlying idea.

trade secret Valuable proprietary information that is not in the public domain and where the firm makes every effort to maintain its secrecy.

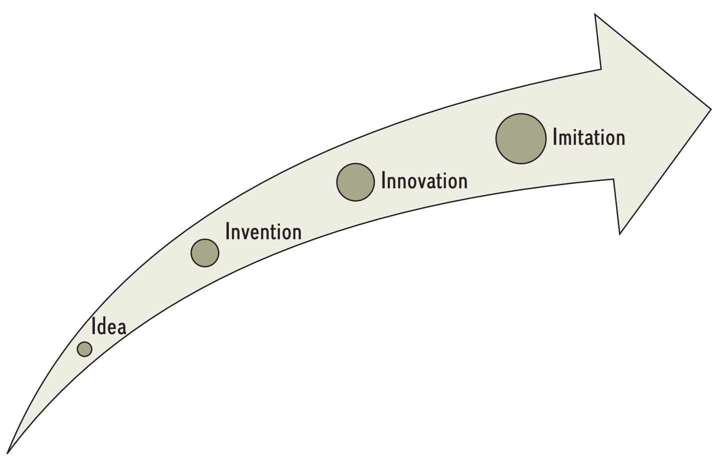


EXHIBIT 7.2

The Four I's: Idea, Invention, Innovation, and Imitation

Coca-Cola recipe, which has been protected for over a century.[9] The same goes for Ferrero's Nutella hazelnut spread, whose secret recipe is said to be known by even fewer than the handful of people who have access to the Coca-Cola recipe.[10]

Avoiding public disclosure and thus making its underlying technology widely known is precisely the reason Netflix does not patent its recommendation algorithm and Google does not patent its PageRank algorithm. Netflix has an advantage over competitors because its recommendation algorithm works best. The same goes for Google—its search algorithm is the best available. Disclosing how exactly these algorithms work would nullify their advantage.

innovation The commercialization of any new product or process, or the modification and recombination of existing ones.

INNOVATION. **Innovation** concerns the *commercialization* of an invention.[11] The successful commercialization of a new product or service allows a firm to earn temporary monopoly profits. As detailed in the ChapterCase, Netflix started with a business model innovation, offering unlimited DVD rentals via the internet, without any late fees. Netflix gained its early lead by applying artificial intelligence to its user preferences not only to predict future demand but also to provide highly personalized viewing recommendations. The success of the latter is evident by the fact that movies that were recommended to viewers scored higher than they were scored prior to the implementation of the recommendation algorithm.

To sustain a competitive advantage, however, a firm must innovate continuously. That is, it must produce a string of successful new products or services over time. To innovate continuously, Netflix further developed its business model innovation, moving from online DVD rentals into streaming video on demand. It then innovated further by creating proprietary content such as *The Crown, 13 Reasons Why, Queen's Gambit,* and *Bridgerton.*

first-mover advantages Competitive benefits that accrue to the successful innovator.

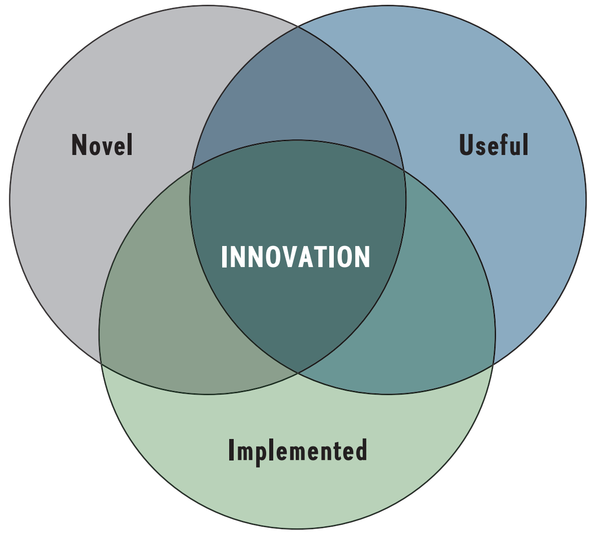
Successful innovators can benefit from a number of **first-mover advantages**,[12] including economies of scale and experience and learning-curve effects (as discussed in Chapter 6). First movers may also benefit from *network effect*s (see the discussion of Netflix and Uber later in this chapter). Moreover, first movers may hold important intellectual property such as critical patents. They may also be able to lock in key suppliers, and by increasing switching costs they may lock in customers as well. For example, users of Microsoft Word might find the switching costs of moving to a different word-processing software prohibitive. Not only would they need to spend many hours learning the new software, but collaborators would also need to have compatible software installed and be familiar with the program to open and revise shared documents.

However, some companies try to minimize rather than maximize switching costs. Alphabet's Google is a good example. By offering a free web-based suite of application software that includes word processing (Google Docs), a spreadsheet program (Google Sheets), and a presentation program (Google Slides), it is attempting to minimize switching costs by leveraging *cloud computing*—a real-time network of shared computing resources via the internet (Google Drive). Rather than requiring all users to have the appropriate software installed on their personal computer, Google maintains and updates the software in the cloud. Files are also saved in the cloud, which allows collaboration in real time globally wherever one can access an internet connection. Microsoft has also moved to a cloud-based computing business model.

Innovation need not be high-tech to be a potent competitive weapon, as P&G's history of innovative product launches such as the Swiffer line of cleaning products shows. P&G uses the *razor–razor-blade business model* (see Chapter 12), where the consumer purchases the handle at a low price but must pay a premium for replacement refills and pads over time. As Exhibit 7.3 shows, an innovation needs to be novel, useful, and successfully implemented to help firms gain and sustain a competitive advantage.

IMITATION. Success attracts attention and competition. The innovation process ends with *imitation.* If an innovation is successful in the marketplace, competitors will attempt to imitate it. Increased competition, in turn, reduces the returns to innovation for the first mover. Competitive imitation transforms the temporary monopoly enjoyed by the innovator into a more fragmented industry, thus reducing the overall profit potential (see Chapter 3).

EXHIBIT 7.3 Innovation: A Novel and Useful Idea That Is Successfully Implemented



Streaming Wars. Successful innovation breeds imitation. Imitation leads to new entry as firms compete to gain a competitive advantage. While Netflix enjoyed a competitive advantage in the early phase of the streaming wave, competition does not stand still:

- Amazon Prime has over 200 million subscribers who enjoy its complimentary streaming services.
- Disney+ has 130 million subscribers. Combined with its other streaming assets (ESPN+, Hulu of which Disney owns the majority), the media and entertainment conglomerate has 200 million subscribers.
- Discovery+, the result of merging Discovery and HBO (which it acquired from AT&T), has 125 million subscribers.
- Paramount Studios has 56 million subscribers.
- Google's YouTube has 25 million paid subscribers for its premium services.
- Comcast, the largest U.S. cable operator, purchased NBCUniversal. This acquisition helps Comcast integrate delivery services and content, with the goal of establishing itself as a new player in the media industry. Its Peacock streaming service has 13 million subscribers.
- Apple TV+ has 25 million subscribers.

Given the finite number of households in the United States, cutthroat competition is ensuing between the various streaming services. With a finite number of subscribers, zero-sum competition ensues. In this scenario, once market saturation is achieved (as in the United States), then gains by one competitor must come at the expense of another. Although there are a dozen options for streaming, consumers' time and discretionary spending are limited. While global markets offer growth opportunities, only in a few rich countries are consumers able to pay subscription fees that cover the cost of the service. Once the competitive intensity in the industry has calmed down, only a handful of streaming services are likely to survive in the anticipated industry shakeout.

In the future, there will be another wave of disruption wrought by an innovation, and the process of creative destruction will start anew. The waves of creative destruction triggered by innovation are a fundamental feature of free-market economies, and they result in dynamic growth and improvements in living standards. For example, innovation in streaming services provided a new way to consume media, more consumer choice, and lower cost in comparison to the preceding wave of cable TV.

THE FOUR INDUSTRIAL REVOLUTIONS

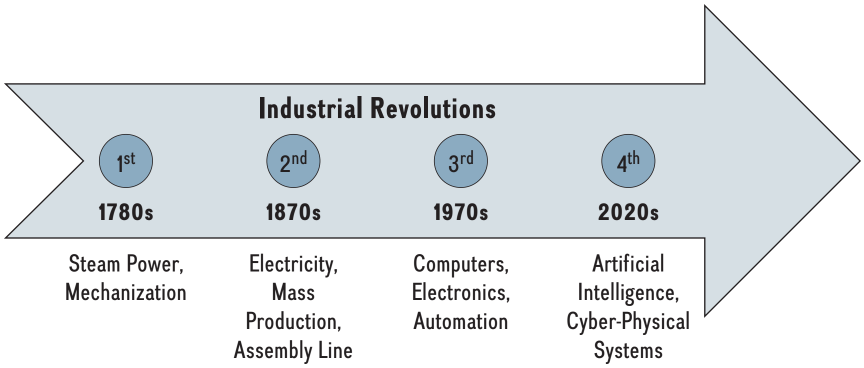
LO 7-2

Outline the four stages of industrial revolutions and derive implications for expected changes in the future.

The process of creative destruction induced by innovation plays out within the broader social and economic environment. What types of innovation to expect is in part a function of the industrial stage we are in. We are currently at the beginning of the fourth industrial

EXHIBIT 7.4

Four Industrial Revolutions from the 1780s to 2020s



revolution. Exhibit 7.4 provides an overview of four waves of industrial revolutions. The right-pointing, horizontal arrow indicates the progress of time, and with it the fact that we can expect more advancements as additional industrial revolutions play out.

FIRST INDUSTRIAL REVOLUTION (1780s). The first industrial revolution marked the transition from traditional agriculture and hand-crafted production methods to large-scale, mechanized manufacturing processes. The steam engine was the transformational innovation that defined the first industrial revolution. The steam engine led to the rise of industrial cities because it freed industrialists to build factories near natural waterways to power engines. Large-scale production combined with specialization led to significant productivity improvement across a range of industries, such as coal, iron, and textiles. Across nations, comparative advantages became apparent and fostered global trade. A **comparative advantage** emerges when each country has a lower opportunity cost in producing one good over another good. A comparative advantage holds even if one country has an absolute advantage in producing both goods as long as the country's opportunity cost of producing one good is higher than that of producing the other good.

comparative advantage A trade advantage that emerges when each country has a lower opportunity cost in producing one good over another good.

A classic example of comparative advantage was developed by the economist David Ricardo during the first industrial revolution. Ricardo showed that it is beneficial for two nations to trade even if one nation has a productivity edge in both products. Assuming the economy consists of only two products (cloth and wine) and Country A (Britain) has an absolute advantage over Country B (Portugal) in producing either cloth or wine, it will still be beneficial to trade. If Britain has a productivity advantage in producing cloth over making wine and Portugal is more efficient in producing wine over making cloth, then each country should specialize. Britain should focus on cloth production and Portugal on winemaking. Because each country produces more of the good than it can consume, cross-border trade enhances the standard of living in both countries. In this example, Britain has a comparative advantage in cloth production while Portugal has a comparative advantage in winemaking.

SECOND INDUSTRIAL REVOLUTION (1870s). The second industrial revolution was marked by fundamental breakthroughs in technology (e.g., electricity, telegraph, telephone, and steelmaking) and advances in manufacturing and production methods. The scientific breakthroughs during this time turbocharged the advances made during the first industrial revolution. The large-scale assembly line allowing for mass production at low cost is one of the defining process innovations of the second industrial revolution. The second industrial revolution allowed for the affordable, mass-produced automobile such as Ford's Model T. Metropolitan cities and road networks were built. During this time, nationwide railroad networks were established and canals were completed, allowing commerce to flourish. Combined, these advances led to unprecedented urbanization and increased global trade.

THIRD INDUSTRIAL REVOLUTION (1970s). The third industrial revolution is defined by computers, electronics, and automation. Although advances in computing go back to the invention of the transistor (in 1947), the third industrial revolution was supercharged by the first commercial microprocessor, developed by Intel (in 1971). The microprocessor led to the personal computer and major advances in communication technologies, marking the beginning of the information age and knowledge work. Subsequently, the internet was invented through a research initiative by the U.S. Department of Defense and made available to the public ("World Wide Web"), allowing ecommerce, e-entertainment, and communication via text, e-mail, and social networks. Further advances led to smartphones, wearable devices, and global positioning systems (GPS such as Google Maps). Modern-day smartphones are a thousand times faster than the supercomputers of the 1980s, several times faster than NASA's *Perseverance* rover that explores Mars (since 2021), and faster than modern-day laptops.

FOURTH INDUSTRIAL REVOLUTION (2020S). The fourth industrial revolution is just commencing. It is characterized by significant advances in artificial intelligence (AI), automation, robotics, gene editing, 3D printing, and cyber-physical systems such as the **internet of things (IoT)**, which connects everyday items such as airplanes, cars, and refrigerators to the internet. The IoT will allow for predictive maintenance and smart sensors to improve the reliability and safety of airplanes, nuclear power plants, cars, factories, and so on. The lines between the physical, biological, and digital worlds are increasingly blurring. For instance, our perception of reality is altered by *augmented reality (AR)* that exceeds our cognitive abilities, knowledge, and natural senses (such as vision, hearing, and language ability). Google Glass is an early example of augmented reality.

An early manifestation of the fourth industrial wave is the *metaverse*, the fully immersive, 3D worlds where people work and play (see discussion of Meta Platform's pivot toward the metaverse in ChapterCase 2). Unlike AR devices, virtual reality is accessed with full-field vision headsets such as the Oculus Rift, a headset that allows for fully immersive rendering of graphics when connected to a high-powered computer. Fully autonomous cars, trucks, trains, and airplanes are in development. In countries with an aging population, such as Japan, robots are already performing some basic tasks of caring for the elderly. Another early manifestation of the fourth industrial revolution is the quantifiable self, where a person tracks all kinds of data such as health indicators with wearable devices that allow **machine learning (ML)** to be applied to the data to improve well-being and increase longevity.

Advances in AI are expected to have a significant impact on the labor market. In their book *The Second Machine Age,*[13] Erik Brynjolfsson and Andrew McAfee conclude that advances in AI will complement cognitive work but substitute for routine work. In other words, knowledge work will become even more valuable when humans combine their creativity with the power of AI. The complementarity between knowledge work and AI implies that the contributions of knowledge workers such as computer programmers, architects, engineers, scientists, lawyers, and academics, among other professionals, will become even more valuable and compensated accordingly. In contrast, routine work such as basic accounting/tax/legal work, call center customer service, telemarketing, order picking (in an Amazon warehouse, for instance), and truck and bus driving are likely to be replaced (substituted) by AI, automation, and robotics. That is, many low-skilled, entry-level jobs are expected to be replaced by automation and robotics.

Inspired by the movie *The Terminator,* Google Glass is an early example of an augmented reality (AR) device. It is a wearable, voice- and motion-controlled pair of eyeglasses that allows the user to access information on the web. Users can conduct online search, get directions via Google Maps, stream video, and translate speech, among other capabilities. As in *The Terminator*, the information is displayed directly in the user's field of vision. Although Google Glass failed commercially, it provides a good example of how AR devices might look when they are more broadly accepted.

Ira Berger/Alamy Stock Photo

internet of things (IoT) A network of physical objects, such as airplanes, cars, and refrigerators, that are embedded with software, sensors, and other technology for the purpose of connecting and exchanging data over the internet.

machine learning (ML) Software algorithms that improve through the use of large amounts of data and experience. Given humans' cognitive limitations in processing large amounts of data, ML allows for insights and ideas that would elude humans.

universal basic income (UBI) A government program in which every citizen receives a set amount of money regularly.

entrepreneurship The process by which people undertake economic risk to innovate—to create new products, processes, and sometimes new organizations.

Some have suggested that the replacement of the labor force by automation and robotics will be so vast that societies will decide to implement a **universal basic income (UBI)**. The UBI is a government program where every citizen receives a set amount of money regularly. UBI advocates claim that the program requires less bureaucracy to administer than current social programs, and is thus cheaper and more effective. More importantly, they argue that UBI is needed to soften the blow of large-scale unemployment anticipated in the wake of automation and robotics.

Like earlier industrial revolutions, the fourth industrial revolution will result in significant social, political, and economic shifts. The transition to the knowledge economy will be supercharged during the fourth industrial revolution. The anticipated upheaval implies that investments in human capital such as education will be even more important and come with higher expected returns.

7.2 Strategic and Social Entrepreneurship

LO 7-3

Apply strategic management concepts to entrepreneurship and innovation.

Entrepreneurship is the process by which change agents (entrepreneurs) undertake economic risk to innovate—that is, to create new products, processes, and sometimes new organizations.[14] Entrepreneurs innovate by commercializing ideas and inventions.[15] They seek or create new business opportunities and then assemble the resources necessary to exploit them.[16] Indeed, innovation is the competitive weapon that entrepreneurs use to exploit opportunities created by change, or to create change themselves, in order to commercialize new products, services, or business models.[17] If successful, entrepreneurship not only drives the competitive process but also creates value for the individual entrepreneurs and society at large.

Although many new ventures fail, some achieve spectacular success. Here are some examples of successful entrepreneurs:

Jeni Bauer, founder and chief creative officer of Jeni's Splendid Ice Creams, started her first venture as a sophomore in college at the Ohio State University.

Brooke LaValley/The Washington Post/Getty Images

- **Jeni Bauer,** founder of and chief creative officer of Jeni's Splendid Ice Creams. Bauer's story begins at the Ohio State University, where she was studying art history. Rather than study, however, she spent most of her time on her fragrance-making hobby. One day, Bauer experimented with mixing essential oils with ice cream. Her first creation was a mix of hot pepper oil and chocolate, which became an instant hit among her friends and classmates. This unique concoction is now a signature ice cream flavor at Jeni's Splendid Ice Creams. After realizing that ice cream was "the perfect carrier of scent,"[18] Bauer decided to leave college to start her first ice cream stand, Scream Ice Cream, at the North Market in Columbus, Ohio. This first venture failed after a short time. Undeterred, Bauer went on to attend Penn State's acclaimed crash course on ice cream making (covering all topics from "Cow to Cone"), which was also attended by Ben Cohen and Jerry Greenfield of the famous Ben & Jerry's Ice Cream. Bauer's tenacity paid off because a few years later she secured the necessary funding to start Jeni's Splendid Ice Creams, with her first location again at North Market, coming full circle. What differentiates Jeni's Ice Creams from other brands is her use of direct trade ingredients, milk from grass-pastured cows, and unique combinations of flavors. Jeni's Splendid Ice Creams now has 50 stores across the United States, distributes prepackaged pints to more than 3,000 stores, and surpassed $75 million in annual revenues in 2020. As her secret recipe for success, Bauer reveals that "every year you get tested and you get stronger. You build more resilience. It becomes who you are."[19]
- **Jeff Bezos,** founder of Amazon (featured in ChapterCase 8), the world's largest online retailer. The stepson of a Cuban immigrant, Bezos graduated with a degree in computer science and electrical engineering before working as a financial analyst on

Wall Street. After reading that the internet was growing by 2,000% a month (in 1994), he set out to leverage the internet as a new distribution channel. Listing products that could be sold online, he finally settled on books because that retail market was fairly fragmented, with huge inefficiencies in its distribution system. Perhaps even more important, books are a perfect commodity because they are identical regardless of where a consumer buys them. The identical nature of books reduced uncertainty when introducing online shopping to consumers. From humble beginnings, Amazon has branched out into a wide variety of business endeavors (see ChapterCase 8). In 2022, Bezos's personal wealth exceeded $160 billion, making him the second wealthiest person in the world, just behind Elon Musk.[20]

Dr. Dre, the first hip-hop billionaire, is known for his strong work ethic and attention to detail. He expects nothing less than perfection from the people with whom he works. Stories abound that Dr. Dre made famous rappers rerecord songs hundreds of times if he was not satisfied with the outcome.

WENN Rights Ltd/Alamy Stock Photo

- **Dr. Dre,** featured in MiniCase 4, a successful rapper, music and movie producer, and *serial entrepreneur* (that is, a person who starts multiple businesses). Born in Compton, California, Dr. Dre focused on music and entertainment during high school, working his first job as a DJ. His major breakthrough as a rapper came with the group N.W.A. One of his first business successes as an entrepreneur was Death Row Records, which he founded in 1991. A year later, his first solo album, *The Chronic,* was a huge hit. In 1996, he founded Aftermath Entertainment and signed famed rappers such as 50 Cent and Eminem. In 2014, he became the first hip-hop billionaire after Apple acquired Beats Electronics for $3 billion, making it Apple's largest acquisition. Beats was co-founded by Dr. Dre and Jimmy Iovine and is best known for its iconic headphones. In 2015, N.W.A's early success was depicted in the biographical movie *Straight Outta Compton,* focusing on group members Eazy-E, Ice Cube, and Dr. Dre, who co-produced the film, which grossed over $200 million at the box office on a production budget of $45 million.[21]
- **Reed Hastings,** founder of Netflix featured in the ChapterCase. Hastings grew up in Cambridge, Massachusetts. He obtained an undergraduate degree in math from Bowdoin College (in Maine) and then volunteered for the Peace Corps for two years, teaching high school math in Swaziland (Africa). Next, he pursued a master's degree in computer science, which brought him to Silicon Valley. Hastings declared his love affair with writing computer code but emphasized that the big idea he got in college was to "turn me on to the entrepreneurial model."[22]
- **Elon Musk,** an engineer and serial entrepreneur with a deep passion to "solve environmental, social, and economic challenges."[23] He is featured in his role as leader of Tesla in ChapterCase 1. Musk left his native South Africa at age 17. He went to Canada and then to the United States, where he completed a bachelor's degree in economics and physics at the University of Pennsylvania. After only two days in a PhD program in applied physics and material sciences at Stanford University, Musk left graduate school to found Zip2, an online provider of content publishing software for news organizations. Four years later, in 1999, computer maker Compaq acquired Zip2 for $341 million (and was in turn acquired by HP in 2002). Musk moved on to co-found PayPal, an online payment processor. When eBay acquired PayPal for $1.5 billion in 2002, Musk had the financial resources to pursue his passion to use science and engineering to solve social and economic challenges. He is leading multiple new ventures simultaneously, including Tesla (electric cars and renewable, decentralized energy) and SpaceX (space exploration), among others. Musk's eccentricity explains why he changed his title to Technoking (in an official SEC filing); he says CEO is just a made-up title, so he made up a new

title that best fits him. With a net worth of over $250 billion (in 2022), Elon Musk is the wealthiest person in the world.

- **Rihanna** leveraged her success in music, acting, and fashion design to create (in cooperation with the French luxury retailer LVMH) the cosmetics brand Fenty Beauty (in 2017) "so that women everywhere would be included."[24] Rihanna spotted an entrepreneurial opportunity when she noticed that the existing makeup products did a poor job of meeting her needs. To address the lack of makeup products for people of color, Fenty Beauty launched an impressive 40 foundation shades to reflect the full spectrum of skin tones. The new cosmetics brand was hugely successful: In the first month after launch, it made $100 million in sales. Its first-year revenues exceeded $550 million. Today, Rihanna is a self-made billionaire and one of the wealthiest people in the United States.
- **Jimmy Wales,** the founder of Wikipedia, typifies *social entrepreneurship.*[25] Raised in Alabama, Wales was educated by his mother and grandmother, who ran a nontraditional school. He dropped out of a doctoral program in economics at Indiana University (in 1994) to take a job at a stock brokerage firm in Chicago. In the evenings he wrote computer code for fun and built a web browser. During the late 1990s internet boom, Wales was one of the first to grasp the power of an open-source method to provide knowledge on a large scale. What differentiates Wales from other web entrepreneurs is his idealism: Wikipedia is free for the end user and supports itself solely by donations and not, for example, by online advertising. Wikipedia has more than 40 million articles in over 300 languages, including some 6 million items in English. About 500 million people use Wikipedia each month. Wales' idealism is a form of social entrepreneurship: His vision is to make the entire repository of human knowledge available to anyone anywhere for free.

Rihanna is a successful entrepreneur. She combined her talents in music, acting, and fashion to create Fenty Beauty, a modern, category-defining cosmetics brand. Key success factors of Fenty Beauty include addressing the needs of people of color, connecting with consumers who value diversity, and pursuing a purpose-driven mission that strives for inclusivity in beauty. Source: Getty Images.

Taylor Hill/WireImage/Getty Images

Entrepreneurs are the agents who introduce change into the competitive system. They do this not only by figuring out how to use inventions but also by introducing new products or services, new production processes, and new forms of organization. Entrepreneurs can introduce change by starting new ventures, such as Reed Hastings with Netflix or Mark Zuckerberg with Facebook (now Meta Platforms). Or they can be found within existing firms, such as Procter & Gamble's A.G. Lafley, who implemented an *open-innovation model* (discussed in Chapter 11). When innovating within existing companies, change agents are often called *intrapreneurs:* They are pursuing *corporate entrepreneurship.*[26]

entrepreneurs The agents that introduce change into the competitive system.

strategic entrepreneurship The pursuit of innovation using tools and concepts from strategic management.

Entrepreneurs who drive innovation need just as much skill, commitment, and daring as the inventors who are responsible for the process of invention.[27] As an example, the engineer Nikola Tesla invented the alternating-current (AC) electric motor and was granted a patent in 1888 by the U.S. Patent and Trademark Office.[28] Because this breakthrough technology was neglected for much of the 20th century and Nikola Tesla did not receive the recognition he deserved in his lifetime, the entrepreneur Elon Musk is not only commercializing Tesla's invention but also honoring Tesla with the name of his company, Tesla, which was formed to design and manufacture all-electric automobiles. Tesla launched several all-electric vehicles based on Tesla's original invention (see ChapterCase 1).

Strategic entrepreneurship is the pursuit of innovation using tools and concepts from strategic management.[29] Innovation can be leveraged for competitive advantage by applying a strategic management lens to entrepreneurship. The fundamental question of strategic entrepreneurship, therefore, is how to combine entrepreneurial actions, create new opportunities, or exploit existing opportunities with strategic actions taken in the pursuit of competitive advantage.[30] Strategic entrepreneurship can take place within new ventures such as Tesla or within established firms such as Apple.

Apple's continued innovation in mobile devices and user experience is an example of strategic entrepreneurship: Apple's leaders use strategic analysis, formulation, and implementation when deciding which new type of mobile device to research and develop, when to launch it, and how to implement the necessary organizational changes to support the product launch. Each new release is an innovation and is therefore an act of entrepreneurship—planned and executed using strategic management concepts.

- Apple's iPhone (introduced in 2007) was one of the major innovation breakthroughs in the past few decades because it created a new category (smartphone) and laid the foundation of the Apple ecosystem linking its products and services.
- Apple entered the market for computer wearables by introducing the Apple Watch (in 2015).
- Apple entered the media and entertainment industry with its subscription service Apple TV+ (in 2019).
- In 2020, Apple introduced its M1 chip to optimize the performance of its MacBook line of computers. The M1 chip provides better performance with higher speed and lower battery consumption. A chip or CPU (central processing unit) is the brain of the computer. The top-of-line Mac Studio desktop computer, launched in 2022 and starting at $4,000, has Apple's highest-end M1 Ultra chip with 114 billion transistors. It is in high demand by video and design professionals. Apple spent billions in R&D to develop the M1, which allowed Apple to enhance the performance of its devices and to insulate itself from global chip shortages during the Covid-19 pandemic.

social entrepreneurship The pursuit of social goals while creating a profitable business.

Social entrepreneurship is the pursuit of social goals while creating a profitable business. Social entrepreneurs evaluate the performance of their ventures not only by financial metrics but also by ecological and social contribution (*profits, planet,* and *people*). They use a *triple-bottom-line* approach to assess performance (discussed in Chapter 5). Examples of social entrepreneurship ventures include Teach For America, TOMS (which gives a pair of shoes to an economically disadvantaged child for every pair of shoes it sells), Better World Books (an online bookstore that uses the power of the free market system to combat illiteracy around the world),[31] and Wikipedia, whose mission is to collect and develop educational information, and make it freely available to any person in the world.

Because entrepreneurs and the innovations they unleash frequently create entirely new industries, we now turn to a discussion of the industry life cycle to derive implications for competitive strategy.

7.3 Innovation and the Industry Life Cycle

LO 7-4

Describe the competitive implications of different stages in the industry life cycle.

Innovations frequently lead to the birth of new industries. For example, innovative advances in IT and logistics facilitated the creation of the overnight express delivery industry by FedEx and that of big-box retailing by Walmart. The internet set online retailing in motion, with new companies such as Amazon and eBay taking the lead, and it revolutionized the advertising industry first through Yahoo, and later through Alphabet's Google and Meta's Facebook. Advances in nanotechnology are revolutionizing many different industries, ranging from medical diagnostics and surgery to lighter and stronger airplane components.[32] Advances in AI are reshaping a wide set of industries ranging from call centers, health care, agriculture, and logistics to transportation via autonomous vehicles and trucks.

industry life cycle The five different stages—introduction, growth, shakeout, maturity, and decline—that occur in the evolution of an industry over time.

As an industry evolves over time, it tends to follow a predictable **industry life cycle** with five distinct stages: *introduction, growth, shakeout, maturity,* and *decline.*[33] In the following sections we illustrate how the type of innovation and resulting strategic implications change at each stage of the life cycle. We also examine how innovation can initiate and drive a new life cycle.

The number, size, and capabilities of competitors change as the industry life cycle unfolds, and different types of consumers enter the market at each stage. Both the supply and demand sides of the market change as the industry ages. Each stage of the industry life cycle requires different competencies for a firm to perform well and satisfy that stage's unique customer group. We will now introduce the life cycle model before discussing different customer groups in more depth when we introduce the crossing-the-chasm concept later in this chapter.[34]

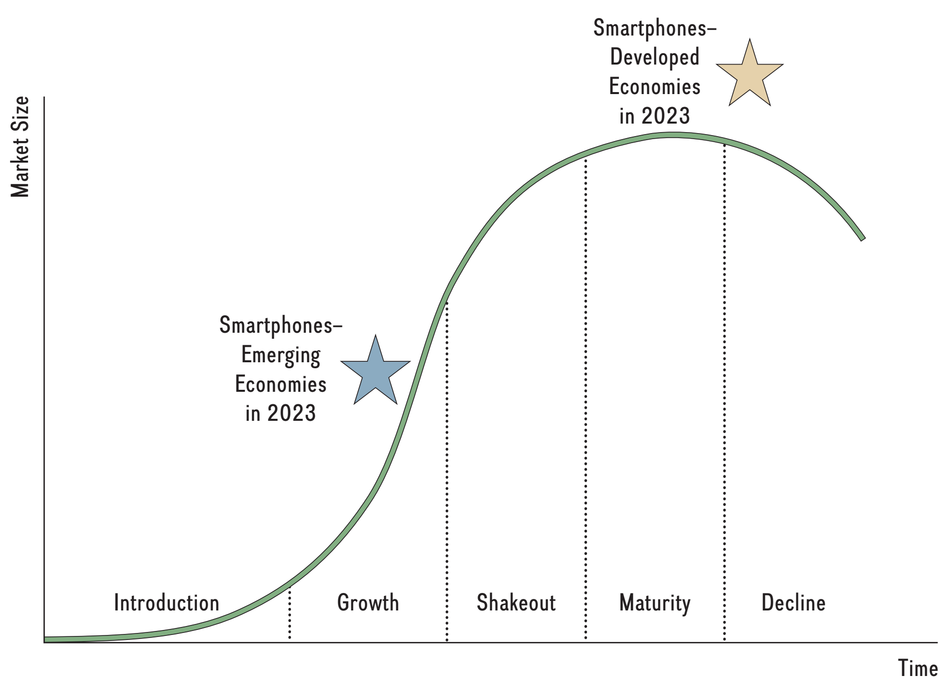
Exhibit 7.5 depicts a typical industry life cycle, focusing on the smartphone industry in emerging and developed economies. In a stylized industry life cycle model, the horizontal axis shows time (in years), and the vertical axis market shows size. In Exhibit 7.5, however, we are taking a snapshot of the global smartphone industry in the year 2023. This implies that we are joining two different life cycles (one for emerging economies and one for developed economies) in the same exhibit at one point in time.

As the exhibit shows, the development of most industries follows an S-curve. Initial demand for a new product or service is often slow to take off. It then accelerates before decelerating and eventually turning to zero, and even becoming negative as a market contracts.

As shown in Exhibit 7.5, in emerging economies such as Argentina, Brazil, China, India, Indonesia, Mexico, and Russia, the smartphone industry is in the growth stage. The market

EXHIBIT 7.5

Industry Life Cycle: The Smartphone Industry in Emerging and Developed Economies



for smartphones in these countries is expected to grow rapidly over the next few years. More and more consumers in these countries with large populations are expected to upgrade from a simple mobile phone to a smartphone.

In contrast, the market for smartphones is in the maturity stage in 2023 in developed economies such as Australia, Canada, Germany, Japan, South Korea, the United Kingdom, and the United States. This implies that developed economies moved through the prior three stages of the industry life cycle (introductory, growth, and shakeout) some years earlier. Because the smartphone industry is mature in these markets, little or no growth in market size is expected over the next few years because most consumers already own smartphones. Thus any gain in market share by one firm must come at the expense of other firms, as users replace older smartphones with newer models. In addition, consumers in developed countries are also holding on longer to their existing (and highly priced) smartphones because they view the improvements in newer models as too incremental. Going forward, competitive intensity in the smartphone industry in advanced economies is expected to be high.

Each stage of the industry life cycle—introduction, growth, shakeout, maturity, and decline—has different strategic implications for competing firms. We now discuss each stage in detail.

INTRODUCTION STAGE

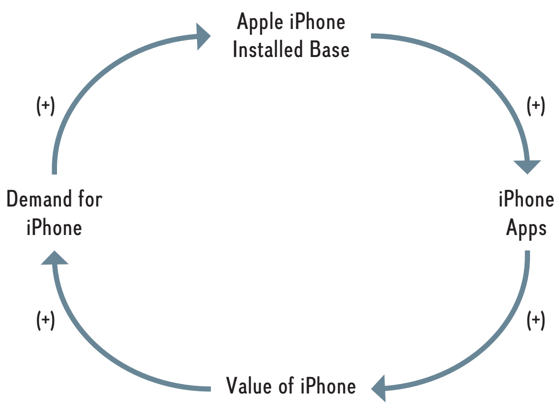
When an entrepreneur or a company is able to transform an invention into an innovation, a new industry may emerge. In the introductory stage, the innovator's core competency is R&D, which is necessary to creating a product category that will attract customers. Creating a new product category is often a capital-intensive process in which the innovator is investing in designing a unique product, trying new ideas to attract customers, and producing small quantities. All of these contribute to a high cost for the innovator and typically result in a high price to the consumer when the product is launched. The initial market size is small, and growth is slow. In the introductory stage, barriers to entry tend to be high, and typically only a few firms are active in the market. In their competitive struggle for market share, they emphasize unique product features and performance rather than price.

Although there are some benefits to being early in the market (as previously discussed), innovators also may encounter *first-mover disadvantages*. They must educate potential customers about the product's intended benefits, find distribution channels and complementary assets, and continue to perfect the fledgling product. Although a core competency in R&D is necessary to create or enter an industry in the introductory stage, some competency in marketing also is helpful in achieving a successful product launch and market acceptance. Competition can be intense, and early winners are well positioned to stake out a strong position for the future.

The strategic objective during the introductory stage is to achieve market acceptance and seed future growth. One way to accomplish these objectives is to initiate and leverage *network effects,*[35] the positive effects that one user of a product or service has on the value of that product for other users. Network effects occur when the value of a product or service increases, often exponentially, with the number of users. Large, positive network effects can propel the industry to the next stage of the life cycle, the growth stage (which we discuss in the next section).

Apple effectively leveraged the network effects generated by numerous complementary software applications (apps) available via the App Store to create a tightly integrated

EXHIBIT 7.6 Leveraging Network Effects to Drive Demand: Apple's iPhone



ecosystem of hardware, software, and services, which competitors find hard to compete with. The result has been a competitive advantage for over a decade, beginning with the introduction of the iPod in 2001 and iTunes in 2003. Apple launched its enormously successful iPhone in 2007. A year later, it followed up with the Apple App Store, which boasts that for almost anything you might need, "there's an app for that." Popular apps allow iPhone users to pay for everyday purchases, access their business contacts via LinkedIn, hail a ride via Uber, attend videoconferences with colleagues overseas via Zoom, check the delivery status of Amazon packages, get the latest news on Twitter, and engage in customer relationship management using Salesforce.com. You can stream music via Apple Music, post photos using Instagram, stream your favorite shows via Netflix, access Facebook to keep in touch with your friends, message others using Snapchat, and post videos on TikTok.

Even more important is the effect that apps have on the value of an iPhone. Arguably, the explosive growth of the iPhone was due to the fact that the Apple App Store offers the largest selection of apps to its users. The App Store offers more than 2 million apps, which have been downloaded some 150 billion times, earning Apple billions of dollars in revenues. Apple argues that users have a better experience because the apps take advantage of the tight integration of hardware and software provided by the iPhone. The availability of apps, in turn, leads to network effects that increase the value of the iPhone for its users. Exhibit 7.6 shows how. Increased value creation, as we know from Chapter 6, is positively related to demand, which in turn increases the installed base, meaning the number of people who use an iPhone. As the installed base of iPhone users further increases, software developers are incentivized to write even more apps. Making apps widely available strengthened Apple's position in the smartphone industry. Based on positive feedback loops, a virtuous cycle emerges where one factor positively reinforces another. Apple's ecosystem based on integrated hardware, software, and services provides a superior user experience that competitors find hard to match.

GROWTH STAGE

Market expansion accelerates in the growth stage of the industry life cycle (see Exhibit 7.5). After the initial innovation has gained market acceptance, demand increases rapidly as first-time buyers rush to enter the market, convinced by the proof of concept demonstrated in the introductory stage.

standard An agreed-upon solution about a common set of engineering features and design choices.

As the size of the market expands, a **standard** signals the market's agreement on a common set of engineering features and design choices.[36] Standards can emerge from the bottom up through competition in the marketplace or be imposed from the top down by government or other standard-setting agencies such as the Institute of Electrical and Electronics Engineers (IEEE), which develops and sets industrial standards in a broad range of industries, including energy, electric power, biomedical and health care technology, IT, telecommunications, consumer electronics, aerospace, and nanotechnology.

Strategy Highlight 7.1 discusses the unfolding standards battle in the automotive industry as it transitions away from internal combustion engines.

Strategy Highlight 7.1

Standards Battle: Which Automotive Technology Will Win?

In the upcoming transition away from gasoline-powered cars, Japanese carmaker Nissan firmly believes the next technological paradigm will be electric motors. Nissan views hybrids (which combine battery power with internal combustion engines) as a "halfway technology" and suggests they will be a temporary phenomenon at best. A number of start-up companies, including Tesla in the United States as well as BYD, NIO, and others in China, share Nissan's belief in this particular future scenario.

One of the biggest impediments to large-scale adoption of electric vehicles (EVs) is the lack of appropriate infrastructure: There are few stations where drivers can recharge their car batteries. With the range of most EVs currently limited to approximately 200 miles, many potential consumers suffer from "range anxiety" and consider the lack of recharging stations a serious problem. In 2017, GM introduced the all-electric Chevy Bolt, with a range of 250 miles per charge, similar to the range of Tesla's Model 3 and Model Y. Higher-end Tesla vehicles can achieve over 300 miles or more per charge. The lower-priced, first-generation Nissan Leaf (an acronym for Leading, Environmentally friendly, Affordable, Family car) can achieve a maximum range of roughly 85 miles. The second-generation Leaf, which came out in 2017, can run for up to 150 miles before needing to be recharged.

Tesla, Nissan, and other independent charging providers such as ChargePoint are working hard to develop a network of charging stations. By 2022, Tesla had a proprietary network of more than 30,000 supercharger stations worldwide. A high density of superchargers in the United States allows for convenient coast-to-coast travel in one of its vehicles.

Industry experts believe EVs will account for 15% of global auto sales by 2025 (up from 2% in 2019). Swedish carmaker Volvo ceased producing cars equipped with only internal combustion engines in 2019. All its new vehicles are now fully electric or hybrid, indicating a strong strategic commitment by a traditional car manufacturer. This commitment is the first of its kind. Similarly, Volkswagen (VW), one of the largest carmakers globally in terms of units, has shifted its strategic focus fully toward the electrification of its vehicles. VW announced (in 2019) an

The Nissan Leaf is one of the world's best-selling electric vehicles. Its second generation has a 150-mile range per single battery charge.

VDWI Automotive/Alamy Stock Photo

ambitious plan to invest some $35 billion to develop and launch 70 new fully EV models over the next decade. VW also committed to phasing out the production of cars with internal combustion engines no later than 2035. Similar to Tesla, VW further announced that it plans to build a Gigafactory to produce and supply its own batteries, rather than rely on an outside vendor such as Panasonic of Japan. In contrast, Toyota remains convinced that gasoline-electric hybrids will play an important role for decades to come. Nonetheless, it has also made investments in fuel cell cars and hopes that the prices of those cars will fall to match those of EVs in the future. Going forward, Toyota also plans to shift more of its resources toward EVs.

These somewhat different predictions have significant influence on how much and where Nissan, VW, Toyota, and others are willing to invest in new technology. For example, Nissan builds its Leaf at a plant in Smyrna, Tennessee. Since the 1990s, it has spent billions developing its electric-car program. Following its debut in December 2010, Nissan's Leaf has become one of the best-selling EVs, selling approximately 600,000 units.

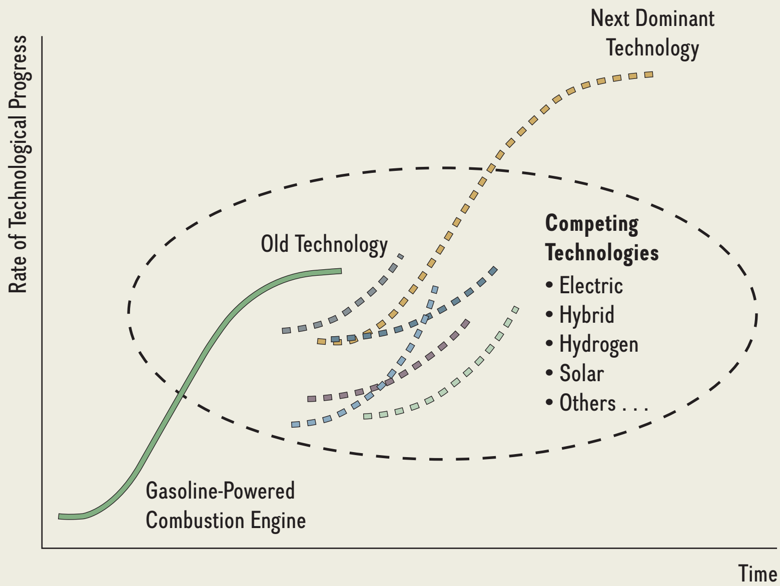
In contrast, Toyota has already sold more than 10 million of its popular Prius car since it was introduced in 1997. Having expanded its R&D investments in hybrid technology, Toyota now offers hybrid technology in most of its vehicles. Eventually, the investments made by Nissan, Tesla, VW, Toyota, and others will yield different returns, depending on which predictions prove more accurate. An alternative outcome in this standards battle is that neither hybrids nor

(Continued)

electric cars will become the next paradigm. Some manufacturers are betting on cars powered by hydrogen fuel cells.

In sum, many alternative technologies are competing to become the winner in setting a new standard for propelling cars. This situation is depicted in Exhibit 7.7, where the new technologies represent a swarm of new entries vying for dominance. At this point, it appears that EV technology will be the likely winner.[37]

EXHIBIT 7.7 Automotive Technologies Compete for Industry Dominance



Because demand is strong during the growth phase, both efficient and inefficient firms thrive; the rising tide lifts all boats. Moreover, production costs begin to fall, often rapidly, as standard business processes are put in place and firms begin to reap economies of scale and learning. Distribution channels are expanded, and complementary assets in the form of products and services become widely available.[38]

product innovation New or recombined knowledge embodied in new products.

process innovation New ways to produce existing products or deliver existing services.

After a standard is established in an industry, the basis of competition tends to move away from product innovations toward process innovations.[39] **Product innovations**, as the name suggests, are new or recombined knowledge embodied in new products—for example, the jet airplane, electric vehicle, smartphone, and wearable devices. **Process innovations** are new ways to produce existing products or to deliver existing services. Process innovations are made possible through advances such as artificial intelligence, the internet, lean manufacturing, Six Sigma, biotechnology, nanotechnology, and so on.

Process innovation need not be high-tech to be impactful. For example, the invention of the standardized shipping container has transformed global trade. Loading goods into uniform containers that can easily be moved among trucks, rail, and ships resulted in significant savings in cost and time. Before containerization was invented about 60 years ago, it cost almost $6 to load a ton of (loose) cargo, and theft was rampant. After containerization, the cost of loading a ton of cargo plummeted to $0.16 and theft all but disappeared (because containers are sealed at the departing factory).

Efficiency gains in terms of labor and time were even more impressive. Before containerization, dock labor could move 1.7 tons per hour onto a cargo ship. After containerization, this number jumped to 30 tons per hour. Ports are now able to accommodate much larger

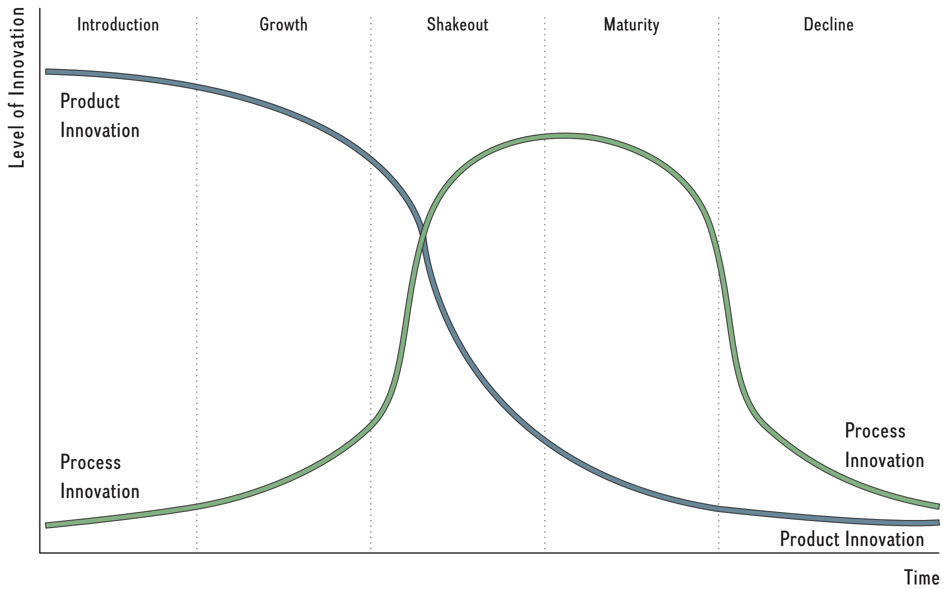


EXHIBIT 7.8

Product and Process Innovation throughout an Industry Life Cycle

ships, and travel time across the oceans has fallen by half. As a consequence, costs for shipping goods across the globe fell rapidly. Moreover, containerization enabled optimization of global supply chains and set the stage for subsequent process innovations such as *just-in-time (JIT) operations management.* A set of research studies estimated that containerization more than tripled international trade in the five years after its introduction.[40]

Exhibit 7.8 shows the level of product innovation and process innovation throughout the entire life cycle.[41] In the introductory stage, the level of *product* innovation is at a maximum because new features increasing perceived consumer value are critical to gaining traction in the market. In contrast, process innovation is at a minimum in the introductory stage because companies produce only a small number of products, often just prototypes or beta versions. The main goal is to commercialize the invention—that is, to demonstrate that the product works and that a market exists.

The relative importance of the two innovation types reverses over time. Frequently, a standard emerges during the growth stage of the industry life cycle (refer to the second column, "Growth," in Exhibit 7.8). At that point, most of the technological and commercial uncertainties about the new product are gone. After the market accepts a new product and a standard for the new technology has emerged, *process* innovation rapidly becomes more important than product innovation. As market demand increases, economies of scale kick in. Firms establish and optimize standard business processes through applications of AI, lean manufacturing, Six Sigma, and so on. As a consequence, product improvements become incremental, while the level of process innovation rises rapidly.

During the growth stage, process innovation ramps up (at increasing marginal returns) as firms attempt to keep up with rapidly rising demand while attempting to bring down costs at the same time. The core competencies for competitive advantage in the growth stage tend to shift toward manufacturing and marketing capabilities. At the same time, the R&D emphasis tends to shift to process innovation for improved efficiency. Competitive rivalry is somewhat muted because the market is growing fast.

Because market demand is robust in this stage and more competitors have entered the market, there tends to be more strategic variety. Some competitors will continue to follow a *differentiation* strategy, emphasizing unique features, product functionality, and reliability.

Sara Blakely, a graduate of Florida State University and former salesperson of fax machines, used innovation and entrepreneurship to create Spanx, a leader in the shapewear industry. In 2021, Blakely sold a majority ownership stake in Spanx to Blackstone, a private equity firm. After the sale, Forbes estimated Blakely's net wealth to be $1.2 billion, which includes $40 million in real estate and minority ownership of the Atlanta Hawks, a basketball team in the NBA.

Marla Aufmuth/Getty Images

Other firms employ a *cost-leadership strategy* in order to offer an acceptable level of value but lower prices to consumers. They realize that lower cost is likely a key success factor in the future because lower cost allows the firm to decrease prices and attract more consumers into the market.

When introduced in 2010, for example, Apple's first-generation iPad was priced at $829 for 64GB with a 3G Wi-Fi connection.[42] Just three years later, in 2013, the same model was priced at only one-third of the original price, or $275.[43] Access to efficient and large-scale manufacturing operations (such as those offered by Foxconn in China, the company that assembles most of Apple's products) and effective supply chain capabilities are key success factors when market demand increases rapidly. By 2017, Gazelle, an ecommerce company that allows people to sell their electronic devices and buy used ones, offered a mere $15 for a "flawless" first-generation iPad. By 2019, the first-generation iPad (in "flawless" condition) was no longer available on any ecommerce sites specializing in used mobile devices.

The key objective for firms during the growth phase is to stake out a strong strategic position not easily imitated by rivals. For example, in the fast-growing shapewear industry, startup company Spanx has staked out a strong position. In 1998, Florida State University graduate Sara Blakely decided to cut the feet off her pantyhose to shape her figure when she wears pants.[44] Soon afterward, she obtained a patent for her body-shaping undergarments, and Spanx began production and retailing of its shapewear in 2000. Sales grew exponentially after Blakely appeared on *The Oprah Winfrey Show*. Taking a risk paid off for Spanx's founder: After investing an initial $5,000 in her startup, Blakely became the world's youngest self-made female billionaire (a title now held by Kylie Jenner, who became the world's youngest self-made billionaire by age 21, beating out Mark Zuckerberg, who was 23 when he became a billionaire).

To stake out a strong position and to preempt competitors, Spanx now offers hundreds of products ranging from slimming apparel and swimsuits to bras and activewear. It also now designs and manufactures body-shaping undergarments for men ("Spanx for Men—Manx"). Spanx products are now available in over 50 countries via the internet. Moreover, to strengthen its strategic position and brand image in the United States, Spanx is opening retail stores across the country. By 2022, Spanx had grown to some 1,000 employees and sold millions of Spanx shapewear with estimated revenues of $500 million.

The shapewear industry's strong growth has attracted several other players: Flexees by Maidenform, BodyWrap, and Miraclesuit, to name a few. They are all attempting to carve out positions in the new industry. Given Spanx's ability to stake out a strong position during the growth stage of the industry life cycle and the fact that it continues to be a moving target, it might be difficult for competitors to dislodge the company.

SHAKEOUT STAGE

Rapid industry growth and expansion cannot go on indefinitely. As the industry moves into the next stage of the industry life cycle, the rate of growth declines (see Exhibit 7.5). Rather than trying to capture a share of an increasing pie, firms begin to compete directly against one another for market share. As competitive intensity increases, the weaker firms are forced out of the industry. This is the reason this phase of the industry life cycle is called the shakeout stage: Only the strongest competitors survive increasing rivalry as firms begin to cut prices and offer more services, all in an attempt to gain more of a market that grows slowly, if at all. Cutthroat competition erodes profitability of all but the most efficient firms in the industry. As a consequence, the industry often consolidates as the weakest competitors either are acquired by stronger firms or exit the industry.

The winners in this increasingly competitive environment are typically firms that stake out a strong position as cost leaders. Key success factors at this stage are the manufacturing and process engineering capabilities that can be used to drive down costs. The importance of process innovation further increases (albeit at diminishing marginal returns) while the importance of product innovation further declines.

Assuming an acceptable value proposition, price becomes a more important competitive weapon in the shakeout stage because product features and performance requirements tend to be well established. A few firms may be able to implement a blue ocean strategy, combining differentiation and low cost, but given the intensity of competition, many weaker firms are forced to exit. Any firm that does not have a clear strategic profile is likely not to survive the shakeout phase.

MATURITY STAGE

After the shakeout is completed and a few firms remain, the industry enters the maturity stage. During this fourth stage of the industry life cycle, the industry structure morphs into an oligopoly with only a few large firms. Most of the demand was largely satisfied in the shakeout stage. Any additional market demand in the maturity stage is limited. Demand now consists of replacement or repeat purchases. The market has reached its maximum size, and industry growth is likely to be zero or even negative going forward. This decrease in market demand increases competitive intensity within the industry. In the maturity stage, the level of process innovation reaches its maximum as firms attempt to lower cost as much as possible, while the level of incremental product innovation sinks to its minimum (see Exhibit 7.8).

Generally, the firms that survive the shakeout stage tend to be larger and enjoy economies of scale, as the industry consolidated and most excess capacity was removed. The domestic airline industry has been in the maturity stage for a long time. The large number of bankruptcies as well as the wave of mega-mergers, such as those of Delta and Northwest, United and Continental, and American Airlines and US Airways, are a consequence of low or zero growth in a mature market characterized by significant excess capacity.

DECLINE STAGE

Changes in the external environment (such as those discussed in Chapter 3 in the context of the PESTEL framework) often move industries from maturity to decline. In this final stage of the industry life cycle, the size of the market contracts further as demand falls, often rapidly. Innovation efforts along both product and process dimensions cease (see Exhibit 7.8). If a technological or business model breakthrough emerges that opens up a *new* industry or resets the industry life cycle, then the dynamic interplay between product innovation and process innovation starts anew. For instance, as 5G (fifth-generation cellular network technology) becomes more prevalent in advanced economies, demand for new, 5G-capable smartphones increases significantly over and above the replacement rate of existing smartphones using the older 4G technology.

Any remaining excess industry capacity in the decline stage puts strong pressure on prices and can further increase competitive intensity, especially if the industry has high exit barriers. During the decline stage of the industry life cycle, leaders generally have four strategic options: *exit, harvest, maintain,* or *consolidate:*[45]

- **Exit.** Some firms are forced to *exit* the industry by bankruptcy, liquidation, or divestments. The U.S. textile industry has experienced a large number of exits over the last few decades, mainly due to low-cost foreign competition.

- **Harvest.** In pursuing a *harvest strategy,* the firm reduces investments in product support and allocates only a minimum of human and other resources. While several companies such as IBM, Brother, Olivetti, and Nakajima still offer typewriters, they don't invest much in future innovation. Instead, they are maximizing cash flow from their existing typewriter product line.
- **Maintain.** Philip Morris is following a *maintain strategy* with its Marlboro brand, continuing to support marketing efforts at a given level despite the fact that U.S. cigarette consumption has been declining.
- **Consolidate.** Although market size shrinks in a declining industry, some firms may choose to *consolidate* the industry by buying rivals. These purchases allow the consolidating firm to stake out a strong position—possibly approaching monopolistic market power, albeit in a declining industry. Although chewing tobacco is a declining industry, Swedish Match has pursued a number of acquisitions to consolidate its strategic position in the industry. It acquired, among other firms, the Pinkerton Tobacco Co. of Owensboro, Kentucky, maker of the Red Man brand. Red Man is the leading chewing tobacco brand in the United States. Red Man has carved out a strong strategic position built on a superior reputation for a quality product and past endorsements of Major League Baseball players since 1904. Despite gory product warnings detailing the health risk of chewing tobacco and a federally mandated prohibition on marketing, the Red Man brand has remained popular and profitable. Competitors have taken note of Swedish Match's success. In 2022, Philip Morris, the world's largest tobacco company, made a $15 billion takeover bid for it. Philip Morris' strategic intent is to achieve more than 50% of its revenues from 50% smoke-free products such as the beloved chewing tobacco from the Red Man brand.

The industry life cycle model assumes a more or less smooth transition from one stage to another. This smooth transition holds true for most continuous innovations that require little or no change in consumer behavior. But not all innovations enjoy such continuity. Rather, different types of customers at the different stages of the industry life cycle have disparate demands and expectations for a new product or service.

LO 7-5

Derive strategic implications of the crossing-the-chasm framework.

CROSSING THE CHASM

In the influential bestseller *Crossing the Chasm*[46] Geoffrey Moore documented that many innovators were unable to successfully transition from one stage of the industry life cycle to the next. Based on empirical observations, Moore's core argument is that *each stage of the industry life cycle is dominated by a different customer group.* That is, different customer groups with distinctly different preferences enter the industry at each stage of the industry life cycle. Each customer group responds differently to technological innovation. These differences result from the psychological, demographic, and social attributes observed in each unique customer segment. According to Moore, the significant differences between the *early* customer groups—who enter during the introductory stage of the industry life cycle—and *later* customers—who enter during the growth stage—can make for a difficult transition between the different parts of the industry life cycle. Such differences between customer groups lead to a big gulf or *chasm* into which companies and their innovations frequently fall. Only companies that recognize these differences and apply the appropriate competencies at each stage of the industry life cycle will have a chance to transition successfully from stage to stage.

crossing-the-chasm framework Conceptual model that shows how each stage of the industry life cycle is dominated by a different customer group.

Exhibit 7.9 shows the **crossing-the-chasm framework** and the different customer segments. The industry life cycle model (shown in Exhibit 7.5) follows an S-curve leading up to 100%

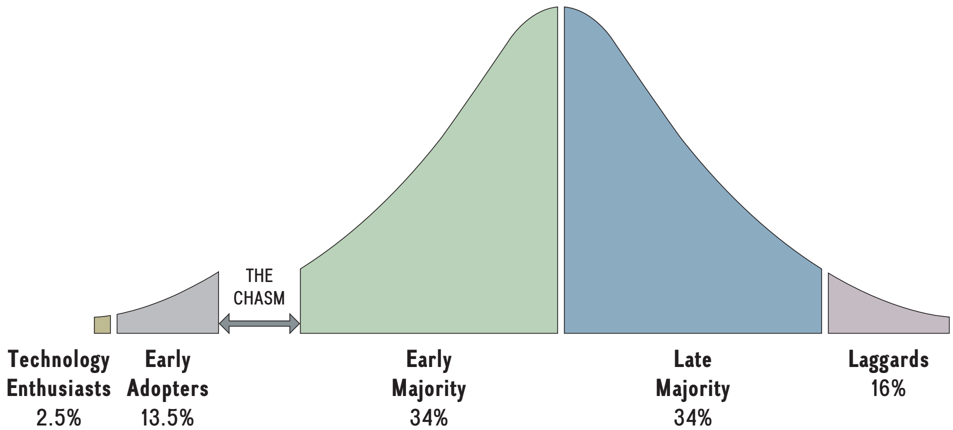


EXHIBIT 7.9

The Crossing-the-Chasm Framework

Source: Author's adaptation from G.A. Moore (1991), *Crossing the Chasm: Marketing and Selling Disruptive Products to Mainstream Customers* (New York: HarperCollins), 17.

total market potential that can be reached during the maturity stage. In contrast, the *chasm framework* breaks down the 100% market potential into different customer segments, highlighting the *incremental* contribution each specific segment can bring into the market. The result is the familiar bell curve. Note the big gulf, or *chasm,* separating the early adopters from the early and late majority that make up the mass market. Social network sites have followed a pattern similar to that illustrated in Exhibit 7.9. Friendster was unable to cross the big chasm. Myspace was successful with the early majority, but only Facebook went on to succeed with the late majority and laggards. Note, too, that each stage customer segment is also separated by smaller chasms. Both the large competitive chasm and the smaller ones have strategic implications.

Both new technology ventures and innovations introduced by established firms have a high failure rate. These failures can be explained as a failure to successfully cross the chasm from the early users to the mass market because the firm does not recognize that the business strategy needs to be fine-tuned for each customer segment. Formulating a business strategy for each segment guided by the *who, what, why,* and *how* questions of competition introduced in Chapter 6 (Whom to serve? What needs to satisfy? Why and how to satisfy them?), strategic leaders will find that the core competencies to satisfy each of the different customer segments are quite different. If not recognized and addressed, these differences will lead to the demise of the innovation as it crashes into the chasm between life cycle stages.

In the following sections, we explain each customer group and map it to the respective stage of the industry life cycle. We then apply the chasm framework to an analysis of the mobile phone industry.

TECHNOLOGY ENTHUSIASTS. The customer segment in the introductory stage of the industry life cycle is composed of **technology enthusiasts**.[47] The smallest market segment, it makes up about 2.5% of total market potential. Technology enthusiasts often have an engineering mindset and pursue new technology proactively. They frequently seek new products before the products are officially introduced. They enjoy using beta versions of products, tinkering with the product's imperfections, and providing (free) feedback and suggestions to companies. For example, many software companies such as Google and Microsoft launch beta versions to accumulate customer feedback to work out bugs before the official launch. Moreover, technology enthusiasts will often pay a premium price to have the latest gadget. The endorsement by technology enthusiasts validates the fact that the new product does in fact work.

technology enthusiasts A customer segment in the introductory stage of the industry life cycle. Often have an engineering mind-set and pursue new technology proactively, frequently seeking out new products before they are officially introduced to the market.

An example of an innovation that appealed to technology enthusiasts is Google Glass, mentioned earlier in this chapter. Google Glass is a mobile computer that is worn like a pair of regular eyeglasses. Instead of a lens, however, one side displays a small, high-definition computer screen. Google Glass was developed as part of Google's wild-card program. Technology enthusiasts were eager to get a hold of Google Glass when it was made available in a beta testing program (in 2013). Those interested had to compose a Google+ or Twitter message of 50 words or less explaining why they would be a good choice to test the device, and the message had to include the hashtag #ifihadglass. Approximately 150,000 people applied, and 8,000 winners were chosen. They were required to attend a Google Glass event and pay $1,500 for the developer's version of the product.

Although many industry leaders, including Apple CEO Tim Cook, agree that wearable computers such as the Apple Watch are important mobile devices, they suggest that there is a large chasm between the current technology for computerized eyeglasses and a successful product for early adopters and the mass market. Alphabet's Google has been unable to cross the chasm for wearable devices between technology enthusiasts and early adopters, even after spending significant amounts of research and development dollars on early projects such as Google Glass. Meanwhile, other companies are attempting to perfect the concept of a computer display in eyeglasses. In 2021, Meta's Facebook launched Stories glasses with a built-in camera, speakers, and hands-free voice control. To avoid the design issues that plagued Google Glass, Facebook's Stories glasses are developed with Ray-Ban, the iconic designer of sunglasses and eyeglasses.

early adopters Customers entering the market in the growth stage of the industry life cycle that are eager to buy early into a new technology or product concept. Their demand is driven by recognizing and appreciating the possibilities the new technology can afford them in their professional and personal lives.

EARLY ADOPTERS. The customers entering the market in the growth stage are **early adopters**. They make up roughly 13.5% of the total market potential. As their name suggests, early adopters are eager to buy early into a new technology or product concept. Unlike technology enthusiasts, however, their demand is driven by their imagination and creativity rather than solely by the new technology per se. They ask themselves the question, *What can this new product do for me or my business?* They recognize and appreciate the possibilities the new technology can bring them in their professional and personal lives. Early adopters' demand is fueled as much by intuition and vision as by an interest in technology.

For instance, early adopters are the people who put down thousands of dollars in deposits to reserve a new Tesla Model S or Model X when they were first introduced, even though they weren't able to test-drive the vehicle or had seen it only on the internet. Many of them waited a significant amount of time before receiving the new vehicle. Because early adopters are influenced by standard technological performance metrics as well as by intuition and imagination, the firm needs to communicate the product's potential applications in a more direct way than when it attracted the initial technology enthusiasts. Attracting the early adopters to the new offering is critical to opening any new high-tech market segment.

early majority Customers coming into the market in the shakeout stage of the industry life cycle. Pragmatists that are mainly concerned with whether adopting a new technological innovation serves a practical purpose or not.

EARLY MAJORITY. The customers coming into the market in the shakeout stage are called the **early majority**. Their main consideration in deciding whether to adopt a new technological innovation is a strong sense of practicality. They are pragmatists and are most concerned with the question of what the new technology can do for them. Before adopting a new product or service, they weigh the benefits and costs carefully. Customers in the early majority are aware that many hyped product introductions will fade away, so they prefer to wait and see how things shake out. They like to observe how early adopters are using the product. Early majority customers rely on endorsements by others. They seek out reputable references such as reviews in prominent magazines such as *Consumer Reports* and by experts online such as the tech YouTuber Marques Keith Brownlee (professionally known as MKBHD).

Because the early majority makes up roughly one-third of the entire market potential, winning them over is critical to the commercial success of the innovation. They are on the cusp of the mass market. Bringing the early majority on board is the key to catching the growth wave of the industry life cycle. Once they decide to enter the market, a *herding effect* is frequently observed: The early majority enters in large numbers.[48]

The significant differences in the attitudes toward technology of the early majority when compared to the early adopters' attitudes signify the wide competitive gulf—*the chasm*—between these two consumer segments (see Exhibit 7.9). Without adequate demand from the early majority, most innovative products wither away.

Fisker Automotive, a California-based designer and manufacturer of premium plug-in hybrid vehicles, fell into the chasm because it was unable to transition to early adopters, let alone the mass market. Between its founding in 2007 and 2012, Fisker sold some 1,800 of its Karma model, a $100,000 sports car, to technology enthusiasts. However, it was unable to follow up with a lower-cost model to attract the early adopters into the market. In addition, technology and reliability issues for the Karma could not be overcome. By 2013, Fisker had crashed into the first chasm (between technology enthusiasts and early adopters), and it filed for bankruptcy. The assets of Fisker Automotive were purchased by Wanxiang, a Chinese auto parts maker.

In 2016, Henrik Fisker launched his latest venture, Fisker Inc., which attempts to develop the Fisker Ocean, an all-electric SUV made from recycled and vegan materials. Fisker Inc. will face the different stages of consumer adoption all over again, beginning with technology enthusiasts. On the up side, Tesla has done much to educate customers and thereby legitimize all-electric vehicles. On the down side, Fisker needs to attract customers in the face of strong incumbents such as Tesla with its strong track record of innovation and world-class manufacturing abilities on a global scale. To compete with Tesla, Fisker struck up an alliance with Foxconn, the Taiwanese maker of the iPhone and other Apple products, to manufacture 250,000 electric vehicles per year.

In contrast, Tesla, the maker of all-electric vehicles introduced in ChapterCase 1 and a fierce rival of Fisker at one time, was able to overcome some of the early chasms. The Tesla Roadster was a proof-of-concept car that demonstrated electric vehicles could achieve performance that is equal to or better than the performance of the best gasoline-engine sports cars. The 2,500 Roadsters that Tesla built between 2008 and 2012 were purchased by technology enthusiasts. Next, Tesla successfully launched the Model S, a family sedan, which it

Marques Keith Brownlee (professionally known as MKBHD) is a tech YouTuber with over 16 million subscribers. His tutorials and reviews of tech products ranging from smartphones to electric vehicles have received 3 billion views. Given his expertise, reach, and impact, MKBHD is a thought leader in technology. His high-quality reviews are especially valuable for customers in the early majority segment.

Courtesy of Marques Keith Brownlee

Tesla CEO Elon Musk (left) in front of a Tesla Roadster; Fisker Automotive CEO Henrik Fisker (right) in front of a Fisker Karma.

Misha Gravenor

sold to early adopters. The Tesla Model S received a strong endorsement as the 2013 *Motor Trend* Car of the Year and the highest test scores ever awarded by *Consumer Reports.* These strong endorsements helped Tesla cross the chasm to the early majority because consumers now feel more comfortable in considering and purchasing a Tesla vehicle. Tesla is crossing the large competitive chasm between early adopters and early majority with its new, lower-priced models, including a smaller sedan (Model 3) and a compact SUV (Model Y).

late majority Customers entering the market in the maturity stage of the industry life cycle that are less confident about their ability to master new technology. Will wait until standards have emerged and become firmly entrenched so as to ensure reduction in uncertainty. Tend to buy from well-established firms with strong brand image.

LATE MAJORITY. The next wave of growth comes from buyers in the **late majority** entering the market in the maturity stage. Like the early majority, they are a large customer segment, making up approximately 34% of the total market potential. Combined, the early majority and late majority form the lion's share of the market potential. Demand coming from just two groups—early and late majority—drives most industry growth and firm profitability.

Members of the early and late majority are also quite similar in their attitudes toward new technology. The late majority shares all the concerns of the early majority. But there are also important differences. Although members of the early majority are confident in their ability to master the new technology, the late majority is not. They prefer to wait until standards have emerged and become firmly entrenched, so as to ensure a reduction in uncertainty. The late majority also prefers to buy from well-established firms with a strong brand image rather than from unknown new ventures.

In addition, consumers in the late majority want to make sure that after-sales support is available. Tesla faces a challenge here. Although it was able to cross over to the late majority with its popular Models S/Y, Tesla's customer service is considered inferior. Customers complain that they have to wait months to get their cars fixed after an accident, for instance. The customer in the late majority segment wants to ensure not only that production kinks are worked out but also that service issues are resolved before they purchase the new product.

laggards Customers entering the market in the declining stage of the industry life cycle. Will adopt a new product only if absolutely necessary, generally don't want new technology, and are generally not a customer segment worth pursuing.

LAGGARDS. **Laggards** are the last consumer segment to come into the market, entering in the declining stage of the industry life cycle. These customers adopt a new product only if it is absolutely necessary, such as first-time cell phone adopters in the United States today. They generally don't want new technology, either for personal or economic reasons. Given their reluctance to adopt new technology, they are generally not considered worth pursuing. Laggards make up no more than 16% of the total market potential. Their demand is far too small to compensate for reduced demand from the early and late majority (jointly almost 70% of total market demand), who are moving on to different products and services.

CROSSING THE CHASM: APPLICATION TO THE MOBILE PHONE INDUSTRY. Let's apply the crossing-the-chasm framework to one specific industry. In this model, the transition from stage to stage in the industry life cycle is characterized by different competitive chasms that open up because of important differences between customer groups. Although the large chasm between early adopters and the early majority is the main cause of demise for innovations, other smaller mini-chasms open between each stage.

Exhibit 7.10 shows the application of the chasm model to the mobile phone industry. The first victim was Motorola's Iridium, an ill-fated satellite-based telephone system.[49] Development began in 1992 after the spouse of a Motorola engineer complained about being unable to get any data or voice access to check on clients while vacationing on a remote island. Motorola's solution was to launch 66 satellites into low orbit to provide global voice and data coverage. In late 1998, Motorola began offering its satellite phone service, charging $5,000 for a handset that was almost too heavy to carry around (equivalent to $9,000 today) and up to $14 per minute for calls (equivalent to $25 per minute today).[50]

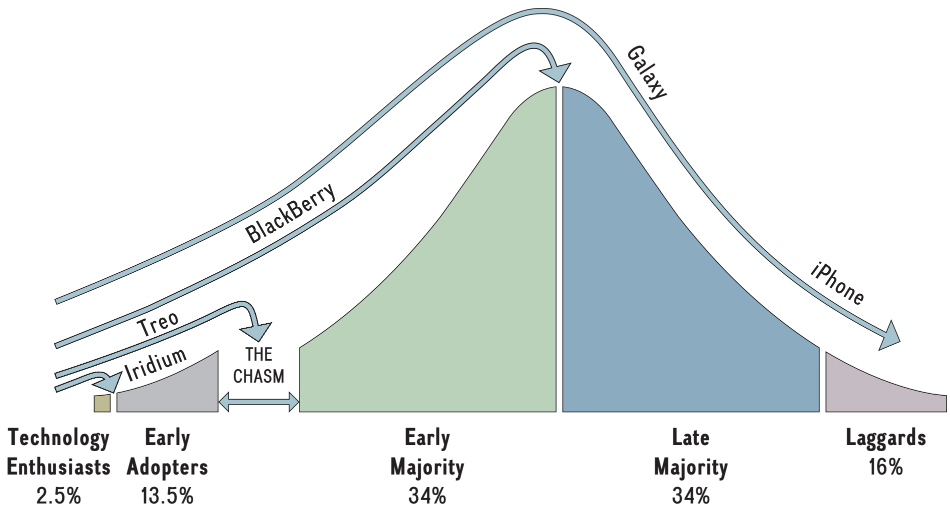


EXHIBIT 7.10

Crossing the Chasm: The Mobile Phone Industry

Problems in consumer adoption beyond the few technology enthusiasts became rapidly apparent. The Iridium phone could not be used inside buildings or in cars. Rather, to receive a satellite signal, the phone needed an unobstructed line of sight to a satellite. Iridium crashed into the first chasm, never moving beyond technology enthusiasts (see Exhibit 7.10). For Motorola, it was a billion-dollar blunder. Iridium was soon displaced by cell phones that relied on Earth-based networks of radio towers. The global satellite telephone industry never moved beyond the introductory stage of the industry life cycle.

The first Treo, a fully functioning smartphone combining voice and data capabilities, was released in 2002 by Handspring. The Treo fell into the main chasm that arises between early adopters and the early majority (see Exhibit 7.10). Technical problems, combined with a lack of apps and an overly rigid contract with Sprint as its sole service provider, prevented the Treo from gaining traction in the market beyond early adopters. The Treo was not an attractive product for the early majority, who rejected it and plunged Treo into the chasm. Just a year later, Handspring was folded into Palm, which in turn was acquired by HP for $1 billion in 2010.[51] HP shut down Palm in 2011 and wrote off the acquisition.[52]

BlackBerry (formerly known as Research in Motion or RIM)[53] introduced its first fully functioning smartphone in 2000. It was a huge success, especially with two key consumer segments. First, corporate IT managers were early adopters. They became product champions for the BlackBerry smartphone because of its encrypted security software and its reliability in staying connected to a company's network, allowing users to receive e-mail and other data in real time, anywhere in the world where wireless service was provided. Second, corporate executives were the early majority pulling the BlackBerry smartphone over the chasm because it allowed 24/7 access to data and voice. BlackBerry was able to create a beachhead to cross the chasm between the technology enthusiasts and early adopters on one side and the early majority on the other.[54] BlackBerry's strategic leaders identified the needs of not only early adopters (e.g., IT managers) but also the early majority (e.g., executives), who pulled the BlackBerry over the chasm. By 2005, the BlackBerry had become a corporate executive status symbol. As a consequence of capturing the first three stages of the industry life cycle, between 2002 and 2007 BlackBerry enjoyed no less than 30% year-over-year revenue growth as well as double-digit growth in other financial performance metrics such as return on equity. BlackBerry enjoyed a temporary competitive advantage.

In 2007, BlackBerry's dominance over the smartphone market began to erode quickly. The main reason was Apple's introduction of the iPhone. Although technology enthusiasts and early adopters argued that the iPhone is an inferior product to the BlackBerry based on technological criteria, the iPhone enticed not only the early majority but also the late majority to enter the market. For the late majority, encrypted software security was much less important than having fun with a device that allows users to surf the web, take pictures, play games, and send and receive e-mail. Moreover, the Apple App Store soon provided thousands of apps. While the BlackBerry couldn't cross the gulf between the early majority and the late majority, Apple's iPhone captured the mass market rapidly. Moreover, consumers began to bring their personal iPhone to work, which forced corporate IT departments to expand their services beyond the BlackBerry. Apple rode the wave of this success to capture each market segment. Likewise, Samsung with its Galaxy line of phones, which successfully imitate the look and feel of an iPhone (as discussed in Chapter 4), is enjoying similar success across the different market segments.

Timing also plays a role in which companies are able to cross the chasms from technology enthusiasts to laggards. Apple's iPhones and Samsung's Galaxy phones crossed the chasms not only because of they were superior products and offered superior services but also because as late entries into the mobile phone market they were able to benefit from the consumer education that early movers provided. In addition, early movers such as BlackBerry provided a template for what type of business model to pursue—specifically, aligning the phone manufacturer with the wireless service providers to offer subsidized phones if users signed up for two-year service contracts. Indeed, AT&T was so eager to get an exclusive deal with Apple when the iPhone was first introduced that it ended up heavily subsidizing the new phones for users. The second aspect of lucky timing for Apple and Samsung was that in 2007 users were not aware of the importance of data privacy. BlackBerry was way ahead of both Apple and Samsung in providing encrypted communications and other features that enhanced user privacy. Here, BlackBerry was too early and its core competency in secure communications was not (yet) highly valued.

This brief application of the chasm framework to the mobile phone industry shows its usefulness. It provides insightful explanations of why some companies failed while others succeeded—and thus goes to the core of strategic management.

In summary, Exhibit 7.11 details the features and strategic implications of the entire industry life cycle at each stage.

A word of caution is in order: Although the industry life cycle is a useful framework to guide strategic choice, industries do not necessarily evolve through these stages. Moreover, innovations can emerge at any stage of the industry life cycle, which in turn can initiate a new cycle. Industries can also be rejuvenated, often in the declining stage.

In addition, although the industry life cycle is a practical tool, it does not explain everything about changes in industries. Some industries may never go through the entire life cycle, while others are continually renewed through innovation. Be aware, too, that other external factors that can be captured in the PESTEL framework (introduced in Chapter 3), such as fads in fashion, changes in demographics, or deregulation, can affect the dynamics of industry life cycles at any stage.

FAILED INNOVATIONS' SECOND WIND. Innovations that failed initially can sometimes get a second chance in a new industry or with a new application. When introduced in the early 1990s as an early wireless telephone system, Iridium never crossed the chasm beyond technology enthusiasts. After its failure, the technology was spun into a standalone venture called Iridium Communications. Some 25 years later, it looks like Iridium's satellite-based communications system will get another chance of becoming a true breakthrough

EXHIBIT 7.11 Features and Strategic Implications of the Industry Life Cycle

	Life Cycle Stages				
	Introduction	**Growth**	**Shakeout**	**Maturity**	**Decline**
Core Competency	R&D, some marketing	R&D, some manufacturing, marketing	Manufacturing, process engineering	Manufacturing, process engineering, marketing	Manufacturing, process engineering, marketing, service
Type and Level of Innovation	Product innovation at a maximum; process innovation at a minimum	Product innovation decreasing; process innovation increasing	After emergence of standard: product innovation decreasing rapidly; process innovation increasing rapidly	Product innovation at a minimum; process innovation at a maximum	Product and process innovation ceased
Market Growth	Slow	High	Moderate and slowing down	None to moderate	Negative
Market Size	Small	Moderate	Large	Largest	Small to moderate
Cost	High	Falling	Moderate	Low	Low to high
Number of Competitors	Few, if any	Many	Fewer	Moderate, but large	Few, if any
Mode of Competition	Non-price competition	Non-price competition	Shifting from non-price to price competition	Price competition	Price or non-price competition
Type of Buyers	Technology enthusiasts	Early adopters	Early majority	Late majority	Laggards
Business-Level Strategy	Differentiation	Differentiation	Differentiation or blue ocean strategy	Cost-leadership or blue ocean strategy	Cost-leadership, differentiation, or blue ocean strategy
Strategic Objective	Achieving market acceptance	Staking out a strong strategic position; generating "deep pockets"	Surviving by drawing on "deep pockets"	Maintaining strong strategic position	Exit, harvest, maintain, or consolidate

innovation.[55] This time around, Iridium is being considered for global deployment by airspace authorities to allow real-time tracking of airplanes. The issue of being able to track airplanes around the globe at all times came to the fore in 2014, when Malaysia Airlines Flight 370 with 239 people on board disappeared without a trace and authorities were unable to locate the airplane.

For decades, air traffic controllers had to rely on ground-based radar to direct planes and to triangulate their positions. A major problem with any ground-based system is that it only works over land or near the shore, but not over oceans, which cover more than 70% of the Earth's surface. Moreover, radar does not work in mountain ranges. Oceans and mountain terrain, therefore, are currently dead zones where air traffic controllers are unable to track airplanes.

By 2019, 10 SpaceX rockets had been launched to complete the $3 billion refurbishments of Iridium's original satellite phone system. Iridium's 66-satellite constellation now hosts the new Aireon technology used for a space-based flight tracking system, covering 100% of the globe. The Aireon system gives air traffic controllers full visibility of, and real-time flight information from, any airplane over both sea and land. It also allows pilots greater flexibility to change routes as necessary to avoid bad weather and turbulence, thus increasing passenger convenience, saving fuel, and reducing greenhouse-gas emissions. In addition, the Aireon technology permits planes to fly closer together (15 miles apart instead of the customary 80 miles), allowing for more air traffic on efficient routes. A research study by an independent body has demonstrated that the global deployment of Aireon can lead to a substantial improvement in air safety.

Providing the next-generation air traffic control technology and services is a huge business opportunity for Iridium Communications. The Iridium-Aireon example goes to show that a second chance of success for an innovation may arise, even after the timing and application of an initial technology wear off.

LO 7-6

Categorize different types of innovations in the markets-and-technology framework.

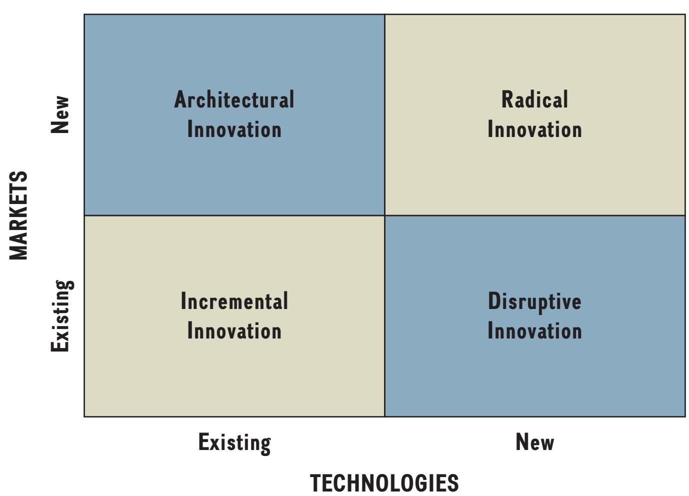
7.4 Types of Innovation

Because of the importance of innovation in shaping competitive dynamics and formulating business strategy, we now turn to a discussion of different types of innovation and the strategic implications of each. We need to know, in particular, the dimensions along which we should assess innovations. This will allow us to formulate a business strategy that can leverage innovation for competitive advantage.

One insightful way to categorize innovations is to measure their degree of newness in terms of *technology* and *markets.*[56] Here, *technology* refers to the methods and materials used to achieve a commercial objective.[57] For example, Amazon integrates different types of technologies (hardware, software, artificial intelligence, cloud computing, logistics) to provide not only the largest selection of retail goods online but also an array of services and mobile devices (e.g., Alexa, a digital personal assistant; Kindle tablets; Prime; and cloud-computing services). We also want to understand the *market* for an innovation—that is, whether an innovation is introduced into a new or an existing market—because an invention turns into an innovation only when it is successfully commercialized.[58] Measuring an innovation along these dimensions gives us the **markets-and-technology framework** depicted in Exhibit 7.12. Along the horizontal axis, we ask whether the innovation builds on existing technologies or creates a new one. On the vertical axis, we ask whether the innovation is targeted toward existing or new markets. Four types of innovations emerge: incremental, radical, architectural, and disruptive. As indicated by the color coding in the exhibit, each diagonal forms a pair: incremental versus radical innovation and architectural versus disruptive innovation.

markets-and-technology framework A conceptual model to categorize innovations along the market (existing/new) and technology (existing/new) dimensions.

EXHIBIT 7.12 Types of Innovation: Combining Markets and Technologies



INCREMENTAL VS. RADICAL INNOVATION

Although radical breakthroughs such as smartphones and magnetic resonance imaging (MRI) capture most of our attention, the vast majority of innovations are incremental. An **incremental innovation** squarely builds on an established knowledge base and steadily improves an existing product or service offering.[59] It targets existing markets using existing technology.

In contrast, **radical innovation** draws on novel methods or materials. It is derived either from an entirely different knowledge base or from a recombination of existing knowledge bases with a new stream of knowledge. It targets new markets by using new technologies.[60] Well-known examples of radical innovations include the automobile, the airplane, X-ray technology, and more recently biotechnology breakthroughs such as genetic engineering and the decoding of the human genome.

incremental innovation An innovation that squarely builds on an established knowledge base and steadily improves an existing product or service.

radical innovation An innovation that draws on novel methods or materials, is derived either from an entirely different knowledge base or from a recombination of the existing knowledge bases with a new stream of knowledge.

Many firms get their start by successfully commercializing radical innovations. Some of them, such as the jet-powered airplane, even give birth to new industries. Although the British firm de Havilland first commercialized the jet-powered passenger airplane, Boeing was the company that rode this radical innovation to industry dominance. More recently, Boeing's leadership has been contested by Airbus; each company has approximately half the market.

A predictable pattern of innovation is that firms (often new ventures) use radical innovation to create a temporary competitive advantage. They then follow up with a string of incremental innovations to sustain that initial lead. Gillette is a prime example of this pattern of strategic innovation. In 1903, entrepreneur King C. Gillette invented and began selling the safety razor with a disposable blade. This *radical innovation* launched the Gillette Co. (now a brand of Procter & Gamble). To sustain its competitive advantage, Gillette introduced its *razor–razor-blade business model* (see Chapter 12), making sure that its razors were not only inexpensive but also widely available to its customers. It also continuously improved its blades. Through a string of *incremental innovations,* Gillette kept adding a blade with each new version of its razor until the total number of blades went from one to six. Though this innovation strategy seemed predictable, it worked. One of Gillette's newest razors, the Fusion ProGlide with Flexball technology, features a handle with a swiveling ball hinge and costs $11.49 per razor ($12.59 for a battery-operated one)![61]

Such *overshooting* of consumer demand provided an opening for a new, low-cost entry. Enter Dollar Shave Club, which is disrupting Gillette's business model with its own incremental innovation, offering razors at a price as low as $1 (thus the name). As a result, Gillette's market share in the $15 billion wet shaving industry has declined from approximately 70% (in 2010) to less than 50% (in 2022). See Strategy Highlight 12.2 for an in-depth discussion on how Dollar Shave Club disrupted Gillette.

Despite its decline in market share, the Gillette example shows how radical innovation can create a competitive advantage and how a company can sustain that advantage through follow-up incremental innovation. Such an outcome is not a foregone conclusion, though. In some instances, the innovator is outcompeted by second movers that quickly introduce a similar incremental innovation to continuously improve their own offerings. For example, although CNN was the pioneer in 24-hour cable news, Fox News is the most-watched cable news network in the United States. (Note: The entire cable TV industry is in decline as viewers now stream content directly via the internet, as discussed in ChapterCase 7 about Netflix.) Once firms have achieved market acceptance of a breakthrough innovation, they tend to follow up with incremental rather than radical innovations. Over time, these companies morph into industry incumbents. Future radical innovations are generally introduced by new entrepreneurial ventures. Why? The reasons concern *economic incentives, organizational inertia,* and the firm's embeddedness in an *innovation ecosystem.*[62]

ECONOMIC INCENTIVES. Economists highlight the role of *incentives* in strategic choice. Once an innovator has become an established incumbent firm (such as Alphabet's Google), it has strong incentives to defend its strategic position and market power. An emphasis on incremental innovations strengthens the incumbent firm's position and maintains high entry barriers. A focus on incremental innovation is particularly attractive once an industry standard has emerged and technological uncertainty is reduced. Moreover, many markets where network effects are important (such as online search) turn into **winner-take-all markets**, where the market leader captures almost all of the market share. As a near monopolist, the winner in these types of markets is able to extract a significant amount of the value created. For example, in both the United States and Europe, Google handles more than 90% of all mobile search queries. The market leader uses incremental innovation to extend the time it can extract profits based on a favorable industry structure (see the discussion in Chapter 3). Any potential radical innovation threatens the market leader's dominant position.

winner-take-all markets Markets where the market leader captures almost all of the market share and is able to extract a significant amount of the value created.

The economic incentives for entrepreneurial ventures are just the opposite. Successfully commercializing a radical innovation is frequently the only option to enter an industry protected by high entry barriers. One of the first biotech firms, Amgen, used newly discovered drugs based on genetic engineering to overcome high entry barriers to the pharmaceutical industry, in which incumbents had enjoyed notoriously high profits for several decades. Because of differential economic incentives, incumbents often push forward with incremental innovations, while new entrants focus on radical innovations.

ORGANIZATIONAL INERTIA. From an organizational perspective, as firms become established and grow, they rely more heavily on formalized business processes and structures. In some cases, the firm may experience *organizational inertia*—resistance to changes in the status quo. Incumbent firms, therefore, tend to favor incremental innovations that reinforce the existing organizational structure and power distribution while avoiding radical innovation that could disturb the existing balance of power. Consider, for instance, the power distribution between different functional areas, such as R&D and marketing. New entrants do not have formal organizational structures and processes, giving them more freedom to launch an initial breakthrough. We discuss the link between organizational structure and firm strategy in depth in Chapter 11.

INNOVATION ECOSYSTEM. A final reason that incumbent firms tend to be sources of incremental rather than radical innovations is that they become embedded in an **innovation ecosystem**: a network of suppliers, buyers, complementors, and so on.[63] They no longer make independent decisions but must consider the ramifications on other parties in their innovation ecosystem. Continuous incremental innovations reinforce this network and keep all its members happy, while radical innovations disrupt it. Again, new entrants don't have to worry about preexisting innovation ecosystems because they will be building theirs around the radical innovation they are bringing to a new market.

innovation ecosystem A firm's embeddedness in a complex network of suppliers, buyers, and complementors, which requires interdependent strategic decision making.

ARCHITECTURAL VS. DISRUPTIVE INNOVATION

Firms can also innovate by leveraging *existing technologies* into *new markets.* Doing so generally requires them to reconfigure the components of a technology, meaning they alter the overall *architecture* of the product.[64] An **architectural innovation** is a new product in which known components, based on existing technologies, are reconfigured in a novel way to create new markets.

architectural innovation A new product in which known components, based on existing technologies, are reconfigured in a novel way to attack new markets.

As a radical innovator commercializing the xerography invention, Xerox was long the most dominant copier company worldwide.[65] It produced high-volume, high-quality, and high-priced copying machines that it leased to its customers through a service agreement. Although these machines were ideal for the high end of the market such as Fortune

100 companies, Xerox ignored small and medium-sized businesses. By applying an architectural innovation, the Japanese entry Canon was able to redesign the copier so that it didn't need professional service. Instead, reliability was built directly into the machine, and the user could replace parts such as the cartridge. Canon applied the *razor–razor-blade business model*, charging relatively low prices for its copiers but adding a steep markup to its cartridges. Xerox had not envisioned the possibility that the components of the copying machine could be put together in an altogether different way that was more user friendly. More importantly, Canon addressed a need in a specific consumer segment—small and medium-sized businesses and individual departments or offices in large companies—that Xerox neglected.

Finally, a **disruptive innovation** leverages *new technologies* to attack *existing markets.* It invades an existing market from the bottom up, as shown in Exhibit 7.13.[66] The dashed lines represent different market segments, from Segment 1 at the low end to Segment 4 at the high end. Low-end market segments are generally associated with low profit margins, while high-end market segments often have high profit margins. As first demonstrated by Clayton Christensen, the dynamic process of disruptive innovation begins when a firm, frequently a startup, introduces a new product or process based on a new technology to meet existing customer needs. To be a disruptive force, this new technology must have additional characteristics:

disruptive innovation An innovation that leverages new technologies to attack existing markets from the bottom up.

1. It begins as a low-cost solution to an existing problem.
2. Initially, its performance is inferior to the existing technology, but its rate of technological improvement over time is faster than the rate of performance increases required by different market segments. In Exhibit 7.13, the solid upward-curved line captures the new technology's trajectory, or rate of improvement over time.

The following examples illustrate disruptive innovations:

- Japanese carmakers successfully followed a strategy of disruptive innovation by first introducing small fuel-efficient cars and then leveraging their low-cost and high-quality advantages into high-end luxury segments, captured by brands such as Lexus (Toyota), Infiniti (Nissan), and Acura (Honda). More recently, the South Korean carmakers Kia and Hyundai have followed a similar strategy. Today, Chinese car manufacturers such as BYD and others are attempting to ride the wave of disruptive innovation with low-cost all-electric vehicles.

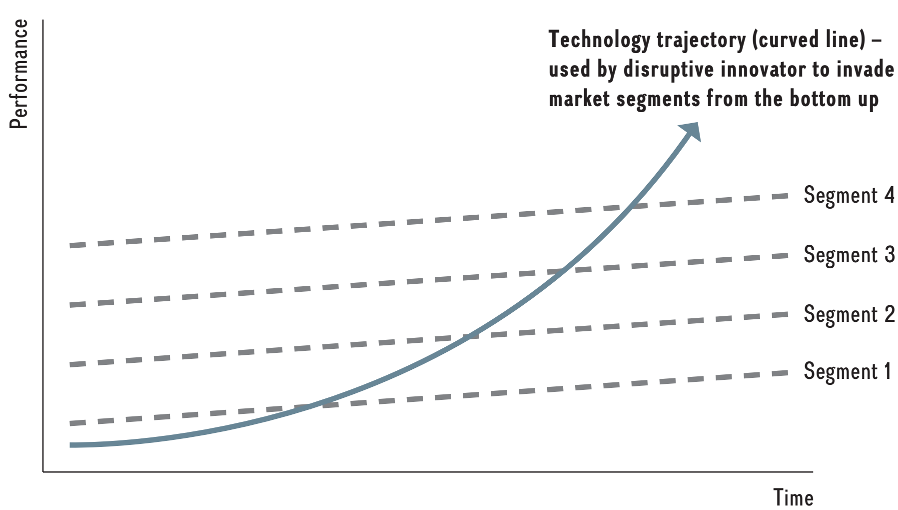


EXHIBIT 7.13

Disruptive Innovation: Riding the Technology Trajectory to Invade Different Market Segments from the Bottom Up

- Digital photography improved enough over time to provide higher-definition pictures. As a result, it replaced film photography, even in most professional applications.
- Laptop computers disrupted desktop computers; next, tablets and larger-screen smartphones disrupted laptops.
- Educational organizations such as Coursera and Udacity are disrupting traditional universities by offering *massive open online courses* (MOOCs), using the web to provide large-scale, interactive online courses.

One factor favoring the success of disruptive innovation is that it relies on a stealth attack: It invades the market from the bottom up, by first capturing the low end. Many times, incumbent firms fail to defend (and sometimes are even happy to cede) the low end of the market, which frequently has low margins. Alphabet's Google, for example, is using its mobile operating system, Android, as a beachhead to challenge Microsoft's dominance in the personal computer industry, where 90% of machines run Windows.[67] Google's Android is optimized to run on mobile devices, the fastest-growing segment in computing. For example, to appeal to users who spend most of their time on the web accessing e-mail and other online applications, it is designed to start in a few seconds. Moreover, Google provides Android free of charge.[68] In contrast to Microsoft's proprietary Windows operating system, Android is open-source software, accessible to anyone for further development and refinement. As a consequence, only two mobile operating systems are relevant today: Google's Android holds 72% market share in mobile operating systems, while Apple's iOS has 28%.[69]

Another factor favoring the success of disruptive innovation is that incumbent firms often are slow to change. Incumbent firms tend to listen closely to their current customers and respond by continuing to invest in the existing technology and in incremental changes to the existing products. When a newer technology matures and proves to be a better solution, those same customers will switch. At that time, the incumbent firm does not yet have a competitive product ready that is based on the disruptive technology. Although customer-oriented visions are more likely to guard against firm obsolescence than product-oriented ones (see Chapter 2), they are no guarantee that a firm can hold out in the face of disruptive innovation. One of the counterintuitive findings that Clayton Christensen unearthed in his studies is that it can hurt incumbents to listen too closely to their existing customers. Apple is famous for not soliciting customer feedback because it believes it knows what customers need before they even realize it.

Netflix, featured in the ChapterCase, disrupted the traditional cable TV bundle from the bottom up (as shown in Exhibit 7.13) with its streaming video-on-demand service. Netflix's streaming service differentiated itself from cable TV by making strategic trade-offs. By initially focusing on older "rerun TV" (such as *Breaking Bad*) and not including local content or exorbitantly expensive live sport events, Netflix was able to price its subscription service considerably lower than cable bundles. Netflix improved the viewing experience by allowing users to watch shows and movies without commercial breaks and on demand, thereby enhancing perceived consumer value. By switching its focus and investments from DVD-by-mail delivery service to streaming, Netflix was able to ride the upward-sloping technology trajectory (shown in Exhibit 7.13) to invade the media industry from the bottom up, all the way to providing premium original content such as *The Crown.* Netflix's pivot to streaming was aided by increased technology diffusion (see Exhibit 7.1) as more and more Americans adopted broadband internet connections in the 2000s.

Strategy Highlight 7.2 takes a close look at how the Canadian startup Shopify disrupted the ecommerce market and allowed merchants to bypass Amazon.com to go directly to consumers.

Strategy Highlight 7.2

How to Compete with Amazon.com? Easy: Use Shopify

About 50% of all ecommerce transactions in the United States take place on one site: Amazon.com. Although Amazon runs its own retail operation, most of the business on the site is done by independent merchants that use Amazon's retail platform. For many years, sellers have complained of being beholden to the online retail giant. Among the objections are that Amazon uses the vendors' sales data to offer competing products at a discount (with over 2,000 "Amazon basics," ranging from batteries to suitcases) and that Amazon favors its products in searches on the site.

Amazon's mission is to be the world's most customer-centric company. It focuses on making the customer happy by providing quality products at low cost, combined with a seamless experience that makes both buying and returning products easy. In pursuing its vision, Amazon has commoditized many products, including top brands. Many of the best-known consumer product companies allege that Amazon does not do enough to root out counterfeit and unsafe products, which are displayed alongside the brand-name products on the site. For these reasons, Nike and sandal-maker Birkenstock decided to no longer sell their products on Amazon.com. While juggernauts such as Nike can afford to create a bespoke ecommerce operation, smaller vendors cannot. How can a mom-and-pop store run a successful online business if it is not on the greatest retail platform? The answer: Use Shopify.

While Amazon focuses on pleasing the end customer, Shopify focuses on making merchants happy. The Canadian startup offers a complete, end-to-end ecommerce solution for vendors to build an online store, including ordering, inventory management, payments, and shipping. Shopify allows merchants to bypass the Amazon platform and go directly to consumers (DTC). It therefore empowers any person to create an online business. Warby Parker, the online seller of fashionable eyeglasses, is one early success story in launching the DTC phenomenon (in 2010). Since its founding in 2006, Shopify has grown to 2 million merchants representing a wide range of businesses, including Allbirds, Kylie Cosmetics, Heinz, and Netflix. Although many of the biggest consumer brands use Shopify as their online backbone, the vast majority of the vendors on Shopify are small entrepreneurial ventures.

Tobias "Tobi" Lütke was born and raised in Germany. After dropping out of high school, he pursued an apprenticeship as a computer programmer. At age 22, Tobi emigrated to Canada after meeting Fiona McKean (now his wife), an Ottawa native, on a snowboarding trip to Whistler, British Columbia. He credits his wife's family for much of his entrepreneurial success because of their unwavering support. Serendipity was critical in morphing his first business into Shopify. Tobi's estimated net worth is $8 billion.

David Fitzgerald/Sportsfile/Getty Images

When, at 23 years old, Tobi Lütke, founder and CEO of Shopify, started selling snowboards online in 2004, he could not have imagined that his side hustle would turn into a multibillion-dollar company. The idea for Shopify came to Tobi when he realized how difficult it was to set up an online store where he could sell directly to consumers and build a community of snowboard enthusiasts. At the time, no off-the-shelf ecommerce software solutions were available at prices that any small business could afford. Amazon and eBay were the most prominent online marketplaces at the time, but they did not offer platforms on which entrepreneurs could build their brands and business.

Frustrated but undeterred by the inadequacy of existing ecommerce software, Tobi Lütke and Shopify's cofounder, Scott Lake, pursued their entrepreneurial endeavor, Snowdevil, by forging their own path. Tobi leveraged his strong programming background to learn a new coding framework called "Ruby on Rails" to build the Snowdevil online storefront from scratch. As Snowdevil's business slowly took off, Tobi continuously improved the online shop and developed an intuitive and streamlined user interface that better suited his and his customers' needs. He also shared some of his developments with the Ruby on Rails community, and other forum members took

(Continued)

note of his ecommerce platform. Soon, people were asking him to license his ecommerce software. As Snowdevil's business started to wane during the spring season, Tobi and Scott realized that selling the software on which Snowdevil was built might be a more promising business venture, and they pivoted from selling snowboards to developing and innovating ecommerce software. Over the course of two years, Snowdevil morphed into Shopify.

Shopify launched with the mission to make commerce better for everyone. As such, Shopify focuses on simplicity, hence its name, which is a portmanteau of "shop" and "simplify." Shopify's innovation disrupted ecommerce because it provides DTC online capabilities to anyone. With it, merchants access a one-stop, complete solution to start and scale up their online businesses. Shopify offers a robust selection of services that help merchants create professionally designed online storefronts, register domain names, manage inventory, process orders and payments, secure financing, build customer relationships, and much more. By consolidating the entire process required to launch a business into a single package, Shopify provides equal opportunity for mom-and-pop shops and top brands to flourish successfully in highly competitive markets. Shopify uses a subscription-based business model, with merchants paying $29 a month for the basic online package. Without Shopify, many would-be entrepreneurs would not be able to pursue their dreams.

In 2015, Shopify debuted on the New York Stock Exchange, issuing 7.7 million shares and raising around $130 million. Tobi Lütke attributed much of the company's success to its partnering with Google, which was looking to promote mobile shopping and simplify purchases with Buy buttons. During the Covid-19 pandemic, Shopify deepened its partnership with Google and allied with Facebook (now Meta Platforms). These digital ad giants provide much of the marketing exposure that small vendors need online, while Shopify takes care of the rest. Industry observers aptly call the Google-Facebook-Shopify pact the "anti-Amazon" alliance. More recently, Shopify also added TikTok to its lineup of partners, further extending its vendors' market reach to the popular short-video app.

While ecommerce's share of total retail sales in the United States had been increasing steadily, the pandemic supercharged its growth. Within a few short weeks in 2020, as people were sheltering at home, ecommerce shot up from 15% of total retail sales to over 23%. Close to $1 in every $4 was spent online in the United States during the pandemic. As Amazon struggled to meet the explosive growth in demand and rationed shipments to "essential goods," consumers had to wait months for other items, and they searched out their favorite brands directly. Running their ecommerce operations on Shopify allowed both well-known brands and smaller, independent merchants to establish a direct relationship with their customers and build online communities around their unique products. As a result, Shopify became one of the biggest winners during the pandemic as its market cap shot up from $35 billion pre-pandemic to a record high of $212 billion.

As the pandemic subsided and many consumers returned to pre-pandemic habits, including shopping in stores, Shopify's market value declined by 75%. It stands at $61 billion (in spring 2022). In this regard, Shopify is in good company: The "pandemic stocks" such as Zoom, Carvana, Netflix, Teledoc Health, PayPal, DoorDash, and Amazon have lost on average 50% of their market cap. What remains, however, is an impressive achievement by Shopify: One out of three businesses conducting ecommerce relies on Shopify. And, with its partners Google and Meta, Shopify is providing tough competition for Amazon.[70]

HOW TO RESPOND TO DISRUPTIVE INNOVATION? Many incumbents tend to dismiss the threat by startups that rely on disruptive innovation because initially the startups' product or service offerings are considered low end and too niche focused. As late as 2010 (the year Blockbuster filed for bankruptcy), the CEO of Time Warner, one of the incumbent media companies later disrupted by Netflix, ridiculed the threat that Netflix might pose. It is critical to have an effective response to disruptive innovation.

The examples in the previous section show that disruptive innovations are a serious threat for incumbent firms. Here are some of the strategic initiatives that incumbent firms have devised to counter them:

1. *Continue to innovate to stay ahead of the competition.* A moving target is much harder to hit than one that is standing still and resting on existing (innovation) laurels. Amazon is

an example of a company that has continuously morphed through innovation,[71] from a simple online book retailer to the largest ecommerce company, including stores on the ground in the grocery sector. It also offers a personalized digital assistant (Alexa), consumer electronics (Kindle tablets), cloud computing, and content streaming, among many other offerings (see ChapterCase 8). Netflix continued to innovate by pivoting to online streaming and away from sending DVDs through the mail.

2. *Guard against disruptive innovation by protecting the low end of the market* (Segment 1 in Exhibit 7.13) by introducing low-cost innovations to preempt stealth competitors. Intel introduced the Celeron chip, a stripped-down, budget version of its Pentium chip, to prevent low-cost entry into its market space. More recently, Intel followed up with the Atom chip, an inexpensive new processor that consumes little battery power, to power low-cost mobile devices.[72] Nonetheless, Intel also listened too closely to its existing personal computer customers such as Dell, HP, and Lenovo, which allowed ARM Holdings, a British semiconductor design company that supplies its technology to Apple, Samsung, and HTC. As a result, it was unable to take the lead in providing designs for high-performing, low-power-consuming processors for smartphones and other mobile devices.
3. *Disrupt yourself, rather than wait for others to disrupt you.* A firm may develop low-cost products specifically for emerging markets such as China and India, and then introduce these innovations into developed markets such as the United States, Japan, or the European Union. This process, called **reverse innovation**,[73] allows a firm to disrupt itself.

reverse innovation An innovation that was developed for emerging economies before being introduced in developed economies. Sometimes also called *frugal innovation.*

7.5 Platform Strategy

LO 7-7

Explain why and how platform businesses can outperform pipeline businesses.

Up to this point in our discussion of strategy and competitive advantage, we've focused mainly on businesses that operate at one or more stages of the linear value chain (introduced in Chapter 4).

A firm's value chain captures the internal activities a firm engages in, beginning with the acquisition of raw materials and ending with retailing and after-sales service and support. This traditional system of horizontal business organization has been described as a *pipeline* because it captures a linear transformation with producers at one end and consumers at the other. Consider BlackBerry as an example of a business using a linear pipeline approach based on a step-by-step arrangement for creating and transferring value. This Canadian ex-leader in smartphones conducted internal R&D, designed the phones, manufactured them (often in company-owned plants), and finally retailed them in partner stores such as AT&T or Verizon stores, which offered wireless services and after-sales support.

THE PLATFORM VS. PIPELINE BUSINESS MODELS

Read the following examples and try to figure out how these businesses' operations differ from the traditional pipeline structure just described.[74]

- Valued at over $100 billion (post-IPO in 2021), the ride-hailing service Uber was launched (in 2009) in a single city, San Francisco. Without owning a single car, Uber is not only disrupting the traditional taxi and limousine business in hundreds of cities around the globe but also reshaping the transportation and logistics industries (e.g., food delivery).
- Reaching over 3 billion people out of an estimated 5 billion users online globally (some 2.7 billion of the world's 7.7 billion people are not yet online), Meta's Facebook is where

people get their news, watch videos, listen to music, and share photos. Garnering over $120 billion in annual advertising revenues (in 2022), Facebook has become one of the largest media companies in the world, without producing a single piece of content.

- China-based ecommerce firm Alibaba offers online retailing as well as business-to-business services on a scale that dwarfs Amazon and eBay combined. On its Taobao site (similar to eBay), Alibaba offers more than 1 billion products, making it the world's largest retailer without owning a single item of inventory. When it went public (in 2014) by listing on the New York Stock Exchange (NYSE), Alibaba was the world's largest IPO, valued at $25 billion. At its peak (in 2020), Alibaba was valued at $800 billion (32 times the IPO valuation), making it one of the most valuable technology companies in the world.

platform business An enterprise that creates value by matching external producers and consumers in a way that creates value for all participants, and that depends on the infrastructure or platform that the enterprise manages.

What do Uber, Facebook, and Alibaba have in common? They are *not* organized as traditional linear pipelines, but instead as **platform businesses**. The five most valuable companies globally (Alphabet, Amazon, Apple, Meta, and Microsoft) all run platform business models. In contrast, ExxonMobil, which runs a traditional linear business model from raw materials (fossil fuels) to distribution (of refined petroleum products) and was long the most valuable company in the world, barely makes it into the top 10. According to the popular book *Platform Revolution* by Geoffrey Parker, Marshall Van Alstyne, and Sangeet Choudary, platforms can be defined along three dimensions:

1. A platform is a business that enables value-creating interactions between external producers and consumers.
2. The platform's overarching purpose is to consummate matches among users and facilitate the exchange of goods, services, or social currency, thereby enabling value creation for all participants.
3. The platform provides an infrastructure for these interactions and sets governance conditions for them.

The business phenomenon of platforms is not a new one. *Platforms*, often also called *multi-sided markets*, have been around for millennia. The town squares in ancient cities were marketplaces where sellers and buyers met under a set of governing rules determined by the owner or operator (such as what type of wares could be offered, when the marketplace was open for business, and which vendor would get what stand on the square). The credit card, often hailed as the most important innovation in the financial sector over the last few decades,[75] provides a more recent example of a multi-sided market. Credit cards facilitate more frictionless transactions between vendors and customers because the vendor is guaranteed payment by the bank that issues the credit card, and customers using credit cards can easily transact online and without the need to carry cash in the physical world. In addition, credit card users can buy goods or services on credit based on their promise of repaying the bank.

In the digital age, *platforms* are business model innovations that use technology (such as the internet, cloud computing, and artificial intelligence) to connect organizations, resources, information, and people in an interactive ecosystem where value-generating transactions (such as hailing a ride on Uber, catching up on news on Facebook, or connecting a Chinese supplier to a U.S. retailer via Alibaba) can be created and exchanged. Effective use of technology allows platform firms to drastically reduce the barriers of time and space: Information is available in real time across the globe, and market exchanges can take place effectively across vast distances (e.g., China to the United States) or even in small geographic spaces (as in the case of Tinder, a location-based dating service).

THE PLATFORM ECOSYSTEM

To formulate an effective platform strategy, the first step is to understand the roles of the players within any **platform ecosystem** (Exhibit 7.14). From a value chain perspective, *producers* create or make available a product or service that *consumers* use. The *owner* of the platform controls the platform IP address and controls who may participate and in what ways. The *providers* offer the interfaces for the platform, enabling its accessibility online.

platform ecosystem The market environment in which all players participate relative to the platform.

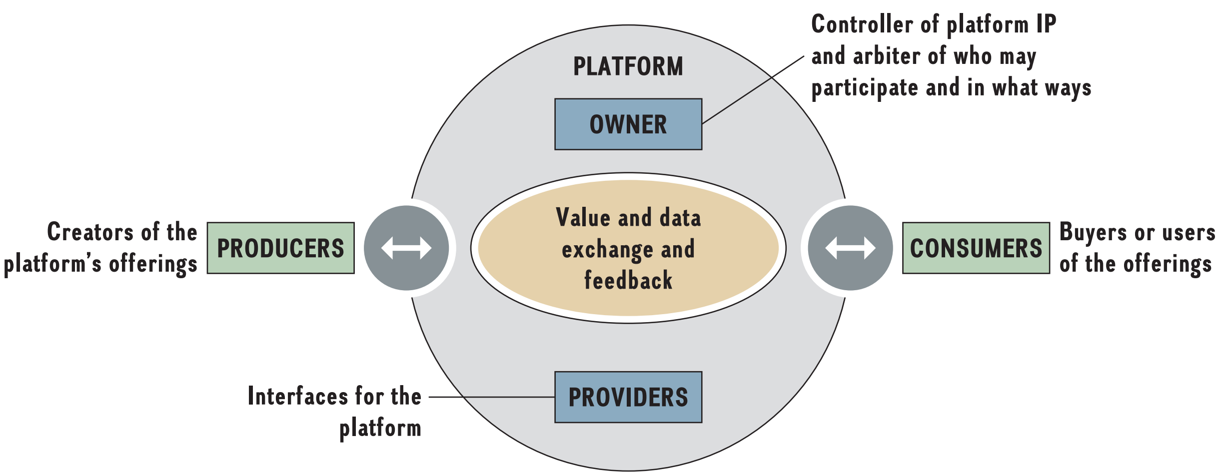
The players in the ecosystem typically fill one or more of the four roles but may rapidly shift from one role to another. For example, a producer may decide to purchase the platform to become an owner, or an owner may use the platform as a producer. Producer and consumer can also switch, as when a passenger (consumer) who uses Uber for transportation decides to become an Uber driver (producer). This is an example of *side switching.*

ADVANTAGES OF THE PLATFORM BUSINESS MODEL. Due to the following advantages, *platform businesses* tend to outperform *pipeline businesses.*[76]

1. *Platforms scale more efficiently than pipelines by eliminating gatekeepers.* Platform businesses leveraging digital technology can grow much faster—that is, they scale efficiently—because platforms create value by orchestrating resources that reside in the ecosystem. The platform business does not own or control these resources, facilitating rapid and often exponential growth.

   In contrast, pipelines tend to be inefficient in managing the flow of information from producer to consumer. When hiring a professional services firm such as a consultant or lawyer, the buyer has to purchase a bundle of services offered by the firm—for example, retaining a consulting team for a specific engagement. This team of consultants contains both senior and junior consultants, as well as administrative support staff. The client is unable to access the services of only one or two senior partners but not the rest of the team, and inexperienced junior associates are also billed at a high rate to the client. Platforms such as Upwork unbundle professional services by making available precisely

EXHIBIT 7.14 The Players in a Platform Ecosystem



Source: Author's adaptation from M. Van Alstyne, G. G. Parker, and S. P. Choudary (2016, April) "Pipelines, platforms, and the new rules of strategy," *Harvard Business Review.*

defined individual services while eliminating the need to purchase a bundle of services as required by gatekeepers in old-line pipelines.

