PART 1

Strategic Management Inputs

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Studying this chapter should provide you with the strategic management knowledge needed to:

1. Define strategic competitiveness, strategy, competitive advantage, above-average returns, and the strategic management process.
2. Describe the competitive landscape and explain how globalization and technological changes shape it.
3. Use the industrial organization (I/O) model to explain how firms can earn above-average returns.
4. Use the resource-based model to explain how firms can earn above-average returns.
5. Describe vision and mission and discuss their value.
6. Define stakeholders and describe their ability to influence organizations.
7. Describe the work of strategic leaders.
8. Explain the strategic management process.
Borders changed the way books were sold and became the largest book retailer in the world. At one time, it had more than 1,300 large stores and approximately 35,000 employees. But, in February 2011, Borders declared bankruptcy. When it did so, it had shrunk to 674 stores and about 19,500 employees. Borders experienced hard times and paid for the ineffective strategies employed by its executive leadership teams. At its peak in the 1990s, Borders stock sold for more than $35 per share. On the day it declared bankruptcy, Borders stock sold for 23 cents per share.

What went wrong? Many goods are now sold by large chain store retailers. However, the way people buy and what they buy is beginning to change—especially in retail sales of books. Since 1995 and the founding of Amazon.com, books have been sold over the Internet. But with the rise of digital technology, electronic books and devices to read them have become highly popular. Quite obviously, they do not require large “brick-and-mortar” stores to sell them. Borders simply did not adjust quickly or effectively to these changes in the marketplace. Of course, it had to compete against Barnes & Noble, Walmart, Costco, and other large retailers selling books. It did not adjust quickly to Amazon’s appearance in the market. It was much slower than Barnes & Noble, and that company required almost two years to launch barnesandnoble.com. One of Borders’ early mistakes was to develop an agreement with Amazon to handle its Internet sales instead of establishing its