2. *Platforms unlock new sources of value creation and supply.* Consider how Airbnb (featured in ChapterCase 3) disrupted the hotel industry. To grow, traditional competitors such as Marriott or Hilton need to add additional rooms to their existing stock. To add new hotel room inventory to their chains, they need to find suitable real estate, develop and build a new hotel, furnish all the rooms, and hire and train staff to run the new hotel. This process often takes years, in addition to the multimillion-dollar upfront investments required and the risks involved.

   In contrast, Airbnb faces no such constraints because it does not own any real estate, nor does it manage any hotels. Just like Marriott or Hilton, however, it uses sophisticated pricing and booking systems to allow guests to find a large variety of rooms that suit their needs almost anywhere in the world. As a digital platform, Airbnb allows any person to offer rooms directly to pretty much any consumer who is using the internet to look for accommodations. Airbnb makes money by taking a cut on every rental through its platform. Because Airbnb is a digital platform, it can grow much faster than old-line pipeline businesses such as Marriott. Airbnb's inventory is basically unlimited as long as it can sign up new users with spare rooms to rent, and it faces little or no cost when it adds inventory to its existing online offerings. Unlike traditional hotel chains, Airbnb's growth is not limited by capital, hotel staff, or ownership of real estate. With its asset-light approach based on its platform strategy, Airbnb is able to offer more accommodations than the three biggest hotel chains combined: Marriott, Hilton, and Intercontinental.

3. *Platforms benefit from community feedback.* Feedback loops from consumers back to the producers allow platforms to fine-tune their offerings and benefit from AI. TripAdvisor, a travel website, derives significant value from a large number of quality reviews (including pictures) by its users of hotels, restaurants, and so on. These reviews enable TripAdvisor to consummate more effective matches between hotels and guests via its website, thus creating more value for all participants. In the process, TripAdvisor captures a percentage of each successful transaction.

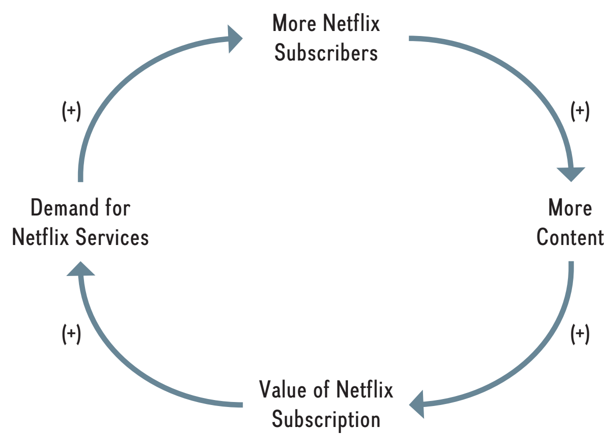
   Netflix also collects large amounts of data about users' viewing habits and preferences across the world. These data allow Netflix not only to make effective recommendations regarding what viewers should watch next but also help the company make decisions regarding content investments. For example, before even producing a single episode of *House of Cards*, Netflix knew that its audience would watch this series. Netflix has continued following the data, which allows the market for media consumption (within the Netflix universe) to shape the new content that the streaming service offers and produces.

NETWORK EFFECTS. For platform businesses to succeed, they must benefit from positive *network effects*. We provided a brief introduction to network effects earlier when we discussed how to gain a foothold for an innovation in a newly emerging industry during the introduction stage of the industry life cycle. We now take a closer look at the role of network effects in platforms, including feedback loops that can initiate virtuous growth cycles leading to platform leadership.

Netflix. Consider how the video-streaming service Netflix (featured in the ChapterCase) leverages network effects for competitive advantage. Netflix's business model is to grow its global user base as large as possible and then monetize it via monthly subscription fees. The established customer base in the old-line DVD rental business gave Netflix a head start when it entered into the new business of online streaming. Meanwhile, costs remained stable or even decreased. The cost to Netflix of establishing a large library of streaming content is more or less fixed, but the per-unit cost falls drastically as more users join. In addition, the marginal cost of streaming content to additional users is extremely low (but not quite zero because Netflix pays for some delivery of content either by establishing servers hosting content in geographic proximity to users or by paying online service providers for faster content streaming).

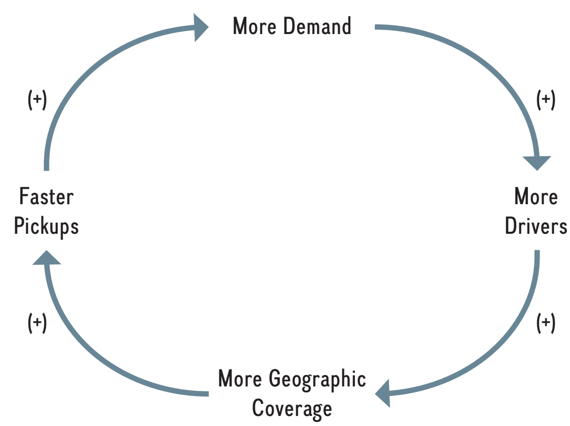
As Netflix adds more content, it increases the value of its subscription service to customers, resulting in more people signing up. With more customers, Netflix can afford to provide more and higher-quality content, further increasing the value of the subscription to its users. This virtuous cycle increased the value of a Netflix subscription as more subscribers signed up (Exhibit 7.15).

EXHIBIT 7.15 Netflix Business Model: Leveraging Network Effects to Drive Demand



Uber. The feedback loop in network effects becomes even more apparent when we take a closer look at Uber's business model. Like many platforms, Uber performs a classic matching service. Specifically, it allows riders to find drivers and drivers to find riders. Uber's deep pockets, thanks to successful rounds of fundraising, allowed the startup to lose money on each ride in order to initiate a positive feedback loop. Uber provided incentives for drivers to sign up (such as extending credit so that potential drivers can purchase vehicles), and it charged lower than market rates for its rides. As more and more drivers signed up in each city and coverage density rose accordingly, the service became more convenient. Demand for its services increased as more riders chose Uber, which in turn brought in more drivers. Uber's positive feedback loop is shown in Exhibit 7.16. Once the installed base of users was large enough, Uber began raising prices to achieve profitability.

EXHIBIT 7.16 Uber's Business Model: Leveraging Network Effects to Increase Demand

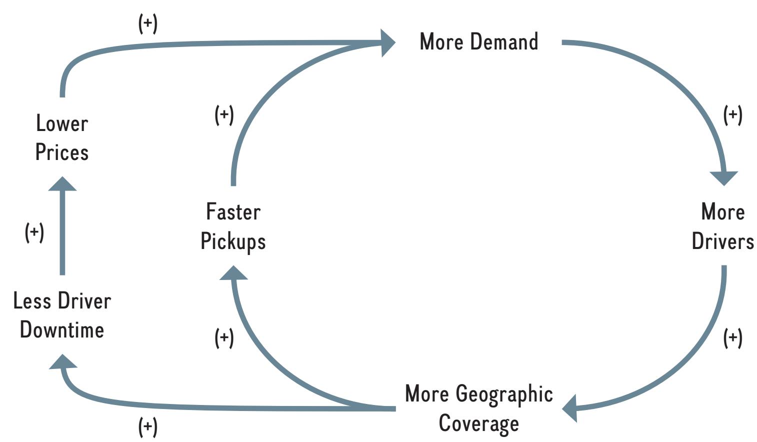


With more and more drivers on the Uber platform, wait time for rides falls, and so does driver downtime. Less downtime implies that a driver can complete more rides in a given time while making the same amount of money, even if Uber should lower its fares. Lower fares and shorter wait time, in turn, bring in more riders on the platform, and so on. This additional feedback loop is shown in Exhibit 7.17.

This feedback loop also explains the much-hated *surge pricing* that Uber employs. Surge pricing is based on dynamic pricing for its services depending on demand. For example, during the early hours of each New Year, demand for rides far outstrips supply. To entice more drivers to work during this time, Uber has to pay them more. Higher pay will bring more drivers onto the platform. Some users complain about surge pricing, but it allows Uber to match supply and demand in a dynamic fashion. As surge pricing kicks in, fewer people

EXHIBIT 7.17

Uber's Network Effects with Feedback Loop



will demand rides, eventually bringing supply and demand back into an equilibrium (see Exhibit 7.17).

The ability of a platform to evince and manage positive network effects is critical to producing value for each participant. Achieving positive returns to scale allows a firm to gain and sustain a competitive advantage. In contrast, negative network effects occur when more and more users exit a platform and the value that each remaining user receives from the platform declines. The social network Myspace experienced negative network effects as more and more users abandoned it for Meta's Facebook. One reason was that Myspace attempted to maximize ad revenues per user too early. In contrast, CEO Mark Zuckerberg at Facebook focused on building a social media platform that provided the best possible user experience before starting to monetize its user base by selling ads.

7.6 Implications for Strategic Leaders

Innovation drives the competitive process. An effective innovation strategy is critical in formulating a business strategy that provides the firm with a competitive advantage. Successful innovation affords firms a temporary monopoly, with corresponding monopoly pricing power. Innovation can lay the foundations for competitive advantage, but continuous innovation is needed to sustain a competitive advantage.

The process of creative destruction induced by innovation plays out within the broader social and economic environment. The types of innovation to expect are partly a function of the industrial stage we are in. The transition to the knowledge economy will be supercharged during the current, fourth industrial revolution.

Entrepreneurs are the agents who introduce change into the competitive system. They do this not only by figuring out how to use inventions but also by introducing new products or services, new production processes, and new forms of organization. Entrepreneurs frequently start new ventures, but they may also be found in existing firms.

The industry life cycle model and the crossing-the-chasm framework have critical implications for the management of innovation. To overcome the chasm, you need to formulate a business strategy guided by the who, what, why, and how questions of competition (see Chapter 6) to meet the distinctly different customer needs inherent along the industry life cycle. You also need to bring different competencies and capabilities to bear at different stages of the industry life cycle.

It is helpful to categorize innovations according to their degree of newness in terms of *technology* and *markets.* Each diagonal pair—incremental versus radical innovation and architectural versus disruptive innovation—has different strategic implications.

Moving from the traditional pipeline business to a platform business model implies three important shifts in strategy focus:[77]

1. A shift from resource control to resource orchestration
2. A shift from internal optimization to external interactions
3. A shift from customer value to ecosystem value

The focus in platform strategy, therefore, shifts from traditional concepts of resource control, industry structure, and firm strategic position to creating and facilitating more or less frictionless market exchanges.

In this and the previous chapter, we discussed how firms can use *business-level strategy*—differentiation, cost leadership, blue ocean, and innovation—to gain and sustain competitive advantage. In Chapter 8, we will turn our attention to *corporate-level strategy* to help us understand how executives make decisions about *where to compete* (in terms of products and services offered, integration along the value chain, and geography) and how to execute that strategy through strategic alliances as well as mergers and acquisitions. A thorough understanding of business and corporate strategy is necessary to formulate and sustain a winning strategy.

CHAPTER**CASE 7** Part II

In spring 2022, Netflix began losing subscribers rapidly, marking its first decline in paid users in more than a decade. Its market cap fell by 75% from its peak, shedding over $220 billion in value. Did Netflix's innovation machine stall?

Netflix is facing several challenges:

- As new users signed up in droves during the Covid pandemic, some of the anticipated subscriber growth was pulled forward, thus reducing expected subscriber growth post-pandemic. When a tech company such as Netflix's growth rate slows, investors sell the stock and reinvest in faster-growing companies, leading not only to a lower market cap but also to constrained financing options for future growth such as online gaming on the Netflix platform.
- Netflix disclosed that among its 220 million subscribers globally, account credentials are shared with over 100 million additional (non-paying) users. This number includes about 30 million households in the United States and Canada.
- The market for streaming services in the United States and Canada is saturated, as indicated by the high household penetration. Basically, every household that wants a streaming subscription has one. Indeed, Netflix is losing subscribers in North America, Latin America, and Europe.
- Intensified competition is resulting in a streaming war. Some of the most potent competitors are Amazon, Apple, and Disney, which are all diversified conglomerates with deep pockets. These companies can run their streaming services at a loss to drive out competition. Indeed, Amazon's streaming service is free to its Prime members, and Apple and Disney charge only a fraction of Netflix's monthly subscription fees.

How will Netflix co-CEOs Reed Hastings and Ted Sarandos address these challenges?

First, Netflix will require people who share their passwords beyond their households to pay more. Rather than cracking down directly on non-paying users, Netflix will ask the account owners to pay more. In the United States, a Netflix subscription that allows for four simultaneous streams is currently priced at $20 a month, while the basic subscription with two streams is $10 a month. One option is to offer a subscription for $25 per month that allows out-of-household sharing. The problem Netflix faces is it has increased prices pretty much every year since it started streaming in 2007. Since then, the price for the standard plan has doubled. Further price increases could lead to higher churn if more people unsubscribe from Netflix. (The *churn rate* measures the loss of subscribers in a given period.) For a subscription-based business such as Netflix, losing paid users is costly because recurring monthly payments vanish, thus reducing the expected future income stream.

To reduce churn, Netflix has vowed to continue investing considerable sums in developing new content. Unfortunately, content development costs have skyrocketed because more companies are trying to find the next hit show, thus bidding up prices for talent, development, and production. In addition, to reduce churn and entice new subscribers, Netflix has announced that it will branch out into new content areas such as gaming. Netflix believes it can deliver a superior gaming experience within its subscription-based, ad-free tier. Its argument goes as follows: Because it can capture monthly, recurring revenue, Netflix is freed from the need to charge for each title and for in-game purchases, both common ways to monetize gaming. This approach, the argument continues, should give creators a greater degree of freedom, which should result in a better gaming experience on the Netflix platform.

Another strategic initiative that Netflix is contemplating is to offer a lower-tier, ad-supported service. Until 2022, there were no ads on Netflix. The lack of ads has been a critical differentiator compared to traditional cable TV and other streaming services. Offering a lower-priced, ad-supported option (e.g., $5 per month) will provide new income streams from advertisers and additional paid subscribers. Offering a low-cost alternative also provides a soft landing for people who use Netflix without paying for the service, albeit at the inconvenience of watching ads while enjoying their favorite shows.[78]

Questions

1. How did Netflix use innovation to gain and sustain a competitive advantage? What role did strategy, technology, and business models play? Explain in detail.
2. Why is competition in streaming services heating up? Who has jumped into the fray, and why? How do these companies differ? Going forward, what results do you expect from this intensifying competition?
3. Do you think creating an ad-supported, lower-cost tier is a smart strategic move for Netflix? Would you pay $5 a month for an ad-supported Netflix subscription? Why or why not?
4. Gaming is one strategic initiative that Netflix is pursuing. Do you see Netflix as being a destination for gamers? Why or why not?
5. In addition to cracking down on password sharing, developing new original content, and moving into gaming, which other strategic initiatives might help Netflix jumpstart its innovation engine and regain its competitive advantage? Explain.

TAKE-AWAY CONCEPTS

This chapter discussed various aspects of innovation and entrepreneurship as business-level strategy, as summarized by the following learning objectives and related take-away concepts.

LO 7-1 / Outline the four-step innovation process from idea to imitation.

- Innovation is the discovery and development of new knowledge in a four-step process captured in the four I's: *idea, invention, innovation,* and *imitation.*
- The innovation process begins with an idea.
- An invention is the transformation of an idea into a new product or process, or the modification and recombination of existing products or processes.
- Innovation is the commercialization of an invention by entrepreneurs (within existing companies or new ventures).
- If an innovation is successful in the marketplace, competitors will attempt to imitate it.

LO 7-2 / Outline the four stages of industrial revolutions and derive implications for expected changes in the future.

- The process of creative destruction induced by innovation plays out within the broader social and economic environment.
- The types of innovation to expect are partly a function of the industrial stage we are in. We are currently at the beginning of the fourth industrial revolution.
- The fourth industrial revolution is characterized by significant advances in artificial intelligence (AI), automation, robotics, gene editing, 3D printing, and cyber-physical systems such as the internet of things (IoT), which connects everyday items such as airplanes, cars, and refrigerators to the internet.

- Many low-skilled, entry-level jobs are expected to be replaced by automation and robotics. The replacement of the labor force by automation and robotics could be so vast that societies will decide to implement a *universal basic income (*UBI).
- The fourth industrial revolution will result in significant social, political, and economic shifts.
- Investments in human capital such as education will be even more important and come with higher expected returns.

LO 7-3 / Apply strategic management concepts to entrepreneurship and innovation.

- Entrepreneurship is the process by which change agents undertake economic risk to innovate—to create new products, processes, and sometimes new organizations.
- Strategic entrepreneurship is the pursuit of innovation using tools and concepts from strategic management.
- Social entrepreneurship is the pursuit of social goals through entrepreneurship. Social entrepreneurs use a triple-bottom-line approach to assess performance.

LO 7-4 / Describe the competitive implications of different stages in the industry life cycle.

- Innovations frequently lead to the birth of new industries.
- Industries generally follow a predictable industry life cycle with five distinct stages: introduction, growth, shakeout, maturity, and decline.
- Exhibit 7.11 details features and strategic implications of the industry life cycle.

LO 7-5 / Derive strategic implications of the crossing-the-chasm framework.

- The core argument of the crossing-the-chasm framework is that each stage of the industry life cycle is dominated by a different customer group that responds differently to a new technological innovation.
- There exists a significant difference between the customer groups that enter early during the introductory stage of the industry life cycle and customer groups that enter later during the growth stage.
- This distinct difference between customer groups leads to a big gulf or chasm into which many companies and their innovations fall.
- To cross the chasm, managers need to formulate a business strategy guided by the who, what, why, and how questions of competition.

LO 7-6 / Categorize different types of innovations in the markets-and-technology framework.

- Four types of innovation emerge when we apply the existing versus new dimensions of technology and markets: incremental, radical, architectural, and disruptive innovations (see Exhibit 7.12).
- An incremental innovation squarely builds on an established knowledge base and steadily improves an existing product or service offering (existing market/existing technology).
- A radical innovation draws on novel methods or materials and is derived either from an entirely different knowledge base or from the recombination of the existing knowledge base with a new stream of knowledge (new market/new technology).
- Architectural innovation is an embodied new product in which known components, based on existing technologies, are reconfigured in a novel way to attack new markets (new market/existing technology).
- Disruptive innovation is an innovation that leverages new technologies to attack existing markets from the bottom up (existing market/new technology).

LO 7-7 / Explain why and how platform businesses can outperform pipeline businesses.

- Platform businesses scale more efficiently than pipeline businesses by eliminating gatekeepers and leveraging digital technology. Pipeline businesses rely on gatekeepers to manage the flow of value from the beginning to the end of the pipeline. Platform businesses leverage technology to provide real-time feedback.
- Platforms unlock new sources of value creation and supply. Thus they escape the limits faced by a pipeline company working within an existing industry based on physical assets.
- Platforms benefit from community feedback. Feedback loops from consumers back to the producers allow platforms to fine-tune their offerings and to benefit from big data analytics.

KEY TERMS

Architectural innovation *(p. 276)*
Comparative advantage *(p. 252)*
Crossing-the-chasm framework *(p. 266)*
Disruptive innovation *(p. 277)*
Early adopters *(p. 268)*
Early majority *(p. 268)*
Entrepreneurs *(p. 256)*
Entrepreneurship *(p. 254)*
First-mover advantages *(p. 250)*
Incremental innovation *(p. 275)*
Industry life cycle *(p. 258)*
Innovation *(p. 250)*
Innovation ecosystem *(p. 276)*
Internet of things (IoT) *(p. 253)*
Invention *(p. 249)*
Laggards *(p. 270)*
Late majority *(p. 270)*
Long tail *(p. 247)*
Machine learning (ML) *(p. 253)*
Markets-and-technology framework *(p. 274)*
Patent *(p. 249)*
Platform business *(p. 282)*
Platform ecosystem *(p. 283)*
Process innovation *(p. 262)*
Product innovation *(p. 262)*
Radical innovation *(p. 275)*
Reverse innovation *(p. 281)*
Social entrepreneurship *(p. 257)*
Standard *(p. 260)*
Strategic entrepreneurship *(p. 256)*
Technology enthusiasts *(p. 267)*
Trade secret *(p. 249)*
Universal basic income (UBI) *(p. 254)*
Winner-take-all markets *(p. 276)*

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CHAPTER

8

Corporate Strategy: Vertical Integration and Diversification

Chapter Outline

Learning Objectives

LO 8-1 Define corporate strategy and describe the three dimensions along which it is assessed.

LO 8-2 Explain why firms need to grow, and evaluate different growth motives.

LO 8-3 Describe and evaluate different options that firms have to organize economic activity.

LO 8-4 Describe the two types of vertical integration along the industry value chain: backward vertical integration and forward vertical integration.

LO 8-5 Identify and evaluate the benefits and risks of vertical integration.

LO 8-6 Describe and examine alternatives to vertical integration.

LO 8-7 Describe and evaluate different types of corporate diversification.

LO 8-8 Apply the core competence–market matrix to derive different diversification strategies.

LO 8-9 Explain when a diversification strategy creates a competitive advantage and when it does not.

Amazon's Corporate Strategy

In 2021, Jeff Bezos (left), Amazon founder and long-time CEO, stepped down to focus on Blue Origin, his space flight and exploration company. Andy Jassy, creator of the highly profitable Amazon Web Services (AWS) and its CEO (since 2016), succeeded Jeff Bezos as CEO of Amazon.com Inc., of which AWS is a subsidiary. In 2022, Amazon's revenues stood at $500 billion. With 2 million employees each, Amazon and Walmart are the largest employers in the United States. Only the U.S. government (in the form of federal, state, and local governments combined) employs more people.

Nareshkumar Shaganti / Alamy Stock Photo; REUTERS/Alamy Stock Photo; rvlsoft/Shutterstock; fStop/Getty Images

Amazon.com, Inc. is a business-invention and strategy-execution machine. Indeed, Amazon is the single largest spender on research and development ($60 billion in 2021, or 13% of revenues). These large outlays fund Amazon's diversification into new products, services, and geographies. Amazon is active in many businesses, including ecommerce, cloud computing, digital content (video, music, and books), advertising, groceries, and logistics. What began as a fledgling online startup has become one of the world's most valuable technology companies, reaching a market valuation of close to $2 trillion (in 2021).

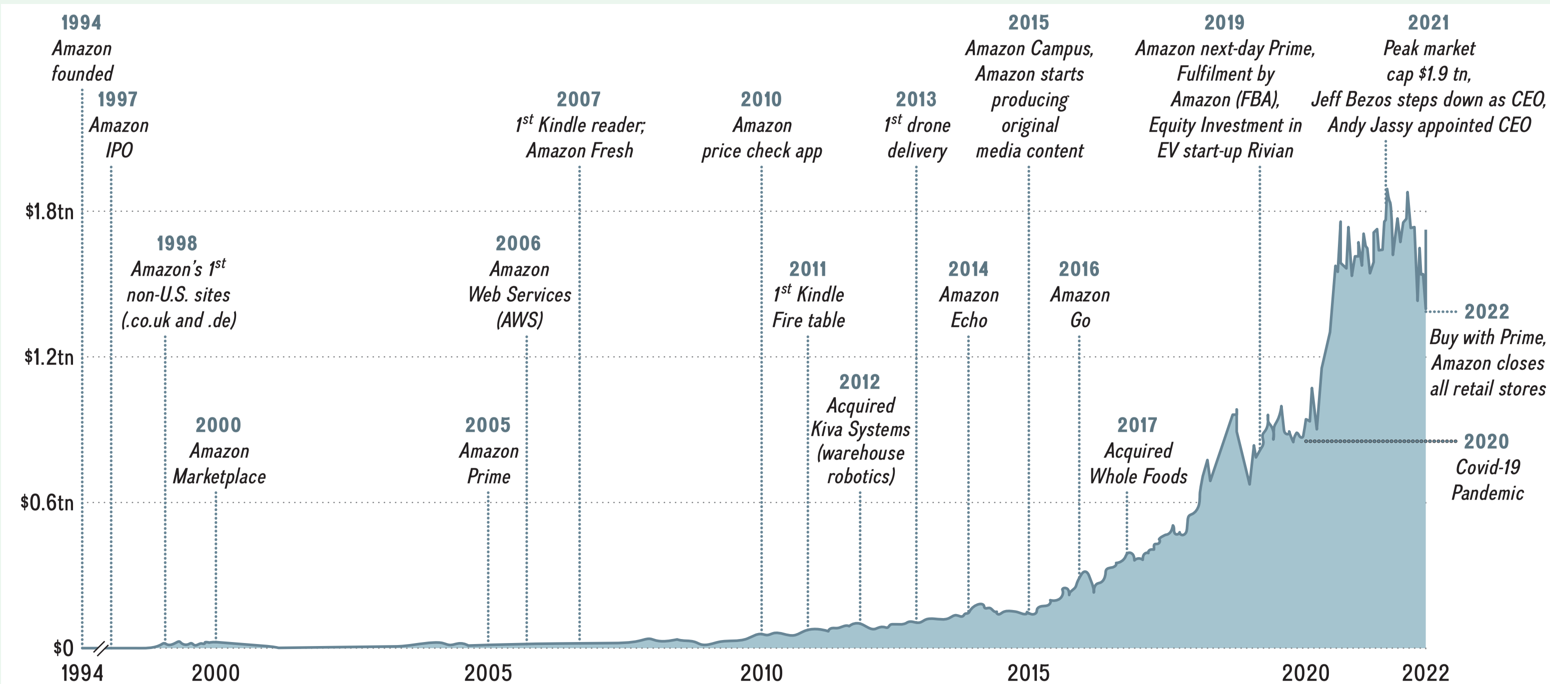
When Jeff Bezos founded Amazon in 1994, he began selling books online. He created a makeshift office out of a garage in a Seattle suburb and furnished it with desks made out of discarded wood doors. The home's basement was the company's first "warehouse," where Bezos stored the inventory of books. Amazon.com went live in 1995 and became an instant success with book lovers everywhere. Every evening, Bezos drove to the local post office to mail orders to customers. In his 1997 letter to shareholders, he declared that Amazon is about focusing relentlessly on customers, creating long-term value for shareholders rather than short-term corporate profit, and making many bold bets on future businesses.

Amazon's geographic diversification began nearly at the outset. For example, it operates country-specific sites in the United Kingdom (amazon.co.uk) and Germany (amazon.de). However, it withdrew from China (in 2019), where domestic tech companies Alibaba and JD.com are the dominant players. Vowing to be a leading player in two of the three main markets for ecommerce (United States, China, and India), Amazon is investing billions to grow its business in India (amazon.in).

Amazon also sells its line of consumer products (Amazon Basics), including screwdrivers, towels, and electronics such as e-readers, tablets, and voice-controlled devices such as Alexa (launched in 2014). The Kindle e-reader (introduced in 2007) has transformed the publishing industry. Amazon holds over 80% market share in e-books; indeed, it sells more e-books than print books. Alexa, an AI-based digital assistant that marks Amazon's foray into augmented reality, sells more than 100 million units per year!

Amazon launched its Prime membership service in 2005. Subscribers initially paid $79 a year to receive free two-day shipping and access to Amazon's video and music streaming services. As part of a university campus initiative, Amazon offers its Prime membership to students (Prime Student) free for a six-month trial period and then charges a discounted $6.49 a month (or about $59 per year). Prime Student guarantees unlimited free delivery of Prime-eligible items ordered online, in addition to all the other Prime membership benefits (free streaming of media content, lending one e-book a month for free, discounts on hardware, and so on). To accomplish next-day delivery, Amazon is using delivery centers on campus. When a package arrives, students receive a text message and can then retrieve the package via code-activated lockers. The on-campus delivery facilities also serve as convenient return centers. Perhaps more important, having a central delivery hub on campus makes addressing the *last-mile problem* (that is, delivering a package to a student's dorm room or apartment) moot. In logistics, the "last mile" is the most expensive part of the

EXHIBIT 8.1 Amazon's Strategic Initiatives and Stock Market Valuation (in $tn), 1994–2022



Source: Author's depiction of publicly available data total shipping cost; with a central delivery hub, Amazon does not need UPS or FedEx to make the final delivery. These business process innovations allow Amazon to offer Prime Student at low cost and high convenience. A nice benefit of the Prime Student initiative for Amazon is that it converts Gen Z students into lifelong subscribers. In 2019, Amazon introduced next-day deliveries for its U.S.-based Prime members. By 2022, over 110 million Americans had signed up for Prime membership, which is priced at $119 a year. Globally, Prime has over 200 million members.

Although Amazon began as an e-tailer selling products it obtained from wholesalers, it transformed into a global online trading platform, matching non-Amazon vendors with online shoppers. It introduced Amazon Marketplace (in 2000), which allows independent third-party sellers to access Amazon customers globally. Third-party sellers began to outsell Amazon.com in 2015 and now account for about 60% of all retail sales on the site. Many entrepreneurs have taken advantage of the Fulfillment by Amazon (FBA) program, which allows third-party merchants to outsource their logistics needs to Amazon. Third-party vendors ship their inventory to Amazon's fulfillment centers, and then Amazon takes care of the rest, including payments, shipping, and returns. Carrying the moniker "the everything store," Amazon has become the largest e-tailer in the United States with over 40% market share, equating to about 6% of the total retail market share. Combining online sales with bricks-and-mortar stores, only Walmart is larger, with about 10% total market share and over $570 billion in annual revenues.

Exhibit 8.1 depicts Amazon's key strategic initiatives and stock market valuation over the years.

In addition to diversifying its products, services, and geographic markets served, Amazon also integrated vertically. By developing its streaming video content with Prime Video, Amazon integrated backward into media production. To compete more effectively with Netflix and other streaming services, in 2015 Amazon began creating original content. To further expand its library of high-quality content, Amazon acquired the Hollywood studio Metro-Goldwyn-Mayer (MGM) for $6.5 billion in 2022. With MGM part of Prime Video, Amazon owns more than 4,000 films, including the *James Bond* and *Rocky* franchises. Other critically acclaimed films in the MGM lineup include *The Handmaid's Tale* and *The Silence of the Lambs.* In addition, Amazon continues to strengthen its inventory of original content. In 2022, content spending was $13 billion for Amazon, $18 billion for Netflix, and $30 billion for Disney.

The Covid-19 pandemic supercharged the growth of ecommerce as people shopped online during lockdowns. In 2022, ecommerce accounted for 16% of total retail sales in the United States, and that number is projected to reach 22% in 2025. To accommodate the rapid growth, Amazon added 1.2 million jobs during the pandemic, increasing Amazon's workforce from 800,000 employees (in 2019) to 2 million (in 2022). It also doubled the number of its super-sized warehouses ("fulfillment centers" in Amazon lingo) to 110. With its distribution centers and its fleet of delivery vans, Amazon has become a logistics company, competing with UPS and FedEx. Working hard to reduce its carbon footprint, Amazon is awaiting delivery of 100,000 all-electric delivery vehicles from Rivian, an EV startup, in which Amazon took a 20% equity stake.

A relentless competitor with the hard-driving culture of a startup, Amazon continues to innovate in ecommerce. In 2022, it introduced "Buy with Prime," a strategic initiative allowing third-party merchants to offer Prime membership perks on their (non-Amazon) sites (e.g., www.yourbusinessname.com). Participating sellers use the Prime logo and display expected delivery dates on eligible products. After shoppers place products in the online shopping basket, checkout goes through Amazon Pay and the company's fulfillment network. Amazon also manages free returns for eligible orders.

An example of horizontal diversification and vertical integration (defined and discussed in detail in this chapter) is Amazon Web Services (AWS), created in 2006. AWS is a cloud-based computing service that includes software applications, data storage, content delivery, payment and billing systems, and other business applications. AWS is also the world's largest cloud-computing provider, ahead of Microsoft's Azure and Google Cloud.[1]

Part II of this ChapterCase appears in Section 8.5.

Over time, Amazon has morphed from a mere online book retailer into the "everything store."[2] In the process, it transformed into one of the world's largest e-tailers. From books, Amazon diversified into groceries, consumer electronics, digital content, cloud-computing services, and other business endeavors. Long-time CEO Jeff Bezos decided to compete in a number of different industries, some related to Amazon's initial business of online retailing, some unrelated. How does a fledgling startup evolve from a small online bookseller into one of the world's most valuable companies? The answer lies in Amazon's corporate strategy of vertical integration and horizontal diversification.

Amazon is an invention machine that spawns new businesses. As a consequence, it is now a widely diversified and integrated technology company. *Vertical integration* is the firm's ownership of the inputs needed for production or of the channels through which it distributes its outputs. For example, Amazon creates its own original content, which it distributes through its Prime Video streaming services. *Horizontal diversification* encompasses the variety of products and services a firm offers or markets. Amazon offers a wide range of products and services, ranging from batteries to fresh grocery delivery to logistics services. The third dimension of corporate strategy is a company's *geographic scope*, that is, the location(s) in which it competes. By virtue of being an online business, Amazon has a global presence that is reinforced by country-specific investments in specialized sites (such as amazon.in in India) and local logistics services.

But how did Amazon's founder Jeff Bezos decide exactly *where to compete?* Answers to this important question—in terms of products and services offered, value chain activities, and geographic markets—are captured in a firm's *corporate strategy,* which we cover in this chapter and the next two chapters. In this chapter, we define corporate strategy and then look at two fundamentals of corporate strategy: vertical integration and horizontal diversification. As with each chapter, we also conclude this one with *Implications for Strategic Leaders*.

LO 8-1

Define corporate strategy and describe the three dimensions along which it is assessed.

8.1 What Is Corporate Strategy?

Strategy formulation centers around the key questions of *where* and *how* to compete. *Business strategy* concerns the question of *how to compete* in a *single product market.* As discussed in Chapter 6, the two generic business strategies that firms can follow in their quest for competitive advantage are either to increase differentiation (while containing costs) *or* to lower costs (while maintaining differentiation). If trade-offs can be reconciled, some firms might be able to pursue a blue ocean strategy by increasing differentiation *and* lowering costs. As firms grow, they are frequently expanding their business activities and seeking new markets both by offering new products and services and by competing in different geographical locations. Strategic leaders must formulate a corporate strategy to guide continued growth. To gain and sustain competitive advantage, therefore, any corporate strategy must align with and strengthen a firm's business strategy, whether it is a differentiation, cost-leadership, or blue ocean strategy.

corporate strategy
The decisions that senior management makes and the goal-directed actions it takes to gain and sustain competitive advantage in several industries and markets simultaneously.

Corporate strategy comprises the decisions that leaders make and the goal-directed actions they take in their quest for competitive advantage in several industries and markets simultaneously.[3] Corporate strategy provides answers to the key question of *where to compete.* It determines the boundaries of the firm along three dimensions: *vertical integration* along the industry value chain, *horizontal diversification* of products and services, and *geographic scope* (regional, national, or global markets). Strategic leaders must determine corporate strategy along these three dimensions and ask three corresponding questions:

1. *Vertical integration:* In what stages of the industry value chain should the company participate? The *industry value chain* refers to the transformation of raw materials into finished goods and services along distinct vertical stages.
2. *Horizontal diversification:* What range of products and services should the company offer?
3. *Geographic scope:* Where should the company compete geographically in terms of regional, national, or international markets?

Exhibit 8.2 depicts the vertical, horizontal, and geographic dimensions along which corporate strategy is assessed. The three dimensions create a space in which corporate executives must formulate corporate strategy in the pursuit of competitive advantage.

In most cases, an implicit desire for growth underlies these three questions. The need for growth is sometimes taken so much for granted that not every manager understands all the

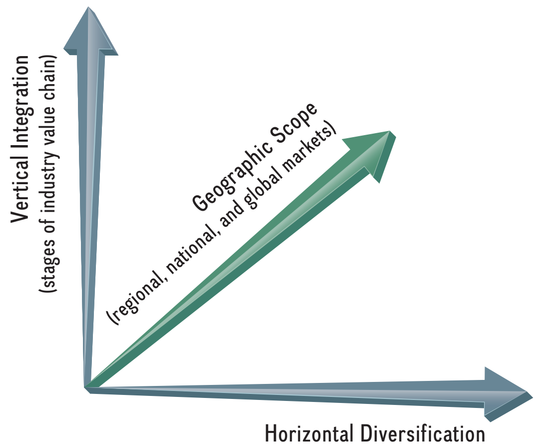


EXHIBIT 8.2

The Three Dimensions of Corporate-Level Strategy: Vertical Integration, Horizontal Diversification, and Geographic Scope

reasons behind it. A clear understanding of growth will help strategic leaders pursue growth for the right reasons and make better decisions for the firm and its stakeholders.

WHY FIRMS NEED TO GROW

LO 8-2

Explain why firms need to grow, and evaluate different growth motives.

Firms need to grow for several reasons:

- To increase profitability
- To lower costs
- To increase market power
- To reduce risk
- To motivate management and employees

Let's discuss each reason in turn.

INCREASE PROFITABILITY. Profitable growth allows businesses to provide a higher return for their shareholders, or owners if the business is privately held. Profitable growth also allows strategic leaders to reinvest into the business and employees by offering higher wages, increasing benefits, and pursuing new business endeavors. For publicly traded companies, the firm's stock market valuation is determined to a large extent by expected future revenue and profit streams.

As featured in the ChapterCase, Amazon's high stock market valuation is based to a large extent on expectations of future profitability, because the company invests for the long term and has yet to show consistent profitability across its various business activities. Some business units such as AWS are highly profitable; others, such as e-tailing, especially outside the United States, are money-losing endeavors at this point.

If firms fail to achieve their growth target, their stock price usually falls. With a decline in a firm's stock price comes a lower overall market capitalization, making it more costly for the firm to raise the required capital to fuel future growth by issuing stock. If its market cap falls significantly, a firm might be at risk of a *hostile takeover* (i.e., being bought without wanting to).

For instance, Peloton, the connected fitness company made famous during the Covid-19 pandemic, lost over 90% of its market cap, from a high of close to $50 billion (in 2021) down to $4 billion (in 2022). With such a low valuation, Peloton is more likely to be acquired through a hostile takeover or taken private through a *leveraged buyout* (i.e., taking the company private by exchanging equity for debt).

LOWER COSTS. Firms are also motivated to grow in order to lower their costs. As discussed in detail in Chapter 6, a larger firm may benefit from *economies of scale,* thus driving down average costs as their output increases. Firms need to grow to achieve minimum efficient scale and thus stake out the lowest-cost position achievable through economies of scale.

INCREASE MARKET POWER. Firms might be motivated to achieve growth to increase their market share and with it their market power. When discussing an industry's structure in Chapter 3, we noted that firms often consolidate industries through horizontal mergers and acquisitions (buying competitors) to change the industry structure in their favor. (We'll discuss mergers and acquisitions in detail in Chapter 9.) Fewer competitors generally equates to higher industry profitability. Moreover, larger firms have more bargaining power with suppliers and buyers (see the discussion of the five forces in Chapter 3).

REDUCE RISK. Firms might be motivated to grow in order to diversify their product and service portfolio through competing in a number of different industries. The rationale behind these diversification moves is that higher performance in one sector (e.g., Amazon's logistics services) may compensate for falling sales and lower performance in another sector (e.g., Amazon's grocery business). Diversified conglomerates attempt to achieve *economies of scope* (as discussed in Chapter 6).

MOTIVATE MANAGEMENT AND EMPLOYEES. Firms need to grow to motivate management. Growing firms afford career opportunities and professional development for employees. Firms that achieve profitable growth can also pay higher salaries and spend more on employee well-being by offering paid sabbaticals and parental leave, among other perks.

Moreover, research in behavioral economics suggests that firms may pursue growth to achieve goals that benefit managers more than stockholders.[4] As we will discuss in detail when presenting the *principal-agent problem* later in this chapter, some managers may be more interested in pursuing their own interests—such as empire building, job security, and managerial perks such as corporate jets and executive retreats at expensive resorts—rather than increasing profitability. Although there is a weak link between CEO compensation and firm performance, the CEO pay package often correlates more strongly with firm size.[5]

Finally, we should acknowledge that promising businesses can fail because they grow unwisely—usually too fast too soon, and based on shaky assumptions about the future. In addition, not all businesses want to grow. For example, some small-business owners operate a business for convenience, stability, and lifestyle; growth could threaten those goals. In social entrepreneurship, business micro-solutions are often undertaken outside of capital motives, because the need to solve a social problem outweighs the firm's need to ensure longevity beyond the solution of the problem. In general, the growth imperative is stronger for publicly traded companies than for privately held ones.

THREE DIMENSIONS OF CORPORATE STRATEGY

Strategic leaders must navigate the three dimensions of corporate strategy: vertical integration, horizontal diversification, and geographic scope. Although many managers provide input, the responsibility for corporate strategy ultimately rests with the CEO.

In determining the corporate strategy for Amazon, CEO Andy Jassy asks three key questions:

Question 1: *In what stages of the industry value chain should Amazon participate*?

With its prevalent delivery lockers in large metropolitan areas and its many bricks-and-mortar retail stores (either standalone, as part of the Prime Student campus initiative, or within Whole Foods), Amazon moved forward in the industry value chain to be closer to its end customer.

With its offering of Amazon-branded electronics and other everyday items, it also moved backward in the industry value chain toward product development and design as well as manufacturing, which it outsources to third-party OEMs (original equipment manufacturers). Similarly, the creation of Amazon Web Services (AWS), now the largest cloud-computing service provider globally, is a backward vertical integration move.

However, Amazon is reducing its forward vertical integration in retail. In 2022, shortly after being appointed Amazon CEO, Andy Jassy decided to close all of Amazon's bricks-and-mortar retail stores such as bookstores and so-called "4-star" retail stores (where it showcased Amazon Basic private-label items, among other products, that received a four-star or higher rating in its online store). This corporate strategy initiative reversed Amazon's former strategy to become more vertically integrated by moving from offering private-label products to selling them in physical retail outlets. In closing some 90 retail outlets, Amazon is shifting its focus to the grocery sector, which it entered after acquiring Whole Foods (in 2017).

Question 2: *What range of products and services should Amazon offer (and not offer)?*

The ChapterCase discusses Amazon's diversification over time in detail.

Question 3: *Where should Amazon compete geographically?*

Jeff Bezos decided to customize certain country-specific Amazon websites despite the instant global reach of ecommerce firms. With this strategic decision, he decided where to compete globally beyond the United States. For instance, Bezos decided to invest heavily in India, a growing ecommerce market in which Amazon faces Flipkart, a strong local competitor. Flipkart was bought by Amazon's archrival Walmart (in 2018). Amazon's CEO also decides where *not* to compete, as the company's withdrawal from China makes clear.

Where to compete in terms of industry value chain, products and services, and geography are the fundamental corporate strategic decisions. The underlying strategic management concepts that will guide our discussion of vertical integration, horizontal diversification, and geographic competition are *core competencies, economies of scale, economies of scope,* and *transaction costs.*

- *Core competencies* are unique strengths embedded deep within a firm (as discussed in Chapter 4). Core competencies allow a firm to differentiate its products and services from those of its rivals, creating higher value for the customer or offering products and services of comparable value at lower cost. According to the *resource-based view of the firm,* a firm's boundaries are delineated by its knowledge bases and core competencies.[6] Activities that draw on what the firm knows how to do well (e.g., Amazon's core competency in developing proprietary recommendation algorithms based on AI) should be done in-house, while non-core activities such as payroll and facility maintenance can be outsourced.
- *Economies of scale* occur when a firm's average cost per unit decreases as its output increases (as discussed in Chapter 6). For example, Anheuser-Busch InBev (AB InBev, the largest global brewer and producer of some 225 brands worldwide, including Budweiser, Bud Light, Miller, Stella Artois, and Beck's) reaps significant economies of scale. After merging with SABMiller in a deal worth more than $100 billion (in 2016), AB InBev now captures some 30% of global beer consumption.[7] As a consequence of its huge scale, it captures some 50% of global beer profits. In terms of beer volume, AB InBev is more than double the size of Heineken, the number-two competitor worldwide. Given its tremendous size, AB InBev is able to spread its fixed costs over the millions of gallons of beer it brews each year. In addition, its large market share gives it significant buying power. The combined result is lower costs.

- *Economies of scope* are the cost savings that come from producing two (or more) outputs or providing different services at less cost than producing each individually with the same resources and technology (as discussed in Chapter 6). In leveraging its online retailing expertise, for example, Amazon benefits from economies of scope: It can offer a large range of different product and service categories at a lower cost than it would cost to offer each product line individually. To offer millions of products to be delivered in two days or less within the United States, Amazon built a large network of fulfillment centers. Such large-scale investments are clear strategic commitments that allow the firm to take advantage of economies of scope.
- *Transaction costs* are all the costs associated with an economic exchange. Understanding transaction costs enables strategic leaders to answer the question of whether it is cost-effective for their firm to expand its boundaries through vertical integration or horizontal diversification.

In the next section, we continue our study of corporate strategy by drawing on transaction cost economics to explain vertical integration, meaning the choices that a firm makes concerning its boundaries. Later, we will explore managerial decisions relating to diversification, which directly affect the firm's range of products and services in multi-industry competition. The third question of geographic scope will receive attention later, especially in Chapter 10.

LO 8-3

Describe and evaluate different options that firms have to organize economic activity.

8.2 The Boundaries of the Firm

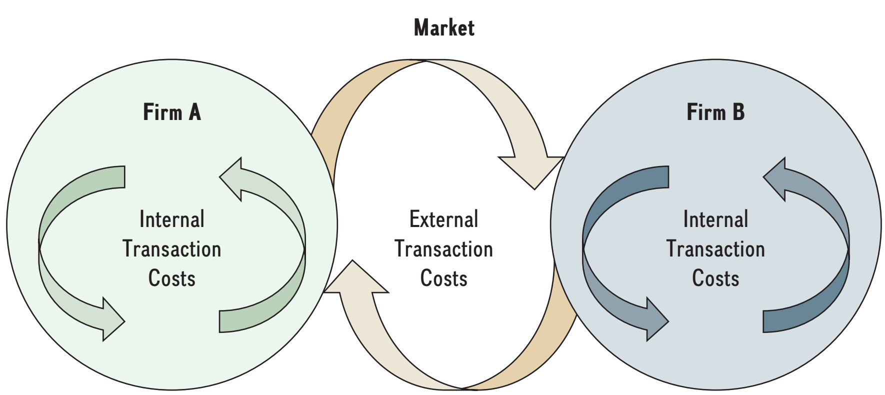
Determining the boundaries of the firm so that it is more likely to gain and sustain a competitive advantage is a critical challenge in corporate strategy.[8] **Transaction cost economics** provides useful theoretical guidance to explain and predict the boundaries of the firm. Insights gained from transaction cost economics help strategic leaders decide what activities to do in-house versus what services and products to obtain from the external market. This stream of research was initiated by Nobel Laureate Ronald Coase, who asked a fundamental question: Given the efficiencies of free markets, why do firms even exist? The key insight of transaction cost economics is that different *institutional arrangements*—markets versus firms—have different costs attached.

transaction cost economics A theoretical framework in strategic management to explain and predict the boundaries of the firm, which is central to formulating a corporate strategy that is more likely to lead to competitive advantage.

transaction costs All internal and external costs associated with an economic exchange, whether within a firm or in markets.

Transaction costs are all internal and external costs associated with an economic exchange, whether it takes place within the boundaries of a firm or in markets.[9] Exhibit 8.3 visualizes the notion of transaction costs. It shows the respective internal transactions costs

EXHIBIT 8.3 Internal and External Transaction Costs



within Firm A and Firm B, as well as the external transactions that occur when Firm A and Firm B do business with each other.

The total costs of transacting consist of external and internal transaction costs, as follows:

- When companies transact in the open market, they incur **external transaction costs**: the costs of searching for a firm or an individual with whom to contract, and then negotiating, monitoring, and enforcing the contract.
- Transaction costs can occur within the firm as well. These **internal transaction costs** include costs pertaining to organizing an economic exchange within a firm—for example, the costs of recruiting and retaining employees; paying salaries and benefits; setting up a shop floor; providing office space and computers; and organizing, monitoring, and supervising work. Internal transaction costs also include administrative costs associated with coordinating economic activity between different business units of the same corporation, such as transfer pricing for input factors, and between business units and corporate headquarters, including important decisions pertaining to resource allocation and capital budgeting. Internal transaction costs tend to increase with organizational size and complexity.

external transaction costs Costs of searching for a firm or an individual with whom to contract, and then negotiating, monitoring, and enforcing the contract.

internal transaction costs Costs pertaining to organizing an economic exchange within a hierarchy; also called administrative costs.

FIRMS VS. MARKETS: MAKE OR BUY?

Predictions derived from transaction cost economics guide strategic leaders in deciding which activities a firm should pursue in-house ("make") versus which goods and services to obtain externally ("buy"). These decisions help determine the boundaries of the firm. In some cases, the costs of using the market—such as search costs, negotiating and drafting contracts, monitoring work, and enforcing contracts when necessary—may be higher than the costs of integrating the activity within a single firm and coordinating it through an organizational hierarchy. When the costs of pursuing an activity in-house are less than the costs of transacting for that activity in the market ($C_{in\text{-}house} < C_{market}$), then the firm should *vertically integrate* by owning the production of the needed inputs or the channels for the distribution of outputs. In other words, when *firms* are more efficient in organizing economic activity than are *markets,* which rely on contracts among many independent actors, firms should vertically integrate.[10]

For example, rather than contracting in the open market for individual pieces of software code, Google (a unit of Alphabet) hires programmers to write code in-house. Owning these software development capabilities is valuable to the firm because its costs, such as salaries and employee benefits to in-house computer scientists, are less than what they would be in the open market. More importantly, Google gains economies of scope in software development resources and capabilities, and it reduces the monitoring costs. Skills acquired in writing software code for its different AI-based service offerings are transferable to new offerings. Computer engineers working on the original proprietary software code for the Google search engine leveraged these skills in creating a highly profitable online advertising business (AdWords and AdSense).[11] Although some of Google's software products are open source, such as the Android mobile operating system, many of the company's internet services are based on closely guarded and proprietary software code. Google, like many leading high-tech companies such as Amazon, Apple, Meta, and Microsoft, relies on proprietary software code and algorithms, because using the open market to transact for individual pieces of software would not only be costly but, perhaps more important, the firms would also need to disclose the underlying software code to outside developers, thus negating the value-creation potential.

EXHIBIT 8.4

Organizing Economic Activity: Firms vs. Markets

	Firm	Markets
Advantages	• Command and control - Fiat - Hierarchical lines of authority • Coordination • Transaction-specific investments • Community of knowledge	• High-powered incentives • Flexibility
Disadvantages	• Administrative costs • Low-powered incentives • Principal-agent problem	• Search costs • Opportunism - Hold-up • Incomplete contracting - Specifying and measuring performance - Information asymmetries • Enforcement of contracts

Firms and markets, as different institutional arrangements for organizing economic activity, have their own distinct advantages and disadvantages, summarized in Exhibit 8.4.

The advantages of firms include:

- The ability to make *command-and-control decisions* by fiat along clear hierarchical lines of authority.
- *Coordination* of highly complex tasks to allow for specialized division of labor.
- *Transaction-specific investments,* such as in AI or specialized robotics equipment that is highly valuable within the firm but of little or no use in the external market.
- Creation of a *community of knowledge,* meaning employees within firms have ongoing relationships, exchanging ideas and working closely together to solve problems. This arrangement facilitates the development of a deep knowledge repertoire and ecosystem within firms. For example, scientists within a biotech company who worked together developing a new cancer drug over an extended time period may have developed group-specific knowledge and routines. These might lay the foundation for innovation but would be difficult, perhaps even impossible, to purchase on the open market.[12]

The disadvantages of organizing economic activity within firms include:

- *Administrative costs* due to necessary bureaucracy.
- *Low-powered incentives,* such as hourly wages and salaries. These often are less attractive motivators than the entrepreneurial opportunities and rewards that can be obtained in the open market.
- The *principal-agent problem.*

principal-agent problem Situation in which an agent performing activities on behalf of a principal pursues his or her own interests.

The **principal-agent problem** is a major disadvantage of organizing economic activity within firms, as opposed to within markets. It can arise when agents such as managers, performing activities on behalf of the principal (the owner of the firm), pursue their own interests.[13] Indeed, the *separation of ownership and control* is one of the hallmarks of a publicly traded company, and so some degree of the principal-agent problem is almost inevitable.[14]

For example, strategic leaders may pursue their own interests such as job security and managerial perks (e.g., corporate jets and golf outings) that conflict with the principal's goals—in particular, creating shareholder value. One potential way to overcome the principal-agent problem is to give stock options to strategic leaders, thus making them owners. The idea is that when managers are also shareholders, the incentives between agents and principals are aligned. We will revisit the principal-agent problem in Chapter 12.

The advantages of markets include:

- *High-powered incentives.* Rather than work as a salaried engineer for an existing firm, for example, an individual can start a new venture offering specialized software. High-powered incentives of the open market include the entrepreneur's ability to capture the venture's profit, to take a new venture through an initial public offering (IPO), and to be acquired by an existing firm. In these so-called *liquidity events,* a successful entrepreneur can make enough money to provide financial security for life.[15]
- *Increased flexibility.* Transacting in markets enables those who wish to purchase goods to compare prices and services among many different providers.

The disadvantages of markets include:

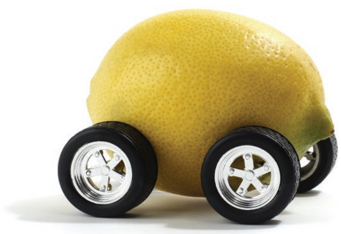
- *Search costs.* Nontrivial *search costs* are perhaps the biggest disadvantage of transacting in markets rather than owning the various production and distribution activities within the firm itself. In particular, a firm faces search costs when it must scour the market to find reliable suppliers from among the many firms competing to offer similar products and services. Even more difficult can be the search to find suppliers when the specific products and services needed are not offered by firms currently in the market. In this case, the production of supplies would require transaction-specific investments, an advantage of firms.
- *Opportunism by other parties.* **Opportunism** is a behavior characterized by self-interest seeking with guile. *Hold-up* is one form of opportunism that firms face when transacting in markets. The **hold-up problem** occurs when it is mutually beneficial for two parties to cooperate, but one party may withhold cooperation because it does not want to give the other party increased bargaining power. For instance, the hold-up problem is inherent in a supplier–buyer relationship of specialized equipment. One solution is to always have a second source as a supplier of, say, semiconductors or lithium-ion batteries. We discuss opportunism in more detail later in the chapter.
- *Incomplete contracting.* Although market transactions are based on implicit and explicit contracts, all contracts are incomplete to some extent because not all future contingencies can be anticipated at the time of contracting. It is also difficult to specify expectations (e.g., What stipulates "acceptable quality" in a graphic design project?) and to measure performance and outcomes (e.g., What does "excess wear and tear" mean when returning a leased car?). Another serious hazard inherent in contracting is *information asymmetry,* which we discuss below.
- *Enforcement of contracts.* It often is difficult, costly, and time-consuming to enforce legal contracts. Not only does litigation absorb a significant amount of managerial resources and attention, but it also can easily lead to several million dollars in legal fees. Legal exposure is one of the major hazards in using markets rather than integrating an activity within a firm's hierarchy.

Frequently, sellers have better information about products and services than buyers, which creates **information asymmetry**, a situation in which one party possesses private information and is therefore more informed than another party. When firms transact in the

opportunism A behavior characterized by self-interest seeking with guile.

hold-up problem Occurs when it is mutually beneficial for two parties to cooperate, but one party may withhold cooperation because it does not want to give the other party increased bargaining power.

information asymmetry Situation in which one party possesses private information and is therefore more informed than another party.



Big Pants Production/ Shutterstock

market, such unequal information can lead to a *lemons problem.* Nobel Laureate George Akerlof first described this situation using the market for used cars as an example.[16] Assume only two types of used cars are sold: good cars and bad cars (lemons). Good cars are worth $10,000 and bad cars are worth $4,000. Moreover, only the seller knows whether a car is good or is a lemon. Assuming the market supply is split equally between good and bad cars, the probability of buying a lemon is 50%. Buyers are aware of the general possibility of buying a lemon and thus would like to hedge against it. Therefore, they split the difference and offer $7,000 for a used car. This discounting strategy has the perverse effect of crowding out all the good cars because the sellers perceive their value to be above $7,000. Assuming that to be the case, all used cars offered for sale will be lemons.

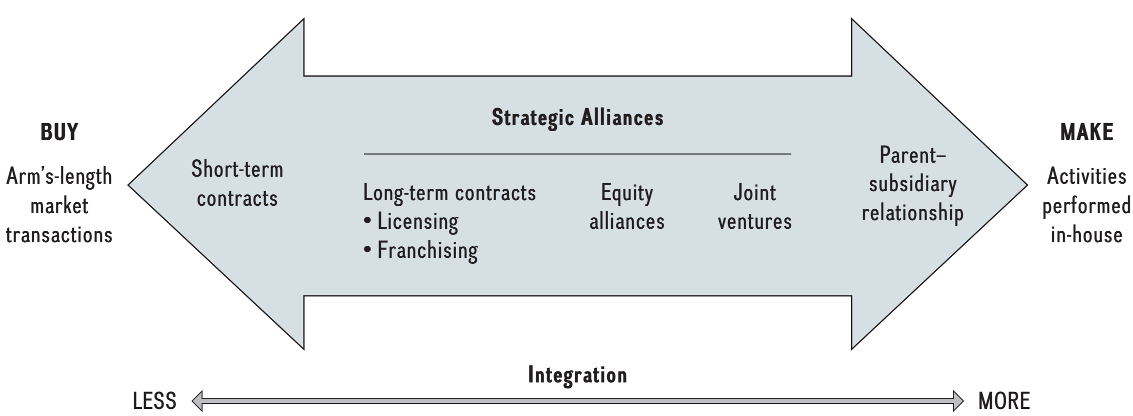
The important take-away here is *caveat emptor*—buyer beware. Information asymmetries can result in the crowding out of desirable goods and services by inferior ones. This crowding-out effect has been shown to exist in many markets, not just for used cars, but also in ecommerce (e.g., eBay), mortgage-backed securities, and even collaborative R&D projects.[17]

THE MAKE-OR-BUY CONTINUUM

The "make" and "buy" choices *anchor each end of a continuum* from markets to firms, as depicted in Exhibit 8.5. Several alternative hybrid arrangements are available between these two extremes.[18] Moving from transacting in the market ("buy") to full integration ("make"), alternatives include short-term contracts as well as various forms of strategic alliances (long-term contracts, equity alliances, and joint ventures) and parent–subsidiary relationships.

SHORT-TERM CONTRACTS. When engaging in *short-term contracting,* a firm sends out *requests for proposals* (*RFPs*) to several companies, initiating competitive bidding for contracts to be awarded with a short duration, generally less than one year.[19] The benefit of this approach is that it allows a somewhat longer planning period than individual market transactions do. Moreover, the buying firm can often demand lower prices due to the competitive bidding process. The drawback is that firms responding to the RFP have no incentive to make any transaction-specific investments (e.g., buy new machinery to improve product quality) due to the short duration of the contract. Refusing to make any transaction-specific

EXHIBIT 8.5 Alternatives on the Make-or-Buy Continuum



investments is exactly what happened in the U.S. automotive industry when GM used short-term contracts for standard car components to reduce costs. When faced with significant cost pressures, suppliers reduced component quality in order to protect their eroding margins. The ultimate result was lower-quality GM cars, contributing to a competitive disadvantage vis-à-vis competitors, most notably Toyota, which used a more cooperative, longer-term partnering approach with suppliers.[20]

STRATEGIC ALLIANCES. As we move along the make-or-buy continuum toward greater integration, the next organizational forms are strategic alliances. **Strategic alliances** are voluntary arrangements between firms that involve the sharing of knowledge, resources, and capabilities with the intent of developing processes, products, or services.[21] Alliances have become ubiquitous, especially in high-tech industries. They can facilitate investments in transaction-specific assets without incurring the internal transaction costs involved in owning firms in various stages of the industry value chain.

strategic alliances Voluntary arrangements between firms that involve the sharing of knowledge, resources, and capabilities with the intent of developing processes, products, or services.

Strategic alliances is an umbrella term that denotes different hybrid organizational forms—among them long-term contracts, equity alliances, and joint ventures. Given their prevalence in today's competitive landscape as a key vehicle to execute a firm's corporate strategy, we take a quick look at strategic alliances here and then study them in more depth in Chapter 9.

Long-Term Contracts. We noted that firms in short-term contracts have no incentive to make transaction-specific investments. *Long-term contracts,* which work much like short-term contracts but with a duration generally greater than one year, help overcome this drawback. **Licensing**, for example, is a form of long-term contracting in the manufacturing sector that enables firms to commercialize intellectual property such as a patent. The first biotechnology drug to reach the market, Humulin (human insulin), was developed by Genentech and commercialized by Eli Lilly based on a licensing agreement.

licensing A form of long-term contracting in the manufacturing sector that enables firms to commercialize intellectual property.

franchising A long-term contract in which a franchisor grants a franchisee the right to use the franchisor's trademark and business processes to offer goods and services that carry the franchisor's brand name.

In service industries, **franchising** is an example of long-term contracting. In these arrangements, a franchisor, such as McDonald's, Burger King, 7-Eleven, H&R Block, or Subway, grants a franchisee (usually an entrepreneur owning no more than a few outlets) the right to use the franchisor's trademark and business processes to offer goods and services that carry the franchisor's brand name. In addition to providing the capital to finance the expansion of the chain, the franchisee generally pays an upfront (buy-in) lump sum to the franchisor plus a percentage of revenues.

Equity Alliances. Yet another form of strategic alliance is an *equity alliance*—a partnership in which at least one partner takes partial ownership of the other partner. A partner purchases an ownership stake by buying stock or assets (in private companies) and thus making an equity investment. The taking of equity tends to signal a greater commitment to the partnership. Strategy Highlight 8.1 describes how soft drink giant Coca-Cola Co. formed an equity alliance with energy-drink maker Monster Beverage Corp.

Why did the Coca-Cola Co. form an equity alliance with Monster Beverage Corp. and not just enter a short- or long-term contract, such as a distribution and profit-sharing agreement? One reason is that an equity investment in Monster might give Coca-Cola an inside look into the company. Gaining more information could be helpful if Coca-Cola decides to acquire Monster in the future. Gaining such private information might not be possible with a mere contractual agreement. In addition, making an equity investment can be seen as a "try before you buy option." Here, the Coca-Cola Co. is buying time, waiting to see how the wrongful death lawsuits play out and thus limiting the potential negative effects on Coca-Cola's wholesome brand image (as mentioned in Strategy Highlight 8.1).

Strategy Highlight 8.1

The Equity Alliance between Coca-Cola and Monster: A Troubled Engagement?

Although Americans are drinking more and more nonalcoholic beverages, the demand for longtime staples such as regular Coke and Pepsi is in free fall. More health-conscious consumers are moving away from sugary drinks at the expense of Coke and Pepsi, the two archrivals among colas. Unlike in the 1990s, however, Americans are not replacing regular Coke and Pepsi with diet sodas, but rather with bottled water and energy drinks.

Over the past decade, the market for energy drinks in the United States has more than tripled in sales from $9 billion in 2008 to almost $30 billion in 2022. The market leader domestically is Monster (41%), followed by Red Bull (39%), then Rockstar (14%). The market for energy drinks is $70 billion globally, with the Austrian energy drink Red Bull leading (43%), followed by Monster (39%), then RockStar (10%). The global market for energy drinks is expected to reach $90 billion by 2025.

Of course, the rapid growth in energy drinks and bottled water did not go unnoticed in Coca-Cola's Atlanta headquarters. Yet, Coca-Cola was slow to catch the trend toward bottled water and other healthier choices such as vitamin water. Coca-Cola was also hesitant to enter the market for energy drinks, which contain more than 3.5 times as much caffeine as regular Coke. In addition, energy drinks contain supplements such as guarana, taurine, and carnitine. The makers of energy drinks, such as Red Bull, Monster, and Rockstar, have faced wrongful death lawsuits that deterred the Coca-Cola Co. from entering the market early on.

Red Bull sponsors the Red Bull F1 racing team, spending $300 million over five years. The popular Netflix series *Drive to Survive* almost tripled viewership in the United States, which is now F1's largest market. Sponsoring one of the most competitive teams in F1 provides Red Bull with awesome marketing exposure.

Abdul Razak Latif/Shutterstock

In contrast, PepsiCo was much more aggressive in moving into the energy-drink business. It owns Amp Energy, a minor brand (3% market share), and distributes Rockstar since 2009. The distribution alliance with Rockstar provided Pepsi with a *try before you buy option.* Subsequently, Pepsi bought the privately held Rockstar Energy Beverages for close to $4 billion (in 2020).

Although it was late to the party, Coca-Cola decided to not miss out completely on energy drinks. After years of deliberation, in 2015 the Coca-Cola Co. formed an equity alliance with Monster Beverage Corp., spending $2 billion for a nearly 17% stake in the edgy energy-drink company. As part of the deal, Coca-Cola is distributing Monster globally and has agreed not to distribute any energy drinks that compete directly with Monster. In 2019, Coca-Cola upped its equity stake and now owns 18.5% of Monster Beverage Corp.

What might have persuaded the traditional Coca-Cola Co. to finally make this important strategic decision? Not only was Monster the market leader with 45% market share in the energy-drink industry (in 2019), but it also had settled a number of wrongful death lawsuits out of court. Meanwhile, however, the U.S. Food and Drug Administration continues to investigate hundreds of "adverse event" reports allegedly linked to the consumption of energy drinks, including more than 30 deaths. While the Coca-Cola Co. insists that it completed its due diligence before concluding energy drinks are safe, it hedges its bets with a minority investment in Monster rather than an outright acquisition. The equity alliance with Monster allows the Coca-Cola Co., which is the market leader in nonalcoholic beverages, to benefit from the explosive growth in energy drinks while limiting potential exposure of Coca-Cola's wholesome image and brand.

Not all is well, however, with the Coca-Cola and Monster engagement. To better serve consumers who prefer all-natural ingredients in energy drinks, Coca-Cola developed two energy products (Coca-Cola Energy and Coca-Cola Energy No Sugar). Coca-Cola launched these two new energy drinks in Europe in 2019 before introducing them in the United States in early 2020. Meanwhile, Monster was crying foul, arguing that the new energy drinks violate the noncompete clause in the alliance agreement. The dispute between Monster and Coca-Cola went to arbitration, and Coca-Cola prevailed.

The timing for the launch of Coca-Cola's new energy drinks was unfortunate because it took place shortly before the beginning of the Covid-19 pandemic in the United States. Because most energy drinks are sold at convenience stores and gas stations, demand for Coca-Cola's new energy drinks was anemic during 2020, when parts of the country were in lockdown and many shops were closed. After one year on the market, Coca-Cola's new energy drinks achieved a meager 0.7% market share despite significant marketing efforts. Given the low demand combined with supply chain bottlenecks during the pandemic, Coca-Cola withdrew several specialty drinks, including its new line of energy drinks, from the market.

In the meantime, Monster is battling other threats. Its 45% market share (in 2019) decreased to 41% in 2022, thanks to new entries in the energy-drink segment, including Bang (owned by Vital Pharmaceuticals Inc.) and Adrenaline Shoc (owned by Keurig Dr Pepper), as well as a consumer push toward more natural ingredients in energy drinks. The early movers in the energy-drink segment—Monster, Red Bull, and 5-hour Energy—can't seem to shake their reputation for being bad for consumer health. Just as Coca-Cola has been slow in addressing the consumer shift away from soft drinks to water and energy drinks, so Monster has been slow to move toward all-natural ingredients. In 2019, Monster finally launched the new Reign line of energy drinks, which contain a dietary supplement for heart health.

In 2022, Monster had sales of $6 billion, compared to sales of $39 billion for the Coca-Cola Co. Nonetheless, Monster's stock market valuation reached a peak of $52 billion (in 2021), which is astonishing because the market for energy drinks was less than $500 million until 2005. In less than 20 years, Monster's market cap increased by more than 100 times, demonstrating the popularity of energy drinks and early-mover advantages.

The Coca-Cola Co. has also reaped a nice windfall from the equity alliance with Monster. Its initial investment of some $2 billion was worth close to $10 billion at Monster's peak valuation (in 2021). Given the strategic interdependence between Coca-Cola Co. and PepsiCo, the Atlanta-based leader in soft drinks may acquire Monster outright in light of Pepsi's acquisition of Rockstar Energy Beverages.[22]

Moreover, in strategic alliances based on a mere contractual agreement, one transaction partner could attempt to *hold up* the other by demanding lower prices or threatening to walk away from the agreement (with whatever financial penalties might be specified by the contract). This possibility might be a real concern for Monster because Coca-Cola is many times larger. To assuage Monster's concerns, with its equity investment Coca-Cola made a **credible commitment**—a long-term strategic decision that is both difficult and costly to reverse. Even with credible commitments, however, equity alliances are no guarantee that strategic differences between partners will not arise (as detailed in Strategy Highlight 8.1).

credible commitment A long-term strategic decision that is both difficult and costly to reverse.

joint venture A stand-alone organization created and jointly owned by two or more parent companies.

Joint Ventures. In a **joint venture**, which is another type of strategic alliance, two or more partners create and jointly own a new organization. Because the partners contribute equity to a joint venture, they enter a long-term commitment, which in turn facilitates transaction-specific investments. Dow Corning, initially created and owned jointly by Dow Chemical and Corning, was an example of a long-standing and successful joint venture. Dow Corning focuses on silicone-based technology; it employs roughly 10,000 people and has $5 billion in annual revenues. That success shows that some joint ventures can be quite large.[23] Dow Corning was acquired by DowDuPont, after Dow Chemical and DuPont merged (in 2017), creating a chemical-agricultural giant with some $120 billion in annual sales. The conglomerate DowDuPont split itself into three companies (in 2019): Dow, DuPont, and Corteva.

Hulu, a subscription streaming service, is also a joint venture, owned by Disney (67% ownership, but 100% voting rights) and Comcast's NBCUniversal (33%). In the United States, Hulu is a smaller competitor to Netflix, Disney+, and Amazon Prime. Hulu's geographic scope is limited because the service is available in the United States only.

PARENT–SUBSIDIARY RELATIONSHIP. The *parent–subsidiary relationship* is the most integrated alternative to performing an activity within a firm's boundaries and thus falls close to the "make" side on the make-or-buy continuum in Exhibit 8.5. The corporate parent

GM CEO Mary Barra divested both Opel and Vauxhall by selling these GM subsidiaries to Peugeot, a French carmaker. The conflict in the parent–subsidiary relationship between GM and its European units over many years shows that even the most integrated form of corporate relationships can be prone to high transaction costs.

Bill Pugliano/Getty Images News/Getty Images

owns the subsidiary and can direct it via command and control (*fiat*). Transaction costs are frequently the result of political turf battles, which may include the capital budgeting process and transfer prices. Other areas of potential conflict are how profitable a strategic business unit is, how centralized or decentralized a subsidiary unit should be, which type of products should be launched, and how technology should be transferred.

For example, although GM owned European carmakers (Opel in Germany and Vauxhall in the United Kingdom), it had problems bringing some of their know-how and design of small fuel-efficient cars back into the United States. This failure put GM at a competitive disadvantage vis-à-vis the Japanese competitors when the Japanese were first entering the U.S. market with more fuel-efficient cars. In addition, the Japanese carmakers were able to improve the quality and design of their vehicles faster, enabling them to gain a competitive advantage in an environment of rising gas prices. More recently, Korean car manufacturers used the same playbook when entering the U.S. market.

The GM versus Opel and Vauxhall parent–subsidiary relationship was burdened by political problems because strategic leaders in Detroit did not respect the engineering behind the small, fuel-efficient cars that Opel and Vauxhall made. They were not interested in using European know-how for the U.S. market and didn't want to pay much or anything for it. Indeed, executives and engineers in Detroit derided the smaller European cars as inferior, small boxes. Moreover, Detroit was tired of subsidizing the losses of Opel and Vauxhall and felt that its European subsidiaries were manipulating the capital budgeting process.[24] In turn, the Opel and Vauxhall subsidiaries felt resentment toward their parent company: GM had threatened to shut them down as part of its bankruptcy restructuring, while they hoped to be divested as independent companies.[25]

After many years of acrimonious parent–subsidiary relationships, GM sold Opel and Vauxhall to Peugeot, a French carmaker, for a bit over $2 billion (in 2017).[26] This divestiture marks GM's exit from the European car market, which has been a notorious money-losing venture for the Detroit automaker. Europe is one of the most competitive automotive markets in the world and home to several strong car brands. The European market also is consistently plagued by excess capacity because of fickle consumer tastes. Rather than focusing GM on being the world's largest carmaker in terms of volume, GM CEO Mary Barra is now focusing more on profitability. GM is much stronger in its American home market, and it is highly profitable there, especially in large pickup trucks and SUVs. Divesting its European operations also allows Barra to focus GM more on growth markets in Asia, especially in China, where GM holds a strong position with Shanghai GM Co., the 50/50 joint venture between GM and SAIC Motor Corp., a Chinese carmaker.

Having laid a strong theoretical foundation in transaction cost economics and the boundaries of the firm, we now turn our attention to the firm's position along the vertical industry value chain.

8.3 Vertical Integration along the Industry Value Chain

The first key question when formulating corporate strategy is: In what stages of the industry value chain should the firm participate? Deciding whether to make or buy the various activities in the industry value chain involves the concept of vertical integration.

Vertical integration is the firm's ownership of the inputs needed for production or of the channels through which it distributes its outputs. Vertical integration can be measured by a firm's value added:

- *What percentage of a firm's sales is generated within the firm's boundaries?*[27] The degree of vertical integration tends to correspond to the number of stages in the industry value chain in which a firm directly participates.

Exhibit 8.6 depicts a generic **industry value chain**. Industry value chains are also called *vertical value chains* because they depict the transformation of raw materials into finished goods and services along distinct stages. Each stage of the vertical value chain typically represents a distinct *industry* in which a number of different firms are competing. A firm's expansion up or down the *vertical* industry value chain is called *vertical* integration.

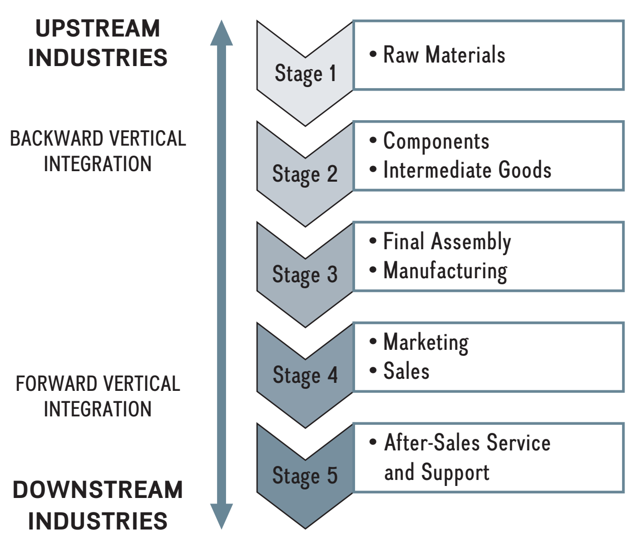
To explain the concept of vertical integration along the different stages of the industry value chain more fully, let's use cell phones as an example. This ubiquitous device is the result of a globally coordinated industry value chain of different products and services:

- *Stage 1: Raw Materials.* The raw materials to make cell phones, such as chemicals, ceramics, metals, and oil for plastic, are commodities. A *commodity* is a basic, non-differentiated good. As such, a commodity is interchangeable with other goods of the same type. Commodities are often inputs in the production of other goods or services with higher value added along the process. In each of these commodity industries, different companies are active, such as DuPont (United States), BASF (Germany), Kyocera (Japan), and ExxonMobil (United States).
- *Stage 2: Intermediate Goods and Components.* Elements such as integrated circuits, displays, touchscreens, cameras, and batteries are provided by firms such as ARM Holdings (United Kingdom), Jabil (United States), Intel (United States), LG Display (Korea), Altek (Taiwan), Samsung (Korea), and BYD (China).
- *Stage 3: Final Assembly and Manufacturing.* Original equipment manufacturing firms (OEMs) such as Flextronics (Singapore) and Foxconn (Taiwan) typically assemble cell phones under contract for consumer electronics and telecommunications companies such as Apple (United States), Samsung and LG (both South Korea), and Huawei and Oppo Electronics (both China). If you look closely at an iPhone, for example, you'll notice it says, "Designed by Apple in California. Assembled in China."
- *Stages 4 and 5: Marketing, Sales, After-Sales Service, Support.* Finally, wireless data and voice service are available from providers such as AT&T, T-Mobile, and Verizon in the United States; América Móvil in Mexico; Oi in Brazil; Orange in France; T-Mobile and Vodafone in Germany; NTT Docomo in Japan; Airtel in India; and China Mobile in China, among others. Alphabet's Google launched wireless services in the United States (in 2015). Called Google Fi, the wireless service plans offered by Google cost $20 a month for unlimited talk and text for one line, including Wi-Fi and international coverage.

vertical integration The firm's ownership of the inputs needed for production or of the channels through which it distributes its outputs.

industry value chain Depiction of the transformation of raw materials into finished goods and services along distinct vertical stages, each of which typically represents a distinct industry in which a number of different firms are competing.

EXHIBIT 8.6 Backward Vertical Integration and Forward Vertical Integration along an Industry Value Chain



Each gigabyte of data costs $10 per month. In offering Google Fi, the company is forwardly integrating to make its line of Pixel phones more attractive; these phones are offered at a discount when a consumer signs up for the wireless service. Google has another goal, too. It hopes that, by providing lower-priced wireless services, it will get more people to connect to the internet, which means more demand for its core online search business and ad-supported YouTube video service.

All of these companies—from the raw-materials suppliers to the service providers—make up the global industry value chain that, as a whole, delivers a working cell phone. Based on its corporate strategy, each firm decides where in the industry value chain to participate. This decision in turn defines the firm's vertical boundaries.

LO 8-4

Describe the two types of vertical integration along the industry value chain: backward vertical integration and forward vertical integration.

TYPES OF VERTICAL INTEGRATION

Along the industry value chain, firms pursue varying degrees of vertical integration in their corporate strategy. Some firms participate in only one or a few stages of the industry value chain, while others participate in many or even all stages. In general, fewer firms are fully vertically integrated. Most firms concentrate on only a few stages in the industry value chain, and some firms focus on just one. The following examples illuminate different degrees of vertical integration along the industry value chain.

E&J Gallo Winery is the world's largest family-owned winery. With sales in some 90 countries, it is also the largest exporter of California wines. As a fully vertically integrated producer and distributor, it participates in all stages of the industry value chain. E&J Gallo's corporate strategy and resulting activities along the industry value chain are guided by the mantra "from grape to glass." E&J Gallo owns its own vineyards, bottling plants, and distribution and logistics network, and it retails via the internet where allowed. (Some U.S. states ban direct-to-consumer sale of alcoholic beverages.)

Being fully vertically integrated allows E&J Gallo to achieve *economies of scale*, resulting in lower cost. Additional operational efficiency is achieved by effective coordination such as scheduling along the industry value chain. E&J Gallo also emphasizes that being fully vertically integrated allows it to control quality better and to provide the end user with a better experience. Offering a number of house brands, consisting of many different wines at different price points, also allows E&J Gallo to differentiate its product and to reap economies of scope. E&J Gallo's value added approaches 100%. Because of its complete vertical integration, the company competes in a number of different industries along the entire vertical value chain. As a consequence, it faces different competitors in each stage of the industry value chain, both domestically and internationally.

E&J Gallo, the California winery, is fully vertically integrated, following its corporate strategy mantra "from grape to glass." It is also the largest exporter of California wines.

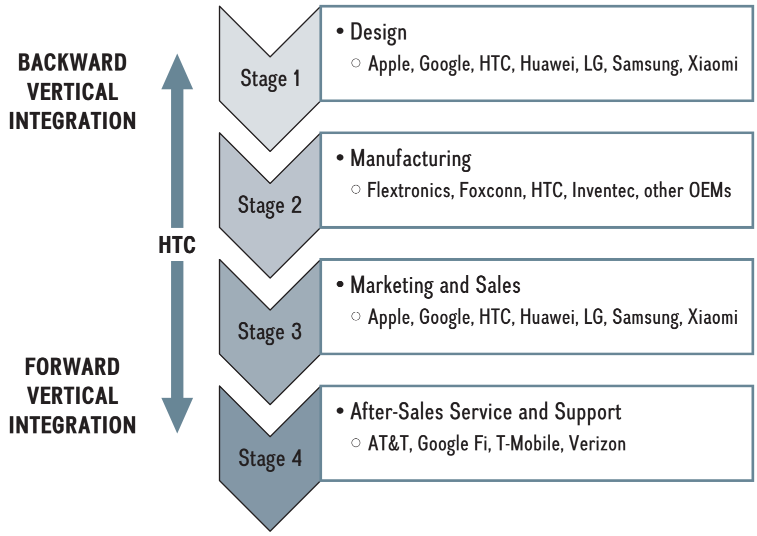
Sherri Camp/123RF

At the other end of the spectrum are firms that are more or less vertically disintegrated, with a low degree of vertical integration. These firms focus on only one or a few stages of the industry value chain. Apple, for example, focuses only on design, marketing, and retailing; it outsources all other value chain activities.

Exhibit 8.7 displays part of the industry value chain for smartphones. In this figure, note HTC's transformation from a no-name OEM manufacturer in stage 2 of the vertical value chain to a player in the design, manufacture, and sale of smartphones (stages 1 and 3). It now offers a lineup of innovative and high-performance smartphones under the HTC brand name.

Firms regularly start out as OEMs and then vertically integrate along the value chain in a backward and/or forward direction. With these moves, former contractual partners to brand-name phone makers such as Apple and Samsung become their competitors. OEMs are able to vertically integrate because they acquire the skills needed to compete in adjacent industry value chain activities from their alliance partners, which need to share the technology behind their proprietary phones to enable large-scale manufacturing.

EXHIBIT 8.7 HTC's Backward Integration and Forward Integration along the Industry Value Chain in the Smartphone Industry



Over time, HTC was able to upgrade its capabilities from merely manufacturing smartphones to also designing products.[28] In doing so, HTC engaged in **backward vertical integration**—moving ownership of activities upstream to the originating inputs of the value chain. Moreover, by moving downstream into sales and increasing its branding activities, HTC has also engaged in **forward vertical integration**—moving ownership of activities closer to the end customer. Although HTC has long benefited from *economies of scale* as an OEM, it is now also benefiting from *economies of scope* through participating in different stages of the industry value chain. For instance, it now can share competencies in product design, manufacturing, and sales while attempting to reduce transaction costs.

backward vertical integration Changes in an industry value chain that involve moving ownership of activities upstream to the originating (inputs) point of the value chain.

forward vertical integration Changes in an industry value chain that involve moving ownership of activities closer to the end (customer) point of the value chain.

HTC's vertical integration into design as well as manufacturing and sales and marketing of smartphones allowed it to build a core competency that Google, a unit of Alphabet, found valuable. Google contracted with HTC to design and build its new high-end phone (the Pixel). It acquired HTC's smartphone engineering group (in 2017). Integrating HTC's smartphone unit within Google will allow engineers to more tightly integrate hardware and software. Tighter integration, in turn, allows Google to differentiate its high-end Pixel phone more from the competition, especially Apple's iPhone models and Samsung's Galaxy line of phones. Even though HTC by itself lost out to Samsung, Apple, and a handful of new Chinese firms in the highly competitive smartphone industry, vertical integration along the industry value chain allowed HTC to build a core competency in the design and manufacturing of smartphones for which Google paid over $1 billion. Google has integrated HTC's core competency more fully with its Android group, which develops the software for Google's mobile operating system.

NOT ALL INDUSTRY VALUE CHAIN STAGES ARE EQUALLY PROFITABLE. There are large differences in profit potential in different stages of the value chain. For instance, Apple captures significant value by designing mobile devices through the integration of hardware and software in novel ways, but it outsources the manufacturing to generic OEMs. The logic behind these decisions can be explained by applying Porter's five forces model and the VRIO model. The many small cell phone OEMs are almost completely interchangeable and are exposed to the perils of perfect competition. However, Apple's competencies in innovation, design, system integration, and marketing are valuable, rare, and unique (non-imitable) resources, and Apple is organized to capture most of the value it creates. Apple's continued innovation through new products and services provides it with a string of temporary competitive advantages.

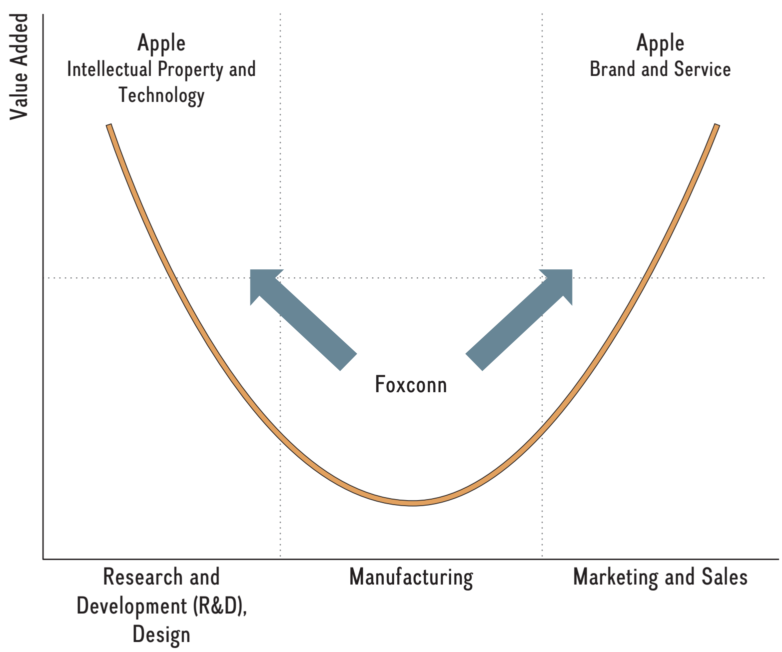
Foxconn, Apple's largest OEM, is also vertically integrating along the industry value chain.[29] It purchased the struggling Japanese electronics manufacturer Sharp for some $4 billion (in 2016). Sharp is known for its high-quality display panels (used in smartphones and elsewhere) as well as other innovative consumer electronics such as microwave ovens, portable TVs, and air purifiers.

Foxconn hopes to move upmarket by leveraging Sharp's strong brand name and to benefit from Sharp's efforts to produce organic light-emitting diode (OLED) displays. Like HTC, Foxconn is moving backward in the industry value chain into the design of consumer electronics and forward into marketing and sales by using the Sharp brand. As this example shows, over time OEMs tend to acquire skills, know-how, and ambition to move beyond mere manufacturing, where profit margins are often razor-thin.

Exhibit 8.8 captures the fact that different stages of the vertical value chain correspond to different profit potentials. In this so-called *smiley curve*,[30] Apple positioned itself along the value chain in areas of the highest profit potential, upstream in R&D and product design and downstream in marketing and sales. Foxconn, in contrast, has a low-profit potential because it focuses on manufacturing. Indeed, Apple captures about 95% of the value created with an iPhone while Foxconn captures 5%.[31] Foxconn is attempting to change this situation. It is pursuing strategic initiatives to move upstream into R&D and design, enabled by years of learning from companies such as Apple. Foxconn is also moving downstream in the value chain by acquiring brands such as Sharp, which it can use for its own products. Foxconn's strategic initiative to improve its profit potential through backward and forward vertical integration is indicated by the arrows in Exhibit 8.8.

EXHIBIT 8.8

The Smiley Curve: Differential Profit Potential along the Industry Value Chain



BENEFITS AND RISKS OF VERTICAL INTEGRATION

LO 8-5

Identify and evaluate the benefits and risks of vertical integration.

To decide the degree and type of vertical integration to pursue, strategic leaders need to understand the possible benefits and risks of vertical integration. At a minimum, they need to proceed with caution and carefully consider the countervailing risks at the same time they consider the benefits.

BENEFITS OF VERTICAL INTEGRATION. Vertical integration, either backward or forward, can have a number of benefits, including:[32]

- Lowering costs.
- Improving quality.
- Facilitating scheduling and planning.
- Facilitating investments in specialized assets.
- Securing critical supplies and distribution channels.

As noted earlier, HTC started as an OEM for brand-name mobile device companies such as Motorola (acquired by Google) and Nokia (acquired by Microsoft) and telecom service providers AT&T and T-Mobile. More recently, HTC has been manufacturing phones for Google (which uses Motorola's patents after its acquisition of Motorola; Google later sold the handset-making unit of Motorola to Lenovo, a Chinese computer company). HTC backwardly integrated into smartphone design by acquiring One & Co., a San Francisco–based design firm.[33] This acquisition allowed HTC to secure scarce design talent and capabilities that it leveraged into the design of smartphones with superior quality and features, enhancing the differentiated appeal of its products. Moreover, HTC can now design phones that leverage its low-cost manufacturing capabilities.

Likewise, forward integration into distribution and sales allows companies to more effectively plan for and respond to changes in demand. HTC's forward integration into sales enables it to offer its products directly to wireless providers such as AT&T, Verizon, and T-Mobile. HTC even offers unlocked phones directly to the end consumer via its own website. With ownership and control of more stages of the industry value chain, HTC is now in a much better position to respond if, for example, demand for its latest phone should suddenly pick up.

Specialized Assets. Vertical integration along the industry value chain can also facilitate *investments in specialized assets.* What does this mean? **Specialized assets** have a high opportunity cost: They have significantly more value in their intended use than in their next-best use.[34] Assets can have different types of specificity:[35]

specialized assets Unique assets with high opportunity cost: They have significantly more value in their intended use than in their next-best use. They come in three types: site specificity, physical-asset specificity, and human-asset specificity.

- *Site specificity* occurs when assets are required to be jointly located in the same specific place (co-locating) such as the equipment necessary for mining bauxite and smelting aluminum.
- *Physical-asset specificity* occurs with assets whose physical and engineering properties are designed to satisfy a particular customer. Examples include the bottling machinery for E&J Gallo. Given the many brands of wine offered by E&J Gallo, unique types of equipment, such as molds and a specific production process, are required to produce the different and trademarked bottle shapes.
- *Human-asset specificity* occurs when investments made in human capital to acquire unique knowledge and skills, such as mastering the routines and procedures of a specific organization, are not transferable to a different employer.

Investments in specialized assets tend to incur high opportunity costs, because making the specialized investment opens up the threat of opportunism by one of the partners. *Opportunism* is defined as self-interest seeking with guile.[36] Backward vertical integration is often undertaken to overcome the threat of opportunism and to secure key raw materials.

For example, in an effort to secure supplies and reduce the costs of jet fuel, Delta was the first airline to acquire an oil refinery. It purchased a Pennsylvania-based facility from ConocoPhillips (in 2012). Delta estimates that this backward vertical integration not only allows it to provide 80% of its fuel internally but also saves it some $300 million in costs annually. Fuel costs are quite significant for airlines; for Delta, they are some 40% of its total operating cost.[37]

RISKS OF VERTICAL INTEGRATION. The risks of vertical integration can outweigh the benefits. Depending on the situation, vertical integration has several risks, some of which directly counter the potential benefits, including:[38]

- Increasing costs.
- Reducing quality.
- Reducing flexibility.
- Increasing the potential for legal repercussions.

A higher degree of vertical integration can lead to increased costs for a number of reasons. In-house suppliers tend to have higher cost structures because they are not exposed to market competition. Knowing there will always be a buyer for their products reduces their incentives to lower costs. Also, because they generally serve a larger market, suppliers in the open market can achieve economies of scale that elude in-house suppliers. Organizational complexity increases with higher levels of vertical integration, thereby increasing administrative costs such as determining the appropriate transfer prices between an in-house supplier and in-house buyer. Administrative costs are part of internal transaction costs and arise from the coordination of multiple divisions, political maneuvering for resources, the consumption of company perks, or simply from employees slacking off.

The knowledge that there will always be a buyer for their products not only reduces in-house suppliers' incentive to lower costs but also can reduce the incentive to increase quality or come up with innovative new products. Moreover, given their larger scale and greater exposure to more customers, external suppliers often can reap higher learning and experience effects and thus develop unique capabilities or quality improvements.

A higher degree of vertical integration can also reduce a firm's strategic flexibility, especially when the firm faces changes in the external environment such as technological change in fluctuations in demand.[39] For instance, when technological process innovations enabled significant improvements in steelmaking, mills such as U.S. Steel and Bethlehem Steel were tied to their fully integrated business models and were thus unable to switch technologies, leading to the bankruptcy of many integrated steel mills. In contrast, non-vertically integrated mini-mills such as Nucor and Chaparral invested in the new steelmaking process and grew their business by taking market share from the less flexible integrated producers.[40]

U.S. regulators such as the Federal Trade Commission (FTC) and Justice Department (DOJ) tend to allow vertical integration, arguing that it generally makes firms more efficient and lowers costs, which in turn can benefit customers. However, due to monopoly concerns, vertical integration has not gone entirely unchallenged.[41] Before engaging in vertical integration, therefore, strategic leaders need to be aware that this corporate strategy can increase the potential for legal repercussions.

Amazon, featured in the ChapterCase, is facing potential legal repercussions because of its increasing scale and scope. Amazon now accounts for roughly 60% of internet retail spending in the United States. In addition, with AWS and its own logistics operation including delivery to the customer's doorstep, Amazon is increasingly becoming a fully vertically integrated enterprise. Many argue that Amazon is much like a utility, providing the backbone for internet commerce in both the business-to-consumer (B2C) space and the business-to-business (B2B) space. Amazon's vertical integration paints a picture of the future in which rivals depend more and more on Amazon's products and services to conduct their own business. Amazon's tremendous scale and scope can bring it increasingly into conflict with governments. Antitrust enforcers such as the DOJ or the FTC might consider legal action.[42]

WHEN DOES VERTICAL INTEGRATION MAKE SENSE?

U.S. business has seen a number of periods of higher than usual vertical integration, and looking back may reveal useful lessons on how a company can make better decisions around its corporate strategy.[43]

In the early days of automobile manufacturing, strategic leaders at Ford Motor Co. were frustrated by shortages of raw materials and the limited delivery of parts suppliers. In response, Henry Ford decided to own the whole supply chain, so his company soon ran mining operations, rubber plantations, freighters, blast furnaces, glassworks, and its own parts manufacturer. In Ford's River Rouge plant, raw materials entered on one end, and new cars rolled out the other end. But over time, the costs of vertical integration caught up. These costs included both financial costs that undid earlier cost savings and operational costs that hampered Ford's flexibility to respond to changing conditions. Indeed, Ford experienced diseconomies of scale (see Exhibit 6.5) due to its level of vertical integration and the unwieldy size of its huge plants.

In the 1970s, the chipmakers and the manufacturers of electronic products tried to move into each others' business. Texas Instruments went downstream into watches and calculators. Bowmar, which at first led the calculator market, tried to go upstream into chip manufacturing and failed. The later 2000s saw a resurgence of vertical integration. In 2009, General Motors tried to reacquire Delphi, a parts supplier that it had sold in 1997. In the 2010s, PepsiCo and Coca-Cola Co., the two major soft drink companies, purchased bottling plants (and later divested them again).

Rita McGrath has suggested that the siren call of vertical integration looms large for companies seeking to completely change the customer's experience: "An innovator who can figure out how to eliminate annoyances and poor interfaces in the chain can build an incredible advantage, based on the customers' desire for that unique solution."[44] So what should company executives do as they contemplate a firm's corporate strategy? As far back as the 1990s, the consulting firm McKinsey was counseling clients to consider carefully *why* they were considering integrating along their industry value chain. McKinsey identified the main reason to vertically integrate: failure of vertical markets.

Vertical market failure occurs when transactions within the industry value chain are too risky, and alternatives to integration are too costly or difficult to administer. McKinsey's recommendation corresponds with the one derived from transaction cost economics earlier in this chapter. When discussing research on vertical integration, *The Economist* concluded, "Although reliance on [external] supply chains has risks, owning parts of the supply chain can be riskier—for example, few clothing-makers want to own textile factories, with their pollution risks and slim profits." The findings suggest that when a company vertically integrates two or more steps away from its core competency, it fails two-thirds of the time.[45]

vertical market failure
When the markets along the industry value chain are too risky, and alternatives too costly in time or money.

The risks of vertical integration and the difficulty of getting it right motivate us to look at alternatives that allow companies to gain some of the benefits of vertical integration without the risks of full ownership of the supply chain.

LO 8-6

Describe and examine alternatives to vertical integration.

ALTERNATIVES TO VERTICAL INTEGRATION

Ideally, companies would like to find alternatives to vertical integration that provide similar benefits without the accompanying risks. Two such alternatives are taper integration and strategic outsourcing.

taper integration A way of orchestrating value activities in which a firm is backwardly integrated but also relies on outside-market firms for some of its supplies and/or is forwardly integrated but also relies on outside-market firms for some of its distribution.

TAPER INTEGRATION. One alternative to vertical integration is **taper integration**. In this method of orchestrating value activities, a firm is backwardly integrated, but it also relies on outside-market firms for some of its supplies, and/or it is forwardly integrated but also relies on outside-market firms for some of its distribution.[46] Exhibit 8.9 illustrates the concept of taper integration along the vertical industry value chain. Here, the firm sources intermediate goods and components from in-house suppliers as well as outside suppliers. In a similar fashion, the firm sells its products through company-owned retail outlets and through independent retailers. Both Apple and Nike, for example, use taper integration: They own retail outlets but also use other retailers, both the bricks-and-mortar type and online.

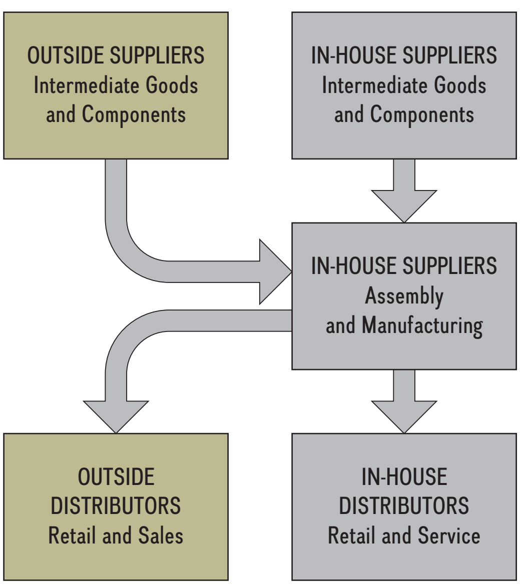
Taper integration has several benefits:[47]

- It exposes in-house suppliers and distributors to market competition so that performance comparisons are possible. Rather than hollowing out its competencies by relying too much on outsourcing, taper integration allows a firm to retain and fine-tune its competencies in upstream and downstream value chain activities.[48]
- Taper integration also enhances a firm's flexibility. For example, when adjusting to fluctuations in demand, a firm could cut back on the finished goods it delivers to external retailers while continuing to stock its own stores.
- Using taper integration, firms can combine internal and external knowledge, possibly paving the path for innovation.

strategic outsourcing Moving one or more internal value chain activities outside the firm's boundaries to other firms in the industry value chain.

Based on a study of 3,500 product introductions in the computer industry, researchers have provided empirical evidence that taper integration can be beneficial.[49] Firms that pursued taper integration achieved superior performance in both innovation and financial performance when compared with firms that relied more on vertical integration or strategic outsourcing.

EXHIBIT 8.9 Taper Integration along the Industry Value Chain



STRATEGIC OUTSOURCING. Another alternative to vertical integration is **strategic outsourcing**, which involves moving one or more internal value chain activities outside the firm's boundaries to other firms in the industry value chain. A firm that engages in strategic outsourcing reduces its level of vertical integration. For example, rather than developing their own human resource management systems, firms outsource these non-core activities to companies such as PeopleSoft (owned by Oracle), EDS (owned by HP), or NTT Data Services (formerly Dell Services), which can leverage their deep competencies and produce scale effects.

In the popular media and in everyday conversation, you may hear the term *outsourcing* used to mean "sending jobs out of the country." Actually, when outsourced activities take place outside the home country, the correct term is *offshoring* (or *offshore outsourcing*). For example, Infosys, one of the world's largest technology companies and providers of IT services to many Fortune 100 companies, is located in

Bangalore, India. Banking and financial services, IT, and health care are the most active sectors in offshore outsourcing. U.S. law firms are also offshoring low-end legal work, such as drafting standard contracts and background research, to India.[50] We discuss *global strategy* in detail in Chapter 10.

8.4 Corporate Diversification: Expanding Beyond a Single Market

Early in the chapter, we listed three questions related to corporate strategy and the boundaries of the firm. We discussed the first question of defining corporate strategy in detail:

1. *Vertical integration: In what stages of the industry value chain should the firm participate?*

We explored this question primarily in terms of firm boundaries based on the *degree of vertical integration.* We now turn to the second and third questions that determine corporate strategy and the boundaries of the firm.

2. *Horizontal diversification: What range of products and services should the firm offer?*

The second question relates to the firm's *degree of product diversification:* What range of products and services should the firm offer? In particular, why do some companies compete in a single product market, while others compete in several different product markets? For example, Coca-Cola Co. focuses on non-alcoholic beverages and thus on a *single* product market. Its archrival PepsiCo competes directly with Coca-Cola by selling a wide variety of soft drinks and other beverages and offering different types of chips such as Lay's, Doritos, and Cheetos, as well as Quaker Oats products such as oatmeal and granola bars. Although PepsiCo is more diversified than Coca-Cola, it has reduced its level of diversification in recent years.

3. *Geographic scope: Where should the firm compete in terms of regional, national, or international markets?*

The third and final key question concerns *where to compete* in terms of regional, national, or international markets. This decision determines the firm's *degree of geographic diversification*. For example, why do some firms compete beyond state boundaries, while others are content to focus on the local market? Why do some firms compete beyond their national borders, while others prefer to focus on the domestic market?

Geographic Diversification: Kentucky Fried Chicken and Chick-fil-A. Kentucky Fried Chicken (KFC), the world's largest quick-service chicken restaurant chain, operates 25,000 outlets in some 145 countries.[51] KFC has more restaurants in China, with over 5,000 outlets, than in the United States, its birthplace, with some 4,500 outlets. Of course, China has 1.4 billion people, and the United States has a mere 330 million. Former PepsiCo CEO Indra Nooyi was instrumental in spinning out KFC, as well as Pizza Hut and Taco Bell, to reduce PepsiCo's level of diversification. The three fast food chains were established as an independent company under the name Yum Brands (in 1997).

Compare KFC with the privately held Chick-fil-A, the world's second-largest quick-service chicken restaurant.[52] KFC and Chick-fil-A are direct competitors in the United States, both specializing in chicken in the fast food market. But Chick-fil-A operates only in the United States.[53] By 2022 it had over 2,800 locations across 47 states (only Hawaii, Alaska, and Vermont have no Chick-fil-A outlets).

Why are KFC and Chick-fil-A pursuing different corporate strategies? Although both companies were founded during roughly the same time period (KFC in 1930 and

Chick-fil-A in 1946), one big difference between KFC and Chick-fil-A is the ownership structure. KFC is a publicly traded stock company, as part of Yum Brands (stock ticker symbol: YUM) and Yum China (traded under YUMC, also on the New York Stock Exchange). Chick-fil-A, in contrast, is privately owned. Indeed, the privately owned Chick-fil-A is one of the largest family-owned businesses in the United States, with estimated revenues of $20 billion (in 2022).

Shareholders often expect public companies to achieve profitable growth, resulting in an appreciation of the stock price and an increase in shareholder value (see the discussion in Chapter 5). Geographic diversification is one option for profitable growth. Yum's China operation was spun off from Yum Brands to achieve more profitable growth stand-alone and reach its full potential. Previously, the higher-performing China subsidized the lower-performing units at Yum Brands (e.g., KFC in the United States).

In contrast, private companies generally grow more slowly than public companies because their growth is mostly financed through retained earnings and debt rather than equity. Before an initial public offering, private companies do not have the option to sell shares (equity) to the public to fuel growth. Large-scale geographic diversification requires significant amounts of capital, generally not available to privately held companies. A publicly traded company can issue stock to finance rapid international expansion. Facing less competition internationally and enjoying first-mover advantages, KFC focuses on international markets, especially China, where future expected growth continues to be high. In contrast, Chick-fil-A focuses on the domestic U.S. market. KFC is geographically diversified, while Chick-fil-A is not.

Diversification. Answers to questions about the number of markets to compete in and where to compete geographically relate to the broad topic of **diversification**. A firm that engages in diversification increases the variety of products and services it offers or markets and the geographic regions in which it competes. A *non-diversified company* focuses on a single market, whereas a *diversified company* competes in several different markets simultaneously.[54]

There are various general diversification strategies:

- A firm that is active in several different product markets is pursuing a **product diversification strategy**.
- A firm that is active in several different countries is pursuing a **geographic diversification strategy**.
- A company that pursues *both* a product *and* a geographic diversification strategy simultaneously follows a **product–market diversification strategy**.

Because shareholders expect continuous growth from public companies, strategic leaders frequently turn to product and geographic diversification to achieve it. It is therefore not surprising that the vast majority of the Fortune 500 companies are diversified to some degree. However, achieving performance gains through diversification is not guaranteed. Some forms of diversification are more likely to lead to performance improvements than others. We now discuss which diversification types are more likely to lead to a competitive advantage, and why.

diversification An increase in the variety of products and services a firm offers or markets and the geographic regions in which it competes.

product diversification strategy Corporate strategy in which a firm is active in several different product markets.

geographic diversification strategy Corporate strategy in which a firm is active in several different countries.

product–market diversification strategy Corporate strategy in which a firm is active in several different product markets *and* several different countries.

TYPES OF CORPORATE DIVERSIFICATION

LO 8-7

Describe and evaluate different types of corporate diversification.

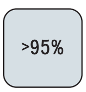
To understand the different types and degrees of corporate diversification, Richard Rumelt developed a helpful classification scheme that identifies four main types of diversification by identifying two key variables:[55]

- The *percentage of revenue* from the dominant or primary business
- The *relationship of the core competencies* across the business units

Note that this classification scheme concerns product markets and not geographic diversification. Knowing the percentage of revenue of the dominant business (the first variable) lets us identify the first two types of diversification: *single business* and *dominant business.* Asking questions about the relationship of core competencies across business units allows us to identify the other two types: *related diversification* and *unrelated diversification.* Taken together, the four main types of business diversification are:

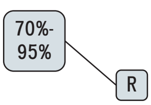
1. Single business.
2. Dominant business.
3. Related diversification.
4. Unrelated diversification: the conglomerate.

Related diversification (type 3) is divided into two subcategories. We discuss each type of diversification now.



SINGLE BUSINESS. A *single-business firm* is characterized by a low level of diversification, if any, because it derives more than 95% of its revenues from one business. The remaining less than 5% of revenue is not (yet) significant to the firm's success.

Founded in 1774, the German company Birkenstock only makes one product: its namesake contoured cork shoes. Although of more recent vintage, Meta Platforms is also a single business at this point because it receives almost all of its revenues from online advertising.



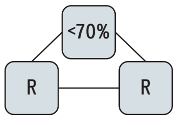
DOMINANT BUSINESS. A *dominant-business firm* derives between 70% and 95% of its revenues from a single business, but it pursues at least one other business activity that accounts for the remainder of revenue. The dominant business shares competencies in products, services, technology, or distribution. In the schematic figure shown here and those to follow, the remaining revenue (*R*) is generally obtained in other strategic business units (SBUs) within the firm. This remaining revenue is by definition less than that of the primary business. (Note: The areas of the boxes in this and the following graphics are not scaled to specific percentages.)

Harley-Davidson, the Milwaukee-based manufacturer of Harley motorcycles, is a dominant-business firm. Of its $5 billion in annual revenues, some 80% comes from selling its iconic motorcycles.[56] The remaining 20% of revenues comes from other business activities such as motorcycle parts, accessories, and general merchandise, as well as licensing the Harley logo. The brand has a loyal following both in the United States and overseas.

related diversification strategy Corporate strategy in which a firm derives less than 70% of its revenues from a single business activity and obtains revenues from other lines of business that are linked to the primary business activity.

RELATED DIVERSIFICATION. A firm follows a **related diversification strategy** when it derives less than 70% of its revenues from a single business activity and obtains revenues from other lines of business linked to the primary business activity. The rationale behind related diversification is to benefit from economies of scale and scope: These multi-business firms can not only pool and share resources but also leverage competencies across different business lines. The two variations of this type, which we explain next, relate to how much the other lines of business benefit from the core competencies of the primary business activity.

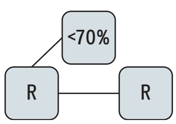
related-constrained diversification strategy A kind of related diversification strategy in which executives pursue only businesses where they can apply the resources and core competencies already available in the primary business.



Related-Constrained Diversification. A firm follows a **related-constrained diversification strategy** when it derives less than 70% of its revenues from a single business activity and obtains revenues from other lines of business related to the primary business activity. Executives engage in a new business opportunity only when they can leverage their existing competencies and resources. That is, the choices of alternative business activities are limited—constrained—by the fact that they need to be related to the primary business activity through common resources, capabilities, and competencies.

ExxonMobil's strategic move into natural gas is an example of related diversification. ExxonMobil bought XTO Energy (in 2009), a natural gas company, for $31 billion.[57] XTO Energy is known for its core competency in extracting natural gas from unconventional places such as shale rock. ExxonMobil leverages its core competency in the exploration and commercialization of oil into the extraction of natural gas. The company is producing nearly equal amounts of crude oil and natural gas, making it the world's largest producer of natural gas. ExxonMobil believes that roughly 50% of the world's energy for the next 50 years will continue to come from fossil fuels and that its diversification into natural gas, the cleanest of the fossil fuels in terms of greenhouse gas emissions, will pay off. ExxonMobil's strategic scenario may be right on the mark. Because of major technological advances in hydraulic fracking to extract oil and natural gas from shale rock by companies such as XTO Energy, by 2022 the United States had emerged as the world's richest country in natural gas resources and the largest producer of crude oil, thus achieving energy independence.[58]

related-linked diversification strategy A kind of related diversification strategy in which less than 70% of a firm's revenues come from a single business and some other business activities share linkages to the main business focus while others do not.

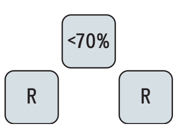


Related-Linked Diversification. When less than 70% of its revenues come from a single business and some other business activities share linkages to the main business focus while others do not, the firm is using a **related-linked diversification strategy**.

Amazon, featured in the ChapterCase, began business by selling only one product: books. Over time, it expanded into CDs and later gradually leveraged its online retailing capabilities into a wide array of product offerings and opened its site to external vendors, creating an ecommerce platform ("the everything store"). As the world's largest online retailer, and given the need to build huge data centers to service its peak holiday demand, Amazon decided to leverage spare capacity into cloud computing (Amazon Web Services [AWS]), again benefiting from economies of scope and scale. Amazon also offers a variety of consumer electronics such as tablets, e-readers, and digital virtual assistants in speakers, as well as proprietary content that can be streamed via the internet and is free to those who subscribe to its Prime service. Amazon follows a related-linked diversification strategy.

unrelated diversification strategy Corporate strategy in which a firm derives less than 70% of its revenues from a single business and there are few, if any, linkages among its businesses.

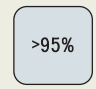
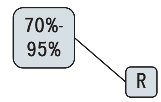
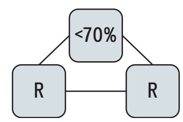
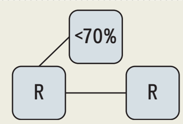
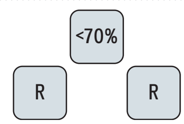
conglomerate A company that combines two or more strategic business units under one overarching corporation; follows an unrelated diversification strategy.



UNRELATED DIVERSIFICATION: THE CONGLOMERATE. A firm follows an **unrelated diversification strategy** when less than 70% of its revenues come from a single business and there are few, if any, linkages among its businesses. A company that combines two or more strategic business units under one overarching corporation and follows an unrelated diversification strategy is called a **conglomerate**.

Some research evidence suggests that an unrelated diversification strategy can be advantageous in emerging economies.[59] Such an arrangement helps firms gain and sustain competitive advantage because it allows the conglomerate to overcome institutional weaknesses

EXHIBIT 8.10 Four Main Types of Diversification

Revenues from Primary Business	Type of Diversification	Competencies (in products, services, technology, or distribution)	Examples	Graphic
>95%	Single business	Single business leverages its competencies.	Birkenstock Coca-Cola Meta Platforms	
70%–95%	Dominant business	Dominant and minor businesses share competencies.	Harley-Davidson Nestlé UPS	
	Related Diversification			
	Related-constrained	Businesses generally share competencies.	ExxonMobil Johnson & Johnson Nike	
<70%	Related-linked	Some businesses share competencies.	Amazon Disney GE	
	Unrelated diversification (conglomerate)	Businesses share few, if any, competencies.	Samsung Berkshire Hathaway Yamaha	

Note: *R* = Remainder revenue, generally in other strategic business units (SBUs) within the firm.

Source: Author's adaptation from R.P. Rumelt (1974), *Strategy, Structure, and Economic Performance* (Boston: Harvard Business School Press).

in emerging economies, such as a lack of capital markets, well-defined legal systems, and property rights. Companies such as Samsung and LG (representing a uniquely South Korean form of organization, the *chaebol*), Warren Buffet's Berkshire Hathaway, the Japanese Yamaha group, and the Tata group of India are all considered conglomerates due to their unrelated diversification strategy.

Exhibit 8.10 summarizes the four main types of diversification—single business, dominant business, related diversification (including its related-constrained and related-linked subcategories), and unrelated diversification.

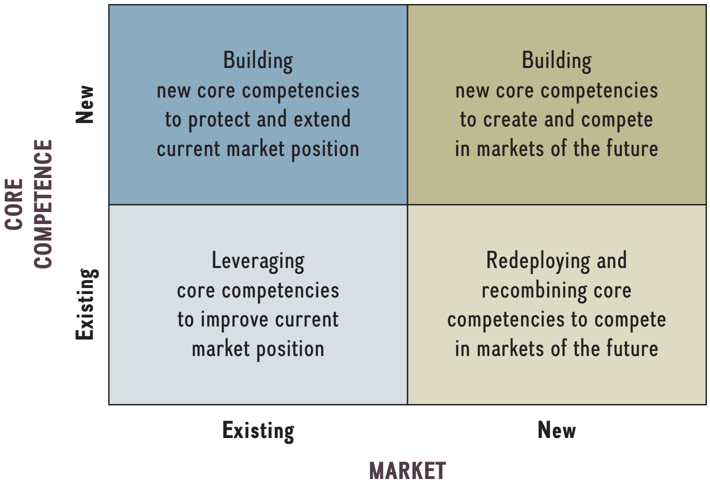
CORE COMPETENCIES AND CORPORATE DIVERSIFICATION

LO 8-8

Apply the core competence–market matrix to derive different diversification strategies.

In Chapter 4, when we looked inside the firm, we introduced the idea that competitive advantage can be based on core competencies. *Core competencies* are unique strengths embedded deep within a firm. They allow companies to increase the perceived value of their

EXHIBIT 8.11 The Core Competence–Market Matrix



Source: Author's adaptation from G. Hamel and C.K. Prahalad (1994), *Competing for the Future* (Boston: Harvard Business School Press).

product and service offerings and/or lower the cost to produce them.[60] Examples of core competencies are

- Walmart's ability to effectively orchestrate a globally distributed supply chain at low cost.
- Infosys's ability to provide high-quality information technology services at a low cost by leveraging its global delivery model. This model implies taking work to the location where it makes the best economic sense, based on the available talent, least amount of acceptable risk, and lowest cost.

To survive and prosper, companies need to grow. This mantra holds especially true for publicly owned companies because they create shareholder value through profitable growth. Strategic leaders respond to this relentless growth imperative by leveraging their existing core competencies to find future growth opportunities. Gary Hamel and C.K. Prahalad advanced the **core competence–market matrix**, depicted in Exhibit 8.11, as a way to guide managerial decisions with regard to diversification strategies. The first task for managers is to identify their existing core competencies and understand the firm's current market situation. When applying an existing or new dimension to core competencies and markets, four quadrants emerge, each with distinct strategic implications.

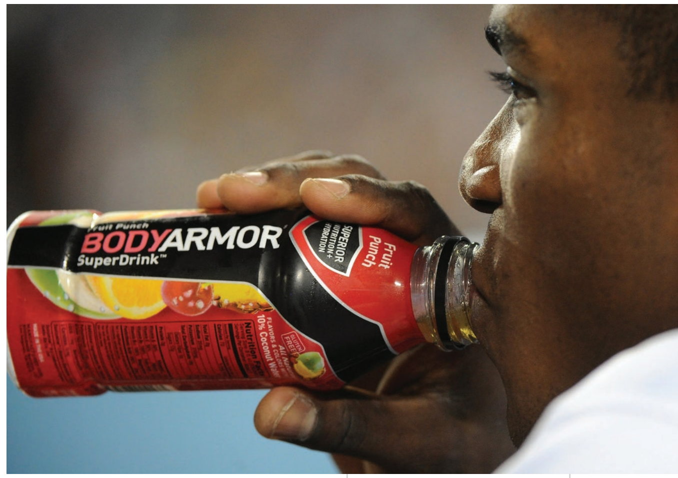
core competence–market matrix A framework to guide corporate diversification strategy by analyzing possible combinations of existing/new core competencies and existing/new markets.

The core competence–market matrix provides guidance to executives on how to diversify to achieve continued growth. Once strategic leaders have a clear understanding of their firm's core competencies (see Chapter 4), they have four options to formulate corporate strategy:

1. Leverage existing core competencies to improve current market position.
2. Build new core competencies to protect and extend current market position.
3. Redeploy and recombine existing core competencies to compete in markets of the future.
4. Build new core competencies to create and compete in markets of the future.

The lower-left quadrant combines existing core competencies with existing markets. Here, strategic leaders must come up with ideas of how to leverage existing core competencies to improve the firm's current market position. For example, Bank of America is one of the largest banks in the United States and has at least one customer in 50% of U.S. households.[61] Developed from the Bank of Italy and started in San Francisco, California, in 1904, it became the Bank of America in 1928. Over the next 60 years it grew in California and then nationally into a major banking powerhouse. Then in 1997, in what was the largest bank acquisition of its time, NationsBank bought Bank of America.

It can be argued that acquisitions were a NationsBank specialty. While still the North Carolina National Bank (NCNB), one of its unique core competencies was identifying, appraising, and integrating acquisition targets. Specifically, it bought smaller banks to supplement its organic growth throughout the 1970s and 1980s. From 1989 to 1992, NCNB purchased more than 200 regional community and thrift banks to further improve its market position. It then turned its core competency to national banks, with the goal of becoming the first nationwide bank. Known as NationsBank in the 1990s, it purchased Barnett Bank, BankSouth, FleetBank, LaSalle, CountryWide Mortgages, and its eventual namesake, Bank of America. This example illustrates how NationsBank, rebranded as Bank of America since 1998, honed and deployed its core competency of selecting, acquiring, and integrating other commercial banks to grow dramatically in size and geographic scope and emerge as one of the leading banks in the United States. We study acquisitions—a key vehicle of corporate strategy—in more detail in Chapter 9.



Yasiel Puig, a professional baseball player, is one of the celebrity endorsers for BodyArmor, a sports drink. In 2018, the Coca-Cola Co. took an equity stake in BodyArmor in an attempt to challenge the market leader Gatorade.

Lisa Blumenfeld/Getty Images

The lower-right quadrant of Exhibit 8.11 combines existing core competencies with new market opportunities. Here, leaders must strategize about how to redeploy and recombine existing core competencies to compete in future markets. For example, during the global financial crisis in 2008, Bank of America bought the investment bank Merrill Lynch for $50 billion.[62] Although many problems ensued for Bank of America following the Merrill Lynch acquisition, it is now the bank's investment and wealth management division. Bank of America's corporate executives applied an existing competency (acquiring and integrating) into a new market (investment and wealth management). The combined entity is now leveraging economies of scope through cross-selling when, for example, the consumer banking business refers its customers to the company's investment bankers.[63]

The upper-left quadrant combines new core competencies with existing market opportunities. Here, leaders must develop strategic initiatives to build new core competencies to protect and extend the company's current market position. For example, in the early 1990s, Gatorade dominated the market for sports drinks, a segment in which it had been the original innovator. Some 25 years earlier, medical researchers at the University of Florida had created the drink to enhance the performance of the Gators, the university's football team, thus the name Gatorade. Stokely-Van Camp commercialized and marketed the drink, and eventually sold it to Quaker Oats. PepsiCo brought Gatorade into its lineup of soft drinks when it acquired Quaker Oats in 2001.

In contrast, Coca-Cola had existing core competencies in marketing, bottling, and distributing soft drinks, but it had never attempted to compete in the sports-drink market. Over a 10-year R&D effort, Coca-Cola developed competencies in the development and marketing of its own sports drink, Powerade, which launched in 1990. Powerade holds 14% of the sports-drink market, making it a viable competitor to Gatorade, which still has close to 70% of the market. But Coca-Cola is not satisfied with just a small part of the $26 billion market for sports drinks. Coca-Cola applied the same playbook featured in Strategy Highlight 8.1 and made an equity investment in sports-drink company BodyArmor (in 2018). This new entry made a splash with star endorsements by basketball greats Skylar Diggins-Smith and the late Kobe Bryant, as well as baseball star Mike Trout and other sports celebrities. In 2021, the upstart BodyArmor held 10% market share of the sports-drink market, and it continues to grow.[64]

Finally, the upper-right quadrant combines new core competencies with new market opportunities. Hamel and Prahalad call this combination *mega-opportunities* that hold significant future growth opportunities. It is likely the most challenging diversification strategy because it requires building new core competencies to create and compete in future markets.

Salesforce.com is a company that employs this diversification strategy well.[65] Salesforce experienced fast growth, the bulk of it coming from the firm's existing core competency in delivering customer relationship management (CRM) software to its clients. Salesforce's product distinguished itself from the competition by providing software as a service via cloud computing: Clients did not need to install software or manage any servers but could easily access the CRM through a web browser (a business model called *software as a service,* or *SaaS*). Salesforce recognized an emerging market for *platform as a service* (*PaaS*) offerings, which enable clients to build their own software solutions that are accessed the same way as the Salesforce CRM. Seizing the opportunity, Salesforce developed a new competency in delivering software development and deployment tools that allowed its customers to either extend their existing CRM offering or build completely new types of software. A decade later, Salesforce's Force.com offering is one of the leading providers of *PaaS* tools and services.

Strategy Highlight 8.2 illustrates how P&G is remaking its diversification strategy to overcome a decade-long competitive disadvantage.

Strategy Highlight **8.2**

P&G's Diversification Strategy: Turning the Tide?

With revenues of some $80 billion (in 2022) and business in basically every country except North Korea, Procter & Gamble (P&G) is the world's largest consumer products company. Some of its category-defining brands are Ivory soap, Tide detergent, Febreze air freshener, Crest toothpaste, and Pampers diapers. As one of the world's largest consumer product conglomerates, P&G comprises more than 20 brands that each bring in over $1 billion in revenues per year. P&G's iconic brands are a result of a clearly formulated and effectively implemented corporate strategy. The company leverages its core competencies for diversification and attempts to create higher perceived value for its customers than its competitors by delivering products with unique features and attributes.

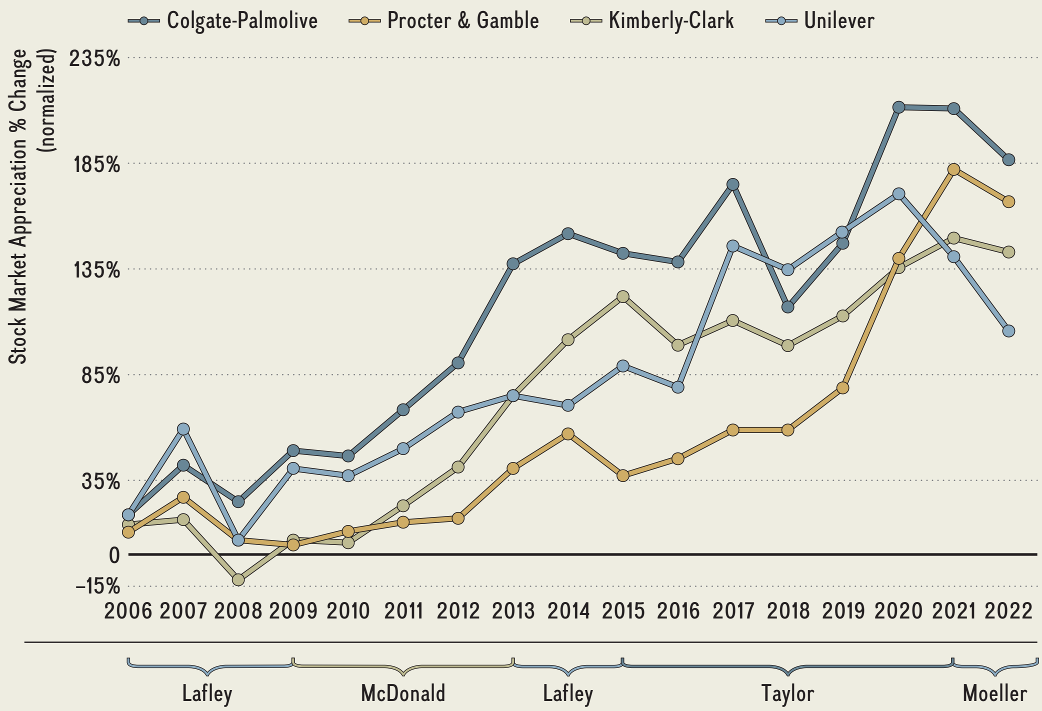
In the 2010s, however, P&G's strategic position weakened considerably. First, it failed to respond to consumers' need to be more frugal following the deep recession in the wake of the financial crisis (2008–2010). U.S. consumers moved away from P&G's higher-priced brands to lower-cost alternatives such as those offered by rivals Colgate-Palmolive, Kimberly-Clark, and Unilever. These firms were faster in cutting costs and prices. P&G also fumbled launches of reformulated products such as Tide Pods (detergent sealed in single-use pouches) and the Pantene line of shampoos and conditioners. The resulting decline in U.S. demand hit P&G especially hard because although the domestic market delivers about one-third of P&G's sales, it represents almost two-thirds of its profits.

Some of P&G's problems can also be attributed to its attempt to achieve growth in the 2000s via an aggressive, unrelated diversification strategy. Given the resulting larger P&G revenue base, future incremental revenue growth for the entire company was harder to achieve—as evidenced by P&G's $57 billion acquisition of Gillette in 2005, engineered by then-CEO A.G. Lafley. The value of this acquisition is being called into question. Although Gillette dominates the $6 billion wet shaving industry, it is losing market share to disruptive online startups such as Dollar Shave Club and Harry's, which both offer low-cost solutions via monthly online subscription plans. P&G found itself caught off guard by how quickly razor sales moved online. To complicate matters, Unilever acquired Dollar Shave Club for $1 billion (in 2016).

Finally, by focusing mainly on the U.S. market, P&G missed out on the booming growth years (during the 2000s) of the emerging BRIC economies—Brazil, Russia, India, and China—leaving these markets open to its rivals. For example, nearly 60% of Unilever's annual revenue comes from emerging markets, compared with only 40% of P&G's. As a consequence, Colgate-Palmolive, Kimberly-Clark, and Unilever all outperformed P&G over the last decade until 2020 (see Exhibit 8.12).

EXHIBIT 8.12 P&G versus Competitors, 2006–2022

(normalized stock market appreciation, % change)



Note: Tenure of P&G CEOs on the horizontal axis.

Source: Author's depiction of publicly available data.

To achieve a turnaround, CEO David Taylor, appointed in 2015, initiated a major shift in corporate strategy with a focus on restructuring, divestitures, and further diversification.

First, P&G has divested most of its underperforming brands, including Duracell batteries, CoverGirl makeup, and Iams pet food. Such moves have allowed P&G to consolidate its brands, bringing the total number down from 170 to 65. P&G has also decreased its number of business units from ten to six. These changes in corporate strategy and structure were made in an effort to refocus the company to leverage its core competencies more fully and to improve its market share in its existing markets. P&G expects the divestments of its non-core brands to free resources that can then be reallocated to improving its category-leading brands. It also expects the divestments to boost its overall revenue and margins. Moreover, having more manageable business units allows regional centers to have more control, which in turn enables them to respond to new market opportunities and changing trends in emerging markets more quickly. P&G has also focused on streamlining its bureaucracy and implementing strict cost-cutting measures by eliminating all spending not directly related to sales. For example, it has more closely aligned salaries with company performance. As part of this initiative, P&G eliminated thousands of jobs; in five years, it reduced its workforce by 25%. P&G has become a leaner and more agile organization as a result and now has a lower cost structure. By restructuring and refocusing P&G, CEO Taylor cut annual costs by $10 billion.

The second component of P&G's corporate strategy is better leveraging its existing core competencies for further diversification. In 2018, P&G acquired Merck KGaA, a German consumer-health business, for $4.2 billion. With this acquisition, P&G added vitamins and food supplements to its health care business unit, which includes well-known brands such as Crest toothpaste and Vicks cold medicine. The goal of this diversification move is to combine existing core competencies with new market opportunities in order to increase value and reduce costs. The combined entity

(Continued)

leverages economies of scope through cross-selling when, for example, consumers are sick with a cold and need extra vitamin supplements to combat the sickness.

P&G also has plans to expand its direct-to-consumer offerings through smaller brand portfolios. It acquired a trio of startups (in 2018): Native natural deodorant and two skincare companies, Snowberry and FAB. P&G uses these acquisitions to better compete with direct-to-consumer upstarts (think Dollar Shave Club and Harry's), which have disrupted the market space in recent years, capturing significant market share from legacy brands and thus forcing these older brands to rethink their business and corporate strategies. By acquiring a slew of start-up companies, P&G plans not only to tap into each business's respective markets but also to gain key insights into online marketing and other business techniques unique to direct-to-consumer upstarts.

Over a six-year tenure (2015–2021), CEO Taylor initiated a successful turnaround by sharpening P&G's corporate strategy. Making P&G more nimble and agile combined with the scale, expertise, and deep resources of an established brand allowed P&G to slowly but steadily improve its market performance, as demonstrated by its rising profits and sales growth in recent years. These corporate strategy initiatives have also helped P&G achieve a better strategic fit with the new environment. It appears that Taylor's corporate strategy pivot helped P&G to turn the tide and regain a competitive advantage (see Exhibit 8.10).

In 2021, Jon Moeller took over as P&G's CEO. He had been Taylor's second in command, serving as chief operating officer (COO). CEO Moeller plans to continue focusing on the mass market, selling brand products to big retailers. P&G attributes its strength in this area to a combination of carefully collected consumer data, a large R&D group, and the world's biggest marketing budget.

Although the Covid-19 pandemic buoyed sales for all consumer product companies, supply chain bottlenecks and close to double-digit inflation might sap some of P&G's momentum because margins in the consumer products business are razor-thin.[66]

LO 8-9

Explain when a diversification strategy creates a competitive advantage and when it does not.

CORPORATE DIVERSIFICATION AND FIRM PERFORMANCE

Corporate executives pursue diversification to gain and sustain competitive advantage. But does corporate diversification indeed lead to superior performance? To answer this question, we need to evaluate the performance of diversified companies. The critical question to ask when doing so is, *Are individual businesses worth more under the company's management than if each were managed individually?*

The diversification-performance relationship is a function of the underlying type of diversification. A cumulative body of research indicates an inverted U-shaped relationship between the type of diversification and overall firm performance, as depicted in Exhibit 8.13.[67] High and low levels of diversification are generally associated with lower overall performance, while moderate levels of diversification are associated with higher firm performance. This implies that companies that focus on a single business, as well as companies that pursue unrelated diversification, often fail to achieve additional value creation. Firms that compete in single markets could potentially benefit from economies of scope by leveraging their core competencies into adjacent markets. Firms that pursue unrelated diversification are often unable to create additional value. They experience a **diversification discount**: The stock price of unrelated-diversified firms is generally valued at less than the sum of their individual business units.[68]

diversification discount Situation in which the stock price of highly diversified firms is valued at less than the sum of their individual business units.

For instance, GE experienced a diversification discount in the wake of the global financial crisis (2007–08) when it became apparent that the conglomerate was too exposed to external macroeconomic factors. The culprit was GE's capital unit, which in the run-up to the financial crisis contributed 50% of profits on one-third of the conglomerate's revenues. At the same time, external conditions in capital markets created too much volatility for GE because its capital unit had grown too large. When the financial crisis hit, credit markets

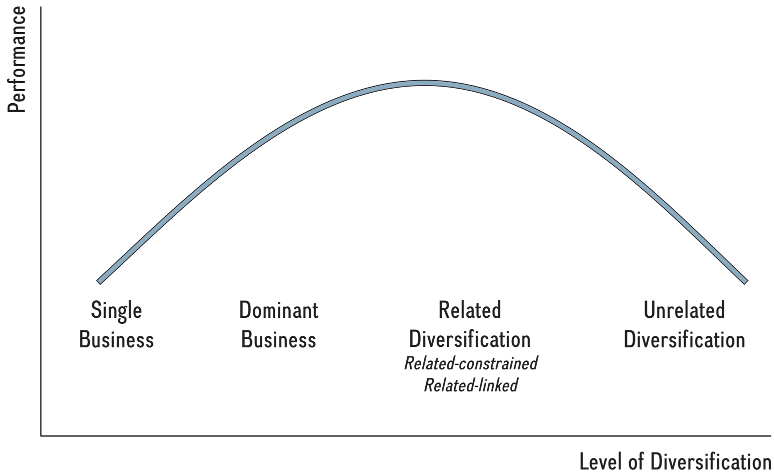


EXHIBIT 8.13

The Diversification-Performance Relationship

Source: Author's adaptation from L.E. Palich, L.B. Cardinal, and C.C. Miller (2001), "Curvilinearity in the diversification-performance linkage: An examination of over three decades of research," *Strategic Management Journal* 21: 155–174.

froze up, and losses on loans mounted, the capital unit almost sank the entire conglomerate. Too much exposure to external macroeconomic factors resulting in a diversification discount in GE's depressed stock price was a major reason GE's then-CEO, Jeffrey Immelt, decided to spin out GE Capital (in 2015).

A **spinout** describes the separation (sale) of a division (strategic business unit) to form a new, stand-alone corporation. The new company takes with it the employees, plants, operations, and other assets and liabilities. As a stand-alone company, the spinout allows it to make its own strategic decision without inference from the conglomerate headquarters, including raising its capital through debt or equity on a stock exchange.

spinout A *spinout* describes the separation (sale) of a division (strategic business unit) to form a new, stand-alone corporation.

On the day announcing the spinout of GE Capital, GE's stock price jumped 11%, adding some $28 billion to GE's market capitalization. This stock appreciation provides some idea of the diversification discount that firms pursuing unrelated diversification may experience.[69]

The presence of the diversification discount depends on the institutional context. Although it holds in advanced economies with developed capital markets such as the United States, some research suggests that an unrelated diversification strategy can be advantageous in emerging economies such as India (e.g., Reliance Industries, the largest conglomerate in India) or some countries in Africa (e.g., the South African Naspers, the largest conglomerate on the continent).[70] Here, unrelated diversification may help firms gain and sustain competitive advantage, because it allows the conglomerate to overcome institutional weaknesses in emerging economies such as a lack of efficient capital markets, courts of law, and so on.

Companies that pursue related diversification are more likely to improve their performance. They create a **diversification premium**: On average, the stock price of related-diversification firms is valued at greater than the sum of their individual business units.[71]

diversification premium Situation in which the stock price of related-diversification firms is valued at greater than the sum of their individual business units.

Why is this so? At the most basic level, a corporate diversification strategy enhances firm performance when its value creation is greater than the costs it incurs. Exhibit 8.14 lists the sources of value creation and costs for different corporate strategies, for vertical integration as well as related and unrelated diversification. For diversification to enhance firm performance, it must do at least one of the following:

- Provide *economies of scale,* which reduces costs
- Exploit *economies of scope,* which increases value
- Reduce costs *and* increase value

EXHIBIT 8.14

Vertical Integration and Diversification: Sources of Value Creation and Costs

Corporate Strategy	Sources of Value Creation (V)	Sources of Costs (C)
Vertical Integration	• Can lower costs • Can improve quality • Can facilitate scheduling and planning ________________________ • Facilitating investments in specialized assets • Securing critical supplies and distribution channels	• Can increase costs • Can reduce quality • Can reduce flexibility ________________________ • Increasing potential for legal repercussions
Related Diversification	• Economies of scope • Economies of scale • Financial economies — Restructuring — Internal capital markets	• Coordination costs • Influence costs
Unrelated Diversification	• Financial economies — Restructuring — Internal capital markets	• Influence costs

We discussed these drivers of competitive advantage—economies of scale, economies of scope, and increase in value and reduction of costs—in depth in Chapter 6 in relation to business strategy. Other potential benefits to firm performance when following a diversification strategy include *financial economies,* resulting from *restructuring* and using *internal capital markets*, discussed in the following sections.

BCG. While strategic leaders are motivated by potential synergies (from economies of scope) and cost savings (from economies of scale) when engaging in horizontal mergers, they focus on increasing agility and future growth potential for standalone units to be spun out. The degree of strategic freedom is enhanced, for a higher-performing SBU is no longer part of a diversified company.

restructuring
The process of reorganizing and divesting business units and activities to refocus a company to leverage its core competencies more fully.

Restructuring is the process of reorganizing and divesting business units and activities to refocus a company to leverage its core competencies more fully. Two main motivations are behind restructuring. First, restructuring allows companies to spin out underperforming units. Second, restructuring enables higher-performing units to become more nimble and pursue future growth opportunities while being no longer constrained by a larger conglomerate structure. Often, high-performing units subsidize lower-performing ones, leaving fewer resources to invest for future growth in the high-performing units. In addition, a conglomerate structure creates additional management layers, and with it, more bureaucracy, red tape, and in-fighting between SBUs, all activities that are detrimental to achieving a competitive advantage. Shareholders also benefit if a spin-out unlocks growth potential not available if the unit remains part of a larger conglomerate due to the *conglomerate discount,* meaning the sum of businesses within the conglomerate is valued at less than the sum of each business if it stood alone.

Several high-profile conglomerates have restructured through divestitures:

- The Belgium-based Anheuser-Busch InBev sold Busch Entertainment, its theme park unit that owns SeaWorld and Busch Gardens, to a group of private investors. This strategic move allows InBev to focus more fully on its core business of brewing and distributing beer across the world.
- eBay spun out PayPal to create a standalone payments company, which has outperformed eBay by a wide margin.
- Kraft Foods spun out its grocery business which retain the company name (Kraft Foods Groups), while the core company transformed itself into Mondelez to focus on the fast-growing snack food business.
- Kellogg split itself into three companies (in 2023): fast-growing and high profitable snack foods; breakfast cereal (North America), a unit that has struggling; and the third line of business that focuses on Kellogg's plant-based foods unit. It appears that Kellogg's move was in part motivated by Kraft's earlier restructuring which unlocked growth potential.
- Johnson & Johnson (J&J), the world's largest health products company by sales, split into two publicly traded companies (in 2023): One for pharmaceuticals, which is a higher-margin but a less predictable business, and the other for consumer health products, which is the core of its storied history but is slower-growing.
- General Electric (GE) split into three standalone companies (in 2023-24): health care, power (energy), and aviation.

The Boston Consulting Group Growth-Share Matrix. Corporate executives can restructure the portfolio of their firm's businesses, much like an investor can change a portfolio of stocks. One helpful tool to guide corporate portfolio planning is the **Boston Consulting Group (BCG) growth-share matrix**, shown in Exhibit 8.15.[72] This matrix locates the firm's individual SBUs in two dimensions:

- Relative market share (horizontal axis)
- Speed of market growth (vertical axis)

Boston Consulting Group (BCG) growth–share matrix A corporate planning tool in which the corporation is viewed as a portfolio of business units, which are represented graphically along relative market share (horizontal axis) and speed of market growth (vertical axis). SBUs are plotted into four categories (dog, cash cow, star, and question mark), each of which warrants a different investment strategy.

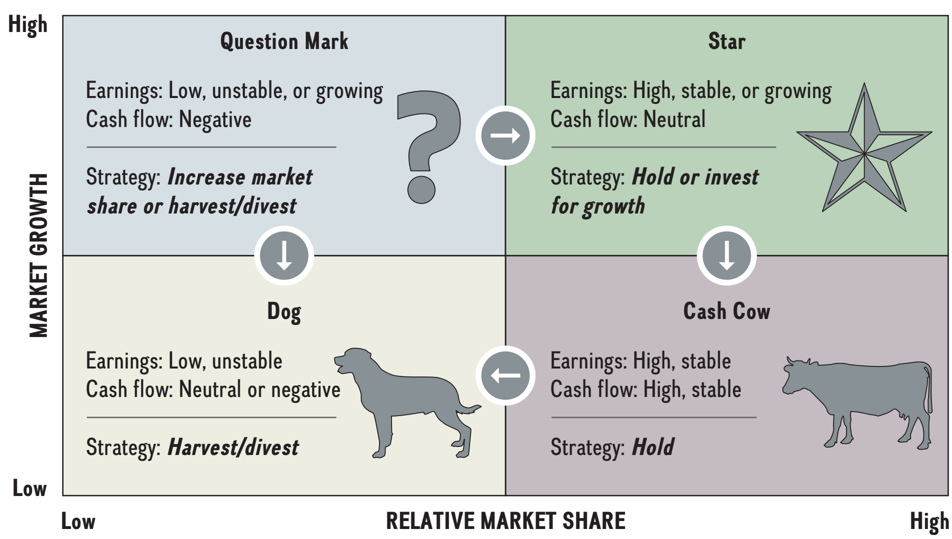


EXHIBIT 8.15

Restructuring the Corporate Portfolio: The Boston Consulting Group Growth-Share Matrix

The firm plots its SBUs into one of four categories in the matrix: *dog, cash cow, star,* or *question mark*. Each category warrants a different investment strategy. All four categories shape the firm's corporate strategy.

SBUs identified as *dogs* are relatively easy to identify: They are underperforming businesses. Dogs hold a small market share in a low-growth market; they have low and unstable earnings, combined with neutral or negative cash flows. The strategic recommendations are either to *divest* the business or to *harvest* it. Harvesting means stopping investment in the business and squeezing out as much cash flow as possible before shutting it or selling it.

Cash cows, in contrast, are SBUs that compete in a low-growth market but hold considerable market share. Their earnings and cash flows are high and stable. The strategic recommendation is to invest enough into cash cows to hold their current position and to avoid having them turn into dogs (as indicated by the arrow in Exhibit 8.15). As a general rule, strategic leaders should manage their SBU portfolio in a clockwise manner (as indicated by three of the four arrows in Exhibit 8.15).

A corporation's *star* SBUs hold a high market share in a fast-growing market. Their earnings are high and either stable or growing. The recommendation is to invest sufficient resources to hold the star's position or even increase investments for future growth. As indicated by the arrow, stars may turn into cash cows as the market in which the SBU is situated slows after reaching the maturity stage of the industry life cycle.

Finally, some SBUs are *question marks:* It is not clear whether they will turn into dogs or stars (as indicated by the arrows in Exhibit 8.15). Their earnings are low and unstable, but they might be growing. The cash flow, however, is negative. Ideally, corporate executives want to invest in question marks to increase their relative market share so they turn into stars. If market conditions change, however, or the overall market growth slows, then a question-mark SBU is likely to turn into a dog (as indicated by the arrow). In this case, executives will want to harvest the cash flow or divest the SBU.

INTERNAL CAPITAL MARKETS. *Internal capital markets* can be a source of value creation in a diversification strategy if the conglomerate's headquarters does a more efficient job of allocating capital through its budgeting process than what could be achieved in external capital markets. Given their access to private information, corporate managers are in a position to discover which of their strategic business units will provide the highest return on invested capital. In addition, internal capital markets may allow the company to access capital at a lower cost.

Until the global financial crisis, GE Capital generated more than half of GE's profits.[73] In combination with GE's triple-A debt rating, having access to such a large finance arm allowed GE to benefit from a lower cost of capital, which in turn was a source of value creation in itself. Yet, while GE Capital provided tremendous upside during the book preceding the global financial crisis, the unit almost bankrupted the entire conglomerate as credit markets froze during the financial crisis. GE overall was too exposed to just one business unit. At the height of the global financial crisis (in 2009), GE lost its AAA debt rating as the capital unit was dragging down the entire conglomerate. The lower debt rating results in a higher cost of capital and a loss in value creation through internal capital markets.

A strategy of related-constrained or related-linked diversification is more likely to enhance corporate performance than either a single or dominant level of diversification or an unrelated level of diversification. The reason is that the sources of value creation include not only restructuring but also the potential benefits of economies of scope and scale. To create additional value, however, the benefits from these sources of incremental value creation must outweigh their costs. A related-diversification strategy entails two types of costs: coordination costs and influence costs. *Coordination costs* are a function of the number, size, and types of businesses that are linked. *Influence costs* occur due to political maneuvering by managers to influence capital and resource allocation and the resulting inefficiencies stemming from suboptimal allocation of scarce resources.[74]

8.5 Implications for Strategic Leaders

An effective corporate strategy increases a firm's chances to gain and sustain a competitive advantage. By formulating corporate strategy, strategic leaders make important choices along three dimensions that determine the boundaries of the firm:

- **Degree of vertical integration**—the stages of the industry value chain in which to participate
- **Type of horizontal diversification**—the range of products and services to offer
- **Geographic scope**—where to compete

Because a firm's external environment never remains constant over time, *corporate strategy needs to be dynamic over time.* As firms grow, they tend to diversify and globalize to capture additional growth opportunities. In the next chapter, we discuss strategic alliances. mergers, and acquisitions, all critical tools in executing corporate strategy. In Chapter 10, we examine geographic diversification by studying how firms compete for competitive advantage around the world.

CHAPTER**CASE 8** Part II

AWS, Amazon's cloud-computing platform, is by far its most profitable business endeavor. Amazon's total revenues stood at some $470 billion in 2021, with retail bringing in $342 billion, AWS $62 billion, and online advertising $31 billion, among other business activities. Amazon's profits were $33 billion, with AWS contributing $19 billion and retail just $6 billion. Thus, AWS's profit margin is 31%, while the online retailing profit margin is a mere 2%.

While Amazon is barely profitable in its online retailing operation in the United States, it is losing money internationally. At the same time, AWS is growing by more than 20% a year. Given its huge success, AWS has become Amazon's cash cow. The profits that AWS generates enable Amazon to undertake various strategic initiatives, such as paying $14 billion for Whole Foods Market (in 2017) and $6.5 billion to acquire the Hollywood studio MGM (in 2022) to develop original content for Prime Video, including recent hits such as *No Time to Die*, an installment in the fabled James Bond series. AWS's net income also bankrolls Amazon's money-losing international retail expansion (see Exhibit 8.1 for an overview of Amazon's strategic initiatives).

Despite these efforts, some clouds are gathering on the horizon over Amazon. Although AWS is growing fast, its growth rate has slowed in recent years. Moreover, competition is heating up with Microsoft's Azure, Google's Cloud, IBM's Cloud, and Apple's iCloud stronger push into cloud computing. In addition, many competitors such as Netflix—a current customer of AWS—may shift to Azure or another cloud services provider for strategic reasons. Moreover, although offering one-day free shipping for Prime members raises the bar on customer service to which Walmart and others need to respond, it does not come cheap. The investment to make one-day free shipping a reality in the United States alone costs Amazon billions of dollars. Given that Amazon's retail operation is barely profitable, the money to fund the retail operations must—at this point—come from AWS. Indeed, AWS profits pay for Amazon's new strategic initiatives, acquisitions, and a significant part of the company's R&D budget.

Because AWS's growth rate is declining, Amazon must create another growth engine to finance future improvements to customer service and other diversification experiments. One candidate is online advertising, where Amazon earned $31 billion (in 2021), with a 33% annual growth rate. Amazon holds a 12% market share in online advertising, third behind Meta (owner of Facebook and Instagram) at 24%, and Alphabet (parent of Google) at 29%. Although most searches in the United States start on Google, Amazon is the leader in the more narrow category of product searches. That is, most U.S. consumers begin an online product search directly on Amazon. Amazon has been described as "a search engine with a warehouse attached to it."[75]

Amazon might be in the best position to take advantage of the future exponential growth in digital advertising because it has the best-quality data. While Google knows what people search for in general terms, Amazon knows what each person views, buys, listens to, watches, and how and when each individual communicates with Alexa. These data will allow Amazon to provide the most fine-grained and targeted ad placements and garner a premium from advertisers. And the more data Amazon has, the more it can boost its online sales. Once positive network effects kick in, Amazon might be the winner in the digital ad space, especially in product searches.[76]

Questions

1. Describe Amazon's diversification strategy using Exhibit 8.10. What type of diversification strategy is Amazon pursuing? Explain.
2. What is Amazon's core business? Is AWS related to Amazon's core business? Why or why not? Some investors are pressuring Amazon's CEO to spin out AWS as a standalone company. Do you agree with this corporate strategy recommendation? Why or why not? Hint: Do you believe AWS would be more valuable within Amazon or as a standalone company?
3. At this point, Alphabet and Meta are the clear leaders in the digital ad space, which is predicted to continue growing exponentially (reaching $256 billion in 2025, more than three times the expected spending of $81 billion on traditional TV advertising). Although Amazon's market share was a mere 12% in online advertising (in 2021), many believe that Amazon is best positioned to be the market leader in the digital ad space in the future. What is the basis of this argument? Do you agree with this assessment? Why or why not? Buttress your position.
4. Amazon continues to spend billions on seemingly unrelated diversification efforts. Do you believe these efforts contribute to Amazon gaining and sustaining a competitive advantage? Why or why not?

TAKE-AWAY CONCEPTS

In this chapter, we defined corporate strategy and then looked at two fundamental corporate strategy topics—vertical integration and diversification—as summarized by the following learning objectives and related take-away concepts.

LO 8-1 / Define corporate strategy and describe the three dimensions along which it is assessed.

- Corporate strategy addresses "where to compete." Business strategy addresses "how to compete."
- Corporate strategy concerns the boundaries of the firm along three dimensions: (1) industry value chain, (2) products and services, and (3) geography (regional, national, or global markets).
- For a firm to gain and sustain competitive advantage, any corporate strategy must support and strengthen the firm's strategic position, regardless of whether it is a differentiation, cost-leadership, or blue ocean strategy.

LO 8-2 / Explain why firms need to grow, and evaluate different growth motives.

- Firm growth is motivated by the desire to increase profits, lower costs, increase market power, reduce risk, and motivate management and employees.
- Not all growth motives are equally valuable.
  - Increasing profits and lowering expenses are clearly related to enhancing a firm's competitive advantage.
  - Increasing market power can contribute to a greater competitive advantage, but it can also result in legal repercussions such as antitrust lawsuits.
  - Growing to reduce risk has fallen out of favor with investors, who generally do not favor corporations with a number of unrelated strategic business units (i.e., conglomerates).
  - Firms need to grow to motivate management and employees, but managerial motives such

as increasing company perks and job security are not legitimate reasons to pursue growth.

LO 8-3 / Describe and evaluate different options firms have to organize economic activity.

- Transaction cost economics help managers decide what activities to do in-house ("make") versus what services and products to obtain from the external market ("buy").
- When the costs to pursue an activity in-house are less than the costs of transacting in the market ($C_{in\text{-}house} < C_{market}$), the firm should vertically integrate.
- Principal-agent problems and information asymmetries can lead to market failures, and thus situations where internalizing the activity is preferred.
- A principal-agent problem arises when an agent, performing activities on behalf of a principal, pursues his or her own interests.
- Information asymmetries arise when one party possesses private information and is therefore more informed than another party.
- Moving from less integrated to more fully integrated forms of transacting, alternatives include short-term contracts, strategic alliances (including long-term contracts, equity alliances, and joint ventures), and parent-subsidiary relationships.

LO 8-4 / Describe the two types of vertical integration along the industry value chain: backward vertical integration and forward vertical integration.

- Vertical integration is the firm's ownership of the inputs needed for production or of the channels through which it distributes its outputs.
- Industry value chains (vertical value chains) depict the transformation of raw materials into finished goods and services. Each stage typically represents a distinct industry in which a number of different firms compete.
- Backward vertical integration involves moving ownership of activities upstream nearer to the originating (inputs) point of the industry value chain.
- Forward vertical integration involves moving ownership of activities closer to the end (customer) point of the value chain.

LO 8-5 / Identify and evaluate the benefits and risks of vertical integration.

- Benefits of vertical integration include lowering costs, improving quality, facilitating scheduling and planning, facilitating investments in specialized assets, and securing critical supplies and distribution channels.
- Risks of vertical integration include increasing costs, reducing quality, reducing flexibility, and increasing the potential for legal repercussions.

LO 8-6 / Describe and examine alternatives to vertical integration.

- Taper integration is a strategy in which a firm is backwardly integrated but also relies on outside-market firms for some of its supplies, and/or is forwardly integrated but also relies on outside-market firms for some if its distribution.
- Strategic outsourcing involves moving one or more value chain activities outside the firm's boundaries to other firms in the industry value chain. Offshoring is the outsourcing of activities outside the home country.

LO 8-7 / Describe and evaluate different types of corporate diversification.

- A single-business firm derives 95% or more of its revenues from one business.
- A dominant-business firm derives between 70% and 95% of its revenues from a single business but pursues at least one other business activity.
- A firm follows a related diversification strategy when it derives less than 70% of its revenues from a single business activity, but obtains revenues from other lines of business that are linked to the primary business activity. A related diversification strategy can be related-constrained or related-linked.
- A firm follows an unrelated diversification strategy when less than 70% of its revenues come from a single business, and there are few, if any, linkages among its businesses.

LO 8-8 / Apply the core competence–market matrix to derive different diversification strategies.

- When applying an existing/new dimension to core competencies and markets, four quadrants emerge, as depicted in Exhibit 8.11.

- The lower-left quadrant combines existing core competencies with existing markets. Here, managers need to develop ideas for how to leverage existing core competencies to improve their current market position.
- The lower-right quadrant combines existing core competencies with new market opportunities. Here, managers need to think about how to redeploy and recombine existing core competencies to compete in future markets.
- The upper-left quadrant combines new core competencies with existing market opportunities. Here, managers must come up with strategic initiatives for how to build new core competencies to protect and extend the firm's current market position.
- The upper-right quadrant combines new core competencies with new market opportunities. This is likely the most challenging diversification strategy because it requires building new core competencies to create and compete in future markets.

LO 8-9 / Explain when a diversification strategy creates a competitive advantage and when it does not.

- The diversification-performance relationship is a function of the underlying type of diversification.
- The relationship between the type of diversification and overall firm performance takes on the shape of an inverted U (see Exhibit 8.13).
- Unrelated diversification often results in a diversification discount: The stock price of highly diversified firms is valued at less than the sum of their individual business units.
- Related diversification often results in a diversification premium: The stock price of related-diversification firms is valued at greater than the sum of their individual business units.
- In the BCG matrix, the corporation is viewed as a portfolio of businesses, much like a portfolio of stocks in finance (see Exhibit 8.15). The individual SBUs are evaluated according to relative market share and the speed of market growth and are placed into one of four categories: dog, cash cow, star, and question mark. Each category warrants a different investment strategy.
- Both low levels and high levels of diversification are generally associated with lower overall performance, while moderate levels of diversification are associated with higher firm performance.

KEY TERMS

Backward vertical integration *(p. 313)*
Boston Consulting Group (BCG) growth–share matrix *(p. 331)*
Conglomerate *(p. 322)*
Core competence–market matrix *(p. 324)*
Corporate strategy *(p. 298)*
Credible commitment *(p. 309)*
Diversification *(p. 320)*
Diversification discount *(p. 328)*
Diversification premium *(p. 329)*
External transaction costs *(p. 303)*
Forward vertical integration *(p. 313)*
Franchising *(p. 307)*
Geographic diversification strategy *(p. 320)*
Hold-up problem *(p. 305)*
Industry value chain *(p. 311)*
Information asymmetry *(p. 305)*
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Licensing *(p. 307)*
Opportunism *(p. 305)*
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Product diversification strategy *(p. 320)*
Product–market diversification strategy *(p. 320)*
Related-constrained diversification strategy *(p. 322)*
Related diversification strategy *(p. 321)*
Related-linked diversification strategy *(p. 322)*
Restructuring *(p. 330)*
Specialized assets *(p. 315)*
spinout *(p. 329)*
Strategic alliances *(p. 307)*
Strategic outsourcing *(p. 318)*
Taper integration *(p. 318)*
Transaction cost economics *(p. 302)*
Transaction costs *(p. 302)*
Unrelated diversification strategy *(p. 322)*
Vertical integration *(p. 311)*
Vertical market failure *(p. 317)*

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CHAPTER

9

Corporate Strategy: Strategic Alliances, Mergers, and Acquisitions

Chapter Outline

Learning Objectives

LO 9-1 Apply the Build-Borrow-Buy framework to guide corporate strategy.

LO 9-2 Define strategic alliances, explain why firms enter into them, and summarize why they are important to implement corporate strategy.

LO 9-3 Describe three alliance governance mechanisms and evaluate their pros and cons.

LO 9-4 Describe the three phases of alliance management and explain how an alliance management capability can lead to a competitive advantage.

LO 9-5 Differentiate between mergers and acquisitions, and explain why firms use them to execute corporate strategy.

LO 9-6 Define horizontal integration and evaluate the advantages and disadvantages of this option to execute corporate-level strategy.

LO 9-7 Explain why firms engage in acquisitions.

LO 9-8 Evaluate whether mergers and acquisitions lead to competitive advantage.

Little Lyft Gets Big Alliance Partners and Beats Uber in Going Public

Uber is the leading ride-hailing service globally, with 110 million monthly users in more than 70 countries. With $82 billion, Uber was also the most valuable private startup before its initial public offering (IPO) in May 2019. Although it is much smaller, Lyft is Uber's closest competitor in the United States. Yet, it was the little Lyft that beat the giant Uber in selling shares to the public.

Why does winning the race among competitors to IPO matter? FOMO ("fear of missing out") often drives investors' eagerness to participate in the latest technology trend. And in 2019, ride-hailing services were hot. Going to IPO sooner allows a startup to capture a larger share of the investment dollars available for a category. Given their significant cash burn rate needed to scale up operations, many startups live or die based on access to capital. Moreover, Lyft was motivated to beat Uber in the IPO race because Travis Kalanick, Uber's abrasive co-founder and CEO at the time, had spoiled Lyft's earlier attempts to raise more money pre-IPO by warning investors: "Before you decide whether you want to invest in [Lyft], just make sure you know that we [Uber] are going to be fund-raising immediately after."[1]

Rather than retrofitting a traditional vehicle with autonomous driving capabilities, Cruise purpose-built the Origin from the ground up as a self-driving vehicle. The Origin has no steering wheel, no pedals, and no mirrors. It is designed to provide an entirely new transportation experience for ride-hailing customers. The vehicle is all electric and designed to have a life span of one million miles. GM manufactures the Origin in Michigan at an estimated production cost of $50,000. Real-world testing of the Origin without a human safety driver began in San Francisco in 2020, and with paid riders in 2023.

David Paul Morris/Bloomberg/Getty Images

In March 2019, Lyft became the first U.S. ride-sharing service to sell its shares to the public, with a valuation of more than $26 billion at the end of its first trading day. Lyft was worth less than one-tenth of Uber (some $7.5 billion) in 2017. Between 2017 and 2019, Lyft increased the number of its active riders from 6 million to almost 20 million, thereby gaining market share vis-à-vis Uber. By the end of its first trading day, Lyft had added $11 billion to its $15 billion pre-IPO valuation. In comparison, Uber had lost $6 billion from its pre-IPO valuation of $82 billion. How did Lyft beat Uber to an IPO and more than triple its valuation within two years?

Lyft is the underdog in the fiercely competitive ride-hailing industry. But a good strategy is about "getting more out of a situation than the starting balance of power would suggest,"[2] and finding partners is critical to turning a weak starting position into stronger than expected results. As when dealing with a schoolyard bully, it helps to have strong friends. In pursuing their underdog strategy against Uber, Lyft's co-founders, Logan Green and John Zimmer, allied Lyft with some powerful friends. What are the benefits of strategic alliances with strong partners?

Strengthen Competitive Position. Strategic alliances with two powerful partners enabled Lyft to strengthen its competitive position against Uber. In 2016, it entered an equity alliance with one of the largest car manufacturers globally, GM, which invested $500 million in Lyft. A year later, Lyft announced an alliance with Waymo, an autonomous car technology venture that is a subsidiary of Alphabet, the parent company of Google. Why did these well-known firms enter strategic alliances with Lyft?

At the time, Waymo was a fierce rival of Uber in developing self-driving car technology. When Lyft announced its alliance with Waymo, Alphabet and Uber were entangled in a lawsuit. Alphabet alleged that Uber stole proprietary technology when acquiring Otto, a self-driving technology company. A former Waymo engineer heading its self-driving car efforts founded Otto. Thus, the alliance with Waymo allowed Lyft to strengthen its competitive position vis-à-vis Uber.

The success of autonomous vehicle technology is critical in achieving sustained profitability for ride-hailing services because human drivers are the most significant cost factor in offering rides. Moreover, autonomous-driving technology is safer than human driving, resulting in fewer accidents. In addition, because intelligent traffic guidance can be employed much more effectively with self-driving cars that can run 24/7/365, traffic congestion is expected to be less and delays fewer. Taken together, the expectation is that ride-hailing platforms such as Uber and Lyft will morph into operators of robo-taxi fleets.

Enter New Markets. GM's equity alliance with Lyft allows GM to enter the mobile transportation and logistics market. Lyft has the second-largest mobile transportation network in North America. The goal is to deploy GM cars on Lyft's network, ideally as self-driving vehicles. To make a fleet of robo-taxis a reality, GM also acquired Cruise, an autonomous vehicle tech startup, in 2016. Cruise developed the Origin, one of the first purpose-built self-driving vehicles designed for use in robo-taxi fleets.

Hedge against Uncertainty. GM's equity investment in Lyft enables GM to hedge against uncertainty. With network effects supporting winner-take-all dynamics, only one or a few mobile transportation companies will likely survive in the long run. GM wants to be in this new market because the age-old private car ownership model is shifting toward fleet ownership and management. Consumers will rent a car for a specific ride rather than own a vehicle as a fixed asset. Private cars in the United States are used only about 5% of the time and sit idle for most of the day. Car owners have the fixed costs of purchasing a car, buying insurance, and maintaining the vehicle. All these costs go away for consumers of ride-hailing services with the new business model.

Learn New Capabilities. Lyft needs to learn how to manage large fleets of cars—a capability that GM, a key supplier to many large car rental companies, can provide. In addition, Lyft may want to learn from the self-driving technology that Waymo can provide. Waymo benefits from the millions of miles that Lyft cars drive each year, and it can use AI to improve its autonomous driving capabilities. In addition, Waymo wants to learn more about establishing and maintaining an extensive mobile logistics network that it can then leverage into more precise target advertising for its Google partner division or other new services it might want to offer in the future.

RIDE-SHARING REALITY

By 2022, the ride-sharing industry had experienced two black swan events: the Covid-19 pandemic and the war in Ukraine. Uber and Lyft feel pressure on both the supply side and the demand side: fewer drivers and fewer riders. Overall, there are 20% fewer riders, and the remaining riders take 35% fewer trips. One reason is that the cost of rides (per mile) has risen by more than a third compared to pre-pandemic levels. At the same time, gas prices doubled. Higher gas prices make driving for ride-hailing services less profitable for drivers. Close to double-digit inflation in the United States also drove up prices for (used) automobiles and insurance. Lower profit margins, in turn, attract fewer drivers. Rising costs made the companies' business model of enticing as many riders to their platform by subsidizing rides unsustainable. Neither ride-sharing service is generating profits: Uber lost $500 million while Lyft lost over $1 billion (in 2021).

Although Lyft was smart in allying with strong partners and beating Uber to the IPO goal line, the race is far from over. While Lyft is a single business focusing on ride-hailing, Uber pursues related-constrained diversification as it offers rides, food delivery, and freight. Uber Eats' business more than tripled during the pandemic and now contributes more than 50% of Uber's revenues. In addition, Lyft focuses on North America (United States and Canada) only, while Uber is geographically diversified, offering services in over 10,000 cities across the globe.[3]

Part II of this ChapterCase appears in Section 9.4.

Lyft used strategic alliances with GM and Waymo to reduce the performance gap with Uber, as highlighted in the ChapterCase. Lyft's strategic leaders realized it would be difficult for Lyft, a much smaller ride-hailing company, to catch up to Uber on its own. Tapping into its partners' resources and expertise allowed Lyft to become a much more potent rival to Uber. Indeed, within two years, Lyft's co-founders were able to triple its valuation and beat Uber in the race to go public. Strategic alliances are especially critical for firms that have weaker starting positions compared to their rivals. The Lyft example shows how strategic alliances can help firms grow and close a performance gap with stronger rivals.

In Chapter 8, we discussed *why* firms grow. In this chapter, we discuss *how* firms grow. In addition to *internal* organic growth (achieved through reinvesting profits; see discussion of

Exhibit 4.4 in Chapter 4), firms have two *external* strategic options to execute corporate strategy: *alliances* and *acquisitions*. For instance, Lyft used strategic partnerships with GM and Waymo to grow, and Uber acquired its Middle Eastern rival Careem (in 2019) to strengthen its global position. We devote this chapter to studying these fundamental pathways through which firms implement corporate strategy.

We begin this chapter by introducing the *Build-Borrow-Buy framework* to guide corporate strategy in deciding whether and when to grow internally *(build),* use alliances *(borrow),* or make acquisitions (*buy*). We then discuss strategic alliances before studying mergers and acquisitions. We discuss alliances before acquisitions because alliances are smaller strategic commitments and thus are much more common. In some cases, alliances may lead to acquisitions later by offering a *try before you buy* option. For example, before Disney acquired Pixar (in 2006), the firms had a long-standing strategic alliance in which Pixar developed computer-animated films that Disney marketed and distributed. We conclude with *Implications for Strategic Leaders,* in which we discuss practical applications.

9.1 How Firms Achieve Growth

LO 9-1

Apply the Build-Borrow-Buy framework to guide corporate strategy.

After discussing in Chapter 8 why firms need to grow, the next question that arises is: *How do firms grow?* Corporate executives can drive firm growth using one of three corporate strategy options: organic growth through *internal* development or *external* growth through alliances and acquisitions. Laurence Capron and Will Mitchell developed an insightful step-by-step decision model to guide managers in selecting the most appropriate corporate strategy.[4] Selecting the most suitable option in response to a specific strategic challenge makes successful implementation more likely.

THE BUILD-BORROW-BUY FRAMEWORK

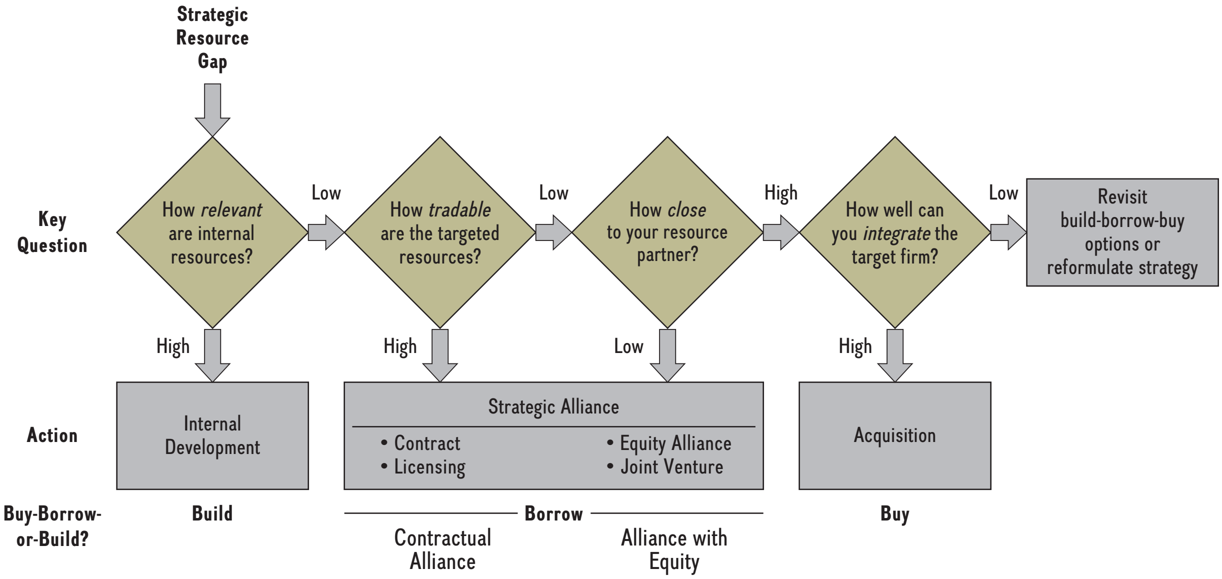
Build-Borrow-Buy framework Conceptual model that aids firms in deciding whether to pursue internal development *(build)*, enter a contractual arrangement or strategic alliance *(borrow)*, or acquire new resources, capabilities, and competencies *(buy)*.

The **Build-Borrow-Buy framework** provides a conceptual model that aids strategic leaders in deciding whether to pursue internal development (*build*), enter a contractual arrangement or strategic alliance (*borrow*), or acquire new resources, capabilities, and competencies (*buy*). Firms that are able to learn how to select the right pathways to obtain new resources are more likely to gain and sustain a competitive advantage. In the Build-Borrow-Buy model, the term *resources* is defined broadly to include capabilities and competencies (as in the *VRIO model* discussed in Chapter 4). Exhibit 9.1 shows the Build-Borrow-Buy decision framework.

Determining which corporate strategy option to use to respond to a strategic challenge begins with identifying a strategic resource gap that will impede future growth. The resource gap is *strategic* because closing this gap can lead to a competitive advantage. As discussed in Chapter 4, resources with the potential to lead to competitive advantage cannot be simply bought on the open market. Indeed, if any firm could readily buy this type of resource, its availability would negate its potential for competitive advantage. It would no longer be *rare*, a key condition for a resource to form the basis of competitive advantage. Moreover, resources that are *valuable, rare*, and *difficult to imitate* are often embedded deep within a firm, frequently making up a resource bundle that is hard to unplug in whole or in part.

The options to close the strategic resource gap are, therefore, to build, borrow, or buy. *Build* in the Build-Borrow-Buy framework refers to internal development, *borrow* refers to the use of strategic alliances, and *buy* refers to acquiring a firm. When acquiring a firm, you buy an entire *resource bundle,* not just a specific resource. If it obeys VRIO principles and is successfully integrated, this resource bundle can then form the basis of competitive advantage.

EXHIBIT 9.1 Guiding Corporate Strategy: The Build-Borrow-Buy Framework



Source: Author's adaptation from L. Capron and W. Mitchell (2012), ***Build, Borrow, or Buy: Solving the Growth Dilemma*** (Boston: Harvard Business Review Press).

Exhibit 9.1 provides a schematic of the Build-Borrow-Buy framework. In this approach strategic leaders must determine the degree to which certain conditions apply by responding to up to four questions sequentially before choosing the best course of action. The questions cover issues of *relevancy, tradability, closeness*, and *integration:*

1. **Relevancy.** How *relevant* are the firm's existing internal resources to solving the resource gap?
2. **Tradability.** How *tradable* are the targeted resources that may be available externally?
3. **Closeness.** How *close* do you need to be to your external resource partner?
4. **Integration.** How well can you *integrate* the targeted firm, if you determine you need to acquire the resource partner?

As shown in Exhibit 9.1, the answers to these questions lead to a recommended action or the next question. We'll now review each question in more depth.

1. HOW *RELEVANT* ARE THE FIRM'S EXISTING INTERNAL RESOURCES TO SOLVING THE RESOURCE GAP? The firm's strategic leaders start by asking whether the firm's internal resources are high or low in relevance. If the firm's internal resources are highly relevant to closing the identified gap, then the firm should build the new resources needed through internal development.

How does a strategic leader know whether the firm's resources are relevant in addressing a new challenge or opportunity? Firms evaluate the relevance of internal resources in two ways. They test whether resources are (1) *similar* to those the firm needs to develop and (2) *superior* to those of competitors in the targeted area.[5] If *both* conditions are met, then the firm's internal resources are relevant, and the firm should pursue internal development.

Let's examine both conditions. Strategic leaders are often misled by the first test because things that might appear similar at the surface are actually quite different deep down.[6] Moreover, they tend to focus on the (known) similarities rather than on (unknown) differences. Strategic leaders often don't know how the resources needed for the existing and new business opportunity differ.

For example, an executive at a newspaper publisher such as *The New York Times* may conclude that the researching, reporting, writing, and editing activities done for a printed newspaper are similar to those done for an online newspaper. Although the activities may be similar, they are also different because the underlying business model and technology for online publishing are radically different from those of traditional print media. Managing the community interactions of online publishing as well as applying data analytics to understand website traffic and reader engagement are entirely new elements. To make the challenge even greater, online news reporting is required in real time, 24/7, 365 days a year. To make the situation even more challenging, old-line news companies are now competing with millions of "citizen journalists" on social media, such as Twitter or Weibo, which often have an edge on breaking news.[7]

The second test, determining whether your internal resources are *superior* to those of competitors in the targeted area, can best be assessed by applying the VRIO framework (see Exhibit 4.6). In the case of the print publisher, its internal resources are neither similar to those that the firm needs to develop nor superior to competitors' resources, which implies that building the new resource through *internal* development is not an option. The firm then needs to consider *external*—borrow or buy—options, which leads us to the next question.

2. HOW *TRADABLE* ARE THE TARGETED RESOURCES THAT MAY BE AVAILABLE EXTERNALLY? For external options, the firm needs to determine how tradable the targeted resources may be. A *tradable* resource is one that the firm is able to source externally through a contract that allows for the transfer of ownership or use of the resource. Short-term as well as long-term contracts, such as licensing or franchising, are ways to *borrow* resources from another company (see the discussion in Chapter 8).

In the biotech-pharma industry, some producers use licensing agreements to transfer knowledge and technology from the licensor's R&D to the licensee's manufacturing. Eli Lilly, for example, has commercialized several breakthrough biotech drugs using licensing agreements with new ventures. Similarly, Pfizer commercialized BioNTech's Covid-19 vaccine by using a licensing contract.

The implication is that if a resource is highly tradable, then the resource should be *borrowed* via a licensing agreement or other contractual agreement. If the resource in question is not easily tradable, then the firm needs to consider either a deeper strategic alliance through an equity alliance or a joint venture, or an outright acquisition.

3. HOW *CLOSE* DO YOU NEED TO BE TO YOUR EXTERNAL RESOURCE PARTNER? Many times, firms are able to obtain the required resources to fill the strategic gap through more integrated strategic alliances such as equity alliances or joint ventures (see Exhibit 8.5) rather than through outright acquisition. As discussed in the Chapter Case, GM entered an equity alliance with Lyft by purchasing an ownership stake in the ride-hailing startup.

Mergers and acquisitions (M&A) are the most costly, complex, and difficult to reverse strategic option. Only if extreme closeness to the resource partner is necessary for understanding and obtaining its underlying knowledge should M&A be considered the *buy* option.

The firm should always consider *borrowing* the necessary resources through strategic alliances before looking at M&A.

4. HOW WELL CAN YOU *INTEGRATE* THE TARGETED FIRM, IF YOU DETERMINE YOU NEED TO ACQUIRE THE RESOURCE PARTNER? The final decision question using the Build-Borrow-Buy lens is: *Can you integrate the target firm?* The list of post-integration failures, often due to differences in corporate culture, is long. Multibillion-dollar failures resulting include the integration of Bayer and Monsanto, Alcatel and Lucent, Daimler and Chrysler, AOL and Time Warner, HP and Autonomy, and Bank of America and Countrywide. More than cultural differences were involved in Microsoft's decision (in 2015) to write down $7.6 billion in losses (or more than 80%) on its $9.4 billion acquisition of Nokia some 15 months earlier. It's now up to Microsoft CEO Satya Nadella to decide whether and how to compete in the mobile device arena after former CEO Steve Ballmer made a desperate gamble on acquiring the Finnish cell phone maker.[8]

Only if the three prior conditions *(low relevancy, low tradability,* and *high need for closeness)* shown in the decision tree in Exhibit 9.1 are met, should the firm's strategic leaders consider M&A. If the firm's internal resources are insufficient to *build, and* the resource needed to fill the strategic gap cannot be *borrowed* through a strategic alliance, *and* closeness to the resource partner is needed, then the final question to consider is whether the integration of the two firms using a merger or acquisition will be successful. In all other cases, the firms should consider finding a less costly *borrow* arrangement when *building* is not an option.

Because strategic alliances are the less costly and more common tool to execute corporate strategy, we discuss alliances first before mergers and acquisitions. Per the Build-Borrow-Buy decision framework, strategic alliances *(borrow)* also need to be considered before mergers and acquisitions *(buy)*.

LO 9-2

Define strategic alliances, explain why firms enter into them, and summarize why they are important to implement corporate strategy.

9.2 Strategic Alliances

Firms enter many types of alliances, from small contracts that have no bearing on a firm's competitiveness to multibillion-dollar joint ventures that can make or break the company. An alliance, therefore, qualifies as *strategic* only if it has the potential to affect a firm's competitive advantage.

strategic alliances Voluntary arrangements between firms that involve the sharing of knowledge, resources, and capabilities with the intent of developing processes, products, or services.

relational view of competitive advantage Strategic management framework that proposes that critical resources and capabilities frequently are embedded in strategic alliances that span firm boundaries.

Strategic alliances are voluntary arrangements between firms that involve the sharing of knowledge, resources, and capabilities with the intent of developing processes, products, or services.[9] The use of strategic alliances to implement corporate strategy has grown significantly in the past few decades, with thousands forming each year. As the speed of technological change and innovation has increased (refer to the discussion in Chapter 7), firms have responded by entering more alliances. Globalization has also contributed to an increase in cross-border strategic alliances (discussed in Chapter 10).

Strategic alliances are attractive for a number of reasons. They enable firms to achieve goals faster and at lower costs than going it alone. Strategic alliances may join complementary parts of a firm's value chain, such as R&D and marketing, or they may focus on joining the same value chain activities. In contrast to mergers and acquisitions, strategic alliances also allow firms to circumvent potential legal repercussions, including potential lawsuits filed by U.S. federal agencies or the European Union.

The locus of competitive advantage is often not found within the individual firm but within a strategic partnership. According to this **relational view of competitive advantage**, critical resources and capabilities frequently are embedded in strategic alliances that span firm boundaries. A strategic alliance has the potential to help a firm gain and sustain a competitive advantage when it joins resources and knowledge in a combination that obeys the VRIO principles (introduced in Chapter 4).[10] Applying the VRIO framework, we know that the basis for competitive advantage is formed when a strategic alliance creates resource combinations that are valuable, rare, and difficult to imitate, and the alliance is organized appropriately to allow for value capture. In support of this perspective, over 80% of Fortune 1000 CEOs indicated in a survey that more than one-quarter of their firms' revenues were derived from strategic alliances.[11]

WHY DO FIRMS ENTER STRATEGIC ALLIANCES?

To affect a firm's competitive advantage, an alliance must promise a positive effect on the firm's economic value creation through increasing value or lowering costs (refer to the discussion in Chapter 5). This logic is reflected in the common reasons firms enter alliances.[12] They do so to

- Strengthen competitive position.
- Enter new markets.
- Hedge against uncertainty.
- Access critical complementary assets.
- Learn new capabilities.

STRENGTHEN COMPETITIVE POSITION. Firms frequently resort to strategic alliances to strengthen their competitive position, as Lyft did when competing against Uber (refer to the ChapterCase). Firms can also use strategic alliances to change the industry structure in their favor by reducing competitive rivalry.[13] Moreover, firms frequently use strategic alliances when competing to set an industry standard (refer to the discussion in Chapter 7).

Strategy Highlight 9.1 shows how Tesla used alliances strategically to strengthen its competitive standing and to position itself advantageously in making electric vehicles a serious contender for the future standard in car propulsion, with the goal of eventually making internal combustion engines obsolete.

ENTER NEW MARKETS. Firms may use strategic alliances to enter new markets, either in terms of products and services or geography.[15]

For example, using a strategic alliance, HP and DreamWorks Animation SKG created the Halo Collaboration Studio, which makes virtual communication possible around the globe.[16] Halo's conferencing technology gives participants the vivid sense that they are in the same room. Clients' conference rooms match to the last detail, giving participants the impression that they are sitting together at the same table. DreamWorks produced several of its computer-animated movies such as the *Shrek* franchise using this new technology for its meetings. Though dispersed geographically, people with different creative skills—script writers, computer animators, directors—were able to participate as if they were in the same room, even seeing the work on each other's laptops. Use of the technology enabled faster decision making, enhanced productivity, reduced (or even eliminated) travel time and expense, and increased job satisfaction. Neither HP nor DreamWorks would have been able to produce this technology breakthrough alone, but moving into the videoconferencing arena together via a strategic alliance allowed both partners to pursue related diversification. Moreover, HP's alliance with DreamWorks Animation SKG enabled HP to compete head on with Cisco's high-end videoconferencing solution, TelePresence.[17] The HP and DreamWorks Animation SKG alliance was motivated by the desire to enter a new market, in terms of products and services offered, that neither could enter alone.

Strategy Highlight 9.1

How Tesla Used Alliances Strategically

Since its IPO in 2010, the electric-car manufacturer Tesla has had a tremendous impact. Indeed, Tesla crossed $1 trillion in market cap (in 2021), making it more valuable than all of the legacy carmakers combined.

One critical factor in the early success of the California startup is the role its alliance strategy played, in particular its alliances with Daimler, Toyota, and Panasonic. The Daimler partnership provided a much-needed cash injection as well as automobile engineering expertise; the Toyota partnership taught Tesla lean manufacturing and gave it access to a world-class manufacturing facility located near its then headquarters in Palo Alto, California; and the Panasonic alliance provided access to best-in-class battery technology.

Initially, Tesla, which began selling its all-electric Roadster model in 2008, had neither a market nor legitimacy. Moreover, it was plagued with both thorny technical problems and cost overruns. Nonetheless, it managed to overcome these early challenges, in part by turning prospective rivals into alliance partners. In 2009, the year before its IPO, Tesla allied with Daimler, whose roots in automobile engineering go back to its invention of the internal combustion engine some 130 years ago. The deal provided Tesla with superior engineering expertise and a cash infusion of $50 million, which helped to save the company from potential bankruptcy.

The alliance with Toyota, signed the following year, brought other critical benefits. It enabled Tesla to buy the former New United Motor Manufacturing Inc. (NUMMI) factory in Fremont, California, in 2010. NUMMI was created as a joint venture between Toyota and General Motors in 1984. The NUMMI plant was the only remaining large-scale car manufacturing plant in California, and it was located only 25 miles from Tesla's Palo Alto headquarters. (In 2021, Tesla moved its headquarters to Austin, Texas.) Without this factory, Tesla would not have been able to produce the Model S, which was critical to its survival because the car was received with much praise by industry insiders and luxury buyers. The strategic partnership with Toyota provided another critical benefit for Tesla: It learned large-scale, high-quality manufacturing from the pioneer of lean manufacturing.

In 2014, Tesla signed another important strategic alliance—this one with Osaka-based Panasonic, the Japanese consumer electronics company and a world leader in battery technology. This relationship is significant as Tesla tries to position itself in the business of sustainable and decentralized energy. The two companies jointly invested $5 billion to build a lithium-ion battery plant ("Gigafactory") in Nevada. The partnership with Panasonic also enabled Tesla to develop one of its first core competencies: the unique way in which it designs its battery packs to both achieve high performance and superior range without overheating ("thermal runaway" in engineering lingo), which had long plagued electric vehicles.

Tesla's ability to attract and work with leading companies in the automotive and other key industries as strategic alliance partners is an important part of its formula for success. The decisions by Tesla to collaborate with Daimler, Toyota, and Panasonic highlight the fact that individual companies do not need to own all of the resources, skills, and knowledge necessary to undertake key strategic growth initiatives. Strategic alliances with premier partners also allow startups to overcome early technological and financial challenges. Finally, noteworthy is the fact that Tesla allied only with best-in-class companies.[14]

When entering new geographic markets, governments of countries such as Saudi Arabia or China may require that foreign firms have a local joint venture partner before doing business in their country. These cross-border strategic alliances have both benefits and risks. While the foreign firm can benefit from local expertise and contacts, it is exposed to the risk that some of its proprietary know-how and intellectual capital may be appropriated by the foreign partner. We will address such issues in Chapter 10 when studying global strategy.

HEDGE AGAINST UNCERTAINTY. In dynamic markets, strategic alliances allow firms to limit their exposure to uncertainty in the market.[18] For instance, in the wake of the biotechnology revolution, incumbent pharmaceutical firms such as Pfizer, Novartis, and Roche entered into hundreds of strategic alliances with biotech startups.[19] These alliances allowed the big pharma firms to make small-scale investments in many of the new biotechnology ventures that were poised to disrupt existing market economics. In some sense, the pharma companies were taking **real options** in these biotechnology experiments, providing them with the right but not the obligation to make further investments when the biotech companies introduced new drugs.

real options Choices that afford managers the right but not the obligation to make further investments.

real-options perspective Approach to strategic decision making that breaks down a larger investment decision into a set of smaller decisions that are staged sequentially over time.

A **real-options perspective** to strategic decision making breaks down a larger investment decision (such as whether to enter biotechnology or not) into a set of smaller decisions that are staged sequentially over time. This approach allows the firm to obtain additional information at predetermined stages. At each stage, after new information is revealed, the firm evaluates whether or not to make further investments. In a sense, a real option—which is the right, but not the obligation, to continue making investments—allows the firm to buy time until sufficient information for a go versus no-go decision is revealed. Once the new biotech drugs were a known quantity, the uncertainty was removed, and the incumbent firms reacted accordingly.

Early in the biotechnology revolution, for instance, the Swiss pharma company Roche initially invested $2.1 billion (in 1990) in an equity alliance to purchase a controlling interest (greater than 50%) in the biotech startup Genentech. After witnessing the success of Genentech's drug discovery and development projects in subsequent years, Roche spent $47 billion (in 2009) to purchase the remaining minority interest in Genentech, making it a wholly owned subsidiary.[20]

Taking a wait-and-see approach by entering strategic alliances allows incumbent firms to buy time and wait for the uncertainty surrounding the market and technology to fade. Many firms in fast-moving markets subscribe to this rationale. However, waiting can be expensive. To acquire the remaining less than 50% of Genentech some 20 years after its initial investment required a price that was some 24 times higher than the initial investment, as uncertainty settled and the biotech startup turned out to be hugely successful. The use of a *real-options perspective* in making strategic investments has also been documented in nanotechnology, semiconductors, and other dynamic markets.[21]

ACCESS COMPLEMENTARY ASSETS. The successful commercialization of a new product or service often requires **complementary assets** such as marketing, manufacturing, and after-sale service.[22] In particular, new firms are in need of complementary assets to complete the value chain from upstream innovation to downstream commercialization. This implies that a new venture that has a core competency in R&D, for example, will need to access distribution channels and marketing expertise to complete the value chain. Building downstream complementary assets such as marketing and regulatory expertise or a sales force is often prohibitively expensive and time-consuming, and thus frequently it is not an option for new ventures.

complementary assets Assets such as marketing, manufacturing, and after-sales service that are needed to commercialize a new product or service successfully. They can be found upstream or downstream in the firm-level value chain.

Strategic alliances allow firms to match complementary skills and resources to complete the value chain. Moreover, licensing agreements enable the partners to benefit from a division of labor, allowing each to efficiently focus on its core competency. In comparison to other options of executing corporate strategy such as internal development or acquisitions, strategic alliances to match complementary assets frequently enhance the speed of commercialization.

The BioNTech-Pfizer Alliance: Speedy Development of the Most Successful Covid Vaccine. The development of the most successful Covid-19 vaccine is a case in point.[23] Prior to the Covid vaccine, the development of a new vaccine took years. One of the major vaccine developments prior to the Covid vaccine was the immunization for mumps, which took four years. Advances in biotechnology such as mRNA technology allowed a German biotech startup, BioNTech, to sketch out a Covid vaccine within days after the DNA sequence of the virus was published online. Lacking complementary assets to further develop the vaccine for manufacturing, testing, and distribution, BioNTech approached Pfizer. The small biotech startup and the giant multinational pharma company entered an exclusive licensing agreement, which allowed for the completion of the value chain from R&D to distribution by matching complementary assets.

Although the Covid-19 pandemic took off in the United States in the spring of 2020, by May of that year Pfizer was already testing the new vaccine on human volunteers. A few months later, in December 2020, Pfizer received emergency approval for use of the new vaccine from the Food and Drug Administration (FDA), a federal regulatory body. Final approval followed in 2021. The BioNTech and Pfizer Covid-19 vaccine turned out to be the most effective and most successful immunization available against the novel coronavirus. As a result, sales for the new BioNTech-Pfizer vaccine were $32 billion (in 2021).

LEARN NEW CAPABILITIES. Firms also enter strategic alliances because they are motivated by the desire to learn new capabilities from their partners.[24] When the collaborating firms are also competitors, *co-opetition* ensues that can lead to *learning races* in strategic alliances.[25]

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

learning races Situations in which both partners in a strategic alliance are motivated to form an alliance for learning, but the rate at which the firms learn may vary.

Co-opetition and Learning Races. **Co-opetition** is a portmanteau word describing cooperation by competitors. They may cooperate to create a larger pie but then might compete about how the pie should be divided. Such co-opetition can lead to **learning races** in strategic alliances,[26] a situation in which both partners are motivated to form an alliance for learning, but the rate at which the firms learn may vary. The firm that learns faster and accomplishes its goal more quickly has an incentive to exit the alliance or, at a minimum, to reduce its knowledge sharing. Because the cooperating firms are also competitors, learning races can have a positive effect on the winning firm's competitive position vis-à-vis its alliance partner.

NUMMI: The GM–Toyota Joint Venture. NUMMI (New United Motor Manufacturing, Inc.) was the first joint venture in the U.S. automobile industry, formed between GM and Toyota (in 1984). Recall from Chapter 8 that joint ventures are a special type of strategic alliance in which two partner firms create a third, jointly owned entity. In the NUMMI joint venture, each partner was motivated to learn new capabilities: GM entered the equity-based strategic alliance to learn the lean manufacturing system pioneered by Toyota to produce high-quality, fuel-efficient cars at a profit. Toyota entered the alliance to learn how to implement its lean manufacturing program with an American workforce. NUMMI was a test run for Toyota before building fully owned *greenfield plants* (new manufacturing facilities) in Alabama, Indiana, Kentucky, Mississippi, Texas, and West Virginia. In the 25-year history of the joint venture, GM and Toyota built some 7 million high-quality cars at the NUMMI plant. In fact, NUMMI was transformed from the worst performer (under GM ownership before the joint venture) to GM's highest-quality plant in the United States. In the end, as part of GM's bankruptcy reorganization during 2009–2010, it pulled out of the NUMMI joint venture. Toyota later sold the NUMMI plant to Tesla (as mentioned in Strategy Highlight 9.1).

The joint venture between GM and Toyota can be seen as a learning race. Who won? Strategy scholars argue that Toyota was faster in accomplishing its alliance goal—learning how to manage U.S. labor—because of its limited scope.[27] Toyota had already perfected lean manufacturing; all it needed to do was (1) learn how to train U.S. workers and suppliers in the method and (2) transfer this knowledge to its subsidiary plants in the United States. On the other hand, GM had to learn a completely new production system. GM was successful in transferring lean manufacturing to its newly created Saturn brand (which was discontinued in 2010 as part of GM's reorganization), but it had a hard time implementing lean manufacturing in its *existing* plants. These factors suggest that Toyota won the learning race with GM, which in turn helped Toyota gain and sustain a competitive advantage over GM in the U.S. market.

Also, note that different motivations for forming alliances are not necessarily independent and can be intertwined. For example, firms that collaborate to access critical complementary assets may also want to learn from one another to subsequently pursue vertical integration (see discussion of the smiley curve in Chapter 8). In sum, alliance formation is frequently motivated by leveraging economies of scale, scope, specialization, and learning.

GOVERNING STRATEGIC ALLIANCES

LO 9-3

Describe three alliance governance mechanisms and evaluate their pros and cons.

In Chapter 8, we showed that strategic alliances lie in the middle of the make-or-buy continuum (see Exhibit 8.5). Alliances can be governed by the following mechanisms:[28]

- Non-equity alliances
- Equity alliances
- Joint ventures

Exhibit 9.2 provides an overview of the key characteristics of the three alliance types, including their advantages and disadvantages.

NON-EQUITY ALLIANCES. The most common type of alliance is a **non-equity alliance**, which is based on contracts between firms. In a non-equity alliance, firms tend to share **explicit knowledge**—knowledge that can be codified. Patents, user manuals, fact sheets, and scientific publications are all ways to capture explicit knowledge, which concerns the notion of *knowing about* a certain process or product. The most common forms of non-equity alliances are *supply agreements, distribution agreements*, and *licensing agreements*. As suggested by their names, these contractual agreements are vertical strategic alliances, connecting different parts of the industry value chain.

non-equity alliance Partnership based on contracts between firms.

explicit knowledge Knowledge that can be codified; concerns knowing about a process or product.

Licensing agreements are contractual alliances in which the participants regularly exchange codified knowledge. In a licensing agreement, each partner focuses on its *comparative advantage* across the industry value chain. Startups frequently have an *invention advantage*, while established firms have an *innovation advantage*, which is an advantage in commercializing an invention. As such, this type of vertical arrangement is often described as a hand-off from the upstream partner to the downstream partner, and it is possible because the underlying knowledge is largely explicit and can be easily codified.

As a case in point, biotech firm Genentech licensed its newly developed drug Humulin (human insulin) to the pharmaceutical firm Eli Lilly for manufacturing, facilitating approval by the Food and Drug Administration (FDA), and distribution. This partnership is an example of a vertical strategic alliance: One partner (Genentech) focused on R&D upstream in the industry value chain, while the other partner (Eli Lilly) focused on manufacturing and distribution downstream in the industry value chain. When Humulin reached the market, it

EXHIBIT 9.2 Key Characteristics of Different Alliance Types

Alliance Type	Governance Mechanism	Frequency	Type of Knowledge Exchanged	Pros	Cons	Examples
Non-equity (supply, licensing, and distribution agreements)	Contract	Most common	Explicit	• Flexible • Fast • Easy to initiate and terminate	• Weak tie • Lack of trust and commitment	• BioNTech–Pfizer (exclusive) licensing agreement for Covid-19 vaccine • Microsoft–IBM (nonexclusive) licensing agreement for MS-DOS
Equity (purchase of an ownership stake or corporate venture capital investment, or investment in kind such as a plant and equipment)	Equity investment	Less common than non-equity alliances, but more common than joint ventures	Explicit; exchange of tacit knowledge possible	• Stronger tie • Trust and commitment can emerge • Window into new technology (option value)	• Less flexible • Slower • Can entail significant investments	• GM's equity investment in Lyft • Coca-Cola's equity investments in Monster and BodyArmor energy drinks
Joint venture (JV)	Creation of new entity by two or more parent firms	Least common	Both tacit and explicit knowledge exchanged	• Strongest tie • Trust and commitment likely to emerge • May be required by institutional setting	• Can entail long negotiations and significant investments • Long-term solution • JV managers have double reporting lines (2 bosses)	• Hulu, owned by Disney (67%) and Comcast (33%) • The A++ trans-Atlantic joint venture, owned by United Airlines, Lufthansa, and Air Canada

was the first approved genetically engineered human therapeutic drug worldwide.[29] Subsequently, Humulin became a billion-dollar blockbuster drug.

Because of their contractual nature, non-equity alliances are flexible and easy to initiate and terminate. However, because they can be temporary in nature, they also sometimes produce weak ties between the alliance partners, which can result in a lack of trust and commitment.

equity alliance Partnership in which at least one partner takes partial ownership in the other.

EQUITY ALLIANCES. In an **equity alliance**, at least one partner takes partial ownership in the other partner. Equity alliances are less common than contractual, non-equity alliances because they often require larger investments. Because they are based on partial ownership rather than contracts, equity alliances are used to signal stronger commitments. Moreover, equity alliances allow for the sharing of **tacit knowledge**—knowledge that cannot be codified.[30] Tacit knowledge concerns *knowing how* to do a certain task. It can be acquired only through actively participating in the process. In an equity alliance, therefore, the partners frequently exchange personnel to make the acquisition of tacit knowledge possible.

tacit knowledge Knowledge that cannot be codified; concerns knowing how to do a certain task and can be acquired only through active participation in that task.

Toyota used an equity alliance with Tesla (featured in ChapterCase 1 and Strategy Highlight 9.1) to learn new knowledge and gain a window into new technology. Toyota made a $50 million equity investment in the California startup (in 2010). In the same year, Tesla purchased the NUMMI plant in Fremont, California, where it now manufactures its high-end Models S/X. Tesla CEO Elon Musk stated, "The Tesla factory effectively leverages an ideal combination of hard-core Silicon Valley engineering talent, traditional automotive engineering talent, and the proven Toyota production system." Toyota in turn hopes to infuse its company with Tesla's entrepreneurial spirit. Toyota President Akio Toyoda commented, "By partnering with Tesla, my hope is that all Toyota employees will recall that 'venture business spirit' and take on the challenges of the future." President Toyoda hoped that a transfer of tacit knowledge would occur, in which Tesla's entrepreneurial spirit would reinvigorate the Japanese automaker.[31] This equity-based learning race ended in 2014 when Toyota sold its stake in Tesla.[32]

Another governance mechanism that falls under the broad rubric of equity alliances is **corporate venture capital (CVC)** investments, which are equity investments by established firms in entrepreneurial ventures.[33] The value of CVC investments is estimated to be in the double-digit billion-dollar range each year. Larger firms frequently have dedicated CVC units, such as Google Ventures, Siemens Venture Capital, Kaiser Permanente Ventures, and Johnson & Johnson Development Corp. Rather than hoping primarily for financial gains, as venture capitalists traditionally do, CVC investments create *real options* in terms of gaining access to new and potentially disruptive technologies.[34] Strategy scholars find that CVC investments have a positive impact on value creation for the investing firm, especially in high-tech industries such as semiconductors, computing, and medical devices.[35]

corporate venture capital (CVC) Equity investments by established firms in entrepreneurial ventures; CVC falls under the broader rubric of equity alliances.

Equity alliances tend to produce stronger ties and greater trust between partners than non-equity alliances do. They also offer a window into new technology that, like a real option, can be exercised if it is successful or abandoned if it is not promising. Equity alliances are frequently stepping-stones toward full integration of the partner firms either through a merger or an acquisition. Essentially, they are often used as a *try before you buy* strategic option.[36] The downside of equity alliances is the amount of investment that can be involved, as well as a possible lack of flexibility and speed in putting together and reaping benefits from the partnership.

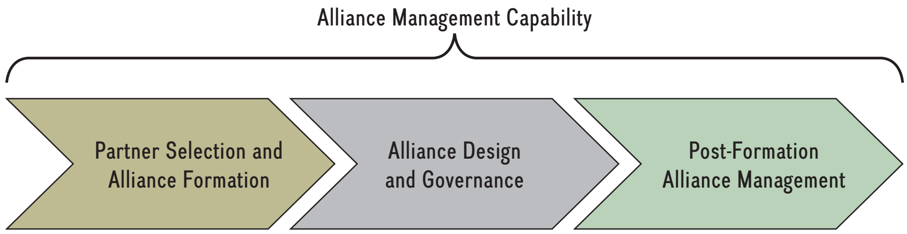
JOINT VENTURES. A *joint venture* (JV) is a standalone organization created and jointly owned by two or more parent companies (as discussed in Chapter 8). For example, Hulu (a streaming service) is jointly owned by Disney and Comcast. Because partners contribute equity to a JV, they are making a long-term commitment. Exchange of both explicit and tacit knowledge through interaction of personnel is typical.

Joint ventures are frequently used to enter international markets where the host country requires such a partnership for a foreign company (multinational enterprise [MNE]) to gain access to the market. In exchange for entering the foreign market, the host country expects the JV provides access for the domestic company to advanced technology and know-how from the MNE. In this scenario, the required JVs for market access function as forced technology transfer. JVs are the least common of the three types of strategic alliances.

The advantages of JVs are the strong ties, trust, and commitment that can result between the partners. However, JVs can entail long negotiations and significant investments. If the alliance doesn't work out as expected, undoing the JV can take some time and involve

EXHIBIT 9.3

Alliance Management Capability



considerable cost. A further risk is that knowledge shared with the new partner could be misappropriated by opportunistic behavior. Finally, any rewards from the collaboration must be shared between the partners.

LO 9-4

Describe the three phases of alliance management and explain how an alliance management capability can lead to a competitive advantage.

ALLIANCE MANAGEMENT CAPABILITY

Strategic alliances create a paradox for managers. Although alliances appear to be necessary to compete in many industries, between 30% and 70% of all strategic alliances do not deliver the expected benefits and are considered failures by at least one alliance partner.[37] Given the high failure rate, effective alliance management is critical to gaining and sustaining a competitive advantage, especially in high-technology industries.[38]

Alliance management capability is a firm's ability to effectively manage three alliance-related tasks concurrently, often across a portfolio of many different alliances (Exhibit 9.3):[39]

- Partner selection and alliance formation
- Alliance design and governance
- Post-formation alliance management

alliance management capability A firm's ability to effectively manage three alliance-related tasks concurrently: (1) partner selection and alliance formation, (2) alliance design and governance, and (3) post-formation alliance management.

PARTNER SELECTION AND ALLIANCE FORMATION. When strategic managers are making the business case for an alliance, the expected benefits of the alliance must exceed its costs. When one or more of the five reasons for alliance formation are present—to strengthen competitive position, enter new markets, hedge against uncertainty, access complementary resources, or learn new capabilities—the firm must select the best possible alliance partner. Partner compatibility and partner commitment are necessary conditions for successful alliance formation.[40] *Partner compatibility* captures aspects of cultural fit between different firms. *Partner commitment* concerns the willingness to make the necessary resources available and to accept short-term sacrifices to ensure long-term rewards.

ALLIANCE DESIGN AND GOVERNANCE. Once two or more firms agree to pursue an alliance, managers must then design the alliance and choose an appropriate governance mechanism from among the three options: non-equity contractual agreement, equity alliance, or joint venture. In a study of more than 640 alliances, researchers found that the joining of specialized complementary assets increases the likelihood that the alliance is governed hierarchically. This effect is stronger in the presence of uncertainties concerning the alliance partner as well as the envisioned tasks.[41]

In addition to the formal governance mechanisms, *interorganizational trust* is a critical dimension of alliance success.[42] Because all contracts are necessarily incomplete, trust between the alliance partners plays an important role in effective post-formation alliance management. Effective governance, therefore, can be accomplished only by skillfully combining formal and informal mechanisms.

POST-FORMATION ALLIANCE MANAGEMENT. The third phase in a firm's alliance management capability concerns the ongoing management of the alliance. To be a source of

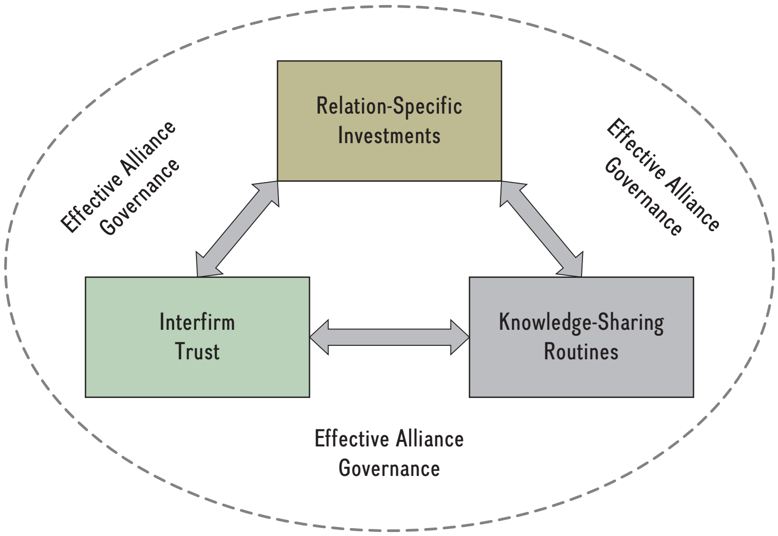


EXHIBIT 9.4

How to Make Alliances Work

Source: Author's adaptation from J.H. Dyer and H. Singh (1998), "The relational view: Cooperative strategy and the sources of intraorganizational advantage," *Academy of Management Review* 23: 660–679.

competitive advantage, the partnership needs to create resource combinations that obey the VRIO criteria. As shown in Exhibit 9.4, the alliance partners can make an alliance work if they *make relation-specific investments, establish knowledge-sharing routines*, and *build interfirm trust*.[43]

Trust is a critical aspect of any alliance. Interfirm trust entails the expectation that each alliance partner will behave in good faith and develop norms of reciprocity and fairness.[44] Such trust helps ensure that the relationship survives and thereby increases the possibility of achieving the goals of the alliance. Interfirm trust is also important for fast decision making.[45] Several firms, including Eli Lilly, HP, Procter & Gamble, and IBM, compete to obtain trustworthy reputations in order to become the alliance partner of choice for small technology ventures, universities, and individual inventors.

Indeed, the systematic differences in firms' alliance management capability can be a source of competitive advantage.[46] But how do firms build alliance management capability? They do so by building capability through repeated experiences over time. In other words, they *learn by doing*. Several empirical studies have shown that firms move down the learning curve (see Section 6.3) and become better at managing alliances through repeated alliance exposure.[47]

The *learning-by-doing* approach has value for small ventures in which a few key people coordinate most of the firms' activities.[48] However, there are clearly limitations for larger companies. Conglomerates such as ABB, GE, Philips, or Siemens are engaged in hundreds of alliances simultaneously. In fact, if alliances are not managed from a *portfolio perspective* at the corporate level, serious negative repercussions can emerge.[49] For example, Groupe Danone, a large French food conglomerate, lost its leading position in the highly lucrative and fast-growing Chinese market because its local alliance partner, Hangzhou Wahaha Group, terminated the long-standing alliance.[50] Wahaha accused different Danone business units of subsequently setting up partnerships with other Chinese firms that were a direct competitive threat to Wahaha. This example makes it clear that although alliances are important pathways by which to pursue business-level strategy, they are best managed as a portfolio of alliances at the corporate level.

To accomplish effective alliance management, strategy scholars suggest that firms create a *dedicated alliance function*,[51] led by a vice president or director of alliance management and endowed with its own resources and support staff. The dedicated alliance function should be given the task of coordinating all alliance-related activity in the entire organization, taking a corporate-level perspective. It should serve as a repository of prior experience and be responsible for creating processes and structures to teach and leverage that experience and related knowledge throughout the rest of the organization across all levels. Research shows that firms with a dedicated alliance function are able to create value from their alliances above and beyond what could be expected based on experience alone.[52]

Pharmaceutical company Eli Lilly is an acknowledged leader in alliance management.[53] Lilly's Office of Alliance Management, led by a director and endowed with several full-time positions, manages its far-flung alliance activity across all hierarchical levels and around the globe. Lilly's process prescribes that each alliance is managed by a three-person team: an alliance champion, alliance leader, and alliance manager.

- The *alliance champion* is a senior, corporate-level executive responsible for high-level support and oversight. This senior manager is also responsible for making sure that the alliance fits within the firm's existing alliance portfolio and corporate-level strategy.
- The *alliance leader* has the technical expertise and knowledge needed for the specific technical area and is responsible for the day-to-day management of the alliance.
- The *alliance manager*, positioned within the Office of Alliance Management, serves as an alliance process resource and business integrator between the two alliance partners and provides alliance training and development, as well as diagnostic tools.

Some companies are able to leverage the relational capabilities obtained through managing alliance portfolios into a successful acquisition strategy.[54] Eli Lilly has an entire department at the corporate level devoted to managing its alliance portfolio. Following up on an earlier 50/50 joint venture formed with ICOS, maker of the $2 billion-plus (in annual revenues) erectile-dysfunction drug Cialis, Lilly acquired ICOS in 2007. Just a year later, Eli Lilly outmaneuvered Bristol-Myers Squibb to acquire biotech venture ImClone for $6.5 billion. ImClone discovered and developed the cancer-fighting drug Erbitux, also a $1 billion blockbuster in terms of annual sales. The acquisition of these two smaller biotech ventures allowed Lilly to address its problem of an empty drug pipeline.[55]

LO 9-5

Differentiate between mergers and acquisitions, and explain why firms use them to execute corporate strategy.

9.3 Mergers and Acquisitions

A popular vehicle for executing corporate strategy is mergers and acquisitions (M&A). Hundreds of M&As occur each year, with a cumulative value in the trillions of dollars.[56] Although the terms are often used interchangeably, and usually in tandem, mergers and acquisitions are, by definition, distinct from each other. A **merger** is the joining of two independent companies to form a *combined entity*. Mergers tend to be friendly; in mergers, the two firms agree to join in order to create a combined entity. In the live event-promotion business, for example, Live Nation merged with Ticketmaster.

An **acquisition** is the purchase or takeover of one company by another. Acquisitions can be friendly or unfriendly. For example, Disney's acquisition of Pixar was a friendly one, in which both strategic leadership teams believed that joining the two companies was a good idea. When a target firm does not want to be acquired, the acquisition is considered a **hostile takeover**. British telecom company Vodafone's acquisition of Germany-based Mannesmann, a diversified conglomerate with holdings in telephony and internet services, at an estimated

merger The joining of two independent companies to form a combined entity.

acquisition The purchase or takeover of one company by another; can be friendly or unfriendly.

hostile takeover Acquisition in which the target company does not wish to be acquired.

value of $180 billion (equal to $300 billion, inflation-adjusted), was a hostile one. It was also the largest takeover in corporate history.

In defining mergers and acquisitions, size can matter as well. The combining of two firms of comparable size is often described as a merger, even though it might in fact be an acquisition. For example, the integration of Daimler and Chrysler was pitched as a merger, though in reality Daimler acquired Chrysler and later sold it. After emerging from bankruptcy restructuring, Chrysler is now majority owned by Fiat, an Italian auto manufacturer.

In contrast, when large, incumbent firms such as GE, Cisco, Alphabet, Meta, or Microsoft buy start-up companies, the transaction is generally described as an acquisition. Although there is a distinction between mergers and acquisitions, many observers simply use the umbrella term *mergers and acquisitions,* or M&A.

WHY DO FIRMS MERGE WITH COMPETITORS?

LO 9-6

Define horizontal integration and evaluate the advantages and disadvantages of this option to execute corporate-level strategy.

In contrast to vertical integration, which refers to the number of activities in which a firm participates up and down the industry value chain (as discussed in Chapter 8), **horizontal integration** is the process of merging with a competitor at the same stage of the industry value chain. Horizontal integration is a type of corporate strategy that can improve a firm's strategic position in a single industry. As a rule, firms should go ahead with horizontal integration (i.e., acquiring a competitor) *if the target firm is more valuable inside the acquiring firm than as a continued standalone company*. In other words, the net value creation of a horizontal acquisition must be positive and aid the acquiring firm in gaining and sustaining a competitive advantage.

horizontal integration The process of merging with competitors, leading to industry consolidation.

An industry-wide trend toward horizontal integration leads to *industry consolidation*. Competitors in the airline, automotive, banking, telecommunications, pharmaceuticals, and health insurance industries frequently merge to respond to changes in their external environment and to change the underlying industry structure in their favor.

There are three main benefits to a horizontal integration strategy:

- Reduction in competitive intensity
- Lower costs
- Increased differentiation

Exhibit 9.5 previews the sources of value creation and costs in horizontal integration, which we discuss next.

REDUCTION IN COMPETITIVE INTENSITY. Let's look at horizontal integration through the lens of Porter's five forces model with a focus on rivalry among competitors (introduced in Chapter 3). Horizontal integration changes the underlying industry structure in favor of the surviving firms. Excess capacity is taken out of the market, and competition tends to decrease, assuming no new entrants. As a whole, the industry structure becomes more consolidated and potentially more profitable. If the surviving firms find themselves in an

EXHIBIT 9.5 Sources of Value Creation and Costs in Horizontal Integration

Corporate Strategy	Sources of Value Creation (V)	Sources of Costs (C)
Horizontal integration through M&A	• Reduction in competitive intensity • Lower costs • Increased differentiation	• Integration failure • Reduced flexibility • Increased potential for legal repercussions

oligopolistic industry structure and maintain a focus on non-price competition (e.g., focus on R&D spending, customer service, or advertising), the industry can indeed be quite profitable, and rivalry will likely decrease among existing firms.

For example, the wave of recent horizontal integration in the U.S. airline industry provided several benefits to the surviving carriers. By reducing excess capacity, the mergers between Delta and Northwest Airlines, United Airlines and Continental, Southwest and AirTran, and American and US Airways lowered competitive intensity in the industry overall.

Horizontal integration can favorably affect several of Porter's five forces for the surviving firms: strengthening bargaining power vis-à-vis suppliers and buyers, reducing the threat of entry, and reducing rivalry among existing firms. Because of the potential to reduce the competitive intensity in an industry, government authorities such as the Federal Trade Commission (FTC) in the United States or the European Commission usually must approve any large horizontal integration activity. Industry dynamics, however, are in constant flux as new competitors emerge and others fall by the wayside.

Antitrust Considerations and Horizontal Integration in the Office Supply Industry. Over the past decade, the office supply industry in the United States has undergone a wave of horizontal integration. Initially, the FTC did not approve a proposed merger between Staples and Office Depot (in 1997), arguing that the remaining industry would have only two competitors, with Office Max being the other. Staples and Office Depot argued that the market for office supplies needed to be defined more broadly to include large retailers such as Walmart and Target. The U.S. courts sided with the FTC, which argued that the prices for end consumers would be significantly higher if the market had only two large big-box retailers that specialize in a given category such as office supplies.[57]

However, a few years later, the competitive landscape had shifted as Walmart and Amazon had emerged as ferocious competitors offering rock-bottom prices for office supplies. Subsequently, in 2013, the FTC approved a merger between Office Depot and Office Max. Just two years later, Staples attempted to acquire the now much larger Office Depot, but the FTC blocked the proposed merger under antitrust grounds because of the resulting industry consolidation. The issue was no longer consumer choice or retail prices but rather the fact that Staples and Office Depot, at the time, were the only national chains capable of supplying the office needs for large Fortune 500 customers. Staples challenged FTC's decision in court, but the judge sided with the FTC.

In 2022, Office Depot remains a publicly traded company with some 1,100 stores in the United States. Staples was bought out by a private equity firm (in 2017) and thus taken private. It was split up into three businesses (as of 2022): U.S. retail operation (1,000 stores), Canadian retail operation (300 stores), and the business-to-business operation that supplies large Fortune 500 firms with office supplies.[58]

LOWER COSTS. Firms use horizontal integration to lower costs through economies of scale and to enhance their economic value creation, and in turn their performance.[59] In industries that have high fixed costs, achieving economies of scale through large output is critical in lowering costs.

For example, the dominant pharmaceutical companies, such as Pfizer, Roche, and Novartis, maintain large sales forces ("detail people") who call on doctors and hospitals to promote the companies' products. These specialized sales forces often number 10,000 or more and thus are a significant fixed cost to the firms, even though part of their compensation is based on commissions. Maintaining such a large and sophisticated sales force (many with MBAs) is costly if the firm has only a few drugs it can show the doctor. As a rule of thumb, if a pharma company does not possess a blockbuster drug that brings in more than

$1 billion in annual revenues, it cannot maintain its own sales force.[60] When existing firms such as Pfizer and Wyeth merge, they join their drug pipelines and portfolios of existing drugs. They are likely to have one sales force for the combined portfolio, consequently reducing the size of the sales force and lowering the overall cost of distribution.

INCREASED DIFFERENTIATION. Horizontal integration through M&A can help firms strengthen their competitive positions by increasing the differentiation of their product and service offerings. In particular, horizontal integration can achieve this goal by filling gaps in a firm's product offering, allowing the combined entity to offer a complete suite of products and services.

As an example, Disney acquired Marvel for $4 billion (in 2009). This acquisition certainly allowed Disney to further differentiate its product offering, in that an entire new lineup of superheroes was joining Mickey's family, and Disney became able to offer Marvel superhero-themed rides and merchandise, such as clothing and toys. The Marvel acquisition passed an important test of value creation because Marvel is seen as more valuable inside Disney than outside Disney.[61] Because of economies of scope and economies of scale, the same argument could be made for other recent Disney acquisitions, including Pixar (acquired for $7.4 billion in 2006), Lucasfilm (acquired for $4 billion in 2012), and 21st Century Fox (acquired for $70 billion in 2019).

WHY DO FIRMS ACQUIRE OTHER FIRMS?

LO 9-7

Explain why firms engage in acquisitions.

When defining terminology, we noted that an *acquisition* is the purchase or takeover of one company by another. Why do firms make acquisitions? Three main reasons stand out:

- Access to new markets and distribution channels
- Access to a new capability or competency
- Strategic preemption

ACCESS TO NEW MARKETS AND DISTRIBUTION CHANNELS. Firms may resort to acquisitions when they need to overcome entry barriers into markets in which they are currently not competing or to access new distribution channels. Strategy Highlight 9.2 discusses Kraft's history with aggressive acquisitions, both successful and otherwise, in this regard.

ACCESS TO A NEW CAPABILITY OR COMPETENCY. Firms often resort to M&A to obtain new capabilities or competencies. For example, to strengthen its capabilities in server systems and equipment and to gain access to the capability of designing mobile chips for the internet of things, Intel acquired Altera for $17 billion (in 2015). To access new capabilities in cloud computing and virtualization software in the B2B (business-to-business) market, the semiconductor firm Broadcom acquired VMware for $61 billion (in 2022).[63]

STRATEGIC PREEMPTION. *Strategic preemption* refers to a desired reduction in competitive intensity as a motivation to acquire. While the motivation to reduce competitive intensity leads to the integration of *existing* competitors through mergers, the motivation of strategic preemption—as its name suggests—is to integrate *potential* competitors through acquisitions. In strategic preemption, incumbent firms acquire promising startups that have the potential to be a competitive threat before this potential is fully realized. Strategic preemption affords two advantages:

1. The acquiring firm removes a potential competitor.
2. The acquiring firm preempts existing competitors from buying the startup.

Strategy Highlight 9.2

Kraft Heinz: From Specializing in Hostile Takeovers to Eating Humble Pie

One firm that pursues acquisitions aggressively is Kraft, a behavior that can be traced through the years. Kraft Foods bought UK-based Cadbury PLC for close to $20 billion in a hostile takeover (in 2010). Unlike the more diversified food-products company Kraft, Cadbury was focused solely on candy and gum. Hailing back to 1824, Cadbury established itself in markets across the globe, in concert with the British Empire.

Kraft was attracted to Cadbury because of its strong position in fast-growing countries such as India, Egypt, Thailand, and many Latin American countries. Cadbury held 70% of the market share for chocolate in India, with its population of more than 1 billion people. Children there specifically ask for "Cadbury chocolate" instead of just plain "chocolate." It is difficult for outsiders like Kraft to break into emerging economies because earlier entrants have developed and perfected their distribution systems to meet the needs of millions of small, independent vendors. To secure a strong strategic position in these fast-growing emerging markets, therefore, Kraft felt that horizontal integration with Cadbury was critical. In global markets Kraft continues to face formidable competitors such as Nestlé and Mars, which are both especially strong in China.

A "Cadbury loyalist" strongly opposes Kraft's acquisition of the company, which has symbolic value in the United Kingdom.

PAUL ELLIS/AFP/Getty Images

We can see Kraft's approach even in its divisions. To focus its different strategic business units more effectively and to reduce costs, Kraft Foods restructured in 2012. It separated its North American grocery-food business from its global snack-food and candy business (including Oreos and Cadbury chocolate), which is now Mondelez International. In 2015, Kraft Foods merged with Heinz (owned by Warren Buffett's Berkshire Hathaway and 3G Capital, a Brazilian hedge fund) in a $37 billion merger, creating the fifth-largest food company in the world, behind Nestlé, Mondelez, PepsiCo, and Unilever.

In the U.S. market, the Cadbury acquisition allows Mondelez greater access to convenience stores, gives it a new distribution channel, and opens a fast-growing market that tends to have high profit margins. Mondelez, which does not directly compete in the United States, licenses its famous Oreo cookie to its subsidiary Nabisco. Moreover, Mondelez licenses the sale of Cadbury chocolate to The Hershey Co., which was founded in 1894 and is now the largest U.S. chocolate manufacturer.

Hershey's main strategic focus is squarely on its home market. However, with the U.S. population growing slowly and becoming more health conscious, Hershey decided in 2013 to enter the Chinese market, the world's fastest-growing candy market. In its long history, Hershey's entry into China was accomplished by its first new product launch ever outside the United States. However, Hershey's sales growth in China has been disappointing. As a result of its unsatisfactory performance in China combined with little or no growth in the United States, Hershey had to cut jobs in recent years.

Inheriting a penchant for hostile takeovers from its parent Kraft Foods, Mondelez saw an opportunity. Spotting a weakness in The Hershey Co., Mondelez made an unsolicited takeover offer to buy the U.S. chocolate maker for some $23 billion in 2016. The goal was to create the world's largest candymaker. But Hershey's board rebuffed the Mondelez takeover bid unanimously. The Hershey Co. is owned by the Hershey Trust, which was established by Milton Hershey some 125 years ago.

The trust's main beneficiary is a school for underprivileged children in Hershey, Pennsylvania, the company's hometown and its namesake.

Continuing its preference for hostile takeovers, in 2017 Kraft Heinz made a whopping $143 hostile takeover bid for Unilever, a British-Dutch consumer goods company. The intent was to merge the world's two largest packaged-food companies. However, Unilever's then-CEO Paul Polman made it clear that Unilever, a multinational with a strong focus on creating shared value, was not interested in pursuing any merger talks with Kraft Heinz. Unilever's shareholders rebuffed Kraft's takeover bid because they viewed it as undervaluing Unilever substantially, and they saw no financial or strategic merit in merging the two companies.

Once the aggressive suitor of rivals through unsolicited takeover bids, by 2019 Kraft Heinz had fallen on hard times. Critics claim that its focus on relentless cost-cutting may have prevented the company from recognizing, adapting to, and profiting from changing customer preferences. In particular, they point the finger at "zero-based budgeting" as a root cause of Kraft Heinz's problems. In zero-based budgeting, managers start off each year with a clean slate and have to justify all projected expenses and financial results. Providing the executive leadership team of Kraft Heinz, 3G Capital pursues zero-based budgeting with religious fervor. The problem, critics assert, is that with this type of cost control, new innovative projects often don't cross the required financial hurdles and are shut down prematurely. In contrast, a real options approach (that is, investing to gain more information about the future potential of projects as time unfolds) is used by many Kraft Heinz competitors such as Unilever, PepsiCo, and Nestlé, which have fared significantly better in the recent past.

As a consequence of these troubles, Kraft Heinz's market cap has fallen from a high of over $160 billion in 2016 to $46 billion in 2022, losing $114 billion (over 70%) of its valuation. In recent years, Kraft Heinz has experienced a sustained competitive disadvantage vis-à-vis its competitors. To accomplish a turnaround of the once-mighty Kraft Heinz, Miguel Patricio was appointed as CEO (in 2019); he comes from AB InBev, the world's largest beer brewer, which is also owned in part by 3G Capital.[62]

Meta Platforms. Facebook's parent, Meta Platforms, has been a serial acquirer over the past few years, buying some 80 tech startups.[64] To preempt rivals, Meta has spent more than $25 billion since 2012 buying promising startups. It acquired, among others, Instagram, a photo- and video-sharing site, for $1 billion (in 2012). Meta then went on to buy the text messaging service startup WhatsApp for $22 billion (in 2014), making it one of the largest tech acquisitions ever. In the same year, Meta paid $2 billion to acquire Oculus, a virtual reality (VR) firm.

This acquisition spree led to antitrust investigation by the U.S. Federal Trade Commission (FTC) to determine if Meta was attempting to head off startups that could one day pose a competitive threat. As a consequence of its investigation, the FTC filed a lawsuit against Meta in 2020, alleging that the company achieved dominance in social media by a multi-year acquisition spree motivated by anticompetitive conduct. As remedies, the FTC demands that Meta spin out the photo-sharing site Instagram and messaging service WhatsApp. Antitrust lawsuits take years to be adjudicated.

Alphabet. Alphabet's Google has also made a string of acquisitions of new ventures to preempt rivals. Google bought YouTube, the video-sharing website, for $1.65 billion (in 2006). Google engaged in a somewhat larger acquisition when it bought Motorola's cell phone unit for $12.5 billion (in 2011) to gain access to Motorola's valuable patent holdings in mobile technology. Google later sold the cell phone unit to Lenovo while retaining Motorola's patents. Next, Google purchased the Israeli start-up company Waze for

$1 billion (in 2013). Google acquired Waze to gain access to a new capability and to prevent rivals from gaining access. Waze's claim to fame is its interactive mobile map app. Google is already the leader in online maps and wanted to extend this capability to mobile devices. Perhaps even more importantly, Google wanted to preempt Apple and Facebook from buying Waze. Apple and Facebook are each comparatively weaker than Google in the increasingly important interactive mobile map and information services segment.

Google then purchased the UK-based technology startup DeepMind for $625 million (in 2014) to enhance its competitive position in artificial intelligence. This move prevented others, such as Facebook or Amazon, from acquiring DeepMind, which made headlines (in 2016) when its AI-based AlphaGo program beat the reigning Go world champion, the South Korean Lee Sedol.

As a consequence of Alphabet's serial acquisitions of startups, the U.S. Department of Justice (DOJ) sued the tech conglomerate (in 2020) for alleged antitrust violations. Although the DOJ has yet to propose specific remedies, it argues that Google's dominance in online search (over 90% market share in mobile searches) equates to a monopoly that is harmful to competition. As in Meta's antitrust suit, it can be years before the lawsuit is adjudicated.

LO 9-8

Evaluate whether mergers and acquisitions lead to competitive advantage.

M&A AND COMPETITIVE ADVANTAGE

Do mergers and acquisitions create competitive advantage? Despite their popularity, the answer, surprisingly, is that in most cases they do not. In fact, the M&A performance track record is rather mixed. Many mergers destroy shareholder value because the anticipated synergies never materialize.[65] Examples of mergers that destroyed significant shareholder value (as measured one year after the deal closed) include Bayer–Monsanto (down 47%), Bank of America–Countrywide (down 45%), Alcatel–Lucent (down 39%), AOL–Time Warner (down 37%), and Spring–Nextel (down 30%).

If shareholder value is created, it generally accrues to the shareholders of the firm that was taken over (the acquiree) because acquirers often pay a premium when buying the target company.[66] Indeed, sometimes companies get involved in a bidding war for an acquisition; the winner may end up with the prize but may have overpaid for the acquisition—thus falling victim to the *winner's curse*.

Given that mergers and acquisitions, *on average*, destroy rather than create shareholder value, why do we see so many mergers? Reasons include:

- Principal-agent problems.
- The desire to overcome competitive disadvantage.
- Superior acquisition and integration capability.

PRINCIPAL-AGENT PROBLEMS. When discussing diversification in the previous chapter, we noted that some firms diversify through acquisitions due to principal-agent problems (refer to the Chapter 8 discussion of managerial motives behind firm growth).[67] Managers, as agents, are supposed to act in the best interest of the principals, the shareholders. However, managers may have incentives to grow their firms through acquisitions—not for anticipated shareholder value appreciation, but to build a larger empire, which is positively correlated with prestige, power, and pay. In addition to providing higher compensation and more corporate perks, a larger organization may also provide more job security, especially if the company pursues unrelated diversification.

Oatmeal: BirchTree/Alamy Stock Photo; Snapple: George W. Bailey/Shutterstock

A related problem is **managerial hubris**, a form of self-delusion in which managers convince themselves of their superior skills in the face of clear evidence to the contrary.[68] Managerial hubris comes in two forms:

1. Managers of the acquiring company convince themselves that they are able to manage the business of the target company more effectively and, therefore, that they are able to create additional shareholder value. This belief is often used to justify an unrelated diversification strategy.
2. Although most top-level managers are aware that the majority of acquisitions destroy rather than create shareholder value, they consider themselves the exceptions to the rule.

managerial hubris A form of self-delusion in which managers convince themselves of their superior skills in the face of clear evidence to the contrary.

Managerial hubris has led to many ill-fated deals, destroying billions of dollars in value. For example, Quaker Oats Co. acquired Snapple because its managers used *reasoning by analogy* to argue that the Snapple acquisition was like their previous successful acquisition of Gatorade (see biases in strategic decision making in Chapter 2).[69] The difference was that Gatorade had been a standalone company and was easily integrated, but Snapple relied on a decentralized network of independent distributors and retailers that did not want Snapple to be taken over and made it difficult and costly for Quaker Oats to integrate Snapple. The acquisition failed—and Quaker Oats itself was taken over by PepsiCo. Snapple was spun out and eventually ended up being part of the Dr. Pepper Snapple Group.

THE DESIRE TO OVERCOME COMPETITIVE DISADVANTAGE. In some instances, mergers are not motivated by gaining competitive advantage but by an attempt to overcome a competitive disadvantage. For example, to compete more successfully with Nike (the worldwide leader in sports shoes and apparel), Adidas (number two) acquired Reebok (number three) for $3.8 billion (in 2006). This acquisition allowed the now-larger Adidas group to benefit from economies of scale and scope that were unachievable when Adidas and Reebok operated independently. The hope was that this acquisition would help in overcoming Adidas' competitive disadvantage vis-à-vis Nike. However, the Reebok acquisition failed, and Adidas sold Reebok to a private equity firm for a mere $100 million (in 2017).

SUPERIOR ACQUISITION AND INTEGRATION CAPABILITY. Acquisition and integration capabilities are not equally distributed across firms. Although there is strong evidence that M&As, *on average*, destroy rather than create shareholder value, it does not exclude the possibility that *some* firms are consistently able to identify, acquire, and integrate target companies to strengthen their competitive positions. Because it is valuable, rare, and difficult to imitate, a superior acquisition and integration capability, together with past experience, can lead to competitive advantage.

Disney has shown superior post-merger integration capabilities after acquiring Pixar, Marvel, Lucasfilm, and 21st Century Fox. Disney managed its new subsidiaries more like alliances than attempting full integration, which could have destroyed the unique value of the acquisitions. In Pixar's case, Disney kept the entire creative team in place and allowed its members to continue to work in Pixar's headquarters near San Francisco with minimal interference. This hands-off approach has paid huge dividends: Although Disney paid a steep $7.4 billion for Pixar, it made some $10 billion on Pixar's *Toy Story 3* franchise revenues alone. As a consequence, Disney has gained a competitive advantage over its rivals such as Sony (with Columbia Pictures), Comcast (with NBCUniversal), and Warner Bros. Discovery.

9.4 Implications for Strategic Leaders

The business environment is constantly changing.[70] New opportunities come and go quickly. Firms often need to develop new resources, capabilities, or competencies to take advantage of opportunities. Examples abound. Traditional book publishers must transform themselves into digital content companies. Old-line banking institutions with expensive networks of branches must now offer seamless online banking services, and they must make them work between a set of traditional and nontraditional payment services on a mobile platform. Energy providers are in the process of changing their coal-fired power plants to gas-fired ones in the wake of the shale gas boom. Moreover, energy providers are challenged by social pressures and potential legislation to transition more aggressively toward renewable energy such as wind and solar power. Pharmaceutical companies need to take advantage of advances in biotechnology and genomics to meet the needs of patients. Food companies are now expected to offer organic, all-natural, and gluten-free products.

The strategic leader also knows that firms need to grow to survive and prosper, especially if they are publicly traded stock companies. A firm's corporate strategy is critical in pursuing profitable growth. To be able to grow as well as gain and sustain a competitive advantage, a firm must not only possess VRIO resources but also leverage existing resources, often in conjunction with partners, and build new ones. The question of how to build new resources, capabilities, and competencies to grow the enterprise lies at the center of corporate strategy. Strategic alliances, mergers, and acquisitions are the key tools that the strategist uses in executing corporate strategy.

Ideally, the tools to implement corporate strategy—strategic alliances and acquisitions—should be centralized and managed at the corporate level, rather than at the level of the strategic business unit. This allows the company not only to assess their effect on the overall company performance, but also to harness spillovers between the different corporate development activities. That is, corporate-level managers should not only coordinate the firm's portfolio of alliances but also leverage their relationships to successfully engage in mergers and acquisitions.[71] Rather than focusing on developing an alliance management capability in isolation, firms should develop a *relational capability* that allows for the successful management of strategic alliances *and* M&As. In sum, to ensure a positive effect on competitive advantage, the management of strategic alliances and M&As needs to be placed at the corporate level.

We now have concluded our discussion of corporate strategy. Acquisitions and alliances are key vehicles to execute corporate strategy, each with its distinct advantages and disadvantages. Strategic alliances, as well as M&As, are a global phenomenon. In the next chapter, we discuss strategy in a global world.

CHAPTERCASE 9 Part II

To compete more effectively against market leader Uber, Lyft entered strategic alliances with GM and Alphabet's Waymo. In particular, Lyft and its powerful partners joined these alliances to strengthen Lyft's competitive position vis-à-vis Uber, enter new markets, hedge against uncertainty, and learn new capabilities (as discussed in Part I).

However, the Lyft-GM-Waymo partnerships were also motivated by three other strategic considerations: access to complementary assets, the "try before you buy" option, and learning races.

Access Complementary Assets. Another strategic reason Lyft entered alliances is access to critical complementary assets. Both Lyft and GM bring complementary assets to bear in this alliance. GM has upstream core competencies in manufacturing cost-competitive and reliable vehicles at a large scale. Lyft, in turn, has downstream competencies as the second-largest mobile transportation network in North America. As such, Lyft generates a large amount of data that allow it to deploy AI to develop proprietary algorithms to meet riders' needs by providing cars at the right time and at the right price.

In addition, Alphabet's Waymo is an early leader in autonomous vehicle development. However, in driverless car technology, Waymo lags Tesla in terms of miles driven. In addition to Tesla owners accruing mileage by driving the cars themselves, they also accrue mileage by using Tesla's autopilot feature—allowing Tesla to rack up billions of miles. As more miles are accrued, more data are collected, which allows the self-driving software to learn and update, making the autopilot feature even better. In addition, Tesla is planning to roll out a fleet of robo-taxis (full self-driving Tesla vehicles) in 2024, contingent upon regulatory approval. This rollout will further increase Tesla's wealth of data accrued through the miles driven by its vehicles. Tesla has 1,000 times more miles driven with its autopilot than Waymo.

Much like Google's Android mobile operating system for phones, Waymo provides the software that is the brains behind the self-driving car technology but lacks an opportunity for large-scale deployment, which constrains testing and learning. The alliance with Lyft allows Waymo to deploy its self-driving car technology on a large scale. One envisioned future is to create a fleet of autonomous GM vehicles on Lyft's network, driving with Waymo's autopilot technology.

Try Before You Buy. GM's strategic partnership with Lyft could be the first step in acquiring Lyft. GM already owns close to 7% of Lyft as a result of its $500 million equity investment made (pre-IPO) in 2016. This equity investment is a *try before you buy* strategic option because it allows GM to obtain private information about how Lyft operates, and it buys GM time to see how Lyft and the industry and technology develop over time.

A further expansion of the Lyft and GM alliance could include GM's subsidiary Cruise, an autonomous vehicle tech company. In this scenario, Lyft provides the ride-hailing platform (match riders with drivers in geographic space and time), Cruise supplies the technology for driverless shuttles like the Origin, and GM manufacturers the robo-taxi at a large scale and thus low unit cost. GM may also buy Lyft and merge it with Cruise. The partnerships would morph into an integrated robo-taxi service, with GM owning the ride-sharing platform (from Lyft) and the autonomous vehicle technology (from Cruise) while manufacturing purpose-built robo-taxis such as the Origin. Here, the end result for GM would be akin to a strategic initiative by Tesla to create a fleet of robo-taxis, announced as part of its Strategic Plan, Part Deux (see ChapterCase 1).

Learning Race. An alternative future between Lyft and GM may play out as a learning race. In this scenario, GM may want to learn from Lyft how to run a ride-sharing platform for mobility services. Once this goal is accomplished, GM may roll out its own ride-hailing service using autonomous vehicles designed by its subsidiary, Cruise. In this future, GM envisions tens of thousands of robo-taxis in its fleet to launch the new service. Indeed, GM already announced that it plans to offer rides in its robo-taxis for as little as $1 to $1.50 per mile, while the going rate for Uber and Lyft is about $5 a mile in urban centers such as San Francisco.

Questions

1. Describe the reasons Lyft entered strategic alliances with GM and Waymo. Are some reasons more important than others? Explain.
2. GM invested $500 million in Lyft (in 2016) to buy a minority ownership stake. What are some possible reasons GM entered an equity alliance with Lyft? Are there any reasons GM would prefer Lyft over Uber as an alliance partner? Explain.

3. What are some possible reasons Waymo entered an alliance with Lyft? Are there any reasons Waymo would prefer Lyft over Uber as an alliance partner? Explain.
4. Uber is a much larger and more valuable firm than Lyft. Uber is also more diversified in that it offers services beyond ride-hailing. Indeed, its initial service of ride-hailing now generates less than 50% of Uber's revenues, while Uber Eats (food delivery) generates most of Uber's revenues (post-pandemic). Do you think the strategic alliances with GM and Waymo could help Lyft to overcome Uber's lead? Can you think of other reasons Lyft could end up as the winner in the mobile transportation network competition? Explain.
5. Evaluate Lyft's overall alliance strategy and weigh the benefits against the risks. What are some of the potential negative effects that might emerge for Lyft as part of its strategy to partner with much larger and more resource-rich companies such as Alphabet (via its Waymo subsidiary) and GM?

TAKE-AWAY CONCEPTS

This chapter discussed two mechanisms of corporate-level strategy—alliances and acquisitions—as summarized by the following learning objectives and related take-away concepts.

LO 9-1 / Apply the Build-Borrow-Buy framework to guide corporate strategy.

- The Build-Borrow-Buy framework provides a conceptual model that aids strategists in deciding whether to pursue internal development *(build)*, enter a contract arrangement or strategic alliance *(borrow)*, or acquire new resources, capabilities, and competencies *(buy)*.
- Firms that are able to learn how to select the right pathways to obtain new resources are more likely to gain and sustain a competitive advantage.

LO 9-2 / Define strategic alliances, explain why firms enter into them, and summarize why they are important to implement corporate strategy.

- Strategic alliances have the goal of sharing knowledge, resources, and capabilities to develop processes, products, or services.
- An alliance qualifies as strategic if it has the potential to affect a firm's competitive advantage by increasing value and/or lowering costs.
- The most common reasons firms enter alliances are to (1) strengthen competitive position, (2) enter new markets, (3) hedge against uncertainty, (4) access complementary resources, and (5) learn new capabilities.

LO 9-3 / Describe three alliance governance mechanisms and evaluate their pros and cons.

- Alliances can be governed by the following mechanisms: contractual agreements for non-equity alliances, equity alliances, and joint ventures.
- There are pros and cons of each alliance governance mechanism, shown in detail in Exhibit 9.2 with highlights as follows:
  - Non-equity alliance's pros: flexible, fast, easy to get in and out; cons: weak ties, lack of trust/commitment.
  - Equity alliance's pros: stronger ties, potential for trust/commitment, window into new technology (option value); cons: less flexible, slower, can entail significant investment.
  - Joint venture pros: strongest tie, trust/commitment most likely, may be required by institutional setting; cons: potentially long negotiations and significant investments, long-term solution, managers may have two reporting lines (two bosses).

LO 9-4 / Describe the three phases of alliance management and explain how an alliance management capability can lead to a competitive advantage.

- An alliance management capability is a firm's ability to effectively manage alliance-related tasks through three phases: (1) partner selection and alliance formation, (2) alliance design and governance, and (3) post-formation alliance management.

- An alliance management capability can be a source of competitive advantage as better management of alliances leads to more likely superior performance.
- Firms build a superior alliance management capability through *learning by doing* and by establishing a dedicated alliance function.

LO 9-5 / Differentiate between mergers and acquisitions, and explain why firms use them to execute corporate strategy.

- A merger is the joining of two independent companies to form a combined entity.
- An acquisition is the purchase or takeover of one company by another. It can be friendly or hostile.
- Although there is a distinction between mergers and acquisitions, many observers simply use the umbrella term *mergers and acquisitions,* or M&A.
- Firms can use M&A activity for competitive advantage when they possess a superior relational capability, which is often built on superior alliance management capability.

LO 9-6 / Define horizontal integration and evaluate the advantages and disadvantages of this option to execute corporate-level strategy.

- Horizontal integration is the process of merging with competitors, leading to industry consolidation.
- As a corporate strategy, firms use horizontal integration to (1) reduce competitive intensity, (2) lower costs, and (3) increase differentiation.

LO 9-7 / Explain why firms engage in acquisitions.

- Firms engage in acquisitions to (1) access new markets and distribution channels, (2) access new capability or competency, and (3) engage in strategic preemption.

LO 9-8 / Evaluate whether mergers and acquisitions lead to competitive advantage.

- Most M&As destroy shareholder value because anticipated synergies never materialize.
- If there is any value creation in M&A, it generally accrues to the shareholders of the firm that is taken over (the acquiree), because acquirers often pay a premium when buying the target company.
- M&As are a popular vehicle for corporate-level strategy implementation for three reasons: (1) principal-agent problems, (2) the desire to overcome competitive disadvantage, and (3) the quest for superior acquisition and integration capability.

KEY TERMS

Acquisition *(p. 358)*
Alliance management capability *(p. 356)*
Build-Borrow-Buy framework *(p. 345)*
Co-opetition *(p. 352)*
Complementary assets *(p. 351)*
Corporate venture capital (CVC) *(p. 355)*
Equity alliance *(p. 354)*
Explicit knowledge *(p. 353)*
Horizontal integration *(p. 359)*
Hostile takeover *(p. 358)*
Learning races *(p. 352)*
Managerial hubris *(p. 365)*
Merger *(p. 358)*
Non-equity alliance *(p. 353)*
Real options *(p. 351)*
Real-options perspective *(p. 351)*
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CHAPTER

10 Global Strategy: Competing Around the World

Chapter Outline

Learning Objectives

LO 10-1 Define globalization, multinational enterprise (MNE), foreign direct investment (FDI), and global strategy.

LO 10-2 Explain why companies expand internationally, and evaluate the advantages and disadvantages of competing globally.

LO 10-3 Apply the CAGE distance framework to guide MNE decisions on which countries to enter.

LO 10-4 Compare and contrast the different options MNEs have for entering foreign markets.

LO 10-5 Apply the cost-responsiveness framework to evaluate the four different strategies MNEs can pursue when competing globally.

LO 10-6 Apply Porter's diamond framework to explain why certain industries are more competitive in specific nations than in others.

CHAPTERCASE 10 Part I

IKEA: The World's Most Profitable Retailer

The world's most profitable global retailer is not Walmart but IKEA, a privately owned home-furnishings company from Sweden. In 2021, IKEA had nearly 460 stores in over 60 countries, employed 225,000 people, and had revenues of more than €42 billion (equivalent to $50 billion). Exhibit 10.1 shows IKEA's growth in terms of the number of its stores and sales worldwide.

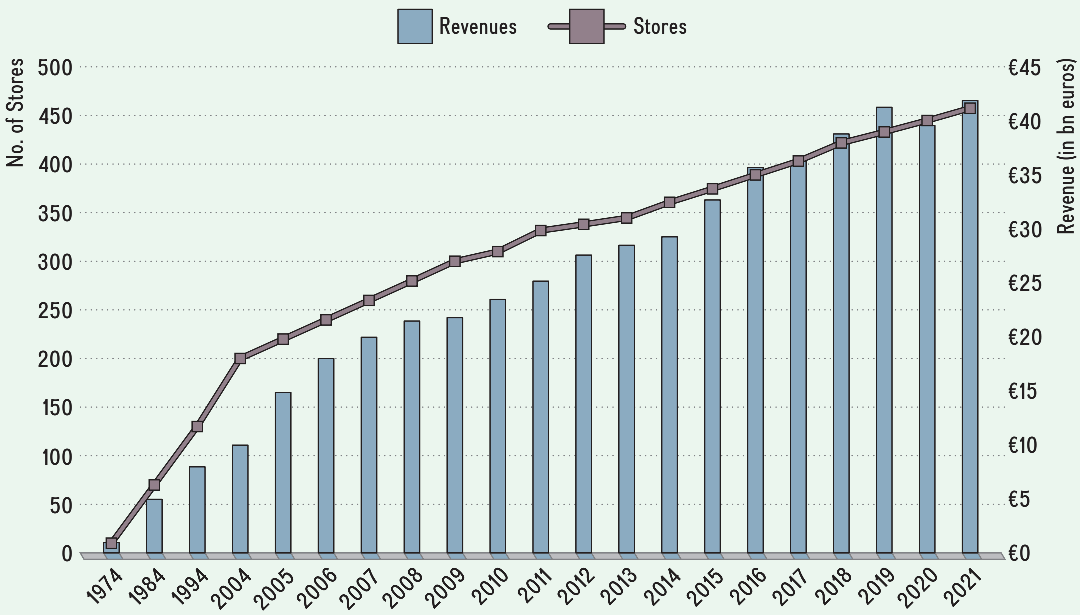
Known today for its iconic blue-and-yellow big-box retail stores that highlight its Swedish origins (blue and yellow are the colors of the Swedish flag), its build-it-yourself furniture, and its focus on flat-pack furniture boxes, IKEA was the brainchild of 17-year-old Ingvar Kamprad, who opened a small retail outlet in 1943. Though IKEA is today a global phenomenon, it was initially slow to internationalize. It took 20 years before the company expanded beyond Sweden to neighboring Norway.

After honing and refining its core competencies of designing modern functional home furnishings at low cost and offering a unique retail experience in its home market, IKEA pursued an *international strategy*, expanding first throughout Europe and then beyond. This international strategy allowed IKEA to leverage its simple, straightforward design to sell the same style of home furnishings across the globe (although some items are modified according to country preferences). Its consistent product lines across various countries show that the IKEA aesthetic is welcome almost everywhere. IKEA's popularity is rising in both developed markets and growth markets, with new locations in the Philippines and Slovenia (in 2021).

Sweden's IKEA is growing quickly not only in developed countries, such as the United States and Australia, but also in rapidly emerging economies such as China.

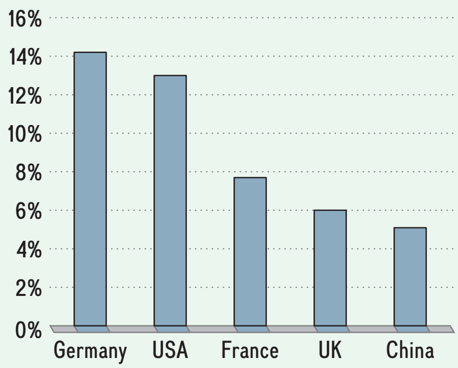
Testing/Shutterstock

EXHIBIT 10.1 IKEA Stores and Revenues, 1974–2021



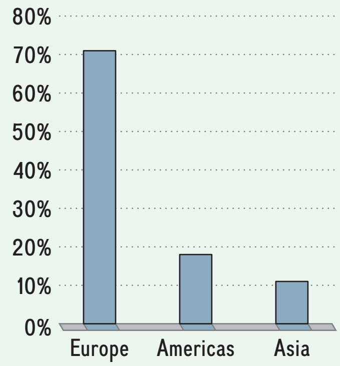
Source: Author's depiction of publicly available data.

EXHIBIT 10.2 IKEA Top Five Countries by Sales (2021)



Source: Author's depiction of publicly available data.

EXHIBIT 10.3 IKEA's Sales by Geographic Region (2021)



Source: Author's depiction of publicly available data.

To protest Russia's invasion of Ukraine, IKEA closed all of its 17 stores in Russia (in 2022). Although Russia accounts for a mere 4% of IKEA's sales, it is a major supplier of wood, the most critical input for furniture companies. As such, IKEA's leadership was careful to emphasize the temporary nature of the store closings in Russia. Exhibit 10.2 shows IKEA's top five countries by sales (in 2021).

From day one, IKEA strived to keep costs low to make products as affordable as possible without sacrificing its signature functional designs (see discussion of IKEA's blue ocean business strategy in Chapter 6). Because of its focus on low cost, IKEA shifted from an international strategy to a global-standardization strategy. It attempts to achieve economies of scale by effectively managing a global supply chain. Globalization has allowed IKEA to gain access to low-cost input factors, such as raw materials and labor. Although Asia currently accounts for only a small fraction of IKEA's sales, this region provides 35% of IKEA's inputs. To drive costs down further, IKEA has begun to implement production techniques from the auto and electronics industries, which employ cutting-edge technologies to address complexity while achieving flexibility and lowering costs. IKEA's sales come mainly from Europe (71%), with the rest from the Americas (18%) and Asia (11%), as shown in Exhibit 10.3.

With projections that 70% of the world's population will live in cities by 2050 and the accompanying changes in consumer demand, IKEA is reinventing itself. It has firmly pushed toward newer retail formats, such as placing smaller stores in city centers, as in London, New York, and Paris. Despite the new smaller store format, IKEA offers its full range of products by providing a hybrid experience with in-store inventory and items available for home delivery through online ordering. The company has also set up click-and-collect locations (small stores to retrieve online purchases). It has begun to offer furniture rentals for itinerant city dwellers who frequently move, often across the globe.

To further reinvent itself, IKEA is investing heavily in its online presence, enabling consumers to make their purchases, schedule delivery, and request installation services. IKEA's online growth was supercharged during the Covid-19 pandemic when in-person stores were closed. IKEA's functional website (ikea.com) was visited 5 billion times in 2021, a growth rate of more than 250%, during the pandemic. The convenience of shopping online is popular among busy urban professionals who have limited time. They are less inclined to travel long distances to an IKEA mega store (on average 320,000 sq. ft, roughly the size of six football fields and three times larger than the average Walmart store) located in an out-of-town setting. The number of customers who visit the existing big-box retail locations had begun to decline even before the pandemic. In total, 775 million customers visited its big-box stores in 2021, down from 1 billion pre-pandemic (in 2019). Yet, despite this decrease in in-store visitors, IKEA has remained relatively immune to the recent retail collapse caused by the Covid-19 pandemic.

To adapt to the fast-changing retail landscape, IKEA is undergoing major restructuring. In addition to the decrease in in-store visits, research also shows that Millennials and Gen Z consumers are less inclined to spend the frustrating hours assembling IKEA furniture. Rarely do customers enjoy "easy assembly"; moreover, the included tools are low quality and the instructions are inferior. To address this customer pain point, IKEA acquired TaskRabbit, a furniture assembly and delivery marketplace (in 2017). It is also testing robots to help assemble IKEA furniture. While researchers in Singapore managed to teach robots how to assemble an IKEA chair, these so-called IKEAbots still have a long way to go before they are fully functional. For example, it took these robots close to 20 minutes to accomplish a task that a human being would have accomplished in just a few. Nonetheless, these steps are the first in creating an automated and more cost-efficient future.[1]

Part II of this ChapterCase appears in Section 10.6.

It is somewhat surprising that the world's most profitable retailer is a privately held furniture maker from Sweden and not a behemoth such as the U.S.-based Walmart. IKEA's success in its international markets is critical to its competitive advantage. Yet, IKEA took time (20 years) to perfect its core competencies before venturing beyond its home country. Today, IKEA succeeds in both rich developed countries, such as the United States and Germany, and emerging economies, such as China and India. Hailing from a small country in Northern Europe, IKEA earns the vast majority of its revenues outside of its borders. Moreover, IKEA's fastest growth is outside Europe.

For more and more U.S. companies, international markets offer the biggest growth opportunities, just as they do for IKEA. Firms from a wide variety of industries—such as Apple, Caterpillar, GE, Intel, and IBM—are global enterprises. They have a global workforce and manage global supply chains, and they obtain the majority of their revenues from outside their home market. In addition, once-unassailable U.S. firms now encounter formidable foreign competitors such as Brazil's Embraer (aerospace); China's Tencent (social media and online gaming), Haier (home appliances), Lenovo (PCs), and Honor (cell phones); India's ArcelorMittal (steel), Infosys (IT services), and Reliance Group (conglomerate); Germany's Siemens (engineering conglomerate) and Daimler, BMW, and VW (vehicles); Japan's Toyota, Honda, and Nissan (vehicles); Mexico's Cemex (cement); South Korea's LG and Samsung (both electronics and appliances); and Sweden's IKEA (home furnishings). This chapter is about how firms gain and sustain competitive advantage when competing around the world.

In Chapter 8, we looked at the first two dimensions of corporate strategy: managing the degree of vertical integration and deciding which products and services to offer (the degree of diversification). Now we turn to the third dimension: competing effectively around the world. We begin this chapter by defining globalization and presenting the stages of globalization. We then tackle a number of questions that a firm must answer: Why should a company go global? Where and how should it compete? We present the CAGE[2] distance model to answer the question of where the firm should compete globally and the cost-responsiveness framework to link a firm's options for competing globally with the different business strategies introduced in Chapter 6 (cost leadership, differentiation, and blue ocean). We then debate the question of why world leadership in specific industries is often concentrated in certain geographic areas. We conclude with the practical *Implications for Strategic Leaders*.

Globalization The process of closer integration and exchange between different countries and peoples worldwide, made possible by falling trade and investment barriers, advances in telecommunications, and reductions in transportation costs.

10.1 What Is Globalization?

LO 10-1

Define globalization, multinational enterprise (MNE), foreign direct investment (FDI), and global strategy.

Globalization is a process of closer integration and exchange between different countries, businesses, and peoples worldwide, made possible by falling trade and investment barriers, advances in telecommunications, and reductions in transportation costs.[3] *Comparative advantages* across nations provide an incentive for global trade because they raise the living standards in the countries involved (see discussion in Chapter 7). Globalization allows companies to source supplies at lower costs, to learn new competencies, and to further differentiate products. Combined, these factors reduce the costs of doing business around the world, opening the doors to a much larger market than any one home country. Over the last few decades, the world's market economies have become more integrated and interdependent. The world marketplace—made up of nearly 200 countries—is a staggering $85 trillion in gross domestic product (GDP), of which the U.S. market is $21 trillion, or close to 25%. The world's second largest economy in absolute GDP is China ($15 trillion), followed by Japan ($5 trillion).[4]

As the ChapterCase indicates, the competitive playing field is becoming increasingly global. Globalization provides significant opportunities for individuals, companies, and countries. Indeed, you can probably see the increase in globalization on your own campus. The number of students enrolled at universities outside their native countries has risen more than fivefold, to 6 million between 1980 and 2019 (pre-Covid-19 pandemic).[5] By 2025, the total number of foreign students worldwide is predicted to reach 8 million.[6] The country of choice for international students remains the United States, with more than 1 million foreign students enrolled per year, followed by the United Kingdom, China, Canada, and Australia. The top five countries (in rank order) sending the most students to study abroad are China, India, South Korea, Germany, and Saudi Arabia.[7]

Globalization has led to significant increases in living standards in many economies around the world. Germany and Japan, whose economies were largely destroyed during World War II, turned into industrial powerhouses, fueled by export-led growth. The Asian Tigers—Hong Kong, Singapore, South Korea, and Taiwan—turned themselves from underdeveloped countries into advanced economies that enjoy some of the world's highest standards of living. China and India continue to offer significant business opportunities.[8] Adjusting GDP for size of population (per capita) and adjusting for differences in cost of living (purchasing power parity), the United States comes in at 10th place, China at 92nd, and Japan at 38th. The three richest countries in the world by income per person are Monaco, Lichtenstein, and Luxembourg, all small and wealthy countries in Europe.

multinational enterprise (MNE) A company that deploys resources and capabilities in the procurement, production, and distribution of goods and services in at least two countries.

global strategy Part of a firm's corporate strategy to gain and sustain a competitive advantage when competing against other foreign and domestic companies around the world.

foreign direct investment (FDI) A firm's investments in value chain activities abroad.

The engine behind globalization is the **multinational enterprise (MNE)**—a company that deploys resources and capabilities in the procurement, production, and distribution of goods and services in at least two countries. MNEs need an effective **global strategy** to gain and sustain a competitive advantage when competing against other foreign and domestic companies around the world.[9] By making investments in value chain activities abroad, MNEs engage in **foreign direct investment (FDI)**.[10]

For example, the European aircraft manufacturer Airbus invested more than $1 billion in the Gulf Coast area in Alabama, to build jetliners.[11] The new Mobile Aeroplex is a 53-acre facility where Airbus builds the vast majority of its single-aisle A-320 jetliners and the smaller A-220. Airbus made a significant strategic commitment to the U.S. market, the destination of the majority of its new jetliners. Being located in Alabama allows Airbus to be much closer to its customers and thus to receive and incorporate feedback as individual airlines request specific customizations. The Alabama location also allows Airbus to take advantage of business-friendly conditions such as lower taxes, lower labor cost, and lower cost of living in comparison to other U.S. locations such as the Northeast or California, plus other incentives provided by host states in the Southern United States. Making Airbus planes in the United States also prevents Airbus from being forced to accept import restrictions or being exposed to tariffs levied on the companies by a U.S. administration.

U.S. MNEs have a disproportionately positive impact on the U.S. economy.[12] Well-known U.S. multinational enterprises include Boeing, Caterpillar, Coca-Cola Co., GE, John

Deere, Exxon Mobil, IBM, Intel, P&G, and Walmart. U.S. MNEs make up less than 1% of the number of total U.S. companies, but they:

- Account for 11% of private-sector employment growth since 1990.
- Employ 19% of the work force.
- Pay 25% of the wages.
- Provide 31% of the U.S. GDP.
- Make up 74% of private-sector R&D spending.

As a business student, you have several reasons to be interested in MNEs. Not only can these companies provide interesting work assignments in different locations throughout the world, but they also frequently offer the highest-paying jobs for college graduates. Even if you don't want to work for an MNE, chances are that the organization you work for will do business with one, so it's important to understand how they compete around the globe.

STAGES OF GLOBALIZATION

Since the beginning of the 20th century, globalization has proceeded through three stages.[13] Each stage presents a different global strategy pursued by MNEs headquartered in the United States.

GLOBALIZATION 1.0: 1900–1941. Globalization 1.0 took place from about 1900 through the early years of World War II. In that period, basically all the important business functions were located in the home country. Typically, only sales and distribution operations took place overseas—essentially, U.S. companies exported goods to other countries. In some instances, firms procured raw materials from overseas. Strategy formulation and implementation, as well as knowledge flows, followed a one-way path—from domestic headquarters to international outposts. This time period, which saw the blossoming of the idea of MNEs, ended with the U.S. entry into World War II.

GLOBALIZATION 2.0: 1945–2000. With the end of World War II came a new focus on growing business—not only to meet the needs that went unfulfilled during the war years but also to repair the damage caused by the war. From 1945 to the end of the 20th century, in the Globalization 2.0 stage, MNEs began to create smaller, self-contained copies of themselves, with all business functions intact, in a few key countries: notably, Western European countries, Japan, and Australia.

This strategy required significant amounts of foreign direct investment. Although it was costly to duplicate business functions in overseas outposts, doing so allowed for greater local responsiveness to country-specific circumstances. While the U.S. corporate headquarters set overarching strategic goals and allocated resources through the capital budgeting process, local mini-MNE replicas had considerable leeway in day-to-day operations. However, knowledge flow back to U.S. headquarters remained limited in most instances.

GLOBALIZATION 3.0: EARLY 21ST CENTURY. Globalization 3.0 commenced in 2001 with China's entry into the World Trade Organization (WTO), an international organization that facilitates and regulates trade across countries with a rules-based system signed and endorsed by its 164 member nations.[14] China's entry into the WTO was the culmination of successful economic reforms and the opening of China to trade by Deng Xiaoping, China's visionary leader whose leadership earned him the reputation as the "Architect of Modern China."[15]

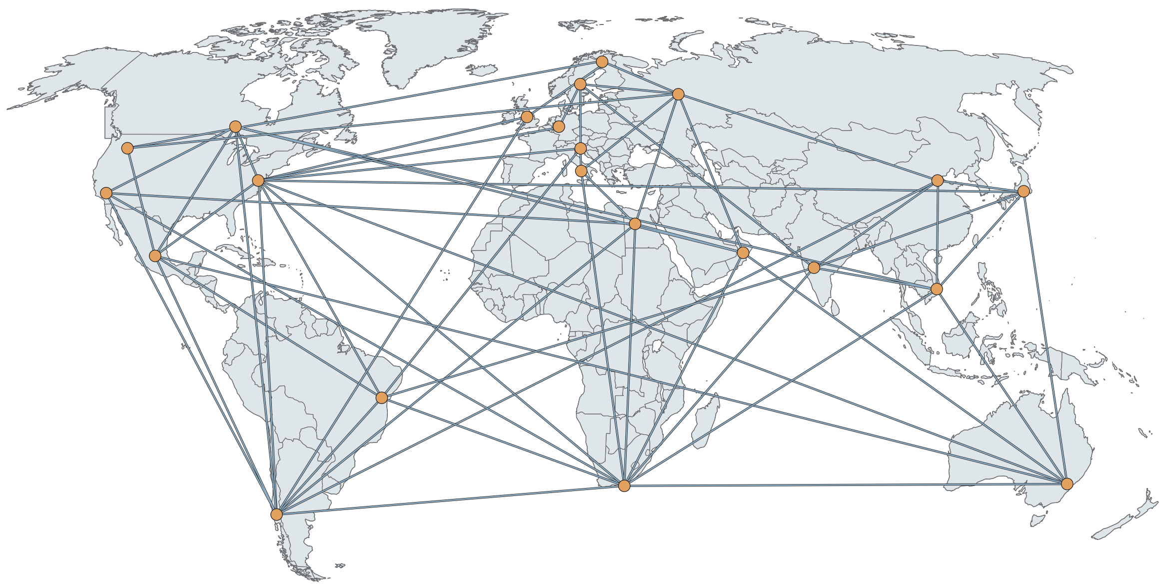
China's gross domestic product (GDP, in constant, inflation-adjusted U.S. dollars) grew by more than 11 times from $1.3 trillion in 2001 to $15 trillion in 2020, an overall growth rate of over 1,000%. China's compound annual growth rate (CAGR) between 2001 and 2020 was almost 14%, an economic success story unprecedented in history. Since joining the WTO and opening itself to trade and foreign investment, China has lifted hundreds of millions of its people out of poverty to become the second-largest economy worldwide.[16] As a comparison, overall world trade (including China) grew from $34 trillion in 2001 to $88 trillion in 2019 (pre Covid-19 pandemic), which means it grew by 1.6 times or a CAGR of 5%. Because of global trade alone, individuals are on average 1.6 times wealthier today compared to 2001 than they would have been without global trade.

To date, Globalization 3.0 has been the most successful period of international trade. In addition to China's awakening as an economic superpower using state-directed capitalism, other important factors in Globalization 3.0 were further integration of the European Union and the so-called *peace dividend*. The term *peace dividend* refers to the economic benefits of a decrease in defense spending after the end of the Cold War between the United States and the USSR, the dissolution of the Soviet Union in 1991, and the increased goodwill among nations as world conflict lessened.

MNEs that had been the vanguard of globalization have now become global collaboration networks (Exhibit 10.4). Such companies prefer to freely locate business functions anywhere in the world based on an optimal mix of costs, capabilities, and PESTEL factors. Huge investments in fiber-optic cable networks around the world have effectively reduced communication distances, enabling companies to operate 24/7, 365 days a year. When engineers in Minneapolis, Minnesota, leave for the evening, engineers in Mumbai, India, begin their workday.

EXHIBIT 10.4 Globalization 3.0: 21st Century

Based on an optimal mix of costs, skills, and PESTEL factors, MNEs are organized as global collaboration networks that perform business functions throughout the world.



Source: Author's adaptation from "A Decade of Generating Higher Value at IBM," www.ibm.com, 2009.

In the Globalization 3.0 stage, the MNE's strategic objective changes. The MNE reorganizes from a multinational company with self-contained operations in a few selected countries to become a more seamless global enterprise with centers of expertise. Each of these centers of expertise is a hub within a global network for delivering products and services. Consulting companies, for example, can now tap into a worldwide network of experts in real time rather than rely on the limited number of employees in their local offices.

Creating a global network of local expertise is beneficial not only in service industries but also in the industrial sector. For example, to increase the rate of low-cost innovation that can then be used to disrupt existing markets, GE organizes local growth teams in China, India, Kenya, and many other emerging countries.[17] GE uses the slogan "in country, for country" to describe the local growth teams' autonomy in deciding which products and services to develop, how to make them, and how to shape the business model. Many of these low-cost innovations, first developed to serve local needs, are later introduced in Western markets to become disruptive innovations. Examples include the Vscan, a handheld ultrasound device developed in China; the MAC 400, an electrocardiogram device developed in India; and the 9100c, an anesthesia system developed in Kenya.[18] In the wake of its corporate reorganization, GE spun out its health care unit (in 2023) to create a standalone business.

Some new ventures organize as global collaboration networks from the start. Logitech, the maker of wireless peripherals such as computer mice, presentation "clickers," and video game controllers, started in Switzerland but quickly established offices in Silicon Valley, California.[19] Pursuing a global strategy right from the start allowed Logitech to tap into the innovation expertise contained in Silicon Valley.[20] Underlying Logitech's innovation competence is a network of best-in-class skills around the globe. Based on its geographic presence, Logitech can organize work continuously because its teams in different locations around the globe can work 24/7.

Indeed, the trend toward global collaboration networks during the Globalization 3.0 stage raises the interesting question, "What defines a U.S. company?" If it's the address of the headquarters, then IBM, GE, and others are U.S. companies—despite the fact that a majority of their employees work outside the United States. In many instances, the majority of their revenues also come from outside the United States. On the other hand, non-U.S. companies such as carmakers from Japan (Toyota, Honda, and Nissan) and South Korea (Hyundai and Kia) and several engineering companies (Siemens from Germany and ABB, a Swiss-Swedish MNE) all have made significant investments in the United States and created a large number of well-paying jobs.

STATE OF GLOBALIZATION

Before we delve deeper into the question of why and how firms compete for advantage globally, a cautionary note concerning *globalization* is in order. Although many large firms are more than 50% globalized—meaning that more than half of their revenues are from outside the home country—the world itself is far less global.[21] If we look at a number of indicators, the level of globalization is no more than 10% to 25%. For example, only:

- 2% of all voice-calling minutes are cross-border.[22]
- 3% of the world's population are first-generation immigrants.
- 9% of all investments in the economy are foreign direct investments.
- 15% of patents list at least one foreign inventor.
- 18% of internet traffic crosses national borders.

These data indicate that the world is not quite flat yet,[23] or fully globalized, but at best *semi-globalized*. Pankaj Ghemawat reasons that many more gains in social welfare and living standards can be had through further globalization if future integration is managed effectively through coordinated efforts by governments.[24]

The European Union is an example of coordinated economic and political integration by 27 countries, of which 19 use the euro as a common currency. This coordinated integration took place over several decades following World War II, precisely to prevent future wars in Europe. The EU encompasses 450 million people, making it one of the largest economic zones in the world, while the United States remains the largest single-country market in the world. Although the EU has monetary authority administered through the European Central Bank, it does not have fiscal (i.e., budgetary) authority. This important responsibility remains with national governments. This separation between monetary and fiscal authority allowed the *sovereign debt crisis* from 2009 to 2015 to emerge. A sovereign debt crisis occurs when a country fails or refuses to service interest payments on its debt or fails to repay its debt. The European debt crisis started when Greece, which was heavily indebted, failed to repay its obligations.

GLOBAL ECONOMIC DEVELOPMENT: IMPACT ON MNEs. Continued economic development across the globe has two consequences for MNEs. First, rising wages and other costs are likely to negate any benefits of access to low-cost input factors. Second, as the standard of living rises in emerging economies, MNEs are hoping that increased purchasing power will enable workers to purchase the products they used to make for export only. China's labor costs, for example, are steadily rising in tandem with an improved standard of living. In the decade between 2011 and 2022, China's labor cost nearly doubled.

Some MNEs have boosted wages following labor unrest in China in recent years. Many now offer bonuses to blue-collar workers and are taking other measures to avoid sweatshop allegations that have plagued companies such as Nike, Apple, and Levi Strauss. Rising wages, fewer workers due to the effects of China's one-child-per-family policy, and appreciation of the Chinese currency now combine to lessen the country's advantage in low-cost manufacturing.[25] This shift aligns with the Chinese government's economic policy, which wants to see a move from "Made in China" to "Designed in China," to capture more of the value added.[26] For instance, the value added of manufacturing an iPhone by Foxconn in China is only about 5%.[27]

GLOBALIZATION 3.1: RETRENCHMENT? Several *black swan events* (that is, highly improbable but high-impact events) have buffeted the world economy in recent years.

- The global financial crisis between 2008 and 2010 led to a deep recession and high unemployment in many parts of the world, including the United States. At the same time, the European sovereign debt crisis unfolded, and several countries teetered on the verge of insolvency, with very high unemployment. For instance, about 50% of people under 25 were unemployed in Spain and Greece.
- In the 2010s, the European refugee crisis unfolded, with millions of people displaced. Fleeing civil war zones as well as territory occupied by the Islamic State, over 1.5 million refugees in 2015 alone streamed into the European Union.
- In 2016, the British voted to leave the EU. In general, the future viability of entire economic trading blocs such as the EU is being questioned.

- While the crises in the United States and the EU unfolded, China continued to rise in both economic power and political power, establishing itself as a superpower to be reckoned with and now challenging the supremacy of the United States.
- Some countries, such as Russia and Turkey, are becoming more autocratic. Indeed, Russia shocked the world when it started a war with Ukraine (in 2022), invading a country bordering the EU and the North Atlantic Alliance (NATO), which is a military alliance between 30 countries (27 European countries plus the United Kingdom, the United States, and Canada).

All of these macro events contributed to a rise of nationalism in the United States and Western Europe. In the United States, the Trump administration pursued an "America first" policy, which resulted in a stronger focus on nationalism and a retrenchment of globalization. Bilateral treaties are now favored over multinational trade deals negotiated by international bodies such as the World Trade Organization (WTO). For instance, the North American Free Trade Agreement (NAFTA) was renegotiated (in 2018). NAFTA was a free trade agreement between Canada, Mexico, and the United States from 1994 to 2020. It was replaced by the United States–Mexico–Canada Agreement (USMCA). In an attempt to protect domestic workers, the Biden administration kept many of the Trump era policies in place, especially tariffs on Chinese imports. Any further changes to existing trade rules are likely to affect cross-border trade in a negative fashion, impacting MNEs the most.

Systemic Rivalry and Techno Cold War. The United States and China are beginning to view each other more as *strategic rivals* that are competing for supremacy than as deeply intertwined trading partners with joint interests such as combating climate change and preventing the proliferation of nuclear weapons. As the competition between different political and economic systems and the race for global supremacy heats up, the United States and China find themselves engaged in a trade war that has critical consequences worldwide. The European Union, which used to be quite China-friendly in an attempt to foster trade, has also changed its tune. The EU now views China not as much as a trading partner but rather as an economic competitor and systemic rival. The systemic competition is between democratic and autocratic governance in the political sphere and between free-market competition and state-managed capitalism in the economic sphere.

Going forward, many experts expect a *techno cold war* between two global trading blocs:[28] one bloc of democratic countries led by the United States versus an autocratic pact of countries led by China and Russia. Such global bifurcation echoes the Cold War (1945–1991) between the United States and its allies on one side, and the (former) USSR and its communist allies on the other. The techno cold war is fought to achieve leadership in strategically important technologies such as 5G networks, artificial intelligence and robotics, payment systems, crypto currencies and block chains, and quantum computing.

There are important differences between this evolving techno cold war and the Cold War in which the United States faced off against the USSR. First, China's total GDP now almost equals U.S. total GDP, while the USSR never came close to matching the United States economically. Indeed, if current GDP growth rates are projected forward, by 2030 China will be the largest economy globally in absolute terms.

Second, the United States and China are economically closely intertwined, so much so that there is codependence on trade between the nations. The United States needs manufactured goods from China, including medical supplies, which became painfully apparent during the Covid-19 pandemic. At the same time, China still depends—although it is working hard to become self-sufficient—on cutting-edge technology from the United States such as advanced microchip designs. To add uncertainty and tension to the U.S.–China relationship, some 90% of cutting-edge microprocessors are, while designed in the West, manufactured in Taiwan by TSMC (Taiwan Semiconductor Manufacturing Company). In contrast, trade between the United States and the USSR was negligible. Indeed, MNEs were embargoed from trading with the former communist bloc.

Third, pre-Covid-19, there were almost 400,000 Chinese students studying at U.S. universities. The number of Chinese students in the United States has doubled in less than 10 years. Moreover, the United States is home to an estimated 3 million Chinese immigrants or some 6% of the overall foreign-born population. About one-half are naturalized U.S. citizens. The Soviet Union did not send students to the United States, and the number of Soviet immigrants to the United States during the Cold War was tiny.

Nonetheless, a serious consequence of the new techno cold war is global retrenchment with two trading blocs (the United States with its Western allies vs. China and Russia with their allies), likely resulting in restricted cross-bloc trading. As a consequence, economic gains from globalization will be reduced as supply chains are intentionally made more redundant, a need that became apparent during the Covid-19 pandemic. Overall, cross-block trade might decline, leading to lower economic growth and thus lower standards of living than could be had with freer trade. In addition, military expenditures are likely to rise significantly over the next couple of years, and thus less government funding will be available for other public services such as health care, education, and infrastructure.

LO 10-2

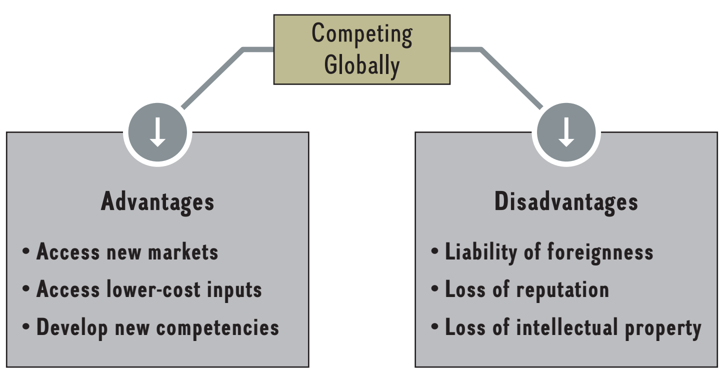
Explain why companies expand internationally, and evaluate the advantages and disadvantages of competing globally.

10.2 Competing Globally: Why?

Strategic leaders consider international expansion if the benefits outweigh the costs. They consider if doing business abroad will enhance economic value creation or lower costs (Chapter 5). Competing globally should reinforce a company's basis of competitive advantage—whether differentiation, low cost, or value innovation (Chapter 6). The linkages between a firm's global strategy and competitive strategy highlight the need to align a firm's corporate strategy (*where to compete?*) with its business-level strategy (*how to compete?*). Next we consider both the advantages and disadvantages of competing globally (Exhibit 10.5).

EXHIBIT 10.5

Advantages and Disadvantages of Competing Globally



ADVANTAGES OF COMPETING GLOBALLY

Why do firms expand internationally? The main reasons firms expand abroad are to:

- Gain access to a larger market.
- Gain access to low-cost input factors.
- Develop new competencies.

GAIN ACCESS TO A LARGER MARKET. Becoming an MNE provides significant opportunities for companies, given *economies of scale* and *scope* that can be reaped by participating in a much larger market. Companies that base their competitive advantage on *economies of scale* and *economies of scope* have an incentive to gain access to larger markets because these economies can reinforce the basis of their competitive advantage, which in turn allows MNEs to out-compete local rivals.

In Strategy Highlight 6.1, we detailed how Narayana Health, a specialty hospital chain in India that was founded and led by Dr. Devi Shetty, obtained a low-cost competitive advantage in complex procedures such as open-heart surgery. Narayana Health is leveraging its low-cost, high-quality position with its specialty hospitals in the Cayman Islands (to serve U.S. patients) and Kuala Lumpur, Malaysia.

The domestic markets in smaller economies are often too small for companies to reach significant economies of scale to compete effectively against other MNEs, leading these companies to expand into other countries. For companies based in smaller economies, becoming an MNE may be necessary to achieve growth or to gain and sustain competitive advantage. Examples include Acer (Taiwan), Casella Wines (Australia), IKEA (featured in the ChapterCase), Nestlé (Switzerland), LEGO (Denmark), Philips (Netherlands), Samsung (South Korea), and Zara (Spain).

At the same time, some other countries such as China, Germany, South Korea, and Japan focus on export-led economic growth, which drives many of their domestic businesses to become MNEs. Developing countries use export-led growth strategies to supercharge economic growth. Indeed, Germany and Japan embarked on this strategy when rebuilding their economies after WWII, Korea after the Korean War, and China after opening itself to the West in the late 1970s. Export-led growth can help to turn poor countries into rich ones because consumption today is postponed for consumption tomorrow. Basically, countries that run a trade surplus (i.e., exporting more than they import) finance the excess consumption of countries such as the United States, which imports more than it exports. Export-led growth can make the MNEs in those countries very competitive because they serve a large and demanding global market, and they generate sufficient funds to reinvest in upgrading their capabilities, which makes them even stronger.

Although export-led growth is a beneficial strategy for developing countries, it can create significant imbalances if countries continue to pursue this strategy long after they have become wealthy. For instance, it can create major imbalances in world trade, which can spill over to financial markets. Countries pursuing an export-led growth strategy often undervalue their currency and so take up a larger share of global demand, which can create problems when world demand is not growing sufficiently. Moreover, an export-led strategy often results in weaker demand in home countries and, thus, a lower standard of living than what could be had. In recent years, for instance, Germany has worked hard to improve its economy's service sector, which is severely underdeveloped given the wealth of the nation overall.

GAIN ACCESS TO LOW-COST INPUT FACTORS. MNEs that base their competitive advantage on a low-cost leadership strategy are particularly motivated to go overseas to gain access to low-cost input factors. Access to low-cost *raw materials* such as lumber, iron ore, oil, and coal was a key driver behind Globalization 1.0 and 2.0. During Globalization 3.0, firms expanded globally to benefit from lower *labor costs* in manufacturing and services.

India. India has carved out a competitive advantage in information technology (IT), especially in business process outsourcing (BPO). India built a deep core competency in IT not only because of lower-cost labor but also because of an abundance of well-educated, English-speaking young people. Infosys, TCS, and Wipro are some of the better-known Indian IT service companies. Together, these companies employ more than 500,000 people and provide services to many of the Global Fortune 500 companies.

Many MNEs in the IT sector have close business ties with Indian firms. Some, such as IBM, Microsoft, and Alphabet's Google, are engaged in foreign direct investment through equity alliances or building their own IT and customer service centers in India. More than a quarter of the work force of Accenture, a consultancy specializing in technology and outsourcing, is now located in Bangalore, India.[29] Drawing on a large pool of talent and a deep core competency in IT, some of the most important U.S. tech firms are led by CEOs who hail from India, including Alphabet (Sundar Pichai), IBM (Arvind Kirshna), and Microsoft (Satya Nadella).

China. China emerged as a manufacturing powerhouse because of lower labor costs and an efficient infrastructure. An American manufacturing worker costs several times more in wages than a similarly skilled worker in China.[30] A cost differential exists not only for low-skilled labor but also for high-skilled labor. For example, Chinese engineers trained at Purdue University earn four times more working in the United States than they would earn working in their native country.[31] However, wages have been rising much more rapidly in China than in the United States, thus closing the wage gap.

China is pursuing its "Designed in China 2025" plan, an industrial strategic policy meant to move beyond low-cost manufacturing and toward the production of higher-value products and services. China aspires to be a world leader in high-tech industries such as aerospace and telecommunications and to lead in technologies of the future, such as AI and robotics. With U.S. export bans on some key technologies, including advanced chip designs and mobile operating systems, China has doubled down on its goals of becoming self-sufficient in core technology and leapfrogging the United States in technological development critical for future industries.

DEVELOP NEW COMPETENCIES. Some MNEs pursue a global strategy to develop new competencies.[32] This motivation is particularly strong for firms that base their competitive advantage on a differentiation strategy. These companies are making foreign direct investments to be part of *communities of learning,* which are often contained in specific geographic regions.[33]

For example, AstraZeneca, a Swiss-based pharmaceutical company, relocated its research facility to Cambridge, Massachusetts, to be part of the Boston biotech cluster, in hopes of developing new R&D competencies in biotechnology.[34] Cisco invested more than $1.6 billion to create an Asian headquarters in Bangalore to support other locations in India and to be located in the middle of India's top IT location.[35] Likewise, Microsoft, one of the largest tech companies globally, has a key research center in Bangalore. Unilever's new-concept center is located in downtown Shanghai, China, where it attracts hundreds of eager volunteers to test the firm's latest product innovations onsite, where Unilever researchers monitor consumer reactions. In these examples, AstraZeneca, Cisco, Microsoft, and Unilever all reap **location economies**—benefits from locating value chain activities in optimal geographies for a specific activity.[36]

Many MNEs are now replacing the one-way innovation flow from Western economies to developing markets with a *polycentric innovation strategy*—a strategy in which MNEs draw on multiple, equally important innovation hubs throughout the world characteristic of Globalization 3.0; refer to Exhibit 10.4. GE Global Research, for example, orchestrates a "network of excellence" with facilities in Niskayuna, New York (United States); Bangalore (India); Shanghai (China); and Munich (Germany). Indeed, emerging economies are becoming hotbeds for low-cost innovations that find their way back to developed markets.[37] For example, in Bangalore, GE researchers developed the MAC 400, a handheld electrocardiogram (ECG).[38] This small, portable device runs on batteries. Although a conventional ECG machine is priced at $2,000, this handheld version is $800 and enables doctors to do an ECG test at a cost of only $1 per patient. The MAC 400 is now entering the United States and other Western markets as a disruptive innovation, with anticipated widespread use in the offices of general medical practitioners and emergency ambulances.

A GE team in China developed the Vscan, an inexpensive, portable ultrasound device, priced at $5,000—rather than the $250,000 of a traditional ultrasound machine used in Western hospitals. The Vscan is now widely used in rural areas of developing countries (as shown here in Thailand) and has made its entry as a disruptive innovation in the United States and other rich countries.

Thierry Falise/LightRocket/Getty Images

location economies Benefits from locating value chain activities in the world's optimal geographies for a specific activity, wherever that may be.

DISADVANTAGES OF COMPETING GLOBALLY

Companies expanding internationally must carefully weigh the benefits and costs of doing so. If the cost of going global as captured by the following disadvantages exceeds the expected benefits in terms of value added ($C > V$)—that is, if the economic value creation is negative—then firms are better off by not expanding internationally. Disadvantages to going global include:

- Liability of foreignness.
- Loss of reputation.
- Loss of intellectual property.

LIABILITY OF FOREIGNNESS. MNEs doing business abroad also must overcome the **liability of foreignness**, which consists of the additional costs of doing business in an unfamiliar cultural and economic environment, and of coordinating across geographic distances.[39]

For instance, Walmart's problems in several international markets are in large part due to the liability of foreignness. In particular, Walmart failed in Germany and experienced a similar fate in South Korea. Defeated by local competitors, Walmart exited both countries (in 2006). In addition, Walmart has tried for many years to successfully enter the fast-growing markets in India and Russia, but with little or no success. Walmart's success recipe that worked so well domestically didn't work in Germany, South Korea, Russia (pre-Ukraine invasion), or India. Strategy Highlight 10.1 illustrates how Walmart underestimated its liability of foreignness when entering and competing in Germany, and how it is now facing the German grocery industry disruptors, Aldi and Lidl, on its home turf.

liability of foreignness Additional costs of doing business in an unfamiliar cultural and economic environment, and of coordinating across geographic distances.

Strategy Highlight 10.1

Walmart Retreats from Germany, and German Ultra-Low-Cost Grocers Invade the United States

After spending billions of dollars and trying for almost a decade to succeed, Walmart exited Germany in defeat (in 2006). This failure shocked an otherwise successful company, and ghosts from the debacle now haunt Walmart on its native shores. What went wrong?

WALMART ENTERS, THEN EXITS, GERMANY

At the turn of the century, Walmart faced a saturated U.S. market. International markets promised future growth opportunities. Germany, then the third-largest economy in the world, looked appealing. Walmart was already active in six foreign countries, with some 500 stores outside the United States. Walmart's strategic leaders decided that the company's superior strategy—as the low-cost leader—that works phenomenally in the domestic market would travel one more time.

Walmart acquired Germany's 21-store Wertkauf chain and 74 hypermarkets from German retailer Spar Handels AG (in 1998). And it followed the U.S. playbook: Walmart cheer, a door greeter, smiling associates always available to customers and offering help, bagging groceries at the checkout. German employees, however, resisted the transfusion of American corporate values. Instead, they upheld the usual gruff standard of retail customer service (or lack thereof) found throughout Germany. They also scoffed at the "no dating of co-workers" policy common in many U.S. companies, but an anathema to Europeans. Worse, the first Walmart boss in Germany—installed directly from the Arkansas headquarters—spoke no German. He decreed that English would be the official in-house language.

Cultural differences aside, Walmart also failed to keep prices down in its German stores. The retailer lacked its domestic economies of scale and efficient distribution centers. Moreover, German labor laws—more protective than labor laws in the United States—drove up costs. Despite the company slogan, the prices at Walmart in Germany were not "always low" but instead fell in the medium range.

Lastly, Walmart faced serious competition. Germany was already home to retail discount powerhouses such as

Together with Aldi, Lidl disrupted the grocery market in the United Kingdom, leading to heavy losses by the British grocery leader, Tesco. In 2017, Lidl entered the United States. Walmart executives are concerned about a repeat in the United States. By 2022, the disruption by ultra-low-cost grocers Aldi and Lidl gathered force as the United States faced high inflation, especially in food prices. As a consequence, consumers search out the lower-ticket items offered at Aldi and Lidl.

Steve Helber/AP Images

Aldi and Lidl, with thousands of smaller outlets offering higher convenience combined with lower prices. Then it faced Metro, a big-box retailer, which started a price war when Walmart entered Germany. In the end, a defeated Walmart sold its stores to Metro.

GERMAN ULTRA-LOW-COST DISCOUNTERS DISRUPT U.S. GROCERY INDUSTRY

In thinking about strategy, decision-makers must answer the question of how to deal with competition.[40] Walmart witnessed what the German ultra-low-cost discounters did to the complacent Tesco, the grocery leader in the UK. Indeed, the entry of the German discounters was so successful in the United Kingdom that Tesco, Britain's leading supermarket chain, had to close dozens of stores, with large-scale layoffs. Tesco's market cap fell over 70%, from $55 billion in 2010 to $16 billion in 2016. In 2022, its market cap stood at $25 billion, 55% down from its peak. Walmart is worried about a similar fate.

Walmart did not find a good strategy for competing with Aldi and Lidl in Germany. Keeping Tesco's experience in mind, Walmart is now concerned that Aldi and Lidl will challenge the world's largest retailer on its home turf. Aldi has been competing in the United States since the 1970s

(Continued)

with its own Aldi stores as well as the Trader Joe's brand. In 2017, Lidl opened its first stores in the United States.

Why does Walmart worry about Lidl's entry into the U.S. grocery business? Aldi has been highly successful with its more than 2,100 stores and another 500 Trader Joe's stores in the United States. Rather than focusing on big-box outlets, Aldi focuses on small stores that are near urban centers with high foot traffic and easy access to public transportation or major roads to suburbia. Trader Joe's, as a neighborhood grocery store, has a loyal customer base. It offers mainly its own brand-name products such as organic, vegetarian, or imported foods at much lower prices than Whole Foods and other grocery stores. Trader Joe's generates twice as much revenue per square foot of retail space as Whole Foods.

Lidl is joining the fray. It already has opened some 200 stores, mainly on the U.S. East Coast, with hundreds more planned. Like Aldi, Lidl competes on ultra-low prices and offers mainly its own store brands. Both of these ultra-low-cost discounters typically offer 2,000 products in a store rather than the standard 40,000 or so found in large U.S. supermarkets. Walmart stores are even more supersized, taking up more than three football fields. A typical Walmart supercenter stocks some 150,000 items. Most grocery stores in the United States sell 30 types of mustard. The German disruptors carry only two. Products arrive shelf-ready, minimizing stocking and inventory costs, albeit often with a wholesale feel. All products are sold at ultra-low prices. There are no daily or weekly specials.

With Amazon on one side (especially after its acquisition of Whole Foods Market and its Amazon Fresh grocery delivery service) and ultra-low-cost industry disruptors such as Aldi and Lidl on the other, Walmart is sharpening its strategic position as a low-cost leader. Walmart is working on the basics to speed up checkout times and lower some prices even more. And Walmart continues to pressure suppliers so that the prices of its products will be 15% lower than the competition's 80% of the time.

This competitive battle is crucial for Walmart because groceries make up some 60% of its annual revenues of over $575 billion (in 2022). With more than 5,000 stores in the United States and over 25% market share, Walmart is the largest grocer. At the same time, high inflation (in the double digits for meat and other food staples) post-pandemic in the United States led many consumers to search out the ultra-low-cost alternatives offered by Lidl and Aldi, creating a major challenge for Walmart.[41]

LOSS OF REPUTATION. In international expansion, firms face risks. One of the most valuable resources that a firm may possess is its reputation. A firm's reputation can have several dimensions, including a reputation for innovation, customer service, or brand reputation. Apple's brand, for example, stands for innovation and superior customer experience. Apple's reputation is also one of its most important resources. Apple's brand is valued at $600 billion, making it (with Amazon's and Google's) one of the three most valuable brands in the world.[42] We detailed in Chapter 4 that a brand can be the basis for a competitive advantage if it is valuable, rare, and difficult to imitate.

Although cost savings can generally be achieved, globalizing a supply chain can also have unintended side effects. These can lead to a loss of reputation and diminish the MNE's competitiveness. A possible loss in reputation can be a considerable risk and cost of doing business abroad. Because Apple's stellar consumer reputation is critical to its competitive advantage, it should be concerned about any potential negative exposure from its global activities. Problems at Apple's main supplier, Foxconn, brought this concern to the fore.

Low wages, long hours, and poor working and living conditions contributed to a spate of suicides (in 2010) at Foxconn, Apple's main supplier in China.[43] The Taiwanese company, which employs more than 1 million people, manufactures computers, tablets, smartphones, and other consumer electronics for Apple and other leading consumer electronics companies. The backlash against alleged sweatshop conditions in Foxconn prompted Apple to work with its main supplier to improve working conditions and wages. Tim Cook, Apple's CEO, visited Foxconn in China to personally inspect its manufacturing facility and workers' living conditions. Although conditions at Foxconn have been improving,[44] Apple started to diversify its supplier base by adding Pegatron, another Taiwanese original equipment manufacturer (OEM).[45]

The need for so-called second source suppliers became even more apparent during the Covid-19 pandemic when many countries shut down their economies for some time. For instance, car manufacturers had to stop work because they were not able to obtain the microprocessors they needed. Although best practice has been just-in-time delivery of parts, products, and other inventory, post Covid-19 many strategic leaders have been working hard to make their supply chains less fragile by building in redundancies and alternative sources of suppliers, often in different countries. These anti-fragility measures allow a supply chain to be more diversified and less exposed to specific country risks, albeit at a higher cost.

MNEs' search for low-cost labor has had tragic effects where local governments are corrupt and unwilling or unable to enforce minimum safety standards. The textile industry is notorious for sweatshop conditions, and many Western companies such as the Gap (United States), H&M (Sweden), and Carrefour (France) have taken a big hit to their reputations as a result of factory accidents in Bangladesh and elsewhere in Southeast Asia. Hundreds of factory workers were killed when a textile factory collapsed in Rana Plaza (in 2013) on the outskirts of Dhaka, Bangladesh.[46] Although much of the blame lies with the often corrupt host governments not enforcing laws, regulations, and building codes, the MNEs that source their textiles in these factories also receive some of the blame, with negative consequences for their reputation. The MNEs are accused of exploiting workers and being indifferent to their working conditions and safety, all in an unending quest to drive down costs (*race to the bottom*).

This challenge directly concerns *creating shared value (CSV)* discussed in Chapter 5. Because some host governments are either unwilling or unable to enforce regulation and safety codes, MNEs need to rise to the challenge.[47] Walmart responded by posting a public list of banned suppliers on its website. These suppliers do not meet adequate safety standards and working conditions. Before the Rana Plaza accident, Walmart had already launched a working and fire-safety academy in Bangladesh to train textile workers.

Given the regulatory and legal void that local governments often leave, several Western MNEs have proposed a concerted action to finance safety efforts and worker training as well as structural upgrades to factory buildings. After earlier revelations about the frequent practice of child labor in many developing countries, Western MNEs in the textile industry worked together to ban their suppliers from using child labor. Moreover, ensuring ethical sourcing of raw materials and supplies is becoming ever more important. In addition to a moral responsibility, MNEs have a market incentive to protect their reputations given the public backlash in the wake of factory accidents, child labor, worker suicides, and other horrific externalities.

LOSS OF INTELLECTUAL PROPERTY. The issue of protecting intellectual property in international markets also looms large. The software, movie, and music industries have long lamented large-scale copyright infringements in many international markets. In addition, when required to partner with an international host firm, companies may find their intellectual property being siphoned off and reverse engineered. Many host countries follow a national industrial policy to supercharge economic growth by acquiring science and technology from Western partners, through both legal and illegal means.

For example, Japanese and European engineering companies entered China to participate in building the world's largest network of high-speed trains worth billions of dollars.[48] Companies such as Kawasaki Heavy Industries (Japan), Siemens (Germany), and Alstom (France) were joint venture partners with domestic Chinese companies. These firms now allege that the Chinese partners built on the Japanese and European partners' advanced technology to create their own, next-generation high-speed trains. To make matters worse, the Japanese and European firms also claim that the Chinese companies now compete against them in other lucrative markets, such as Saudi Arabia, Brazil, and even California, with trains of equal or better capabilities at much lower cost. The China Railway Corporation, a state-owned MNE, rejects these allegations, arguing that it "re-innovated" by building on its partners' technology. This example highlights the *intellectual property exposure* that firms can face when expanding overseas.

10.3 Competing Globally: Where and How?

LO 10-3

Apply the CAGE distance framework to guide MNE decisions on which countries to enter.

After discussing why companies expand internationally, we now turn to the question of how to guide MNE decisions on which countries to enter and how to enter those countries.

WHERE IN THE WORLD TO COMPETE? THE CAGE DISTANCE FRAMEWORK

The question of where to compete geographically is, following vertical integration and diversification, the third dimension of determining a firm's *corporate strategy*. The primary drivers behind firms expanding beyond their domestic market are (1) the strengthening of their competitive position by gaining access to larger markets and low-cost input factors and (2) the development of new competencies.

Given these drivers, won't companies choose new markets solely based on measures such as per capita consumption of the product and per capita income? Yes and no. Consider that several countries and locations can score similarly on such *absolute* metrics of attractiveness. Ireland and Portugal, for example, have similar cost structures, and both provide access to 450 million customers in the European Union. Both countries use the euro as a common currency, and both have a similarly educated work force and infrastructure. Given these similarities, how does an MNE decide between them?

To aid MNEs in deciding where in the world to compete, Pankaj Ghemawat introduced the **CAGE distance framework**. Rather than looking at absolute measures, MNEs need to consider *relative distance* in the CAGE model. CAGE is an acronym for different kinds of distance:

CAGE distance framework A decision framework based on the relative distance between home and a foreign target country along four dimensions: cultural distance, administrative and political distance, geographic distance, and economic distance.

- **C**ultural
- **A**dministrative and political
- **G**eographic
- **E**conomic[49]

Most of the costs and risks involved in expanding beyond the domestic market are created by *distance.* Distance not only denotes geographic distance (in miles or kilometers), but also includes, per the CAGE acronym, cultural distance, administrative and political distance, and economic distance. The CAGE distance framework breaks distance into different relative components between any two country pairs that affect the success of foreign direct investment (FDI).

Although absolute metrics such as country wealth or market size matter to some extent—we know, for example, that a 1% increase in country wealth leads to a 0.8% increase in international trade—the relative factors captured by the CAGE distance model matter more. For instance, countries that are 5,000 miles apart trade only 20% of the amount traded among countries that are 1,000 miles apart. Cultural distance matters even more.

A common language increases trade between two countries by 200% over country pairs without a common language. Thus, in the earlier example regarding which EU country to select for FDI, a U.S. MNE should pick Ireland, while a Brazilian MNE should select Portugal. In the latter case, Brazil and Portugal also share a historic colony–colonizer relationship. This link increases the expected trade intensity between these two countries by yet another 900% in comparison to country pairs where that relationship is absent.

Other CAGE distance factors are significant in predicting the amount of trade between two countries. If the countries belong to the same regional trading bloc, they can expect another 330% in trade intensity. Examples include not only the United States, Canada, and Mexico in the USMCA (update of NAFTA) treaty, but also the member states of the European Union. If the two countries use the same currency, trade intensity is increased by 340%. For example, the euro is used as the common currency in 19 EU countries.[50]

Exhibit 10.6 presents the CAGE distance model. It details factors that increase the overall distance between the two countries and how distance affects different industries or products along the CAGE dimensions.[51] Next, we briefly discuss each of the CAGE distance dimensions.[52]

national culture The collective mental and emotional "programming of the mind" that differentiates human groups.

CULTURAL DISTANCE. In his seminal research, Geert Hofstede defined and measured **national culture**, the collective mental and emotional "programming of the mind" that differentiates human groups.[53] Culture is made up of a collection of social norms and mores, beliefs, and values. Culture captures the often unwritten and implicitly understood rules of the game.

EXHIBIT 10.6 The CAGE Distance Framework

Distance	*C* Cultural	*A* Administrative and Political	*G* Geographic	*E* Economic
Between two countries increases with …	• Different languages, ethnicities, religions, social norms, and dispositions • Lack of connective ethnic or social networks • Lack of trust and mutual respect	• Absence of trading bloc • Absence of shared currency (monetary association) or political association • Absence of colonial ties • Political hostilities • Weak legal and financial institutions	• Lack of common border, waterway access, adequate transportation, or communication links • Physical remoteness • Different climates and time zones	• Different consumer incomes • Different costs and quality of natural, financial, and human resources • Different information or knowledge
Most affects industries or products …	• With high linguistic content (media) • Related to national and/or religious identity (foods) • Carrying country-specific quality associations (wines)	• That a foreign government views as staples (electricity), as building national reputations (aerospace), or as vital to national security (telecommunications)	• With low value-to-weight ratio (cement) • That are fragile or perishable (glass, meats) • In which communications are vital (financial services)	• For which demand varies by income (cars) • In which labor and other cost differences matter (textiles)

Source: Author's adaptation from P. Ghemawat (2001, Sep.), "Distance still matters: The hard reality of global expansion," *Harvard Business Review*: 137–147.

Although there is no one-size-fits-all culture that accurately describes any nation, Hofstede's work provides a useful tool to proxy cultural distance. Based on data analysis from more than 100,000 individuals from many countries, four main dimensions of culture emerged: *power distance, individualism, masculinity–femininity,* and *uncertainty avoidance*.[54] Hofstede's data analysis yielded scores for the different countries, for each dimension, on a range of 0 to 100, with 100 as the high end. More recently, Hofstede added two additional cultural dimensions: *long-term orientation* and *indulgence*.[55]

When Starbucks entered the Chinese market (in 2000), it moved fast to overcome cultural barriers by handing out key chains to help new customers order. Now it leverages Chinese social media (WeChat, Weibo, and Jiepang) and fine-tunes its own mobile apps and loyalty programs to appeal to China's growing middle class. The result? Today China is Starbucks' second-largest market and growing.[57]

Courtesy of Resonance China

Cultural differences find their expression in language, ethnicity, religion, and social norms. They directly affect customer preferences (refer to Exhibit 10.6). Because of religious beliefs, for example, Hindus do not eat beef, and Muslims do not eat pork. In terms of content-intensive service, cultural and language differences are also the reason global internet companies, such as Amazon and Google, offer country-specific variations of their sites. Despite these best efforts, they are often outflanked by native providers because of the latter's deeper cultural understanding. For example, in China the leading websites are domestic ones: Alibaba in ecommerce, and Baidu in online search. In Russia, the leading ecommerce site is Ozon, while the leading search engine is Yandex.

Using Hofstede's national-culture research, managers can combine the distinct dimensions of culture into an aggregate measure for each country. MNEs then can compare the national-culture measures for any two country pairings to inform their entry decisions.[56] The difference between scores indicates **cultural distance**, the cultural disparity between the internationally expanding firm's home country and its targeted host country. A greater cultural distance can increase the cost and uncertainty of conducting business abroad. In short, greater cultural distance increases the liability of foreignness.

cultural distance Cultural disparity between an internationally expanding firm's home country and its targeted host country.

If we calculate the cultural distance from the United States to various countries, for example, we find that some countries are culturally close to the United States. Australia, for instance, has an overall cultural distance score of 0.02, a very low number. Other countries are culturally quite distant from the United States. Russia has an overall cultural distance score of 4.42. As can be expected, English-speaking countries such as Canada (0.12), Ireland (0.35), New Zealand (0.26), and the United Kingdom (0.09) all exhibit a low cultural distance to the United States. Because culture is embedded in language, it comes as no surprise that cultural and linguistic differences are highly correlated.

Culture even matters in the age of Meta's Facebook with its global reach of 3 billion users. Most Facebook friends are local rather than cross-border. This makes sense when one considers that the online social graph that Facebook users develop in their network of friends is mostly a virtual network laid above a (pre)existing social network, rather than a new one.[58]

ADMINISTRATIVE AND POLITICAL DISTANCE. Administrative and political distances are captured in factors such as the absence or presence of shared monetary or political associations, political hostilities, and weak or strong legal and financial institutions.[59] The 19 European countries in the eurozone, for example, not only share the same currency but also integrate politically to some extent. It should come as no surprise, then, that most cross-border trade between European countries takes place within the EU. Germany, one of the world's largest exporters, conducts roughly 75% of its cross-border business within the EU.[60] Similarly, Canada and Mexico partner with the United States in the USMCA treaty, facilitating trade in goods and services among the three countries. In terms of total trade, United States is the largest trading partner of both Canada and Mexico, while Canada followed by Mexico are the largest trading partners for the United States. Only in exports to the United States does China beat Mexico, with Canada coming in third place.[61] British companies continue to trade heavily with businesses from its former colonies in the commonwealth; Spanish companies trade heavily with Latin American countries; and French businesses trade with the franc zone of West Africa.

Many foreign (target) countries erect political and administrative barriers, such as tariffs, trade quotas, and FDI restrictions, to protect domestic businesses. For example, in many instances, China requests the sharing of technology in a joint venture when a foreign company enters China. This was the case in the high-speed train developments discussed earlier in this chapter. Other countries, including the United States and EU members, protect national champions such as Boeing or Airbus from foreign competition. Industries that are considered critical to national security—domestic airlines and telecommunications—are often protected.

Finally, strong legal and ethical pillars in addition to well-functioning economic institutions such as capital markets and an independent central bank reduce distance. Strong institutions, both formal and informal, reduce uncertainty and thus reduce transaction costs.[62]

GEOGRAPHIC DISTANCE. The costs of cross-border trade rise with geographic distance. It is important to note, however, that geographic distance does not simply capture how far two countries are from each other but also includes additional attributes, such as the countries' physical size (enormous Canada versus tiny Singapore), the within-country distances to their borders, the countries' topography and time zones, and whether the countries are contiguous to one another or have access to waterways and the ocean. Each country's infrastructure, including road, power, and telecommunications networks, also plays a role in determining its geographic distance from possible trading partners. Geographic distance is particularly relevant when trading products with low value-to-weight ratios, such as steel, cement, or other bulk products, and fragile and perishable products, such as glass or fresh meats and fruits.

ECONOMIC DISTANCE. The wealth and per capita income of consumers are the most important determinants of economic distance. Wealthy countries engage in relatively more cross-border trade than poorer ones. Rich countries tend to trade with other rich countries; poor countries also trade more frequently with rich countries than with other poor countries. MNEs from wealthy countries benefit in cross-border trade with other wealthy countries when their competitive advantage is based on *economies of experience, scale, scope,* and *standardization.* Why? Replication of an existing business model is much easier in a country where incomes are relatively similar and resources, complements, and infrastructure are of roughly equal quality. Although Walmart in Canada is a virtual carbon copy of Walmart in the United States, Walmart in China is quite different.[63]

Companies from wealthy countries also trade with companies from low-wealth countries to benefit from *economic arbitrage*, which is one of the main benefits of going global. The textile industry (discussed earlier) is a prime example. In going global, it has successfully accessed low-cost input factors.

A final word: Although the CAGE distance framework helps determine the attractiveness of foreign target markets in a fine-grained manner based on relative differences, it is only a first step. A deeper analysis requires strategic managers to look inside the firm (as explained in Chapter 4) to understand how a firm's strengths and weaknesses work to increase or reduce distance from specific foreign markets. A company with a large cadre of cosmopolitan managers and a diverse work force will be much less affected by cultural differences, for example, than a company with a more insular and less diverse culture whose managers all come from the home country. Although technology may make the world seem smaller, the costs of distance along all its dimensions are real, and they can be quite high when a company expands internationally. Ignoring these costs can be expensive (refer to Walmart's adventure in Germany, discussed in Strategy Highlight 10.1) and can lead to a competitive disadvantage.

HOW DO MNEs ENTER FOREIGN MARKETS?

LO 10-4

Compare and contrast the different options MNEs have for entering foreign markets.

Assuming an MNE has decided why and where to enter a foreign market, the remaining decision is *how* to do so. Exhibit 10.7 displays the different options managers have when entering foreign markets, along with the required investments necessary and the control they can exert. On the left end of the continuum in Exhibit 10.7 are vehicles of foreign expansion that require low investments but allow for only a low level of control. On the right are foreign-entry modes that require a high level of investments in terms of capital and other resources, but afford a high level of control. Foreign-entry modes with a high level of control such as foreign acquisitions reduce the firm's exposure to two particular downsides of global business: loss of reputation and loss of intellectual property.

Exporting—producing goods in one country to sell in another—is one of the oldest forms of internationalization (part of Globalization 1.0). It is often used to test whether a foreign market is ready for a firm's products. When studying vertical integration and diversification (in Chapter 8), we discussed in detail different forms along the make-or-buy continuum. As discussed in Chapter 9, strategic alliances (including licensing, franchising, and joint ventures) and acquisitions are popular vehicles for entry into foreign markets. Because we discussed these organizational arrangements in detail in previous chapters, we keep this section on foreign-entry modes brief.

The framework illustrated in Exhibit 10.7, moving from left to right, has been suggested as a *stage model* of sequential commitment to a foreign market over time.[64] Though it does not apply to globally born companies such as internet companies, it is relevant for manufacturing companies that are just now expanding into global operations. In some instances, the host country requires foreign companies to form joint ventures in order to conduct business there, but some MNEs prefer *greenfield operations*—building new, fully owned plants and facilities from scratch. Motorola received permission to build a fully owned plant in China

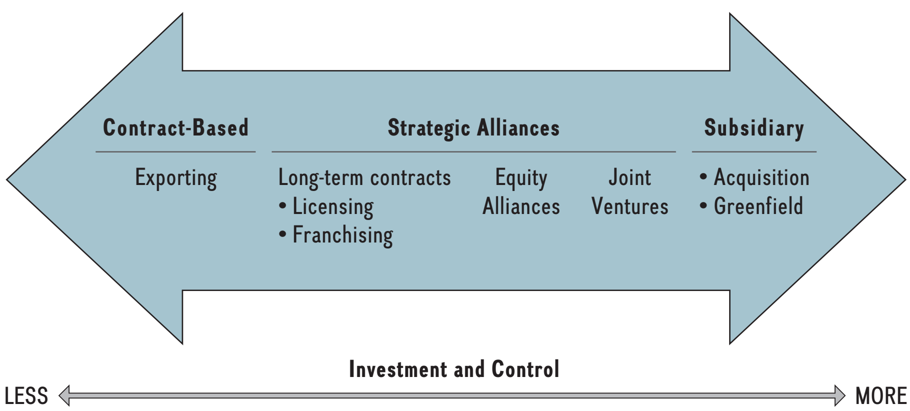


EXHIBIT 10.7

Modes of Foreign-Market Entry along the Investment and Control Continuum when it entered (in the 1990s)[65] as did Tesla when it built its Giga factory in Shanghai, with the first cars (Models 3/Y) rolling off the assembly line in 2020. Tesla cars built in China are for the domestic market and for export to European markets. Estimates indicate that Tesla's production cost per car is about 30% lower in China than in the United States, with no quality differences.

LO 10-5

Apply the cost-responsiveness framework to evaluate the four different strategies MNEs can pursue when competing globally.

10.4 Cost Reductions vs. Local Responsiveness

MNEs face two opposing forces when competing around the globe: *cost reductions* versus *local responsiveness*. Cost reductions achieved through a global-standardization strategy often reinforce a cost-leadership strategy at the business level. Local responsiveness increases the differentiation of products and services, reinforcing a differentiation strategy at the business level. Taken together, however, cost reductions and local responsiveness present strategic trade-offs because higher local responsiveness frequently goes along with higher costs. Conversely, a focus on cost reductions does not allow for much local responsiveness. Just like differentiation and low cost at the business strategy level, cost reductions and local responsiveness are trade-offs when firms compete globally.

One of the core drivers for globalization is the expansion of a firm's total market to achieve economies of scale and drive down costs. For many business executives, the move toward globalization is based on the **globalization hypothesis**, which states that consumer needs and preferences throughout the world are converging and thus becoming increasingly homogenous. Theodore Levitt stated, "Nothing confirms [the globalization hypothesis] as much as the success of McDonald's from [the] Champs-Élysées to Ginza, of Coca-Cola in Bahrain and Pepsi-Cola in Moscow, and of rock music, Greek salad, Hollywood movies, Revlon cosmetics, Sony televisions, and Levi jeans everywhere."[66] In support of the globalization hypothesis, IKEA, as featured in the ChapterCase, sells its home furnishings successfully in 50 countries. Toyota sells its hybrid Prius vehicle in over 90 countries. Most vehicles today are built on global platforms and modified (sometimes only cosmetically) to meet local tastes and standards.

globalization hypothesis Assumption that consumer needs and preferences throughout the world are converging and thus becoming increasingly homogenous.

The strategic foundations of the globalization hypothesis are based primarily on cost reduction. Lower cost is a key competitive weapon, and MNEs attempt to reap significant cost reductions by leveraging economies of scale and by managing global supply chains to access the lowest-cost input factors.

Although there seems to be some convergence of consumer preferences across the globe, national differences remain, due to distinct institutions and cultures. For example, Ford Motor Co. followed a one-size-fits-all strategy by offering a more or less identical car throughout the world: the Ford Mondeo, sold as the Ford Contour and the Mercury Mystique in North America (in the 1990s). Ford learned the hard way, by lack of sales, that consumers did not subscribe to the globalization hypothesis at the same level as the Ford executives and were not yet prepared to ignore regional differences.[67]

In some instances, MNEs experience pressure for **local responsiveness**—the need to tailor product and service offerings to fit local consumer preferences and host-country requirements. For example, Walmart sells live animals (snakes, eels, toads) for food preparation in China. IKEA sells kimchi refrigerators and metal chopsticks in South Korea. McDonald's uses chicken and fish instead of beef in India and offers a teriyaki burger in Japan, even though its basic business model of offering fast food remains the same the world over. Local responsiveness generally entails higher cost, which sometimes even outweighs cost advantages from economies of scale and lower-cost input factors.

local responsiveness The need to tailor product and service offerings to fit local consumer preferences and host-country requirements.

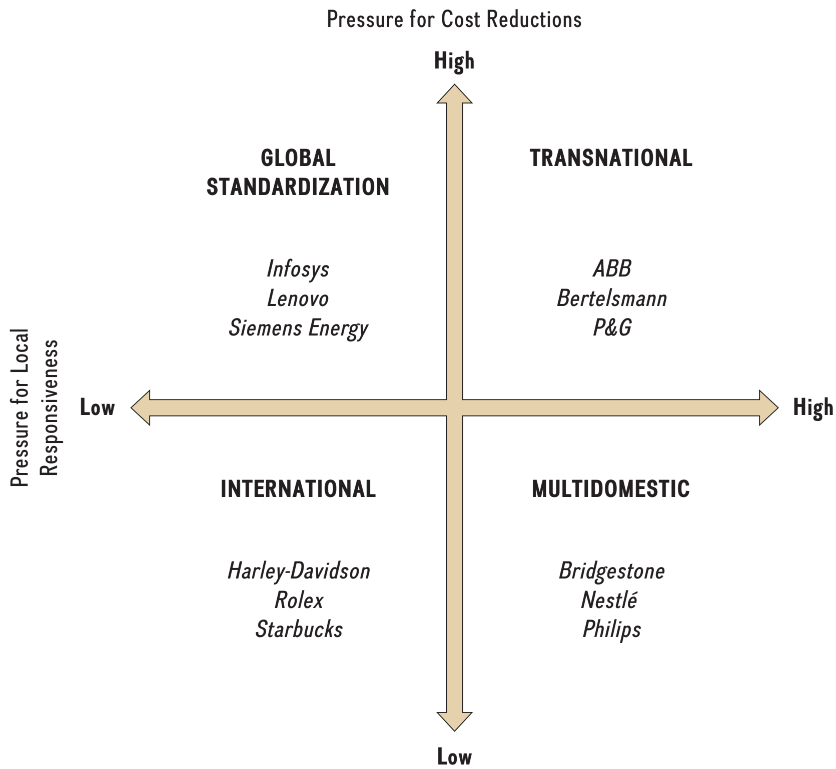


EXHIBIT 10.8

The Cost-Responsiveness Framework: Global Strategy Positions and Representative MNEs

Sources: Author's adaptation from C.K. Prahalad and Y.L. Doz (1987), *The Multinational Mission* (New York: Free Press); and K. Roth and A.J. Morrison (1991), "An empirical analysis of the integration-responsiveness framework in global industries," *Journal of International Business Studies* 21: 541–564.

Given the two opposing pressures of cost reductions and local responsiveness, scholars have advanced the **cost-responsiveness framework**, shown in Exhibit 10.8.[68] This framework juxtaposes the opposing pressures for cost reductions and local responsiveness to derive four different strategic positions to gain and sustain competitive advantage when competing globally. The four strategic positions, which we discuss in the following sections, are as follows:

- International
- Multidomestic
- Global standardization
- Transnational[69]

At the end of this discussion, Exhibit 10.9 summarizes each global strategy.

cost-responsiveness framework Strategy framework that juxtaposes the pressures an MNE faces for cost reductions and local responsiveness to derive four different strategies to gain and sustain competitive advantage when competing globally.

INTERNATIONAL STRATEGY

An **international strategy** is essentially a strategy in which a company sells the same products or services in domestic markets and foreign markets. It enables MNEs to leverage their home-based core competencies in foreign markets. An international strategy is one of the oldest types of global strategies (Globalization 1.0) and is frequently the first step companies take when they begin to conduct business abroad. As shown in the cost-responsiveness framework, this strategy is advantageous when the MNE faces low pressures for both local responsiveness and cost reductions.

international strategy Strategy that involves leveraging home-based core competencies by selling the same products or services in both domestic and foreign markets.

An international strategy is often used successfully by MNEs with relatively large domestic markets and with strong reputations and brand names. These MNEs, capitalizing on the fact that customers abroad want to buy the original product, tend to use differentiation as their preferred business strategy. For example, bikers in Shanghai, China, like their Harley-Davidson motorcycles to roar just like the ones ridden by motorcycle clubs in the United States. A Brazilian entrepreneur importing machine tools from Germany expects superior engineering and quality. Apple's latest iPhone model is a desired luxury product and status symbol the world over. An international strategy tends to rely on exporting or the licensing of products and franchising of services to reap economies of scale by accessing a larger market.

A strength of the international strategy—its limited local responsiveness—is also a weakness in many industries. For example, when an MNE sells its products in foreign markets with little or no change, it leaves itself open to the expropriation of intellectual property (IP). Looking at the MNE's products and services, pirates can reverse-engineer the products to discover the intellectual property embedded in them. In addition to the risk of exposing their IP, MNEs following an international strategy are highly affected by exchange-rate fluctuations.

Due to increasing globalization, fewer and fewer markets correspond to this situation—low pressures for local responsiveness *and* cost reductions—that gives rise to the international strategy.

MULTIDOMESTIC STRATEGY

multidomestic strategy Strategy pursued by MNEs that attempts to maximize local responsiveness, with the intent that local consumers will perceive them to be domestic companies.

MNEs pursuing a **multidomestic strategy** attempt to maximize local responsiveness, hoping that local consumers will perceive their products or services as local. This strategy arises out of the combination of high pressure for local responsiveness and low pressure for cost reductions. Many MNEs use a multidomestic strategy when entering host countries with large and idiosyncratic domestic markets, such as Japan or Saudi Arabia. This is one of the main strategies MNEs pursued in the Globalization 2.0 stage.

A multidomestic strategy is common in the consumer products and food industries. For example, Swiss-based Nestlé, the largest food company in the world, is known for customizing its product offerings to suit local preferences, tastes, and requirements. Given the quality in the consumer products and food industries, along with the strong brand names and core competencies in R&D, it is not surprising that MNEs in these industries generally pursue a differentiation strategy at the business level. An MNE following a multidomestic strategy faces reduced exchange-rate exposure because the majority of the value creation takes place in the host-country business units, which tend to span all functions.

On the downside, a multidomestic strategy is costly and inefficient because it requires the duplication of key business functions across multiple countries. Each country unit tends to be highly autonomous, and the MNE is unable to reap economies of scale or learning across regions. Moreover, the risk of IP appropriation increases when companies follow a multidomestic strategy. In addition to exposing codified knowledge embedded in products (as in an international strategy), a multidomestic strategy requires exposing tacit knowledge because products are manufactured locally. Tacit knowledge that is at risk of appropriation may include, for example, the process of how to create consumer products of higher perceived quality.

GLOBAL-STANDARDIZATION STRATEGY

global-standardization strategy Strategy attempting to reap significant economies of scale and location economies by pursuing a global division of labor based on wherever best-of-class capabilities reside at the lowest cost.

MNEs following a **global-standardization strategy** attempt to reap significant economies of scale and location economies by pursuing a global division of labor based on wherever best-of-class capabilities reside at the lowest cost. The global-standardization strategy arises out of the combination of high pressure for cost reductions and low pressure for local responsiveness. MNEs using this strategy are often organized as networks (Globalization 3.0), allowing them to strive for the lowest-cost position possible. Their business-level strategy tends to be cost leadership. Because products are standardized and there is little or no differentiation or local responsiveness, price becomes the main competitive weapon. To be cost competitive, the MNE must maintain a minimum efficient scale (see Chapter 6).

MNEs that manufacture commodity products such as computer hardware or offer services such as business process outsourcing generally pursue a global-standardization strategy. Lenovo, the Chinese computer manufacturer, is the maker of the ThinkPad line of laptops, which it acquired from IBM (in 2005). To keep track of the latest developments in computing, Lenovo's research centers are located in Beijing and Shanghai in China; in Raleigh, North Carolina (in the Research Triangle Park); and in Japan.[70] To benefit from low-cost labor and to be close to its main markets to reduce shipping costs, Lenovo's manufacturing facilities are in Mexico, India, and China. The company describes the benefits of its global-standardization strategy insightfully: "Lenovo organizes its worldwide operations with the view that a truly global company must be able to quickly capitalize on new ideas and opportunities from anywhere. By forgoing a traditional headquarters model and focusing on centers of excellence around the world, Lenovo makes the maximum use of its resources to create the best products in the most efficient and effective way possible."[71]

TRANSNATIONAL STRATEGY

MNEs pursuing a **transnational strategy** attempt to combine the benefits of a localization strategy (high local responsiveness) with those of a global-standardization strategy (lowest-cost position attainable). This strategy arises out of the combination of high pressure for local responsiveness and high pressure for cost reductions. A transnational strategy is generally used by MNEs that pursue a blue ocean strategy at the business level by attempting to reconcile product and service differentiations at low cost.

transnational strategy Strategy that attempts to combine the benefits of a localization strategy (high local responsiveness) with those of a global-standardization strategy (lowest-cost position attainable).

In addition to harnessing economies of scale and location, a transnational strategy aims to benefit from global learning. MNEs typically implement a transnational strategy through a global matrix structure. This organizational structure combines economies of scale along specific product divisions with economies of learning attainable in specific geographic regions. The idea is that best practices, ideas, and innovations will be diffused throughout the world, regardless of their point of origin. The managers' mantra is to *think globally but act locally*.

Although a transnational strategy is quite appealing, the required matrix structure is rather difficult to implement because of the organizational complexities involved. High local responsiveness typically requires key business functions to be duplicated in each host country, leading to higher costs. Further compounding the organizational complexities is the challenge of finding managers who can dexterously work across cultures in the ways required by a transnational strategy. We discuss organizational structure in more depth in Chapter 11.

The German multimedia conglomerate Bertelsmann attempts to follow a transnational strategy. Bertelsmann employs over 100,000 people, with two-thirds of that work force outside its home country. Bertelsmann operates in more than 60 countries throughout the world and owns many regional leaders in their specific product categories, including Penguin Random House in the United States and RTL Group, Europe's second-largest TV, radio, and production company (after the BBC in the United Kingdom). Bertelsmann operates its over 500 regional media divisions as more or less autonomous profit-and-loss centers but attempts to share best practices across units; global learning and human resource strategies for executives are coordinated at the network level.[72]

Strategy Highlight 10.2 explains how a transnational strategy aids Netflix in generating breakout hits.

Strategy Highlight 10.2

Squid Game: Netflix's Transnational Strategy

South Korea has become a cultural center in Asia over the past decade. The success of K-dramas is part of a broader cultural trend in which South Korea has become a leader in film, beauty (K-beauty), and music (K-pop). Movie lovers in the West became intrigued by K-dramas when watching *Parasite,* streamed by Hulu. This dark comedy won six Oscars (in 2020), a record for a foreign film, including Best Picture, a first for a non-English-speaking movie.

Squid Game, a Netflix original series produced for the Korean market, is a hyperviolent version of *Hunger Games*. Instead of teenagers, 456 grown-up players, all facing financial distress, face off in a set of Korean children's games for the chance of winning $40 million. The six rounds of games take place on a dystopian island with rules akin to those of a battle royale esports game such as Fortnite, where the last person surviving is the winner. All other contestants die in the six rounds of games. The winner takes the jackpot and returns to "normal life," which is depicted as so hopeless for some in the highly stratified Korean society that all contestants choose voluntarily to compete in *Squid Game*. They prefer a minuscule chance of winning and almost certain death over continuing life in the real world.

Squid Game was produced for the Korean market but became a global phenomenon. Netflix's experiments with sponsoring many lower-budget local TV dramas paid off handsomely with Squid Game, which appealed to a worldwide audience by anchoring the show in universal concerns about social injustice and discontent with the capitalist system. Squid Game also captured the dystopian zeitgeist during the peak of the Covid-19 pandemic.

Entertainment Pictures/Alamy Stock Photo

Netflix released *Squid Game* in 2021. Within a few short weeks, it became a global sensation. Indeed, it rose to the No. 1 series on Netflix in some 100 countries, including the United States. No other Netflix series has had so much success from the get-go. Even more surprising is the fact that Netflix didn't spend any money promoting *Squid Game*. Instead, social media such as TikTok created the buzz organically.

Squid Game is a local show that became a global phenomenon. *Squid Game*'s remarkable worldwide success is an outstanding feat, especially considering the significant cultural distance between Korea and the rest of the world. In addition to being produced in Korea, *Squid Game* is steeped firmly in Korean culture. It features popular Korean children's games (which give the show its title), references events from Korean history, features a North Korean defector, and highlights stark socioeconomic class differences.

Netflix did make minor changes to *Squid Game* to make the show more palatable to global audiences. First, because TV dramas have a large amount of linguistic content, they tend to face the obstacle of high cultural distance because culture is embedded in language. The larger the cultural distance between countries, the more difficult it is for content to travel across borders, especially to countries with a different language (which means all countries other than North Korea, where it is illegal to consume South Korean media content, even though that content is in high demand in the underground market). To overcome the cultural differences embedded in language, Netflix spent millions to have *Squid Game* professionally dubbed in 13 languages, and subtitles are available in more than 30 languages. Over 95% of all viewers of *Squid Game* are outside Korea. Many Americans prefer watching foreign films with English dubbing rather than reading subtitles. Netflix's finely tuned algorithms automatically select whether to serve up a dubbed version or subtitles based on the subscriber's past viewing habits.

Second, some traditional Korean games were simplified to make it easier for global audiences to understand them. Netflix also focused on striking visual languages such as bright green tracksuits, pink uniforms, and colorful sets such as children's playgrounds that are visually appealing, albeit dystopian. Ultimately, Netflix overcame

(Continued)

cultural distance by presenting a story that is chock full of universal values and issues such as good versus evil, socioeconomic class struggles, inequality, disenchantment with the capitalist system, and a dystopian sense of the zeitgeist during the peak of the global Covid-19 pandemic.

Squid Game's outstanding success is a triumph in Netflix's transnational strategy. Since 2016, Netflix has spent over $1 billion on Korean films, with $500 million spent in 2021, out of a total content budget of $17 billion for that year (highest in the industry when considering streaming only). In that five-year period, Netflix introduced 80 Korean movies and TV series, focusing on a large number of lower-budget productions. Netflix views each local movie production as an experiment, hoping that a few will make it big. And *Squid Game* certainly did! So did *Lupin* (France), *Money Heist* (Spain), and *Roma* (Mexico). Even Jeff Bezos, founder and longtime CEO of Amazon, which has a strong streaming presence with Prime, was impressed. Bezos tweeted: "@ReedHastings and Ted Sarandos and the team @Netflix get it right so often. Their internationalization strategy isn't easy, and they're making it work. Impressive and inspiring."[73]

In comparison, Disney pursues an international rather than a transnational strategy and spends big on each of its productions. For instance, the sequel *Avengers: Endgame* in Disney's lineup of movies from the Marvel Universe cost more than 20 times ($400 million) as much as the entire season (9 episodes) of *Squid Game*. Disney's international strategy is a direct outflow of its business model of producing a few high-impact blockbuster movies. Disney then leverages each movie's success into billion-dollar franchises through movie sequels, theme-park attractions, merchandise, and licensing. Disney has a strong preference for a few quality movies over several mediocre ones. Disney, therefore, focuses on the billion-dollar franchises with an international strategy, exporting movies much like Harley-Davidson exports motorcycles.

In summary, Netflix is pursuing a transnational strategy by hoping that locally produced content will break out globally. A transnational strategy suits Netflix well because it is active in 190 countries. Locally produced content tends to be much lower budget than the traditional (overproduced and costly) Hollywood productions. With Netflix facing increasing competition in the North American market, which has reached saturation, its future growth may lie in leveraging a transnational strategy where smaller-budget local movies may break out globally. Given that Netflix runs thousands of such experiments across the globe, chances are that the next global breakout hit on Netflix will again come from outside the United States.[74]

Exhibit 10.9 provides a detailed summary of each of the four global strategies in the cost-responsiveness framework.

DYNAMIC STRATEGIC POSITIONING: THE CASE OF YOUTUBE. Recall that effective strategic positions are not constant and are as dynamic as the environment. They can change over time. Consider, for instance, how Google shifted the positioning of its paid YouTube offering. It launched YouTube Red (in 2015), a streaming subscription service that allows users to stream any video and music content via YouTube ad-free and to download videos for viewing offline without an internet connection. Moreover, YouTube Red offers original content on its free YouTube service that is not available on other free services; this original content includes *Cobra Kai*, *Step Up: High Water*, and *Youth & Consequences*. What strategic steps did Google take to achieve these repositioning efforts?[75]

First, when Google launched YouTube Red, it followed an *international strategy*, making the service first available in the United States. In 2016 it then made the service available in only two other countries that, according to Hofstede's index discussed earlier, exhibit close cultural proximity to the United States—namely, Australia and New Zealand. Across both of these countries, YouTube Red remained the same product offering.

Second, in rebranding YouTube Red as YouTube Premium in 2018 (alongside a relaunch of YouTube Music, again as a separate paid streaming service), Google followed a *multidomestic strategy:* It offered YouTube Premium in initially 17 countries, including some, such as Germany, Russia, and South Korea, that are culturally distant from the United

EXHIBIT 10.9 International, Multidomestic, Global-Standardization, and Transnational Strategies: Characteristics, Benefits, and Risks

Strategy	Characteristics	Benefits	Risks
International	Often the first step in internationalizing. Used by MNEs with relatively large domestic markets or strong exporters (e.g., MNEs from the United States, Germany, Japan, South Korea). Well suited for high-end products with high value-to-weight ratios such as machine tools and luxury goods that can be shipped across the globe. Products and services tend to have strong brands. Main business-level strategy tends to be differentiation because exporting, licensing, and franchising add additional costs.	Leveraging core competencies. Economies of scale. Low-cost implementation through: • Exporting or licensing (for products) • Franchising (for services) • Licensing (for trademarks)	No or limited local responsiveness. Highly affected by exchange-rate fluctuations. IP embedded in product or service could be expropriated.
Multidomestic	Used by MNEs to compete in host countries with large and/or lucrative but idiosyncratic domestic markets (e.g., Germany, Japan, Saudi Arabia). Often used in consumer products and food industries. Main business-level strategy is differentiation. MNE wants to be perceived as local company.	Highest-possible local responsiveness. Increased differentiation. Reduced exchange-rate exposure.	Duplication of key business functions in multiple countries leads to high cost of implementation. Little or no economies of scale. Little or no learning across different regions. Higher risk of IP expropriation.
Global Standardization	Used by MNEs that are offering standardized products and services (e.g., computer hardware or business process outsourcing). Main business-level strategy is cost leadership.	Location economies: global division of labor based on wherever best-of-class capabilities reside at lowest cost. Economies of scale and standardization.	No local responsiveness. Little or no product differentiation. Some exchange-rate exposure. “Race to the bottom” as wages increase. Some risk of IP expropriation.
Transnational	Used by MNEs that pursue a blue ocean strategy at the business level by simultaneously focusing on product differentiation and low cost. Mantra: Think globally, act locally.	Attempts to combine benefits of localization and standardization strategies simultaneously by creating a global matrix structure. Economies of scale, location, experience, and learning.	Global matrix structure is costly and difficult to implement, leading to high failure rate. Some exchange-rate exposure. Higher risk of IP expropriation.

States. Although the majority of YouTube Premium content is available in most countries, Google's fine-tuned search and recommendation engine serves up country- and culture-specific content to appeal to local audiences. Recommending local content is in line with predictions derived from the CAGE distance framework because cultural distance mostly affects products with high linguistic and artistic content. As of 2022, YouTube Premium was available in over 100 countries.

Third, moving forward, Google aims to refine its search and recommendation engine in order to pursue a *transnational strateg*y in the near future. The strategic intent is to allow YouTube Premium subscribers, no matter where they are located, access to some of the same content that appeals to the vast majority of viewers, while also promoting geographic-, language-, and culture-specific content. As YouTube Premium competes more and more with other global video-streaming services such as Netflix, lowering the cost of globally popular content that may come from different regions becomes critical. Keep in mind that YouTube Premium does not rely on advertising as a source of income. Instead, YouTube Premium follows a subscription-based business model and thus must compete for users willing to pay for their services. The ability to build a large, installed global base of users is essential to creating, curating, and offering quality content. Moreover, with its user-generated content (500 hours every minute), YouTube runs exponentially more experiments than Netflix. Although the vast majority of YouTube user-generated content is of vastly inferior quality, the probability that some content will break out and become a mega-hit is much greater given that even a small percentage of a very large number is still a large number.

Exhibit 10.10 tracks how Google changed (and plans to change) the strategic positions for its paid YouTube service in its quest for competitive advantage over time.

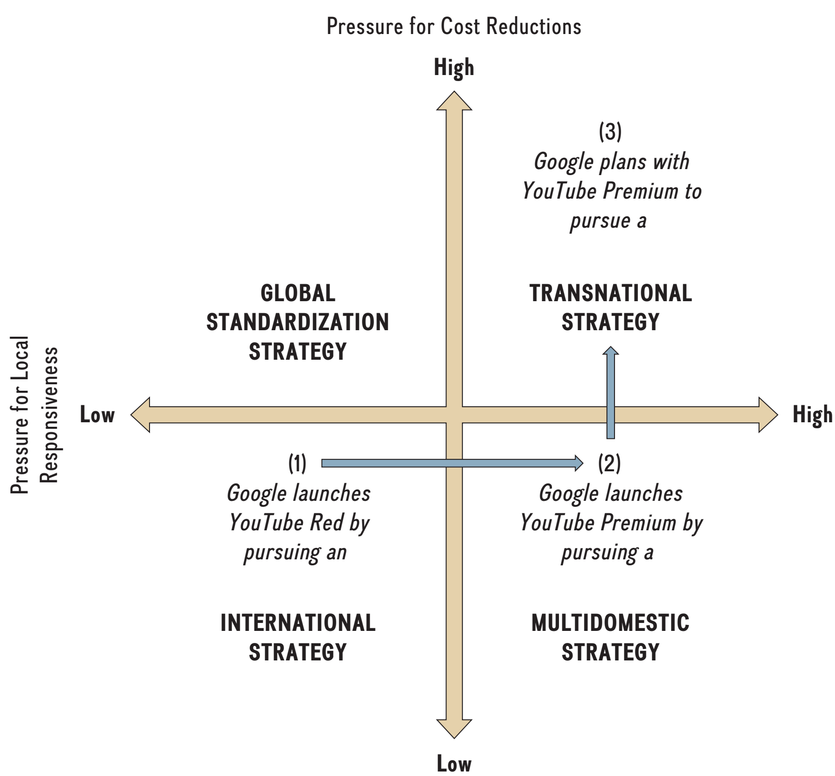


EXHIBIT 10.10

Dynamic Strategic Positioning: Google's YouTube

10.5 National Competitive Advantage: World Leadership in Specific Industries

Advances in communications technology (e.g., "work-from-anywhere") and transportation logistics can lead us to believe that firm location is becoming increasingly less important.[76] Because firms can now, more than ever, source inputs globally, many believe that location must be diminishing in importance as an explanation of firm-level competitive advantage. This idea is called the **death-of-distance hypothesis**.[77] The need for robust supply chains (*anti-fragility*) became painfully apparent during the Covid-19 pandemic. Anti-fragile supply chains are achieved through second sources and through keeping supply chains closer to home. Although some redundancies increase costs, anti-fragility buffers companies from black swan events such as a pandemic or political instability.

death-of-distance hypothesis Assumption that geographic location alone should not lead to firm-level competitive advantage because firms are now, more than ever, able to source inputs globally.

Yet, even prior to the Covid-19 pandemic, the *death-of-distance* hypothesis was more hype than reality. Despite an increasingly globalized world, it turns out that high-performing firms in certain industries *are* geographically concentrated in specific countries.[78] For example, the leading biotechnology, software, and tech companies are headquartered in the United States. Some of the world's best computer manufacturers are in China, and the best chip makers are in Taiwan. Some of the most advanced companies in mobile devices, robotics, and AI are clustered in Shenzhen, China. Many of the leading consumer electronics companies are in South Korea and Japan. The top mining companies are in Australia. The leading business process outsourcing companies are in India. Some of the best engineering and car companies are in Germany. The world's top fashion designers are in Italy. The best wineries are in France. The list goes on.

Although globalization lowers the barriers to trade and investments and increases human capital mobility, one key question remains: *Why are certain industries more competitive in some countries than in others?* This question goes to the heart of the issue of **national competitive advantage**, which in turn has a direct effect on firm-level competitive advantage. Companies from home countries that are world leaders in specific industries tend to be the strongest competitors globally.

national competitive advantage World leadership in specific industries.

PORTER'S DIAMOND FRAMEWORK

LO 10-6

Apply Porter's diamond framework to explain why certain industries are more competitive in specific nations than in others.

Michael Porter advanced a framework to explain national competitive advantage—why some nations outperform others in specific industries. This framework is called Porter's diamond of national competitive advantage. As shown in Exhibit 10.11, it consists of four interrelated factors:

- Factor conditions
- Demand conditions
- Competitive intensity in a focal industry
- Related and supporting industries/complementors

FACTOR CONDITIONS. *Factor conditions* describe a country's endowments in terms of natural, human, and other resources. Other important factors include capital markets, a supportive institutional framework, research universities, and public infrastructure (airports, roads, schools, health care system).

Interestingly, *natural resources* are often not needed to generate world-leading companies because competitive advantage is often based on other factor endowments such as human capital and know-how. Several of the world's most resource-rich countries (such as

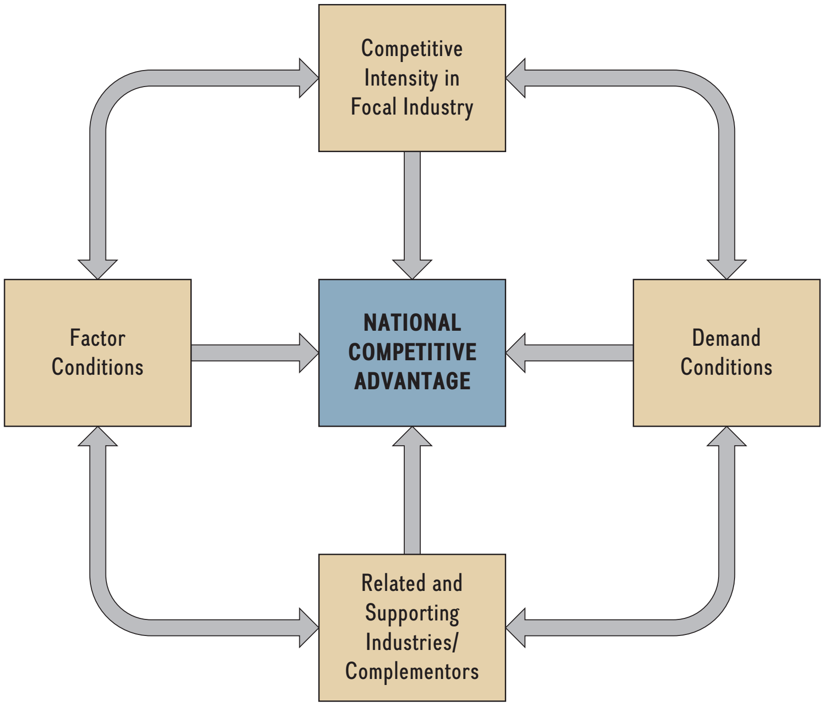


EXHIBIT 10.11

Porter's Diamond of National Competitive Advantage

Source: Author's adaptation from M.E. Porter (1990, Mar–Apr), "The competitive advantage of nations," *Harvard Business Review*: 78.

Afghanistan,[79] Iran, Iraq, Russia, Saudi Arabia, and Venezuela) are not home to any of the world's leading companies, even though some (though not all) have in place institutional frameworks allowing them to be a productive contributor to world commerce. In contrast, countries that lack natural resources (such as Denmark, Finland, Israel, Japan, Singapore, South Korea, Switzerland, Taiwan, and the Netherlands) often develop world-class human capital to compensate.[80]

DEMAND CONDITIONS. *Demand conditions* are the specific characteristics of demand in a firm's domestic market. A home market made up of sophisticated customers who hold companies to a high standard of value creation and cost containment contributes to national competitive advantage. Moreover, demanding customers may also clue firms into the latest developments in specific fields and may push firms to move research from basic findings to commercial applications for the marketplace.

For example, due to dense urban living conditions, hot and humid summers, and high energy costs, it is not surprising that customers in Japan demand small, quiet, and energy-efficient air conditioners. In contrast, Finland has a sparse population living in a more remote countryside. A lack of landlines for telephone service has resulted in customers in Finland demanding high-quality wireless services, combined with reliable handsets (and long-life batteries) that can be operated in remote, often hostile, environments. Cell phones have long been a necessity for survival in rural areas of Finland. This situation enabled Nokia to become an early leader in cell phones.[81]

COMPETITIVE INTENSITY IN A FOCAL INDUSTRY. Companies that face a highly competitive environment at home tend to outperform global competitors that lack such intense domestic competition. For example, fierce domestic competition in Germany, combined with demanding customers and the no-speed-limit autobahn, create a tough environment for any German car company. Success requires top-notch engineering of chassis and engines, as well as keeping costs and fuel consumption ($8-per-gallon gas) in check. Further, it is interesting to note that other than Volkswagen, which is located in Wolfsburg (an artificial city created during the Nazi rule in Germany), all other German carmakers (Audi, Porsche, BMW, and Mercedes) are located in the southern part of Germany, within easy driving distance from one another. The extremely tough home environment amply prepared German car companies such as Volkswagen (which also owns Audi and Porsche), BMW, and Daimler for global competition. To be part of this competitive crucible, Tesla chose to locate its first European factory in Germany.

RELATED AND SUPPORTING INDUSTRIES/COMPLEMENTORS. Leadership in related and supporting industries can also foster world-class competitors in downstream industries. The availability of top-notch *complementors*—firms that provide a good or service that leads customers to value the focal firm's offering more when the two are combined—further strengthens national competitive advantage. For example, Switzerland leveraged its early lead in industrial chemicals into pharmaceuticals.[82] A sophisticated health care service industry sprang up as an important complementor, providing further stimulus for growth and continuous improvement and innovation.

The effects of sophisticated customers and highly competitive industries ripple through the industry value chain to create top-notch suppliers and complementors. Toyota's global success in the 1990s and early 2000s was based to a large extent on a network of world-class suppliers in Japan.[83] This tightly knit network allowed for fast two-way knowledge sharing—which in turn improved Toyota's quality and lowered its cost, which it leveraged into a successful blue ocean strategy at the business level.

It is also interesting to note that by the 2010s, Toyota's supplier advantage had disappeared.[84] It was unable to solve the trade-off between drastically increasing its volume and maintaining superior quality. Toyota's rapid growth in its quest to become the world's leader in volume required quickly bringing on new suppliers outside Japan. Quality standards, however, could not be maintained. Part of the problem lies in path dependence (discussed in Chapter 4), because suppliers in China and other suppliers could not be found quickly enough, nor could most foreign suppliers build at the required quality levels fast enough. The cultural distance between Japan and China exacerbated these problems. These factors highlight the importance of related and supporting industries to national competitive advantage.

10.6 Implications for Strategic Leaders

In addition to determining the degree of vertical integration and level of diversification, the strategic leader needs to decide if and how the firm should compete beyond its home market. Decisions along all three dimensions help the firm formulate its corporate strategy. Because of increasing global integration in products and services as well as capital markets, the benefits of competing globally outweigh the costs for more and more enterprises. This statement is true not just for large MNEs but also for small and medium enterprises (SMEs). Even small startups are now able to leverage technology such as the internet and AI to compete beyond their home market.

Strategic leaders have a number of frameworks at their disposal to make global strategy decisions. The CAGE framework allows for a detailed analysis of any country pairing. Rather than looking at simple absolute measures such as market size, the strategist can determine the *relative* distance or closeness of a target market to the home market along cultural, administrative/political, geographic, and economic dimensions. Once the firm decides which countries to enter, the *mode* of foreign entry needs to be determined.

Considerations of the degree of investment and level of control help strategists make this decision. Higher levels of control, and thus greater protection of IP and a lower likelihood of any loss in reputation, go along with more investment-intensive foreign-entry modes such as acquisitions or greenfield plants (refer to Exhibit 10.7).

A firm's business-level strategy (discussed in Chapter 6) provides important guidance regarding possible strategies to be pursued globally. A cost leader, for example, is more likely to have the capabilities to be successful with a global-standardization strategy. In contrast, a differentiator is more likely to be successful in pursuing an international or multidomestic strategy. The same caveats concerning a blue ocean strategy at the business level apply at the corporate level: Although attractive on paper, a transnational strategy combining high pressures for cost reductions with high pressures for local responsiveness is difficult to implement because of inherent trade-offs.

Finally, strategic leaders must be aware of the fact that despite globalization and the emergence of the internet, a firm's geographic location has maintained its importance. Critical masses of world-class firms are clearly apparent in *regional geographic clusters.* Think of computer technology firms in Silicon Valley, medical device firms in the Chicago area, and biotechnology firms in and around Boston. Regional clusters are a worldwide phenomenon. Known for their engineering prowess, car companies such as Daimler, BMW, Audi, and Porsche are clustered in southern Germany. Many fashion-related companies (clothing, shoes, and accessories) are located in northern Italy. Singapore is a well-known cluster for semiconductor materials, and India's leading IT firms are in Bangalore. Porter captures this phenomenon succinctly: "Paradoxically, the enduring competitive advantages in a global economy lie increasingly in local things—knowledge, relationships, and motivation that distant rivals cannot match."[85]

This chapter concludes our discussion of global strategy. We have now completed our study of the first two pillars of the AFI framework—*strategy analysis* (Chapters 1 to 5) and *strategy formulation* (Chapters 6 to 10). Next, we turn to the third and final pillar of the AFI framework—*strategy implementation.* In Chapter 11, we study what leaders can do to implement their carefully crafted strategies successfully and how to avoid failure. In Chapter 12, we study corporate governance, business ethics, and business models.

CHAPTER**CASE 10** Part II

Despite its tremendous success, IKEA faces significant challenges. Although online shopping is growing fast and accounts for about a quarter of IKEA's total sales, opening new stores is critical to driving future growth. Customers prefer to see home furnishings arranged by interior designers in a physical store, a sensation that is difficult to replicate online. Visiting an IKEA mega store is a unique experience, complete with onsite childcare and a restaurant offering salmon and quintessential Swedish meatballs at discounted prices. Moreover, while IKEA's main markets in Europe and the United States have seamless online shopping and delivery infrastructure, many emerging markets do not. In rising economies such as China and India, IKEA expects significant future growth as the middle class expands.

A related challenge for IKEA is finding new sources of supply to serve more customers globally. Although supply chain bottlenecks due to the pandemic are more or less resolved, sourcing large amounts of wood sustainably remains a significant challenge for IKEA because wood remains one of IKEA's main inputs. At the same time, the world's consumers are becoming more sensitive to the issue of deforestation and its link to climate change. Soon, IKEA must find low-cost replacement materials for wood. The need to find an environmentally friendly replacement for wood has become even more urgent for IKEA after it closed its stores in Russia to protest the invasion of Ukraine. Russia is a crucial wood supplier.

The home furniture market in the United States was \$110 billion (in 2021). Although IKEA is growing in North America, it holds less than a 5% market share there, compared to its 30% market share in Europe. The U.S. market is quite fragmented, with a dozen or more traditional competitors, including Ashley Furniture Stores, Williams-Sonoma, Rooms to Go, and Restoration Hardware. Other powerful bricks-and-mortar retailers have taken notice of IKEA's success in North America. As a result, IKEA faces intense competition from bricks-and-mortar retailers expanding their lineup of home furnishings, such as Target, The Home Depot, Sam's Club, and Costco. For instance, Target recruited top designers and launched a wide range of low-priced furnishings to compete with IKEA.

In the rapidly growing online space, IKEA faces not only the ecommerce giant Amazon but also Wayfair, an online home-furnishing startup with \$14 billion in annual sales (in 2021). This Boston-based online home furnishings startup opened its first physical stores in 2022 to better integrate the online and in-person shopping experience. This strategic initiative is part of a major push by online retailers to open physical locations to improve the customer experience and increase revenue streams. It highlights the move toward omnichannel retailing in the industry, combining in-store, online, and hybrid variations.

In addition to these external challenges, IKEA faces significant internal challenges. Since the company's founding in 1943, no strategic decisions had been made without Ingvar Kamprad's involvement and approval. He passed away in 2018 at age 91. Kamprad's three sons have taken on more substantial leadership roles at IKEA, including chairing the foundation that controls IKEA. The question remains if they can follow in their legendary father's footsteps. Many observers compare Kamprad's influence on IKEA's culture and organization to the legendary Sam Walton at Walmart. That Arkansas-based big-box retailer struggled for several years after Walton's passing (see Strategy Highlight 10.1).

To address the Covid-19 pandemic's challenges and position IKEA for success in the rapidly changing world of retail, Jon Abrahamsson Ring was appointed CEO in 2020. Under this new leadership, IKEA began a major push into online sales. IKEA's lack of a solid online presence became painfully apparent during the Covid-19 pandemic. As a result, IKEA underwent a major restructuring, eliminating thousands of jobs and creating new ones that focus on improving its online presence, delivery offerings, and in-store experience. To help increase in-person store visits, IKEA redesigned its retail spaces to appear more like showrooms than large inventory warehouses. This showroom approach allows consumers to see how the images of online products appear in the physical world.

With so many competitors in the online market, companies must find ways to differentiate themselves from one another, and after-market services such as furniture assembly are one way to do so. IKEA acquired TaskRabbit to offer furniture-assembly services, but it has to compete with companies such as Wayfair, Walmart, Home Depot, and others, which also offer inexpensive furniture-assembly services. In 2021, these services accounted for a mere 3% of IKEA's total revenues.

IKEA also faces some limitations because of its complicated ownership structure. The firm is privately held through a complex network of foundations and holding companies in the Netherlands, Lichtenstein, and Luxembourg. This arrangement provides benefits in terms of reducing tax exposure, but it creates significant constraints in allowing IKEA to access the large sums of capital needed for rapid global expansion. In addition, many EU countries and the United States have become increasingly sensitive to the issue of tax-avoidance schemes by large multinational enterprises. As a result, over 130 countries, covering more than 90% of world trade, have agreed to levy a minimum global tax rate of 15% for MNEs.

IKEA needs to address a slew of internal and external challenges to achieve its strategic intent of doubling its number of yearly openings to capture a larger slice of fast-growing markets such as the United States and make stronger in-roads in newer markets such as China and India. As more and more people are buying furniture online, IKEA also has to contend with Wayfair, Amazon, JD.com (in China), and other online retailers specializing in home furnishings.

Questions

1. List IKEA's external and internal challenges. Looking at IKEA's challenges, which ones do you think pose the most significant threats? Why? How would you address these challenges?
2. Did it surprise you to learn that both wealthy developed countries (e.g., the United States and Australia) and emerging economies (e.g., China and India) are the fastest-growing international markets for IKEA? Does this fact pose any challenges to how IKEA ought to compete across the globe? Why or why not? Explain.
3. What can IKEA do to continue to drive growth globally, especially given its strategic intent to double annual store openings?
4. Assume IKEA has hired you to consult on *creating shared value* (refer to the discussion in Chapter 5). Which areas would you recommend the company be most sensitive to, and how should these be addressed?

TAKE-AWAY CONCEPTS

This chapter discussed the roles of MNEs in economic growth; the stages of globalization; why, where, and how companies go global; four strategies MNEs use to navigate between cost reductions and local responsiveness; and national competitive advantage, all as summarized by the following learning objectives and related take-away concepts.

LO 10-1 / Define globalization, multinational enterprise (MNE), foreign direct investment (FDI), and global strategy.

- Globalization involves closer integration and exchange between different countries and peoples worldwide. It is made possible by factors such as falling trade and investment barriers, advances in telecommunications, and reductions in transportation costs.
- A multinational enterprise (MNE) deploys resources and capabilities to procure, produce, and distribute goods and services in at least two countries.
- Many MNEs are more than 50% globalized; they receive the majority of their revenues from countries other than their home country. In general, though, the level of globalization based on a number of indicators is no more than 10% to 25%, meaning the world is *semi-globalized.*
- Foreign direct investment (FDI) refers to a firm's investments in value chain activities abroad.
- Global strategy refers to a firm's corporate strategy to gain and sustain a competitive advantage when competing against other foreign and domestic companies around the world.

LO 10-2 / Explain why companies expand internationally, and evaluate the advantages and disadvantages of competing globally.

- Firms expand beyond their domestic borders if they can increase their economic value creation and enhance their competitive advantage.
- Advantages of competing internationally include gaining access to a larger market, gaining access to low-cost input factors, and developing new competencies.
- Disadvantages of competing internationally include the liability of foreignness, the possible loss of reputation, and the possible loss of intellectual property.

LO 10-3 / Apply the CAGE distance framework to guide MNE decisions on which countries to enter.

- Most of the costs and risks involved in expanding beyond the domestic market are created by *distance.*
- The CAGE distance framework determines the *relative* distance between home and foreign target country along four dimensions: cultural distance, administrative and political distance, geographic distance, and economic distance.

LO 10-4 / Compare and contrast the different options MNEs have for entering foreign markets.

- The strategist has the following foreign-entry modes available: exporting, strategic alliances (licensing for products, franchising for services, equity alliances), joint venture, and subsidiary (acquisition or greenfield).
- Higher levels of control, and thus a greater protection of IP and a lower likelihood of any loss in reputation, go along with more investment-intensive foreign-entry modes such as acquisitions or greenfield plants.

LO 10-5 / Apply the cost-responsiveness framework to evaluate the four different strategies MNEs can pursue when competing globally.

- To navigate between the competing pressures of cost reductions and local responsiveness, MNEs have four strategy options: international, multidomestic, global standardization, and transnational.
- An international strategy leverages home-based core competencies into foreign markets, primarily through exports. It is useful when the MNE faces low pressures for both local responsiveness and cost reductions.
- A multidomestic strategy attempts to maximize local responsiveness in the face of low pressure for cost reductions. It is costly and inefficient because it requires the duplication of key business functions in multiple countries.

- A global-standardization strategy seeks to reap economies of scale and location by pursuing a global division of labor based on wherever best-of-class capabilities reside at the lowest cost. It involves little or no local responsiveness.
- A transnational strategy attempts to combine the high local responsiveness of a localization strategy with the lowest-cost position attainable from a global-standardization strategy. It also aims to benefit from global learning. Although appealing, it is difficult to implement due to the organizational complexities involved.

LO 10-6 / Apply Porter's diamond framework to explain why certain industries are more competitive in specific nations than in others.

- National competitive advantage refers to a country's world leadership in specific industries.
- Four interrelated factors explain national competitive advantage: (1) factor conditions, (2) demand conditions, (3) competitive intensity in a focal industry, and (4) related and supporting industries/complementors.
- Even in a more globalized world, the basis for competitive advantage is often local.

KEY TERMS

CAGE distance framework *(p. 391)*
Cost-responsiveness framework *(p. 397)*
Cultural distance *(p. 393)*
Death-of-distance hypothesis *(p. 404)*
Foreign direct investment (FDI) *(p. 378)*
Global-standardization strategy *(p. 398)*
Global strategy *(p. 378)*
Globalization *(p. 377)*
Globalization hypothesis *(p. 396)*
International strategy *(p. 397)*
Liability of foreignness *(p. 387)*
Local responsiveness *(p. 396)*
Location economies *(p. 387)*
Multidomestic strategy *(p. 398)*
Multinational enterprise (MNE) *(p. 378)*
National competitive advantage *(p. 404)*
National culture *(p. 392)*
Transnational strategy *(p. 399)*

ENDNOTES

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8. More recent events currently favor India and China; see: "What is the state of the BRIC economies?" *World Economic Forum,* www.weforum.org/agenda/2016/04/what-is-the-state-of-the-brics-economies/.

9. We define *global strategy* as a "strategy of firms around the globe—essentially various firms' theories about how to compete successfully." This definition expands on a narrower alternative use of the term *global strategy,* which implies a global cost-leadership strategy in standardized products. This narrower approach we denote as *global-standardization strategy*. In both of these definitions we follow the work of M.W. Peng; see: Peng, M. (2013), *Global Strategy,* 3rd ed. (Mason, OH: South-Western Cengage) and elsewhere.

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49. This section is based on: Ghemawat, P. (2001, Sep.), "Distance still matters: The hard reality of global expansion," *Harvard Business Review*; see also Ghemawat, P. (2011), *World 3.0: Global Prosperity and How to Achieve It* (Boston: Harvard Business Review Press).

50. The euro is the official currency of the European Union and is the official currency in the following member countries: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain.

51. To obtain scores for any two country pairings and to view interactive CAGE distance maps, go to www.ghemawat.com.

52. The discussion of the CAGE distance frameworks and the attributes thereof is based on: Ghemawat, P. (2001, Sep.), "Distance still matters: The hard reality of global expansion," *Harvard Business Review*; see also Ghemawat, P. (2011), *World 3.0: Global Prosperity and How to Achieve It* (Boston: Harvard Business Review Press).

53. Hofstede, G.H. (1984), *Culture's Consequences: International Differences in Work-Related Values* (Beverly Hills, CA: Sage), 21. The description of Hofstede's four cultural dimensions is drawn from Rothaermel, F.T., S. Kotha, and H.K. Steensma (2006), "International market entry by U.S. Internet firms: An empirical analysis of country risk, national culture, and market size," *Journal of Management* 32: 56–82.

54. The *power-distance dimension* of national culture focuses on how a society deals with inequality among people in terms of physical and intellectual capabilities and how those methods translate into power distributions within organizations. High power-distance cultures, like the Philippines (94/100, with 100 = high), tend to allow inequalities among people to translate into inequalities in opportunity, power, status, and wealth. Low power-distance cultures, like Austria (11/100), on the other hand, tend to intervene to create a more equal distribution among people within organizations and society at large. The *individualism dimension* of national culture focuses on the relationship between individuals in a society, particularly in regard to the relationship between individual and collective pursuits. In highly individualistic cultures, like the United States (91/100), individual freedom and achievements are highly valued. As a result, individuals are only tied loosely to one another within society. In less-individualistic cultures, like Venezuela (12/100), the collective good is emphasized over the individual, and members of society are strongly tied to one another throughout their lifetimes by virtue of birth into groups like extended families. The *masculinity–femininity dimension* of national culture focuses on the relationship between genders and its relation to an individual's role at work and in society. In more "masculine" cultures, like Japan (95/100), gender roles tend to be clearly defined and sharply differentiated. In "masculine" cultures, values like competitiveness, assertiveness, and exercise of power are considered cultural ideals, and men are expected to behave accordingly. In more "feminine" cultures, like Sweden (5/100), values like cooperation, humility, and harmony are guiding cultural principles. The masculinity–femininity dimension uncovered in Hofstede's research is undoubtedly evolving over time, and values and behaviors are converging to some extent. The *uncertainty-avoidance dimension* of national culture focuses on societal differences in tolerance toward ambiguity and uncertainty. In particular, it highlights the extent to which members of a certain culture feel anxious when faced with uncertain or unknown situations. Members of high uncertainty-avoidance cultures, like Russia (95/100), value clear rules and regulations as well as clearly structured career patterns, lifetime employment, and retirement benefits. Members of low uncertainty-avoidance cultures, like Singapore (8/100), have greater tolerance toward ambiguity and thus exhibit less emotional resistance to change and a greater willingness to take risks.

55. See: http://geert-hofstede.com/nationalculture.html. The available data, however, on the new dimensions are not, at this point, as comprehensive as for the four original dimensions. Alternatively, see the GLOBE cultural dimensions at www.grovewell.com/pub-GLOBE-intro.html.

56. This is based on: Kogut, B., and H. Singh (1988), "The effect of national culture on the choice of entry mode," *Journal of International Business Studies* 19: 411–432; Rothaermel, F.T., S. Kotha, and H. K. Steensma (2006), "International market entry by U.S. internet firms: An empirical analysis of country risk, national culture, and market size," *Journal of Management 32:* 56–82. Cultural distance from the United States, for example, is calculated as follows:

$$CD_j = \sum_{i=1}^{4}[(I_{ij} - I_{iu})^2/V_i)/4$$

where I_{ij} stands for the index for the ith cultural dimension and jth country, V_i is the variance of the index of ith dimension, u indicates the United States, and CD_j is the cultural distance difference of the jth country from the United States.

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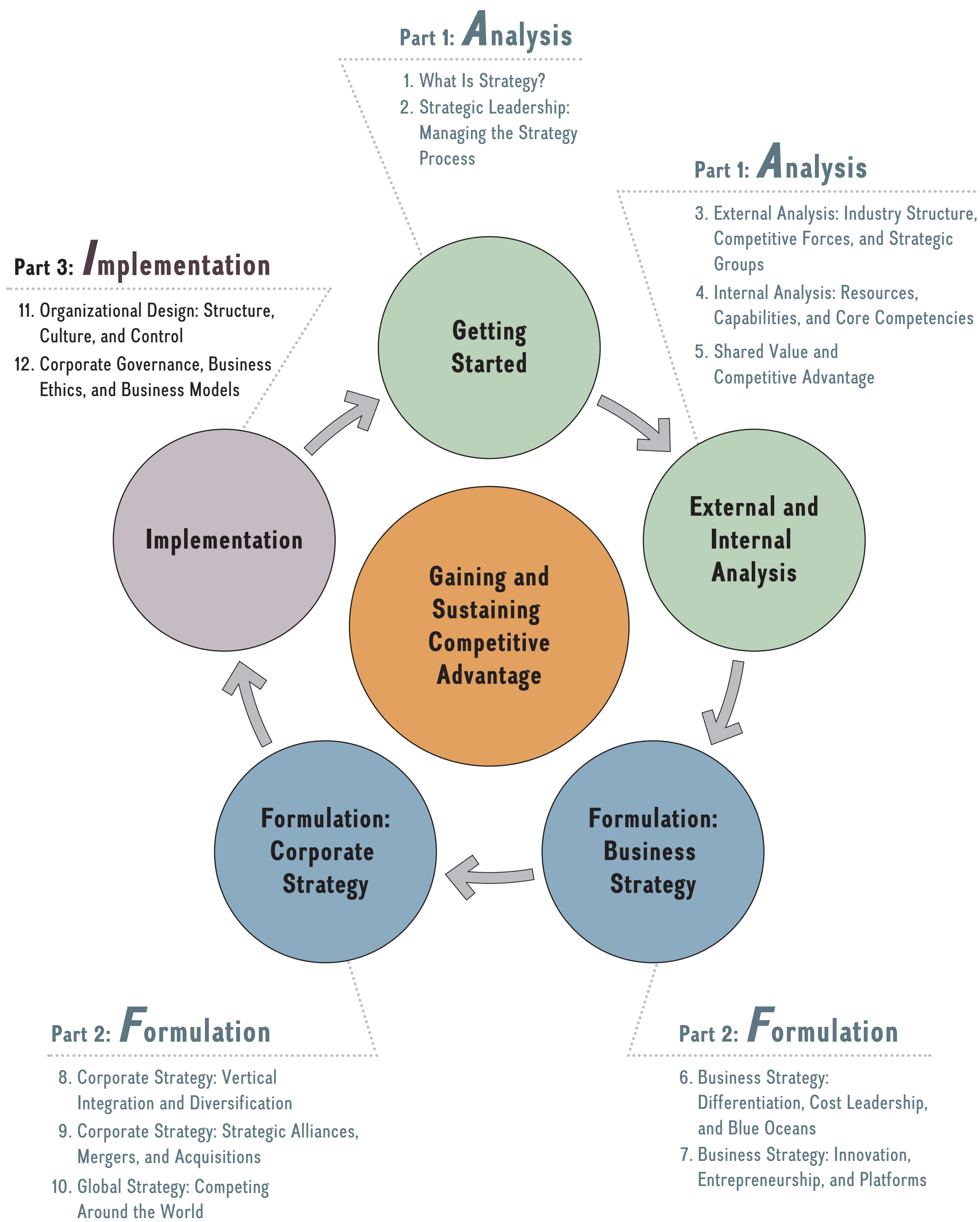
PART 3

Implementation

The AFI Strategy Framework



CHAPTER

11

Organizational Design: Structure, Culture, and Control

Chapter Outline

Learning Objectives

LO 11-1 Define organizational design and list its three components.

LO 11-2 Explain how organizational inertia can lead established firms to failure.

LO 11-3 Define organizational structure and describe its four elements.

LO 11-4 Compare and contrast mechanistic organizations and organic organizations.

LO 11-5 Describe different organizational structures and match them with appropriate strategies.

LO 11-6 Evaluate closed and open innovation, and derive implications for organizational structure.

LO 11-7 Describe the elements of organizational culture, and explain where organizational cultures can come from and how they can be changed.

LO 11-8 Compare and contrast different strategic control-and-reward systems.

CHAPTERCASE 11 Part I

"A" Is for Alphabet and "G" Is for Google

"Google is not a conventional company. We do not intend to become one,"[1] wrote founders Larry Page and Sergey Brin for the company's initial public offering (in 2004). These computer science graduate students turned entrepreneurs, best known for creating the world's most successful online search engine, also indicated they would make "smaller bets in areas that might seem very speculative or even strange when compared to our current businesses."[2] Some of these smaller bets seemed farfetched at the time, but they resulted in Google Maps, YouTube, Chrome, and Android—all of which have billions of users today. To say that Google has been hugely successful is an understatement. Since listing on the stock market, it has managed to outperform the tech-heavy NASDAQ-100 index. Google's market cap crossed the $2 trillion threshold (in 2021), making it only the third company (after Apple and Microsoft) to reach this milestone.

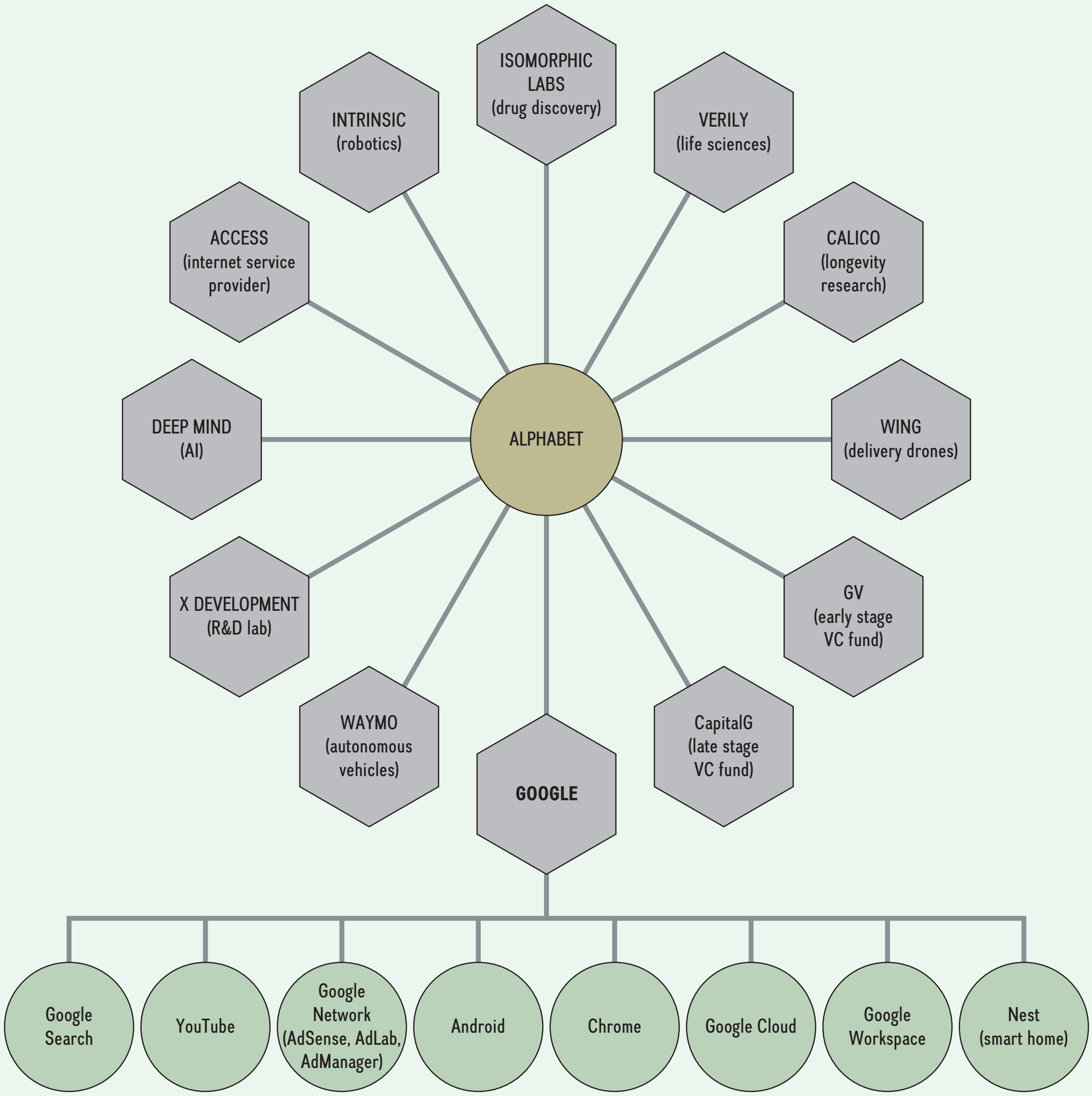
Google proved it was not a conventional company yet again when it split itself into several standalone strategic business units, or SBUs (in 2015). As Google's structure became more and more complex and its number of business lines grew increasingly unrelated (think online search and longevity research), Google's strategic leaders decided to transition from a *functional structure* to a *multidivisional structure*. They formed Alphabet, a new corporate entity, to act as the parent company in charge of overseeing these varied SBUs, each with its own CEO and profit-and-loss responsibilities. Then-CEO Page said he modeled Alphabet's new organizational structure after that of Berkshire Hathaway, a conglomerate led by Warren Buffett. Page had long admired Buffet for effectively managing a set of unrelated businesses. In addition to Google, Alphabet's business units include Waymo (autonomous vehicles), X Development (R&D lab), Deep Mind (artificial intelligence), Access (internet service provider), Intrinsic (robotics), Isomorphic Labs (drug discovery), Verily (life sciences), Calico (longevity research), Wing (delivery drones), GV (early-stage venture capital fund), and CapitalG (late-stage venture capital fund). Exhibit 11.1 shows Alphabet's corporate structure.

This sweeping restructuring allowed the company to separate its highly profitable search and advertising business from its moonshots, which are projects that address a significant problem affecting millions of people for which a solution seems impossible when embarking on the project. Examples include autonomous vehicle driving technology (Waymo) and delaying aging, disease, and death by multiple decades (Calico). At Alphabet, separating out moonshots created greater financial transparency and accountability.

Sundar Pichai is CEO of Alphabet. Born and raised in India, Pichai moved to the United States to pursue graduation education (an MBA and an MS in materials science and engineering). After a short time in management consulting, Pichai joined Google in 2004 as a product lead for Chrome and the cloud offering Google Drive. Under Pichai's astute product management leadership, Chrome became the world's most successful web browser (used in two-thirds of all visits to the web globally). Pichai saw Chrome as much more than a simple tool for web navigation, and he laid the foundation for Chrome OS, a super-fast operating system that powers Google's Chromebook laptop computers. As the Covid pandemic supercharged demand for laptops, Chromebook sales surged, outpacing Apple's MacBooks, and Chromebooks have become a mainstay in mobile computing. After the creation of Alphabet, Pichai was appointed Google's CEO in 2015, and in 2019 he became CEO of Alphabet.

David Paul Morris/Bloomberg/Getty Images

EXHIBIT 11.1 Alphabet's Corporate Structure



Perhaps the most notable outcome of Google's restructuring is its pursuit of business opportunities that went far beyond Google's roots in online search—opportunities potentially worth billions of dollars. In his letter to shareholders announcing the restructuring, Larry Page stated that the new structure would prevent Alphabet from becoming complacent and would encourage the firm to take a long-term view in pursuing ambitious but highly uncertain projects. One of Page's major goals was to ensure that Google continues to pursue radical innovation rather than remain satisfied with incremental innovation only, as is common among other incumbent firms in the industry. Following Google's reorganization to become Alphabet, Sundar Pichai was appointed CEO of Google, and in 2019 Pichai became CEO of Alphabet when Page stepped down. In the 2021 Annual Report, Pichai reiterated the founder's commitment to moonshots:

"Companies get comfortable doing what they have always done, making only incremental changes. This incrementalism leads to irrelevance over time, especially in technology, where change tends to be revolutionary. People thought we were crazy when we acquired YouTube and Android and launched Chrome, but those efforts have matured into major platforms for digital video and mobile devices and a safer, popular browser. We continue to look toward the future and to invest for the long term within each of our segments. ... We will not shy away from high-risk, high-reward projects that we believe in, as they are key to our long-term success."[3]

In keeping with this goal, Alphabet spent over $31 billion in research and development (in 2021), second only to the $56 billion that Amazon spent. Although slimmer and more focused post-reorg, Google continues to generate 99% of Alphabet's revenues, bringing in over $275 billion (in 2022). Currently, Google's business lines include online search and advertising, YouTube, Maps, Android, Chrome, Cloud and Apps Services, and the reintegrated Nest, a smart-home company.

Alphabet houses a number of SBUs that are run by independent CEOs. In addition to creating financial transparency and accountability for each SBU, this new organizational structure allows Alphabet to retain and develop a cadre of top-notch executives for the various leadership positions within the conglomerate. YouTube, another of Google's successful companies, is run by CEO Susan Wojcicki. To provide resources for each SBU, Alphabet's head office oversees a rigorous capital allocation process so that each unit can execute its strategy.[4]

Susan Wojcicki, CEO of YouTube, was one of Google's first employees, joining the company in 1999. Google had been incorporated a year earlier and set up shop in Susan Wojcicki's parents' garage in Menlo Park, California. Wojcicki was instrumental in Google's acquisition of YouTube in 2006, during the early days of user-generated video content. Following Google's reorganization into Alphabet with stand-alone SBUs, Wojcicki was appointed CEO of YouTube in 2014. With 2 billion monthly active users, YouTube is the second most popular web destination, beaten only by Google's search engine. YouTube generated close to $30 billion in revenues (in 2021), mostly in ads but also from its premium offering (no ads) and streaming subscription, which offers more than 80 channels. YouTube remains the clear leader in fueling the creator economy. Yet, TikTok is rising fast, and it is slated to become an even more attractive destination for creators, especially for a younger demographic.

David Paul Morris/Bloomberg/Getty Images

Part II of this ChapterCase appears in Section 11.6.

The ChapterCase highlights how much weight Alphabet's strategic leaders place on its organizational structure. Co-founders Larry Page and Sergey Brin feel that getting the organizational structure right will allow Alphabet to continue to innovate with more radical technology breakthroughs, while providing financial transparency, accountability, and leadership development opportunities.

This chapter begins our discussion of the final part of the *AFI framework:* strategy implementation. *Strategy implementation* concerns the organization, coordination, and integration of how work gets done (refer to the discussion in Chapter 2). Effective strategy implementation is critical to gaining and sustaining a competitive advantage. Although the discussion of *strategy formulation* (what to do) is distinct from *strategy implementation* (how to do it), formulation and implementation must be part of an interdependent, reciprocal process to ensure continued success. That need for interdependence explains why the AFI framework is illustrated as a circle rather than as a linear diagram (see Part 3 Opener). The design of an organization, the matching of strategy and structure, and its control-and-reward systems determine whether an organization that has chosen an effective strategy will be able to gain and sustain a competitive advantage.

In this chapter, we study the three key levers strategic leaders have at their disposal when designing their organizations for competitive advantage: *structure*, *culture*, and *control*. Managers employ these three levers to coordinate work and motivate employees across different levels, functions, and geographies. How successful they are in this endeavor determines whether they are able to translate their chosen business, corporate, and global strategy into strategic actions and business models, and ultimately whether the firm is able to gain and sustain a competitive advantage.

We begin our discussion with organizational structure. We discuss different types of organizational structures as well as why and how they need to change over time as successful firms grow in size and complexity. We highlight the critical need to match strategy and structure. We also present different ways to organize for innovation and then take a closer look at corporate culture. An organization's culture can either support or hinder its quest for competitive advantage.[5] We next study strategic control systems, which allow leaders to receive feedback on how well a firm's strategy is being implemented. We conclude our discussion of how to design an organization for competitive advantage with practical *Implications for Strategic Leaders*.

LO 11-1

Define organizational design and list its three components.

11.1 Organizational Design and Competitive Advantage

organizational design The process of creating, implementing, monitoring, and modifying the structure, processes, and procedures of an organization.

Organizational design is the process of creating, implementing, monitoring, and modifying the structure, processes, and procedures of an organization. The key components of organizational design are structure, culture, and control. The goal is to design an organization that allows strategic leaders to effectively translate their formulated strategy into a realized one.

As discussed in the ChapterCase, Google changed its organizational structure from functional (organized according to domain expertise) to multidivisional or M-form (composed of a number of independent strategic business units). Alphabet's strategic leaders hope this new structure will aid in generating radical innovations. Moreover, because each SBU has profit and loss responsibility, the new structure allows Alphabet to provide leadership development opportunities for a number of its executives as they are being trained for larger roles in the future. For instance, after co-founder Larry Page stepped down as CEO of Alphabet, the CEO of Google, Sundar Pichai, was promoted to CEO of the umbrella company overseeing all of Alphabet's SBUs, including Google.

Investors are happy with this new organizational structure because it provides a clearer picture of Google's profitability. Before the reorganization, Google subsidized all of the loss-making long shots, which in turn depressed its net income. When all businesses were under Google, it was unclear how much Google invested in R&D to improve its core businesses (online search and advertising) versus how much it spent on moonshots. The new organizational structure freed Google from the huge outlays it had incurred through funding of risky projects over the years, and of which investors had become much less tolerant. If any of the non-core businesses take off in the same way that Waymo has, then Alphabet could decide to spin out Waymo as an initial public offering (IPO) that will fund future Waymo growth independent of Alphabet, which stands to gain significantly if Waymo goes public.

Although Alphabet's strategic leaders have high expectations for their new M-form structure, effective strategy implementation remains challenging. It is therefore not surprising that the inability to implement strategy effectively is the number-one reason boards of directors fire CEOs.[6]

Yahoo's Failure to Change Structure to Accommodate Strategy. Although Google has been highly successful, Yahoo, once one of Google's main competitors, has struggled, largely due to the lack of an effective organizational design. Indeed, Yahoo's co-founder and former CEO Jerry Yang was ousted (in 2008) precisely because he failed to implement necessary strategic changes after Yahoo lost its competitive advantage.[7] In the two years leading up to his exit, Yahoo lost more than 75% of its market value. Yang was described as someone who preferred consensus among his managers to making tough strategic decisions needed to change Yahoo's structure. That preference led to bickering and infighting. Yang's failure to make the necessary changes to Yahoo's organizational structure led to a destruction of billions of dollars in shareholder value and thousands of layoffs. A number of short-term and interim CEOs followed Yang without much success.

As CEO of Yahoo, Marissa Mayer attempted a turnaround of the struggling company by making changes to Yahoo's organizational structure and culture, among other strategic initiatives. In the end, a successful turnaround of the once-leading internet company remained elusive. Although Yahoo was once valued at $125 billion (in 2000), Verizon bought Yahoo for a mere $4.5 billion (in 2017) and later wrote off the acquisition.

Robyn Beck/AFP/Getty Images

Then, in 2012, Yahoo hired former Google star executive Marissa Mayer as president and CEO. Mayer's turnaround efforts focused on improving the user experience to drive mobile advertising revenues. This strategic pivot required changes in the organizational structure and culture. Despite all these changes, Yahoo was not able to gain significant ground in the online advertising space, which Alphabet and Meta have dominated, though Amazon is quickly catching up. Eventually, Yahoo—a former leader in online search that was once valued at $125 billion at the height of the dot-com boom—was acquired by Verizon for $4.5 billion in 2017.[8] In 2018, Verizon wrote off $4.5 billion of the close to $9 billion it spent on acquiring Yahoo and AOL (bought for $4.4 billion in 2015) as Verizon's online search and advertising business faltered.[9]

Zappos' Flexible Organizational Structure. Zappos (www.zappos.com), the online shoe and clothing retailer (featured in Strategy Highlight 11.1), exemplifies a company with a flexible organizational structure. When establishing customer service as a core competency, then-CEO Tony Hsieh made the very difficult decision to pull the plug on drop-shipment orders, which are orders for which Zappos would be the intermediary, relaying them to particular shoe vendors that then ship directly to the customer. Such orders were profitable because Zappos would not have to stock the shoes. They were also appealing because the fledgling startup was still losing money. But the problem was twofold. The vendors were slower than Zappos in filling orders. In addition, they did not accomplish the reliability metric that Zappos wanted for exceptional service: 95% accuracy was simply not good enough. Instead, Zappos decided to forgo drop shipments and instead build a large warehouse in Kentucky to stock a full inventory. This move enabled the firm to achieve close to 100% accuracy in its shipments, many of which were overnight. Unlike other online retailers, Zappos stocks everything it sells in its own warehouses—this is the only way to get the merchandise to the customer as quickly as possible with 100% accuracy. Strategy, therefore, is as much about deciding what to do as it is about deciding what *not* to do.

ORGANIZATIONAL INERTIA: THE FAILURE OF ESTABLISHED FIRMS

LO 11-2

Explain how organizational inertia can lead established firms to failure.

Implementation transforms strategy into actions and business models. Strategy execution, therefore, often requires changes of the organizational structure and reward systems. However, strategy implementation often fails because managers are unable to make the necessary changes due to the effects on resource allocation and power distribution within an organization.[10] Strategic leaders are hesitant to disturb the status quo (as in the earlier Yahoo example).

As demonstrated by business historian Alfred Chandler in his seminal book *Strategy and Structure,* organizational structure must follow strategy for firms to achieve superior performance: "Structure can be defined as the design of organization through which the enterprise is administered ... *structure follows strategy.*"[11] This tenet implies that to implement a strategy successfully, organizational design must be flexible enough to accommodate the formulated strategy and future growth and expansion. In reality, however, a firm's strategy often follows its structure.[12] This reversal implies that some managers consider only strategies that do not change existing organizational structures; they do not want to confront the inertia that often exists in established organizations.[13]

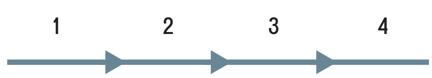
inertia A firm's resistance to changing the status quo, which can set the stage for the firm's subsequent failure.

Inertia, a firm's resistance to changing the status quo, can set the stage for the firm's subsequent failure. Indeed, successful firms often plant the seed of subsequent failure by optimizing their organizational structure to the current situation. That tightly coupled system can break apart as a result of internal or external pressures.

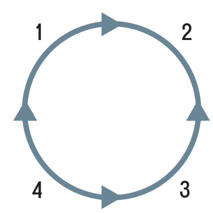
Organizational inertia is often the result of success in a particular market during a particular time; it becomes difficult to argue with success. Successful firms often follow a particular path:

1. Mastery of, and fit with, the current environment
2. Success, usually measured by financial metrics
3. Structures, measures, and systems to accommodate and manage size
4. A resulting organizational inertia that tends to minimize opportunities and accentuate challenges created by shifts in the internal and external environment

What's missing, of course, is the conscious strategic decision to change the firm's internal environment to fit with the new external environment, which would turn four steps leading to the endpoint of inertia (Option A) into a virtual circle where the firm essentially reboots and reinvents itself (Option B).



Option A
The Firm Arrives at Inertia



Option B
The Firm Rises above Inertia

The need for structural reorganization can be especially intense in many industries where the rate of change is high and potential disruption is frequent. In addition, business leaders find it much easier to create and manage within developed structures than to restructure their organizations to match where they need to be in future.

Exhibit 11.2 illustrates how success in the current environment can lead to a firm's downfall in the future, when the tightly coupled system of strategy and structure experiences internal or external shifts.[14] First, the managers achieve a mastery of, and fit with, the firm's current environment. Second, the firm often defines and measures success by financial metrics, with a focus on short-term performance (see discussion in Chapter 5). Third, the firm puts in place structures, metrics, and systems to accommodate and manage increasing firm size and complexity due to continued success. Finally, as a result of a tightly coupled but successful system, organizational inertia sets in—and with it, resistance to change.

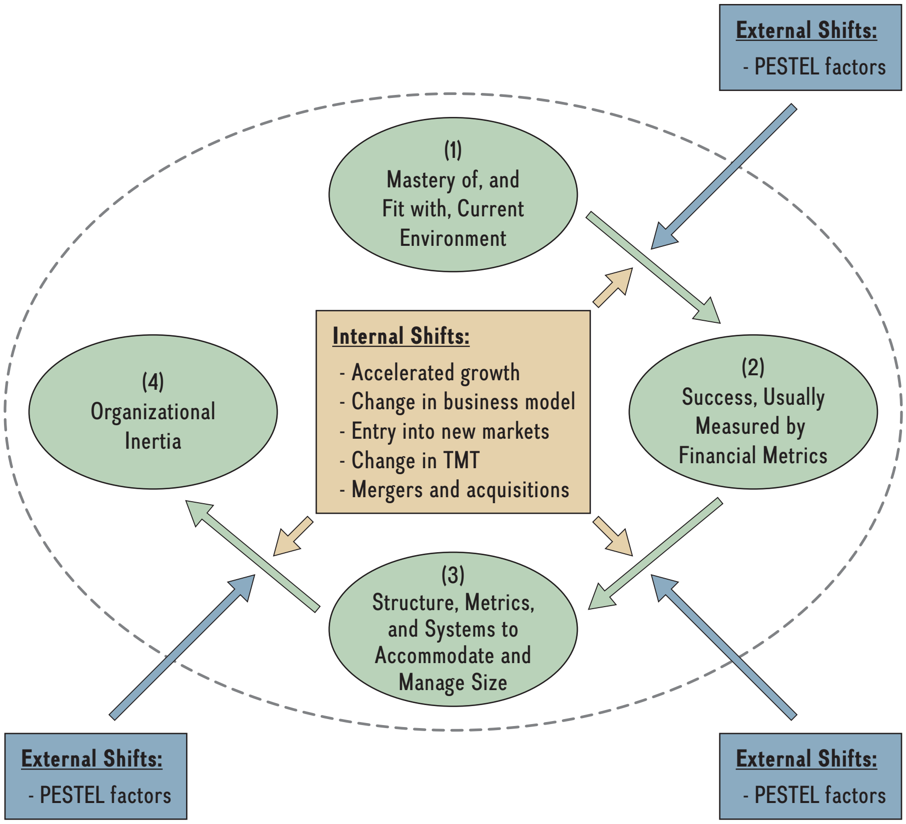


EXHIBIT 11.2

Organizational Inertia and the Failure of Established Firms to Respond to Shifts in the External or Internal Environments

Such a tightly coupled system is prone to break apart when external and internal shifts put pressure on the system.[15] In Exhibit 11.2, inside the dashed oval, the longer internal arrows show the firm's tightly coupled organizational design over time. The shorter internal arrows indicate pressures radiating from internal shifts such as accelerated growth, a change in the business model, entry into new markets, a change in the top management team (TMT), or mergers and acquisitions. Accelerated growth, for example, was the reason for a decline in employee productivity at Zappos, as discussed in Strategy Highlight 11.1. The longest arrows pointing into and piercing the boundary of the firm indicate external pressures, which can stem from any of the PESTEL forces (political, economic, sociocultural, technological, ecological, and legal, as discussed in Chapter 3). Strong external or internal pressure can break apart the current system, which may lead to firm failure.

To avoid inertia and possible organizational failure, the firm needs a flexible and adaptive structure to effectively translate the formulated strategy into action. Ideally, the firm will maintain a virtual cycle of reorganizing, as implied by Option B discussed earlier in this section. As noted in the ChapterCase, the strategic intent of transitioning Google from a functional structure to an M-form structure was to help Google and its other SBUs rise above inertia, to improve its flexibility and responsiveness in order to promote radical innovations rather than mere incremental innovations. As firms grow in size and complexity, they have a tendency and an incentive to focus on incremental innovation (refer to Chapter 7); however, the result can be inertia and subsequent failure.

LO 11-3

Define organizational structure and describe its four elements.

ORGANIZATIONAL STRUCTURE

Some of the key decisions strategic leaders must make when designing effective organizations pertain to the firm's **organizational structure**. That structure determines how the work efforts of individuals and teams are orchestrated and how resources are distributed. In particular, an organizational structure defines how jobs and tasks are divided and integrated, delineates the reporting relationships up and down the hierarchy, defines formal communication channels, and prescribes how individuals and teams coordinate their work efforts. The key building blocks of an organizational structure are:

organizational structure A key to determining how the work efforts of individuals and teams are orchestrated and how resources are distributed.

- Specialization.
- Formalization.
- Centralization.
- Hierarchy.

specialization An organizational element that describes the degree to which a task is divided into separate jobs (i.e., the division of labor).

SPECIALIZATION. **Specialization** describes the degree to which a task is divided into separate jobs—that is, the *division of labor*. Larger firms, such as Fortune 100 companies, tend to have a high degree of specialization; smaller entrepreneurial ventures tend to have a low degree of specialization. For example, an accountant for a large firm may specialize in only one area (e.g., internal audit), whereas an accountant in a small firm needs to be more of a generalist and take on many different things (e.g., internal auditing, payroll, accounts receivable, financial planning, and taxes). Specialization requires a trade-off between breadth and depth of knowledge. Although a high degree of division of labor increases productivity, it can also have unintended side effects such as reduced employee job satisfaction due to the repetition of tasks.

formalization An organizational element that captures the extent to which employee behavior is steered by explicit and codified rules and procedures.

FORMALIZATION. **Formalization** captures the extent to which employee behavior is steered by explicit and codified rules and procedures. Formalized structures are characterized by detailed written rules and policies of what to do in specific situations. These are often codified in employee handbooks. McDonald's, for example, uses detailed standard operating procedures throughout the world to ensure consistent quality and service.

Formalization is not necessarily negative; in fact, formalization often is necessary to achieve consistent and predictable results. Airlines, for instance, must rely on a high degree of formalization to instruct pilots on how to fly their airplanes to ensure safety and reliability. Yet a high degree of formalization can slow decision making, reduce creativity and innovation, and hinder customer service.[16] Most customer service reps in call centers, for example, follow a detailed script. This is especially true when call centers are outsourced to overseas locations. Zappos deliberately avoids this approach because customer service is its core competency.

centralization An organizational element that refers to the degree to which decision making is concentrated at the top of the organization.

CENTRALIZATION. **Centralization** refers to the degree to which decision making is concentrated at the top of the organization. Centralized decision making often correlates with slow response time and reduced customer satisfaction. In decentralized organizations such as Zappos, decisions are made and problems solved by empowered lower-level employees who are closer to the source of issues.

Different strategic management processes (discussed in Chapter 2) match with different degrees of centralization:

- Top-down strategic planning takes place in highly centralized organizations.
- Planned emergence is found in more decentralized organizations.

Whether centralization or decentralization is more effective depends on the specific situation. For example, during the Gulf of Mexico oil spill in 2010, BP's response was slow and cumbersome because key decisions were initially made in its UK headquarters and not onsite. In this case, centralization reduced response time led to a prolonged crisis. In contrast, the FBI and the CIA were blamed in the 9/11 Commission report for *not being centralized enough.*[17] The report concluded that although each agency had different types of evidence that a terrorist strike in the United States was imminent, their decentralization and work in silos prevented them from putting together the pieces to prevent the 9/11 attacks.

HIERARCHY. **Hierarchy** determines the formal, position-based reporting lines and thus stipulates *who reports to whom.* Let's assume two firms of roughly equal size: Firm A and Firm B. If many levels of hierarchy exist between the frontline employee and the CEO in Firm A, it has a *tall structure.* In contrast, if there are few levels of hierarchy in Firm B, it has a *flat structure.*

hierarchy An organizational element that determines the formal, position-based reporting lines and thus stipulates who reports to whom.

span of control The number of employees who directly report to a manager.

The number of levels of hierarchy, in turn, determines the managers' **span of control**—how many employees directly report to a manager. In tall organizational structures (Firm A), the span of control is narrow. In flat structures (Firm B), the span of control is wide, meaning one manager supervises many employees. In recent years, firms have de-layered by reducing the headcount (often middle managers), making the organizations flatter and more nimble. However, this move to a flatter structure puts more pressure on the remaining managers, who have to supervise and monitor more direct reports due to an increased span of control.[18] Recent research suggests that managers are most effective at an intermediate point where the span of control is not too narrow or too wide.[19]

Span of Control at Amazon and Tesla. Some companies, including Amazon and Tesla, have increased their span of control. In 2018, Jeff Bezos initiated a "span of control" directive in which he required each manager to have at least six direct reports. This directive led to a major reorganization in which top-level executives started increasing their span of control as needed. The initiative filtered down the organization through multiple levels. In the end, middle managers who did not have at least six employees reporting to them either were laid off (bottom 20% in Amazon's annual stacked ranking of employees) or became line staff members who reported upwards to a new superior and had no direct reports. With the goal to achieve profitability, Bezos' "span of control" directive was intended to achieve profitability by reducing Amazon's fixed cost and avoiding bureaucratic bloat, or what he calls a "Day 2" mindset. At the same time, Bezos was focused on maintaining an entrepreneurial mindset, which he dubbed "Day 1," even in a mega-sized cooperation such as Amazon.[20]

Likewise, in 2022, Elon Musk decided to increase the span of control of Tesla's managerial staff. To do so, Tesla laid off 10% of its salaried workers. Musk did not like that 61% of all Tesla employees were white-collar workers, which meant that only 39% of employees were blue-collar workers on the shop floor. Tesla's workers on the factory floor are the people who produce the cars and are therefore the only employees engaged in primary, value-creating activities (see discussion of the value chain in Chapter 4). In contrast, salaried employees provide support activities and are not engaged in direct value creation. Musk bristled at the notion that Tesla had more than 1.5 support employees for every worker on the shop floor. Thus the cut in the workforce applied only to white-collar, managerial jobs. As part of the cut, Tesla increased the span of control of the remaining managers. To top things off, Musk also decreed that all salaried employees had to be in the office at least 40 hours a week on five days a week, stating that this is less than what Tesla requires of factory workers. Musk also ended all work-from-home arrangements. He wrote in an e-mail to employees that “remote work is no longer acceptable” and if people want to work from home “they should pretend to work somewhere else.”[21]

LO 11-4

Compare and contrast mechanistic organizations and organic organizations.

MECHANISTIC VS. ORGANIC ORGANIZATIONS

Several of the building blocks of organizational structure frequently appear together, creating distinct organizational forms—mechanistic organizations or organic organizations.[22]

mechanistic organization Characterized by a high degree of specialization and formalization and by a tall hierarchy that relies on centralized decision making.

MECHANISTIC ORGANIZATIONS. **Mechanistic organizations** are characterized by a high degree of specialization and formalization and by a tall hierarchy that relies on centralized decision making. The fast food chain McDonald’s fits this description quite well. Each step of every job such as deep-frying fries is documented in minute detail (e.g., what kind of vat, the quantity of oil, how many fries, what temperature, how long). Decision power is centralized at the top of the organization: McDonald’s headquarters provides detailed instructions to each of its franchisees so that they provide comparable quality and service across the board although with some local menu variations. Communication and authority lines are top-down and well defined. To ensure standardized operating procedures and consistent food quality throughout the world, McDonald’s operates Hamburger University, a state-of-the-art teaching facility in a Chicago suburb, where 50 full-time instructors teach courses in chemistry, food preparation, and marketing. To facilitate its global expansion, McDonald’s opened a second Hamburger University campus in Shanghai, China (in 2010). Mechanistic structures allow for standardization and economies of scale, and they are often used when the firm pursues a cost-leadership strategy at the business level.

organic organization Characterized by a low degree of specialization and formalization, a flat organizational structure, and decentralized decision making.

ORGANIC ORGANIZATIONS. **Organic organizations** have a low degree of specialization and formalization, a flat organizational structure, and decentralized decision making. Organic structures tend to be correlated with the following: a fluid and flexible information flow among employees in both horizontal and vertical directions; faster decision making; and higher employee motivation, retention, satisfaction, and creativity. Organic organizations also typically exhibit a higher rate of entrepreneurial behaviors and innovation. Organic structures allow firms to foster R&D and/or marketing, for example, as a core competency. Firms that pursue a differentiation strategy at the business level frequently have an organic structure.

W.L. Gore’s Organic Structure. W.L. Gore & Associates, inventors of such innovative new products as breathable GORE-TEX fabrics, Glide dental floss, and Elixir guitar strings, uses an organic structure to foster continuous innovation.[23] Bill Gore, a former long-time employee of chemical giant DuPont, founded W.L. Gore & Associates (in 1958) with the vision to create an organization “devoted to innovation … where imagination and initiative would flourish, where chronically curious engineers would be free to invent, invest, and succeed.”[24] Gore articulated four core values that still guide the company and its associates to this day:

- Fairness to each other and everyone with whom the firm does business
- Freedom to encourage, help, and allow other associates to grow in knowledge, skill, and scope of responsibility
- The ability to make one’s own commitments and keep them
- Consultation with other associates before undertaking actions that could cause serious damage to the reputation of the company (“blowing a hole below the waterline”)[25]

W.L. Gore & Associates is organized in an informal and decentralized manner. It has no formal job titles, job descriptions, chains of command, formal communication channels, written rules, or standard operating procedures. Face-to-face communication is preferred over e-mail. There is no organizational chart. In what is called a *lattice* or *boundaryless* organizational form, everyone is empowered and encouraged to speak to anyone else in the organization. People who work at Gore are called *associates* rather than *employees,* indicating their professional expertise and status. Gore associates organize themselves in project-based teams that are led by sponsors, not bosses. Associates invite other team members based on their expertise and interests in a more or less ad hoc fashion. Peer control in these multidisciplinary teams further enhances associate productivity. Group members evaluate each other's performance annually, and these evaluations determine each associate's level of compensation. Moreover, all associates at W.L. Gore are also shareholders of the company and thus are part owners who share in the company's profits and losses.

Gore's informal culture has been linked to greater employee satisfaction and retention, higher personal initiative and creativity, and innovation at the firm level. Although W.L. Gore's organizational structure may resemble something you might find in a small, high-tech startup, the company has 10,000 employees and over $3 billion in revenues, making it one of the largest privately held companies in the United States. W.L. Gore is consistently ranked in *Fortune*'s "100 Best Companies to Work For" list, and it has been included in every edition of that prestigious ranking.

Exhibit 11.3 summarizes the key features of mechanistic and organic structures.

EXHIBIT 11.3 Mechanistic vs. Organic Organizations: Building Blocks of Organizational Structure

	Mechanistic Organizations	Organic Organizations
Specialization	• High degree of specialization • Rigid division of labor • Employees focus on narrowly defined tasks	• Low degree of specialization • Flexible division of labor • Employees focus on "bigger picture"
Formalization	• Intimate familiarity with rules, policies, and processes necessary • Deep expertise in narrowly defined domain required • Task-specific knowledge valued	• Clear understanding of organization's core competencies and strategic intent • Domain expertise in different areas • Generalized knowledge of how to accomplish strategic goals valued
Centralization	• Decision power centralized at top • Vertical (top-down) communication	• Distributed decision making • Vertical (top-down and bottom-up) as well as horizontal communication
Hierarchy	• Tall structures • Low span of control • Clear lines of authority • Command and control	• Flat structures • High span of control • Horizontal as well as two-way vertical communication • Mutual adjustment
Business Strategy	• Cost-leadership strategy • Examples: McDonald's, Walmart	• Differentiation strategy • Examples: W.L. Gore, Zappos

Although at first glance organic organizations may appear to be more attractive than mechanistic ones, their relative effectiveness depends on context. McDonald's, with some 40,000 restaurants across the globe, would not be successful with an organic structure. Similarly, a mechanistic structure would not allow Zappos or W.L. Gore to develop and hone their respective core competencies in customer service and product innovation.

The key point is this: To gain and sustain competitive advantage, *structure must follow strategy.* Moreover, the chosen organizational form must match the firm's business strategy. We expand further on the required strategy–structure relationship in the next section.

LO 11-5

Describe different organizational structures and match them with appropriate strategies.

11.2 Strategy and Structure

The important and interdependent relationship between strategy and structure directly impacts a firm's performance. Moreover, the relationship is dynamic, changing over time in a somewhat predictable pattern as firms grow in size and complexity. Successful new ventures generally grow first by increasing sales, then by obtaining larger geographic reach, and finally by diversifying through vertical integration and entering into related and unrelated businesses.[26]

Different stages in a firm's growth require different organizational structures. This important evolutionary pattern is depicted in Exhibit 11.4. As we discuss next, organizational structures range from simple structures to matrix structures.

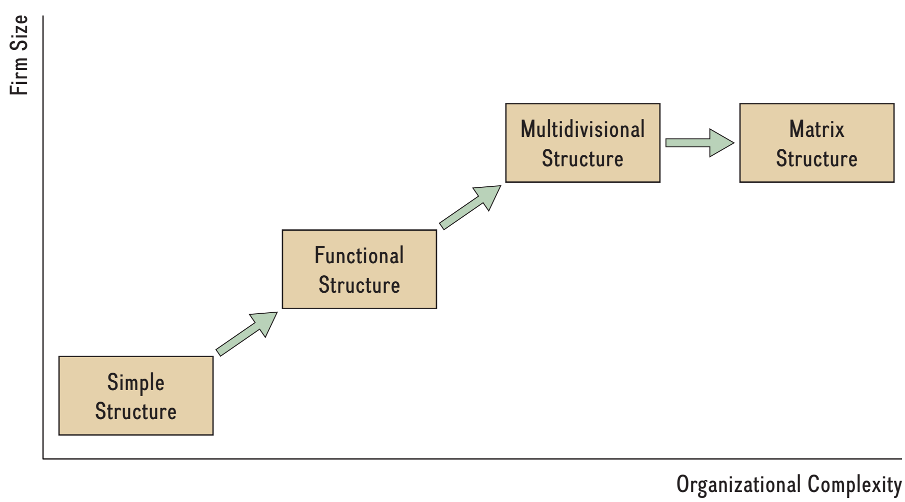
SIMPLE STRUCTURE

simple structure Organizational structure in which the founders tend to make all the important strategic decisions as well as run the day-to-day operations.

A **simple structure** generally is used by small firms with low organizational complexity. In such firms, the founders tend to make all the important strategic decisions and run the day-to-day operations. Examples include entrepreneurial ventures such as Google (in 1998) when the startup operated out of Susan Wojcicki parents' garage in Menlo Park, California. (Wojcicki is the CEO of YouTube.) Other common examples of firms with simple structures are professional service firms such as smaller advertising, consulting, accounting, and law firms, as well as family-owned businesses. Simple structures are flat hierarchies operated in a decentralized fashion. They exhibit a low degree of formalization and specialization. Typically, neither professional managers nor sophisticated systems are in place, which often leads to an overload for the founder and/or CEO when the firms experience growth.

EXHIBIT 11.4

Changing Organizational Structures and Increasing Complexity as Firms Grow



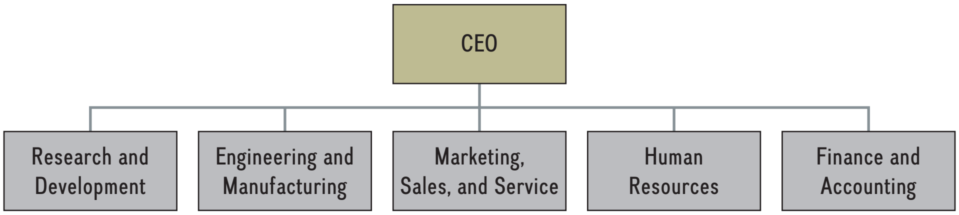


EXHIBIT 11.5

Typical Functional Structure

FUNCTIONAL STRUCTURE

As sales increase, firms generally adopt a **functional structure**, which groups employees into distinct functional areas based on domain expertise. These functional areas often correspond to distinct stages in the value chain, such as R&D, engineering and manufacturing, marketing and sales, and supporting areas such as human resources, finance, and accounting.

functional structure Organizational structure that groups employees into distinct functional areas based on domain expertise.

Exhibit 11.5 shows a functional structure, with the lines indicating reporting and authority relationships. The department head of each functional area reports to the CEO, who coordinates and integrates the work of each function. A business school student generally majors in a functional area such as finance, accounting, IT, marketing, operations, or human resources, and is then recruited into a corresponding functional group.

W.L. Gore & Associates started as a simple structure business operating out of Gore's basement. Two years after its founding, the company received a large manufacturing order for high-tech cable that it could not meet with its ad hoc basement operation. At this point W.L. Gore reorganized into a functional structure. A simple structure would not have provided the effective division, coordination, and integration of work required to accommodate the order, much less future growth.

A functional structure allows for a higher degree of specialization and deeper domain expertise than a simple structure. Higher specialization also allows for a greater division of labor, which is linked to higher productivity.[27] Although work in a functional structure tends to be specialized, it is centrally coordinated by the CEO (refer to Exhibit 11.5). A functional structure allows for an efficient top-down and bottom-up communication chain between the CEO and the functional departments, and thus relies on a relatively flat structure.

FUNCTIONAL STRUCTURE AND BUSINESS STRATEGY. A functional structure is recommended when a firm has a fairly narrow focus in terms of product/service offerings (i.e., low level of diversification) combined with a small geographic footprint. It matches well, therefore, with the different *business* strategies discussed in Chapter 6: cost leadership, differentiation, and blue ocean. Although a functional structure is a preferred method for implementing business strategy, different variations and contexts require careful modifications in each case:

- The goal of a *cost-leadership strategy* is to create a competitive advantage by reducing the firm's cost below that of competitors while offering acceptable value to customers. The cost leader sells a no-frills, standardized product or service to mainstream customers. To effectively implement a cost-leadership strategy, therefore, managers must create a functional structure that contains the organizational elements of a *mechanistic structure*—one that is centralized, with well-defined lines of authority up and down the hierarchy. Using a functional structure allows the cost leader to nurture and constantly upgrade necessary core competencies in manufacturing and logistics. Moreover, the cost leader needs to create incentives to foster process innovation to drive down costs. Finally, because the firm services the average customer, and thus targets the largest market segment possible, it should focus on leveraging economies of scale to further drive down costs.

- The goal of a *differentiation strategy* is to create a competitive advantage by offering products or services at a higher perceived value while controlling costs. The differentiator, therefore, sells a non-standardized product or service to specific market segments in which customers are willing to pay a higher price. To effectively implement a differentiation strategy, managers rely on a functional structure that resembles an *organic organization*. In particular, decision making tends to be decentralized to foster and incentivize continuous innovation and creativity as well as flexibility and mutual adjustment across areas. Using a functional structure with an organic organization allows the differentiator to nurture and constantly upgrade necessary core competencies in R&D, innovation, and marketing. Finally, the functional structure should be set up to allow the firm to reap economies of scope from its core competencies—for example, by leveraging its brand name across different products or its technology across different devices.
- A successful *blue ocean strategy* requires the reconciliation of the trade-offs between differentiation and low cost. To effectively implement a blue ocean strategy, the firm must be both efficient and flexible. It must balance centralization to control costs with decentralization to foster creativity and innovation. Managers must therefore attempt to combine the advantages of the functional-structure variations used for cost leadership and differentiation while mitigating their disadvantages. Moreover, the firm pursuing a blue ocean strategy needs to develop several distinct core competencies to both drive up perceived value and lower cost. It must further pursue both product and process innovations in an attempt to reap economies of scale and scope. All of these challenges make it clear that although a blue ocean strategy is attractive at first glance, it is quite difficult to implement given the range of important trade-offs that must be addressed.

  A firm's structure is therefore critical when pursuing a blue ocean strategy. The challenge that strategic leaders face is to structure their organizations so that they control cost *and* allow for creativity that can lay the basis for differentiation. Doing both is hard. Achieving a low-cost position requires an organizational structure that relies on strict budget controls, while successful differentiation requires an organizational structure that allows creativity and customer responsiveness, which typically necessitates looser organizational structures and controls.

ambidextrous organization An organization able to balance and harness different activities in trade-off situations.

ambidexterity A firm's ability to address trade-offs not only at one point but also over time. It encourages managers to balance exploitation with exploration.

exploitation Applying current knowledge to enhance firm performance in the short term.

exploration Searching for new knowledge that may enhance a firm's future performance.

The Ambidextrous Organization: Balancing Trade-Offs. The goal for leaders who want to pursue a blue ocean strategy is to build an **ambidextrous organization**, one that enables managers to balance and harness different activities in trade-off situations.[28] The trade-offs to be addressed involve the simultaneous pursuit of low-cost and differentiation strategies. Notable management practices that companies use to resolve this trade-off include flexible and lean manufacturing systems, total quality management, just-in-time inventory management, and Six Sigma.[29] In addition, some companies, including Tesla and SpaceX, use a high degree of vertical integration to create higher quality products at lower costs. Other management techniques that allow firms to reconcile cost and value pressures are the use of teams in the production process, as well as decentralized decision making at the level of the individual customer.

Ambidexterity describes a firm's ability to address trade-offs not only at one point but also over time. It encourages strategic leaders to balance **exploitation**—applying current knowledge to enhance firm performance in the short term—with **exploration**—searching for new knowledge that may enhance a firm's future performance.[30] For example, although Intel focuses on maximizing sales from its *current* cutting-edge microprocessors, it also has

EXHIBIT 11.6

Matching Business Strategy and Structure

Business Strategy	Structure
Cost-leadership	**Functional** • Mechanistic organization • Centralized • Command and control • Core competencies in efficient manufacturing and logistics • Process innovation to drive down costs • Focus on economies of scale
Differentiation	**Functional** • Organic organization • Decentralized • Flexibility and mutual adjustment • Core competencies in R&D, innovation, and marketing • Product innovation • Focus on economies of scope
Blue ocean	**Functional** • Ambidextrous organization • Balancing centralization with decentralization • Multiple core competencies along the value chain are required: R&D, manufacturing, logistics, marketing, etc. • Process and product innovations • Focus on economies of scale and scope

several different teams with different time horizons working on *future* generations of microprocessors.[31] In ambidextrous organizations, strategic leaders must constantly analyze their existing business processes and routines, looking for ways to change them in order to resolve trade-offs across internal value chain activities and time.[32]

Exhibit 11.6 presents a detailed match between different business strategies and their corresponding functional structures.

DISADVANTAGES OF FUNCTIONAL STRUCTURE. While certainly attractive, the functional structure is not without significant drawbacks. Although the functional structure facilitates rich and extensive communication between members of the *same* department, it frequently lacks effective communication channels *across* departments. Notice in Exhibit 11.5 the lack of direct links between different functions. The lack of linkage between functions is the reason, for example, that R&D managers often do not communicate directly with marketing managers. In an ambidextrous organization, a top-level manager such as the CEO must take on the necessary coordination and integration work.

To overcome the lack of cross-departmental collaboration in a functional structure, strategic leaders can set up *cross-functional teams*. In these temporary teams, members come from different functional areas to work together on a specific project or product, usually from start to completion. Each team member reports to two supervisors: the team leader and the respective functional department head. Many companies, including Apple, Nike, and W.L. Gore, employ cross-functional (project) teams successfully.

A second critical drawback of the functional structure is that it cannot effectively address a higher level of diversification, which often stems from further growth.[33] This is the stage at which firms find it effective to evolve and adopt a multidivisional structure or matrix structure, which we discuss next.

MULTIDIVISIONAL STRUCTURE

multidivisional structure (M-form) Organizational structure that consists of several distinct strategic business units (SBUs), each with its own profit-and-loss (P&L) responsibility.

Over time, as a firm diversifies into different product lines and geographies, it generally implements a multidivisional or a matrix structure (as shown in Exhibit 11.4 and discussed in the ChapterCase). The **multidivisional structure** (or **M-form**) consists of several distinct strategic business units (SBUs), each with its own profit-and-loss (P&L) responsibility. Each SBU is operated more or less independently, and each is led by a CEO (or equivalent general manager) who is responsible for the unit's business strategy and day-to-day operations. The CEOs of each division report to the corporate office, which is led by the company's highest-ranking executive (titles vary and include president or CEO for the entire corporation). Because most large firms are diversified to some extent across different product lines and geographies, the M-form is a widely adopted organizational structure.

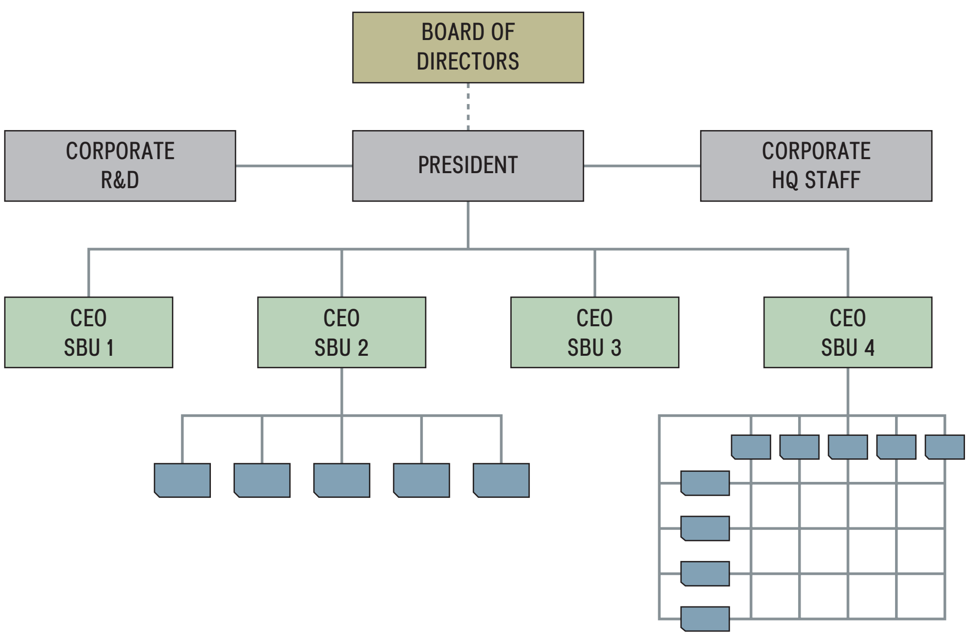
As featured in the ChapterCase, Google has moved from a functional structure to an M-form structure by creating the parent company Alphabet. Each unit under Alphabet is an independent SBU, run by a CEO who is responsible for the unit's P&L. The individual CEOs report to Sundar Pichai, who is the CEO of Alphabet and who oversees the capital allocation and strategy execution. As CEO of the holding company, Pichai also monitors each SBU's performance and adjusts rewards accordingly.

A typical M-form is shown in Exhibit 11.7. In this example, the company has four SBUs, each led by a CEO. Corporations may use SBUs to organize around different businesses and

EXHIBIT 11.7

Typical Multidivisional (M-Form) Structure

Note that SBU 2 uses a functional structure, and SBU 4 uses a matrix structure.



product lines or around different geographic regions. Each SBU represents a self-contained business with its own hierarchy and organizational structure. Note that in Exhibit 11.7, SBU2 is organized using a functional structure, while SBU 4 is organized using a matrix structure. The CEO of each SBU must determine which organizational structure is most appropriate to implement the SBU's business strategy.

A firm's corporate office (such as Alphabet's) is supported by company-wide staff functions, including human resources, finance, and corporate R&D. These staff functions support all of the company's SBUs but are centralized at corporate headquarters to benefit from economies of scale and to avoid duplication within each SBU. Because most of the larger enterprises are publicly held stock companies, the CEO and president report to a board of directors representing the interests of the shareholders, as indicated by the dashed line from the board of directors to the president in Exhibit 11.7.

The CEO and/or president of the parent company, with support from corporate headquarters staff, monitors the performance of each SBU and determines how to allocate resources across units.[34] Corporate headquarters adds value by functioning as an internal capital market. The goal is to be more efficient at allocating capital through its budgeting process than what could be achieved in external capital markets. This system can be especially effective if the corporation overall can access capital at a lower cost than competitors due to a favorable (AAA) debt rating. Corporate headquarters can also add value by restructuring the company's portfolio of SBUs by selling low-performing businesses and adding promising businesses through acquisitions.

Moreover, corporate executives can also spin off successful strategic business units to grow on their own. For instance, the travel site Expedia was spun out from Microsoft through an initial public offering. In other cases, frustrated employees may leave the parent corporation and start new ventures on their own. Former Fairchild employees started Intel. Likewise, former Xerox employees started Adobe. Ex-Amazon employees started Flipkart, an Indian ecommerce company (later acquired by Walmart).

M-FORM AND CORPORATE STRATEGY. To achieve an optimal match between strategy and structure, different corporate strategies require different organizational structures. In Chapter 8, we identified four types of corporate diversification (refer to Exhibit 8.10: *single business, dominant business, related diversification*, and *unrelated diversification*. Each is defined by the percentage of revenues obtained from the firm's primary activity.

- Firms that follow a *single-business strategy* or a *dominant-business strategy* at the corporate level gain at least 70% of their revenues from their primary activity; they generally use a *functional structure*.
- For firms that pursue either *related* or *unrelated diversification*, the *M-form* is the preferred organizational structure.
- Firms using the M-form organizational structure to support a *related-diversification* strategy tend to concentrate decision making at the top of the organization. Doing so allows a high level of integration. It also helps corporate headquarters leverage and transfer across different SBUs the core competencies that form the basis for related diversification.
- Firms using the M-form structure to support an *unrelated-diversification* strategy often decentralize decision making. Doing so allows general managers to respond to specific circumstances and leads to a low level of integration at corporate headquarters.

Exhibit 11.8 matches different corporate strategies and their corresponding organizational structures.

EXHIBIT 11.8

Matching Corporate Strategy and Structure

Corporate Strategy	Structure
Single business	**Functional structure**
Dominant business	**Functional structure**
Related diversification	**Cooperative multidivisional (M-form)** • Centralized decision making • High level of integration at corporate headquarters • Co-opetition among SBUs — Competition for resources — Cooperation in competency sharing
Unrelated diversification	**Competitive multidivisional (M-form)** • Decentralized decision making • Low level of integration at corporate headquarters • Competition among SBUs for resources

DISADVANTAGES OF M-FORM. Moving from the functional structure to the M-form results in adding another layer of corporate hierarchy (corporate headquarters). This additional layer comes with all the known problems of increasing bureaucracy, red tape, and sometimes duplication of efforts. It also slows decision making, because in many instances a CEO of an SBU must get approval from corporate headquarters when making major decisions that might affect a second SBU or the corporation as a whole.

Also, because each SBU in the M-form is evaluated as a standalone profit-and-loss center, SBUs frequently end up competing with each other. A high-performing SBU might be rewarded with greater capital budgets and strategic freedoms; low-performing businesses might be spun off. SBUs compete with one another for resources such as capital and managerial talent, but they also need to cooperate to share competencies. *Co-opetition*—competition and cooperation at the same time—among the SBUs is both inevitable and necessary. Sometimes, however, it can be detrimental when a corporate process such as resource allocation or transfer pricing between SBUs becomes riddled with corporate politics and turf wars.

In some instances, spinning out SBUs to make them independent companies is beneficial. As discussed in Chapter 8, the BCG growth-share matrix helps corporate executives who are making these types of decisions. For example, when owned by eBay, PayPal outperformed its parent company. PayPal's executives (and investors) were tired of subsidizing eBay's stagnant business. eBay had bought PayPal in the aftermath of the dot-com stock market crash in 2002 for $1.5 billion. In 2015, eBay and PayPal were de-merged. PayPal was spun off through an initial public offering and became an independent company again. PayPal is now able to fully unlock its value. Investors also liked separating eBay and PayPal. Since it was spun out, PayPal's valuation peaked at more than $360 billion (in 2021). As a standalone company, eBay's highest market cap was $51 billion (also in 2021).[35]

Strategy Highlight 11.1 discusses how the online retailer Zappos experimented with new organizational forms after realizing the M-form did not yield the expected benefits. Although its approach was quite innovative, Zappos' results have been mixed.

Strategy Highlight 11.1

Zappos: Of Holacracy and (Not Much) Happiness

Zappos (www.zappos.com) made its mark by delivering shoes and happiness. When Tony Hsieh, then-CEO of Zappos, wrote about the company's unique approach in 2010s *Delivering Happiness*, the book became a *New York Times* bestseller. Hsieh believed that making customers and employees happy drives success by "delivering WOW through service." The result? The online shoe and clothing store grew from a startup to become a major player in the industry. Service includes easy online shopping with free shipping to and from its customers and a generous 365-day return policy. Although this level of service is now standard at reputable online sellers, especially for well-known brands in their efforts to sell directly to customers, when Zappos introduced a "no-hassle" free return policy in 2003, the move was seen as both revolutionary and misguided. Yet, it made its customers happy, and they came back often.

Zappos also made its investors happy. In just 10 years after its founding, Zappos achieved more than $1 billion in annual sales (in 2008). A year later, Amazon acquired Zappos for $1.2 billion. Although it is now a subsidiary of Amazon, Zappos continues to operate as an independent business unit, as Amazon maintains a hands-off policy. If anything, new ideas flow up from Zappos to its parent. One example: Zappos weeds out cultural misfits by paying employees to leave after the orientation program. Amazon CEO Jeff Bezos said the "clever people at Zappos" inspired him to offer warehouse workers as much as $5,000 to quit if they were not totally enthusiastic about the importance of their work to Amazon's future.[36]

Zappos had grown so much since its founding—receiving over 20 million unique visitors a month to its website—that it needed to reorganize to continue offering the best customer service possible. At one point, to keep the organization flat and responsive to customers, Zappos restructured into 10 separate business units, including Zappos.com, Zappos Gift Cards, Zappos IP, and 6pm.com. But to fight the slow bureaucracy that affects larger companies,

A flock of birds in flight, immediately shifting direction with self-regulating unity, frequently serves a metaphor of holacracy in action.

greatonmywall/Alamy Stock Photo

Hsieh announced (in 2013) an even more radical approach to reorganization—a structure called *holacracy*.

Here is what we know about holacracy. Brian Robertson developed the concept in the 2000s, working from ideas introduced by Arthur Koestler in his 1967 book, *The Ghost in the Machine,* in which Koestler coined the term. Forgoing traditional top-down hierarchy, **holacracy** purports to achieve control and coordination by distributing power and authority to self-organizing groups (so-called circles) of employees. Circles of employees are meant to self-organize and self-govern around a specific task, such as confirming online orders or authorizing a customer's credit card. Often compared to a computer's operating system, holacracy is a new organizational structure for governing and running a company. Because it greatly changes how workers interact, its proponents hail it as a *social operating system*.

Hsieh explained holacracy as follows:

> *Research shows that every time the size of a city doubles, innovation or productivity per resident increases by 15%. But when companies get bigger, innovation or productivity per employee generally goes down. So we're trying to figure out how to structure Zappos more like a city and less like a bureaucratic corporation. In a city, people and businesses are self-organizing. We're*

(Continued)

holacracy An organizational structure in which decision-making authority is distributed through loose collections or circles of self-organizing teams.

trying to do the same thing by switching from a normal hierarchical structure to a system called holacracy, which enables employees to act more like entrepreneurs and self-direct their work instead of reporting to a manager who tells them what to do.[37]

Zappos grouped its more than 1,500 employees in some 400 circles, with each employee in two or more circles. Order is supposed to emerge from chaos through a bottom-up process, rather than rely on top-down command and control. The rules are spelled out explicitly in a so-called constitution, which defines the power and authority of each circle. For coordination, the employee circles overlap horizontally, and without a vertical hierarchy. The CEO's last act as the highest-ranking person in the organization is to sign the constitution in a symbolic act, relinquishing all executive powers. Thereafter the former strategic leader becomes the "ratifier of the holacracy constitution."

As is often the case, a new concept sounds great in theory but proves hard to implement. Zappos' implementation of holacracy is not going well. As a consequence, employee morale has plummeted, and Zappos employees are no longer as happy. In 2011, Zappos was ranked sixth in Fortune's list of "100 Best Companies to Work For" (one of the highest rankings for a relatively young firm). By 2015, after it started implementing holacracy, Zappos fell to 86th. In the six years afterward (2016 to 2021), Zappos failed to place in Fortune's "100 Best Companies to Work For" list. Note that the ranking is determined by what employees say about their own company in anonymous surveys—not some arbitrary external assessment.

Hsieh was frustrated that three years into the transition to holacracy it was still not complete. To accelerate the process, he offered a three-month severance package to employees not willing to adopt the new structure. More than 200 employees, or some 14% of Zappos' workforce, accepted the offer and resigned. By 2016, Zappos had lost 18% of its workforce.

Employees who remained with Zappos have complained that holacracy has removed clear paths for career advancement. They have wondered openly how hiring, firing, and promoting will be done. They are also concerned that relying on employee circles for making decisions will not only induce paralysis but also make the organization more, not less, political. In sum, they find that holacracy forces them to waste time in endless meetings rather than allowing them to get the actual work done. That Hsieh made top-down decisions for Zappos, a company that ostensibly celebrated democracy and participation, to implement holacracy or to sell the company to Amazon a few years earlier is an irony that was not lost on Zappos' employees.

Frustrated by the lack of progress in implementing the new organizational structure and struggling with substance abuse, Tony Hsieh resigned from Zappos in August 2020, a company he had led for 21 years. Less than three months later, Hsieh died during a house fire. While his death was ruled an accident, investigative reporting by *The Wall Street Journal* revealed that Hsieh had locked himself into a tool shed near the house and indulged his obsession with fire and inhaling nitrous oxide, which may have contributed to his early and tragic death at age 46.[38]

MATRIX STRUCTURE

matrix structure
Organizational structure that combines the functional structure with the M-form.

To reap the benefits of both the M-form and the functional structure, many firms use a mix of these two organizational forms, called a **matrix structure**. Exhibit 11.9 shows an example. In it, the firm is organized according to SBUs along a horizontal axis (like in the M-form) but also has a second dimension of organizational structure along a vertical axis. In Exhibit 11.9, the second dimension consists of different geographic areas, each of which generally would house a full set of functional activities. The idea behind the matrix structure is to combine the benefits of the M-form (domain expertise, economies of scale, and efficient processing of information) with those of the functional structure (responsiveness and decentralized focus).

The horizontal and vertical reporting lines between SBUs and geographic areas intersect, creating nodes in the matrix. Exhibit 11.9 highlights one employee, represented by a large dot and called out by an arrow. This employee works in a group with other employees in

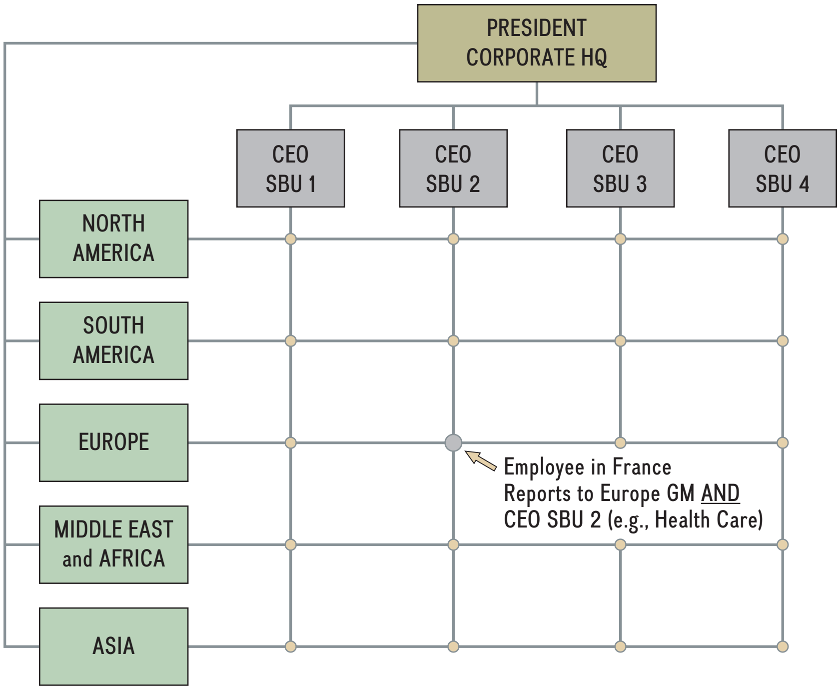


EXHIBIT 11.9

Typical Matrix Structure with Geographic and SBU Divisions

SBU 2, the company's health care unit for the Europe division in France. This employee has two bosses—the CEO of the health care SBU and the general manager (GM) for the Europe division. Both supervisors report to corporate headquarters, which is led by the president of the corporation (indicated in Exhibit 11.9 by the reporting lines from the SBUs and geographic units to the president).

Firms tend to use a *global matrix structure* to pursue a *transnational strategy*, in which the firm combines the benefits of a multidomestic strategy (high local responsiveness) with those of a global-standardization strategy (lowest-cost position attainable). In a global matrix structure, the geographic divisions are charged with local responsiveness and learning. At the same time, each SBU is charged with driving down costs through economies of scale and other efficiencies. A global matrix structure allows the firm to feed local learning back to different SBUs and thus diffuse it throughout the organization. The specific organizational configuration depicted in Exhibit 11.9 is a global matrix structure.

The matrix structure is quite versatile because managers can assign different groupings along the vertical and horizontal axes. A common form of the matrix structure uses different projects or products on the vertical axis and different functional areas on the horizontal axis. In that traditional matrix structure, *cross-functional* teams work together on different projects. The teams in a matrix structure tend to be more permanent rather than project-based with a predetermined time horizon.

Given the advances in online collaboration tools, some firms have replaced the more rigid matrix structure with a *network structure*. A network structure allows the firm to connect centers of excellence, regardless of their global location (refer to Exhibit 10.4).[39] The firm benefits from *communities of practice*, which store important organizational learning and expertise. To avoid undue complexity, these network structures need to be supported by corporate-wide procedures and policies to streamline communication, collaboration, and the allocation of resources.[40]

MATRIX STRUCTURE AND GLOBAL STRATEGY. We already noted that a global matrix structure fits well with a transnational strategy. To complete the strategy–structure relationships in the global context, we also need to consider the international, multidomestic, and standardization strategies discussed in Chapter 10. Exhibit 11.10 shows how different global strategies best match different organizational structures.

- In an *international strategy*, the company leverages its home-based core competency by moving into foreign markets. An international strategy is advantageous when the company faces low pressure for both local responsiveness and cost reductions. Companies pursue an international strategy through a differentiation strategy at the business level. The best match for an international strategy is a *functional* organizational structure, which allows the company to leverage its core competency most effectively. This approach is similar to matching a business-level differentiation strategy with a functional structure (discussed in detail earlier).
- When a multinational enterprise (MNE) pursues a *multidomestic strategy*, it attempts to maximize local responsiveness in the face of low pressures for cost reductions. An appropriate match for this type of global strategy is the *multidivisional* organizational structure. That structure enables the MNE to set up different divisions based on geographic regions (e.g., by continent). The different geographic divisions operate more or less as standalone SBUs to maximize local responsiveness. Decision making is decentralized.
- When following a *global-standardization strategy*, the MNE attempts to reap significant economies of scale as well as location economies by pursuing a global division of labor based on wherever best-of-class capabilities reside at the lowest cost. Because the product offered is more or less an undifferentiated commodity, the MNE pursues a cost-leadership strategy. The optimal organizational structure match is, again, a *multidivisional* structure. Rather than focusing on geographic differences as in the multidomestic strategy, the focus is on driving down costs due to consolidation of activities across different geographic areas.

EXHIBIT 11.10

Matching Global Strategy and Structure

Global Strategy	Structure
International	**Functional**
Multidomestic	**Multidivisional** • Geographic areas • Decentralized decision making
Global-standardization	**Multidivisional** • Product divisions • Centralized decision making
Transnational	**Global matrix** • Balance of centralized and decentralized decision making • Additional layer of hierarchy to coordinate both: — Geographic areas — Product divisions

DISADVANTAGES OF MATRIX STRUCTURE. Though it is appealing in theory, the matrix structure does have shortcomings. It is usually difficult to implement: Implementing two layers of organizational structure creates significant organizational complexity and increases administrative costs. Also, reporting structures in a matrix are often not clear. In particular, employees can have trouble reconciling goals presented by their two (or more) supervisors. Less-clear reporting structures can undermine accountability by creating multiple principal-agent relationships, which can make performance appraisals more difficult. Adding an additional layer of hierarchy can also slow decision making and increase bureaucratic costs.

As just discussed, the development pattern of how organizational structures tend to change in time as firms grow in size and complexity is fairly predictable: starting with a simple structure, then moving to functional structure, and finally implementing a multidivisional or matrix structure. Exhibit 11.11 summarizes the advantages and disadvantages of different organizational structures.

EXHIBIT 11.11 Advantages and Disadvantages of Different Organizational Structures

	Advantages	Disadvantages
Simple Structure	• Fast decision making • Nimble and responsive organization • Integration of expertise across areas • Given low bandwidth, organizations with simple structures are easily pushed into “crisis mode,” requiring “all hands on deck” (i.e., everyone working long hours until the project is completed)	• CEO overload • Lack of domain expertise in distinct business functions (e.g., accounting, finance, marketing) • Unable to accommodate growth • No separation of strategic and day-to-day decision making
Functional Structure	• Clear, top-down lines of authority and decision making • Deeper domain expertise • Higher productivity due to specialization and division of labor • Responsive organization	• Emergence of silos (i.e., no effective communication across different departments) • Growth is limited • Employee alienation, especially in startups that move from simple structure to functional structure
Multidivisional Structure (M-Form)	• Accommodates growth (horizontal, vertical, and geographic) • Clear profit-and-loss responsibilities at SBU level, run by CEO or equivalent • Efficient processing of information • Allows for different competitive strategies at SBU level, while integration takes place at corporate level	• Additional layer of corporate hierarchy (i.e., corporate headquarters) when moving from functional to M-form structure • SBUs stand in competition with one another • Political infighting • Opportunistic behavior by SBUs
Matrix Structure	• Accommodates growth (horizontal, vertical, and geographic) • Combines advantages of functional structure with M-form	• Two layers of organizational structure create multiple principal-agent relationships • Slow in decision making • Potentially inaccurate performance appraisals • Quite difficult to implement

LO 11-6

Evaluate closed and open innovation, and derive implications for organizational structure.

11.3 Organizing for Innovation

After emphasizing throughout this text (and especially in Chapter 7) that continued innovation is critical to gaining and sustaining competitive advantage in today's fast-moving world, the question arises: *How should firms organize for innovation?* During the 20th century, the *closed innovation* approach was the dominant research and development (R&D) approach for most firms: They focused on discovering, developing, and commercializing new products and services internally.[41] Although this approach was costly and time-consuming, it allowed firms to fully capture the returns made from their R&D investments to generate their own innovations.

Closed Innovation vs. Open Innovation. Several factors have led to a shift in the knowledge landscape from closed innovation to open innovation in recent years. They include:

- The increasing supply and mobility of skilled workers.
- The exponential growth of venture capital.
- The increasing availability of external options (such as spinning out new ventures) to commercialize ideas that were previously shelved or to insource promising ideas and inventions.
- The increasing capability of external suppliers globally.

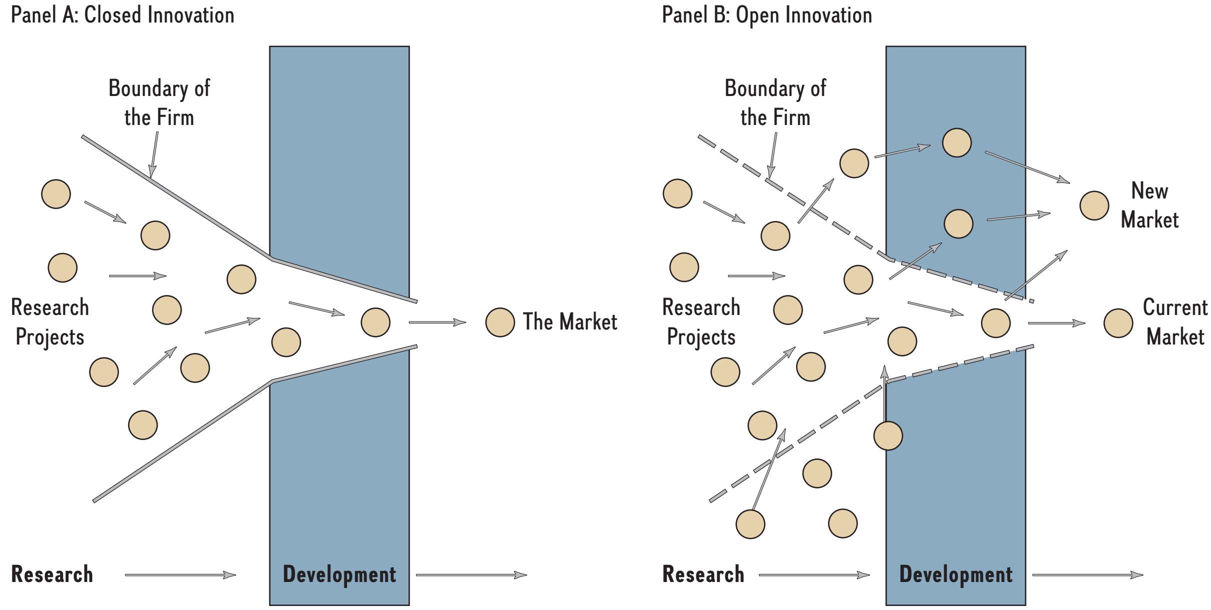
open innovation A framework for R&D that proposes permeable firm boundaries to allow a firm to benefit not only from internal ideas and inventions, but also from external ones. The sharing goes both ways: Some external ideas and inventions are insourced while others are spun out.

These factors have led more and more companies to adopt an open innovation approach to research and development. **Open innovation** is a framework for R&D that proposes permeable firm boundaries to allow a firm to benefit not only from internal ideas and inventions, but also from ideas and innovation from external sources. External sources of knowledge can be customers, suppliers, universities, start-up companies, and even competitors.[42] The sharing goes both ways: Some external R&D is insourced (and further developed in-house) while the firm may spin out internal R&D that does not fit its strategy to allow others to commercialize it. Even the largest companies, such as AT&T, IBM, Siemens, and Pfizer, are shifting their innovation strategy toward a model that blends internal with external knowledge sourcing via licensing agreements, strategic alliances, joint ventures, and acquisitions.[43]

Exhibit 11.12 depicts the closed and open innovation models. In the closed innovation model (Panel A), the firm is conducting all research and development in-house, using a traditional funnel approach. The boundaries of the firm are impenetrable (indicated by the solid lines in Panel A). Outside ideas and projects cannot enter, nor does the firm allow its own research ideas and development projects to leave the firm. Firms in the closed innovation model are extremely protective of their intellectual property. This approach not only allows the firm to capture all the benefits from its own R&D but also prevents competitors from benefiting from it. The mind-set of firms in the closed innovation model is that to profit from R&D, the firm must come up with its own discoveries, develop them on its own, and control the distribution channels. Strength in R&D is equated with a high likelihood of benefiting from first-mover advantages. However, firms following the closed innovation model are much more likely to fall prone to the *not-invented-here syndrome:*[44] "If the R&D leading to a discovery and a new development project was not conducted in-house, it cannot be good."

As documented, the pharmaceutical company Merck suffers from the *not-invented-here syndrome.*[45] That is, if a product was not created and developed at Merck, then Merck assumes it cannot be good enough. Merck's culture and organizational systems perpetuate this belief, which assumes that because Merck hired the best people, the smartest people in the industry must work for Merck, and so the best discoveries must be made at Merck. The

EXHIBIT 11.12 Closed Innovation vs. Open Innovation



Source: Author's adaptation from H. Chesbrough (2003, Spring), "The era of open innovation," *MIT Sloan Management Review*: 35–41.

company leads the industry in terms of R&D spending because Merck believes that if it is the first to discover and develop a new drug, then that drug will be the first to market. Merck is one of the most successful companies by total number of active R&D projects. In addition, several of Merck's researchers have been awarded Nobel Prizes for their breakthrough research, a considerable point of pride for Merck's personnel.

In the open innovation model, in contrast, a company attempts to commercialize both its own ideas and research from other firms. It also finds external alternatives such as spin-off ventures or strategic alliances to commercialize its internally developed R&D. The boundary of the firm has become porous (as represented by the dashed lines in Panel B in Exhibit 11.12), allowing the firm to spin off some R&D projects while insourcing other promising projects. Companies using an open innovation approach realize that great ideas can come from both inside and outside the company. Significant value can be had by commercializing external R&D and letting others commercialize internal R&D that does not fit with the firm's strategy. The focus is on building a more effective *business model* to commercialize both internal *and* external R&D, rather than focusing on being first to market.

One key assumption underlying the open innovation model is that combining the best of internal *and* external R&D will more likely lead to a competitive advantage. This approach requires the company to continuously upgrade its internal R&D capabilities to enhance its **absorptive capacity**—its ability to understand external technology developments, evaluate them, and integrate them into current products or create new ones.[46] Exhibit 11.13 compares and contrasts open innovation and closed innovation principles.

Strategy Highlight 11.2 provides a detailed account of how Sony's continued use of a closed innovation system led over time to a sustained competitive disadvantage and inferior performance. In contrast, Apple leveraged an open innovation model for decade-long superiority, becoming the first company to reach a valuation of $3 trillion.

absorptive capacity A firm's ability to understand external technology developments, evaluate them, and integrate them into current products or create new ones.

EXHIBIT 11.13 Contrasting Principles of Closed and Open Innovation

Closed Innovation Principles	Open Innovation Principles
The smart people in our field work for us.	Not all the smart people work for us. We need to work with smart people inside and outside our company.
To profit from R&D, we must discover it, develop it, and ship it ourselves.	External R&D can create significant value; internal R&D is needed to claim (absorb) some portion of that value.
If we discover it ourselves, we will get it to market first.	We don't have to originate the research to profit from it; we can still be first if we successfully commercialize new research.
The company that gets an innovation to market first will win.	Building a better business model is often more important than getting to market first.
If we create the most and best ideas in the industry, we will win.	If we make the best use of internal and external ideas, we will win.
We should control our intellectual property (IP), so that our competitors don't profit from it.	We should profit from others' use of our IP, and we should buy others' IP whenever it advances our own business model.

Source: Adapted from H.W. Chesbrough (2003), *Open Innovation: The New Imperative for Creating and Profiting from Technology* (Boston: Harvard Business School Press).

Strategy Highlight **11.2**

Sony vs. Apple: Whatever Happened to Sony?

Apple's market capitalization in 2001 was $7 billion, while Sony's was $55 billion. In other words, Sony was almost eight times larger than Apple. At that time, most people would have picked Sony as the company to revolutionize the mobile device industry given its stellar innovation track record. Instead, that honor went to Apple when it introduced the iPod, a portable digital music player, in 2001 and 18 months later the iTunes Store (now the Apple Music App). Through these two strategic moves, Apple redefined the music industry, reinventing itself as not only a mobile device but also a content-delivery and services company. Many observers wondered what happened to Sony, the company that created the portable music industry by introducing the Walkman in 1979.

Sony's strategy was to differentiate itself through the vertical integration of content and hardware, driven by its 1988 acquisition of CBS Records (later part of Sony Entertainment) and its 1989 acquisition of Columbia Pictures. This vertical integration strategy contrasted sharply with Sony Music division's desire to protect its lucrative revenue-generating, copyrighted compact discs (CDs). Sony Music's engineers were aggressively combating music piracy by inhibiting the Microsoft Windows media player's ability to rip CDs and by serializing discs (assigning unique ID numbers to discs). The CD became the dominant format for selling music in the early 1990s, replacing analog audiocassettes. The CD had been jointly developed by Sony and European electronics manufacturer Philips.

Media technology, however, soon moved to digital. With the rise of the internet and digital music files in the mid-1990s, illegal file sharing on the internet was rampant. Napster allowed peer-to-peer sharing of files, which meant individual users could upload entire albums of music, to be downloaded by anyone, with no payments going to the artists or the record companies. While Sony

Sony created the portable music industry with the Walkman, introduced in 1979.

Chris Willson/Alamy Stock Photo

focused on preventing media players that could rip CDs, Apple was developing a digital rights management (DRM) system to allow for legal downloads of digital music while protecting copyright at the same time. The iTunes Store enabled users to legally download individual songs at the affordable price of 99 cents each. Apple's DRM and iTunes succeeded, protecting the music studios' and artists' interests while creating value that enabled consumers to enjoy portable digital music.

Sony had a long history of creating category-defining electronic devices of superior quality and design using a closed innovation approach. It had all the right competencies in-house to launch a successful counterattack to compete with Apple: electronics, software, music, and computer divisions. Sony even supplied the batteries for Apple's iPod. Cooperation among strategic business units had served Sony well in the past, leading to breakthrough innovations such as the Walkman, PlayStation, CD, and VAIO computer line. In digital music, however, the hardware and content divisions each seemed to have their own idea of what needed to be done. Cooperation among the Sony divisions was also hindered by the fact that their centers of operations were spread across the globe: Music operations were located in New York City and electronics design was in Japan, inhibiting face-to-face communications and making real-time interactions more difficult.

Nobuyuki Idei, then-CEO of Sony, learned the hard way that the music division managers were focused on the immediate needs of protecting the IP in their recordings while competing against the consumer-driven market forces (i.e., file sharing). In 2002, Idei shared his frustrations with the cultural differences between the hardware and content divisions:

> *The opposite of soft alliances is hard alliances, which include mergers and acquisitions. Since purchasing the Music and Pictures businesses, more than 10 years have passed, and we have experienced many cultural differences between hardware manufacturing and content businesses. … This experience has taught us that in certain areas where hard alliances would have taken 10 years to succeed, soft alliances can be created more easily. Another advantage of soft alliances is the ability to form partnerships with many different companies. We aim to provide an open and easy-to-access environment where anybody can participate, and we are willing to cooperate with companies that share our vision. Soft alliances offer many possibilities.*[47]

In contrast, Apple organized a small, empowered, cross-functional team to produce the iPod in just a few months. Using open innovation, Apple successfully insourced many of its components from external partners (including Sony and Samsung) and then integrated them. The phenomenal speed and success of the iPod and iTunes development and the seamless integration of hardware and software became a structural approach that Apple applied to its successful development and launches of other category-defining products such as the iPhone, iPad, and Apple Watch.

Apple's market capitalization grew from just $7 billion in 2001 to over $1 trillion in 2018, making it the most valuable company globally at the time and the first company globally to cross the $1 trillion threshold. In contrast, in almost 20 years, Sony's market capitalization has barely moved, increasing from $55 billion in 2001 to only $65 billion in 2019. The companies' different ways of organizing

(Continued)

and implementing innovation had a great deal to do with these outcomes.

In the meantime, Sony has pivoted toward its strengths in gaming, where it is a leader with some 30% market share. Sony released the PlayStation 5 (PS5), its most successful gaming console to date, in 2020. Released during the height of the Covid-19 pandemic, when consumers were stuck at home with a lot of time on their hands and flush with cash from stimulus checks in most Western countries, the PS5 has sold more than 20 million units, outselling Microsoft's Xbox Series X/S game consoles by a wide margin. Sony Pictures also made a smart move by licensing its high-quality content to streaming services such as Netflix, Disney+, and Hulu rather than attempting to build its own direct-to-consumer streaming service and thus avoiding the anticipated shakeout in "streaming wars," in which a large number of services compete for a fixed number of subscribers. Noteworthy, Sony does not license its movie content to Apple for its streaming service, Apple TV+. As a result of its pivot, Sony was able to recover its market valuation, reaching a peak of $160 billion (in early 2022). Yet, Sony's valuation is only a bit more than 5% of Apple's, which stood at $3 trillion.[48]

LO 11-7

Describe the elements of organizational culture, and explain where organizational cultures can come from and how they can be changed.

11.4 Organizational Culture: Values, Norms, and Artifacts

Organization design consists of formal and informal building blocks, as shown in Exhibit 11.14. The formal component is a firm's organizational structure (discussed in the previous sections), while the informal building block of organizational design is a firm's culture. Organizational culture is the second key building block when designing organizations for competitive advantage. Just as people have distinctive personalities, so too do organizations have unique cultures that capture "how things get done around here." Culture is an informal and thus an intangible building block of organizational design that unlike the formal structure cannot be easily observed or codified.

organizational culture The collectively shared values and norms of an organization's members; a key building block of organizational design.

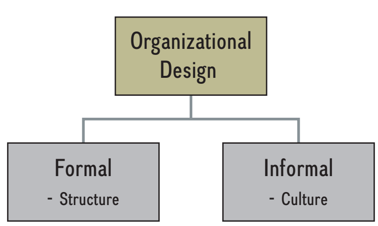
Norms Unwritten rules that define appropriate employee attitudes and behaviors in employees' day-to-day work and interactions.

Organizational culture is the collectively shared values and norms of an organization's members.[49] *Values* define what is considered important—goals that each organizational member should strive to achieve. As discussed in Chapter 2, an organization's core values are a set of guiding principles to guide employees in achieving an organization's vision and fulfilling its mission. **Norms** define appropriate employee attitudes and behaviors in their day-to-day work and interactions.[50]

In a recent survey of almost 2,000 CEOs across the globe, these strategic leaders ranked culture as the most important value driver, above operations, marketing, and finance.[51] One clear implication is that a strategic leader must get an organization's culture right. Effective cultures (such as Google's) are credited for being partly responsible for a firm's stellar performance, while ineffective cultures are blamed for corporate failures. Consider, for example, Wells Fargo's account fraud scandal and VW's Dieselgate. (We discuss the Dieselgate affair in Strategy Highlight 12.1.)

EXHIBIT 11.14

Formal and Informal Building Blocks of Organizational Design



Wells Fargo has been at the center of a number of headline-grabbing scandals, with the most recent involving the opening of 3.5 million fraudulent bank accounts by Wells Fargo employees.[52] Other offenses include charging customers for car insurance they did not need or request and overcharging members of the U.S. armed forces who were refinancing mortgages. How could these activities take place at one of the largest banks in the United States? The one common denominator in these ethical and legal infractions is Wells Fargo's organizational culture, which is known to be hard-driving and demanding. For example, employees faced strict sales quotas around new account openings, insurance sales, and mortgage refinancing fees. Their compensation and bonuses were directly tied to these super-ambitious sales targets. The problem with these targets was not just that they were overly ambitious, but they also were unrealistic. What do people tend to do when the stakes are high and the pressure is intense? They cut corners. This is precisely what happened at Wells Fargo: Achieving unrealistic goals took precedence over ethical and legal practice.[53] This slew of scandals has cost the bank dearly. Its stock market valuation fell by 25% (in 2018), and two CEOs in a row subsequently lost their jobs. Additionally, all of the 5,300 employees involved in opening the fraudulent bank accounts were fired.

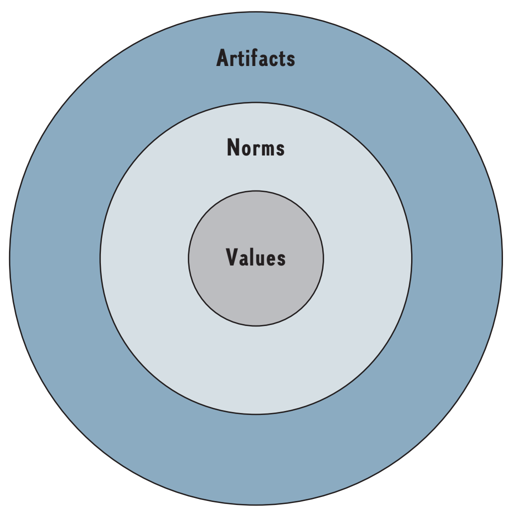
Setting the right values and norms allows strategic leaders to create an effective culture, which can lay the foundation for competitive advantage. Effective cultures allow for smooth execution of strategy, while ineffective cultures can lead to unintended, unethical, and sometimes even illegal outcomes. Interestingly, the researchers conducting the corporate culture survey also found that only 15% of the strategic leaders indicated they have an effective culture in their organization, while a bit more than half of the strategic leaders indicated their organizational culture needed some work; about one-third said their cultures needed considerable work or a substantial overhaul.

artifacts Elements that allow corporate culture to be expressed, such as via the design and layout of physical space, symbols, vocabulary, what stories are told, what events are celebrated and highlighted, and how they are celebrated.

Employees learn about an organization's culture through *socialization,* a process whereby employees internalize an organization's values and norms through immersion in its day-to-day operations.[54] Thus, it is critical that strategic leaders not only set and refine the corporate cultures, but also live them in their day-to-day activities and thus lead by example. Strategic leaders should strive for buy-in of all employees across all levels. *Strong cultures* emerge when the company's core values are widely shared among the firm's employees and when the norms have been internalized. Corporate culture finds its expression in **artifacts**. Artifacts include elements such as the design and layout of physical space (e.g., cubicles or private offices), symbols (e.g., the type of clothing worn by employees), vocabulary, what stories are told, what events are celebrated and highlighted, and how those events are celebrated (e.g., a formal dinner versus a casual barbecue when the firm reaches its sales target).

Exhibit 11.15 depicts the elements of organizational culture—values, norms, and artifacts—in concentric circles. The most important yet least visible element—values—is in the center. As we move outward in the figure, from values to norms to artifacts, culture becomes more observable. Understanding what organizational culture is, and how it is created, maintained, and changed, can help you be a more effective strategic leader.

EXHIBIT 11.15 The Elements of Organizational Culture: Values, Norms, and Artifacts



Google's Culture. From Google's earliest days in 1998, its quirky co-founders Larry Page and Sergey Brin instilled a set of strong core values that laid the foundation of their company's

EXHIBIT 11.16 Google's 10 Things the Founders Know to Be True

1. Focus on the user and all else will follow.
2. It's best to do one thing really, really well.
3. Fast is better than slow.
4. Democracy on the web works.
5. You don't need to be at your desk to need an answer.
6. You can make money without doing evil.
7. There's always more information out there.
8. The need for information crosses all borders.
9. You can be serious without a suit.
10. Great just isn't good enough.

Source: Excerpted from "Ten things we know to be true," www.google.com/about/philosophy.html.

unique culture. The co-founders created a tech company that is in many respects strikingly similar to their own personalities. Both Page and Brin suggest that their worldview is shaped by early experiences in Montessori schools as well as their engineering training, especially in computer science.

Page and Brin came up with 10 principles they "know to be true," including some of the best-known Google core values today such as *make money without doing evil; focus on the user first, and profits will follow; you can be serious without a suit;* and *great is just not good enough*.[55] Exhibit 11.16 lists Google's 10 core values.

Eric Schmidt, Google's longtime CEO during its early years (2001–2011), explained how surprised he was that strategic leaders as well as rank-and-file employees believed strongly in their company's core values and made day-to-day decisions based on them. For example, when asked how the core value of not doing evil helped Google, Schmidt recalled:

> When I showed up, I said, "You've got to be kidding." Then one day, very early on, I was in a meeting where an engineer said, "That would be evil." It was as if he'd said there was a murderer in the room. The whole conversation stopped, but then people challenged his assumptions. This had to do with how we would link our advertising system into search. We ultimately decided not to do what was proposed, because it was evil. That kind of story is repeated every hour now with thousands of people. Think of "Don't be evil" as an organizing principle about values.[56]

Some decisions based on the "Don't be evil" credo relate to minor decisions such as not accepting ads for hard liquor or guns. Other decisions are far more wide reaching with significant strategic implications. For instance, in 2006, Google entered the Chinese market with a customized search engine (google.cn) to service the then 400 million online customers in China.[57] This customized search engine was a self-censored version of its regular search engine (google.com) to comply with China's restrictions on free speech. At that time, Google felt the good that access to its searches, although censored, would bring to the Chinese people would outweigh its discomfort with censorship.

In the wake of the #MeToo Movement, Google employees staged a global walkout over the company's handling of sexual harassment. In particular, the Google employees protested a workplace culture that they allege promotes and protects perpetrators of sexual harassment.

Mason Trinca/Getty Images

But by 2010, Google felt it could no longer continue to provide self-censored searches; it alleged that Google was the target of sophisticated hacker attacks that accessed some of its users' Gmail accounts, including those of Chinese human rights activists. Google decided it would no longer censor its searches in China, and thus it risked having its search engine shut down by the Chinese government. Google's strong values—such as "Democracy on the web works," "You can make money without doing evil," and "The need for information crosses all borders"—guided this decision, which had potentially far-reaching strategic consequences. Google voluntarily withdrew from mainland China, and from 2010 onward, it ran its China website on a server in Hong Kong (www.google.com.hk).

Google's exit from mainland China further strengthened the lead of Baidu, a domestic Chinese company that had 85% market share (in 2022). Today, China has 1 billion internet users, by far the largest online market globally and the fastest growing. In comparison, the United States has 310 million internet users, which makes the Chinese market more than three times the size of the U.S. market. The size and growth of the Chinese market proved too alluring for Google's strategic leaders to ignore. In 2018, it was revealed that a Google team was secretly working on a search project for China, code named Dragonfly, that would adhere to the Chinese government's censoring requirements.[58] Upset Google employees wrote an open protest letter and staged a walkout, carrying signs saying "Don't be evil" and "OK Google, Don't contribute to internet censorship in China" and demanding that the clandestine project be shut down. In 2018, during a congressional hearing, Google CEO Sundar Pichai stated the company has no intention of launching a search engine in China at this point.

This example shows how difficult it is to balance deeply held core values with business opportunities, especially because some of Google's strategic leaders argue that providing search services in China—even censored searches—might do more good than harm, while many employees feel otherwise.

WHERE DO ORGANIZATIONAL CULTURES COME FROM?

Often, company founders define and shape an organization's culture, which can persist for many decades after their departure. This phenomenon is called **founder imprinting**.[59] Founders set the initial strategy, structure, and culture of an organization by transforming their vision into reality. We have already seen how the beliefs of Google founders Page and Brin shaped Google's culture. Other famous founders that have left strong imprints on their organizations include Beyoncé (Parkwood Entertainment), Sara Blakely (Spanx), Michael Dell (Dell), Walt Disney (Disney), Bill Gates (Microsoft), Arianna Huffington (Media), Steve Jobs (Apple), Herb Kelleher (Southwest Airlines), Phil Knight (Nike), Ralph Lauren (Polo Ralph Lauren), Rihanna (Fenty Beauty), Martha Stewart (Martha Stewart Living Omnimedia), Oprah Winfrey (Harpo Productions and OWN, the Oprah Winfrey Network), and Whitney Wolfe Herd (Tinder and Bumble).

founder imprinting A process by which the founder defines and shapes an organization's culture, which can persist for decades after the founder's departure.

Walmart founder Sam Walton personified the retailer's cost-leadership strategy. At one time the richest person in America, Sam Walton drove a beat-up Ford pickup truck, got $5 haircuts, went camping for vacations, and lived in a modest ranch home in Bentonville, Arkansas.[60] Everything Walton did was consistent with the low-cost strategy. Walmart stays true to its founder's tradition. Home to one of the largest companies globally, the company's Arkansas headquarters in Bentonville was described by Thomas Friedman in his book *The World Is Flat* as "crammed into a reconfigured warehouse ... a large building made of corrugated metal, I figured it was the maintenance shed."[61]

The culture that founders initially imprint is reinforced by their strong preference to recruit, retain, and promote employees who subscribe to the same values. In turn, more people with similar values are attracted to that organization.[62] As the values and norms held by the employees become more similar, the firm's corporate culture becomes stronger and more distinct, possibly resulting serious negative side-effect: *groupthink*, a situation in which opinions coalesce around a leader without individuals critically evaluating and challenging that leader's opinions and assumptions. Cohesive, non-diverse groups are highly susceptible to groupthink, which can lead to flawed decision making with potentially disastrous consequences.

In addition to founder imprinting, a firm's culture also flows from its values, especially when they are linked to the company's reward system. For example, Zappos (featured in Strategy Highlight 11.1) established its unique organizational culture through explicitly stated values that are connected to its reward system. To recruit people who fit with the company's values, each new hire goes through a four-week training program that covers such topics as company history, culture, vision, and customer service.[63] New hires also spend two weeks on the phone as customer service reps. What's novel about Zappos' approach is that at the end of the month-long employee orientation, the company offers an "exit prize": one month's pay plus pay for the time already with Zappos. This system allows the company to entice people to leave if they are qualified for the job but may not fit with Zappos' culture. Individuals who choose to stay despite the enticing offer tend to fit well with and strengthen Zappos' distinct culture.[64]

HOW DOES ORGANIZATIONAL CULTURE CHANGE?

An organization's culture can be one of its strongest assets but also its greatest liability. An organization's culture can turn from a core competency into a *core rigidity* if a firm relies too long on the competency without honing, refining, and upgrading as the firm and the environment change.[65] (Refer to the discussion in Chapter 4.) Over time, the original core competency is no longer a good fit and turns from an asset into a liability. This is the time when a culture needs to change.

Mary Barra, General Motors CEO, was appointed with the mandate to fix GM's dysfunctional corporate culture and to make the company competitive again.

Bill Pugliano/Getty Images

For example, GM's bureaucratic culture, combined with its innovative M-form structure, was once hailed as the key to its superior efficiency and management.[66] However, that culture became a liability when the external environment changed following the oil-price shocks in the 1970s and the entry of Japan-based carmakers into the United States.[67] GM's strong culture led to organizational inertia, resulting in a failure to adapt to changing customer preferences for more fuel-efficient cars. It also prevented higher-quality and more innovative car designs. GM lost customers to foreign competitors that offered these features.

More recently, GM's strong culture was again faulted for corporate ineptitude when delaying recalling defective cars.[68] Over 25 million GM cars were recalled for safety defects (in 2014), the largest recall ever. In particular, many GM cars were eventually recalled because of a faulty ignition switch, which could turn off the engine while driving and thus disable the airbags. This problem has been linked to more than 120 fatalities in the United States alone.[69] GM is alleged to knowingly have withheld information about the faulty ignition switches and delayed the needed recalls by several years. Indeed, during a U.S. Senate hearing, GM was described as dominated by a "culture of cover-up."[70] In such times of crisis, corporate culture must be changed to avoid such problems in the future and to address a breakdown in the culture-environment fit.

The primary means of cultural change is for the corporate board of directors to bring in new leadership at the top, which is then charged to make changes in strategy and structure. After all, executives shape corporate culture in their decisions on how to structure the organization and its activities, allocate its resources, and develop its system of rewards (refer to the discussion on strategic leadership in Chapter 2). GM's board of directors appointed Mary Barra as CEO (in 2014) with the charge to fix GM's dysfunctional corporate culture and to make the company competitive again.

Similarly, when Marissa Mayer was appointed CEO of Yahoo (in 2012), one of the first things she did was to change the corporate culture and norms. Yahoo had become overly bureaucratic and lost the zeal characteristic of high-tech startups. Many Yahoo employees worked from home (pre-pandemic). For those who worked in the office, weekends began Thursday afternoons, leaving empty parking garages at Yahoo's campus in Sunnyvale, California. In response, Mayer withdrew the option to work remotely. All of Yahoo's 12,000 employees would have to come to the office. She also instituted weekly town-hall meetings (called FYI) where she and other executives provided updates and fielded questions. All employees were expected to attend and encouraged to participate in the Q&A. Questions were submitted online during the week, and the employees voted which questions executives should respond to. Although Mayer succeeded in reenergizing the once leading internet firm, in the end, a successful turnaround failed and Yahoo was acquired by Verizon for a fire sale price.

ORGANIZATIONAL CULTURE AND COMPETITIVE ADVANTAGE

Can organizational culture be the basis of a firm's competitive advantage? For this to occur, the firm's unique culture must help it in some way to increase its *economic value creation* ($V–C$). That is, organizational culture must either help in increasing the perceived value of the product/service and/or lower its cost of production/delivery. Moreover, according to the resource-based view of the firm, the resource—in this case, organizational culture—must be *valuable, rare,* and *difficult to imitate,* and the firm must be *organized* to capture the value created. The VRIO principles (discussed in Chapter 4) must apply even to organizational culture itself.[71]

Let's examine one well-known example of how culture affects employee behavior and ultimately firm performance. Southwest Airlines (SWA) operates a little differently from other airlines. Flight attendants might sing a song about the city they are landing in, or they might slide bags of peanuts down the aisle at takeoff. Employees celebrate Halloween in a big way by wearing costumes to work. Some argue that SWA's business strategy—being a cost leader in point-to-point air travel—is fairly simple, and that SWA's competitive advantage actually comes from its unique culture.[72] It's not all fun and games, though: Friendly and highly energized employees work across functional and hierarchical levels. Even Southwest's pilots pitch in to help load baggage quickly when necessary. As a result, SWA's turn time between flights is only 15 minutes, whereas competitors frequently take two to three times as long. SWA's unique culture helps it keep costs low by turning around its planes faster, thus keeping them flying longer hours (among many other activities that lower SWA's cost structure).[73]

Let's consider how an organization's culture can have a strong influence on employee behavior.[74] A positive culture motivates and energizes employees by appealing to their higher ideals. Internalizing the firm's values and norms, employees feel that they are part of a larger, meaningful community attempting to accomplish important things. When employees are intrinsically motivated this way, the firm can rely on fewer levels of hierarchy, and close monitoring and supervision are not needed as much. Motivating through inspiring values allows the firms to tap employees' emotions so they use both their heads and their hearts when making business decisions. Strong organizational cultures that are strategically relevant therefore align employees' behaviors more fully with the organization's strategic goals. In doing so, they better coordinate work efforts, and they make cooperation more effective. They also strengthen employee commitment, engagement, and effort. Effective alignment in turn allows the organization to develop and refine its core competencies, which can form the basis for competitive advantage. As the firms grow and external economic environments change, the organizational culture must be flexible enough to adapt.

Applying the VRIO principles to the SWA example, we see that its culture is *valuable* (lowering costs for SWA), *rare* (none of its competitors has an identical culture), *non-imitable* (despite attempts by competitors), and *organized* to capture some part of the incremental economic value created due to its unique culture. It appears that at SWA, a unique organizational culture can provide the basis for a competitive advantage. Of course, this culture needs to be in sync with and in support of the business strategies pursued: cost leadership in the case for SWA.

Once it becomes clear that a firm's culture is a source of competitive advantage, some competitors will attempt to imitate that culture. Therefore, only a culture that cannot be easily copied can provide a competitive advantage. Two reasons explain why it can be difficult to imitate the culture of successful firms: *causal ambiguity* and *social complexity.* Although one can observe that a firm has a unique culture, the causal relationships among values, norms, artifacts, and the firm's performance may be hard to establish, even for the people who work within the organization. For example, employees may become aware of the effect that culture has on performance only after significant organizational changes occur. Moreover, organizational culture is socially complex. It encompasses not only interactions among employees across layers of hierarchy but also the firm's outside relationships with its customers and suppliers.[75] Such a wide range of factors is difficult for any competing firm to imitate.

It is best to develop a strong and strategically relevant culture in the first few years of a firm's existence. This is precisely what the Google co-founders did. Strategy scholars have documented that the initial structure, culture, and control mechanisms established in a new firm can be a significant predictor of later success.[76] And, according to other empirical research, founder CEOs had a stronger positive imprinting effect than non-founder CEOs.[77] This stronger imprinting effect, in turn, resulted in higher performance of firms led by founder CEOs. In addition, consider that the vehicles of cultural change—changing leadership and M&As—do not have a stellar record of success.[78] Indeed, researchers estimate that only about 20% of organizational change attempts are successful.[79] Thus, it is even more important to get the culture right from the beginning and then adapt it as the business evolves.

By combining theory and empirical evidence, we can see that organizational culture can help a firm gain and sustain competitive advantage *if* the culture makes a positive contribution to the firm's economic value creation and obeys the VRIO principles. Organizational culture is an especially effective lever for new ventures due to its malleability. Firm founders, early-stage CEOs, and venture capitalists, therefore, should be proactive in attempting to create a culture that supports a firm's economic value creation.

LO 11-8

Compare and contrast different strategic control-and-reward systems.

11.5 Strategic Control-and-Reward Systems

Strategic control-and-reward systems are the third and final key building block in designing organizations for competitive advantage. **Strategic control-and-reward systems** are internal governance mechanisms put in place to align the incentives of principals (shareholders) and agents (employees). These formal systems allow managers to specify goals, measure progress, and provide performance feedback. Chapter 5 discussed how firms can use the balanced-scorecard framework as a strategic control system. Here, we discuss additional control-and-reward systems: organizational culture, input controls, and output controls.

strategic control-and-reward systems Internal-governance mechanisms put in place to align the incentives of principals (shareholders) and agents (employees).

As discussed in the preceding section, *organizational culture* can be a powerful motivator. It also can be an effective control system. Norms, which are informal and tacit in nature, act as a social control mechanism. Peer control, for example, exerts a powerful force on employee conformity and performance.[80] Values and norms also provide control by helping employees address unpredictable and irregular situations and problems (which are common in service businesses). In contrast, rules and procedures (e.g., those codified in an employee handbook) can address only circumstances that can be predicted.

Google relies on data analysis and the latest findings in behavioral economics and psychology research to motivate its employees and to achieve high productivity.[81] The tech industry in general is plagued by problems of employee attrition, turnover, and confidentiality breaches. In addition, highly capable individuals such as star programmers are in short supply and thus have strong bargaining power. Google differs from other employers in its generous on-the-job perks, which include not only free gourmet food, beverages, and coffee but also onsite child care, car detail services, and educational opportunities. Google also provides relaxation opportunities such as complimentary massages and naps in nap pods. Employees are also invited to play table tennis or foosball. In 2022, Google had 164,000 employees and revenues of $275 billion. These numbers imply that each employee on average generates $1.7 million in revenues, justifying the pricey on-the-job perks.

Less well-known is Google's fine-tuned compensation and reward systems based on pay for performance. Google uses the **Objectives and Key Results (OKRs)** framework as one of its strategic control-and-reward systems; in addition to helping a team and its individual members monitor objectives and outcomes, the OKR framework helps them to set ambitious stretch goals (for example, increase users by 25%). The more objective the goal, the more easily it can be measured. Google also makes the individual and team OKRs public—doing this puts a degree of peer pressure on those team members who are not carrying their weight. The more public their individual progress, the more likely they will work toward helping their teams achieve their OKRs.

Objectives and Key Results (OKRs) A strategic reward and control system that helps a team and its individual members monitor objectives and outcomes, as well as set ambitious stretch goals.

INPUT CONTROLS

Input controls seek to define and direct employee behavior through a set of explicit, codified rules and standard operating procedures. Firms use input controls when the goal is to define the ways and means to reach a strategic goal and to ensure a predictable outcome. They are called input controls because management designs these mechanisms so they are considered *before* employees make any business decisions. Thus, they are an input into the value-creating activities.

input controls Mechanisms in a strategic control-and-reward system that seek to define and direct employee behavior through a set of explicit, codified rules and standard operating procedures that are considered before the value-creating activities.

The use of *budgets* is key to input controls. Managers set budgets before employees define and undertake the actual business activities. For example, strategic leaders decide how much money to allocate to a certain R&D project before the project begins. In diversified companies using the M-form, corporate headquarters determines the budgets for each division. Public institutions, including some universities, also operate on budgets that must be balanced each year. Their funding often depends to a large extent on state appropriations and thus fluctuates depending on the economic cycle. During recessions, budgets tend to be cut, and they expand during boom periods.

Standard operating procedures, or policies and rules, are also frequently used input controls. The discussion of formalization described how McDonald's relies on detailed operating procedures to ensure consistent quality and service worldwide. The goal is to specify the conversion process from beginning to end in great detail to guarantee standardization and minimize deviation. This goal is important when a company operates in different geographies and with different human capital throughout the globe but needs to deliver a standardized product or service.

OUTPUT CONTROLS

Output controls seek to guide employee behavior by defining expected results (outputs), but they leave the means to those results open to individual employees, groups, or SBUs. Firms frequently tie employee compensation and rewards to predetermined goals, such as a

output controls Mechanisms in a strategic control-and-reward system that seek to guide employee behavior by defining expected results (outputs), but leave the means to those results open to individual employees, groups, or SBUs.

specific sales target or return on invested capital. Output controls are especially effective when factors internal to the firm determine the relationship between effort and expected performance. At the corporate level, outcome controls discourage collaboration among different strategic business units. They are best applied when a firm focuses on a single line of business or pursues unrelated diversification.

These days, more and more work requires creativity and innovation, especially in highly developed economies.[82] As a consequence, so-called *results-only-work-environments (ROWEs)* have attracted significant attention. ROWEs are output controls that attempt to tap intrinsic (rather than extrinsic) employee motivation, which is driven by the employee's interest in and the meaning of the work itself. In contrast, extrinsic motivation is driven by external factors such as awards and higher compensation, or punishments such as demotions and layoffs (the *carrot-and-stick approach*). According to a recent synthesis of the strategic human resources literature, intrinsic motivation in a task is highest when an employee has the following:

- Autonomy *(about what to do)*
- Mastery *(how to do it)*
- Purpose *(why to do it)*[83]

Today, 3M is best known for its adhesives and other consumer and industrial products.[84] But its full name reflects its origins: 3M stands for Minnesota Mining and Manufacturing Co. Over time, 3M has relied on the ROWE framework and has morphed into a highly science-driven innovation company. At 3M, employees are encouraged to spend 15% of their time on projects of their *own choosing.* If any of these projects look promising, 3M provides financing through an internal venture capital fund and other resources to further develop their commercial potential. In fact, several of 3M's flagship products, including Post-it Notes and Scotch Tape, were the results of serendipity. To foster continued innovation, moreover, 3M requires each of its divisions to derive at least 30% of their revenues from products introduced in the past four years.

11.6 Implications for Strategic Leaders

This chapter has a clear practical implication for the strategist: Formulating an effective strategy is a necessary but not sufficient condition for gaining and sustaining competitive advantage; strategy *execution* is at least as important for success.

The key levers for strategic leaders to achieve effective strategy implementation are structure, culture, and control. Successful strategy implementation, therefore, requires leaders to design and shape structure, culture, and control mechanisms. In doing so, they execute a firm's strategy as they put its accompanying business model into action. Strategy formulation and strategy implementation are therefore iterative and interdependent activities.

Some argue that strategy implementation is more important than strategy formulation.[85] Often, managers do a good job of analyzing the firm's internal and external environments to formulate a promising business, corporate, and global strategy, but then fail to implement the chosen strategy successfully. That is why some scholars refer to implementation as the "graveyard of strategy."[86] In reality, both strategy formulation *and* strategy implementation are necessary to gain and sustain a competitive advantage.

As a company grows and its operations become more complex, it adopts different organizational structures over time following a generally predictable pattern, beginning with a simple structure, then adopting a functional structure, and then using a multidivisional or matrix structure. Organizing for competitive advantage therefore is a dynamic, not a static, process. As discussed in the Google example in ChapterCase 11 and throughout the chapter, to maintain competitive advantage, companies need to restructure as they grow and the competitive environment changes.

Organizing for innovation is another area to which strategic leaders need to pay careful attention. Many of the more successful companies have either adopted or are moving toward an open innovation model. Strategic leaders must actively manage a firm's internal and external innovation activities.

Internally, strategists can *induce innovation* through a top-down process or motivate innovation through *autonomous actions,* a bottom-up process.[87] In induced innovation, strategic leaders need to put in place a structure and system to foster innovation. Consider this statement from 3M: "A core belief of 3M is that creativity needs freedom. That's why ... we've encouraged our employees to spend 15% of their working time on their own projects. To take our resources, to build up a unique team, and to follow their own insights in pursuit of problem-solving."[88] We discussed *autonomous actions* in detail in Chapter 2.

To not only motivate innovations through autonomous behavior but also ensure their possible success, *internal champions* need to be willing to support promising projects. In Strategy Highlight 2.2, we detailed how Howard Behar, at that time a senior executive at Starbucks, was willing to support the bottom-up idea of Frappuccino, which turned out to be a multibillion-dollar business. Externally, strategic leaders must manage innovation through cooperative strategies such as licensing, strategic alliances, joint ventures, and acquisitions. These are the vehicles of *corporate strategy* discussed previously.

This concludes our discussion of organizational design. We now move on to our concluding chapter, where we study corporate governance, business ethics, and business models.

CHAPTER**CASE 11** Part II

Alphabet remains a one-trick pony, with its Google unit bringing practically all the profits (99.7%). Yet, competition in the online advertising space is heating up. Three companies (Google, Meta, and Amazon) hold 65% market share in digital ad spending, which equates to roughly 50% of the $1 trillion spent on advertising globally (in 2022). Sundar Pichai, Alphabet's CEO, has twin worries: that Google remains Alphabet's only source of profits, and that Google's market share in digital ad spending has been decreasing, from 32% in 2019 to 28% in 2022, with another estimated decrease to 26% in 2023. In contrast, Amazon's ad business has almost doubled, from 8% (in 2019) to an estimated 15% (in 2023). Meta, with its Facebook and Instagram properties, has become a viable alternative to Google, and is—with a 24% market share—predicted to almost reach parity with Google in 2023 (although Meta is facing challenges with Apple's changes to its app tracking technology on iPhones; see ChapterCase 2).

Google has data on what people search for. Amazon has data on what people buy, and Meta has data on people's social graphs and online activities. A user's social graph and online activities allow for micro-targeting of ads, which is highly effective. For example, Meta can help an advertiser find 2,000 people who graduated within the last five years with a degree in engineering, are making over $150,000 a year, and live in Atlanta.

With Alphabet's multidivisional (M-form) organizational structure, CEO Sundar Pichai hopes for more radical innovation that will turn into highly profitable businesses like Google. Before its reorganization from a functional to M-form structure, which Alphabet implemented to manage a set of unrelated businesses, Google had developed many of its most well-known products and services through planned emergence, in which the impetus for strategic initiatives comes from the bottom up through autonomous actions by lower-level employees. Google organized the work of its engineers according to a 70-20-10 rule. The majority of the engineers' time (70%) focused on its main business—search and ads.

However, engineers dedicated one day a week (20%) to developing ideas of their own choosing, and they spent the remainder (10%) on total wild cards such as Project Loon, an envisioned network of high-altitude balloons that travel on the edge of space to provide wireless internet services to the people who do not have internet access—primarily those in rural and remote areas. An estimated 33% of the world's population (2.6 billion people) has never used the internet. Loon appeared to be promising, and as such it "graduated" from X Development (Alphabet's R&D lab) and became a standalone unit with its own CEO in 2018. Yet, just three years later, Alphabet decided to shut Loon down. Loon CEO Alastair Westgarth explained that despite years of heavy R&D spending and engineering resources, the inability to drive down costs low enough to create "a long-term, sustainable business" led to Loon's termination.[89]

Despite Loon's failure, Google has reported that half of its new products came from the 20% rule. These products include Gmail, Google Maps, Google News, Orkut, and AdSense. AdSense started as an experiment by two Google engineers: They attempted to match Gmail content with targeted ads based on that content. Today, AdSense enables content creators such as bloggers to serve online ads that are targeted to the site's content.

Although Google has a stellar track record for strategy process as planned emergence, it has fumbled its social networking endeavors multiple times. These missteps left the space open to Meta, now Google's fiercest competitor in the digital ad space with its Facebook and Instagram properties. Google's first attempt at social networking goes back to 2002, two years (eons in internet time) before Facebook was founded. Google engineer Orkut Buyukkokten had developed a social network, called Orkut, using his 20% discretionary time. Marissa Mayer, then Google's vice president in charge of the project, liked what she saw and provided initial support. More engineers were eventually added to further Orkut's development. Google was astonished at Orkut's early success: Within the first month after its release, hundreds of thousands of people had signed up. By 2014, Orkut had 30 million users, mostly in Brazil and India. But this number paled in comparison to Facebook's more than 1 billion users worldwide at the time.

Why did Google fumble its early lead over Facebook? Google had a huge opportunity to become the leader in social networking because Myspace imploded after it was acquired by News Corp. Despite initial support, Google's top executives felt that social networking did not fit its vision *to organize the world's information and make it universally accessible and useful.* Google relied on highly complex and proprietary algorithms to organize the knowledge available on the internet and serve up targeted search ads. Social networking software, in comparison, is fairly pedestrian. Additionally, Page and Brin, both exceptional computer scientists, felt their Page-Rank algorithm, which accounts for hundreds of variables and considers all available websites, was far superior because it provides *objective* recommendations to users' search queries rather than *subjective* endorsements by someone's online friends. As a consequence, they snubbed social networking. Moreover, given the many different projects Google was pursuing at that time, the company's top executives ranked Orkut as a low priority. Starved of further resources, the social networking site withered and was eventually shut down in 2014, making Meta the undisputed leader.

In yet another effort to catch up with Meta, Google launched Google Plus in 2011. This social networking site integrated all of Google's services—Gmail, YouTube, Chrome, and others—into one user interface. It required users to sign into its portal, even if they were using just one Google product. After a data breach, Google Plus was shut down unceremoniously in 2019. Meanwhile, Meta has 3 billion active users on its platforms (Facebook and Instagram)—and Google is unable to access any of the information tied to these users. Not being able to access Meta users' activities on its social networks limits Google's ability to serve targeted ads, which in turn cuts directly into its main line of business. Meanwhile, Alphabet's CEO Sundar Pichai is still hoping for another major breakthrough that will open up a new line of business beyond what Google does.

Questions

1. Why did Google restructure itself and create Alphabet? What is it hoping to accomplish? For additional insights, see Larry Page's post announcing the restructuring at https://abc.xyz/.
2. Do you think the reorganization is beneficial for Alphabet's moonshots, now housed in their own business unit with profit-and-loss responsibility? Why or why not? Explain.
3. Why has Google "failed" to develop other profitable businesses? Is Google's strategy process of planned emergence to blame? Why or why not? Will Alphabet's new structure with independent SBUs enable the company to innovate more and find the next highly profitable business beyond online search and advertising? [Hint: Take a look at Alphabet's most recent annual report.]

TAKE-AWAY CONCEPTS

This chapter explored the three key levers that managers have at their disposal when designing their firms for competitive advantage—structure, culture, and control—as summarized by the following learning objectives and related take-away concepts.

LO 11-1 / Define organizational design and list its three components.

- Organizational design is the process of creating, implementing, monitoring, and modifying the structure, processes, and procedures of an organization.
- The key components of organizational design are structure, culture, and control.
- The goal is to design an organization that allows managers to effectively translate their chosen strategy into a realized one.

LO 11-2 / Explain how organizational inertia can lead established firms to failure.

- Organizational inertia can lead to the failure of established firms when a tightly coupled system of strategy and structure experiences internal or external shifts.
- Firm failure happens through a dynamic, four-step process (refer to Exhibit 11.2).

LO 11-3 / Define organizational structure and describe its four elements.

- An organizational structure determines how firms orchestrate employees' work efforts and distribute resources. It defines how firms divide and integrate tasks, delineates the reporting relationships up and down the hierarchy, defines formal communication channels, and prescribes how employees coordinate work efforts.
- The four building blocks of an organizational structure are specialization, formalization, centralization, and hierarchy (refer to Exhibit 11.3).

LO 11-4 / Compare and contrast mechanistic organizations and organic organizations.

- Organic organizations are characterized by a low degree of specialization and formalization, a flat organizational structure, and decentralized decision making.
- Mechanistic organizations are characterized by a high degree of specialization and formalization, along with a tall hierarchy that relies on centralized decision making.
- The comparative effectiveness of mechanistic versus organic organizational forms depends on the context.

LO 11-5 / Describe different organizational structures and match them with appropriate strategies.

- To gain and sustain competitive advantage, not only must structure follow strategy, but also the chosen organizational form must match the firm's business strategy.
- The strategy–structure relationship is dynamic, changing in a predictable pattern—from simple to functional structure, then to multidivisional (M-form) and matrix structure—as firms grow in size and complexity.
- In a simple structure, the founder tends to make all the important strategic decisions as well as run the day-to-day operations.
- A functional structure groups employees into distinct functional areas based on domain expertise. Its different variations are matched with different business strategies: cost leadership, differentiation, and blue ocean (refer to Exhibit 11.6).
- The multidivisional (M-form) structure consists of several distinct SBUs, each with its own profit-and-loss responsibility. Each SBU operates more or less independently, led by a CEO responsible for the business strategy of the unit and its day-to-day operations (refer to Exhibit 11.7).
- The matrix structure is a mixture of two organizational forms: the M-form and the functional structure (refer to Exhibit 11.9).
- Exhibits 11.8 and 11.10 show how best to match different corporate and global strategies with respective organizational structures.

LO 11-6 / Evaluate closed and open innovation, and derive implications for organizational structure.

- Closed innovation is a framework for R&D that proposes impenetrable firm boundaries. The key to success in the closed innovation model is that the firm discovers, develops, and commercializes new products internally.

- Open innovation is a framework for R&D that proposes permeable firm boundaries to allow a firm to benefit not only from internal ideas and inventions, but also from external ones. The sharing goes both ways: Some external ideas and inventions are insourced while others are spun off.
- Exhibit 11.12 compares and contrasts principles of closed and open innovation.

LO 11-7 / Describe the elements of organizational culture, and explain where organizational cultures can come from and how they can be changed.

- Organizational culture is the collectively shared values and norms of the organization's members.
- Values define what is considered important, and norms define appropriate employee attitudes and behaviors.
- Corporate culture finds its expression in artifacts, which are observable expressions of an organization's culture.

LO 11-8 / Compare and contrast different strategic control-and-reward systems.

- Strategic control-and-reward systems are internal governance mechanisms put in place to align the incentives of principals (shareholders) and agents (employees).
- Strategic control-and-reward systems allow managers to specify goals, measure progress, and provide performance feedback.
- In addition to the balanced-scorecard framework, managers can use organizational culture, input controls, and output controls as part of the firm's strategic control-and-reward systems.
- Input controls define and direct employee behavior through explicit and codified rules and standard operating procedures.
- Output controls guide employee behavior by defining expected results, but they leave the means to those results open to individual employees, groups, or SBUs.

KEY TERMS

Absorptive capacity *(p. 441)*
Ambidexterity *(p. 430)*
Ambidextrous organization *(p. 430)*
Artifacts *(p. 445)*
Centralization *(p. 424)*
Exploitation *(p. 430)*
Exploration *(p. 430)*
Formalization *(p. 424)*
Founder imprinting *(p. 447)*
Functional structure *(p. 429)*
Hierarchy *(p. 425)*
Holacracy *(p. 435)*
Inertia *(p. 422)*
Input controls *(p. 451)*
Matrix structure *(p. 436)*
Mechanistic organization *(p. 426)*
Multidivisional structure (M-form) *(p. 432)*
Norms *(p. 444)*
Objectives and Key Results (OKRs) *(p. 451)*
Open innovation *(p. 440)*
Organic organization *(p. 426)*
Organizational culture *(p. 444)*
Organizational design *(p. 420)*
Organizational structure *(p. 424)*
Output controls *(p. 451)*
Simple structure *(p. 428)*
Span of control *(p. 425)*
Specialization *(p. 424)*
Strategic control-and-reward systems *(p. 450)*

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CHAPTER

12 Corporate Governance, Business Ethics, and Business Models

Chapter Outline

Learning Objectives

LO 12-1 Explain the role of corporate governance.

LO 12-2 Apply agency theory to explain why and how companies use governance mechanisms to align the interests of principals and agents.

LO 12-3 Evaluate the board of directors as the central governance mechanism for public stock companies.

LO 12-4 Evaluate other governance mechanisms.

LO 12-5 Explain the relationship between strategy and business ethics.

LO 12-6 Use the business model framework to put strategy into action.

LO 12-7 Explain the long-tail concept and how it can be used as a business model innovation to implement strategy.

Theranos: Bad Blood

Elizabeth Holmes was 19 years old when she founded Theranos, a medical diagnostic company, in 2003. Ambitious and entrepreneurial, she dropped out of college with the intent to disrupt the health care industry. Holmes' big invention was a miniaturized lab that could run 200 diagnostic tests from a single drop of blood drawn from a painless finger prick—quite a departure from the traditional method of using needles to draw vials of blood from veins. The technology and process of diagnosing blood hadn't changed much since the 1950s, and Holmes was convinced that the diagnostic blood testing market was ripe for disruption. She proclaimed she could develop a new technology that could spot everything from cholesterol to cancer within minutes and more accurately than traditional blood-drawing methods. She would accomplish this feat by merging scientific advances in medical devices with bioengineering.

Holmes' strategic intent did not just focus on developing more consumer-friendly blood tests; it also focused on providing faster, less expensive, more reliable, and more convenient tests. She wanted consumers to be able to take blood tests at their local pharmacy or even in the comfort of their own homes. This convenience would be an important step toward achieving individualized health care, which would allow consumers to obtain important information as they needed it to make their own medical decisions. Because consumers could have an entire suite of blood tests conducted every two weeks or so, and have the resulting data shared with their physicians, people would find themselves with a much more dynamic view of their overall health profiles. Holmes theorized that repeated testing over short intervals would allow for early detection and prevention of diseases. With its revolutionary technology, Theranos set out to challenge incumbent diagnostic companies Quest Diagnostics and LabCorp, which were both using decades-old technology and charging hundreds of dollars for standard blood tests. Government agencies such as Medicare have sued these firms for overcharging by billions of dollars. Together, Quest Diagnostics and LabCorp had long dominated the U.S. market in a cozy duopoly and owned more than 80% of the market.

Elizabeth Holmes, founder and CEO of Theranos, is pictured here with a "nanotainer," a small container holding a drop of blood to be inserted for testing into the Edison machine, a Theranos invention. Although the Edison machine was a promising and appealing idea, Theranos never got it to work. In 2022, Holmes was convicted of defrauding investors. Now a convicted felon, she faces up to 20 years in prison plus millions in restitution and fines.

Ethan Pines/The Forbes Collection/Contour RA/Getty Images

At the time Theranos got off the ground, Steve Jobs was dominating Silicon Valley with his larger-than-life presence. He so inspired Holmes that she duplicated things he did—wearing black turtlenecks every day, hiring former Apple employees who had worked with Jobs, hiring the same advertising firm, and scheduling meetings on the same day as Jobs did (Wednesdays). Jobs was known for his uncanny ability to convince pretty much anyone who encountered him that *his* reality was the true reality, regardless of facts and other constraints. This version of reality has come to be known as Jobs' "reality distortion field." To effect her own reality distortion field, Holmes held constant eye contact with individuals and never blinked, an effect that was reinforced by her large blue eyes. In addition, to sound more assertive and confident, she trained herself to use a deep baritone voice rather than her natural voice.

So promising was the new Theranos technology that Holmes managed to persuade her adviser, Channing Robertson, then senior associate dean in the School of Engineering at Stanford University, to leave his tenured professorship and join her startup. Robertson's endorsement was enough to convince Tim Draper, of the famous venture capital firm DFJ, to provide initial funding. Draper was also the first to invest in the now-famous startups Tesla, Skype, and Baidu (China's version of Google). He was convinced that Holmes would "dedicate her life to mak[ing] something extraordinary happen to change the world."[1]

The media hype around the charismatic Holmes and her startup was enormous; she was featured frequently on the covers of such high-profile business publications as *Fortune, Forbes, Bloomberg Businessweek,* and *Inc.* She also made several TV appearances on CNBC and elsewhere. Many investors were gripped by FOMO ("fear of missing out") on the next big thing. As a result, other venture capital firms began to invest in Theranos, as did billionaires Rupert Murdoch, Robert Kraft, the Walton family, the DeVos family, and others—with each investing $100 million or more. By 2014, Theranos was valued at $10 billion, making it one of the world's most valuable startups. Indeed, it was more valuable than other famous *unicorns* (private startups with valuations of over $1 billion) such as Uber, Airbnb, and Spotify. With approximately $5 billion in Theranos stock, Elizabeth Holmes had become the world's youngest self-made female billionaire. At its peak, Theranos had more than 800 employees and was considered one of the hottest tech startups in Silicon Valley.

Once Theranos went live with its blood testing, however, things began to unravel. Walgreens, in an attempt to preempt rival CVS, began to offer Theranos services to its Arizona-based customers in 2013. The initial idea was to install Theranos' Edison machines (mini-labs) in each Walgreens wellness center, so blood could be drawn by finger prick and analyzed onsite within minutes, at lower cost and with higher accuracy. The problem was that Theranos machines were medical devices that needed FDA approval—which Theranos did not obtain. As a work-around, onsite Walgreens technicians collected blood samples by finger prick, stored them in nanotainers, and shipped them to Theranos headquarters in Palo Alto, California, where the blood samples were analyzed. The results then were sent to the customers.

However, the Theranos technology failed to work well, if at all, and patients' lab results turned out to be inaccurate. Because the Edison machines couldn't handle the scope of tests Theranos had advertised, Holmes decided to analyze the blood samples collected in Walgreens' Arizona locations using old-line medical devices. Furthermore, because only a drop of blood was drawn from each patient, the samples needed to be diluted to meet the volume required for testing with the older equipment, which further reduced the accuracy of the results. In other instances, Theranos advised patients that larger amounts of blood were needed for testing to be possible, which led patients back to the traditional method of having blood drawn by an intravenous needle. So began the gradual unraveling of a $10 billion deception.

Elizabeth Holmes' story is so compelling that media companies could not resist. HBO was first with the documentary *The Inventor: Out for Blood in Silicon Valley.* Based on John Carreyrou's investigative reporting for the *Wall Street Journal* that resulted in the bestselling book *Bad Blood: Secrets and Lies in a Silicon Valley Startup,* Apple Studios is producing a Hollywood movie starring Jennifer Lawrence as Elizabeth Holmes. In addition, Hulu streamed the popular TV series *The Dropout*.[2]

Part II of this ChapterCase appears in Section 12.4.

The Theranos ChapterCase illustrates how intricate and intertwined business ethics issues and competitive advantage can be. With $10 billion in valuation, Theranos was at one point the most promising startup in Silicon Valley. Elizabeth Holmes, the 19-year-old inventor and CEO of Theranos, had several novel ideas on how to disrupt the medical diagnostic industry using new technology on which she obtained several patents. As Holmes accumulated more and more funding for her startup, pressures mounted to get the technology to work. With increasing pressure and less and less time, Holmes began to cut corners, and things went from bad to worse. Even though Holmes started out with some promising ideas and great potential, cutting corners under high pressure led to a pattern of unethical behavior that turned illegal. These unethical behaviors included defrauding patients, health care providers, and investors, in addition to treating Theranos employees poorly.

In this chapter, we wrap up our discussion of strategy implementation and close the circle in the AFI framework by studying three important areas: corporate governance, business ethics, and business models. We begin by discussing effective *corporate governance* mechanisms to direct and control the enterprise. A firm must put these mechanisms in place to ensure pursuit of its intended goals. Effective governance is a necessary condition to achieve a sustainable competitive advantage. It is also needed to prevent unethical practices such as those by Theranos, as discussed in the ChapterCase.

Elizabeth Holmes' controversial decisions and questionable behavior highlight the link between business ethics and sustainable competitive advantage. As such, we study *business ethics,* which enable strategic leaders to think through complex decisions in an increasingly dynamic, interdependent, and global marketplace. To complete our discussion of strategy implementation, we take a close look at *business models* because they are critical to executing strategy. The translation of strategy into action takes place in the firm's business model. Getting the business model right is required for effective strategy implementation and thus critical to achieving and sustaining a competitive advantage. We conclude with *Implications for Strategic Leaders.*

12.1 Corporate Governance

LO 12-1

Explain the role of corporate governance.

Corporate governance concerns the mechanisms to direct and control an enterprise in order to ensure that it pursues its strategic goals successfully and legally.[3] Corporate governance is about checks and balances and about asking tough questions at the right time. The accounting scandals of the early 2000s and the global financial crisis of 2008 got so out of hand partly because the enterprises involved did not practice effective corporate governance.

corporate governance A system of mechanisms to direct and control an enterprise in order to ensure that it pursues its strategic goals successfully and legally.

As discussed in the ChapterCase, Theranos did not have effective corporate governance mechanisms in place. The startup's unethical competitive tactics and decisions were also found to be illegal because they defrauded investors (see ChapterCase Part II). While Theranos was still a private company that had not yet gone through an initial public offering, it was organized like a public company with a board of directors and shareholders (i.e., investors, board members, employees, and so on). Theranos' board of directors failed in their oversight but was also duped by the founder and CEO, Elizabeth Holmes, now a convicted felon.

In publicly traded companies, shareholders own the enterprise but hire managers to run the business, which creates the *principal-agent problem* (introduced in Chapter 5). Corporate governance attempts to address the *principal-agent problem*, which can occur any time an agent performs activities on behalf of a principal.[4] This problem can arise whenever a principal delegates decision making and control over resources to agents, with the expectation that they will act in the principal's best interest.

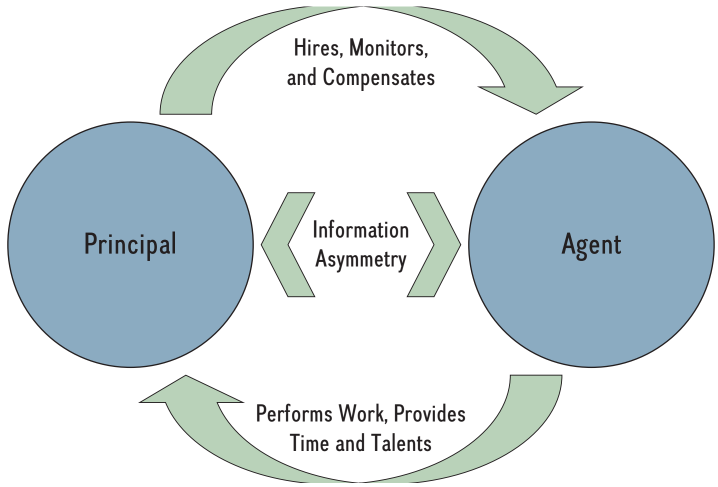
We mentioned earlier in this book that the separation of ownership and control is one of the major advantages of public stock companies. However, this benefit is also the source of the principal-agent problem. In publicly traded companies, the stockholders are the legal owners of the company, but they delegate decision-making authority to professional managers. The conflict arises if the agents pursue their own personal interests, which can be at odds with the principals' goals. Principals desire maximization of total returns to shareholders, but agents may be more interested in maximizing their total compensation, including benefits, job security, status, and power.

The risk of opportunism on behalf of agents is exacerbated by *information asymmetry:* The agents are generally better informed than the principals. Exhibit 12.1 depicts the principal-agent relationship.

Managers, executives, and board members tend to have access to *private information* concerning important company developments to which outsiders, especially investors, are not privy. Often this informational advantage is based on timing—insiders are the first to learn about important developments before the information is released to the public.

EXHIBIT 12.1

The Principal-Agent Problem



Although possessing insider information is not illegal and indeed is part of an executive's job, what *is* illegal is acting on it by trading stocks or passing on the information to others who might do so.

Information Asymmetry, Insider Trading, and On-the-Job Consumption. Insider-trading cases provide good examples of the egregious exploitation of information asymmetry. The hedge fund Galleon Group (which at its peak managed assets worth $7 billion) was engulfed in an insider-trading scandal involving private information about important developments at companies such as Goldman Sachs, Google, IBM, Intel, and P&G.[5] Galleon Group's founder, Raj Rajaratnam, the mastermind behind a complex network of informants, was sentenced to 11 years in prison and fined more than $150 million. In one instance, an Intel manager had provided Rajaratnam with internal Intel data such as orders for processors and production runs. These data indicated that demand for Intel processors was much higher than analysts had expected. Galleon bought Intel stock well before this information was public to benefit from the anticipated share appreciation.

In another instance, Rajaratnam benefited from insider tips provided by Rajat Gupta, a former McKinsey chief executive who served on Goldman Sachs' board. Often within seconds after the end of a Goldman Sachs board meeting, Gupta would call Rajaratnam. In one of these phone calls, Gupta revealed the impending multibillion-dollar liquidity injection by Warren Buffett into Goldman Sachs during the midst of the global financial crisis. This information allowed the Galleon Group to buy Goldman Sachs shares before the official announcement about Buffett's investment was made, thus allowing the Galleon Group to profit from the subsequent stock appreciation. In another call, Gupta informed Rajaratnam that the investment bank would miss its earnings estimates. Based on this insider information, the Galleon Group sold its holdings in Goldman Sachs stock before the announcement, avoiding a multimillion-dollar loss.[6]

Information asymmetry can also breed *on-the-job consumption,* perquisites, and excessive compensation. Although use of company funds for golf outings, resort retreats, professional sporting events, or elegant dinners and other entertainment is an everyday manifestation of on-the-job consumption, other forms are more extreme. Dennis Kozlowski, former CEO of Tyco, a diversified conglomerate, used company funds to furnish his $30 million New York City apartment (the shower curtain alone was $6,000) and to throw a $2 million birthday party for his spouse.[7] During the height of the global financial crisis (in 2008), John Thain, former CEO of Merrill Lynch, spent $1.2 million of company funds on redecorating his office while demanding cost cutting and frugality from his employees.[8] Such uses of company funds, in effect, mean that shareholders pay for those items and activities. Thain also allegedly requested a bonus of up to $30 million in 2009, during the height of the global financial crisis, despite Merrill Lynch having lost billions of dollars and being unable to continue as an independent company. Merrill Lynch was later acquired by Bank of America in a fire sale.

AGENCY THEORY

LO 12-2

Apply agency theory to explain why and how companies use governance mechanisms to align the interests of principals and agents.

The principal-agent problem is a core part of **agency theory**, which views the firm as a nexus of legal contracts.[9] In this perspective, corporations are viewed as a set of legal contracts between different parties. Conflicts that may arise are to be addressed in the legal realm. Agency theory finds its everyday application in employment contracts, for example.

agency theory A theory that views the firm as a nexus of legal contracts.

In addition to affecting the relationship between shareholders and managers, principal-agent problems also cascade down the organizational hierarchy (shown in Exhibit 5.1). Senior executives, such as the CEO, face agency problems when they delegate authority of strategic business units to general managers.

Employees who perform the actual operational labor are agents who work on behalf of the managers. Such frontline employees often enjoy an informational advantage over management. They may tell their supervisor that it took longer to complete a project or serve a customer than it actually did, for example. Some employees may be tempted to use such informational advantage for their own self-interest (e.g., spending time on TikTok and Instagram during work hours, watching YouTube videos, or using the company's computer and internet connection for personal business).

WAYMO, UBER, AND THE PRINCIPAL-AGENT PROBLEM. The lawsuit between Uber and Waymo (mentioned in ChapterCase 9) illustrates the thorny issues that arise out of the inherent principal-agent problem in employment relationships.[10] In this case, Anthony Levandowski, the engineer at the heart of the lawsuit, was alleged to have set up his autonomous-vehicle company, Otto, while still working at Waymo, as a front to siphon off trade secrets and proprietary technology from his employer. Shortly after Levandowski formally left Waymo, Uber acquired his start-up company Otto for close to $700 million in 2016. Waymo alleges that Levandowski set up Otto to steal trade secrets and proprietary designs, and to turn around and use this knowledge to advance self-driving technology at Uber. Waymo alleges that Levandowski and Uber not only acted opportunistically but also illegally.

In 2018, the two companies settled the lawsuit, with Uber giving Waymo $245 million worth of equity as well as the promise that Uber wouldn't use any of Waymo's autonomous-vehicle technology. In 2019, federal authorities charged Anthony Levandowski with trade-secret theft. Levandowski formally pleaded guilty and was sentenced to 18 months in prison. He was required to pay close to $800 million to Waymo as restitution. During the sentencing, the judge said, "This is the biggest trade secret crime I have ever seen. ... This was massive in scale," but he described Levandowski as a brilliant, groundbreaking engineer that our country needs (Levandowski was born in Belgium and moved to the United States as a teenager). "We need those people with vision," the judge said. "I'm going to give him that."[11] In 2021, Anthony Levandowski received a full presidential pardon.

The managerial implication of agency theory relates to the management functions of organization and control: The firm needs to design work tasks, incentives, and employment contracts and other control mechanisms in ways that minimize opportunism by agents.

Such governance mechanisms are used to align incentives between principals and agents. These mechanisms need to be designed to overcome two specific agency problems: *adverse selection* and *moral hazard.*

adverse selection A situation that occurs when information asymmetry increases the likelihood of selecting inferior alternatives.

ADVERSE SELECTION. **Adverse selection** occurs when information asymmetry increases the likelihood of selecting inferior alternatives. In principal-agent relationships, for example, adverse selection refers to a situation in which agents misrepresent their ability to do the job. Such misrepresentation is common during the recruiting process. Once hired, the principal may not be able to accurately assess whether the agents can do the work for which they are being paid. The problem is especially pronounced in team production, in which the principal often cannot ascertain the contributions of individual team members. This situation creates an incentive for opportunistic employees to take advantage of others' efforts ("free-rider problem").

moral hazard A situation in which information asymmetry increases the incentive of one party to take undue risks or shirk other responsibilities because the costs incur to the other party.

MORAL HAZARD. In general, **moral hazard** describes a situation in which information asymmetry increases one party's incentive to take undue risks or shirk responsibilities because the costs accrue to the other party. For example, bailing out homeowners from their mortgage obligations or bailing out banks from the consequences of undue risk-taking in lending are examples of moral hazard. The costs of default are rolled over to society. Knowing that there is a high probability of being bailed out ("too big to fail") increases moral hazard. In this scenario, any profits remain private, while losses become public.

In the principal-agent relationship, moral hazard describes the principal's difficulty in ascertaining whether the agent has really put forth a best effort. In this situation, the agent is *able* to do the work but may decide not to do so. For example, company scientists at a biotechnology company may decide to work on their own research project, hoping to eventually start their own firm, rather than on the project they were assigned.[12] While working on their own research on company time, they might also use the company's laboratory and technicians. Given the complexities of basic research, it is often challenging, especially for nonscientist principals, to ascertain which problem a scientist is working on.[13] To overcome these principal-agent problems, firms put several governance mechanisms in place. We discuss several of these mechanisms next, beginning with the board of directors.

LO 12-3

Evaluate the board of directors as the central governance mechanism for public stock companies.

THE BOARD OF DIRECTORS

board of directors The centerpiece of corporate governance, composed of inside and outside directors who are elected by the shareholders.

The shareholders of public stock companies appoint a **board of directors** to represent their interests (refer to Exhibit 5.1). The board of directors is at the center of corporate governance in such companies. However, the board can face a major challenge: Shareholders' interests may not be uniform. For example, the goals of some shareholders, including institutional investors such as retirement funds and governmental bodies, are generally the enterprise's long-term viability and profitable growth. Long-term viability and profitable growth should allow consistent dividend payments and result in stock appreciation over time. In contrast, other shareholders, such as hedge funds, have different goals, such as profiting from short-term movements of stock prices. These so-called activist investors often demand changes in a firm's strategy, such as spinning out certain divisions or splitting up companies into parts to enhance overall performance. Votes at shareholder meetings, generally in proportion to the amount of ownership, determine whose representatives are appointed to the board of directors.

The day-to-day business operations of a publicly traded stock company are conducted by its managers and employees, under the direction of the chief executive officer (CEO) and the oversight of the board of directors. The board of directors is composed of inside and outside directors who are elected by the shareholders:[14]

- **Inside directors** are generally part of the company's senior management team such as the chief financial officer (CFO) and the chief operating officer (COO). Inside directors are appointed by shareholders to provide the board with necessary information pertaining to the company's internal workings and performance. Without this valuable inside information, the board would not be able to effectively monitor the firm. Because they are senior executives, however, inside board members' interests tend to align with management and the CEO rather than the shareholders.
- **Outside directors**, in contrast, are not employees of the firm. They frequently are senior executives from other firms or full-time professionals who are appointed to a board and who serve on several boards simultaneously. Given their independence, they are more likely to watch out for shareholders' interests.

inside directors Board members who are generally part of the company's senior management team; appointed by shareholders to provide the board with necessary information pertaining to the company's internal workings and performance.

outside directors Board members who are not employees of the firm, but who are frequently senior executives from other firms or full-time professionals.

The board of directors is elected by the shareholders to represent their interests. All directors have a *fiduciary responsibility*—a legal duty to act solely in another party's interests—toward the shareholders because of the trust placed in them. Prior to the annual shareholders' meeting, the board proposes a slate of nominees, although shareholders can also directly nominate director candidates. In general, large institutional investors support their favored candidates through their accumulated proxy votes. The board members meet several times a year to review and evaluate the company's performance and to assess its future strategic plans as well as opportunities and threats.

In addition to general strategic oversight and guidance, the board of directors has other, more specific functions, including:

- Selecting, evaluating, and compensating the CEO. The CEO reports to the board. If the CEO loses the board's confidence, the board may fire that person.
- Overseeing the company's CEO succession plan.
- Providing guidance to the CEO in the selection, evaluation, and compensation of other senior executives.
- Reviewing, monitoring, evaluating, and approving any significant strategic initiatives and corporate actions, such as large acquisitions.
- Conducting a thorough risk assessment and proposing options to mitigate risk.
- Ensuring that the firm's audited financial statements represent a true and accurate picture of the firm.
- Ensuring the firm's compliance with laws and regulations.

Board independence is critical to effectively fulfilling a board's governance responsibilities. Given that board members are directly responsible to shareholders, they have an incentive to ensure that the shareholders' interests are pursued. If they do not fulfill that responsibility, they can experience a loss in reputation or can be removed outright. More and more directors are also exposed to legal repercussions should they fail in their fiduciary responsibility. To perform their strategic oversight tasks, board members apply the strategic management theories and concepts presented in this book, along with other more specialized finance and accounting tools.

The functions of the CEO and chairperson of the board differ distinctly. A board of directors broadly oversees a company's business activities. The company's CEO reports to the board of directors and acts as a liaison between the company and the board. The CEO maintains high-level responsibilities of strategy and all other management activities while the board's responsibilities include approving the annual budget and dealing with stakeholders. In addition, the CEO is the public face of a company or organization and takes the hit or pat on the back if the company fails or succeeds, while the board of directors is there to steer the company on behalf of its shareholders.

Arguments can be made both for and against splitting the roles of CEO and chairperson of the board. On the one hand, the CEO has invaluable inside information that can help in chairing the board effectively. The benefit of a combined CEO and chair of the board is unity that streamlines and speeds the decision-making process and strategy implementation. On the other hand, the chairperson may influence the board unduly through setting the meeting agendas or suggesting board appointees who are friendly toward the CEO. Because one of the key roles of the board is to monitor and evaluate the CEO's performance, there can be a conflict of interest when the CEO chairs the board.

CEO/chairperson duality Situation where the CEO of a publicly traded company is also the chairperson of the board of directors.

The practice of **CEO/chairperson duality**—holding both the role of CEO and chairperson of the board—has been declining somewhat in recent years.[15] Among the largest 500 publicly traded companies in the United States, about 70% of firms had the dual CEO-chair arrangement in 2005 (before the global financial crisis), but this number had declined to some 50% of companies in 2018 (post-global financial crisis). High-profile examples of the same person serving as CEO and chair of the board include Mary Barra (GM), Arvind Krishna (IBM), Satya Nadella (Microsoft), Peter Zaffino (AIG), and Mark Zuckerberg (Meta).

LO 12-4

Evaluate other governance mechanisms.

OTHER GOVERNANCE MECHANISMS

While the board of directors is the central governance mechanism for a public stock company, several other corporate mechanisms are also used to align incentives between principals and agents, including:

- Executive compensation.
- The market for corporate control.
- Financial statement auditors, government regulators, and industry analysts.

EXECUTIVE COMPENSATION. The board of directors determines executive compensation packages. To align incentives between shareholders and management, the board frequently grants **stock options** as part of the compensation package. This mechanism is based on agency theory and gives the recipient the right, but not the obligation, to buy a company's stock at a predetermined price sometime in the future. If the company's share price rises above the negotiated strike price, which is often the price on the day when compensation is negotiated, the executive stands to reap significant gains.

stock options An incentive mechanism to align the interests of shareholders and managers, by giving the recipient the right (but not the obligation) to buy a company's stock at a predetermined price sometime in the future.

The topic of executive compensation—and CEO pay, in particular—has attracted significant attention in recent years. Two issues are at the forefront:

1. The absolute size of the CEO pay package compared with the pay of the average employee
2. The relationship between CEO pay and firm performance

Absolute Size of Pay Package. The ratio of CEO to average employee pay in the United States is about 350 to 1, up from roughly 30 to 1 in 1980.[16] The median compensation of CEOs in the S&P 500 was $15 million (in 2021). Note: Annual compensation is broadly defined to include salary, stock options, equity grants, bonuses, and pension payments. Many of the CEOs with the highest compensation run tech, media, and financial companies. In 2021, the three highest-paid CEOs were Peter Kern of Expedia, an online travel company (pay package of $295 million); David Zaslav of Discovery, a media company ($250 million); and Bill McDermott of Service Now, a cloud computing software company ($165 million).

CEO Pay and Firm Performance. What is the relationship between CEO pay and firm performance? Survey results show that two-thirds of CEO pay is linked to firm performance.[17] However, although the relationship between pay and performance is positive, the link is weak at best. Although agency theory predicts a positive link between pay and performance, some recent experiments in *behavioral economics* caution that incentives that are too high-powered (e.g., outsized bonuses) may have a negative effect on job performance.[18] That is, when the incentive level is very high, an individual may get distracted from strategic activities because too much attention is devoted to the outsized bonus to be enjoyed in the near future. This situation can increase job stress and negatively impact job performance. In addition, outsized bonuses can reinforce *short-termism*—an exclusive focus by the CEO on short-term projects and objectives that will lead to immediate stock appreciation at the expense of long-term performance. However, many of the most thorny problems, such as addressing climate change, require long-term thinking.

THE MARKET FOR CORPORATE CONTROL. Whereas the board of directors and executive compensation are *internal* corporate governance mechanisms, the *market for corporate control* is an important *external* corporate governance mechanism. It consists of activist investors who seek to gain control of an underperforming corporation by buying shares of its stock in the open market. To avoid such attempts, corporate managers strive to protect shareholder value by delivering strong share-price performance or putting in place poison pills (discussed later).

Here's how the market for corporate control works: If a company is poorly managed, its performance suffers and its stock price falls as more and more investors sell their shares. Once shares fall to a low enough level, the firm may become the target of a *hostile takeover* (as discussed in Chapter 9) when new bidders believe they can fix the internal problems that are causing the performance decline. In addition to competitors, so-called *corporate raiders* (e.g., Carl Icahn and Daniel Loeb) or *private-equity firms* and *hedge funds* (e.g., The Blackstone Group and Pershing Square Capital Management) may buy enough shares to exert control over a company.

Leveraged Buyout (LBO). In a **leveraged buyout (LBO)**, a single investor or group of investors buys, with the help of borrowed money (leveraged against the company's assets), the outstanding shares of a publicly traded company to take it private. In short, an LBO changes the ownership structure of a company from public to private. The expectation is often that the private owners will restructure the company and eventually take it public again through an initial public offering (IPO). The term *private equity* is often used interchangeably with *leveraged buyout.*

leveraged buyout (LBO) A single investor or group of investors buys, with the help of borrowed money (leveraged against the company's assets), the outstanding shares of a publicly traded company in order to take it private.

Private companies enjoy certain benefits that public companies do not. Specifically, private companies are not required to disclose their financial statements. They receive less scrutiny from analysts and can often focus more on long-term viability. These are also some of the reasons some unicorns delay going public in the first place.

Dell's LBO, Transformation, and Re-Listing as Public Company. Let's look in depth at one example of an LBO. After years of consistently poor performance, computer maker Dell Inc. became a takeover target of famed corporate raider Carl Icahn (in 2013).[19] Icahn jumped into action after Dell's founder and largest shareholder, Michael Dell, announced he was planning a *leveraged buyout* with the help of Silverlake Partners, a private-equity firm, to take the company private. In the Dell buyout battle, many observers, including Icahn—who was then the second-largest shareholder of Dell Inc.—saw Dell's attempt to take the company private as the "ultimate insider trade."

In other words, Icahn believed that Dell, who was also CEO and chairman, had private information about the future value of the company and that his offer was too low. Dell Inc., which had $57 billion in revenues at the time, had been struggling in the ongoing transition from personal computers to mobile devices and services. Within just five years (2004–2009), Dell, which until just a few years earlier was the number-one computer maker, lost more than 80% of its market capitalization, which dropped from $76 billion to $14 billion. Dell's shareholders approved the founder's $25 billion offer to take the company private (in 2013), thus avoiding a hostile takeover.

To continue with its makeover and the transformation of the company, which Michael Dell founded in 1984 in a dorm room at the University of Texas at Austin, Dell acquired EMC, a cloud computing company, for $60 billion (in 2016). Just two years later, Dell engineered a *reverse takeover* in which Dell and VMware, a virtualization-software unit, swapped equity shares. (Virtualization software allows you to run two or more operating systems on one PC.) A *reverse takeover* is the acquisition of a larger private company by a smaller but public company. This type of acquisition allows the larger private firm to list on the public stock market without having to go through the lengthy, complex, and frequently costly process of an IPO. The reverse takeover of VMware allowed Michael Dell to re-list his company on a public stock exchange. Since 2018, the new Dell Technologies Inc. is again a publicly traded company (NYSE ticker: Dell), and it had a market valuation of $36 billion in the summer of 2022. In addition, in 2021 Dell spun out VMware, which is valued at $50 billion (in 2022). Michael Dell still holds over 40% ownership in VMware. That same year, Broadcom, a semiconductor company, offered $61 billion to acquire VMWare, thus completing the successful turnaround of the company that Michael Dell took private through a leveraged buyout in 2013.

Hostile Takeovers and Poison Pills. If a hostile takeover attempt is successful, the new owner is likely to replace the old management and board of directors so as to manage the company in a way that creates more value for shareholders. In some instances, the new owner breaks up the company and sell its pieces. In either case, because a firm's existing executives face the threat of losing their jobs and their reputations in the face of a sustained competitive disadvantage, the market for corporate control is a credible governance mechanism.

poison pill Defensive provisions to deter hostile takeovers by making the target firm less attractive.

To avoid being taken over against their consent, some firms put in place a **poison pill**, which is a defensive provision that kicks in if a buyer reaches a certain level of share ownership without top management approval. For example, a poison pill could allow existing shareholders to buy additional shares at a steep discount. Those additional shares make any takeover attempt much more expensive and function as a deterrent to would-be corporate raiders. With the rise of actively involved institutional investors, poison pills have become rare because they hinder the effective function of equity markets.

Although poison pills are becoming rarer, the market for corporate control is alive and well, as exemplified by the battle for control of Dell Inc., the hostile takeover of Cadbury by Kraft (featured in Strategy Highlight 9.2), and Elon Musk's bid to buy Twitter. However, the market for corporate control is a last resort because it comes with significant transaction costs. To succeed in a hostile takeover bid, buyers generally pay a significant premium over the given share price, which often leads to overpaying for the acquisition and subsequent shareholder value destruction—the so-called *winner's curse.* However, the market for corporate control is useful when internal corporate-governance mechanisms have not functioned effectively and the company is underperforming.

AUDITORS, GOVERNMENT REGULATORS, AND INDUSTRY ANALYSTS. Auditors, government regulators, and industry analysts serve as additional external governance mechanisms. All public companies listed on the U.S. stock exchanges must file a number of financial statements with the *Securities and Exchange Commission (SEC),* a federal regulatory agency that oversees stock trading and enforces federal securities laws. To avoid the misrepresentation of financial results, all public financial statements must follow *generally accepted accounting principles (GAAP)*[20] and be audited by certified public accountants.

As part of its disclosure policy, the SEC makes all financial reports filed by public companies available electronically via the EDGAR database.[21] This database contains millions of financial statements, going back several years. For each stock company, the database maintains four key statements: balance sheets, income statements, cash flow statements, and statements of shareholders' equity. Industry analysts scrutinize these reports in great detail, trying to identify any financial irregularities and assess firm performance.

Industry analysts often base their buy, hold, or sell recommendations on financial statements filed with the SEC and business news published in *The Wall Street Journal, Bloomberg Businessweek, Fortune, Forbes,* and other business media such as CNBC. Researchers have questioned the independence of industry analysts and credit-rating agencies that evaluate companies (such as Fitch Ratings, Moody's, and Standard & Poor's)[22] because the investment banks and rating agencies frequently have lucrative business relationships with the companies they are supposed to evaluate, creating conflicts of interest. A study of over 8,000 analysts' ratings of corporate equity securities, for example, revealed that investment bankers rated their own clients more favorably.[23]

In addition, an industry has sprung up around assessing the effectiveness of corporate governance in individual firms. Research outfits, such as GMI Ratings,[24] provide independent corporate governance ratings. The ratings from these external watchdog organizations inform a wide range of stakeholders, including investors, insurers, auditors, and regulators.

Corporate governance mechanisms play an important part in aligning the interests of principals and agents. They enable closer monitoring and controlling, and they provide incentives to align the interests of principals and agents. Perhaps even more important are the "most internal of control mechanisms": *business ethics*—a topic we discuss next.

12.2 Strategy and Business Ethics

LO 12-5

Explain the relationship between strategy and business ethics.

Corporate scandals (such as the Theranos scandal featured in the ChapterCase or VW's Dieselgate, discussed in Strategy Highlight 12.1), high-profile accounting frauds, and the global financial crisis have placed business ethics center stage in the public eye. **Business ethics** are an agreed-upon code of conduct in business, based on societal norms. Business ethics lay the foundation and provide training for "behavior that is consistent with the principles, norms, and standards of business practice that have been agreed upon by society."[25] These principles, norms, and standards of business practice differ to some degree in different cultures around the globe. Nonetheless, many research studies have found that some notions—such as fairness, honesty, and reciprocity—are universal norms.[26] As such, many of these values have been codified into law.

business ethics An agreed-upon code of conduct in business, based on societal norms.

However, law and ethics are not synonymous. This distinction is important and not always understood by the general public. Staying within the law is a *minimum acceptable standard.* A note of caution is therefore in order: A manager's actions can be completely legal but ethically questionable. For example, consider the actions of mortgage-loan officers who—being incentivized by commissions—persuaded unsuspecting consumers to sign up for exotic mortgages, such as option ARMs (adjustable rate mortgages). These mortgages offer borrowers the choice to pay less than the required interest, which is then added to the principal while the interest rate can adjust upward. Such arrangements may be legal, but they are unethical, especially if there are indications that the borrower might be unable to repay the mortgage once the interest rate moves up.[27]

One morning (in 2008), Unilever executives were greeted by Greenpeace activists dressed in orangutan costumes. Having scaled to the balcony of Unilever's London headquarters, the protesters displayed banners reading "Dove: Stop Destroying My Rainforest." Much to the executives' chagrin, the press was already there and videos had gone viral on YouTube and social media sites. The Greenpeace activists were protesting Unilever's massive use of palm oil, the most widely used oil globally to make soap, shampoo, cosmetics, and other consumer products. The huge demand for palm oil has resulted in environmental disasters, including deforestation of large tracks of land in Indonesia on which the apes live, and so threatening them with extinction. Deforestation is the result of burning down forests, which releases huge amounts of greenhouse gases into the atmosphere, contributes to climate change, and pollutes air and water supplies. To respond to the protests and to calm the unwarranted public attention, Patrick Cescau, then Unilever's CEO, pledged that by 2015, Unilever would source 100% sustainable palm oil only, up from 0% at the time of the protests. Yet, by 2015 Unilever sourced only 19% of palm oil sustainably. Under the visionary leadership of Paul Polman, CEO from 2009 to 2019, Unilever achieved 100% sustainable sourcing of palm oil. As of 2022, with some 25% market share, Dove remains the world's leading soap brand in the multi-billion dollar market.[28]

WENN Rights Ltd/Alamy Stock Photo

To go beyond the minimum acceptable standard codified in law, many organizations have explicit *codes of conduct*. These codes go above and beyond the law in detailing how the organization expects employees to behave and to represent the company in business dealings. Codes of conduct allow an organization to overcome moral hazards and adverse selections as they attempt to resonate with employees' deeper values of justice, fairness, honesty, integrity, and reciprocity. Because business decisions are not made in a vacuum but are embedded within a societal context that expects ethical behavior, managers can improve their decision making by also considering the following:

- When facing an ethical dilemma, a manager can ask whether the intended course of action falls within the *acceptable norms of professional behavior* as outlined in the organization's code of conduct and defined by the profession at large.
- The manager should imagine whether they would feel *comfortable explaining and defending the decision in public*. How would the media report the business decision if it were to become public? How would the company's stakeholders feel about it?

Strategy Highlight 12.1 examines the Volkswagen emissions scandal.

Strategy Highlight 12.1

VW's Dieselgate: School of Hard NOx

Volkswagen (VW) used to have a reputation as one of the most reliable car manufacturers in the world.[29] VW cars were known for their highly reliable engines with superior performance, in a class above other competitors in the mass market. The iconic Volkswagen Beetle, designed by Ferdinand Porsche in the 1930s, became the symbol of the counterculture in the United States during the 1960s and 1970s. During that time, VW sold 500,000 cars per year in the U.S. market. But VW didn't keep up with the times because it failed to innovate. By the early 1990s, sales and profits had dropped as fast as its vehicles' quality. In 1993, VW's U.S. sales had fallen to a low of 38,000 vehicles in a market that sold 17 million vehicles that year. That is, VW market share had declined to 0.2%! Given its poor product lineup at the time, VW's losses were mounting, and the mighty company faced bankruptcy.

Ferdinand Piëch, who was leading the much smaller Audi brand at the time, was brought in to turn around the struggling VW. Audi was one of VW's luxury brands and had just gained market share against BMW and Mercedes thanks to Piëch's innovation and rebranding. Piëch is the grandson of VW founder Ferdinand Porsche (who also designed the famous Porsche sports car). Piëch himself is known to be a world-class automotive engineer who is supercompetitive. In his first press conference as newly appointed head of the VW Group, Piëch made his marching orders clear: "Whenever there is war, fewer remain at the end. There are always winners and losers. And I intend … to emerge victorious!"[30]

Ads like these promoted the benefits of VW's TDI clean diesel technology, which is environmentally friendly, fuel-efficient, and high performing. The VW Group had huge success in the United States between 2009 and 2015. But it turned out that the cars with TDI engines were all equipped with defeat devices to produce fraudulent results during mandatory and stringent emissions tests in the United States.

Source: VW Group

In the early years of his reign, however, Piëch was caught up in an internal power struggle. In the early 2000s, the Porsche company was attempting a hostile takeover of the much larger Volkswagen Group. In terms of size, VW was more than 15 times larger than Porsche at that time. The hostile takeover attempt of the teetering VW Group was partially motivated by a bitter family feud between estranged members of the Porsche and Piëch families, each holding leading executive positions in both companies. The two families are directly related to each other as they share Ferdinand Porsche as their grandfather. As the global financial crisis took hold, the Porsche company collapsed under a heavy debt burden caused by the hostile takeover attempt. Piëch turned the tables and took over Porsche in 2012, fired the existing Porsche executive team, and sidelined his cousins.

Meanwhile Piëch, as chairman of the board of the VW Group, installed his protégé Martin Winterkorn as CEO of VW in 2007. Winterkorn had worked closely with Piëch at Audi, and he viewed his role as implementer of Piëch's grand ideas. At Audi, Piëch had developed a smaller diesel engine for use in passenger cars. This smaller diesel engine provided superior performance and higher fuel efficiency due to turbocharging and fuel-injection technology. Using a diesel engine in a passenger car was a revolutionary concept at the time because diesel engines were used only in larger commercial trucks. This engine laid the foundation for the "clean diesel" initiative upon which VW would later embark.

In the mid-1990s, Piëch decreed that the clean diesel engine (called "TDI," an abbreviation for turbocharged direct injection) would be key to conquering the U.S. market—the only market globally where VW was not a leader. In 1996, VW introduced the new clean diesel concept in the United States with great fanfare and provocative TV ads. VW's clean diesel cars seemed like a dream come true for environmentally conscious drivers. They drove like sports cars, got 800 miles to a tank, and seemed to last forever (diesel engines can run over 1 million miles).

However, the problem with diesel engines is that there is an engineering trade-off between performance, fuel efficiency, and emissions. You can achieve two of the three goals, but not all three at the same time. This was not a problem until the Bush (in 2007) and Obama (in 2009) administrations raised the U.S. emissions standards to a much more stringent level than what Europe deems acceptable. The goal was to combat air pollution: Smog was becoming a serious problem in the United States, especially in larger cities such as Los Angeles, and the link to climate change was becoming clearer.

At the same time, VW's strategy was to become the world's largest car manufacturer, and success in North America was key. VW CEO Winterkorn decided the company would continue to bet on the new TDI engine, which customers in Europe loved. However, diesel engines disgorge nasty pollutants such as nitrogen oxides (NOx) that endanger human health. To meet the stricter U.S. environmental standards, VW engineers created NOx traps to burn and catch these pollutants. But this specialized equipment had a threefold problem: It was expensive, it needed to be replaced frequently, and it lowered engine performance and fuel efficiency. Given the TDI engines' inherent trade-offs between performance, fuel efficiency, and emissions, VW engineers could not meet the U.S. environmental regulations.

When stakes are high and the pressure to deliver results is intense, people tend to cut corners. Beginning with the 2009 model year, VW engineers installed so-called defeat devices in all its smaller (2.0 liter) TDI engines. These defeat devices were software codes contained in the car's onboard computer. The computer was programmed to detect when the car was being tested for emissions by assessing a host of variables, including whether the car was moving or stationary, whether the steering wheel was being touched, and the speed and duration of the engine run. This sophisticated defeat device allowed the vehicles to pass the required and rigid U.S. emissions tests. In reality, however, the vehicles equipped with TDI engines actually exceeded the limits for pollutants by up to 40 times during use. Between 2009 and 2015, VW sold 500,000 TDI vehicles equipped with defeat devices in the United States and a total of 11 million worldwide. Dieselgate turned out to be one of the biggest corporate frauds in history.

When the Dieselgate scandal broke in the fall of 2015, VW's share price dropped by more than 30%. Senior executives at the VW Group were replaced, and some were prosecuted and jailed. VW had to repurchase all the vehicles sold in the United States or retrofit them with proper emissions software and technology. Some former long-term VW employees insist the orders for the defeat devices must have been top-down (or at least approved by the top) because rules at VW are so strict that "you can't even get a pen without three signatures on the proper request form."[31] In contrast, VW's top executives insist the defeat devices were created and installed by some rogue, midlevel engineers without their knowledge. In the end, Dieselgate cost VW $25 billion in fines and legal settlements, not to mention the loss of reputation.[32]

BAD APPLES VS. BAD BARRELS

Some people believe that unethical behavior is limited to a few "bad apples" in organizations.[33] The assumption is that the vast majority of the population—and by extension, organizations—is good, and that we need only safeguard against abuses by a few bad actors. According to agency theory, it's the "bad agents" who act opportunistically, and principals need to be on guard against bad actors.

However, research indicates it is not just a few "bad apples" but entire organizations that can create a climate in which unethical and even illegal behavior is tolerated.[34] While there clearly are some people with unethical or even criminal inclinations, in general one's ethical decision-making capacity depends very much on the organizational context. Research shows that if people work in organizations that expect and value ethical behavior, then they are more likely to act ethically.[35] The opposite is also true. Enron's *stated* key values included respect and integrity, and its mission statement proclaimed that all business dealings should be open and fair.[36] Yet, the ethos at Enron was all about creating an inflated share price at any cost, and its employees observed and followed the behavior set by their leaders.

Sometimes, it's the bad barrel that can spoil the apples! This is precisely what some former VW employees claim happened with Dieselgate, featured in Strategy Highlight 12.1. Strategic leaders are ultimately responsible for what happens in their organization. Given that VW's software for the defeat device was installed on 11 million vehicles, it is hard to believe that some midlevel engineers went rogue and installed the device without top management approval, as VW's strategic leaders argue. Even if those leaders did not know of or condone any wrongdoing, they are responsible for the company's actions. If they didn't know what was going on, they should have known.

Employees take cues from their environment on how to act. For this reason, ethical leadership is critical, and strategic leaders set the tone for the ethical climate within an organization. This is one of the reasons the HP board removed then-CEO Mark Hurd (in 2010) even without proof of illegal behavior or violation of the company's sexual-harassment policy. The forced resignation was prompted by a lawsuit filed by a woman who worked for HP as an independent contractor and who alleged that Hurd had sexually harassed her. This example shows that CEOs of Fortune 500 companies are under constant public scrutiny and must adhere to the highest ethical standards. If they do not, then they cannot rationally expect their employees to behave ethically. Unethical behavior can quickly destroy a CEO's reputation, which is one of the most important assets that a CEO possesses.

To foster ethical behavior in employees, boards must be clear in their ethical expectations, and top management must create an organizational structure, culture, and control system that values and encourages desired behavior. Furthermore, a company's formal and informal cultures must be aligned, and executive behavior must be in sync with the formally stated vision and values. Employees will quickly see through any duplicity. Actions by executives speak louder than words in vision statements. Strategic goals must be achievable with legal means. As shown in Strategy Highlight 12.1, when the stakes are high and top-down pressure to meet goals is intense, employees are more likely to cut corners and act unethically and sometimes even illegally.

A MANAGEMENT OATH. Many professions have an accepted code of conduct (e.g., the bar association in the practice of law and the Hippocratic oath in medicine), but management does not.[37] Some argue that management needs an accepted code of conduct,[38] holding members to a high professional standard and imposing consequences for misconduct. Misconduct by an attorney, for example, can result in the attorney being disbarred and losing the right to practice law. Similarly, medical doctors can lose their professional accreditations if they engage in misconduct.

To anchor future managers in professional values and to move management closer to truly professional status, a group of Harvard Business School students developed an MBA oath (Exhibit 12.2).[39] Since 2009, thousands of MBA students from hundreds of institutions around the world have taken this voluntary pledge, which explicitly recognizes the role of business in society and its responsibilities beyond shareholders. Based on almost universally accepted principles, it holds managers to a high ethical standard in order to "create value responsibly and ethically."[40] Having the highest personal integrity is of utmost importance to one's career. It takes decades to build a career, but sometimes just a few moments to destroy one. The voluntary MBA oath sets professional standards, but its effect on behavior is unknown, and it does not impose any consequences for misconduct.

EXHIBIT 12.2

The MBA Oath

Source: MBA Oath and Max Anderson.

As a business leader I recognize my role in society.

- *My purpose is to lead people and manage resources to create value that no single individual can create alone.*
- *My decisions affect the well-being of individuals inside and outside my enterprise, today and tomorrow.*

Therefore, I promise that:

- *I will manage my enterprise with loyalty and care, and will not advance my personal interests at the expense of my enterprise or society.*
- *I will understand and uphold, in letter and spirit, the laws and contracts governing my conduct and that of my enterprise.*
- *I will refrain from corruption, unfair competition, or business practices harmful to society.*
- *I will protect the human rights and dignity of all people affected by my enterprise, and I will oppose discrimination and exploitation.*
- *I will protect the right of future generations to advance their standard of living and enjoy a healthy planet.*
- *I will report the performance and risks of my enterprise accurately and honestly.*
- *I will invest in developing myself and others, helping the management profession continue to advance and create sustainable and inclusive prosperity.*

In exercising my professional duties according to these principles, I recognize that my behavior must set an example of integrity, eliciting trust and esteem from those I serve. I will remain accountable to my peers and to society for my actions and for upholding these standards.

This oath I make freely, and upon my honor.

LO 12-6

Use the business model framework to put strategy into action.

12.3 Business Models: Strategy in Action

Strategy is a set of goal-directed actions a firm takes to gain and sustain superior performance relative to competitors or the industry average. The translation of strategy into action takes place in the firm's *business model.* Getting the business model right is required for effective strategy implementation and thus critical to gaining and sustaining a competitive advantage.

A **business model** stipulates how the firm conducts its business with its buyers, suppliers, and partners. In particular, a business model details the firm's competitive tactics and initiatives to deliver value to its customers. A business model identifies the firm's target market, customer needs, and how the firm's products or services will meet those needs. Simply put, the firm's business model explains how the firm intends to make money.[41]

business model
Translates strategy into action by detailing the firm's competitive tactics and initiatives to deliver value to its customers and make money. It identifies the firm's target market, customer needs, and how the firm's products or services will meet those needs.

THE BUSINESS MODEL FRAMEWORK

To come up with an effective business model, a firm's leaders need to transform their strategy of how to compete into a blueprint of actions and initiatives that support the overarching goals. Next, managers implement this blueprint through structures, processes, culture, and procedures. The framework shown in Exhibit 12.3 guides strategic leaders through the process of formulating and implementing a business model by asking the important questions of why, what, who, and how.

APPLYING THE BUSINESS MODEL FRAMEWORK TO MICROSOFT. Let's focus on Microsoft to illuminate the questions asked in the business model framework. The Microsoft

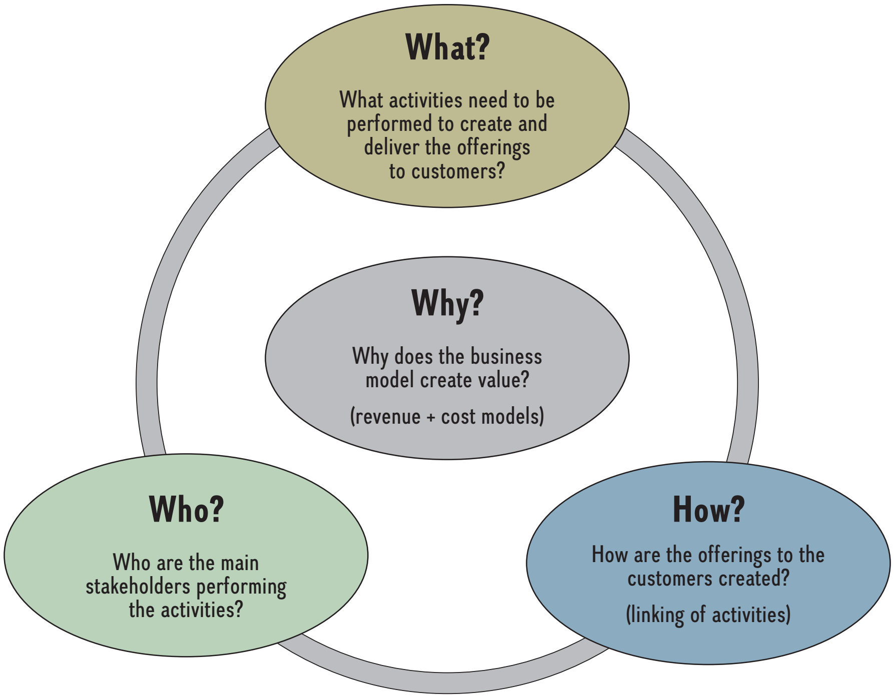


EXHIBIT 12.3

The Business Model Framework

Source: Author's adaptation from R. Amit and C. Zott (2012, Spring), "Creating value through business model innovation," *MIT Sloan Management Review*: 41–49.

example shows how a firm can readjust its business model to respond to business challenges.

1. **Why does the business model create value?**
   Under CEO Satya Nadella, Microsoft pivoted from a *Windows-centric* to a *mobile-first, cloud-first* business model. In the new business model, Microsoft does not sell stand-alone software licenses. Instead it uses cloud computing to provide software-as-a-service (SAAS) to which users can subscribe. Microsoft's new business model creates value for both customers and stockholders. Using cloud computing, customers always have the latest software, can access it anywhere, and can collaborate online with other users. Users no longer need to upgrade the software or worry about backward compatibility, meaning the ability to read older (e.g., Word) files with newer software versions. Microsoft enjoys steady revenues that over time provide a greater income stream than the earlier perpetual license model, significantly reduce the problem of software piracy, and balance the cost of ongoing support with the ongoing flow of revenues.
2. **What activities need to be performed to create and deliver the offerings to customers?**
   To pivot to the new *mobile-first, cloud-first* business model, Microsoft is making huge investments to create and deliver new offerings to its customers. This Redmond, Washington-based company needed to rewrite much of its software to be functional in a cloud-based environment. CEO Satya Nadella also decided to open the Office suite of applications to competing operating systems including Google's Android, Apple's iOS, and Linux, an open-source operating system. In all these activities, Microsoft's Azure, its cloud-computing service, plays a pivotal role in its new business model.
3. **Who are the main stakeholders performing the activities?**
   Microsoft continues to focus on both the individual end consumer and more profitable business clients. Microsoft's Azure is particularly attractive to its business customers.

For example, Walmart, still the largest retailer globally with some 12,000 stores staffed by over 2 million employees and revenues of some $600 billion, runs its cutting-edge logistics on Microsoft's Azure servers, rather than on Amazon's AWS service; Amazon is a major competitor to Walmart. Likewise, The Home Depot, one of the largest retailers in the United States, uses Microsoft Azure for its computing needs.

4. **How are the offerings to the customers created?**

   Microsoft shifted most of its resources, including R&D and customer support, to its cloud-based offerings not only to make them the best in class but also to provide a superior user experience.

MICROSOFT'S BUSINESS MODEL PIVOT: RESULTS. To appreciate the value of the pivot in the business model under CEO Nadella, we should consider the problems the change allows Microsoft to address.

- Before, with the perpetual license model, Microsoft had revenue spikes on the sale of new updates but zero revenues thereafter to support users and produce additional updates. Now, Microsoft matches revenues to its costs and even comes out further ahead, in that after two years or so, Microsoft makes more money on a software subscription than a standalone software license.
- Before, customers had a financial disincentive to keep their software current, which creates all kinds of problems, including data security risks. Now, users always have the latest software, can access it anywhere, and can collaborate online with other users without worries about backward compatibility. They also always have software with the latest security patches.
- Perhaps most impressively, the new model deals effectively with software piracy. Before, Microsoft suffered tremendous losses through software piracy. Piracy affects consumers too, as the cost of piracy is borne by paying consumers to a large degree. Now, pirating cloud-based software is much more difficult because Microsoft can easily monitor how many users (based on unique internet protocol [IP] addresses) are using the same log-in information at different locations and perhaps even at the same time. Once the provider suspects piracy, it tends to disable the accounts, as piracy goes against the terms of service agreed upon when subscribing to the software, not to mention that copyright infringement is illegal. Indeed, the scope of the piracy problem is driven home by the survey-based claim that some 60% of computer users confess to pirating software.[42]

POPULAR BUSINESS MODELS

Given their critical importance in achieving competitive advantage, business models are constantly evolving. Here we discuss some of the more popular business models:[43]

- Razor–razor blades
- Subscription
- Pay-as-you-go
- Freemium
- Ultra-low cost
- Wholesale
- Agency
- Bundling

Understanding the more popular business models today will increase the tools in your strategy toolkit.

- **Razor–razor blades**. The initial product is often sold at a loss or given away to drive demand for complementary goods. The company makes its money on the replacement part needed. As you might guess, it was invented by Gillette, which gave away its razors and sold the replacement cartridges for relatively high prices. The razor–razor blade model is found in many business applications today. For example, HP charges little for its printers but high prices for its replacement ink and toner cartridges.
- **Subscription**. The subscription model has been traditionally used for print magazines and newspapers. Users pay for access to a product or service regardless if they use the product or service during the payment term. Microsoft uses a subscription-based model for its Office 365 suite of application software. Other industries that use this model presently are cable television, cellular service providers, satellite radio, internet service providers, and health clubs. Netflix also uses a subscription model.
- **Pay-as-you-go**. In the *pay-as-you-go business model,* users pay for only the services they consume. The pay-as-you-go model is most widely used by utilities providing power and water and cell phone service plans, but it is gaining momentum in other areas such as rental cars and cloud computing such as Microsoft's Azure.
- **Freemium.** The *freemium (free + premium) business model* provides the basic features of a product or service *free* of charge, but it charges the user for *premium* services such as advanced features or add-ons.[44] For example, companies may provide a minimally supported version of their software as a trial (e.g., business application or video game) to give users the chance to try the product. Users later have the option of purchasing a supported version of software, which includes a full set of product features and product support. Also, news providers such as *The New York Times* and *The Wall Street Journal* use a freemium model. They frequently provide a small number of articles for free per month, but users must pay a fee (often a flat rate) for unlimited access (including a library of past articles). Another version of the *freemium* model is to provide free (e.g., Meta's Facebook or Google Search) or heavily discounted services (Netflix) but place ads against user attention.
- **Ultra-low cost.** An ultra-low-cost business model is quite similar to freemium: a model in which basic service is provided at a low cost and extra items are sold at a premium. The business pursuing this model has the goal of driving down costs. Examples include Spirit Airlines (in the United States), Ryanair (in Europe), and AirAsia, which provide minimal flight services but allow customers to pay for additional services and upgrades à la carte, often at a premium.
- **Wholesale.** The traditional model in retail is called a *wholesale model*. The book publishing industry is an example. Under the wholesale model, book publishers would sell books to retailers at a fixed price (usually 50% below the recommended retail price). Retailers, however, are free to set their own price on any book and profit from the difference between their selling price and the cost to buy the book from the publisher (or wholesaler).
- **Agency.** In this model, the producer relies on an agent or retailer to sell the product, at a predetermined percentage commission. Sometimes the producer also controls the retail price. The *agency model* has long been used in the entertainment industry, in which agents place artists or artistic properties and then take their commission. More recently we see this approach at work in a number of online sales venues, as in Apple's pricing of book products or its app sales (see upcoming discussion).
- **Bundling.** The *bundling* business model sells products or services for which demand is negatively correlated *at a discount.* Demand for two products is negatively correlated if a

user values one product more than another. In the Microsoft Office Suite, a user might value Word more than Excel and vice versa. Instead of selling both products for $120 each, Microsoft bundles them in a suite and sells them combined at a discount, say $150. This bundling strategy allowed Microsoft to become the number-one provider of all major application software packages such as word processing, spreadsheets, and slideshow presentation. Before its bundling strategy, Microsoft faced strong competition in each segment. Indeed, Word Perfect was outselling Word, Lotus 1-2-3 was outselling Excel, and Harvard Graphics was outselling PowerPoint. The problem for Microsoft's competitors was that they did not control the operating system (Windows), which made their programs less seamless on this operating system. In addition, the competitor products to Microsoft were offered by three independent companies, so they lacked the option to bundle them at a discount.

DYNAMIC NATURE OF BUSINESS MODELS

Business models evolve dynamically, and we can see many combinations and permutations. Sometimes business models are tweaked to respond to disruptions in the market, efforts that can conflict with fair trade practices and may even prompt government intervention.

COMBINATION. Telecommunications companies such as AT&T or Verizon combine the *razor–razor blade* model with the *subscription* model. They frequently subsidize a high-end phone when customers sign up for a two-year wireless service plan. That is, telecom providers recoup the subsidy provided for the smartphone by requiring customers to sign up for lengthy service plans. This is why it is so critical for telecom providers to keep their *churn rate*—the proportion of subscribers who leave, especially before the end of the contractual term—as low as possible.

EVOLUTION. The *freemium* business model can be seen as an evolutionary variation on the *razor–razor blade* model. The base product is provided free, and the producer finds other ways to monetize the usage. The freemium model is used extensively by open-source software companies (e.g., Red Hat), mobile app companies, and other internet businesses. Many of the free versions of applications include advertisements to make up for the cost of supporting nonpaying users. In addition, the paying premium users subsidize the free users. The freemium model is often used to build a consumer base when the marginal cost of adding another user is low or even zero (as in software sales). Many online video games, including massive multiplayer online games and app-based mobile games, follow a variation of this model, allowing basic access to the game for free, but charging for power-ups, customizations, special objects, and other things that enhance the game experience for users.

DISRUPTION. When introducing the *agency* model, we mentioned Apple and book publishing. Amazon severely disrupted the traditional wholesale model for publishers. Amazon took advantage of the pricing flexibility inherent in the wholesale model and offered many books (especially e-books) below the cost that other retailers had to pay to publishers. In particular, Amazon offered newly released bestsellers for $9.99 to promote its Kindle e-reader. Publishers and other retailers strongly objected because Amazon's retail price was lower than the wholesale price paid by retailers competing with Amazon. Moreover, the $9.99 e-book offer by Amazon made it untenable for other retailers to continue to charge $28.95 for newly released hardcover books (for which they had to pay $14 to $15 to the publishers). With its aggressive pricing, Amazon not only devalued the printed book but also lost money on every book it sold. It followed this business model to increase the number of users of its Kindle e-readers and tablets.

RESPONSE TO DISRUPTION. The market is dynamic, and in the previous example book publishers looked for another model. Many book publishers worked with Apple on an agency approach in which the publishers set the price and received 70% of the revenue while Apple received 30%. This approach is similar to the Apple App Store pricing model for iOS applications in which developers set a price for applications and Apple retains a percentage of the revenue.

Use of the agency model was intended to give publishers the leverage to raise e-book prices for retailers. Under the agency model, publishers could increase their e-book profits and price e-books more closely to the prices of printed books. Publishers inked their deals with Apple, but how could they get Amazon to play ball? For leverage, publishers withheld new releases from Amazon. This forced Amazon to raise prices on newly released e-books in line with the agency model to around $14.95.

LEGAL CONFLICTS. The rapid development of business models, especially in response to disruption, can lead producers to breach existing commerce laws. In the previous example, the publishers' response prompted an antitrust investigation. The Department of Justice determined (in 2012) that Apple and major publishers had conspired to raise prices of e-books. To settle the legal action, each publisher involved negotiated new deals with retailers, including Amazon. A year later, Apple was found guilty of colluding with several major book publishers to fix prices on e-books and had to change its agency model.[45]

BUSINESS MODEL INNOVATION

To implement strategy effectively, any firm needs a business model that details the firm's competitive tactics and strategic initiatives to deliver value to its customers. Moreover, just like products and services, business models are not static. Strategic leaders experiment and innovate with their business models to gain a competitive edge. As such, *business model innovation* is a key competitive weapon. A **business model innovation** is a novel and useful way to deliver value to customers. A firm's competitive advantage based on product innovation is less likely to be made obsolete if it is embedded within a business model innovation. Business model innovation complements product and service innovation, and it raises the barriers to imitation, which in turn allows a firm that successfully combines product and business model innovation to extend its competitive advantage.

business model innovation A novel and useful way to deliver value to customers.

For example, Airbnb, Amazon, Apple, Dell, Netflix, Tesla, Uber, and others used business model innovation to gain and sustain a competitive advantage. How companies do business can sometimes be as important, or even more important, in gaining and sustaining competitive advantage. Indeed, a slight majority (54%) of senior executives responded in a survey that they consider business model innovation to be more important than process or product innovation.[46] Why? Product and process innovation is often more costly, is higher risk, and takes longer to come up with in the first place and to then implement. Business model innovation is often an area that is overlooked in a firm's quest for competitive advantage, and thus much value can be unlocked by focusing on business model innovation.

APPLE'S SERVICE ECOSYSTEM. After the introduction of the iPod (2001) and iTunes (now App Store, in 2003), Apple was able to extend its competitive advantage for more than a decade. The business model innovation of embedding products into services (starting with the iPod and iTunes) allowed Apple to link music producers to consumers, and to benefit from each transaction. That is, Apple started by providing a two-sided platform for (legal) exchange to take place between music producers and consumers (see discussion in

Chapter 7 on platform strategy for more details). As such, Apple extended its locus of innovation from mere product innovation to how it conducts its business.

As of 2023, Apple has about 2 billion users of iOS (Apple's mobile operating system). Apple's iOS users are embedded within its ecosystem made up of many different products and services, including Apple Music, App Store, iCloud, and Apple Pay. Once embedded in Apple's ecosystem of services, users are less likely to leave Apple for a competing product, even if a competitor's smartphone, tablet, or laptop are by themselves better.

Strategy Highlight 12.2 demonstrates how Dollar Shave Club used business model innovation to disrupt the billion-dollar wet shaving industry.

Strategy Highlight **12.2**

Business Model Innovation: How Dollar Shave Club Disrupted Gillette

Although most of our attention is captured by fancy high-tech innovations such as the iPhone or Tesla's sleek electric vehicles, innovations do not need to be high-tech or radical to be successful. Until recently, Gillette, a company that invented the safety razor and the razor–razor blade business model, dominated the market for wet shaving. Yet Dollar Shave Club, a young, fledgling startup with an initial budget of $8,000, disrupted the powerful Gillette with a low-tech innovation and is gaining market share rapidly. How can the powerful Gillette, a unit of Procter & Gamble with annual revenues of $80 billion, be beaten by a brash startup? Gillette's pattern of incremental innovation over time led to overshooting in the market, resulting in a product that was overengineered and too expensive.

Entrepreneur Michael Dubin founded Dollar Shave Club using a business model innovation by providing an online subscription-based mail-order alternative to in-store retail purchases of razor blades. Many customers were not only turned off by Gillette's premium prices but also by the inconveniences that in-store purchases entail. Given that packs of razor blades are a prime target for shoplifters, many stores lock them in glass display cases, much to the dismay of customers who have to hunt down an employee with a key to access the razor blades.

Dan Krauss

King Gillette invented the safety razor about 115 years ago. The Gillette company also came up with the highly profitable business model of selling the razor for a low price and charging a premium for replacement razor blades. This business model is now widely adopted (think printers and cartridges, for example), and is called the razor–razor blade business model to commemorate its origins. When introduced, the new safety razor was a radical innovation, allowing Gillette a temporary competitive advantage. To sustain this advantage over time, Gillette followed up with incremental innovations, mainly by adding additional razor blades to the razor, all the way from one blade to six. As a result of this innovation pattern over time, one of Gillette's newest razors, the Fusion ProGlide with Flexball technology, a razor handle that features a swiveling ball hinge, costs $11.49 per razor (and $12.59 for a battery-operated razor).

This situation exposed Gillette to low-cost disruption. One key is that the high-end, highly priced offering of the market leader is not only overshooting what the market demands but also is often priced too high. One wonders if a person really does need six blades on one razor, or wants to pay over $10 for one cartridge.

Seeing this opening provided by Gillette's focus on the high-end, high-margin business of the market, Dollar Shave Club established a low-cost alternative to invade Gillette's market from the bottom up. With a small budget and the help of a hilarious promotional video that went viral with over 25 million views, the entrepreneur Michael Dubin launched Dollar Shave Club, an ecommerce startup that delivers razors by mail. After the promotional video was uploaded on YouTube (in 2012), some 12,000 people signed up for Dollar Shave membership within the first 48 hours. The company also raised more than $20 million in venture capital funding from prominent firms such as Kleiner Perkins Caufield & Byers and Andreessen Horowitz, among others. Dollar Shave Club followed up with advertising on regular television in addition to its online campaigns and has expanded its product lines with the introduction of additional personal grooming products.

Dollar Shave Club is an ecommerce company that uses a subscription-based business model. As the company's name suggests, its entry-level membership plan delivers a razor and five cartridges a month for just $1 (plus $2 shipping). The member selects an appropriate plan, pays a monthly fee, and receives razors every month in the mail. Dollar Shave Club is using a business model innovation to disrupt an existing market. *Technology* is defined as the methods and materials used to achieve a commercial objective. The technology or method here is the business model innovation, a potent competitive weapon. The entrepreneur identified the need in the market for serving those who don't like to go shopping for razors and who certainly don't like to pay the high prices commanded by market leaders such as Gillette.

Procter & Gamble's competition also took notice. Unilever, P&G's European rival, has long stayed away from the U.S. wet shaving market because Gillette was so dominant. But seeing how Dollar Shave Club disrupted Gillette, resulting in a rapid market share decline, Unilever saw its opening. This Anglo-Dutch multinational consumer products company, which has some $60 billion in annual revenues and thus is roughly the same size as P&G, offered a whopping $1 billion in cash in 2016 to buy Dollar Shave Club. Not a bad offer for a five-year-old startup. Michael Dubin happily accepted the offer and sold Dollar Shave Club to Unilever.

With sales of razors and razor blades moving rapidly online, Unilever is hoping to leverage this business model innovation to unseat Gillette's dominance in the U.S. market. But Gillette responded swiftly by offering its own subscription-based service (Gillette Shave Club) and by lowering prices up to 20%, an unimaginable move in recent history. Successful innovations also led to imitations. A mere two years after Dollar Shave Club started, two entrepreneurs founded Harry's, also an online, subscription-based mail-order business for shaving equipment. After Target invited Harry's to put displays in all its stores in 2016, its business took off. This was a smart move on Target's part because it allowed Target to put pressure on Gillette, which held more or less a monopoly position as a supplier with 75% market share. Similar to Dollar Shave Club, Harry's business is growing rapidly. As a consequence of increased competition, Gillette's market share in the $15 billion wet shaving industry has declined to less than 50% (in 2022).[47]

LO 12-7

Explain the long-tail concept and how it can be used as a business model innovation to implement strategy.

THE LONG TAIL AND BUSINESS MODEL INNOVATION. Digitization of content and services offers opportunities for business model innovation. As such, the digitization of content such as music, books, and movies has been an especially disruptive force for bricks-and-mortar retailers. Digitization does not stop there: Online providers such as Teledoc, TurboTax, and LegalZoom are replacing basic medical, tax, and legal services. One thing is for sure: Everything that can go digital will—creating some losers and some winners.

Given the relatively *low fixed cost* of hosting digital content on servers, plus the *zero marginal cost* of selling another unit of digital content (no physical inventory, no packaging, no marketing, no shipping), digitization allows for an unlimited inventory of titles. Combining unlimited selection with algorithmic or even organic recommendations can result in the long-tail phenomenon. These observations and their strategic implications have been explained by Chris Anderson in his bestseller *The Long Tail.*[48]

Traditionally, 80% of sales in a given product category (such as music, books, and movies) come from blockbusters in the *short head* of the distribution curve, which represents only 20% of the offerings in a category. This relationship is captured by the **Pareto principle,** also known as the 80–20 rule, which says that roughly 80% of effects come from 20% of the causes. The short head represents the mainstream, where all the popular titles,

Pareto principle
Roughly 80% of effects come from 20% of the causes.

bestsellers, and hits are to be found. These products tend to appeal to the largest segment of the mass market with tastes that are more or less homogenous (manufactured) through big marketing budgets combined with limited selection. In the physical world of bricks-and-mortar retail stores, these product selections are often the only choice on display because there are significant costs to carrying broader inventory to meet a wider variety of consumer needs. And, for a long time, the big-budget movies were the only ones shown in theaters. The relationship between hits (20% of offerings) and sales (80% from hits) also implies that 80% of the items in a category are either sold in low quantities or not offered at all (Exhibit 12.4).

long tail Business model innovation in which companies can obtain a large part of their revenues by selling a small number of units from among almost unlimited choices.

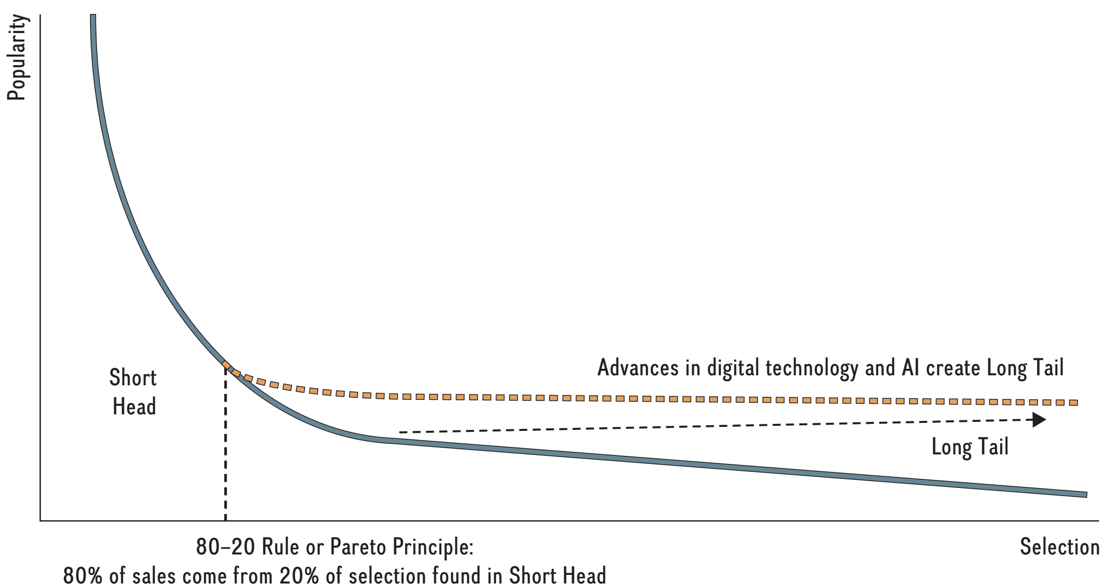
The **long-tail** concept is a business model innovation in which companies can obtain a large(r) part of their revenues by selling a small number of units from among almost unlimited choices. That is, offerings that live in the long tail have a low sales volume per unit, but when selling an unlimited selection that number can add up to a large portion of sales. Given the zero marginal cost of content, some businesses obtain more revenues from the long tail than from the short head. Why? A small dollar amount of an unlimited selection adds up to a very large overall dollar amount (long tail), which is often higher than a larger dollar amount for a handful of mega-hits (short head).

Amazon, Netflix, Spotify, and other businesses have leveraged the long-tail concept. Amazon, for instance, achieves higher sales from books in the long tail than it sells in the short head. As such, many companies sell fewer units of many titles, but they sell many more choices by taking advantage of low-cost, unlimited virtual shelf space. As shown by the dashed line in Exhibit 12.4 the combined effects of advances in technology make it possible to increase the number of units sold—that is, to create the long tail. Keep in mind that these companies sell titles in the short head *plus* the additional sales obtained through the long tail. In contrast, given constrained inventory and carrying costs, physical retailers sell only titles in the short head.

thin markets Markets in the physical world in which transactions are unlikely to take place because there are only a few buyers and a few sellers who have difficulty finding each other in time and space.

Leveraging the long tail allows firms to overcome the problem of **thin markets** in the physical world, in which transactions are unlikely to take place because there are only a few

EXHIBIT 12.4 The Short Head and the Long Tail



Source: Author's adaptation from Anderson, Chris. *The Long Tail: Why the Future of Business is Selling Less of More*. New York: Hyperion, 2006.

buyers and a few sellers and they have difficulty finding each other. Digitization, combined with sophisticated search engines and inventory management, allows firms to drive down transaction costs to match individual consumer demand with supply in time and space. Consider eBay, with 20 million sellers and 160 million active users, as an example. This ecommerce platform overcomes the problem of thin markets as it enables sellers and buyers to meet virtually anytime regardless of geography. eBay applies a long-tail business model because it enables buyers and sellers to exchange any good, no matter how exotic, at basically no search cost to the buyer and no marketing cost to the seller. Meta's Facebook and Alphabet's Google also leverage the long tail because they are able to match advertising of even the smallest businesses with their desired target demographics.

The long -tail business model solves an important strategic trade-off. It lowers the costs of shelf space, inventory, and distribution to near zero and enables firms to aggregate non-hits and match unique consumer preferences to supply. Although the long-tail business model is most powerful in digital-only products, it is also effective for hybrid businesses such as Amazon, which offers both digital products (e-books, movies, and music) and physical products that need to be shipped. As a platform that matches buyers and sellers unconstrained from time and space, Amazon can move deeply into the long tail to profitably sell items that are not in high demand.

In Strategy Highlight 10.2, we discussed the breakout success of Netflix's original *Squid Game.* Netflix leverages the long tail with its personalized recommendation algorithm combined with producing a large quantity of low-budget content. Netflix views each of its original productions as an experiment that lives in the long tail. And, given the large number of experiments Netflix runs, some are destined to break out as mega-hits, such as *Tiger King*. In contrast, Disney focuses on the short head, producing a few high-impact blockbuster movies. Disney then leverages each mega-hit success into billion-dollar franchises through movie sequels and prequels e.g., *Star Wars*), theme-park attractions, merchandise, and licensing.

Threadless: Combining the Long Tail and Crowdsourcing. Threadless, an online design community and apparel store (www.threadless.com), uses business model innovation to gain an advantage in the highly competitive apparel industry. Threadless' business model innovation combines the long-tail concept with crowdsourcing. This novel combination helped the internet startup gain and sustain a competitive advantage in a fad-driven industry.

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

Members of the Threadless community, which is millions strong, do most of the work, which they consider fun: They submit T-shirt designs online, and community members vote on which designs they like best. The designs receiving the most votes are put in production, printed, and sold online. Each Monday, Threadless releases new designs and reprints more T-shirts throughout the week as inventory is cleared out. The cost of Threadless T-shirts is a bit higher than that of competitors, about $25. Each designer enters the weekly competition to win a $250 gift code for the website and, more importantly, the artists receive royalties on each sale and retain the copyrights to their work. By bringing in a large and diverse set of designers, Threadless leverages the *long-tail* concept because it allows niche designs to surface. Many more unique designs are offered, and thus

Threadless sells fewer units per design but many more designs than traditional T-shirt companies that rely on formulaic designs.

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

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

Not surprisingly, Threadless has sold most of the T-shirts it has printed. Moreover, it has a cult-like following and is outperforming established companies American Eagle, Old Navy, and Urban Outfitters with their more formulaic T-shirt designs. In 2021, estimated revenues for the privately owned Threadless were estimated to be more than $100 million with a 35% profit margin.[49]

12.4 Implications for Strategic Leaders

An important implication for strategic leaders is the recognition that effective corporate governance and solid business ethics are critical to sustaining competitive advantage over time. Governance and ethics are closely intertwined at the intersection of setting the right organizational core values and then ensuring compliance.

A variety of corporate governance mechanisms can be effective in addressing the principal-agent problem. These mechanisms tend to focus on monitoring, controlling, and providing incentives, and they must be complemented by a strong code of conduct and strategic leaders who act with integrity. The effective strategic leader must help employees to *walk the talk*; leading by ethical example often has a stronger effect on employee behavior than words alone.

The strategist needs to look beyond shareholders and apply a stakeholder perspective to ensure the long-term survival and success of the firm. A firm that does not respond to stakeholders beyond stockholders in a way that keeps them committed to its vision will not be successful. Stakeholders want fair treatment even if not all of their demands can be met. Fairness and transparency are critical to maintaining good relationships within the network of stakeholders the firm is embedded in. A large number of glaring ethical lapses in recent decades makes it clear that organizational core values and a code of conduct are key to the continued professionalization of management. Strategic leaders need to live organizational core values by example.

Finally, business models play a crucial role in effectively implementing strategy. Business model innovation is one of the less appreciated but increasingly important weapons to gain and sustain competitive advantage.

CHAPTERCASE 12 Part II

Shortly after founding Theranos, securing initial funding, and receiving endorsements from high-powered venture capitalists and scientists, Elizabeth Holmes set out to build a hand-selected board of directors (in 2004). Assembling Theranos' board of directors was not done with the goal of providing strategic guidance and overseeing corporate governance, but rather to provide a seal of approval and legitimacy. A powerful board of directors would allow Theranos, Holmes reasoned, to intimidate government agencies such as regulatory bodies not to challenge Theranos' assertion that its technology worked as proclaimed. Holmes convinced elder statesman George Schultz, Henry Kissinger (former secretary of state), James Matthis (future secretary of defense), and William Perry (former secretary of defense), among other high-powered individuals, to join Theranos' board of directors. Holmes was also close to the Clinton Global Initiative and former President Bill Clinton; she even threw a fundraiser for then–presidential candidate Hillary Clinton. Holmes connected to the Obama administration as well, touring the Theranos facility in the Bay Area with then–vice president Joe Biden and explaining that he had just witnessed the lab of the future—Theranos was going to provide higher-quality services at lower costs.

Shortly after Theranos went live with its blood testing in 2013, however, medical doctors began questioning the lab results their patients had obtained from Theranos. Some actually had their patients retested at traditional labs. After comparing Theranos' results with those obtained from Quest or LabCorp for the same patients, physicians found discrepancies, proving that Theranos technology was faulty. Recognizing the inherent risks of providing patients with faulty lab results (which can result, for instance, in the start of aggressive treatments for combating cancer or not undertaking a treatment when needed), one Theranos employee filed a whistleblower complaint with a government agency, while another employee shared information with an investigative reporter at *The Wall Street Journal (WSJ)*. The *WSJ* published a series of articles in 2015 exposing the Theranos fraud, which resulted in several unannounced inspections at Theranos by regulatory agencies.

In 2018, federal prosecutors filed criminal charges against Elizabeth Holmes and her enforcer and second in command at Theranos, Ramesh "Sunny" Balwani, alleging they defrauded investors, doctors, and patients. In 2022, in a jury trial delayed by the Covid-19 pandemic, Elizabeth Holmes was convicted of multiple counts of wire fraud and one count of conspiracy to commit wire fraud by lying to investors to raise money for her startup. She was found not guilty of defrauding patients who had used Theranos' blood tests. A convicted felon, Holmes was sentenced to more than 11 years in prison.

Questions

1. What was the original mission and vision of Theranos founder Elizabeth Holmes? How did Holmes set out to fulfill her mission?
2. What is the designated role of a board of directors? Did the Theranos board of directors fulfill this role? Why or why not? If not, what was Holmes' motivation for stacking the board the way she did? Explain.
3. Theranos was valued at some $10 billion at its peak. Did the investors overlook any red flags? Or was it simply FOMO ("fear of missing out") that made them hurry to jump on the Theranos bandwagon? Why were so many people caught up in the hype around Theranos and Elizabeth Holmes, its charismatic leader?
4. Why and how did Theranos get in trouble?
5. What lessons can be learned from the Theranos case?

TAKE-AWAY CONCEPTS

In this final chapter, we looked at corporate governance, business ethics, and business models, as summarized by the following learning objectives and related take-away concepts.

LO 12-1 / Explain the role of corporate governance.

- Corporate governance involves mechanisms used to direct and control an enterprise to ensure that it pursues its strategic goals successfully and legally.
- Corporate governance attempts to address the principal-agent problem, which occurs in any situation in which an agent performs activities on behalf of a principal.

LO 12-2 / Apply agency theory to explain why and how companies use governance mechanisms to align the interests of principals and agents.

- Agency theory views the firm as a nexus of legal contracts.
- The principal-agent problem concerns the relationship between owners (shareholders) and managers and also cascades down the organizational hierarchy.
- The risk of opportunism by agents is exacerbated by information asymmetry: Agents are generally better informed than the principals.
- Governance mechanisms are used to align incentives between principals and agents.
- Governance mechanisms need to be designed to overcome two specific agency problems: adverse selection and moral hazard.

LO 12-3 / Evaluate the board of directors as the central governance mechanism for public stock companies.

- The shareholders are the legal owners of a publicly traded company and appoint a board of directors to represent their interests.
- The day-to-day business operations of a publicly traded stock company are conducted by its managers and employees, under the direction of the chief executive officer (CEO) and the oversight of the board of directors. The board of directors is composed of inside and outside directors, who are elected by the shareholders.
- Inside directors are generally part of the company's senior management team, such as the chief financial officer (CFO) and the chief operating officer (COO).
- Outside directors are not employees of the firm. They frequently are senior executives from other firms or full-time professionals who are appointed to a board and who serve on several boards simultaneously.

LO 12-4 / Evaluate other governance mechanisms.

- Other important corporate mechanisms are executive compensation, the market for corporate control, and financial statement auditors, government regulators, and industry analysts.
- Executive compensation has attracted significant attention in recent years. Two issues are at the forefront: (1) the absolute size of the CEO pay package compared with the pay of the average employee and (2) the relationship between firm performance and CEO pay.
- The board of directors and executive compensation are internal corporate governance mechanisms. The market for corporate control is an important external corporate governance mechanism. It consists of activist investors who seek to gain control of an underperforming corporation by buying shares of its stock in the open market.
- All public companies listed on the U.S. stock exchanges must file a number of financial statements with the Securities and Exchange Commission (SEC), a federal regulatory agency that oversees stock trading and enforces federal securities laws. Auditors and industry analysts study these public financial statements carefully for clues to a firm's future valuations, financial irregularities, and strategy.

LO 12-5 / Explain the relationship between strategy and business ethics.

- The ethical pursuit of competitive advantage lays the foundation for long-term superior performance.

- Law and ethics are not synonymous; obeying the law is the minimum that society expects of a corporation and its managers.
- A manager's actions can be completely legal but ethically questionable.
- Some argue that management needs an accepted code of conduct that holds members to a high professional standard and imposes consequences for misconduct.

LO 12-6 / Use the business model framework to put strategy into action.

- The translation of a firm's strategy *(where and how to compete for competitive advantage)* into action takes place in the firm's business model *(how to make money).*
- A business model details how the firm conducts its business with its buyers, suppliers, and partners.
- How companies do business is as important to gaining and sustaining competitive advantage as what they do.
- The why, what, who, and how framework guides managers through the process of formulating and implementing a business model.

LO 12-7 / Explain the long-tail concept and how it can be used as a business model innovation to implement strategy.

- The long-tail concept is a business model innovation in which companies can obtain a large(r) part of their revenues by selling a small number of units from among almost unlimited choices.
- Leveraging the long tail allows firms to overcome the problem of thin markets in the physical world, in which transactions are unlikely to take place because there are only a few buyers and a few sellers and they have difficulty finding each other.

KEY TERMS

Adverse selection *(p. 466)*
Agency theory *(p. 465)*
Board of directors *(p. 466)*
Business ethics *(p. 471)*
Business model *(p. 476)*
Business model innovation *(p. 481)*
CEO/chairperson duality *(p. 468)*
Corporate governance *(p. 463)*
Inside directors *(p. 467)*
Leveraged buyout (LBO) *(p. 469)*
Long tail *(p. 484)*
Moral hazard *(p. 466)*
Outside directors *(p. 467)*
Pareto principle *(p. 483)*
Poison pill *(p. 470)*
Stock options *(p. 468)*
Thin markets *(p. 484)*

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PART 4

Mini**Cases***

***Connect includes assignable case analyses for each MiniCase. Teaching notes are in the Connect Library tab.**

How to Conduct a Case Analysis

How to Conduct a Case Analysis

THE CASE STUDY is a fundamental learning tool in strategic management. The cases that accompany this text are carefully written to ensure tight integration with the strategic management concepts and frameworks presented. The goal is to ensure that the student learner is exposed to a wide variety of key concepts, industries, protagonists, and strategic problems.

In simple terms, cases tell the story of a company facing a strategic dilemma. Each case has a protagonist who has to make one or a set of strategic decisions to address the situation presented. The idea is that you put yourself in the situation of the protagonist and view the case from the protagonist's perspective. The firms may be real or fictitious, and the problem may be current or past. Although the details of the cases vary, in general they start with a description of the challenge(s) to be addressed, followed by the history of the firm up until the decision point, and then additional information to help you with your analysis. To address the strategic dilemma, you will use the AFI Strategy Framework to conduct a case analysis as well as the strategic management tools and concepts provided in this text. After careful analysis, you will be able to formulate a strategic response and make recommendations about how to implement it.

Why Do We Use Cases?

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

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

Cases also invite you to "walk in" and explore many more kinds of companies in a wider array of industries than you will ever be able to work at in your lifetime. With this strategy content, you will find MiniCases (i.e., shorter cases) about coffee chains (Starbucks), mass media and entertainment (Disney), technology (Apple), and innovative business models (Dollar Shave Club), among others. Some of these featured companies have enjoyed success (e.g., Apple and Disney), while others have struggled or failed (e.g., GE, Yahoo, BlackBerry, and JCPenney). Longer cases with complete financial data about companies such as Airbnb, Vanguard, Facebook, Tesla, McDonald's, and Uber are available in Connect and on Create.

Your personal organizational experiences are usually somewhat limited, defined by the jobs held by your family members or by your own forays into the working world. Learning about companies that are involved in so many different types of products and services may open up new employment possibilities for you. Diversity also forces us to think about the ways in which industries (as well as people) are both similar, yet distinct, and to critically examine the degree to which lessons learned in one forum transfer to other settings (i.e., to what degree they are generalizable). In short, cases are a great training tool, and they are fun to study.

Many of our cases are written from the perspective of the CEO or general manager responsible for strategic decision making in the organization. While you do not need to be a member of a top management team to utilize the strategic management process, these senior leaders are usually responsible for determining strategy in most of the organizations we study. Importantly, cases allow us to put ourselves “in the shoes” of strategic leaders and invite us to view the issues from their perspective. Having responsibility for the performance of an entire organization is quite different from managing a single project team, department, or functional area. Cases can help you see the *big picture* in a way that most of us are not accustomed to in our daily organizational lives. We recognize that most undergraduate students and even MBAs do not land immediately in the corporate boardroom. Yet having a basic understanding of the types of conversations going on in the boardroom not only increases your current value as an employee but also improves your chances of getting there someday, should you so desire. Perhaps even more important, it allows you to find a company that aligns with your values and aspirations, and to develop a career with significant future upside.

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

Strategic Case Analysis

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

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

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

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

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

CALCULATING FINANCIAL RATIOS. Financial ratio analysis is an important tool for assessing the outcomes of a firm's strategy. Although financial performance is not the only relevant outcome measure, long-term profitability is a necessary precondition for firms to remain in business and to serve the needs of all their stakeholders. Accordingly, we have provided a table of financial measures that can be used to assess firm performance (see Appendix at the end of this module).

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

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

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

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

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

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

Formulation: Proposing Feasible Solutions

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

The purpose of doing case analysis is to *look past* the easy answers and to help figure out not just what works but what might be *a better* answer. In other words, do not just take the first idea that comes to your mind and run with it. Instead, write down that idea for subsequent consideration but then think about what other solutions might achieve the same (or even better) results. Some of the most successful companies engage in scenario planning, in which they develop several possible outcomes and estimate the likelihood that each will happen. If their first prediction turns out to be incorrect, then they have a Plan B ready and waiting to be executed.

Plan for Implementation

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

1. *What activities need to be performed?* The value chain is a very useful tool when you need to figure out how different parts of the company are likely to be affected. What are the implications of your plan

with respect to both primary activities (e.g., operations and sales/marketing/service) and support activities (e.g., human resources and infrastructure)?

2. *What is the timeline?* What steps must be taken first and why? Which ones are most critical? Which activities can proceed simultaneously, and which ones are sequential in nature? How long is your plan going to take?
3. *How are you going to finance your proposal?* Does the company have adequate cash on hand, or does it need to consider debt and/or equity financing? How long until your proposal breaks even and pays for itself?
4. *What outcomes is your plan likely to achieve?* Provide goals that are "SMART": specific, measurable, achievable, realistic, and timely in nature. Make a case for how your plan will help the firm to achieve a strategic competitive advantage.

Exhibit CA.1 aids you in assessing the implementation proposals you come up with along time and resource intensity.

In-Class Discussion

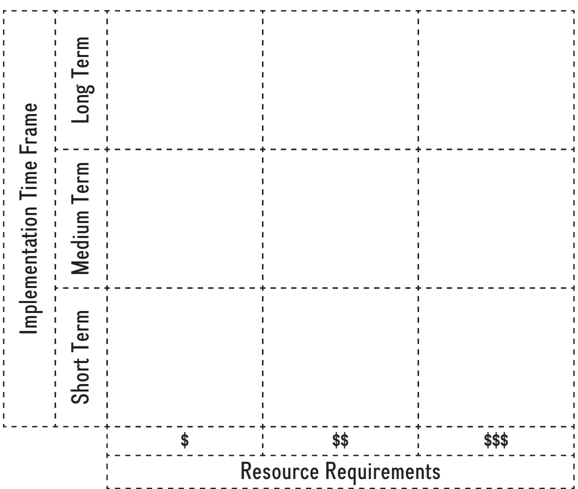
Discussing your ideas in class is often the most valuable part of a case study. The instructor will moderate the class discussion, guiding the AFI process and asking probing questions when necessary. Case discussion classes are most effective and interesting when everybody comes prepared and participates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

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

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

EXHIBIT CA.1

Assessing Implementation Proposals along Time and Resource Intensity



Source: Author's own creation.

Things to Keep in Mind While Doing Case Analysis

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

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

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

Case Limitations

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

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

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

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

Frequently Asked Questions about Case Analysis

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

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

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

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

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

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

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

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

APPENDIX When and How to Use Financial Measures to Assess Firm Performance

Overview: We have grouped the financial performance measures into five main categories:

Table 1a: Profitability: How profitable is the company?

Table 1b: Activity: How efficient are the operations of the company?

Table 1c: Leverage: How effectively is the company financed in terms of debt and equity?

Table 1d: Liquidity: How capable is the business of meeting its short-term obligations as they fall due?

Table 1e: Market: How does the company's performance compare to other companies in the market?

Table 1a: Profitability Ratios	**Formula**	**Characteristics**
Gross margin (or EBITDA, EBIT, etc.)	(Sales – COGS)/Sales	Measures the relationship between sales and the costs to support those sales (e.g., manufacturing, procurement, advertising, payroll)
Return on assets (ROA)	Net income/Total assets	Measures the firm's efficiency in using assets to generate earnings
Return on equity (ROE)	Net income/Total stockholders' equity	Measures earnings to owners as measured by net assets
Return on invested capital (ROIC)	Net income/Invested capital	Measures how effectively a company uses its total invested capital, which consists of two components: (1) shareholders' equity through the selling of shares to the public, and (2) interest-bearing debt through borrowing from financial institutions and bondholders
Return on revenue (ROR)	Net income/Revenue	Measures the profit earned per dollar of revenue

(*Continued...*)

Dividend payout	Common dividends/Net income	Measures the percent of earnings paid out to common stockholders
Limitations	1. Static snapshot of balance sheet. 2. Many important intangibles not accounted for. 3. Affected by accounting rules on accruals and timing. One-time nonoperating income/expense. 4. Does not take into account cost of capital. 5. Affected by timing and accounting treatment of operating results.	
Table 1b: Activity Ratios	**Formula**	**Characteristics**
Inventory turnover	COGS/Inventory	Measures inventory management
Receivables turnover	Revenue/Accounts receivable	Measures the effectiveness of credit policies and the needed level of receivables investment for sales
Payables turnover	Revenue/Accounts payable	Measures the rate at which a firm pays its suppliers
Working capital turnover	Revenue/Working capital	Measures how much working (operating) capital is needed for sales
Fixed asset turnover	Revenue/Fixed assets	Measures the efficiency of investments in net fixed assets (property, plant, and equipment after accumulated depreciation)
Total asset turnover	Revenue/Total assets	Represents the overall (comprehensive) efficiency of assets to sales
Cash turnover	Revenue/Cash (which usually includes marketable securities)	Measures a firm's efficiency in its use of cash to generate sales
Limitations	Good measures of cash flow efficiency, but with the following limitations: 1. Limited by accounting treatment and timing (e.g., monthly/quarterly close) 2. Limitations of accrual vs. cash accounting	
Table 1c: Leverage Ratios	**Formula**	**Characteristics**
Debt to equity	Total liabilities/Total stockholders' equity	Direct comparison of debt-to-equity stakeholders and the most common measure of capital structure
Debt to assets	Total liabilities/Total assets	Debt as a percent of assets
Interest coverage (times interest earned)	(Net income + Interest expense + Tax expense)/Interest expense	Direct measure of the firm's ability to meet interest payments, indicating the protection provided from current operations
Long-term debt to equity	Long-term liabilities/Total stockholders' equity	A long-term perspective of debt and equity positions of stakeholders
Debt to market equity	Total liabilities at book value/Total equity at market value	Market valuation may represent a better measure of equity than book value; most firms have a market premium relative to book value.

Bonded debt to equity	Bonded debt/ Stockholders' equity	Measures a firm's leverage in terms of stockholders' equity
Debt to tangible net worth	Total liabilities/(Common equity – Intangible assets)	Measures a firm's leverage in terms of tangible (hard) assets captured in book value
Financial leverage index	Return on equity/Return on assets	Measures how well a company is using its debt
Limitations	Overall good measures of a firm's financing strategy; needs to be looked at in concert with operating results because 1. These measures can be misleading if looked at in isolation. 2. They can also be misleading if using book values as opposed to market values of debt and equity.	

Table 1d: Liquidity Ratios	**Formula**	**Characteristics**
Current	Current assets/Current liabilities	Measures short-term liquidity. Current assets are all assets that a firm can readily convert to cash to pay outstanding debts and cover liabilities without having to sell hard assets. Current liabilities are a firm's debt and other obligations that are due within a year.
Quick (acid-test)	(Cash + Marketable securities + Net receivables)/Current liabilities	Eliminates inventory from the numerator, focusing on cash, marketable securities, and receivables
Cash	(Cash + Marketable securities)/Current liabilities	Considers only cash and marketable securities for payment of current liabilities
Operating cash flow	Cash flow from operations/Current liabilities	Evaluates cash-related performance (as measured from the statement of cash flows) relative to current liabilities
Cash to current assets	(Cash + Marketable securities)/Current assets	Indicates the part of current assets that are among the most fungible (i.e., cash and marketable securities)
Cash position	(Cash + Marketable securities)/Total assets	Indicates the percent of total assets that are most fungible (i.e., cash)
Current liability position	Current liabilities/Total assets	Indicates what percent of total assets the firm's current liabilities represent
Limitations	Liquidity measures are important, especially in times of economic instability, but they also need to be looked at holistically along with financing and operating measures of a firm's performance. 1. Accounting processes (e.g., monthly close) limit efficacy of these measures when you want to understand daily cash position. 2. No account taken of risk and exposure on the liability side.	

(*Continued...*)

Table 1e: Market Ratios	Formula	Characteristics
Book value per share	Total stockholders' equity/Number of shares outstanding	Equity or net assets, as measured on the balance sheet
Earnings-based growth models	P = kE/(r – g), where E = earnings, k = dividend payout rate, r = discount rate, and g = earnings growth rate	Valuation models that discount earnings and dividends by a discount rate adjusted for future earnings growth
Market-to-book	(Stock price × Number of shares outstanding)/Total stockholders' equity	Measures accounting-based equity
Price-earnings (PE) ratio	Stock price/EPS	Measures market premium paid for earnings and future expectations
Price-earnings growth (PEG) ratio	PE/Earnings growth rate	PE compared to earnings growth rates, a measure of PE "reasonableness"
Sales-to-market value	Sales/(Stock price × Number of shares outstanding)	A sales activity ratio based on market price
Dividend yield	Dividends per share/Stock price	Direct cash return on stock investment
Total return to shareholders	Stock price appreciation + Dividends	
Limitations	Market measures tend to be more volatile than accounting measures but also provide a good perspective on the overall health of a company when used holistically with the other measures of financial performance. 1. Market volatility/noise is the biggest challenge with these measures. 2. Understanding what the result is of a firm strategy/decision vs. the broader market can be challenging.	

MiniCase 1

Whitney Wolfe Herd's Dating Strategy: From Tinder to Bumble

"There were days where I didn't want to live ... the internet defined me ... [people] calling me the most ugly names in the world ... but through all of this pain and struggle, I still had an itch to create. ... I can start something. ... I can change what I hate that I see in the world."

Whitney Wolfe Herd, CEO and Founder of Bumble Inc.[1]

Whitney Wolfe Herd became the world's youngest self-made female billionaire with a net wealth of $1.5 billion after taking Bumble Inc. public (in 2021). Wolfe Herd helped start not just one but two of the most popular dating apps: Tinder and Bumble. What was her strategy to become so successful?

Online Dating

Match.com, launched in 1995, was one of the first online dating services. It's hard to believe today, but in the early days of the internet, people who engaged in online dating were considered desperate, awkward, and maybe a little weird. Today, most Millennials and members of Gen Z (as well as many people of older generations) participate in online dating.

In the most abstract sense, dating is a problem of matching preferences in time and space. Pre-internet dating took place in thin markets, meaning the number of potential dates someone could encounter was limited by real-life circumstances such as school, work, and social life. Online dating transformed thin markets into thick markets with seemingly unlimited supply and demand—that is, a large number of potential people to date.

Since the launch of the iPhone in 2007, the use of mobile apps has skyrocketed, including the use of app-based dating targeted to many different audiences. Given

Shortly after graduating from Southern Methodist University, Whitney Wolfe Herd helped transform online dating by launching Tinder and Bumble. An entrepreneur and marketing wizard, Wolfe Herd turned the disappointment and pain she experienced from sexual and online harassment at Tinder into energy and creativity to found Bumble. She turned the old-age dating script on its head: At Bumble, women make the first move, always.

Vivien Killilea/Getty Images

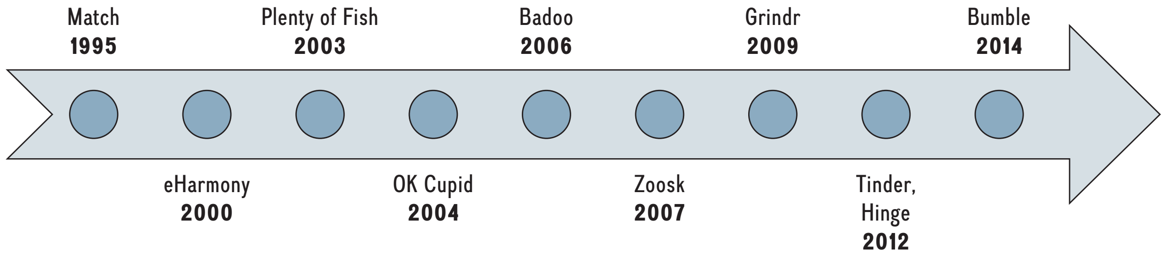
the low barriers to entry, online dating is a fragmented and highly competitive market space. In 2022, revenues for the U.S. online dating industry were $3 billion, with 44 million people in the United States using the services and 27 million using phone dating apps. Exhibit MC1.1 shows a timeline of the launch of some of the primary online dating services, and Exhibit MC1.2 shows the dating app market share. Combined, Tinder and Bumble hold over 50% market share: With a 30% market share, Tinder is the largest online dating service, followed by Bumble (22%). Whitney Wolfe Herd was instrumental in creating both of them.

Tinder Disrupts Online Dating

Traditional dating websites such as Match and eHarmony sought to connect users based on hundreds of criteria. In their advertising on Hulu, YouTube, and elsewhere, they continue to highlight their ability to help people form long-term relationships. Launched in

Frank T. Rothaermel prepared this MiniCase with Veronica Bian, who provided superb research assistance. The MiniCase is based on public sources and is for class discussion. It is not intended to be used for any endorsement, source of data, or depiction of efficient or inefficient management. All opinions expressed and all errors and omissions are entirely the author's. Revised and updated: July 16, 2022.

EXHIBIT MC1.1 A Timeline of Major Online Dating Services in the U.S.



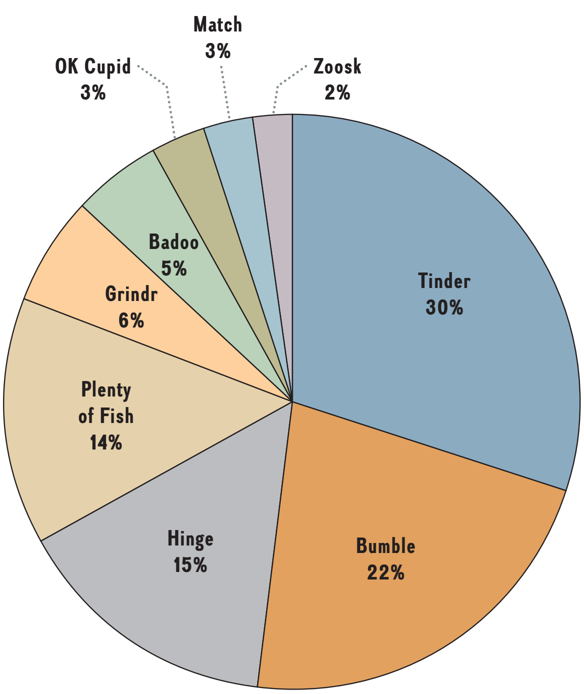
Source: Author's depiction of publicly available data.

2012, Tinder disrupted the online dating market. Whereas traditional players in the market require new users to fill out lengthy personality questionnaires, the Tinder app asks users to sign up via Facebook and select pictures to feature on their Tinder profiles.

By making sign-up fast and frictionless, Tinder achieved two things. First, it increased its user base by focusing on Millennials and Gen Zers, early tech adopters. Second, it removed the frustration of going through so much effort to join a dating site. With access to a comprehensive data set, Tinder offers users more personalized experiences and limits the number of overcurated profiles that often appear on traditional dating sites. Because Tinder is connected to users' Facebook profiles, the app delivers targeted results by leveraging data on users' mutual friends and interests rather than bombarding users with random profiles. In addition to Facebook, people can sign up for Tinder with their Google account or mobile number.

EXHIBIT MC1.2

Dating App Market Share in the U.S. (2022)



Source: Author's depiction of publicly available data.

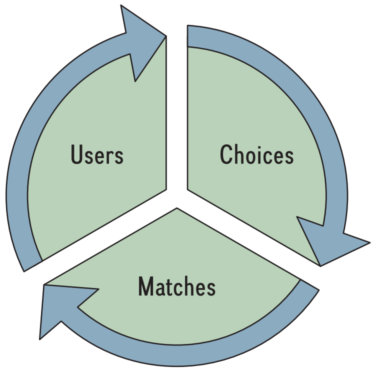
Tinder relies on geolocation to generate a stream of profiles for a user to "swipe left" on profiles (not interested) or "swipe right" (interested). If both users swipe right after viewing each other's profile ("double opt-in"), they are alerted to the "match" and can message each other to meet up in person. Users set their geographic preferences; they can choose to see possible matches who live within, say, a 100-mile radius, or they can choose to view the profiles of people from anywhere in the world. Only when users match are they prompted to chat; this system reduces the fear of rejection often caused by the uncertainty of eliciting a response from a random user on a traditional dating site.

Tinder users engage in billions of swipes each day across the globe in some 200 countries, and individual users often spend more than one hour a day on the app going through hundreds and perhaps even thousands of profiles. This system has some drawbacks: Critics argue that dating has become an online game with judgments made in split seconds based on simple cues: attractiveness, availability, and location.

Wolfe Herd's first foray into the dating app industry started at Tinder, where she served as vice president of marketing. While she did not help to found the company, she was a part of the early time that made Tinder so successful. Tinder took the online dating market by storm, spearheading the dating app revolution. Within a few short months after launch, Tinder had amassed a

EXHIBIT MC1.3

Positive Network Effects: The Dating App Flywheel



Source: Author's depiction of publicly available data.

user base of over 100,000 and created nearly 10 million "matches," or pairings of users who express mutual interest. Tinder's rapid growth resulted from its business model innovation and marketing.

Tinder's hugely successful marketing strategy was Wolfe Herd's ingenious idea. She was a recent college graduate and had been a sorority member. She was well positioned to leverage her deep knowledge of the dating scene among college students, specifically in colleges' Greek organizations. She hosted social events on college campuses, which lit a fire as Tinder grew rapidly through word-of-mouth advertising. Soon, celebrities and influencers were sharing their Tinder experiences. As more users joined the Tinder app, a larger pool of potential dates became available, leading to more matches. As the number of successful matches grew impressively, more users joined, and positive network effects set in. Exhibit MC1.3 shows the ingenious flywheel the marketing wizard Wolfe Herd initiated to supercharge Tinder's growth.

Enter Bumble, the Feminist Dating App

"Our mission is to create a world where all relationships are healthy and equitable."[2]

Although Wolfe Herd helped Tinder achieve massive success, she left the company under difficult circumstances in September 2014. She faced tremendous online abuse following her departure. Instead of feeling defeated, she rechanneled her torment to fuel her desire to create a dating space focused on empowering women, founding Bumble in December 2014.

Wolfe Herd describes Bumble as the first feminist dating app.[3] Her deep understanding of the online dating scene allowed her to innovate the Tinder business model by embedding a women-centric focus into the Bumble app. Bumble features a more controlled marketplace that establishes a safe space for individuals to find more meaningful, longer-lasting relationships. On Bumble, women "make the first move" after an (opposite-sex) "match" occurs. After a match, the woman must make the first move to initiate a conversation within 24 hours. If she does not, the match disappears.[4] Other safeguards include an AI-based "private detector" feature, which blurs out any explicit pictures sent in chats.

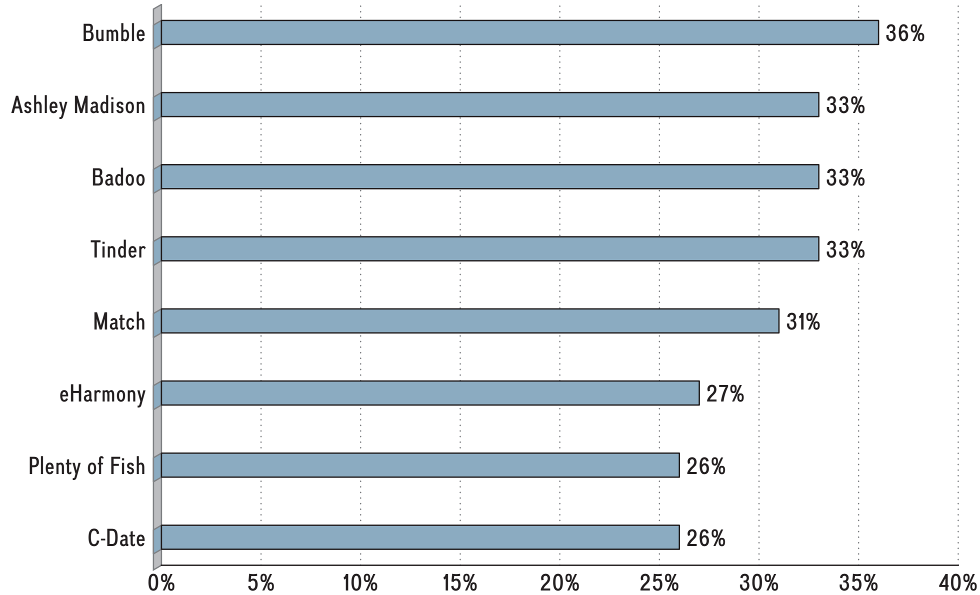
Wolfe Herd quickly grew Bumble's user base by leveraging a marketing playbook similar to the one she'd used when launching Tinder. Bumble rapidly gained traction with many users of online dating services, especially women who had bad experiences on other dating platforms. Within the first month of its release, Bumble had over 100,000 downloads. Within three years of the app's launch, Bumble had garnered over 22 million users, achieving more than 70% year-over-year growth. Bumble's astonishing growth was seven times faster than Tinder's. In 2021, Wolfe Herd took Bumble public with a $7 billion valuation.

By 2022, Bumble's community had grown to more than 125 million people globally, and the platform expanded to include more differentiated features: (1) Bumble Date for those seeking romantic relationships, (2) Bumble BFF for forming new friendships, and (3) Bumble Bizz for professional networking. In the dating app industry, Bumble has the second largest market share behind Tinder (see Exhibit MC1.2), but it has the highest percentage of paying customers (Exhibit MC1.4).

Most dating apps follow a *freemium* (free + premium) business model in which the basic service is free, and Bumble is no exception. Bumble charges users for premium services such as Beeline (showing users who have liked their profile and thus facilitating matches), Rematch (keeping expired matches in a user's queue for an additional 24 hours), Busy Bee (allowing unlimited 24-hour extensions for matches), and SuperSwipes (in which a user can like another user, who is then notified of the like, again facilitating matches).

While launching Bumble, Whitney Wolfe also had time for romance. She married Michael Herd (in 2017), and they are now the proud parents of two children. Guess how they met? Not online, but in real life during a ski vacation.

EXHIBIT MC1.4 Dating Apps by Share of Paying Customers in U.S. (2022)



Source: Author's depiction of publicly available data.

DISCUSSION QUESTIONS

Strategy is a set of goal-directed actions a firm takes to gain and sustain superior performance relative to competitors. In any competitive situation, a good strategy enables a firm to achieve superior performance and sustainable competitive advantage relative to its competitors. As discussed in Chapter 1, a good strategy consists of three components:

- Step 1: A diagnosis of the competitive challenge
- Step 2: A guiding policy to address the competitive challenge
- Step 3: A set of coherent actions to implement the firm's guiding policy

1. Apply the three-step strategy process to explain how Tinder achieved a competitive advantage.
2. Given the crowded marketspace in online dating, apply the three-step strategy process to explain Bumble's success.
3. What do you conclude about the sustainability of competitive advantage in the online dating industry? Use Exhibit MC1.3 in making your arguments.
4. Why is Whitney Wolfe Herd so successful? Identify some of the characteristics that made her the youngest female self-made billionaire. Which traits would you want to emulate to help you succeed in your professional endeavors?

Endnotes

1. NPR (2017, Oct. 16), "Bumble: Whitney Wolfe," How I Built This podcast, https://www.npr.org/2017/11/29/557437086/bumble-whitney-wolfe
2. Bumble Company Profile, https://www.shecancode.io/bumble-company-profile-page
3. Yashari, L. (2015, Aug. 7), "Meet the Tinder co-founder trying to change online dating forever. On Bumble, women always go first," *Vanity Fair.*
4. In same-sex matches, either person can reach out.

Sources: Bumble Inc. (2021), Annual report; Bumble blog: The beehive, https://thebeehive.bumble.com/bumbleblog; Au-Yeung, A. (2021, Feb. 11), Bumble cofounder becomes world's youngest self-made woman billionaire, thanks to IPO, *Forbes;* Subin, S. (2021, Feb. 11), "Bumble IPO: The female founder behind the dating app making market history," *CNBC;* O'Connor, C. (2017, Nov. 14), "Billion-dollar Bumble: How Whitney Wolfe Herd built America's fastest-growing dating app," *Forbes;* NPR (2017, Oct. 16), "Bumble: Whitney Wolfe," How I Built This podcast, https://www.npr.org/2017/11/29/557437086/bumble-whitney-wolfe; HBS Digital Innovation and Transformation (2017, Feb. 26), "Tinder's growth strategy: Swiping to success," https://digital.hbs.edu/platform-digit/submission/tinders-growth-strategy-swiping-to-success/; Santoro, E. (2013, Nov. 1) "Your app to find that 'perfect' someone," CNBC; Lynley, M. (2013, Feb. 6), "Why you are seeing this dating app popping up everywhere," *The Wall Street Journal;* Yashari, L. (2015, Aug. 7), "Meet the Tinder co-founder trying to change online dating forever. On Bumble, women always go first," *Vanity Fair.*

MiniCase 2

Microsoft: Satya Nadella Hits Refresh

Satya Nadella "didn't completely break with the past—when you hit refresh on your browser, some of what's on the page stays the same. But under Satya's leadership, Microsoft has been able to transition away from a purely Windows-centric approach. He led the adoption of a bold new mission for the company. ... [H]e is making big bets on a few key technologies, like artificial intelligence and cloud computing, where Microsoft will differentiate itself."[1]

Bill Gates, co-founder of Microsoft and longtime CEO (1975–2000)

The World's Most Valuable Company

Valued at over $1 trillion,[2] Microsoft was the most valuable company in the world in 1999. Having established a near-monopoly on operating systems and personal computer software, Microsoft appeared to be set for a golden age. The launch of the hugely successful Windows 95 seemed to cement Microsoft's unassailable lead (see Exhibit MC2.1, which compares normalized changes in Microsoft's share price with the tech-heavy Nasdaq-100 index).

What followed, however, was a period of immense stagnation. Microsoft's market cap dropped by up to one-half of its peak for the next 15 years and fell as low as $140 billion (in 2009), down 80%. What happened? Microsoft rested on its Windows laurels and stopped innovating.

While its rivals in big tech had achieved massive gains through product and process innovation, releasing category-defining products and services such as Apple's iPhone and iTunes, the Google search engine, and social media platforms such as Facebook, Microsoft stood stagnant. Rather than continuing to innovate, the Redmond, Washington–based software giant focused solely on Windows-related products. Why? They were highly profitable. This Windows-centric focus was Microsoft's business model: Create a large user base for the Windows operating system and then make money by selling application software such as the Office suite (containing Word, Excel, PowerPoint, Outlook, and other software programs).

The Windows Company

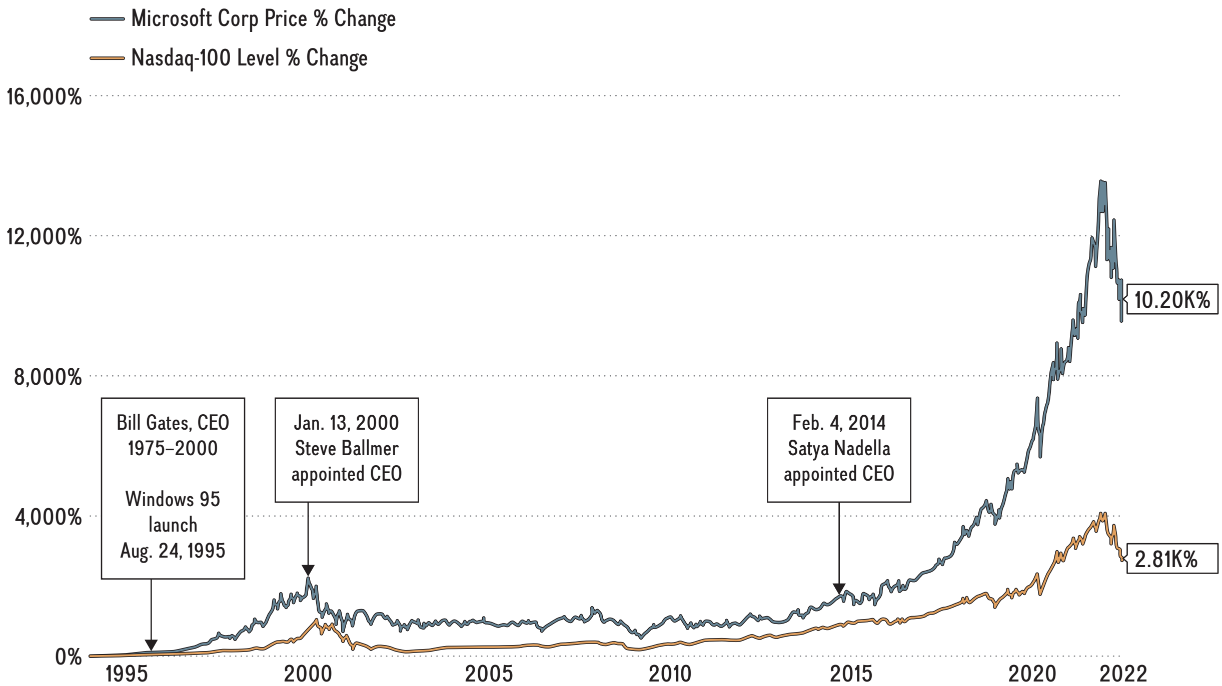
Since its founding in 1975 by college dropouts Bill Gates and Paul Allen, Microsoft has been a fierce competitor. It aggressively pursued Bill Gates' mission of a computer on every desk running, of course, Microsoft software. Gates succeeded beyond his wildest imagination, and his mission became a reality, making him at that time the world's richest person.

In the early decades of the PC revolution, Microsoft was the undisputed leader. It set the standard in the world of personal computers with its Windows operating system, on which 90% of all PCs ran. Microsoft's application software integrated seamlessly with the Windows operating system, on which other software programs either ran poorly or not at all. In addition, Microsoft bundled its application software into the Office suite. Microsoft Office became the number-one productivity software package globally. Before Office, Microsoft was not a leader in application software. Indeed, none of its standalone software (Word, Excel, PowerPoint) was a category leader. Microsoft took the number-one slot in application software only by bundling different products and selling them at a discounted price.

Setting the standard in operating systems and selling application software was highly profitable because all the cost of software is upfront in developing the first copy of a program. Each additional unit is sold almost at a pure profit because the only costs of selling the

Frank T. Rothaermel prepared this MiniCase from public sources with Duncan Siebert, who provided superb research assistance. The MiniCase is intended for class discussion; it is not intended to be used for any endorsement, source of data, or depiction of efficient or inefficient management. All opinions expressed and all errors and omissions are entirely the author's. Revised and updated: July 5, 2022.

EXHIBIT MC2.1 Microsoft vs. Nasdaq-100 Index, 1994-2022*



* Normalized change in price (Microsoft) and level (Nasdaq-100 index).

Source: Author's depiction of publicly available data.

software were packaging (discs) and retailing. The sales cost drops even further when software is downloaded digitally. Microsoft replicated this highly profitable business model with its corporate and government clients. Once computer servers became ubiquitous, Microsoft offered IT departments e-mail systems, databases, and other business applications tightly integrated with Windows. Almost all of Microsoft's revenues were directly or indirectly tied to its Windows franchise.

Microsoft's strategy of offering bundled discounted software with its operating system allowed it to create a strong strategic position and extract high profits for many years. At its zenith in 2000, Microsoft's founder and longtime CEO, Bill Gates, stepped down, and Steve Ballmer, the hard-charging salesperson and longtime Gates lieutenant, took the reigns as CEO (see Exhibit MC2.1).

Steve Ballmer — Reality Bites

Ballmer, who managed the Harvard Crimson football team when he attended college with Gates, doubled down on the Windows-centric strategy. In particular, he stopped all projects that were not directly related to the Windows franchise. With his single-minded focus on Windows, he killed advanced in-house projects that could have been category-defining, such as smartphones, tablets, cloud computing, e-book devices, and car software. The few ideas that filtered up from the many hierarchical layers that Ballmer put in place were dismissed as flights of fancy if they did not support the Windows business model.

As Microsoft became more successful, its culture became more rigid and hierarchical. After a decade of being an agile innovator, Microsoft became bloated and bureaucratic, with competition between co-workers becoming the norm. Tensions between longer-tenured Microsoft workers who had made millions when early stock options vested and new hires who failed to do so when the stock languished for many years often broke out into open arguments and resentment. Layers of more and more middle management were stacking up. At times, Ballmer was removed from front-line engineers by a dozen layers of hierarchy, and he did not allow employees to bypass their superiors.

To manage employee bloat, Ballmer was a fan of the stacked rating system, in which performance is judged relative to other team members in each team. This system meant that a fixed number of employees (e.g., the bottom 10%) would be rated as poor or below-average performers, even if they achieved their goals for the year. Many of the poor performers were let go (thus the derogative term "rank-and-yank" system). Naturally, a stacked rating system discouraged teamwork and drove high performers to shun each other. They avoided working with other talented people and even actively sabotaged each other. Politicking flourished while innovation languished.

Although Steve Ballmer was an effective manager, he was not a technology visionary. Front-line engineers and others in the tech scene saw him as out of touch. Although Microsoft continued to be profitable, its share price remained basically unchanged because its innovation machine had stalled. That is, investors expected little future growth from the company, which had succeeded in the PC revolution but missed the transition to online search and mobile computing, which started to accelerate in the 2000s.

Things started to unravel as Microsoft's success began to attract unwanted attention. As it established itself as the sole player in desktop computing software, Microsoft drew legal scrutiny from the U.S. Department of Justice. For years, Microsoft had used its monopoly position to shut out other application software providers. Things came to a head when the U.S. government sued Microsoft in an antitrust case (in 1998), alleging that it used its monopoly position to prevent others, such as the new Netscape internet browser, from competing. In particular, Microsoft required all computer makers such as Compaq, Dell, and Gateway to pre-load Microsoft's Internet Explorer on any PC with a Windows operating system (basically all of them).

After years of hostile litigation, Microsoft settled the case. It was required to pay a hefty fine (over $1.1 billion) and share its programming interfaces with non-Microsoft software developers, allowing third-party developers to create software that would run seamlessly on the Windows operating system. More importantly, Microsoft's reputation was severely damaged. Its top management team, in particular Gates, was so distracted by the lawsuit that they completely missed the impending paradigm shift to mobile and internet-enabled computing.

Satya Nadella Hits Refresh

Microsoft had to change, and it had to do so quickly. The board of directors often changes the CEO to

In 2014, alongside Bill Gates (left) and Steve Ballmer (right), Satya Nadella was introduced to employees as Microsoft's third CEO. These three are Microsoft's only chief executives since the company's founding in 1975. By setting a new strategy, Satya Nadella achieved a remarkable turnaround of a company that had struggled for over a decade. A naturalized U.S. citizen, Nadella hails from India. After training as an electrical engineer at the Manipal Institute of Technology, he emigrated to the United States in the late 1980s to pursue a master's degree in computer science at the University of Wisconsin–Milwaukee. After a short stint at Oracle, he joined Microsoft in 1992. While at Microsoft, he pursued an MBA at the University of Chicago. Before being appointed Microsoft's CEO, Nadella spearheaded several strategic initiatives, including the company's pivot toward cloud computing, which was a huge success. Once a promising cricket player, he remains an avid fan of the sport and frequently applies cricket metaphors to business.

Microsoft/ZUMA Press/Newscom

initiate a new strategy, and Satya Nadella, a longtime Microsoft employee, was appointed CEO in 2014. Nadella effectively reset the company, moving away from its aggressive Windows-centric strategy and toward cooperation within Microsoft and across companies. He focused Microsoft on cutting-edge technologies, such as mobile and cloud computing. His main concerns were ending the Windows-centric business model and ushering in the "mobile first, cloud first world," a phrase he coined in one of his first e-mails as CEO to all 130,000 employees globally.

To accomplish the envisioned transformation, Nadella put several strategic initiatives in place. First, he decreed that all of Microsoft's application software, such as the Office Suite, must be able to run not only Windows but also on Apple's iOS operating system. Second, Nadella decided to provide all comers with the newest operating system, Windows 10, free of charge. The goal was to bring as many users into the Windows fold as possible and to redeem the company from its poorly received prior Windows versions, which attempted to straddle both tablets and PCs but failed to work properly.

Thanks to these two strategic initiatives, more people were using Microsoft products. The new software was excellent and free of charge. It generated much goodwill, especially among younger users who often don't have the money to buy expensive software but need it for school and college. These moves also diminished the public perception of Microsoft as a greedy monopolist using its market power to prevent competition and extract as much money as possible from its customers, who have no choice but to buy the company's products.

Removing the focus on Windows also enabled Microsoft to seriously consider alternative products and technologies as part of its core offerings instead of giving up on innovative side projects because they might distract from Windows. This creative freedom also allowed for a more agile approach, empowering all Microsoft employees to be part of a bottom-up strategy process.

To foster creativity and collaboration, Nadella also ended the much-hated "rank-and-yank" system. Open collaboration within and across Microsoft's boundaries was essential for Nadella's ambitions because pivoting to cloud-based services requires significant creativity. Microsoft Azure is now the second-largest cloud service in the world (behind Amazon's AWS), with over $60 billion in revenue. In building a new cloud division, Nadella reset Microsoft's mission to "build tools, build platforms so that others can build more technology."[3]

Nadella was also unafraid to drop projects and initiatives that seemed unlikely to achieve success. Recognizing that Microsoft had lost the smartphone battle, he decided to drop the idea of a Windows phone, writing off almost $8 billion that his predecessor spent acquiring the struggling phone maker Nokia just a year before Nadella became CEO. Instead, Nadella redirected investments toward a line of new acquisitions in gaming, cloud, productivity, and AI. Many of these acquisitions synergize with existing Azure products, providing cloud security or productivity features and helping Microsoft create a strong product ecosystem.

Arguably the most significant changes Nadella made were in the realm of the corporate culture. Taking a gentle and compassionate tone in all his communications, Nadella emphasized collaborating with other technology firms to create products that work well across firm boundaries and learning from rivals. In addition, Nadella tackled the famously aggressive workplace environment by establishing empathy as one of Microsoft's core ethical values, asking all top executives to read a book on nonviolent communication. He also strove to cultivate a growth mindset for the company. Employees were encouraged to view challenges and problems as learning opportunities to further their skills rather than as roadblocks. A crucial step in reinforcing the new culture was putting in place a more performance-based pay system to ensure that employees feel free to collaborate and are rewarded for their efforts instead of punished for their mistakes, as in the prior system. Additionally, to make time for more holistic and growth-focused management, Nadella reduced the number of mandatory meetings and performance reviews for managers, instead requiring more time for informal face-to-face interactions and coaching sessions.

Nadella has also placed some big bets on the future of Microsoft apart from investing in cloud and mobile services. Microsoft has acquired several gaming studios in the past few years, buying industry mainstays such as Mojang, ZeniMax Media, and Blizzard Activision for $75 billion (in 2022). These seemingly distinct acquisitions connect to Microsoft's cloud and mobile-based ambitions to compete in what has become a buzzword in big-tech: the metaverse. The metaverse is a three-dimensional virtual world in which people immerse themselves in performing all sorts of activities, including shopping, socializing, and working. It is also one of the most hotly anticipated trends in technology, with Facebook recently changing its name to Meta to reflect its focus on the future.

In a space where expensive hardware such as gaming PCs or consoles is considered necessary, Microsoft is attempting to disrupt the burgeoning metaverse using cloud gaming. Cloud gaming is a technology in which consumers can stream games on most internet-connected devices, drawing the advanced computing power necessary from the cloud. This approach will severely lower the barriers to entry to the video game market and allow anyone to join as long as they have a screen or mobile device, potentially creating a much larger gaming market. Microsoft has also been trying to innovate the revenue model used for gaming. Rather than purchasing individual games and consoles, Microsoft wants gamers to sign up for its subscription-based gaming service, Game Pass, which gives them access to an extensive rotating library of games (similar to Netflix). In addition, Microsoft hopes to differentiate itself by incorporating its expertise in business-to-business by developing a corporate metaverse. Microsoft released a version of Microsoft teams that features 3D digital avatars in 2022.

Satya Nadella has restored Microsoft to its former glory, raising the market cap to an astonishing $2 trillion from around $300 billion in 2014 (see

Exhibit MC2.1). With Apple, Microsoft is now again one of the most valuable companies on the planet. Yet many challenges loom in the future. Microsoft's acquisition of Activision Blizzard has been mired in controversy because of gender-pay disparities and sexual harassment lawsuits filed against the company. Additionally, Microsoft may yet again be the subject of antitrust lawsuits due to its bundling of cloud technologies and productivity software and some less-than-competitive pricing practices it has been putting into place. Satya Nadella's strategic reset of Microsoft has resulted in almost a decade of success. However, while it is difficult to regain a competitive advantage, it is even more challenging to sustain it for long periods.

DISCUSSION QUESTIONS

1. What are the most critical roles of a strategic leader?
2. Looking at the traits that make for effective strategic leaders, how do you evaluate Steve Ballmer's and Satya Nadella's leadership? What are the strengths and weaknesses of each? Be specific.
3. Which strategic management process did Steve Ballmer put in place? Which strategic management process did Satya Nadella institute?
4. Why did Microsoft struggle starting in 2000? How can the things that make a company successful also sow the seeds of decline when the environment changes?
5. Why is new strategic leadership often needed to change strategy? What are the pros and cons of changing a CEO?
6. In his book, *Hit Refresh,* Nadella states that one of the hardest things for strategic leaders is to change corporate culture. Why do you think that is? What did Nadella do to create a culture that was supportive of his strategy?

Endnotes

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MiniCase 3

Robinhood: Democratizing Investing or Robbing Investors?

Our mission is to democratize finance for all.

Robinhood Markets, Inc. is a financial services firm best known for its commission-free stock trading app, which went live in 2015. The Robinhood app is popular with Millennials and Gen Z; it had 23 million users (in 2022). Indeed, users doubled during the Covid-19 pandemic, when people were stuck at home and flush with cash from stimulus checks. Many young people started investing using the Robinhood app. More than 50% of Robinhood users are first-time investors.

Just six days after going public in 2021, Robinhood's market valuation reached $60 billion. At the IPO, Robinhood had a mere 2,800 employees. In comparison, Goldman Sachs, one of the oldest and most prestigious investment firms, had 44,000 employees and a peak valuation of $141 billion (also in the summer of 2021). How did Robinhood accomplish such a remarkable feat?

Baiju Bhatt (left) and Vladimir Tenev, who met as undergraduate physics students, founded Robinhood Markets, Inc. (in 2013) with the mission to "democratize finance for all" and the belief that "the financial system should be built to work for everyone."[1] Robinhood went public in 2021 at a valuation of $32 billion, making the founders billionaires. Tenev is Robinhood's CEO, while Bhatt serves as chief creative officer.

Cindy Ord/Getty Images

Robinhood Disrupts the Financial Services Industry

Stock trading was traditionally a conservative, low-tech industry in which consumers had to visit, mail, or call their stockbrokers. Consumers also faced exorbitant commissions and additional fees. The first wave of disruption arrived with the internet, an external technology shock that decreased barriers to entry to the financial services industry. New entrants such as TD Ameritrade and E-Trade launched a novel business model by providing online trading for retail investors.

A *retail investor* is a non-professional who buys and sells stocks and mutual funds using a brokerage firm such as Charles Schwab, among others. In contrast, an *institutional investor* pools funds to invest on behalf of others, such as hedge funds, mutual funds, pension funds, and university endowments. While retail investors use their own money, institutional investors invest on behalf of a third party. Because they trade in large quantities, institutional investors receive preferential treatment from large financial institutions, such as research insights and lower fees. As a consequence of new brokerage firms entering the industry in the wake of the internet disruption, the financial services industry fragmented, providing lower costs, better service, and many more choices for retail investors.

To launch the second wave of disruption, Robinhood founders combined technological innovation with business model innovation. They initiated a novel approach to retail investing. In addition to commission-free trading, Robinhood introduced fractional share trading. That is, an investor can buy a small slice of a stock. For instance, fractional trading enables anyone to own a small part (say $50) of Alphabet, where one share costs more than $2,000, or Warren Buffett's firm, Berkshire Hathaway, where one share costs $400,000.

Frank T. Rothaermel prepared this MiniCase from public sources with Duncan Siebert, who provided superb research assistance. The MiniCase is intended for class discussion; it is not intended to be used for any endorsement, source of data, or depiction of efficient or inefficient management. All opinions expressed and all errors and omissions are entirely the author's. Revised and updated: July 8, 2022.

The two founders of Robinhood, Baiju Bhatt and Vladimir Tenev, who had been developing automated trading software for Wall Street before starting Robinhood, envisioned high-speed trading on smartphones with a user-friendly mobile trading app that made investing fun. Instead of relying on the traditional financial infrastructure (which is costly, clunky, and requires high-powered PCs for day traders), investors would use their smartphones to communicate with trading centers and execute trades. Using smartphones as a distributed trading platform was made possible by ever faster wireless internet connections, such as the new 5G standard, which is 100 times faster than 4G (or LTE).

Relying on smartphones also allowed Robinhood to create an appealing, visually attractive, and potentially addictive interface by hooking young users through gamification. That is, retail investing was turned into a fun, app-based game. For instance, investors would see confetti rain on their screen after their first trade. The numbers in the amounts of money displayed would click into place like the images on a slot machine. Investors also received text messages with emojis congratulating them on their transactions. In addition, Robinhood provided fun interactive tutorials that made investing less intimidating for first-time users. The Robinhood founders used these tweaks, borrowed from behavioral psychology, to encourage inexperienced investors to trade often. Why? Because the more users trade, the more money Robinhood makes.

Instead of generating revenue by charging users fees on trades and commissions, as in the business model used by existing online brokers, Tenev and Bhatt realized they could make money by selling user orders to large financial firms, so-called "payments for order flow." When a user places an order to purchase stocks in the Robinhood app, that offer is passed on to market makers. Large financial institutions such as banks are *market makers* because they are able to pool buy-and-sell orders from many clients and can offer instant transactions by providing prices for selling and buying shares. Robinhood matches the user's order to a market maker based on who offers the best price. In this sense, Robinhood is a two-sided trading platform that matches retail investors with market makers.

Next, the market maker executes the trade, earning money on the difference between its buying and selling prices for those specific stocks (called the "spread") and passing a percentage back to Robinhood. The more its millions of users trade, the more money Robinhood makes, especially from so-called *day traders*, who trade multiple times a day. A fun phone app with seamless functioning encourages more transactions, especially by young users who spend hours each day on their smartphones.

Combining technological and business-model innovations poised Robinhood to enter the financial services industry as a disruptive innovator. First, Robinhood provided a no-cost solution to an existing problem and entered the market from the bottom up. Second, Robinhood brought in a new customer segment that had been underserved by traditional retail brokers: young, first-time investors. Individually, this customers segment is a low-margin business, but having millions of people trade several times a day generates large fees earned from payments for order flow. Indeed, Robinhood earned $2 billion in revenues (in 2022), almost all from payments for order flow. Third, locking in young, first-time investors allows Robinhood to grow with them as their financial situation improves over time and their demand for additional financial services increases.

Robinhood did everything it could to target a younger audience, appealing to the zeitgeist of anti-elitist and anti-capitalist sentiments amongst Gen Zers, even though owning stock in a publicly traded company makes a person a capitalist in the purest sense. (Karl Marx based his analysis of the economic system on two key production factors where capital exploits labor.) The company tailored its business model for this particular consumer segment and even chose its name—Robinhood Markets, Inc.—to channel the popular folk hero who steals from the rich and gives to the poor.

Robinhood's emphasis on first-time investors was hypercharged by the Covid-19 pandemic. Many young people were stuck in their homes, unable to work but receiving government stimulus checks. Given the ready accessibility of Robinhood, many decided to become first-time investors. An investing frenzy was exacerbated by the bull market during the pandemic. The opportunities it provided for becoming rich quickly created FOMO (fear of missing out), driving more people to use the Robinhood app. During the pandemic lockdown, the power of individual retail investors banding together on online forums such as Reddit's WallStreetBets became apparent as they drove up meme stocks such as GameStop from a valuation of $200 million pre-pandemic to more than $12 billion (an appreciation of 6,000%) at the height of the Covid outbreak.

The confluence of technological and business model innovations with the pandemic contributed to Robinhood's enormous $60 billion stock market valuation, driving a paradigm shift in the industry. Robinhood's new model for retail investing forced other financial services firms to provide commission-free trading and user-friendly apps.

Robinhood Investors Are Robbed

One year after its successful IPO, Robinhood's market cap had dropped by 90%, to only $6 billion. What happened?

The factors contributing to Robinhood's meteoric rise also caused its downfall. This situation is called the *Icarus Paradox*, after the Greek myth in which Icarus is trapped on the island of Crete with his father, Daedalus, who is an inventor. Daedalus makes wings from wax and feathers so both can fly away. Daedalus warns his son not to fly too close to the sun, but Icarus ignores his father's sage advice. He soars through the skies and loves flying ever higher. But he flies too close to the sun and the wings melt, causing him to plummet to his death.

In a business context, the *Icarus Paradox* describes a situation in which a business fails rapidly after great success. The failure results from the very strengths that led to success in the first place.[2] Robinhood's slick, gamified user interface (UI) proved dangerous and addictive. Robinhood's mission of "helping the little guy" was fraudulent in several ways, and its business model and operations became subject to intense scrutiny in the heavily regulated financial sector.

Although Robinhood's app is intuitive and easy to use, it also provides inexperienced investors easy access to complex trading instruments such as options, other derivatives, and cryptocurrencies. Due to their volatile nature and hidden, often unlimited downside exposure, these categories can lead to enormous losses for novice investors. However, these exotic instruments are incredibly lucrative for Robinhood, generating over half of its revenues. As previously mentioned, day traders are Robinhood's most profitable users. Robinhood encourages users to trade several times a day with its slick UI, which lights up in bright green and red, constantly sending notifications and raining confetti. Researchers found that Robinhood's users traded around 40 times as much per dollar in their account compared to customers of Charles Schwab, another online brokerage firm.[3] Heavy day trading would be in keeping with Robinhood's mission if it weren't for the fact that day traders mostly underperform market averages, a fact well established in the finance literature.

The downside of gamification to encouraging heavy trading in exotic instruments by novice investors came to the fore when a 20-year-old student and Robinhood day trader committed suicide after believing he owed $730,000 in a sophisticated options trade gone sour. Alex Kearns was a student at the University of Nebraska living at home with his parents in a Chicago suburb during the pandemic. Robinhood's aggressive tactics were implicated in his suicide note, where he wrote: "How was a 20 year old with no income able to get assigned almost a million dollars worth of leverage?"[4] In reality, Kearns had several outstanding options that could have in part covered his financial obligations. But he was misled into believing that he owed almost $1 million based on the information displayed on the app combined with the complexity of these trades.

Robinhood's business model also proved to be problematic in the long run. It turned out that Robinhood did not offer the best prices for trades to consumers. Instead, it sold to market makers that paid them more. Rather than users benefitting from the improved prices gained from market makers, Robinhood and the market makers were capturing most of the value. Robinhood was found to make, on average, twice as much from every 100 shares traded as competitor Charles Schwab. This behavior later resulted in an SEC (Securities and Exchange Commission) investigation that led to Robinhood being charged a $65 million SEC fine and a $125 million FINRA (Financial Industry Regulation Authority) fine.

Additionally, despite marketing itself as a nontraditional financial services firm, Robinhood was still bound by the same strict regulations and rules that apply to more traditional stock brokerages. This situation was made clear during the GameStop stock crisis in 2021. As the GameStop stock took off ("to the moon") and superheavy trading ensued, Robinhood restricted trading of GameStop stocks due to the inability to meet collateral requirements under financial regulation. The inability to trade drew the ire of Robinhood users and the public. It also led to accusations of market manipulation because one of Robinhood's most significant sources of profit, the market maker Citadel, had heavily shorted GameStop stock (that is, selling it by betting that the stock price would fall). Several lawsuits against Robinhood were initiated by investors claiming they lost out on GameStop's meteoric rise.

These factors, along with app outages and negligent security measures that resulted in data breaches, eroded consumers' trust in Robinhood. It also appears that Robinhood peaked during the pandemic because user growth in 2022 was flat. In addition, its users traded much less than they did during the height of the pandemic. And, because payment for order flow is illegal in Canada and the United Kingdom and strictly regulated in Europe, there are few places for Robinhood to expand. The SEC in the United States is also considering stricter regulation for payments of order flow, which would create severe problems for Robinhood's business model.

Robinhood's stagnating user numbers also result from the wide availability of substitutes in the financial services market. As mentioned, other brokerage firms have changed their business model to zero-commission as well. The rapid imitation of Robinhood's innovations meant that the startup could not protect its temporary competitive advantage. In addition, on a macro level, economic conditions have changed dramatically, with the United States experiencing the highest inflation in 40 years and the onset of a global recession (in 2022). The stock market had the worst first six months in decades, with the tech-heavy Nasdaq, on which Robinhood trades, dropping by more than 30%.

Despite these challenges, Robinhood is attempting to move forward. It is focusing on cryptocurrency and moving toward 24/7 availability of trading to generate more revenue from day traders, its primary revenue source. Robinhood aims to build crypto and NFT (non-fungible token) wallets to draw in more crypto and NFT enthusiasts, who generate a disproportionate amount of Robinhood's revenue. It is also focusing on features that appeal to more mainstream investors, such as a stock lending program in which users can lend out stocks in their portfolio to financial institutions, thereby generating interest, and offering a debit rewards card. Robinhood is doubling down on its vital money makers and neglecting the thorny issues that turned off regular investors. While the future is uncertain, many see Robinhood, with its low market cap, as a takeover target.

DISCUSSION QUESTIONS

1. Have you used the Robinhood trading app? If so, what is your experience? If not, why not? Would you consider using it? Explain.
2. Delineate the PESTEL factors that supported Robinhood's rise. How did the startup match its strategy to take advantage of the opportunities in the PESTEL environment? Identify and discuss relevant PESTEL factors and their effect on Robinhood's strategy.
3. Although Robinhood was quite innovative, it could not sustain its competitive advantage. How did the PESTEL factors change over time to impact Robinhood negatively? Identify and discuss relevant PESTEL factors and their effect on Robinhood's competitive position.
4. What does the rapid and successful imitation of Robinhood's differentiating features (such as zero-commission trades and slick mobile apps) tell you about the competitive intensity in the financial services industry?
5. Disruptors, especially technologically advanced disruptors, often face legal or political challenges. What are some ways they can overcome these challenges?
6. The financial industry is one of the most heavily regulated industries. Do you think regulation hinders competition or encourages corporate responsibility? Explain.

Endnotes

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MiniCase 4

Dr. Dre's Core Competency: Coolness Factor

Andre Young—also known as Dr. Dre—became the first hip-hop billionaire after Apple acquired Beats Electronics for $3 billion (in 2014). Dr. Dre has a long track record as a successful music producer, rapper, and entrepreneur. Known for his strong work ethic, he expects nothing less than perfection from the people he works with. He shares some of the personality traits ascribed to the late Steve Jobs, co-founder and long-time CEO of Apple.

As an entrepreneur, Dr. Dre created and sold several successful music record labels. He also co-founded Beats Electronics with Jimmy Iovine, a record and film producer who is also an entrepreneur. Founded in 2008, Beats Electronics is best known for its premium consumer headphones, Beats by Dr. Dre, which Dr. Dre claims allow listeners to hear all the music. Since 2014, the company has been offering Beats Music, a streaming subscription service. With its headphones and streaming service, Beats strives to "bring the energy, emotion, and excitement of playback in the recording studio to the listening experience and introduce an entirely new generation to the possibilities of premium sound entertainment."[1] However, many acoustics experts maintain that playback of digitally compressed MP3 audio files is inferior to high fidelity. Also, the sound quality of Beats headphones is considered poor compared to that of other premium-brand headphones such as Bose, JBL, and Sennheiser.

Why, then, would Apple pay $3 billion to acquire Beats Electronics—its largest acquisition to date? Three main reasons: First, Apple hopes that some of Beats' coolness will spill over to its brand, which has become somewhat stale. Second, although Apple is the world's largest music vendor with over 1 billion iTunes accounts, the music industry faced a second wave of disruption (streaming) after first moving from analog (CDs) to digital files. Third, Apple needs a new creative and cultural figurehead, a role that Steve Jobs played masterfully.

Erica Muhl (dean of the USC Roski School of Art and Design), Dr. Dre, Jimmy Iovine, and Carol Folt (president of the University of Southern California) [from left to right], at the ribbon cutting (in 2019) for the Iovine and Young Academy of Arts, Technology, and the Business of Innovation at the University of Southern California. The two entrepreneurs endowed the Academy with a $70 million gift. Among other degrees, the Academy offers a Bachelor of Science in Arts, Technology, and the Business of Innovation; a Master of Science in Integrated Design, Business, and Technology; and a Master of Science in Product Innovation. Classes are held at the Iovine and Young Hall, a large, state-of-the-art building featuring many personal items from Iovine and Dr. Dre, representing their unique approach to innovation and educational vision.

Beats' Coolness Factor

Beats by Dr. Dre achieved an unprecedented coolness factor with celebrity endorsements from music icons and athletes, actors, and other stars. Before Beats, no musician endorsed audio headphones like a basketball player such as Michael Jordan endorsed his Nike shoes, Air Jordans. Dr. Dre was the first legendary music producer to popularize premium headphones. In addition, he created custom Beats for stars such as Justin Bieber, Lady Gaga, and Nicki Minaj. Other music celebrities, including Skrillex, Lil Wayne, and will.i.am, endorsed

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Tennis champion Naomi Osaka endorses Beats as a spokesperson for the company.
Tiziana Fabi/AFP/Getty Images

Beats by wearing them in their music videos and at live events and mentioning them on social media. But Beats did not stop at musicians. Famous athletes—including basketball superstar LeBron James, tennis champion Serena Williams, and soccer star Cristiano Ronaldo—wear Beats by Dr. Dre in public and endorse the brand in advertisements.

In the "coolness space," Apple faces an innovative rival in music streaming service Tidal, founded by rapper and entrepreneur Jay-Z and others. Tidal is innovative because it introduced several novel and differentiating features. First, Tidal is owned by the artists, who get to keep all the profits. When artists sign with a record label (often owned by large media companies), the record label extracts the majority of profits while artists receive a smaller percentage as royalties. In addition to Jay-Z, the founders of Tidal included the top names in pop music: Jason Aldean, Beyoncé, J. Cole, deadmau5, Arcade Fire, Calvin Harris, Alicia Keys, Chris Martin, Madonna, Nicki Minaj, Daft Punk, Rihanna, Kanye West, Jack White, and Usher. Tidal has exclusive release contracts with these and other superstar artists. As a second innovation, Tidal was the first music streaming service to offer high-fidelity audio.

To rev up growth, Tidal needed more cash. It sold one-third of the company to Sprint (in 2017), a telecommunications service provider, which in turn was merged into T-Mobile (in 2020). In 2021, the payments company Square (now Block) acquired a majority stake in Tidal for $300 million. Tidal is growing fast, although from a small base. Between 2016 and 2022, the number of paid subscribers more than doubled to 7 million.

Disruption in Content Delivery

During a time of rampant piracy, Apple saved the music industry by unbundling albums and offering legal downloads for 99 cents per song. After disrupting the music industry with the launch of iTunes (in 2003), Apple found its service being disrupted by leaders in the music streaming industry, such as Spotify. In the second wave of disruption, music and video delivery has shifted from ownership of digital files via downloads to streaming on demand. Consequently, purchasing music downloads has declined rapidly while subscription services have taken off.

To address the disruptive threat of content streaming, Apple created iTunes Radio (in 2013), its first music streaming initiative. However, iTunes Radio did not gain traction until Apple bought Beats Music. This acquisition turned Apple into a powerful player again—this time in the music streaming space. In 2015, just a year after the Beats acquisition, Apple launched its new streaming service, Apple Music. The strategic intent is to make Apple Music a cultural platform that is a one-stop shop for pop culture. In 2022, Apple Music had over 100 million paid subscribers, up from zero when Apple launched the service in the wake of the Beats acquisition. Spotify, the leader in music streaming, has about 200 million paid subscribers.

The Front Man

Although many observers are convinced that Apple purchased Beats Electronics for its brand's coolness factor and to gain a stronger position in the content streaming business, others suggest that what Apple bought are the talents that Beats' co-founders, Jimmy Iovine and Dr. Dre, bring to the table. They are two of the best-connected businesspeople in the music industry, with personal networks spanning hundreds and comprising both famous and up-and-coming artists.

Since the premature death of Steve Jobs, Apple's visionary leader, the company has lacked the inspired personality it needs to remain a cultural icon. Critics argue that Apple needs someone with a creative vision combined with a wide-reaching industry network and the ability to close a deal, especially in music, where the personalities of celebrities are known to be idiosyncratic. In music jargon, Apple needs a "front man." With the acquisition of Beats, it got two of the most creative talents in the music industry, with long and successful track records and profound and far-reaching networks.

Although Jimmy Iovine left Apple (in 2018), Dr. Dre remains in a creative role at Apple. Dr. Dre's work at Apple was supposed to expand beyond music to video content. Apple was producing an original series titled *Vital Signs,* based on the life of Dr. Dre. The idea was to benefit from economies of scope by creating original video content for its fledgling streaming service Apple TV+ while featuring Apple Music. Apple TV+, with a mere 25 million paid subscribers, is not even in the same league as Disney+ (165 million) and Netflix (225 million).

Apple TV+ is struggling because its content library is tiny, a deficit Dr. Dre was supposed to help by creating original content. In 2015, Dr. Dre co-produced *Straight Outta Compton,* a biographical music crime drama, which generated over $200 million at the box office and had an estimated budget between $28 and $50 million. However, the *Vital Signs* endeavor failed. Apple's CEO Tim Cook canceled the show because it featured gratuitous sex, drawn guns, and people doing lines of cocaine. Tim Cook is adamant that Apple must retain its pristine reputation. Dr. Dre's creative role has been reduced since Tim Cook shut down *Vital Signs.*

In the meantime, Apple still struggles to move beyond hardware. Its services (including Apple Music, Apple TV+, iCloud, and Wallet) bring in only about 20% of its total revenues (in 2022). Continued breakthrough innovation to produce category-defining products is hard. And Apple's challenges in generating breakthrough product innovations have further increased since Jony Ive, Apple's design chief, left the company in 2019. Ive worked closely with Jobs for almost 30 years to design the most iconic Apple products, from the Mac to the iPhone. The iPhone, one of the most significant consumer product innovations since the turn of the century, is more than 15 years old and has become a commodity, given successful imitations by Samsung and Google's line of Pixel phones.

DISCUSSION QUESTIONS

1. Which music streaming service do you use, if any? Why are you using this particular service and not others? Are you a paid subscriber? Why or why not?
2. This MiniCase argues that Beats Electronics' core competency lies in its marketing savvy and Dr. Dre's coolness. Do you agree with this assessment? Why or why not?
3. This MiniCase provides three explanations for why Apple purchased Beats Electronics. Briefly summarize each of them. Which do you believe is most accurate, and why?
4. Suppose you believe Apple bought Beats Electronics to bring Jimmy Iovine and Dr. Dre into Apple. What are the potential downsides of this multibillion-dollar "acqui-hire" (an acquisition to hire key personnel)?
5. If Beats Electronics' core competencies are indeed intangibles, such as coolness and marketing savvy, do you think these competencies will remain valuable under Apple's ownership? Why or why not?

Endnote

1 "People aren't hearing all the music," *Beats By Dre*, www.beatsbydre.com/aboutus.

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MiniCase 5

Sustaining Shared Value: The Rise and Fall of Toms Shoes

"I always thought that I would spend the first half of my life making money so I can spend the second half of my life giving it all away. And one of the defining moments of my life was when I realized that I could do both at the same time with Toms."[1]

—Blake Mycoskie, Founder of Toms Shoes

Growing up with the goal of becoming a professional tennis player, Blake Mycoskie attended Southern Methodist University as a recruit for the NCAA Division I men's tennis team. During his first year, Blake injured his Achilles tendon. As a result, he had to wear a cast for several months and couldn't play tennis. He also couldn't do his laundry because he could only move around on crutches and the laundry facilities were in the basement of this dorm. Having inherited his nose for entrepreneurial opportunities from his mother, who wrote and self-published a best-selling nutrition book, Blake noticed a need he could solve through a business idea—offering laundry services on campus for students who did not want to do their laundry. The business took off and expanded to several campuses. With the loss of his ability to play competitive tennis and the laundry business taking off, Blake dropped out of school.

Realizing his talent for starting new ventures to solve problems, Blake went on to sell the laundry business and created two more startups before the age of 24: a billboard advertising business featuring country music stars and their new album releases and an online driver's ed school. Blake's businesses were successful, and he didn't need to work for a living after selling them. He planned to kick back and enjoy leisure time. But a vacation to Argentina changed all that.

Frank T. Rothaermel prepared this MiniCase from public sources for class discussion. It is not intended to be used for any endorsement, source of data, or depiction of efficient or inefficient management. All opinions expressed and all errors and omissions are entirely the author's. Revised and updated: August 15, 2022.

This photo shows Toms founder Blake Mycoskie on a giving trip. He prefers the title of Chief Shoe-Giver over Chief Executive Officer (CEO). With Toms, Blake popularized the one-for-one business model, which has become a staple for many purpose-driven companies. Socially conscious consumers prefer to patronize companies that match their values.

TOMS Shoes, LLC

Shoeless in Argentina

Blake decided to learn how to play polo and signed up for a camp near Buenos Aires, Argentina's capital. While there, he chanced upon a charitable group organizing a shoe drive. The concept of volunteer charity work was entirely new to Blake. He was struck by the abject poverty just a few miles away from the affluent areas in the big cities. Not having shoes prevented underprivileged children from attending school. After delivering shoes to children in need, Blake wrote in his journal that he had never been happier in his life, seeing how the eyes of the children lit up and how happy they were to receive a pair of shoes.

Blake's entrepreneurial mind shifted into overdrive when he realized that a lack of shoes was a significant problem for many children, even in the relatively developed nation of Argentina. He immediately understood that charity shoe drives, despite being noble efforts, were unsustainable. Charity shoe donations are one-off actions that are not scalable and thus do not make a significant enough difference in solving the underlying problem. Seeing an entrepreneurial opportunity, Mycoskie decided to start Toms.[2] This company would tie the consistent need for shoes in economically challenged countries to consumer demand in rich countries. At the same time, Blake was intrigued by the Alpargata, an everyday linen shoe that is environmentally friendly and super popular with Argentines.

Interestingly, Blake viewed his earlier three ventures (laundry service, advertising, and driver's ed) as *real* businesses, but he initially saw Toms as his *project.* He is a social entrepreneur, and he believes that companies are much better at providing for societal needs than governments or charities. Blake founded Toms (in 2006) as a for-profit company to provide children in less developed countries with shoes. A social entrepreneurship venture such as Toms uses the profit motive to solve social, cultural, and environmental problems.

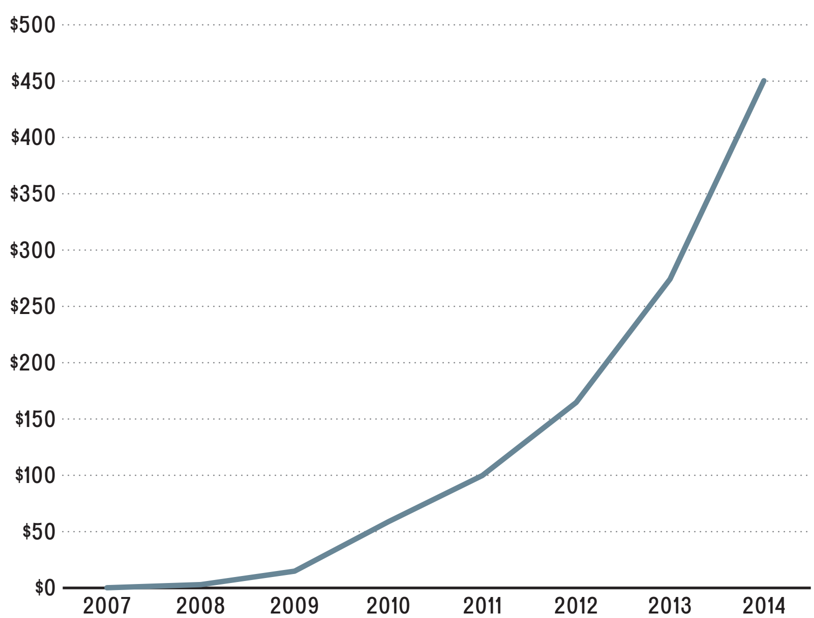
The One-for-One Business Model

Blake's big idea is the invention of the "one-for-one" business model, in which a consumer buys a product, such as pair of shoes, and another product is given away to someone in need. Toms' initial mission was to give a pair of shoes to a child in need for every pair of shoes purchased. The Alpargata shoe and Toms' appealing one-for-one model propelled the company forward, creating a massive buzz in the United States, especially among more socially concerned younger customers.

Combining capitalism with a focus on helping needy children, Toms was hailed as a pioneer in creating shared value (CSV). That is, the company's value creation was focused on economic and societal benefits from the beginning. Rather than adding philanthropy as an afterthought, which often comes across as a non-authentic public-relations exercise, companies that follow the CSV approach think about how to create shared value as an integral part of the firm's competitive strategy from the start, as informed by a purpose-driven mission. In the case of Toms, the purpose-driven mission was "to use business to improve lives."[3]

Blake started to manufacture Alpargata shoes locally in Argentina and imported them to the United States. Through some lucky circumstances, Toms was featured in the *LA Times* and then in *Vogue*. This exposure supercharged demand for Toms shoes. It also struck an emotional cord with consumers, who felt good about buying Toms shoes because they knew their consumer choice was helping underprivileged people. Toms became the fastest-growing shoe company in the world. Annual revenues grew by a compound annual growth rate (CAGR) of nearly 200%, from $300,000 during the startup's first year (in 2007) to $450 million by 2014. That same year, Blake Mycoskie sold half of the company to a private equity firm and stepped down as Toms' CEO. Exhibit MC5.1 shows Toms' annual revenues during the initial ramp-up phase.

EXHIBIT MC5.1 Toms' Annual Revenues During the Ramp-Up Phase (in $ millions)



Source: Author's depiction of publicly available data.

Indeed, Toms was so successful that it reached a valuation of $625 million (in 2014). However, a few years later (in 2019), Toms had fallen on hard times and was taken over by its creditors to stave off bankruptcy as loans of more than $300 million were due. What went wrong with the darling of social entrepreneurship?

What Went Wrong?

Matching Demand with Supply. Toms' first set of problems emerged because of super-fast growth. Indeed, the stylish Alpargata shoe, combined with the appeal of the one-for-one business model, was so popular that Toms could not meet demand. A related issue was that Toms could not give away shoes as fast as they were selling them.

Rather than building a direct-to-consumer (DTC) relationship with customers via its website, Toms relied heavily on the wholesale model to sell its shoes. Consequently, Toms was beholden to large and powerful retailers such as Target and Nordstrom, which were able to dictate sales terms. In addition, Toms did not have any influence over how its shoes were priced for end consumers. And, lacking the detailed customer information that an online store provides, Toms could not build a personalized relationship with its customers.

However, the biggest problem for Toms during the first few years was making the shoes. The company did not have adequate production facilities to match demand, and the quality of the shoes was also lacking. Initially, the Alpagarta shoes that Toms imported to the United States were made in a cottage industry.[4] In addition, Blake was interested in helping people but disdained "corporate" supply chain and operations management. He hired a team of professional managers to help overcome production bottlenecks and quality issues. Soon, he clashed with the leadership team, leaving Toms (in 2012).

The Hero Product Becomes Stale. The Alpargata shoe was so popular that it turned into a hero product. In marketing, a *hero product* is a category-defining brand such as the iPhone. Successful hero products attract imitators. Not long after Toms introduced the Alpargata shoe to American consumers, competitors such as Skechers launched their line of look-alike shoes. And Skechers topped Toms by giving away two pairs of shoes for each pair sold.

On top of consumers viewing Toms as synonymous with the Alpargata shoe, another problem was that the shoe itself was a fashion item. Fashion items can quickly become stale. Celebrities and social influencers always look for the next cool thing to set them apart from the masses. Toms refreshed its product line too late, and the hero product became yesterday's fashion item. A lack of focus on product improvements and new shoe models was compounded by the distraction that Tom's new lines of business (sunglasses and coffee roasting) presented.

The One-for-One Company. After a year away from Toms, Blake returned with new ideas for expanding the business. Consumers viewed Toms as the Alpargata shoe company with a social mission. In contrast, Blake viewed Toms not as a shoe company but as the inventor of the one-for-one business model. His goal was to apply the buy-one, give-one model to as many opportunities as possible to help alleviate suffering worldwide. He decided that Toms should make sunglasses and donate eyeglasses and sight-restoring medical treatments for each pair of glasses sold. In addition, he decided to launch Toms Roasting, a coffee brand. For every purchase from Toms Roasting, the company would donate a week's worth of clean water to those in need. Both initiatives flopped.

Although the one-for-one business model was easy to comprehend with shoes, it was not so obvious for the other initiatives, which did not have such a simple but powerful message: buy one, give one away (of the same product). Making the leap from sunglasses to eye surgery, and from coffee roasting to clean drinking water, was more challenging for consumers to comprehend.

Criticisms of the One-for-One Business Model. Not long after all of the media hype that Toms received, criticisms of the one-for-one business model grew louder. Questions like "Is Toms hurting local footwear industries in nations where it donated?" and "Did Toms donations make a difference in the lives of recipients?" were posed. Rigorous studies provided evidence that a one-for-one business model might damage the local manufacturing industry. And most disturbing, the donations fostered a dependence mindset in the recipients, reinforcing the idea that outsiders should take care of their needs. Some critics conclude from these research findings that the one-for-one business model is more harmful than helpful for local economies. Other cynics submit that the buy-one, give-one business model is merely a public relations ploy that makes consumers in rich countries feel good by making them think that they help alleviate poverty.

Creating Shared Value vs. Corporate Social Responsibility

When creditors took over Toms, the company abandoned its iconic one-for-one business model. In response to the public criticism and research findings, Toms jettisoned the buy-one, give-one business model in favor of donating a third of company profits to specific social causes. Although creating shared value was foundational to launching Toms, the company could not sustain its commitment to CSV. Ultimately, Toms pivoted from CSV to corporate social responsibility (CSR). Economic value creation is foundational to CSR. From the CSR perspective, a company commits to philanthropy *after* achieving a competitive advantage.

Toms' lasting impact has been pioneering the one-for-one business model. The buy-one, give-one business has become popular with other purpose-driven ventures such as Warby Parker (see MiniCase 6), Better World Books (new and used books to enhance global literacy), and Bombas (a comfort-focused sock and apparel brand).

DISCUSSION QUESTIONS

1. Have you bought any products from Toms? Why did you choose Toms over alternatives?
2. The one-for-one model worked for Toms shoes because consumers could visualize a tangible impact and build a connection with the product and the company. What are some other products or services you think would be viable for the one-for-one model? Explain.
3. This MiniCase details how Toms struggled to gain and sustain a competitive advantage. Why did Toms fail to do so? Do you think the one-for-one model can maintain a competitive advantage over the long term? Why or why not?
4. To turn around the failing company, Toms' new leadership pivoted from creating shared value (CSV) to corporate social responsibility (CSR). Is this a wise choice? Why or why not?
5. Compare and contrast the CSR and the CSV approach. In which situations would one method be preferable to the other? Explain.

Endnotes

1. Blake Mycoskie Quotes. BrainyQuote.com, https://www.brainyquote.com/quotes/blake_mycoskie_532012

2. The name derived from the initial idea of "Shoes for Tomorrow," which morphed into "Tomorrow's Shoes" and was then abbreviated to Toms to fit on a small brand label attached to each pair of shoes.

3. See Toms website: https://www.Toms.com/us/impact.html

4. A cottage industry is composed of small businesses that are run from someone's home, and often involve some handcrafting, such as knitting or pottery.

Sources: Meyer, A. (2021, Jun. 18), "How Toms tweaked its mission without losing its power," *Inc.com;* Kim, I.A. (2020, Dec. 27), "How Toms went from a $625 million company to being taken over by its creditors," *Business Insider*; accompanying video "The rise and fall of Toms" [10:05 min] https://www.youtube.com/watch?v=gbWj33Ej3rA; Yerak, B. (2019, Dec. 29), "Toms shoes gets new owners in out-of-court debt restructuring," *The Wall Street Journal;* NPR (2017, May 29), "Toms: Blake Mycoskie," How I Built This podcast with Guy Raz; Mycoskie, B. (2016, Jan.-Feb.) "The founder of Toms on reimagining the company's mission," *Harvard Business Review*; Wydick, B., E. Katz, F. Calvo, F. Gutierrez, and B. Jane (2016, Sep.), "Shoeing the children: The impact of the Toms shoe donation program in rural El Salvador," *World Bank Group, Policy Research Working Paper 7822;* "Free two shoes," *The Economist* (2016, Nov. 5); Kurutz, S. (2015, Nov. 13), "For brands like Toms, it's all about the experience," *The New York Times;* "Hard-nosed compassion," *The Economist* (2015, Sep. 24); "Putting the boot in development," *The Economist* (2014, Oct. 27); Joyner, A. (2014, Apr. 7), "Beyond buy-one-give-one retail," *The New Yorker*; Strom, S. (2014, Mar. 11), "Turning coffee into water to expand business model," *The New York Times*; Newman, A.A. (2013, Nov. 4), "'Buy one, give one' spirit imbues an online store," *The New York Times;* Oloffson, K. (2010, Sep. 30), "In Toms' shoes: Start-ups copy 'one-for-one' model," *The Wall Street Journal;* and Binkley, C. (2010, Apr. 1), "Charity gives shoe brand extra shine," *The Wall Street Journal.*

MiniCase 6

Warby Parker's Blue Ocean Strategy

"[While traveling] I lost my only pair of glasses, I left them on a plane. I came back to the U.S. as a full-time student and I needed to buy two things, one was a new pair of glasses and one was a phone. The iPhone 3G had just come out ... and I bought my first iPhone for $200, it was this magical device ... and I realized I have to pay $700 for a new pair of glasses, and the math just didn't compute to me."

—Dave Gilboa, co-founder of Warby Parker and co-CEO[1]

Returning from a six-month backpacking trip, Dave Gilboa left his eyeglasses on an airplane. Just about to enter Wharton's MBA program (in the fall of 2008), he needed new glasses. Gilboa was shocked to discover that the price to replace his glasses was several times what he had just paid for (at the time) the latest and greatest iPhone. Unwilling to fork over several hundred dollars for prescription eyeglasses, he decided to attend grad school without them. But he told everyone who would listen how shocked he was that the price of prescription glasses was several times the price of an iPhone. He could not fathom why eyeglasses, an 800-year-old technology that hadn't changed much over time, were priced many times higher than the most advanced technology gadgets.

Dave's experience resonated with three classmates: Neil Blumenthal, Andrew Hunt, and Jeffrey Raider. All four of them had experienced sticker shock when needing eyeglasses. They researched how a simple, low-tech product could be so expensive. What they found astonished them even more: Just one company—Luxottica—controls 80% of the market! Luxottica is now even larger after it merged with Essilor (in 2018).

A French-Italian conglomerate, EssilorLuxottica is vertically integrated from product design to marketing and sales of prescription eyeglasses, sunglasses, and contact lenses. It owns retail stores across the world. LensCrafters, Pearle Vision, SunglassHut, and Target Optical are some of its best-known stores in the United States. It also owns the most common eyewear brands, including Ray-Ban, Oakley, Michael Kors, and many others. It has favorable licensing agreements with the fashion labels that lend their logos to EssilorLuxottica's eyeglass frames, such as Armani, Chanel, Coach, Dolce & Gabbana (D&G), Gucci, Polo Ralph Lauren, Prada, and Versace. In addition, EssilorLuxottica owns EyeMed, an insurance company that many customers use to pay for their vision products. In 2021, EssilorLuxottica had a stock market valuation exceeding $100 billion with $24 billion in revenues. Its monopoly position explains why it sells its prescription eyeglasses with a 1,000% margin. That is, the $700 pair of eyeglasses that Dave Gilboa initially bought cost the company no more than $64.[2]

A Business Plan and the Founding Team

In an entrepreneurship class, Gilboa, Blumenthal, Hunt, and Raider wrote a business plan to disrupt the eyewear market. Their goal was to drastically reduce prices while still providing excellent customer service. Each of the budding entrepreneurs had a unique skill set that contributed to this potent new-venture team:

- Neil Blumenthal had worked as a director for VisionSpring for five years before attending Wharton's MBA program. VisionSpring is a nonprofit organization with the goal of providing "affordable, quality glasses to the 2.5 billion people worldwide who need them."[3] To accomplish its mission, VisionSpring manufactures eyeglasses for communities in need. Neil oversaw projects in Bangladesh, Honduras, El Salvador, and elsewhere. When he visited eyeglass frame and lens manufacturers, he learned that the big companies, including Luxottica, were using the same production lines as VisionSpring. The difference was that the nonprofit

Frank T. Rothaermel prepared this MiniCase from public sources with Veronica Bian, who provided superb research assistance. The MiniCase is intended for class discussion; it is not intended to be used for any endorsement, source of data, or depiction of efficient or inefficient management. All opinions expressed and all errors and omissions are entirely the author's. Revised and updated: July 28, 2022.

VisionSpring paid $6 for the eyeglasses and donated them to people in need, while for-profit companies retailed the same glasses from the same production line and sold them for $600 in the United States and Europe. Neil also gained a deep understanding of the industry and the value chain from raw materials through design, manufacturing, distribution, and meeting the custom needs of different eyewear users. Blumenthal is co-CEO of Warby Parker.

- Both of Dave Gilboa's parents were doctors. From an early age, they had instilled in him the idea that helping others is a noble professional calling. Indeed, he too had planned to become a medical doctor. He studied bioengineering as an undergraduate, took the MCAT (medical school admission test), and worked in the health care industry. Gilboa is co-CEO of Warby Parker.
- Andrew Hunt's deep interest is ecommerce. Although available in 2008, it was still in its infancy. He wondered why there were no websites that sold eyeglasses. After co-founding Warby Parker and completing his MBA, Andrew returned to the venture capital industry.
- Jeffrey Raider is a serial entrepreneur. His skill is setting up direct-to-consumer (DTC) businesses. After co-founding Warby Parker, he founded Harry's, using a DTC business model to disrupt the wet shaving industry. In 2019, Harry's was acquired by Edgewell, the owner of the Schick brand of shaving products, for $1.4 billion.

LAUNCHING WARBY PARKER. In 2010, during the second year of their MBA program, the four students founded Warby Parker. Although their initial idea was to reduce the exorbitantly high price of eyeglasses, they also wanted to create a fashion brand. They planned to pursue a blue ocean strategy by creating more value for customers by providing eyeglasses as fashion items at a low cost.

A *blue ocean strategy* is a business-level strategy that successfully combines differentiation and cost-leadership activities using *value innovation* to reconcile the inherent trade-offs in those two distinct strategic positions. *Blue oceans* denote untapped market space, the creation of additional demand, and the resulting opportunities for highly profitable growth. To implement its vision, the Warby Parker team needed a strategy that would lower costs *and* increase perceived customer value.

Lowering Costs The Warby Parker founders already knew that industry consolidation was to blame for the high price of eyewear. As they dove deeper into their

Warby Parker co-founders and co-CEOs Neil Blumenthal (left) and Dave Gilboa ring the opening bell on the New York Stock Exchange (NYSE). On September 29, 2021, Warby Parker made its stock market debut with a valuation of $6 billion. The company's mission is to inspire and impact the world with vision, purpose, and style. In addition to a cutting-edge ecommerce site, the company has som e 200 retail stores and employs over 3,000 people. Having a social impact is one of the company's goals. Through its Buy a Pair, Give a Pair program, Warby Parker has distributed over 10 million pairs of eyeglasses to people in need.

Richard Drew/AP Images

research, they also learned that price was not the only consumer pain point. A person buying eyeglasses had to go through the hassle of going to the local optics store, picking frame styles from the limited selection available at the store, and wearing the same pair of glasses for a few years before replacing them. The entire process of acquiring glasses was so inefficient that Warby Parker's founders set out to create a unique end-to-end solution for eyeglass wearers. The team's novel approach to meeting consumers' needs for eye care was to put in place a business model that would cut the cost of acquiring eyeglasses to a fraction of current prices while increasing convenience for the consumer.

The team's first decision was to launch Warby Parker using a DTC business model via the internet. The founders looked at Zappos, the online shoe retailer, for inspiration. Warby Parker started online only and copied Zappos' excellent customer service with free shipping both ways, which was novel at the time. But they also learned that Zappos had a return rate of 40%, which Warby Parker could not afford because eyeglasses are custom-made, and if they are returned the company loses the entire cost of the product. In response, they developed their try-at-home program, in which they send five frames for the customer to choose from, with free shipping both ways. Warby Parker adds the bespoke prescription lenses and ships only after a customer selects and pays for a frame.

Warby Parker successfully drove down costs by implementing a DTC business model, effectively eliminating the need for bricks-and-mortar stores where consumers traditionally tried on glasses. The company's focus on ecommerce allowed it to save on rental and staff costs and pass those savings on to consumers. In addition, Warby Parker introduced a simple, unified pricing strategy, with frames, including prescription lenses, starting at $95, a price drastically lower than that offered by competing companies.

The timing of the Warby Parker launch in 2010 was critical to its ability to gain traction in the marketplace. As a result of the global financial crisis, the United States was in a deep recession. Consumers were looking for lower-cost alternatives to fashionable items. Many DTC businesses were thriving during this period of austerity. Once the website went live, the demand for Warby Parker eyeglasses surprised even the founders. The company hit its first year's sales targets in three weeks and sold out its top 15 styles in four weeks. The founders did not have any more capital to buy and store more inventory because they had bootstrapped the company, using only their savings of $130,000.

Increasing Perceived Customer Value The founders of Warby Parker did not want their company to be considered merely a discounter, selling glasses online. Instead, they wanted Warby Parker to be a fashion brand equated with everyday chic, quality, and customer service. To communicate the fashion brand's aspirations, they needed an appropriate name. They came up with the regal-sounding Warby Parker, a combination of two Jack Kerouac characters' names. (Jack Kerouac was an American writer of fiction and poetry. His best-known work is *On the Road.*)

Warby Parker invested some of its meager resources in public relations to enhance its stylish appeal. It hired a fashion publicist who helped sell the idea of Warby Parker as a desirable brand. The company's efforts to target premier fashion editors to cover its brand paid off when both *GQ* (the leading men's magazine) and *Vogue* (the premier fashion and lifestyle magazine) released articles featuring Warby Parker shortly before the company launched its website.

Upon the company's launch, Warby Parker's founders were ecstatic to find that its business struck a chord with many. But they had to figure out how to process their waitlist of 20,000 customers. Not wanting to disappoint its first customers and potentially ruin its brand image, Warby Parker focused on prioritizing customer service. The four founders reached out to everyone on the waitlist, apologizing to customers who'd had bad experiences and even giving them free glasses and discounts. The company was in the business of doing good, and treating customers fairly was a core tenet.

Warby Parker was founded with the mission *to inspire and impact the world with vision, purpose, and style.* The founders highlighted that bringing down the cost of designer eyewear from $600 to $95 is a social good, but they went even further. Warby Parker creates shared value with its *Buy a Pair, Give a Pair* program, in which it gives a free pair of eyeglasses to someone in need for every pair sold. The company had this program in place from day one and has distributed over 10 million pairs of free glasses to help alleviate the problem of impaired vision, which keeps many—especially the world's most underprivileged—from achieving their potential. Warby Parker took its social mission a step further when, in 2021, it converted its legal structure to a public-benefit corporation (B Corporation). While a publicly traded company has a fiduciary duty to focus on shareholders, a B Corp is legally bound to balance all its stakeholders' interests. Strategic leaders of a B Corp focus on ESG dimensions of environmental, social, and governance (transparency and accountability) standards in their pursuit of balancing profits with purpose.

Warby Parker's social mission is fundamental to what the company stands for. The founding team is pursuing a stakeholder strategy, balancing the interests of customers, employees, communities, the environment, and shareholders. Each business decision is evaluated through the prism of how it affects all stakeholders. The founders firmly believe that creating shareholder value and stakeholder strategy are not mutually exclusive, but rather that doing good results in the company doing well. They state that Warby Parker's first focus is making its customers happy by providing a superior product at a lower price and with excellent customer service. To keep customers happy, they need to hire the best and the brightest. Today that means those who want to work for a company with a social mission like Warby Parker's.

Warby Parker's corporate strategy of vertical integration helped further enhance the company's value for customers. Vertical integration allows a company to achieve better quality control, to be more agile, and to respond faster to changing fashion trends. By owning the production of necessary inputs, such as designing its eyewear in-house, Warby Parker significantly reduces the lead time for new models. With high-quality, fashionable glasses delivered at incredible speed, customers feel like they are constantly on the cutting edge of consumer trends. Warby Parker effectively transformed eyeglasses into a fashion item, allowing consumers to own multiple eye frames and wear them for various occasions, not unlike other accessories such as handbags, watches, or jewelry. Warby Parker has become a lifestyle brand. To increase its offerings beyond prescription eyewear and sunglasses, the company also launched its Scout line of contact lenses. Following the discount model, a three-month supply of contact lenses is priced at $110.

In addition to backward vertical integration into the design of eyeglass frames and fitting them with prescription lenses, Warby Parker also integrated forward by opening physical retail outlets. Since then, the company has focused on its omnichannel approach, combining its online presence with retail stores. The company has about 200 retail locations in the United States and Canada and is planning to open more physical locations for customers to go in and try on frames in front of full-length mirrors or to return online orders. Although Warby Parker started as an ecommerce company, today about one-half of its business is done in its physical retail stores. The company's co-CEOs want to transform Warby Parker retail outlets into full-service eye clinics. Every store will have staff optometrists who can provide eye examinations and write prescriptions. The company designs its stores to embody its brand, promote awareness, and serve its customers efficiently, giving customers the complete Warby Parker experience.

STRONG START, BUT STRUGGLING TO GAIN A COMPETITIVE ADVANTAGE. The goal of strategy is to gain and sustain a competitive advantage. Warby Parker had a strong start. It went public in 2021, valuing the company at $6 billion. That value had risen to almost $7 billion a few weeks later. However, although beloved by its customers, Warby Parker has been struggling. It is still a tiny player in the overall market, with just a 1% market share. In addition, the company continues to lose money. In 2021, it lost $144 million on $541 million in revenues, up from a loss of $56 million on revenues of $400 million in 2020. As the company's losses widened, Warby Parker's stock has consistently underperformed broad market indices such as the Nasdaq-100 (an index of non-financial companies) or the overall market by a wide margin. By the summer of 2022, Warby Parker's stock market valuation had dropped by 80% from its peak to $1.4 billion.

DISCUSSION QUESTIONS

1. Do you have any experience with Warby Parker (either through the free try-at-home program or visiting a store)? Why or why not? If you have used Warby Parker, describe your experience.
2. The four co-founders launched Warby Parker using a blue ocean strategy. Apply the *eliminate-reduce-raise-create framework* (discussed in Chapter 6) to identify and explain how Warby Parker is using value innovation to lower costs while increasing perceived consumer benefits. Which of these factors do you consider most important, and why? Is it the individual success factors that matter, or is it their combination? Explain.
3. Warby Parker generated a lot of customer excitement based on its pursuit of a blue ocean strategy. Focusing on value innovation, its plan was to drive up perceived customer value while reducing costs. Yet Warby Parker struggles to gain a competitive advantage. Indeed, the company is losing money, and its losses are increasing over time. Are these losses just part of the start-up phase, and will the company become profitable once it can lock in more customers? Or is it the difficulty of reconciling the trade-offs in a blue ocean strategy that has caused the company's inferior financial performance (to date)?
4. If Warby Parker can gain a competitive advantage, do you think the company can sustain it? Given the resources of giant conglomerates such as EssilorLuxottica, what prevents them from studying and copying some of Warby Parker's key success factors?

Endnotes

1. Dave Gilboa (2021, Feb. 21), "Warby Parker," The Founder Hour Podcast, https://bit.ly/3vdAfBY.
2. The formula is: margin = profit / (unit cost × 100%)
3. VisionSpring, About us, https://visionspring.org/about-us/our-story.

Sources: Kostov, N. (2022, Jul. 1), "Billionaire Ray-Ban owner Leonardo del Vecchio dies at 87," *The Wall Street Journal;* Scott, C.L. (2022, Mar. 17), "Warby Parker, launched as an online disrupter, now bets big on bricks and mortar," *The Wall Street Journal;* Ovide, S. (2021, Sep. 30), "Warby Parker and the spirit of invention," *The New York Times;* Hirsch, L. (2021, Sep. 29), "With sales soaring, Warby Parker prepares for its market debut," *The New York Times; The Wall Street Journal* (2021, Sep. 22), "The economics of Warby Parker: why it sees physical retail as key to growth," WSJ video [7:15 min], available at https://on.wsj.com/3PYAg4w; *The Economist* (Sep. 11, 2021), "Direct-to-consumer retailers try to bring pizzazz to dull goods"; Chin, K. (2021, Aug. 24), "Warby Parker plans to go public via direct listing," *The Wall Street Journal;* Scott, C.L. (2021, May 29), "Warby Parker founders explain why they are adding 35 stores after pandemic," *The Wall Street Journal;* The Founder Podcast (2021, Feb. 8), "Dave Gilboa: Warby Parker," [71 min], available at https://bit.ly/3zEx0pr; Ingrassia, L. (2020, Jan. 23), "They changed the way you buy your basics," *The New York Times;* Foster, T. (2018, May), "Over 400 startups are trying to become the next Warby Parker. Inside the wild race to overthrow every consumer category," *Inc.*; How I Built This Podcast with Guy Raz (2018, Feb. 19), "Warby Parker: Dave Gilboa & Neil Blumenthal," [32 min], available at https://n.pr/3oC3URr; Pressler, J. (2013, Aug. 9), "20/30 vision," *The New York Magazine;* Warby Parker Impact Report (multiple years), and Warby Parker Annual Report 2021.

Mini**Case** 7

Platform Strategy: How PayPal Solved the Chicken-or-Egg Problem

Long before Venmo and Apple Pay, PayPal disrupted the stodgy banking system by developing a seamless online payment system that allowed anyone with a credit card to use their e-mail address to exchange money. A first mover in the peer-to-peer payments space, PayPal remains a leader, with some 500 million active customer accounts and a growing number of transactions per account. With many people homebound, its users roughly doubled during the Covid-19 pandemic. PayPal is available in 200 countries/regions and supports 25 currencies. Users can send and receive payments quickly over international borders without worrying about filling out endless banking forms, paying an exorbitant wire fee, or dealing with language barriers.

One of the biggest impediments PayPal had to overcome when launching its digital payments platform was the infamous chicken-or-egg problem. Generating network effects is critical to the success of any two-sided platform. *Network effects* refer to the positive impact that one user of a product or service has on the value of that product or service for other users. In the business world, positive network effects are captured by the metaphor of the *flywheel,* where small initial wins build on each other, often in an exponential fashion, gaining so much momentum that they drive further growth almost effortlessly. When network effects are present, the product or service's value increases with the number of users. When more sellers use PayPal, more buyers will want to use it (and vice versa).

Positive network effects are attractive and relatively easy to comprehend. However, initiating network effects is super hard. The chicken-or-egg problem is especially pronounced when it comes to new payment systems. Without sellers of products and services willing to accept the new form of payment, buyers won't use the new service. At the same time, buyers have no incentive to sign up for the new digital payment service if sellers won't invest the necessary time and resources to join the platform. This situation results in the thorny issue of how to successfully launch a new payments platform when you have no starting base and each side is dependent on the other to join.

At first glance, this problem might seem unsolvable. But through a series of smart strategic moves, PayPal not only solved it but also leveraged network effects to stimulate more demand and become increasingly successful. Its first step was to make the sign-up process more straightforward. The simplicity of using just an e-mail address and a credit card to sign up was a significant differentiator between PayPal and previous online payment systems, which often required several rounds of verification and a tedious setup process. By making the initial joining process easy, PayPal was able to attract a good number of buyers, but not quite enough to start attracting sellers to use PayPal to facilitate online transactions.

PayPal's next big challenge was to grow its user base. Company leaders attempted various methods, including advertising and business development deals with banks, but to no avail. They finally realized that organic, viral growth was the most effective way to build a user base for their platform. To accomplish this growth, they started giving away "free money." New customers received \$10 for signing up, and existing customers received \$10 for referrals (\$17 in today's money, inflation-adjusted). This new incentive-driven approach led to exponential growth, significantly increasing PayPal's customer base by up to 10% daily.

The ingenuity of this tactic lies not only in incentivizing sign-ups but also retaining users. This move effectively guaranteed user participation on the platform—if only to spend the \$10 they had been gifted. The key takeaway for the PayPal team was: Simply getting people to sign up was not enough. The importance of customer retention

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far exceeded that of customer acquisition. PayPal's strategic leaders knew that giving away free money to attract more users was not sustainable if the new customers did not use their new PayPal accounts frequently.

The explosive growth from the "free money" tactic led to the creation of numerous positive feedback loops. The more users experienced the convenience of online payment methods and cashless transactions, the more they expected sellers to have this payment method available for online shopping. As a result, more sellers signed up and displayed the PayPal logo on their websites, which helped to spread the word about PayPal further and led to more user sign-ups. PayPal also rolled out a referral fee for sellers to attract even more buyers and sellers.

PayPal's success thus far was partly due to its ability to leverage network effects to drive demand. Increased demand for its services, in turn, spawned the viral growth needed to jumpstart the platform and initiate network effects. To increase the positive network effects, the leadership team focused its efforts on eBay, a natural niche for the online payments platform because most sellers on eBay are average folks who are not set up to accept credit cards or other forms of online payments.

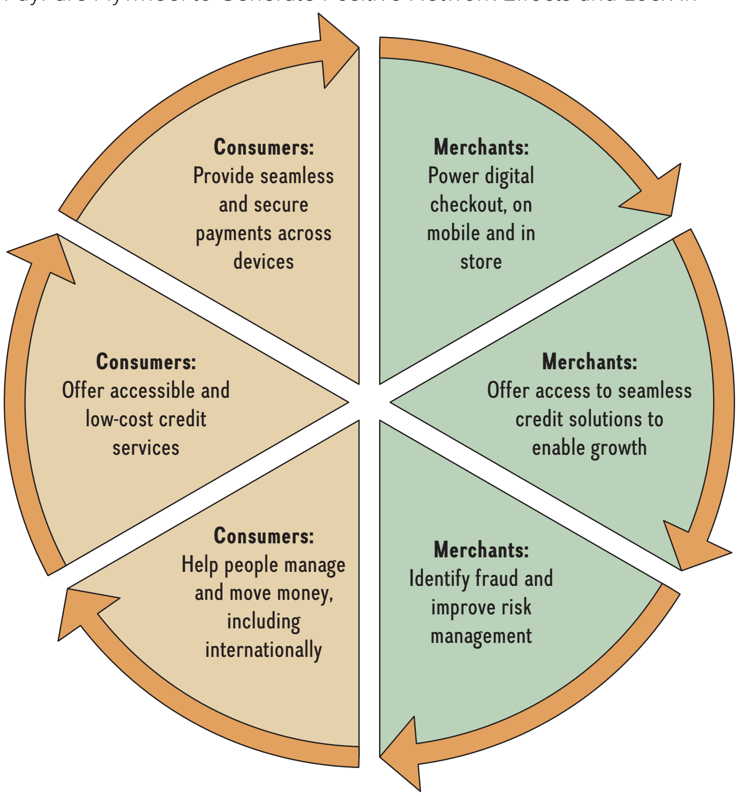
PayPal simulated consumer demand on eBay by creating a bot to buy goods and then insisting on using PayPal to pay for the merchandise. This apparent growth in demand led more eBay sellers to sign up for PayPal's service, which led to more people using PayPal to pay for goods (thus initiating yet another positive feedback loop). The bot then turned around and resold the goods on eBay, insisting that buyers use PayPal. The bot buy-and-sell method was so effective that within three months, PayPal's user base grew from 100,000 to 1 million. Seeing how effective PayPal was in facilitating ecommerce and how popular it had become, eBay acquired PayPal for $1.4 billion (in 2002), a mere two years after its founding. In 2015, eBay spun out PayPal to create a standalone payments company. PayPal has since outperformed eBay by a wide margin.

PayPal continues to innovate by finding more ways to initiate positive feedback loops. As such, PayPal acquired Venmo in 2012. Venmo, a seamless mobile payment service emphasizing social sharing, was initially launched to provide users with the ability to split bills. About 90% of Venmo transactions are shared within a social context, a coveted feature from a merchant's point of view. Identifying the merchant in the subject line of the payment becomes free advertising for that merchant. With ever-present social media, viral advertising is not only free advertising but also one of the most potent ways of getting a brand out there (replacing the old "word-of-mouth" method). Embedding transactions within social networking triggers another positive feedback loop as more merchants begin providing "Pay with Venmo" as an option on their website and in stores, which leads to more users signing up for Venmo. With some 100 million active users, Venmo has become a ubiquitous payment method and is particularly popular with Gen Zers.

PayPal's ability to generate and manage positive network effects has been critical in producing user value and allowing PayPal to gain and sustain a competitive advantage over other online payment platforms. But PayPal does not stand still. Its current focus is on having users transact more often rather than bringing in new users, who might sign up only for the initial incentives. The return on investment is higher for existing users who transact more frequently on the platform than the ROI on bringing in additional users. Exhibit MC7.1 shows PayPal's current flywheel and how it is creating

EXHIBIT MC7.1

PayPal's Flywheel to Generate Positive Network Effects and Lock-In



Source: Author's adaptation from PayPal Holdings, Inc. 2021 Annual Report.

value for both consumers and merchants, thereby *locking in* users (i.e., creating barriers to switching to a competitor by increasing costs in time and money to do so) and inducing more frequent use of the payments app.

DISCUSSION QUESTIONS

1. Why was PayPal successful while other online payment services failed?
2. Why are positive network effects so crucial to the success of platform strategy?
3. Why is it so difficult to initiate positive network effects?
4. How did PayPal overcome the thorny chicken-or-egg problem?

Sources: Soni, J. (2022), *The Founders: The Story of PayPal and the Entrepreneurs Who Shaped Silicon Valley* (New York: Simon & Schuster); Collins, J. (2019), *Turning the Flywheel: A Monograph to Accompany Good to Great* (New York: Random House); Paul, K. (2018, Feb. 19), "PayPal's vision for the future of mobile payments," *Wall Street Journal*; Parker, G.G., M.W. Van Alstyne, and S.P. Choudary (2016), *Platform Revolution: How Networked Markets Are Transforming the Economy–and How to Make Them Work for You* (New York: W.W. Norton & Company); PayPal Holdings, Inc. annual reports (multiple years), and https://www.paypal.com/al/webapps/mpp/country-worldwide.

MiniCase 8

GE: Corporate Strategy Gone Wrong

At its peak, General Electric (GE) was one of the largest and most admired companies in the United States. With its light bulbs, ovens, refrigerators, plane engines, and medical devices, GE touched the lives of every American. Today, the company is a shadow of its former self, broken up into three parts: aviation, health care, and energy. Two of them (health care and energy) will be spun out as independent companies, while the venerable GE (likely from 2024 on) will be active in only one business: aviation. This is the story of how bad strategy felled GE—the bluest of blue-chip companies in the United States.

From Jack Welch to Larry Culp, 2000–2022

In 2000, GE was the most valuable company globally, with a market capitalization of almost $600 billion, equivalent to $1 trillion today (see Exhibit MC8.1). An investment of $100 in GE on April 22, 1981, the day Jack Welch took over as CEO, would have been worth $10,679 on August 28, 2000, when GE's market value peaked. Given his success in making GE the most valuable company globally, the media hailed Jack Welch as the best CEO of the century. And investors loved Jack Welch.

Jack Welch was a hard-charging CEO who felt that GE was hampered by inefficient bureaucracy. To address this problem, Welch eliminated some 100,000 jobs during his tenure as CEO, which earned him the nickname "Neutron Jack"—After a neutron bomb is dropped, buildings and machinery remain, but the people are gone. Welch also championed outsourcing and required each of GE's businesses to be either number one or number two in its market. If it was not, he told his leaders to "fix it, close it, or sell it."[1] Moreover, all GE managers were required to provide a stacked ranking of their employees; each year, the bottom 10% were fired.

Jack Welch's success ushered in the heyday of stakeholder capitalism, with many companies imitating his no-nonsense, hard-hitting approach and his laser focus on financial results and the company's stock market valuation. Many executives who were overlooked for more senior positions at GE left the company to become CEOs of some of the best-known Fortune 100 companies. Trained under Welch, they used the GE playbook to manage then-leading companies such as Boeing, Chrysler, and The Home Depot, often with disastrous results. Fast forward to spring 2022, when GE's market valuation had dropped to $70 billion. GE had lost a whopping $530 billion, or almost 90% of its entire valuation. What happened? Answer: A bad corporate strategy!

GE's Corporate Strategy

GE is a conglomerate active in a variety of businesses. Strategic leaders formulate corporate strategy to decide where to compete as a multi-business enterprise along the three dimensions:[2]

1. *Vertical integration:* In what stages of the industry value chain should the company participate?
2. *Diversification*: What range of products and services should the company offer?
3. *Geographic scope*: Where should the company compete in regional, national, or international markets?

GE, founded in 1892, is known as a maker of home appliances, power turbines, locomotive engines, jet engines, MRI machines, and TV shows (including *Seinfeld*). In terms of corporate strategy, GE was pursuing unrelated diversification: Nuclear power plants, light bulbs, and TV shows have little in common. By 2001, when Jack Welch stepped down as CEO, GE Capital accounted for roughly 50% of all revenues and profits. By that point, Welch had transformed what was once an industrial conglomerate into an unregulated bank.

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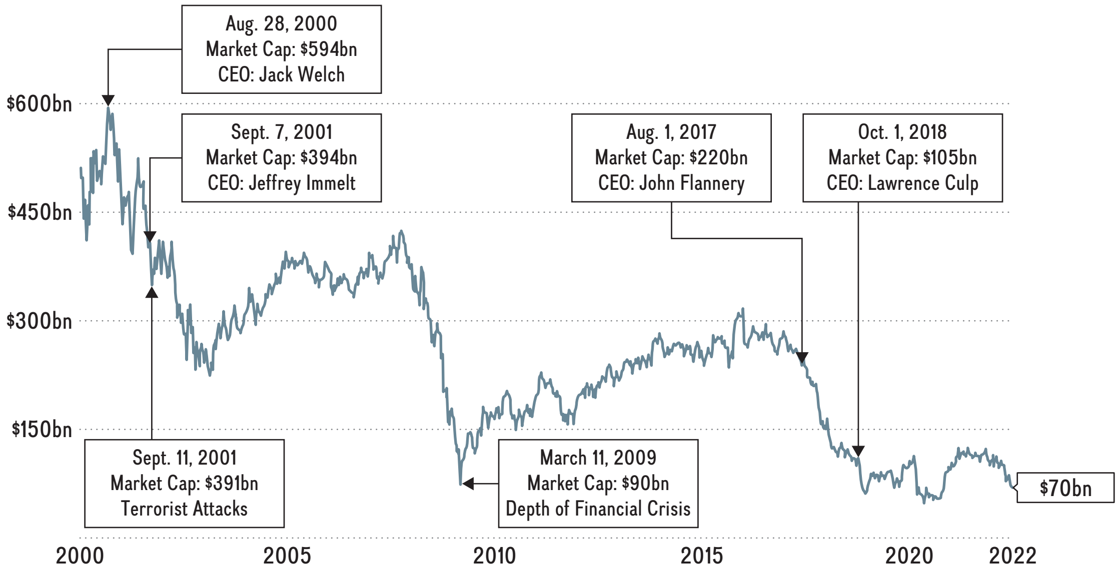
EXHIBIT MC8.1 General Electric's Market Cap and Key Events, 2000–2022

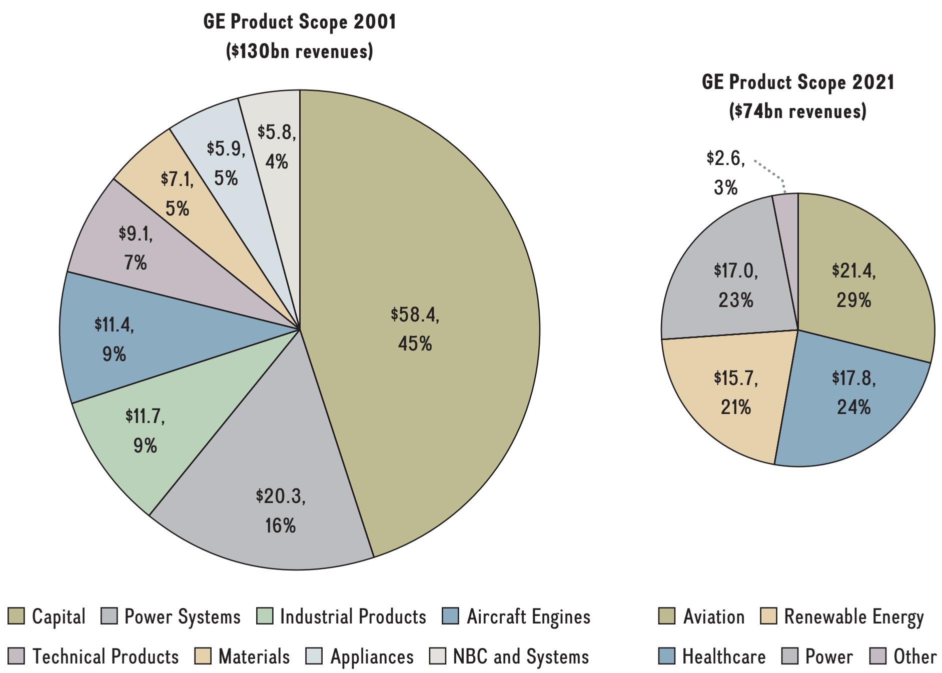


Source: Author's depiction of publicly available data.

Exhibit MC8.2 depicts GE's product scope in 2001 (the last year of Welch's 20-year tenure) and 2021.

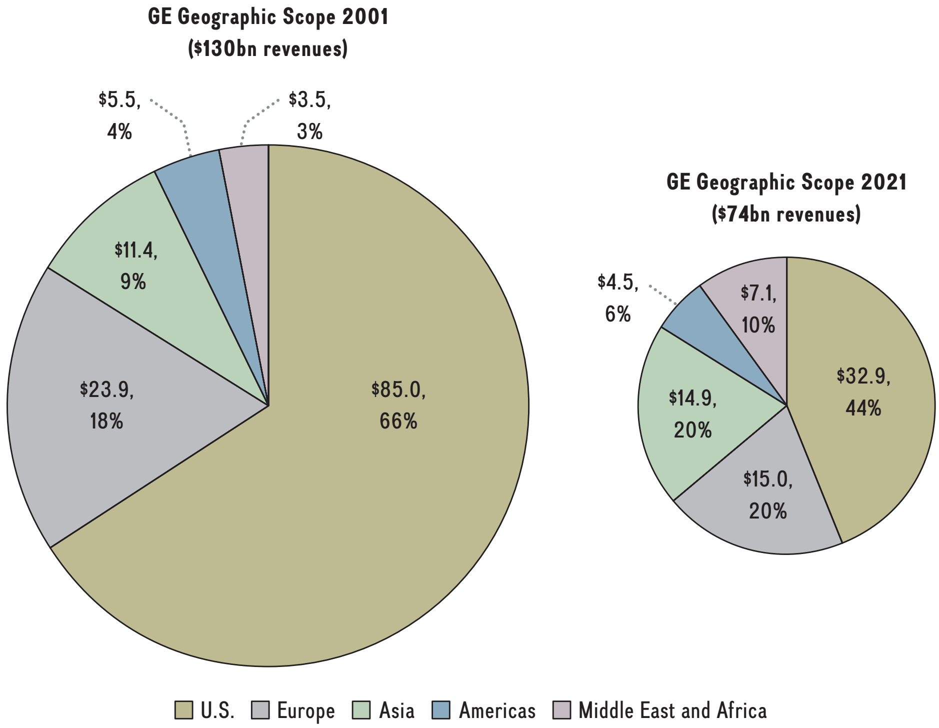
Under Jack Welch, GE's success was driven by its hugely profitable GE Capital unit, which provided discounted financing to each of GE's businesses. GE's AAA credit rating allowed it to access capital at a lower cost than rivals. Although it was highly profitable for many years, GE Capital ultimately became the

EXHIBIT MC8.2 GE's Product Scope, 2001 and 2021*



* Pie segments show revenues in billions of dollars and as a percentage of total revenues (rounded).
Source: Author's depiction of publicly available data.

EXHIBIT MC8.3 GE's Geographic Scope, 2001 and 2021*



* Pie segments show revenues in billions of dollars and as a percentage of total revenues (rounded).
Source: Author's depiction of publicly available data.

conglomerate's fundamental weakness. GE Capital created huge exposure to macroeconomic forces for what, at its core, was an industrial company co-founded by Thomas Edison, the famous American inventor and entrepreneur.

Another point of exposure for GE was that, under Jack Welch, GE was a domestic-focused company, with two-thirds of its revenues coming from its home market (see Exhibit MC8.3 for GE's geographic scope). During the 2000s the focus on the U.S. market prevented GE from taking advantage of the significant global growth opportunities resulting from rapid growth in the emerging BRIC economies (Brazil, Russia, India, and China).

Jeffrey Immelt became CEO of GE on September 7, 2001 (see Exhibit MC8.1). Over the past two decades, the external environment has been shaped by several black swan events: the social and economic effects of the 9/11 terrorist attacks, then the 2008–2009 global financial crisis followed by the Covid-19 pandemic and Russia's invasion of Ukraine (in 2022). Incidentally, 2001 was also the year that China joined the World Trade Organization (WTO). China's resulting tremendous economic growth transformed the world's most populous country from a poor nation into the second-largest economy, after the United States.

Although GE is a diversified conglomerate that spans many industries and markets, the recession in 2001 and the even deeper recession of 2008–2009 hit the company especially hard. One reason was the financial blow that GE Capital took because more than half of GE's profits came from that unit. In a critical 17 months, GE's share price fell 84%, from $42.12 (on October 2, 2007) to a low of $6.66 (on March 5, 2009), equating to a loss in shareholder value of $378 billion (see Exhibit MC8.1).

To make matters worse, GE also lost its AAA credit rating, and the company had to ask for a $15 billion liquidity injection from famed investor Warren Buffett to stay afloat. The U.S. government had to bail out GE as the Federal Reserve stepped in to ensure continued liquidity for one of the largest banks in the United States, which GE had de facto become. Indeed, during the global financial crisis, the Federal Reserve had designated GE as one of the few "systemically important financial institutions (SIFIs)," which meant that its failure could trigger a financial crisis ("too big to fail"). With the SIFI designation for GE came additional federal regulation and oversight, limiting executives' freedom to make decisions. Once GE lost its AAA credit rating, it also lost favorable access to debt funding, which had once provided a competitive edge over other engineering companies such as Siemens. The 2008 financial crisis demonstrated the risk of selling and financing its products, a practice at the core of how GE did business. For example, GE would build power plants in emerging economies and simultaneously provide discounted financing through GE Capital to its customers in the emerging economies that built the power plants.

Conglomerates such as GE that pursue unrelated diversification tend to experience a *diversification discount*: The stock price of such highly diversified firms is valued at less than the sum of their individual business units. GE experienced a significant diversification discount, as its capital unit contributed about half of all profits for many years. The presence of a diversification discount depressed GE's stock price. Then CEO Jeffrey Immelt decided to *spin out* GE Capital (in 2015).[3] On the day of the spin-out announcement, GE's stock price jumped 11%, adding some $28 billion to GE's market capitalization and highlighting the magnitude of GE's diversification discount (see Exhibit MC8.1).

The need for corporate restructuring was clear to then-CEO Jeffrey Immelt. By 2009, GE's five business units (Technology Infrastructure, Energy Infrastructure, Capital Finance, Consumer and Industrial, and NBC Universal) brought in $157 billion in annual revenues. By then, more than 50% of those revenues came from outside the United States, and GE employed more than 300,000 people in over 100 countries. Immelt decided to refocus GE's portfolio of businesses to reduce its exposure to capital markets and to achieve reliable and sustainable future growth by leveraging its core competency in industrial engineering. Due to the strategic pivot, GE sold NBC Universal to Comcast, the largest U.S. cable operator; it also sold its century-old appliance unit to Haier, a Chinese manufacturer. As mentioned, in 2015 GE also sold GE Capital.

Jeffrey Immelt used the cash injection from the sale of GE Capital to double down on the power business by acquiring the ailing French engineering group Alstom for a deal valued at $17 billion (in 2015). After the restructuring under Immelt, GE focused more on industrial products and engineering, with aviation, power, oil and gas, and health care as its four largest units. In addition, Immelt discontinued some of Welch's management philosophies, which had fallen out of favor and caused low morale among GE employees. Immelt's restructuring efforts were too little, too late. Immelt had 16 years to turn around GE and failed.

In 2017, the board of GE replaced the haphazard Jeffrey Immelt with John Flannery, a GE insider of 30 years and leader of the health care unit (see Exhibit MC8.1). After only one year on the job, CEO Flannery was fired by the board because he was too indecisive. Flannery focused more on analysis and consensus building in endless meetings rather than on the drastic actions that they felt were needed to right GE. As a low point and a further blow to the already low morale of GE employees, in 2018 GE was dropped from the Dow Jones Industrial Average (DJIA) and replaced by Walgreens. GE had been part of the DJIA, the most widely cited stock index representing America's 30 most prestigious companies, since 1907.

In 2018, GE's board of directors appointed Lawrence "Larry" Culp as the new CEO. He previously led Danaher Corporation, a globally diversified conglomerate, albeit much smaller than GE. Notably, Culp is GE's first outside CEO in its 126-year history. To GE "lifers" such as Welch, Immelt, and Flannery, the appointment of an outsider as CEO of GE came as a complete shock because, in their minds, GE produced the world's best managers who could run any business better than anyone else. Indeed, some executives who did not ascend to the CEO job at GE left the company and became CEOs of some of the most significant American enterprises. Also noteworthy is the fact that GE's board of directors included a seat held by the activist investor Trian Fund, run by billionaire Nelson Peltz, who wanted to shake things up at GE.

At the time of Culp's appointment as CEO, GE was continuing to lose money. After the Alstom acquisition, GE's power unit was its second-largest strategic business, but its revenues had fallen over 20% by the end of that year. In the third quarter of 2018, GE posted a loss of $34 billion! GE had too much debt and too little cash flow. The diagnosis was that Jeffrey Immelt overpaid on several high-profile acquisitions (such as Alstom or the oilfield services company Baker Hughes for $32 billion) while selling some of the GE units that were spun off for too little.

By 2022, GE had also become somewhat less diversified in its geographic scope, with the United States accounting for 44% of annual sales, and Europe and Asia each accounting for about 20% of revenues. Its product scope had shrunk to four business units:

aviation, health care, power, and renewables (see Exhibits MC8.2 and MC8.3). After refocusing its product scope, GE announced that it would focus on three distinct entities: aviation, health care, and energy (combining renewables and power). Despite two decades of restructuring, GE still lags far behind in performance compared to its rivals, Honeywell and Siemens.

The once-mighty industrial conglomerate announced plans to spin out health care (in 2023) and energy (in 2024) into separate publicly traded companies. The remaining GE will be shrunk to just one unit: aviation. In the aviation business, GE focuses on making and servicing jet engines. In 2021, aviation's revenues stood at $21 billion, a far cry from the $250 billion (inflation-adjusted) revenues at GE's peak in 2008.

DISCUSSION QUESTIONS

1. What kind of diversification was GE pursuing? What are the sources of value creation with this type of diversification?
2. Discuss changes in GE's product and geographic scope (depicted in Exhibits MC8.2 and MC8.3). Describe the most important trends. What stands out to you?
3. Why has GE lost a whopping $530 billion or almost 90% of its valuation since its peak? What went wrong?
4. Looking at the diversification-performance relationship (depicted in Exhibit 8.13 in Chapter 8), why was GE able to buck this trend for a long time before economic realities caught up with it?
5. After leaving GE, Jeffrey Immelt stated (in 2018), "The notion of plugging financial services and industrial companies together, maybe it was a good idea at a point in time, but it is a uniquely bad idea now."[4] To what is Immelt referring? Why does he think this is a bad idea? Do you agree? Why or why not?
6. In the bestseller *Good to Great,* Jim Collins advances the hypothesis that the greatness of a leader is known only after the leader has left the company. The business press has celebrated Jack Welch as the greatest CEO of the last century. After reading this MiniCase, do you agree with Collins' strategic leadership hypothesis? Why or why not? Note: When interviewed in 2018 about the GE situation, Jack Welch had this to say: "I give myself an A for the operation of GE, but an F for my choice of successor."[5]

Endnotes

1. As quoted in: Gryta, T., and T. Mann (2018, Dec. 15), "GE powered the American century–then it burned out," *The Wall Street Journal*.

2. For the discussion of GE's corporate strategy, we will focus on diversification (product scope) and geographic scope (where to compete).

3. A spinout describes the separation (sale) of a division (strategic business unit) to form a new, standalone corporation. The new company takes with it the employees, plants, operations, and other assets and liabilities. As a standalone company, the spinout allows it to make its own strategic decision without inference from the conglomerate headquarters, including raising its capital through debt or equity on a stock exchange.

4. As quoted in: Gryta, T., and T. Mann (2018, Dec. 15), "GE powered the American century–then it burned out," *The Wall Street Journal*.

5. As quoted in: Gryta, T., and T. Mann (2018, Dec. 15), "GE powered the American century–then it burned out," *The Wall Street Journal*.

Sources: Gelles, D. (2022), *The Man Who Broke Capitalism: How Jack Welch Gutted the Heartland and Crushed the Soul of Corporate America–and How to Undo His Legacy* (New York: Simon & Schuster); Gryta, T. (2021, Nov. 9), "General Electric to split into three public companies," *The Wall Street Journal;* Gryta, T., and T. Mann (2020), *Lights Out: Pride, Delusion, and the Fall of General Electric* (New York: Mariner); Gryta, T., and T. Mann (2018, Dec. 15), "GE powered the American century–then it burned out," *The Wall Street Journal;* "General Electric powers downwards," *The Economist* (2018, Nov. 3); Gryta, T., J.S. Lublin, and D. Benoit (2018, Feb. 21), "How Jeffrey Immelt's 'success theater' masked the rot at GE," *The Wall Street Journal;* Collins, J. (2001). *Good to Great: Why Some Companies Make the Leap and Others Don't* (New York: Harper Business); and GE annual reports (various years).

MiniCase 9

LVMH Acquires Tiffany: The American Jeweler Learns How to Speak French

In 2020, LVMH acquired Tiffany for $16 billion, the largest takeover in the industry. With little or no growth for a decade, Tiffany had fallen on hard times. Why did the American jeweler struggle? Why did LVMH acquire Tiffany? And how will the merger impact a company that is an American cultural icon?

Tiffany Feeling Blue

Tiffany & Co. is the quintessential American jeweler, best known for its iconic blue box and romantic engagement rings. It has been a mainstay in American culture for almost 200 years. Before the LVMH acquisition, Tiffany focused on providing affordable luxury for many Americans, including gifts for baby births, weddings, and graduations. Engagement rings, wedding bands, and other jewelry are among its most popular items. For instance, entry-level sterling silver pieces, such as the Elsa Peretti heart necklaces that are priced less than $300, are beloved by generations of teenagers. Tiffany's reputation is one of understated, classic elegance.

Since key scenes of the 1961 movie *Breakfast at Tiffany's* were shot at Tiffany's Fifth Avenue flagship store in New York City, it has become a magnet for window shoppers and tourists, who often wait in long lines to enter the store. Tiffany certainly provided an unparalleled in-store shopping experience for customers looking to be part of an aspirational brand. Indeed, Tiffany's 330 retail outlets are the primary source of its revenues, generating almost 95% of its sales. Compared to other jewelers, Tiffany's online presence is underdeveloped. Moreover, Tiffany's business is heavily concentrated in its home market, where it earns roughly 45% of its revenues, compared with 15% in Japan, 30% in the rest of Asia, and 10% in Europe. Tiffany's sales were $4 billion in 2019, its last year as an independent company.

Resting on past laurels, Tiffany stopped innovating and changing with the times. Its iconic brand had become stale and associated with an older generation. Professional Millennials and Gen Zers do not consider Tiffany a place where they want to shop for luxury items. They believe high-tech gadgets such as an Apple Watch, the latest iPhone, or fashion items such as a Supreme hoodie are much more desirable than a diamond ring. Others prefer a Tesla vehicle over bling.

With almost all of its sales concentrated in retail stores and focused on the U.S. market, Tiffany had huge exposure to external events. So, in due course, the Covid-19 pandemic hit Tiffany much harder than other competitors in the luxury business. Tiffany's sales plunged as its stores closed for extended periods and international travel was suspended.

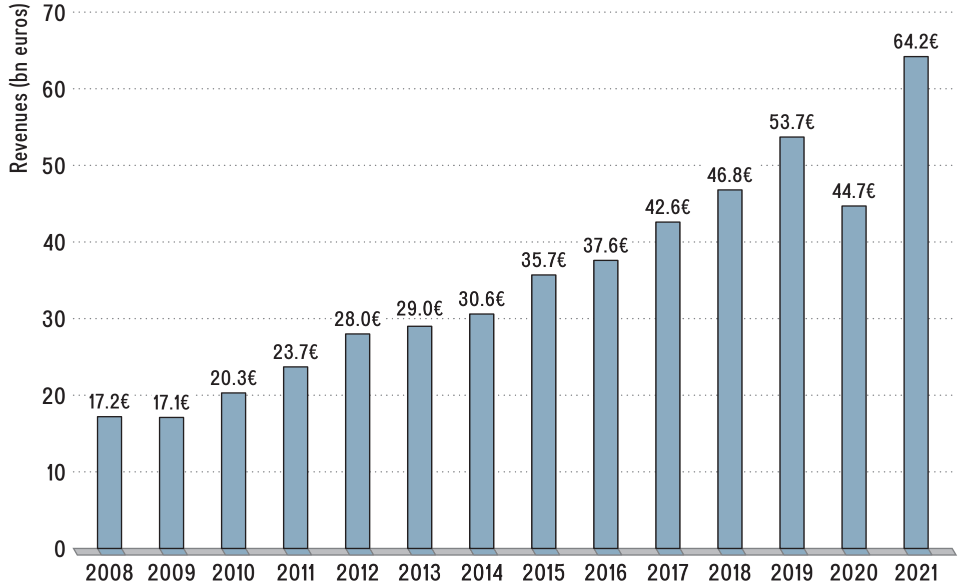
The Wolf in Cashmere to the Rescue

The "wolf in cashmere" refers to Bernard Arnault, chairman and CEO of LVMH, the largest luxury conglomerate globally. Arnault is the wealthiest person in Europe, with a net worth of $150 billion. He earned the moniker "wolf in cashmere" when he turned a family construction company from the gritty town of Roubaix in northern France into a luxury behemoth. His first step was to acquire Dior, the French luxury fashion house, before gaining control of LVMH in the 1980s.

Louis Vuitton is the flagship brand of France's Moët Hennessy Louis Vuitton S.A., better known as LVMH. Its most popular products are Louis Vuitton handbags with the iconic LV monogram. The largest purveyor of luxury brands globally, LVMH owns some 75 luxury lines in fashion (Dior and Fendi), jewelry and watches (Bulgari and TAG Heuer), wine and spirits (Moët Hennessy and Armand de Brignac by Jay-Z), perfumes and cosmetics (Sephora, and Fenty Beauty

Frank T. Rothaermel prepared this MiniCase from public sources and for class discussion. It is not intended to be used for any endorsement, source of data, or depiction of efficient or inefficient management. All opinions expressed and all errors and omissions are entirely the author's. Revised and updated: July 13, 2022.

EXHIBIT MC9.1 LVMH Group Total Revenues, 2008-2021 (billion euros)

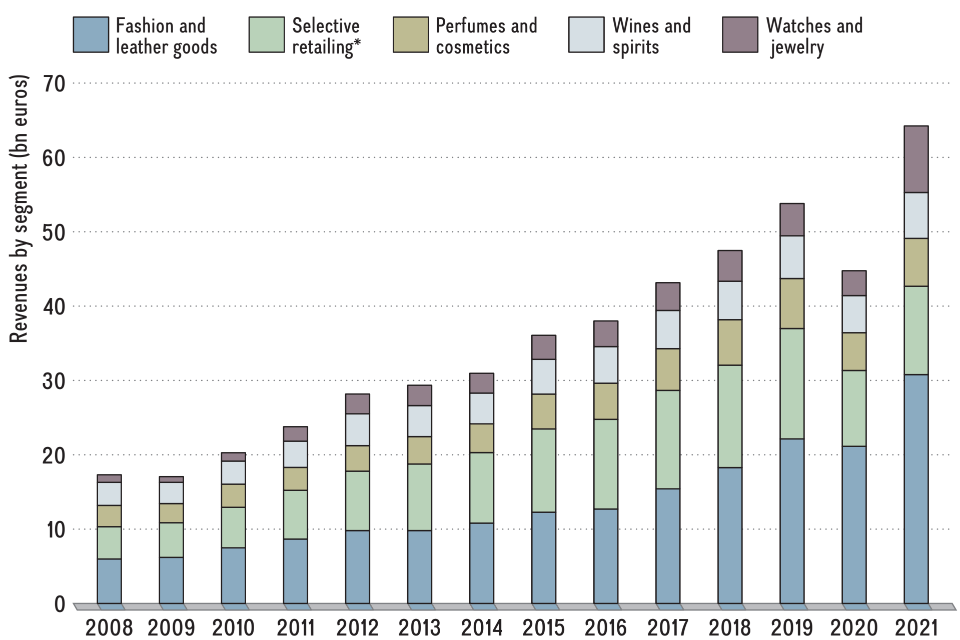


Source: Author's depiction of publicly available data.

by Rihanna), and luxury yachts. Exhibit MC9.1 shows the revenues of the LVMH Group, which reached 64.2 billion euros (equivalent to $76 billion) in 2021.

Exhibit MC9.2 breaks down LVMH Group's revenues by segment. In 2021, about 48% of the 64.2 billion euros came from fashion and leather goods, 18% from selective retailing (which makes certain products available only in specific stores and locations such as Sephora and Le Bon Marché), 10% from perfumes and cosmetics, 9% from wines and spirits, and 14% from watches and jewelry.

EXHIBIT MC9.2 LVMH Group Revenues by Segment, 2008-2021 (billion euros)



*Selective retailing makes certain products available only in specific stores and locations such as Sephora and Le Bon Marché,

Source: Author's depiction of publicly available data.

LVMH has grown by acquisition. By acquiring Tiffany, LVMH has engaged in *horizontal integration*, which is the process of merging with a competitor at the same stage of the industry value chain. Horizontal integration is a corporate strategy that can improve a firm's strategic position in a single industry. As a rule, firms should go ahead with horizontal integration (i.e., acquiring a competitor) if the target firm is more valuable inside the acquiring firm than as a continued standalone company.

LVMH believes it can unlock more value from Tiffany within the conglomerate. For one, Tiffany helps strengthen its position in jewelry and watches. Since the Tiffany acquisition, LVMH's sales of jewelry and watches increased from 3.4 billion euros (or 7% of total) in 2020 to 9 billion euros (or 14% of total) in 2021. As a standalone category, sales of jewelry and watches increased by 265% (see Exhibit MC9.2), thus aiding in diversifying the conglomerate's product mix.

Second, by owning Tiffany, LVMH can strengthen its presence in the U.S. market and enhance its geographic diversification. In contrast to Tiffany, LVMH earns over 90% of its revenues outside its home country of France, with about 65% of its sales in Asia, 25% in Europe, and only 10% in the United States.

Third, by acquiring Tiffany, LVMH preempted rivals from doing so. The global luxury industry is dominated by three conglomerates: LVMH, Kering (Gucci and Yves Saint Laurent), and Richemont (Cartier and Montblanc). LVMH is more than twice the size of Kering and Richemont combined.

Tiffany Moves into the 21st Century

LVMH immediately set to work in attempting to unlock value at Tiffany by moving the company into the 21st century. It brought in a new top management team from France, including a new CEO for Tiffany, Anthony Ledru, and Alexandre Arnault, the 29-year-old son of Bernault Arnault. The younger Arnault's official title is executive vice president of product and communications. Although Alexandre Arnault is supposed to report to the CEO per the new org chart, in meetings he often leverages his father's authority by stating, "I spoke with BA [Bernard Arnault] and this is what we agreed on."[1] American employees bristled at the blatant nepotism. When asked during a town hall meeting shortly after the acquisition what LVMH would do to promote more women to leadership positions at Tiffany, the new CEO responded, "Leave some jobs for us men, because we need to work, too," which he meant as a joke. Still, it was not well received in a post-#MeToo world.[2]

The tight-knit French executives set to work immediately to change Tiffany's strategy, structure, and culture. First, meetings were streamlined, with no more than 10 executives, rather than the more than 40 people common during Tiffany's days as an independent jeweler. Second, they implemented a clear hierarchical structure at Tiffany, which had been known more as an egalitarian and consensus-oriented workplace. Third, the French leadership team required people to work in the offices during the pandemic and controlled attendance by checking the electronic swipe in/out records of employee batches. They argued that jewelry could not be appraised or designed via Zoom calls.

After being replaced by French executives, longtime American leaders quit. Rank-and-file employee turnover was also high during the pandemic as people sought out employers that allowed them to work from home. The remaining Tiffany employees joked that the ability to speak French was a prerequisite for job security. Shortly after the acquisition, an unsanctioned memo titled "Franco-American Cultural Nuances and Etiquette" made its way around Tiffany, including tips on cultural differences between French and American workplace culture. It counseled against discussing weekend plans as small talk. Employees

Jay-Z and Beyoncé are Tiffany brand ambassadors; they are featured here in the "About Love" campaign, masterminded by the 29-year-old Alexandre Arnault, executive vice president of product and communications and son of Bernard Arnault, chairman and CEO of the LVMH conglomerate. To overcome its staid image, Tiffany is attempting to pivot toward a younger generation of successful professionals. Beyoncé is wearing a 128-carat Tiffany diamond, making her one of only four women ever to wear it. In the background is Jean-Michel Basquiat's painting *Equals Pi,* which has a place of honor in the newly renovated flagship store. LVMH owner Bernard Arnault bought the painting for an estimated $15–$20 million.

Mason Poole/Tiffany & Co

should expect a much less welcoming workplace, short on positive feedback but long on criticism: "French people share more negative feedback" and workers should "expect less warm and fuzzy: 'amazing,' 'fabulous,' and excessively positive comments are not the norm."[3] The new CEO firmly pushed back and indicated that the memo was not representative of the values held by LVMH.

Alexandre Arnault designed new marketing campaigns to communicate Tiffany's fresh approach. A Millennial himself, the younger Arnault wants to make Tiffany attractive to a younger audience. To support this positioning, Tiffany released the ad campaign "Not Your Mother's Tiffany." The initiative received an immediate backlash, with many young women expressing outrage on social media, indicating that they look to their mothers for inspiration and view the new branding as degrading their mothers' style. While negatively received, the campaign did intend to reach a broader audience by showing that there are other options besides the classic Tiffany style. Next, Tiffany launched the "About Love" campaign featuring Beyoncé and Jay-Z.

In addition to targeting a new audience for Tiffany products, LVMH is also attempting to position Tiffany upmarket. Rather than selling entry-level items for a few hundred dollars, LVMH wants Tiffany to focus on the luxury segment. As a prime example of the new Tiffany, it introduced a 180-carat diamond necklace as part of its fine-jewelry collection, at an estimated price of \$20–\$30 million. LVMH is attempting to move Tiffany upmarket while remaining attractive to the U.S. consumer. High-end jewelry sales above \$100,000 are up 50% at Tiffany's compared to 2019. The more robust demand for high-end jewelry translated into a 35% increase in spending by the average consumer, particularly those under 40.

At the same time, LVMH wants Tiffany to increase its sales overseas, especially in Asia, which is home to a large and wealthy middle class in China and other countries. The new CEO plans to open super-high-end Tiffany stores in Europe and Asia to provide a best-in-class customer experience. Making Tiffany more attractive internationally is a top priority because most of its sales have been in the United States. The new marching orders are: Go upmarket and go global while remaining strong in the home market.

DISCUSSION QUESTIONS

1. Why did Tiffany become a takeover target?
2. Acquisitions are one tool to execute corporate strategy. Why did LVMH acquire Tiffany? In your answer, focus on product and geographic diversification.
3. How is LVMH attempting to unlock value at Tiffany?
4. Do you believe that LVMH will be successful with its new strategy for Tiffany? Why or why not? Be specific.
5. Who do you think should be Tiffany's target audience? What should Tiffany be selling to them?
6. Conglomerates often experience a diversification discount. LVMH is already the largest luxury conglomerate in the world, more than double the size of the following two conglomerates combined (Kering and Richemond). Do you think LVMH will experience a diversification discount? Is there a limit to conglomerate size? Or is bigger always better?

Endnotes

1. Quoted in Kapner, S. (2021, Dec. 23), "Tiffany's new French owner brings a makeover—and a culture clash," *The Wall Street Journal*.

2. Quoted in Kapner, S. (2021, Dec. 23), "Tiffany's new French owner brings a makeover—and a culture clash," *The Wall Street Journal*.

3. Quoted in Kapner, S. (2021, Dec. 23), "Tiffany's new French owner brings a makeover—and a culture clash," *The Wall Street Journal*.

Sources: Satran, R. (2022, Feb. 8), "How Alexandre Arnault is shaking things up at Tiffany & Co." *WSJ Magazine;* Kapner, S. (2021, Dec. 23), "Tiffany's new French owner brings a makeover—and a culture clash," *The Wall Street Journal;* Gibson, K. (2021, Aug. 24), "Tiffany ad featuring Beyoncé and Jay-Z includes Jean-Michel Basquiat painting long out view," *CBS Moneywatch;* Kapner, S. (2021, Jan. 7), "LVMH replaces leadership at Tiffany," *The Wall Street Journal;* "LVMH tests the limits of luxury," *The Economist* (2019, Nov. 28); Danziger, P.N. (2020, Nov. 14), "What's ahead for Tiffany once LVMH takes over?" *Forbes*; Thomas, L., and R. Frank (2019, Nov. 19), "With Tiffany, LVMH grows in jewelry. And Tiffany gets another chance to shine," *CNBC;* LVMH Moët Hennessy Louis Vuitton (LVMH) Annual Reports (various years); Tiffany & Co. Annual Reports (various years).

MiniCase 10

Hollywood Goes Global

Hollywood films have always been quintessentially American products. Globalization, however, has changed the economics of the movie industry. By 2022, foreign ticket sales for Hollywood blockbusters made up over 80% of worldwide totals (or $17 billion of the total $21 billion), up from 50% in 2000. Some movies such as *Transformers: Age of Extinction* and *The Fast and the Furious* gross around 80% of their total box-office receipts overseas. Foreign sales now make or break the success of newly released big-budget movies.

Avengers: Endgame (released in 2019, with $2.8 billion in total revenues) is the second highest-grossing movie of all time. Its international performance highlights the importance of foreign sales (around 70% of the total). Produced by Marvel, it was shown in English in India and translated into three major Indian languages (Hindi, Tamil, and Telugu). Marvel even licensed an Indian Marvel Anthem by Oscar-winning Indian composer A. R. Rahman. In China, *Endgame* is currently the highest-grossing foreign movie. Given that *Avengers* was released just a few years ago, it has an excellent chance of becoming the most successful movie ever.

In the meantime, *Avatar* remains the highest-grossing movie to date, earning almost $3 billion since its release in 2009. Non-U.S. box-office sales account for close to 75% of that number. *Avatar* was hugely popular in Asia, especially in China, where the government permitted the number of movie theaters showing the film to increase from 5,000 to 35,000. Another of James Cameron's famous films, *Titanic*, grossed around 70% of its close to $2 billion earnings in overseas markets.

Exhibit MC10.1 depicts the lifetime revenues of Hollywood's all-time blockbuster movies, broken down into domestic (U.S.) and foreign revenues by dollars.

Frank T. Rothaermel prepared this MiniCase from public sources with Duncan Siebert, who provided superb research assistance. The MiniCase is intended for class discussion; it is not intended to be used for any endorsement, source of data, or depiction of efficient or inefficient management. All opinions expressed and all errors and omissions are entirely the author's. Revised and updated: July 7, 2022.

The Marvel movie *Avengers: Endgame* broke all records in its release year. It is set to become the highest-grossing movie ever. With 70% of its box-office revenues coming from outside the United States, it highlights the need for Hollywood studios to create content that can break out internationally.

Imaginechina/AP Images

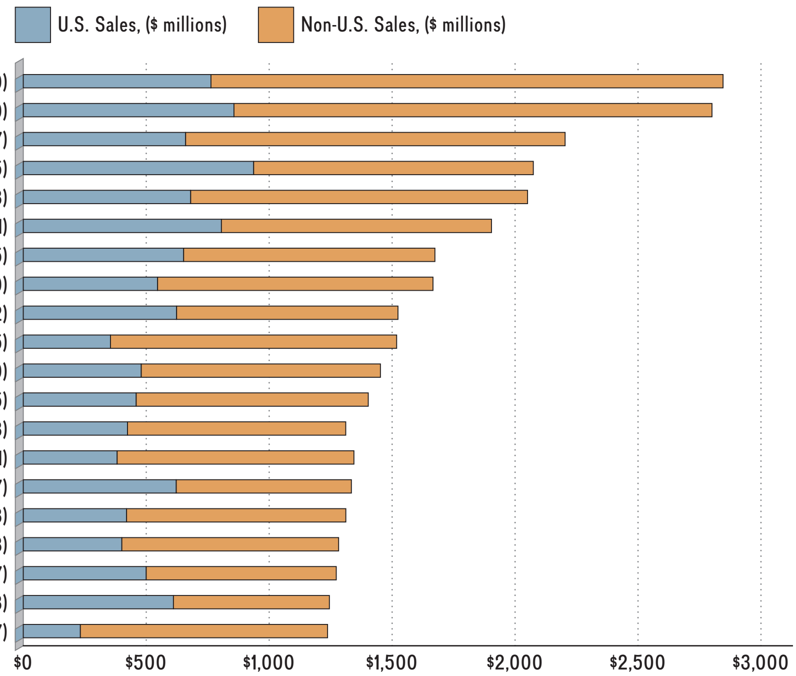
Exhibit MC10.2 shows the breakdown between U.S. and foreign revenues for films produced by Marvel Studios, which is owned by Disney. Hollywood now garners roughly $8 of every $10 of its revenues internationally, which is somewhat surprising given several constraints that U.S. films face when selling internationally.

"We Need Movies That Break Out Internationally"

Given the increasing importance of non-U.S. box-office sales, Hollywood studios are changing their business models. Rob Moore, vice chairman of Paramount Pictures, explains, "We need to make movies that can break out internationally. That's the only way to make the economic puzzle of film production work today."[1]

Embracing the importance of their movies' global appeal, movie studios have changed several tactics. Some mega-releases, such as Disney's *Monsters University* (the prequel to *Monsters, Inc.*), premiere first in foreign markets before being shown in the United

EXHIBIT MC10.1 Lifetime Revenues of Top 20 Hollywood Movies by U.S. and Non-U.S. Sales ($ millions)



Source: Author's depiction of data from Box Office Mojo (http://boxofficemojo.com).

States. Hollywood is also adapting scripts to appeal to global audiences, casting foreign actors in leading roles, and pulling the plug on projects that seem too U.S.-centric. For example, Marvel's *Eternals* featured Pakistani American actor Kumail Ali Nanjiani, Indian actor Harish Patel, and South Korean actor Ma Dong-Seok. Although Hollywood has had to release edited versions of films to meet local censorship rules for many years, a recent phenomenon has been inserting unique scenes to cater to audiences in specific markets.

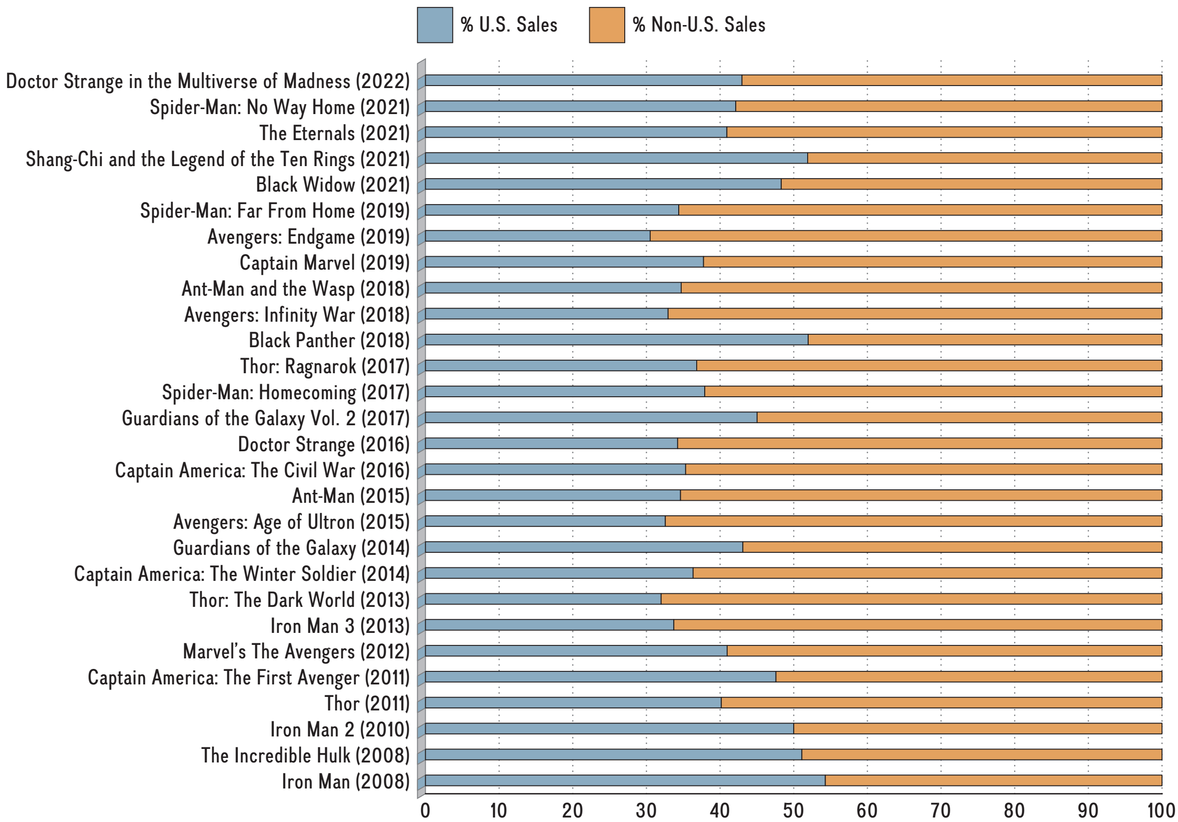
Other challenges also loom. Hackers penetrated Sony Pictures and posted damaging internal e-mails publicly as retaliation for the comedy film *The Interview* (2014), which is about the fictional assassination of North Korean leader Kim Jong-un. In addition to potential government interference with content, there are numerous piracy concerns. Even in the European Union (EU), where countries such as France impose fines on producers and buyers of pirated content, other countries, such as Spain, have long been havens for distributing illegal movies and music. Although Spain passed a law (in 2011) to provide better protection of copyrighted material, enforcement is notoriously tricky in a country where piracy was valued at over $45 billion (in 2020). Often, movie studios release expected blockbusters simultaneously worldwide to reduce revenues lost to piracy.

China: Now the Largest Movie Market

The idea that the economics of the movie industry have fundamentally changed is bolstered by the fact that in 2021 China was by far the world's largest box-office market, with close to $7.3 billion in annual revenues, compared to the U.S. domestic box-office market revenue of $4.5 billion. China now exceeds the United States in the number of movie screens. Exhibit MC10.3 depicts overall box-office revenues for the United States and China for the period 2000–2022.

However, stringent regulations by the Chinese government mean that only a select few Hollywood movies can make it to Chinese theaters. Officially, China allows 34+ full-fledged foreign movie imports a year (20 titles plus 14 or more in an enhanced [3D or IMAX] format). During national holidays, Chinese theaters are restricted to showing domestic movies.

EXHIBIT MC10.2 Marvel Cinematic Films: Percentage of U.S. Sales vs. Non-U.S. Sales



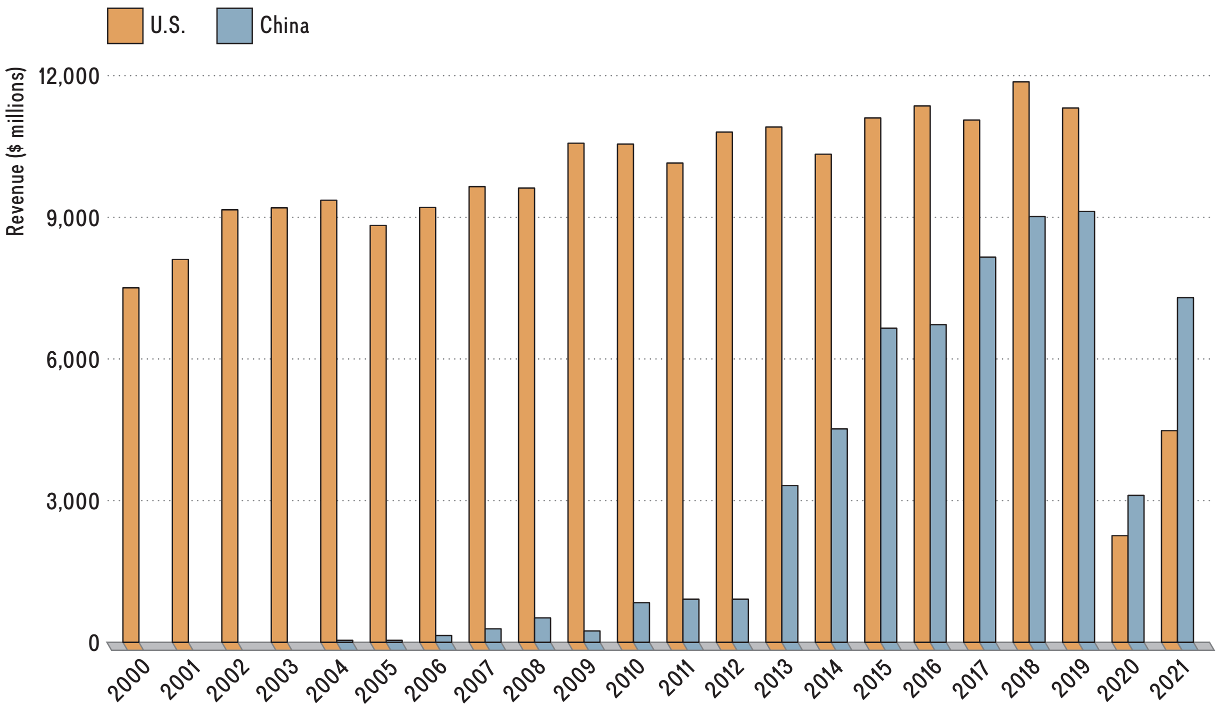
Source: Author's depiction of data from Box Office Mojo (http://boxofficemojo.com).

Given these constraints and China's importance as a movie market, it is no wonder that Hollywood executives aim to please. For instance, Disney's Marvel Studios produced two versions of the box-office hit *Iron Man 3*. One film version was made for general release and another targeted Chinese moviegoers. The latter version included extensive product placement, Beijing bonus footage, and guest appearances by Chinese movie stars. In addition, the hits *Doctor Strange* and *Skyfall* were edited for the Chinese market to cut scenes that Chinese censors thought portrayed China negatively. In *Doctor Strange,* the editing involved changing a character from being a Tibetan monk to a Celtic mystic to avoid any references to Tibet. In *Skyfall,* the movie's director cut out the death of a Chinese security guard, and a character's backstory involving prostitution in Macau was removed.

Some critics assert that Hollywood's accommodating of Chinese preferences is going too far and amounts to pandering. For instance, in *The Martian* (2015), NASA has to plead with its counterpart, the China National Space Administration, to provide a classified booster rocket that will carry a payload to Mars and thus allow NASA (which does not have such an advanced rocket at its disposal) to rescue one of its stranded astronauts.[2]

The Great Wall (released in China in 2016 and in the United States in 2017) marked a new level of U.S.–China collaboration in movie production. *The Great Wall* co-stars Matt Damon and Jing Tian, and it was directed by Zhang Yimou, the creative director for the opening and closing ceremonies of the 2008 Beijing Summer and 2022 Winter Olympics. Matt Damon plays a European mercenary who joins forces with a Chinese commander (played by Jing Tian) to fight

EXHIBIT MC10.3 Box Office Revenue in the United States and China (2000–2022, $ millions)



Source: Author's depiction of data from IHS Markit.

mysterious invaders at the Great Wall. With an enormous budget of almost $200 million, *The Great Wall* is the most ambitious co-production between Hollywood and Chinese film studios. It is also the most expensive movie ever shot exclusively in China. As an official co-production between U.S. and Chinese companies, *The Great Wall* combined cast and effects from both countries and was thought to offer a template for future American–Chinese movies.

Although studio executives hoped that *The Great Wall* would appeal to Chinese and American audiences, the movie flopped in the United States. Critics highlight the difficulties of creating films that blend Eastern and Western stories and characters. Moreover, to produce *The Great Wall,* the companies had to retain more than 100 interpreters and constantly had to deal with conflicts among cast and crew members based on different cultural understandings. In the United States, *The Great Wall* brought in only about $45 million. Yet, movie studios are undeterred. Movie executives continue to highlight the substantial market opportunities in China and emphasize that they will soon find the right formula to make movies that are attractive to both American and Chinese audiences.

As suggested earlier, a serious challenge is content editing by government officials before the screening. The Oscar-winning film *Django Unchained* saw its release in China temporarily canceled for "technical reasons," which meant excessive violent and sexual content. By the time the film was recut and released, it performed poorly, partly because many Chinese filmgoers had already seen the film unedited on pirated DVDs.

In 2012, MGM Studio was in dire need of a blockbuster to forestall bankruptcy. Studio executives set out to remake *Red Dawn,* the 1984 hit in which American teenagers fight communist forces from the USSR, who had invaded their Colorado hometown. MGM rewrote the script with help from Tom Cruise, the head of United Artists, with China as the invading force. The condemnation was swift when screenshots of the *Red Dawn* remake made it into Chinese news outlets and social media. For instance, *China Daily,* an English-language daily newspaper controlled by the Chinese Communist Party, wrote "Tempers [in China] will probably explode like kernels of movie house popcorn [when the movie comes out]," and called the movie a "ticking time bomb."[3]

As a result, after the movie was produced, MGM Studios executives decided to edit it in postproduction to change the invading Chinese army to a North Korean army to avoid offending Chinese consumers and, more importantly, government officials approving the screening of foreign movies. Not coincidentally, Hollywood is not selling any movie tickets in North Korea. In addition, MGM Studios did not want a repeat of the China ban that it endured during the 1990s when it released *Red Corner,* about a U.S. businessman (Richard Gere) trapped in legal limbo in China. In the end, the *Red Dawn* remake was a flop, with MGM losing millions on the production, and the movie did not show in China. At least, MGM executives had kept on good terms with China, and MGM's James Bond series remains hugely successful there.

The Wall Street Journal concluded, "*Red Dawn* would become a case study observed by every producer in Hollywood who needed this market to make a profit. ... [N]o Hollywood executive would touch a movie that turned their most important new customer [China] into the villain." And soon, it won't be just Hollywood taking the lesson of the movie to heart. Every industry that wants to do business with China, from cars to fashion to smartphones, now knows you don't get far by "angering the regime."[4]

One of the most significant issues for Hollywood in China is the country's decreasing reliance on foreign films for entertainment. In 2021, China let in only 21 Hollywood movies, falling far short of even the lower boundary of the 34+ quota in the U.S.–China Film Agreement. Although the reasons may be due to political sentiment and the pandemic, it is also clear that Chinese audiences' taste for American entertainment is declining. In 2021, U.S. films accounted for less than 12% of China's total box-office revenue. Additionally, only two Hollywood films have earned at least $100 million in box-office revenue in China since 2020, but more than 20 Chinese films did so in that same time period.

With the move from physical media such as DVDs and Blu-ray discs to streaming, Chinese streaming services are growing rapidly. In 2016, PPTV, a Chinese video-on-demand website, secured the post-theater rights to *Warcraft* for $24 million, indicating a potential new source of revenue for Hollywood. While Netflix does not do business directly in China, and the government blocks computers in China from accessing its service, it is estimated that 20 million Chinese access Netflix using proxy servers that mask the actual location of the user's machine. Netflix's original series *House of Cards* was an enormous success in the United States and China, and Netflix continues to produce various Mandarin content and distribute Chinese films to the rest of the world. Still, it has made little headway breaking into China apart from a brief and ineffective partnership with its Chinese counterpart, iQIYI.

Enter Bollywood

The vast opportunities in the global movie market have also attracted new entrants. In addition to wanting to cater to international audiences, Hollywood film studios are also feeling squeezed by low-cost foreign competition. While certainly not number one in revenue, India's Bollywood films have long been king in total ticket sales. With its generally smaller budget productions than Hollywood, the Hindi film industry in Bollywood produces four times as many films per year.

Moreover, Bollywood brings in low-cost but high-impact actors such as Freida Pinto and Dev Patel, who played the lead roles in the mega-success *Slumdog Millionaire*. *Slumdog*'s budget was a mere $14 million, but the movie grossed almost $400 million and won eight Oscars. By comparison, Hollywood's budget for *Home Alone*, a similar success in terms of revenues, was nearly five times as large.

Globalization also puts pressure on the pay of Hollywood stars. Given the importance of online streaming (e.g., Netflix is available in some 200 countries), international audiences, and the availability of foreign stars and movies, the days are over when star actors such as Tom Hanks, Angelina Jolie, Jennifer Lawrence, or Denzel Washington could demand 20% royalties on total ticket sales. This issue came to the fore when actor Scarlett Johansson sued Disney over the Marvel installment *Black Widow*'s simultaneous release in movie theaters and online streaming (in 2021), arguing that it was a breach of a contract that stipulated a certain percentage of royalties on movie ticket sales. Johansson demanded $80 million from Disney to make her whole, in addition to the $20 million salary she received for the movie. The case was settled out of court, which means Disney made an additional (undisclosed) payment.

DISCUSSION QUESTIONS

1. How has the global environment changed for U.S. (Hollywood) movie studies since 2000? Explain.
2. Use the CAGE distance model to explain why it is challenging to produce movies that are attractive to different types of audiences across the world.

3. Apply the cost-responsiveness framework to describe which global strategy Hollywood studios initially followed and how their strategic positioning has changed over time. Explain how and why.
4. Given the economics of the now-global movie industry, what are the strategic implications for Hollywood studios? What are some opportunities, and what are some threats? How should Hollywood movie studios take advantage of these opportunities while mitigating the threats?
5. When commenting on the disappointing performance of *The Great Wall*, movie executives continue to highlight the vast market opportunities in China and emphasize that they will soon find the right formula to make movies that are attractive to both American and Chinese audiences. Assuming that movie studios can create breakthrough hits that are attractive to both Eastern and Western audiences, what type of global strategy would that entail? What are some benefits of this type of global positioning? What are some of its risks? Why is this type of global positioning so hard to achieve?

Endnotes

1. As quoted in Schuker, L. (2010, Aug. 2), "Plot change: foreign forces transform Hollywood films," *The Wall Street Journal*.

2. Although Andy Weir's (2011) novel *The Martian*, on which the movie is based, includes the situation in which NASA requests help from their Chinese counterparts, in the Hollywood movie production, NASA is pleading for help from China National Space Administration, which is depicted as technologically superior to NASA.

3. Schwartzel, E. (2022, Feb. 5), "How China's growing clout led Hollywood to look for a new villain," *The Wall Street Journal*.

4. Schwartzel, E. (2022, Feb. 5), "How China's growing clout led Hollywood to look for a new villain," *The Wall Street Journal*.

Sources: Frater, P. (2022, May 23). "North America set to beat China as the global box office's biggest market," *Variety*; Kharpal, A. (2019, May 10), "Netflix has a China strategy—but it doesn't involve launching there soon," *CNBC*; Brzeski, P. (2022, Mar. 31), "Does Hollywood need to rethink its China strategy?" *The Hollywood Reporter;* Schwartzel, E. (2022, Feb. 5), "How China's growing clout led Hollywood to look for a new villain," *The Wall Street Journal;* Flint, J., and E. Schwartzel (2021, Sep. 30), "Disney and Scarlett Johansson settle suit over 'Black Widow' contract," *The Wall Street Journal;* "'Avengers: Endgame' has been an unusual hit in China," *The Economist* (2019*,* May 2); "'Avengers: Endgame' is already the year's highest-grossing film," *The Economist* (2019, Apr. 29); Schwartzel, E. (2019, Apr. 28), "*Avengers: Endgame* pulverizes box-office records with $1.2 billion debut," *The Wall Street Journal;* McNary, D. (2019, Jan. 2), "2018 worldwide box office hits record as Disney dominates," *Variety;* Hong, W. (2018, Dec. 31), "China's box office revenue growth slowed in 2018," *CNBC;* Shaw, L. (2018, Dec. 13), "China approves release of more U.S. films to meet goal," *Bloomberg*; Faughnder, R. (2017, Apr. 25), "Matt Damon's "The Great Wall' to lose $75 million; future U.S.-China productions in doubt," *The Hollywood Reporter,* http://www.hollywoodreporter.com/news/what-great-walls-box-office-flop-will-cost-studios-981602, accessed July 4, 2017; Schwartzel, E. (2016, Aug. 18), "'Warcraft' deal sets record for streaming video in China," *The Wall Street Journal*; "How China's censors influence Hollywood," *NPR* (2015, May 18), www.npr.org/sections/parallels/2015/05/18/407619652/how-chinas-censors-influence-hollywood, retrieved July 5, 2015; Brook, T. (2014, Oct. 21), "How the global box office is changing Hollywood," *BBC*; Kuo, L. (2014, Mar. 27), "China's film market is going gangbusters, but it may not help Hollywood much," *Quartz*; Miller, D. (2014, Jun. 14), "After the controversy, 'Django Unchained' flops in China," *The Los Angeles Times*; McCarthy, N. (2014, Sep. 3), "Bollywood: India's film industry by the numbers," infographic, *Forbes*; Takada, K. (2013, Apr. 11), "China debut of *Django Unchained* suddenly cancelled for technical reasons," *Reuters*; MacSlarrow, J. (2013, Jun. 7), "Is Bollywood India's next greatest export?" Global Intellectual Property Center; "China gets its own version of *Iron Man 3* after Disney allows the country's film censors onto the set," *MailOnline* (2012, Apr. 14); Levin, D., and J. Horn (2011, Mar. 22), "DVD pirates running rampant in China," *Los Angeles Times*; "Ending the open season on artists," *The Economist* (2011, Feb. 17); "Bigger abroad," *The Economist* (2011, Feb. 17); Schuker, L. (2010, Aug. 2) "Plot change: Foreign forces transform Hollywood films," *The Wall Street Journal*; Schuker, L. (2009, Apr. 2) "Hollywood squeezes stars' pay in slump," *The Wall Street Journal*; "News corporation," *The Economist* (2009, Feb. 26); Cieply, M., and Carr, D. (2009, Feb. 23), "A 'Slumdog' kind of night at the Oscar ceremony," *The New York Times*.

MiniCase 11

Chick-fil-A's Structure, Culture, and Control

"To glorify God by being a faithful steward of all that is entrusted to us. To have a positive influence on all who come in contact with Chick-fil-A."[1]

S. Truett Cathy, Chick-fil-A founder

What is America's most profitable fast food restaurant? Answer: Chick-fil-A, with sales per restaurant double that of McDonald's, more than double that of Chipotle, and almost three times as much as Wendy's (see Exhibit MC11.1). How does a smaller chain of restaurants serving chicken sandwiches outperform multinational giants such as McDonald's, Burger King, and Starbucks by such a wide margin? Clearly, Chick-fil-A has a competitive advantage—but how did it gain and sustain it? Chick-fil-A's structure, culture, and control afford it advantages that other competitors find hard to match.

Chick-fil-A's Birth and Values

Chick-fil-A founder S. Truett Cathy grew up during the Great Depression (1929–1939) in Hapeville, Georgia, a small town close to Atlanta's international airport. Like many Americans, the Cathy family faced financial hardships during that challenging time. The family lived in the nation's first federal housing project. Unable to cope with the stresses of his life, Truett's father was abusive and regularly beat his children.

Truett adored his mother. From her, he inherited his love for the teachings of Jesus Christ and learned her Southern cooking skills. From a young age, he turned to his Christian faith to sustain him during the economic and family hardships he faced during his formative years. He also learned early on that he needed to take care of himself, which lit the fire of ambition sustained by a strong work ethic.

After serving in the Army during World War II, Truett opened a tiny 24-hour diner near the Atlanta airport (in 1946) with the fitting name of Dwarf Grill. Implementing his Christian faith into his business, he decided from Week One never to open on Sundays, stating that if he had to work seven days a week to make a living, he should find a different profession. A devout Southern Baptist, he attended church each Sunday and taught Sunday school for over 50 years.

The Classic Chick-fil-A Sandwich

A beneficial chance event was crucial in creating the now-iconic Chick-fil-A sandwich. The Dwarf Grill was doing okay, but Truett faced a highly competitive market because many returning GIs opened diners after World War II. As such, Truett was always looking for ways to differentiate his offerings. In the early 1960s, a local poultry supplier for Delta Airlines provided boneless chicken breasts to fit in the small plastic trays for in-flight meals. However, the chicken breasts in one batch were too big for the trays. Needing to unload the chicken breasts, the poultry supplier asked Truett if he would buy them.

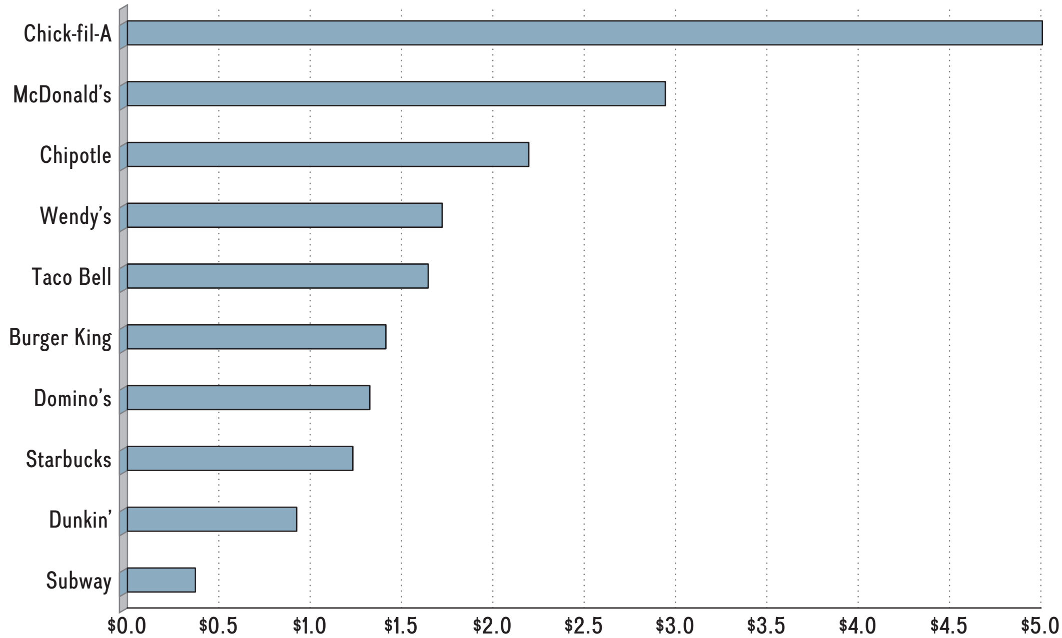
In his search to develop a different menu, Truett bought the chicken breasts and started experimenting with a pressure cooker, peanut oil, and seasoning for the breading. By 1964, long after the first batch of chicken breasts was gone, he had come up with the perfect recipe: a breaded chicken breast on a buttered bun with two pickles. His guests loved it, so Truett decided to stop tinkering with the recipe. He wrote down the recipe on a piece of paper, which is now locked in the company's vault. It is said to be known to fewer people than the Coca-Cola formula. To communicate that his chicken is more like an A-grade filet, he christened his sandwich the Chick-fil-A.

Growth

Having perfected the classic chicken sandwich that his customers loved, Truett Cathy set out to expand beyond the Dwarf Grill. Catching the economic boom

Frank T. Rothaermel prepared this MiniCase from public sources for class discussion. It is not intended to be used for any endorsement, source of data, or depiction of efficient or inefficient management. All opinions expressed and all errors and omissions are entirely the author's. Revised and updated: August 10, 2022.

EXHIBIT MC11.1 Average Sales per Restaurant ($ millions, 2021)



Source: Author's depiction of publicly available data.

of the 1960s, during which large shopping malls were springing up near cities, he opened the first Chick-fil-A restaurant in 1967 in the Greenbriar Mall (Atlanta). Cathy was not only an inventor in the kitchen but also one of the first restaurateurs to realize that building take-out joints in a mall was much cheaper than running stand-alone diners. As such, he was a pioneer in helping to create food courts in shopping malls.

In the 1980s, the United States experienced a severe recession. Chick-fil-A faced its first serious challenges because business declined, and no new malls opened. The company's leaders debated whether to sell the company. But instead, they ended up going on the offensive by building free-standing Chick-fil-A restaurants with drive-throughs. Sales took off. By 2006, Chick-fil-A had booked more than $2 billion in annual sales. And just 10 years later, in 2016, Chick-fil-A crossed $10 billion in sales. In 2019, Chick-fil-A moved beyond the United States by opening a restaurant in Toronto, Canada. Exhibit MC11.2 shows the Chick-fil-A timeline from its founding until 2022.

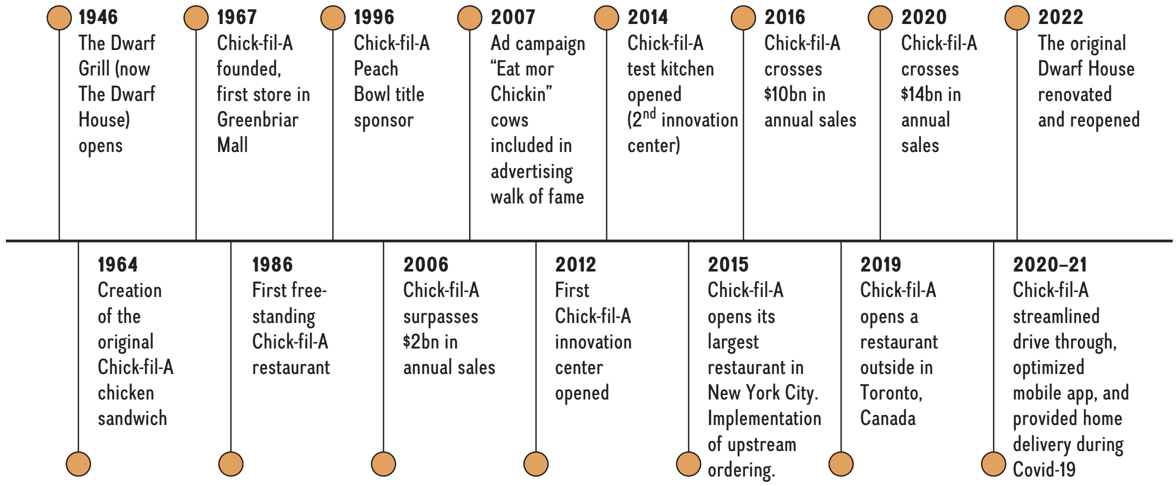
In 2021, Andrew Cathy, Truett's grandson, took over as CEO of Chick-fil-A from his father, Dan Cathy. In 2022, Chick-fil-A had about 3,000 restaurants, and sales were over $16 billion. While McDonald's has about five times as many restaurants, Chick-fil-A has become the third largest restaurant chain by annual sales, after McDonald's and Starbucks. And it is the leader in average sales per restaurant by a wide margin (see Exhibit MC11.1).

Unlike fast-growing franchises such as Chipotle, Chick-fil-A purposefully grows slowly, opening no more than 100 restaurants a year. Chick-fil-A remains a private, family-owned company. Andrew Cathy, the CEO, has stated that Chick-fil-A will never go public. As a privately owned company, Chick-fil-A must therefore finance its growth through retained earnings (net income). In contrast, publicly traded companies such as Chipotle can draw on debt (by issuing bonds) and equity financing (by selling shares) to supercharge their expansion.

Franchise Model

Although Chick-fil-A's culture is unique—its employees are imbued with the belief that their work serves a higher purpose—the chicken sandwich chain also differs markedly from other quick-service restaurants in its structure and control. While traditional fast food franchises such as Burger King and Wendy's require millions from their franchisees in total startup cost, Chick-fil-A requires its operators to contribute only

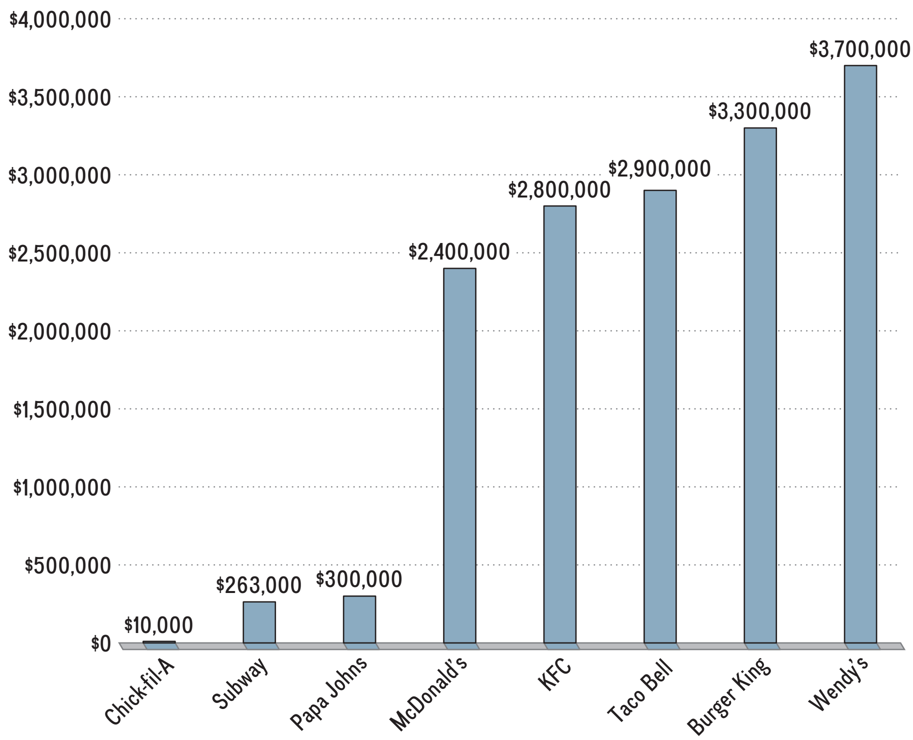
EXHIBIT MC11.2 Chick-fil-A Timeline



Source: Author's depiction of publicly available data

$10,000 to cover the franchise fee. This considerable difference stems from the fact that other fast food chains require the franchisee to pay for the land and the construction of the restaurants. In contrast, Chick-fil-A owns all its restaurants, the stores' equipment, and the land they sit on. Exhibit MC11.3 depicts the average start-up costs for popular fast food restaurants.

EXHIBIT MC11.3 Average Startup Costs for Fast-Food Restaurants ($ millions, 2021)



Source: Author's depiction of publicly available data.

To communicate its unique organizational structure, Chick-fil-A calls its franchisees "operators." Chick-fil-A relies on centralized, top-down control, dictating every detail of a restaurant's operation, including its site location, menu, and how the stores are run. Although the monetary investment to buy a Chick-fil-A franchise seems to be a low hurdle, being selected as an operator is super-difficult. Out of 8,000 applications each year, Chick-fil-A selects no more than 130 people. This ratio equals a 1.6% acceptance rate—lower than the admittance rate to the most selective colleges in the United States.

Chick-fil-A allows each operator to run only one restaurant. In rare cases, exceptional operators are granted a second restaurant. The company makes its expectations for its operators clear: "Franchising is not an opportunity for passive financial investment, working from the sidelines, or adding to a portfolio of business ventures."[2] A successful operator can earn over $1 million annually through a profit-sharing incentive scheme.[3]

People

Because Chick-fil-A does not allow passive franchise investment, all operators must be on-site and personally run a restaurant, know their employees, and be involved in the local community. Chick-fil-A operators put in long hours, six days a week. While other investors may own several McDonald's and delegate the running of the restaurants to professional managers, Chick-fil-A operators must personally manage a team of more than 100 hourly employees.

For many employees, Chick-fil-A is their first job. Chick-fil-A uses a rigorous training program for all employees, even part-time workers. At this purpose-driven company, two-sided matching takes place. Most applicants for a job at Chick-fil-A know what the company stands for. At the same time, Chick-fil-A ensures that each team member fits into its distinctive culture. The company selects team members based on three C's: character, competence, and chemistry. All employees are trained for several weeks and will not be hired unless they can commit to working for the company for at least one year.

In 2022, Chick-fil-A employed more than 170,000 people, whom the company calls "team members." The hourly pay is competitive, starting at around $15 per hour for part-time, entry-level workers and rising to above $20 per hour for high performers. Each employee receives one free meal a day, and uniforms are provided by the company. Perhaps more critical for high-school and college students seeking their first job is the fact that Chick-fil-A has a scholarship program ("Remarkable Futures") for which team members can apply. Since the Remarkable Futures program started in 1973, Chick-fil-A has provided scholarships for more than 80,000 team members. One employee described growth opportunities at Chick-fil-A on *Glassdoor* as follows: "You can walk off the street and within a year or 1.5 years become management."[4]

Chick-fil-A values positive interactions with each customer. As such, the company's signature hospitality is easily recognizable in the politeness of each employee. At the end of each interaction employees have with customers, they always respond with a smile and say, "My pleasure," a differentiator to customers' experience with other fast food restaurants. In 2022, *Forbes* named Chick-fil-A "Best Employer in America," and *Glassdoor* named it "a top company for career opportunities for Black employees."

Operations

A strong culture and a unique structure allow Chick-fil-A to provide superior customer service and implement an efficient and lean operation. Chick-fil-A achieves consistency in quality and exceptional customer responsiveness through simplicity.

First, the classic Chick-fil-A sandwich has only four ingredients (breaded chicken breast, two pickles, butter, and a bun). In contrast, flagship sandwiches of other fast food chains such as McDonald's Big Mac

To speed up orders and to provide a more pleasant customer experience, Chick-fil-A uses upstream ordering. This system lets employees meet customers in their cars and take orders and payments via tablets. Customers love Chick-fil-A's friendly service and value their food offerings more than those of competitors.

Brandon Bell/Getty Images

and Burger King's Whopper have a dozen more ingredients. Second, Chick-fil-A has kept the menu simple and focused, offering few options of chicken, fries, salads, and some desserts, while the menu at other chains has as many as 125 items. More items on the menu increase operational complexities, resulting in longer wait times and lower customer satisfaction because more things can and do go wrong. In addition, we know from research in psychology ("Paradox of Choice")[5] that more choice (on a menu, for example) creates consumer confusion, delays decision making, and leads to lower customer satisfaction.

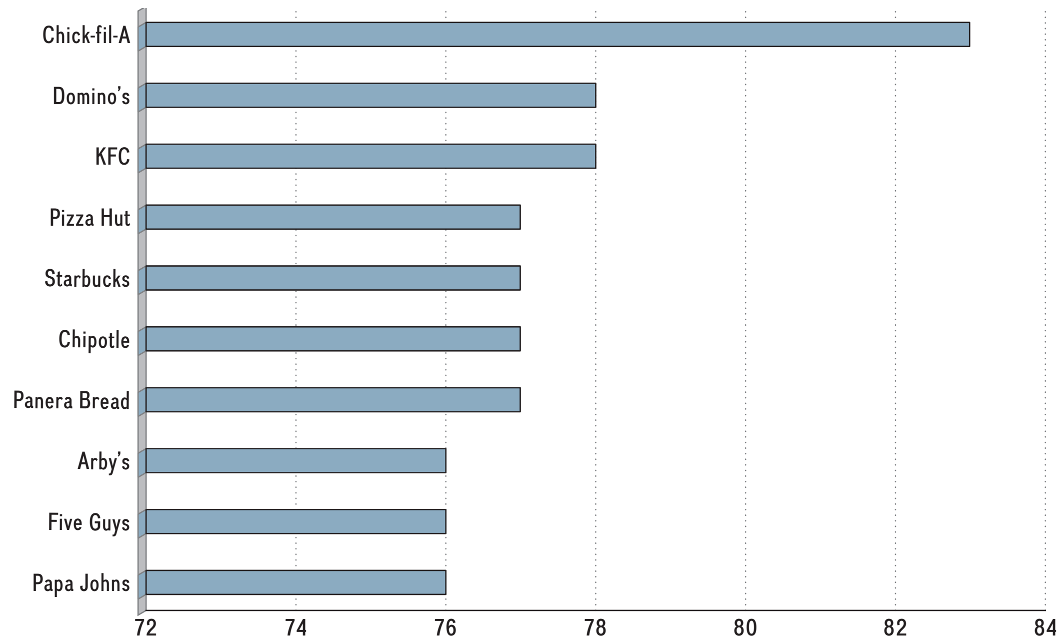
Third, Chick-fil-A introduced upstream ordering for its busy drive-throughs in 2015. In upstream ordering, several employees fan to customer cars and take the order face-to-face via a portable tablet. Friendly and smiling employees then confirm the order and accept payment. The employees conclude each customer interaction with "My pleasure." Upstream ordering differs markedly from the older approach of talking to a disembodied speaker system, which makes communication between the customer and store employee challenging and error-prone. In Chick-fil-A's system, all upstream orders feed into a central computer, which then ranks them based on which car is next to the pick-up window. Upstream ordering also allows for multiple drive-through lanes, speeding up the process and creating a better customer experience. The timing of Chick-fil-A's upstream ordering process was fortunate because by the time Covid-19 restrictions shut down in-store dining, Chick-fil-A had already optimized its new system. Although Chick-fil-A has a fast drive-through experience, regularly long lines indicate quality and scarcity to observers, making them more likely to join the line.

Chick-fil-A's people, structure, and systems combine to produce the best customer experience in the industry, as reflected in the highest customer satisfaction scores for several years (see Exhibit MC11.4).

The Downside of Strong Corporate Cultures

Chick-fil-A's strong corporate culture is critical to the company's success. In a strong culture, employees internalize values, norms, traditions, symbols, and expectations that guide their behavior. The selection and training of employees reinforce Chick-fil-A's strong culture. Chick-fil-A's founder, S. Truett Cathy, imbued his beliefs into his business by declaring that its purpose is "to glorify God by being a faithful steward of all that is entrusted to us ... [and] to have a positive

EXHIBIT MC11.4 Customer Satisfaction at Popular Fast-Food Restaurants (2021)



Source: Author's depiction of publicly available data.

influence on all who come in contact with Chick-fil-A."[6] For instance, Chick-fil-A's policy of not opening on Sundays would likely not be tenable in a publicly traded company.

Problems arise when a robust corporate culture clashes with societal culture and values. Indeed, Chick-fil-A became embroiled in several controversies. One issue was Chick-fil-A's corporate social responsibility. In particular, the company donated millions of dollars to foundations that oppose same-sex marriage. A related issue was public statements by then-CEO Dan Cathy that were hateful toward members of the LGBTQ+ community. Many Christians believed that these comments ran counter to the teachings of Jesus Christ, which focus on love for others. Not surprisingly, the public outcry was swift. Protests and calls for boycotts of Chick-fil-A ensued.

Although the boycotts received significant media attention, they did not impact Chick-fil-A's bottom line. Indeed, the boycotts turned into "buycotts" as Chick-fil-A fans turned out in droves to show their support for the company. Nonetheless, the negative media coverage and public outcry resulted in Chick-fil-A implementing changes to some of its controversial policies. In particular, Chick-fil-A changed its giving policy. It now focuses on education, homelessness, and hunger.

Observers also noted that while Chick-fil-A's founder, S. Truett Cathy, served as CEO for almost 50 years and was working in the restaurant business for 70 years (until the age of 92), his son Dan Cathy retired from the CEO position after only eight years.[7] When appointed CEO in 2021, Andrew Cathy was only in his early 40s. Shortly after becoming CEO, Andrew Cathy stated in an interview with *The Wall Street Journal* that Chick-fil-A "should treat everybody with honor, dignity, respect, and we open our doors to everybody ... [and] we serve everybody."[8]

DISCUSSION QUESTIONS

1. Detail the roles that Chick-fil-A's structure, culture, and control play in the company's achieving a competitive advantage. Which components are most important? Or, is the interplay of the elements an integrated system that forms the basis of the company's competitive advantage?
2. Do you agree with the author's thesis that Chick-fil-A's structure, culture, and control form the basis of the company's competitive advantage? Why or why not? Or, are other things such as the secret recipe for the classic chicken sandwich and the food quality more important in explaining Chick-fil-A's success? Discuss.
3. Chick-fil-A is a privately owned family business. As such, its strategic leaders have more degrees of freedom in the way they run the business (e.g., not opening on Sundays). Yet, being privately owned limits access to capital because all growth must be financed through retained earnings. Self-financing results in a slower pace of expansion. Should Chick-fil-A consider going public by issuing stock? An initial public offering would provide access to vast financial resources to fuel expansion domestically and internationally. Faster growth can allow for first-mover advantages by locking up the most desirable locations, suppliers, and so on. Some critics argue that Chick-fil-A should go public because more people can participate in the company's success, and the purpose-driven company can "bless more lives." Discuss the pros and cons of Chick-fil-A's ownership structure and the implications if the company were to go public.
4. This MiniCase indicates that strong corporate cultures are often a plus but can have downsides. Chick-fil-A created controversy with its giving policies (now changed) and statements by its then-CEO. As a strategic leader, what can you do to develop a robust corporate culture while not conflicting with societal values? Also, did it surprise you that the Chick-fil-A boycotts turned into a "buycott" (i.e., the company's sales rose)? Why or why not? Explain.
5. Given its popularity, Chick-fil-A will eventually reach maturity in the United States. Although Chick-fil-A's distinctive culture and approach traveled well beyond Georgia, can it succeed outside the United States? Do you think its unique culture, structure, and control are suitable for international expansion? Why or why not? Explain.

Endnotes

1. Quote from https://www.chick-fil-a.com/, see https://bit.ly/3JKWBAu
2. Quote from https://www.chick-fil-a.com/franchise
3. Let's do a back-of-the-envelope calculation: Exhibit MC11.1 indicates that the average Chick-fil-A (CFA) restaurant makes about $5 million in revenue per year. CFA corporate takes 15% royalties off the top line, which leaves $4,250,000. This net revenue amount is split 50/50 between the operator and CFA. The growth profit for the operator, therefore, is $2,125,000. Assuming that the operator has 50% costs in running the store (e.g., employee wages, supplies, utilities), the operator

can earn a net profit (before taxes) of a bit more than $1 million ($1,062,500 to be exact for this hypothetical example).

4. Glassdoor is a website where current and former employees anonymously review companies. A Chick-fil-A review posted on August 7, 2022, https://www.glassdoor.com/Reviews/Chick-fil-A-Reviews-E5873.htm

5. See the work by Barry Schwartz (2004), *The Paradox of Choice: Why More Is Less* (New York: Ecco).

6. Quote from https://www.chick-fil-a.com/, see https://bit.ly/3JKWBAu

7. Chick-fil-a was officially founded in 1967, so S. Truett Cathy served as CEO for 46 years, but 67 years as owner and operator of restaurants, because the Dwarf Grill, which was founded in 1946, and a second restaurant which was open shortly after the Dwarf Grill (run by Truett's brother Ben, who died in a plane crash in 1949 alongside another brother, Horace).

8. Haddon, H. (2021, Oct. 31), "A new generation leads Chick-fil-A's growing flock," *The Wall Street Journal*.

Sources: Mai-Duc, C. (2022, Apr. 23), "Chick-fil-A's crazy long drive-through lines have Santa Barbara residents squawking," *The Wall Street Journal;* Haddon, H. (2021, Oct. 31), "A new generation leads Chick-fil-A's growing flock," *The Wall Street Journal;* Georgia Historical Society (2020, May), *Georgia Business History Initiative: Chick-fil-A*; Maidenberg, M. (2019, May 8), "Chick-fil-A's lean menu helps chain bulk up," *The Wall Street Journal;* Taylor, K. (2016, Jan. 28), "Why Chick-fil-A will never go public," *Business Insider;* Kruse, K. (2015, Dec. 8), "How Chick-fil-A created a culture that lasts," *Forbes;* Calia, M., and J. Jargon (2014, Sep. 8), "Chick-fil-A founder, a champion of conservatism and chicken, dies at 93," *The Wall Street Journal;* Schwartz, B. (2004), *The Paradox of Choice: Why More Is Less* (New York: Ecco); "The Economics of Chick-fil-A," a WSJ video [8:23 min] https://www.youtube.com/watch?v=grkHcEyZu04; and various webpages at https://www.chick-fil-a.com/about/history.

MiniCase 12

Purdue Pharma and the Opioid Addiction Crisis

"Delayed absorption, as provided by OxyContin tablets, is believed to reduce the abuse liability of a drug."[1]

Purdue Pharma's OxyContin is one of the world's most successful legal drugs. Its revenues soared from $48 million in 1996, when the drug launched, to over $1 billion in 2000, an astonishing 120% year-over-year growth rate. In 2010, OxyContin crossed the $3 billion sales per year threshold. By the time Purdue Pharma filed for bankruptcy in 2019, OxyContin had accumulated $35 billion in sales. In a few short years before the bankruptcy filing, the Sackler family, owners of Purdue Pharma, siphoned off $13 billion in profits, making it one of the world's wealthiest billionaire families.

How did OxyContin achieve such massive commercial success, especially in the highly regulated prescription-drug market? The answer: Purdue Pharma used aggressive lobbying and marketing tactics. In the process, it co-opted regulators, medical accreditation boards, hospitals, and doctors to do its bidding. As a result, over 1 million Americans have died from OxyContin overdoses since 2000. In just one year, 2021, almost 110,00 Americans fatally overdosed. Indeed, OxyContin claimed more lives than the total number of casualties the United States sustained in World War I (53,400) and the Vietnam War (53,200), which are the third and fourth deadliest wars the United States has fought.[2]

The economists Anne Case and Angus Deaton believe that the opioid addiction crisis directly leads to "deaths of despair."[3] These are behavior-related medical conditions in people who view their social and economic prospects as bleak. Diseases, addictions, and psychological problems leading to deaths of despair include drug overdose and alcoholism. OxyContin is a gateway drug to street heroin and illicit fentanyl, which is many times

OxyContin was among the most successful legal drugs in the last 20 years. Some patients hailed it as a "wonder prescription" because it allowed them to get their lives back by living without chronic pain, while others described it as "a prescription from hell." Economists determined that the opioid addiction crisis began with an aggressive marketing push by Purdue Pharma. By the time the company filed for bankruptcy, OxyContin had brought in $35 billion in total sales, making the Sackler family one of the wealthiest families in the world.

REUTERS/Alamy Stock Photo

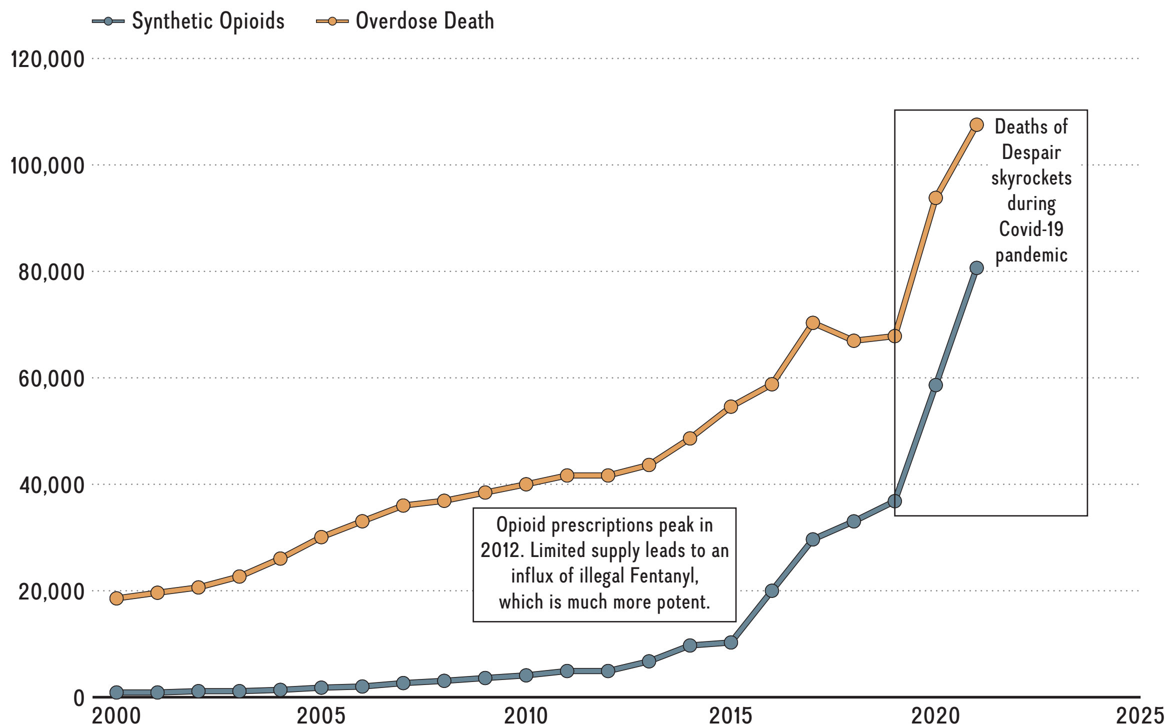
more potent (but legal when prescribed by a doctor). In another study, a team of researchers provided empirical evidence that Purdue Pharma's marketing push for OxyContin marked the start of the opioid addiction crisis.[4] While sobering, the results of these studies are not surprising, considering that the United States has only 4% of the world population but consumes 80% of all opioids globally. Exhibit MC12.1 shows the number of overdose deaths in the United States from synthetic opioids such as OxyContin and fentanyl and the total number of overdose deaths since 2000.

Purdue Pharma

Purdue Pharma was a privately held pharmaceutical company owned by the Sackler family. Until the mid-1980s, Purdue Pharma was a humdrum business,

Frank T. Rothaermel prepared this MiniCase with Veronica Bian, who provided superb research assistance. The MiniCase is based on public sources and is for class discussion. It is not intended to be used for any endorsement, source of data, or depiction of efficient or inefficient management. All opinions expressed and all errors and omissions are entirely the author's. Revised and updated: July 19, 2022.

EXHIBIT MC12.1 Number of Overdose Deaths in the United States from Synthetic Opioids and the Total Number of Opioid Overdose Deaths, 2000-2021



Source: Author's depiction of publicly available data.

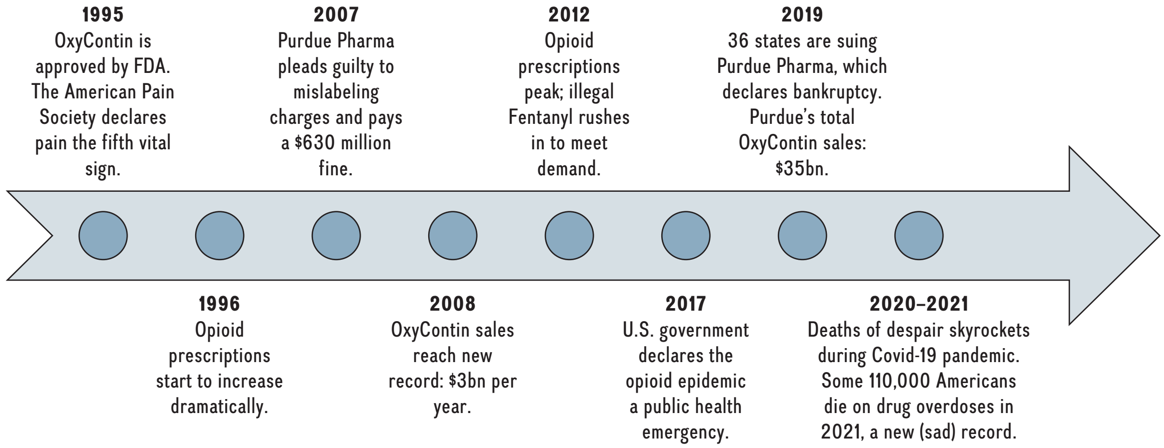
selling over-the-counter medications such as laxatives and earwax removal kits. Spearheaded by the ambitious, second-generation Richard Sackler, Purdue Pharma entered the market for opioids with MS Contin in 1987. Opioids such as morphine and heroin are derived from the opium poppy and are used to treat severe pain, as in late-stage cancer. The government strictly controls medicines such as morphine and opioids because they are highly addictive.

Purdue Pharma's innovation breakthrough with MS Contin was a time-controlled release formulation.[5] That is, in patients taking MS Contin, morphine was released evenly into the bloodstream over several hours. Before MS Contin, cancer patients, for instance, had to stay in a hospital to manage their pain because opioids had to be delivered via intravenous (IV) drip. Once morphine was available in tablet form, cancer patients could treat their pain at home. The U.S. Food and Drug Administration (FDA) approved MS Contin in 1987 with highly restricted use for severe pain or end-of-life palliative care. Although MS Contin was a successful product for Purdue Pharma, it had narrow applications and thus represented a small market. Because the dispensing of MS Contin was tightly controlled, there were no known reports of MS Contin abuse.

The Sackler family—many of them serving on Purdue Pharma's board and as executives—wanted more. The patent for MS Contin was about to expire, and the company was trying to identify other situations in which the innovative time-controlled formula would be useful. Following a suggestion by Kathe Sackler, researchers at Purdue Pharma came up with the idea of combining the time-release formula with oxycodone, an inexpensive opioid. Thus, OxyContin was born.

Purdue Pharma obtained a patent on OxyContin because it was the first drug with pure codeine combined with the novel extended-release formula. The company obtained FDA approval in late 1995 and launched OxyContin in early 1996 as a long-lasting, less addictive narcotic for treating moderate to severe pain. Because many believed codeine was not as potent as morphine, and because the codeine was

EXHIBIT MC12.2 Timeline of Key Events Since OxyContin's Release (1995-2021)



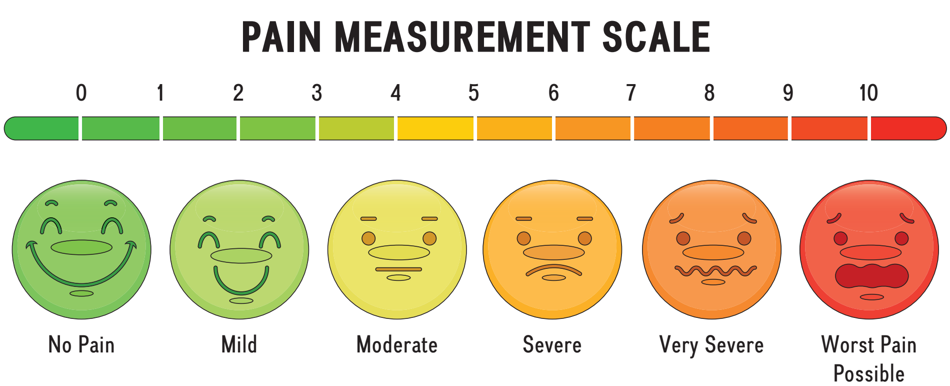
Source: Author's depiction of publicly available data.

combined with the time-release mechanism, the FDA approved OxyContin not just for severe pain but also for moderate pain such as that caused by a sprained ankle or a migraine headache. Exhibit MC12.2 depicts a timeline of key events since the release of OxyContin.

Ethically Questionable Tactics

Purdue Pharma turbocharged the marketing for OxyContin, creating demand by manipulating physicians and their prescribing habits. Purdue Pharma's marketing spending for OxyContin far exceeded the company's marketing budget on its previous drug, MS Contin. Specifically, it spent over $200 million to double its sales force and launch a highly effective marketing campaign with false claims that wooed physicians nationwide. Here are some examples of how the company made OxyContin a smashing success:

- **Creating a National Pain Movement.** In the 1990s, treating pain as "the fifth vital sign"[6] became a trend propelled by the American Pain Society. Thus, the idea that pain was widely undertreated permeated the medical industry. Purdue Pharma helped propagate this view by funding "independent" pain societies that advocated for the increased use of opioids to treat chronic pain. The company even funded articles on pain treatment



To generate awareness of pain as an undertreated condition and to facilitate prescriptions of OxyContin for any type of pain, Purdue Pharma funded several "pain societies" that outfitted doctors' offices with pain scales like the one shown above. The problem with using pain as the "fifth vital sign" is that, unlike the other vital signs (blood pressure, pulse rate, respiration [breathing] rate, and body temperature), the experience of pain is highly subjective and cannot be estimated objectively.

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that were published in highly regarded academic medical journals and other essential periodicals for health professionals. In doing so, the company shifted the national narrative to combat the epidemic of pain undertreatment, and Purdue Pharma had a solution: OxyContin.

- **Obtaining FDA Approval.** At the same time, Purdue Pharma heavily lobbied the FDA, a federal regulatory agency whose mandate is to protect public health by ensuring the safety and efficacy of medications. The FDA approved OxyContin for a broad application of pain management, ranging from mild to severe pain. Moreover, the FDA granted OxyContin an unprecedented label stating that the drug was less addictive than earlier opioids. The label's wording was confusing and vague (see quote at the beginning of this MiniCase), allowing Purdue Pharma to promote OxyContin for alleviating everyday pains that typically do not necessitate the use of opioids. Purdue Pharma claimed that OxyContin provides 12-hour relief, a duration over twice as long as what other pain-relief medications were able to offer at the time. Yet, a clinical trial showed these claims were false; many patients given OxyContin were asking for more pain relievers before 12 hours had passed. Nevertheless, Purdue Pharma pressed the FDA to approve OxyContin. The FDA relented. The FDA examiner who approved OxyContin left the FDA shortly afterwards to trade his lower-paying government job for a $400,000-a-year position at Purdue Pharma (inflation-adjusted $780,000 salary).
- **Downplaying the Risk of Addiction.** In its widely circulated marketing materials and its sales reps' visits with doctors, Purdue Pharma stated that the risk of addiction to OxyContin was less than 1%. Although this statement was factually false, it misled many physicians to overprescribe the drug. In reality, the drug's risk of addiction among patients experiencing chronic, non-cancer-related pain can reach 50% or more depending on the dose and duration of opioid exposure. Moreover, Purdue Pharma targeted general practitioners rather than working with oncologists and pain specialists who have a deep understanding of opioids. In particular, Purdue Pharma reps fanned out to rural areas such as West Virginia, where people worked in coal mines and other high-risk jobs and had a lot of injuries. General practitioners were much more easily duped than specialists.
- **Ignoring Symptoms of Addiction.** When doctors prescribing OxyContin reported their patients were showing signs of withdrawal and requesting more pain medication, Purdue Pharma quelled their concerns. The Pharma reps told the doctors that their patients were experiencing "pseudo-addiction," a sensation that resembles addiction but is caused by unrelieved pain. Purdue Pharma assured doctors that these patients weren't addicts but simply needed more OxyContin. When it became clear that people were abusing OxyContin by crushing and snorting the pills to experience a quicker high, Purdue Pharma insisted that those people were not taking the drug as directed. Meanwhile, users could learn about abuse methods by reading a warning label on each prescription stating, "Taking broken, chewed, or crushed OxyContin tablets could lead to the rapid release and absorption of a potentially toxic dose." People with a drug abuse disorder preferred OxyContin over illicit street drugs such as heroin because they knew that the synthetic opioid in the pill was pure. After all, it was an approved medical drug manufactured with best-in-class processes.
- **Hiring and Rewarding Ambitious Sales Representatives.** OxyContin's success is primarily due to aggressive sales representatives motivated by Purdue Pharma's lucrative bonus system. Sales commissions were tied to the number of milligrams of OxyContin sold, thus encouraging reps to push ever larger doses of OxyContin. When first released, OxyContin started with a 10-mg tablet, upgraded in steps to 160 mg (enough to overdose with one pill if the taker was not opioid tolerant). Purdue Pharma's sales representatives were told to do whatever it took to achieve sales, whether bribing the doctors' receptionists or establishing rapport with physicians. Purdue Pharma focused on building a sales force of people who were highly ambitious, young, and physically attractive. The drug maker also preferred people who knew little to nothing about opioids and narcotics, making them eager consumers of any information that Purdue Pharma provided.
- **Targeting High Prescribers.** Purdue Pharma bought fine-grained data that provided insight into physicians' prescribing behaviors by geographic region across the nation. The company noticed that doctors in distressed, rural towns were already prescribing opioids at higher rates than most other

doctors were. Purdue Pharma leveraged this insight to heavily market OxyContin to physicians viewed as indiscriminate prescribers with a patient population with a high need for pain management. Sales representatives were keen to zero in on these high prescribers, whom they termed “whales.” The sales reps provided doctors with all sorts of gifts, from paying for a family Disney vacation to filling up their car with gas or bringing lunch to the office every time they showed up. When meeting with the doctors, the salespeople emphasized catchphrases, such as: “OxyContin is the drug to start on, and to stay on” and “Less than 1% of patients will be addicted.” Indeed, some of the so-called “pain mill doctors” made millions of dollars by over-prescribing OxyContin to all comers.

- **Pampering Physicians.** Purdue Pharma hosted many all-expenses-paid “pain management symposiums” at exclusive resorts in Florida, Arizona, and California. Attended by over 5,000 nurses, physicians, and pharmacists, these lavish symposiums subliminally influenced clinicians’ prescription practices. Although these pain symposia camouflaged as professional meetings focused on the continuing education of health care providers, in reality they were a combination of a frat party and religious revival meeting, with some entertaining lectures thrown in. Purdue Pharma spent up to $9 million annually just to wine and dine doctors.
- **Changing Regulations.** In 2010, the Patient Protection and Affordable Care Act took effect, providing insurance access for millions of previously uninsured Americans. With expanded health coverage, doctors were happy to prescribe pain medications such as OxyContin, which insurance companies would pay for. Indeed, in 2010, OxyContin hit its sales record of over $3 billion per year.
- **Hiring McKinsey.** Since 2004, Purdue Pharma had retained McKinsey, a premier strategy consultancy, to help turbocharge sales. Still, sales started to decline after prescriptions for OxyContin peaked in 2012. In 2017, the U.S. government declared the opioid epidemic a national health emergency. Rather than viewing this situation as a moral crisis, McKinsey provided detailed recommendations on how Purdue Pharma could continue to reap vast sales each year. Indeed, McKinsey furnished a report and clear guidance on increasing sales by $400 million annually. One recommendation was to go on a public relations offensive to counter the emotional messages from parents with teenagers who had overdosed on the drug. Another McKinsey recommendation was to provide discounts to pharmacies when a patient overdosed so that Purdue Pharma would make up the pharmacies’ losses.

The Endgame

Since launching OxyContin, Purdue Pharma has faced thousands of lawsuits by entities across the country who accuse the firm of fueling the opioid crisis. Most notably, in 2007, Purdue Pharma pled guilty to criminal charges of mislabeling its blockbuster drug as less addictive than it is and less likely to be abused than other opioids. The company paid over $600 million in fines but was not deterred by the settlement. It went on to triple sales of OxyContin in the following two years.

After an almost 25-year run making billions, in 2019, the gig was up after three dozen states sued the company and named members of the Sackler family as defendants (Exhibit MC12.2). The company, Purdue Pharma, but none of its executives, pleaded guilty to federal felonies regarding its marketing of OxyContin. The company filed for bankruptcy because Purdue Pharma faced thousands of claims valued at $1 trillion. The Sackler family worked out a deal that they would pay $4.5 billion in fines and leave the pharma business. Purdue Pharma would be restructured and turned into a benefits corporation whose proceeds would go to the states dealing with the fallout of opioid addiction. In addition, the members of the Sackler family would receive immunity from all future civil and criminal litigations. In 2021, a bankruptcy court approved the agreement.

Some state attorneys general appealed the decision, which a federal court subsequently overturned. In 2022, the Sackler family cut another deal with several states that had initially sued them. The states settled for $6 billion with the condition of a complete release from all future claims against the Sacklers. Other states still objected. Although the case remains in legal limbo, the Sackler family has the resources to buy the best defense money can afford. It is not clear they would be convicted of any wrongdoing—especially because their crucial argument is that they just sold a government-approved drug that helps millions of legitimate pain patients. Indeed, the Sacklers received hundreds of letters from patients thanking them for OxyContin and "for giving them their life back"—a life without chronic pain such as arthritis.

Even if the Sacklers are convicted, securing the $13 billion the family had taken out of the business shortly before bankruptcy would be challenging because the money is stashed away in offshore trusts. And any legal proceedings could go on for many years. At this point, it appears that the Sackler family members could walk away from the OxyContin scandal unscathed, other than having their names removed from the museums and universities to which they gave money.

DISCUSSION QUESTIONS

1. Who is responsible for the opioid crisis: Purdue Pharma, the FDA, patients, people with a drug use disorder, or all the above? Where lies the blame? Anand Giridharadas, *New York Times* bestselling author of *Winners Take All: The Elite Charade of Changing the World,* concludes: "If you look at the way in which the opioid crisis killed people, it is a direct, malicious, forthright set of choices by various actors that predictably, reliably, foreseeably killed very large numbers of people."[7] Do you agree with this assessment? Discuss.
2. The Sackler family and executives of Purdue Pharma maintain that they have done nothing wrong. They argue that all they did was develop and market an innovative drug that the FDA approved. The Sacklers firmly believe they did something good with OxyContin, which has allowed millions of people to cope with debilitating pain. They view pain (arthritis, back pain, and so on) as heavily undertreated in the United States. They maintain that the problem lies with the drug abusers and not with the company that developed the drug. Advancing a libertarian argument, the Sacklers liken their company to a gun manufacturer and argue that the gun manufacturer doesn't shoot people, but people kill people using guns. To date, none of the Sacklers has been convicted of any wrongdoing. They maintain their innocence and feel they are scapegoats for the drug-addiction crisis and for other pharma companies that also sold opioids. How do you assess this viewpoint?
3. Discuss the tension between ethical actions and legal actions. Some tactics might be legal but unethical. What should an executive do when faced with this tension? What would you do?
4. Purdue Pharma's significant innovation was the time-released version of codeine, which led to OxyContin. Purdue Pharma promoted the drug as less addictive, a claim the FDA approved. Yet, the claim was phony. It was based not on a scientific study but on a small anecdotal sample described in a letter to the editor of a leading medical journal (*JAMA*, or *Journal of the American Medical Association*). When do marketing claims become unethical?
5. In ChapterCase 12, we learned that two Theranos executives, Elizabeth Holmes and Sunny Balwani, will face prison for committing fraud. Yet, not a single death was caused by Theranos' medical devices. In contrast, over 1 million Americans have died of despair, with most of those deaths directly or indirectly related to opioid addictions, which started with OxyContin's marketing push. None of the Sacklers has been convicted, nor have they lost the billions they stashed away in overseas trusts. Where is the justice? How do you assess this situation, especially since many of the Sackler family members held similar executive positions at Purdue Pharma as Holmes and Balwani at Theranos? And both companies were private, not publicly owned stock companies.
6. The consultancy McKinsey paid $600 million to settle investigations for its role in advising Purdue Pharma on how to push OxyContin sales while not admitting any wrongdoing. The senior partners at McKinsey were unhappy because each partner takes a share of the company's profits, which are now $600 million less due to the settlement. To show their disapproval, McKinsey partners did not renew the term of their CEO, an unusual occurrence. They argued that McKinsey did nothing wrong and they were entitled to the $600 million. And, if it went that far, McKinsey should have fought any lawsuit. Does McKinsey have any blame for the opioid addiction crisis? How do you assess the sentiment of the company's senior partners? What would you do if you were working at McKinsey and were assigned to be part of the Purdue Pharma consulting project? Discuss.

Endnotes

1. FDA-approved package insert for OxyContin, which played a key role in Purdue Pharma's marketing, cited and discussed in: Keefe, P.R. (2021), *Empire of Pain: The Secret History of the Sackler Dynasty* (New York: Doubleday).

2. The highest number of U.S. military casualties were sustained in World War II (292,000) and the Civil War (215,000).

3. Case, A., and A. Deaton (2020), *Deaths of Despair and the Future of Capitalism* (Princeton, NJ: Princeton University Press).

4. Alpert, A.E., W.N. Evans, E.M.J. Lieber, and D. Powell (2019), "Origins of the opioid crisis and its enduring impacts," NBER Working Paper 26500, doi 10.3386/w26500.

5. "Contin" is short for "continuous."

6. The four vital signs are blood pressure, pulse rate, respiration [breathing] rate, and body temperature. These four are objective metrics that can be compared across patients. In contrast, pain is a subjective feeling a patient has, and there is no objective metric to assess someone's pain.

7. Giridharadas, A. (2021, Feb. 25), Capitalisn't [podcast], University of Chicago, transcript at https://bit.ly/3ySVoSF.

Sources: Randles, J. (2022, Mar. 3), "Purdue's Sacklers, states reach opioid deal valued at up to $6 billion," *The Wall Street Journal;* Hoffman, J. (2022, Mar. 3), "Sacklers and Purdue Pharma reach new deal with states over opioids," *The New York Times;* Randles, J. (2021, Sep. 1), "Purdue Pharma bankruptcy plan approved, freeing Sacklers from lawsuits," *The Wall Street Journal;* Scheck, J., and V. Fuhrmans (2021, Feb. 24), "McKinsey partners vote out leader in wake of opioid settlement, other crises," *The Wall Street Journal;* Forsythe, M., and W. Bogdanich (2021, Feb. 3), "McKinsey settles for nearly $600 million over role in opioid crisis," *The Wall Street Journal;* Keefe, P.R. (2021), *Empire of Pain: The Secret History of the Sackler Dynasty* (New York: Doubleday); Chow, R. (2021), "Purdue Pharma and OxyContin – a commercial success but public health disaster," *Harvard Public Health Review* 28; The Megyn Kelly Show (2021, Dec. 24), "'Dopesick' - the Sackler family: a Megyn Kelly Show true crime special [episode 229], https://youtu.be/U57Od-0vIEdM; U.S. Department of Health and Human Services (2021, Oct. 27), "What is the U.S. opioid epidemic?" hhs.gov; Mann, B. (2021, Sep. 1), "The Sacklers, who made billions from OxyContin, win immunity from opioid lawsuits;" *NPR,* npr.org; Preuss, C.V., A. Kalava, and K.C. King (2021, Aug. 31), "Prescription of controlled substances: benefits and risks," StatPearls, https://www.ncbi.nlm.nih.gov/books/NBK537318/; National Institute on Drug Abuse (2021, Mar. 11), "Opioid overdose crisis," NIDA, nida.nih.gov; Centers for Disease Control and Prevention Injury Center (2021, Mar. 17), "Understanding the epidemic | drug overdose," cdc.gov; Sweeney, C. (2021, Feb. 16), "A crisis on top of a crisis: COVID-19 and the opioid epidemic," Harvard School of Public Health; Case, A., and A. Deaton (2020), *Deaths of Despair and the Future of Capitalism* (Princeton, NJ: Princeton University Press); Kolodny, A. (2020, Aug.) "How FDA failures contributed to the opioid crisis," *AMA Journal of Ethics,* journalofethics.ama-assn.org; Alpert, A.E., W.N. Evans, E.M.J. Lieber, and D. Powell (2019), "Origins of the opioid crisis and its enduring impacts," *NBER Working Paper* 26500, doi 10.3386/w26500; Hopkins, J.S., and A. Scurria (2019, Oct. 4), "Sacklers received as much as $13 billion in profits from Purdue Pharma," *The Wall Street Journal;* Macy, B. (2018), *Dopesick: Dealers, Doctors, and the Drug Company that Addicted America* (New York: Little, Brown and Company); Prince, J., and W. Seiden (2017, Jun.), "The national opioid epidemic: local, state, and national responses," *Wisconsin Medical Journal,* wmjonline.org; Zee, A. (2009), "The promotion and marketing of OxyContin: commercial triumph, public health tragedy," *American Journal of Public Health* 99(2); Adams, C. (2002, May 16), "Painkiller's sales far exceeded levels anticipated by maker," *The Wall Street Journal.*

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FINANCIAL RATIOS FOR CASE ANALYSIS

	Formula
Profitability Ratios: "How profitable is the company?"	
Gross Margin (or EBITDA, EBIT, etc.)	(Sales − COGS) / Sales
Return on Assets (ROA)	Net Income / Total Assets
Return on Equity (ROE)	Net Income / Total Stockholders' Equity
Return on Invested Capital (ROIC)	Net Operating Profit After Taxes / (Total Stockholders' Equity + Total Debt − Value of Preferred Stock)
Return on Revenue (ROR)	Net Profits / Revenue
Dividend Payout	Common Dividends / Net Income
Activity Ratios: "How efficient are the operations of the company?"	
Inventory Turnover	COGS / Inventory
Receivables Turnover	Revenue / Accounts Receivable
Payables Turnover	Revenue / Accounts Payable
Working Capital Turnover	Revenue / Working Capital
Fixed Asset Turnover	Revenue / Fixed Assets
Total Asset Turnover	Revenue / Total Assets
Cash Turnover	Revenue / Cash (which usually includes marketable securities)
Leverage Ratios: "How effectively is the company financed in terms of debt and equity?"	
Debt to Equity	Total Liabilities / Total Stockholders' Equity
Financial Leverage Index	Return on Equity / Return on Assets
Debt Ratio	Total Liabilities / Total Assets
Interest Coverage (Times Interest Earned)	(Net Income + Interest Expense + Tax Expense) / Interest Expense
Long-Term Debt to Equity	Long-Term Liabilities / Total Stockholders' Equity
Debt to Market Equity	Total Liabilities at Book Value / Total Equity at Market Value
Bonded Debt to Equity	Bonded Debt / Stockholders' Equity
Debt to Tangible Net Worth	Total Liabilities / (Common Equity − Intangible Assets)
Liquidity Ratios: "How capable is the company of meeting its short-term obligations?"	
Current	Current Assets / Current Liabilities
Quick (Acid-Test)	(Cash + Marketable Securities + Net Receivables) / Current Liabilities
Cash	(Cash + Marketable Securities) / Current Liabilities
Operating Cash Flow	Cash Flow from Operations / Current Liabilities
Cash to Current Assets	(Cash + Marketable Securities) / Current Assets
Cash Position	Cash / Total Assets
Current Liability Position	Current Liabilities / Total Assets
Market Ratios: "How does the company's performance compare to other companies?"	
Book Value per Share	Total Stockholders' Equity / Number of Shares Outstanding
Earnings-Based Growth Models	$P = kE / (r - g)$, where k = Dividend Payout Rate, E = Earnings, r = Discount Rate, and g = Earnings Growth Rate
Market-to-Book	(Stock Price × Number of Shares Outstanding) / Total Stockholders' Equity
Price-Earnings (PE) Ratio	Stock Price / EPS
Price-Earnings Growth (PEG) Ratio	PE / Earnings Growth Rate
Sales-to-Market Value	Sales / (Stock Price × Number of Shares Outstanding)
Dividend Yield	Dividends per Share / Stock Price
Total Return to Shareholders	Stock Price Appreciation + Dividends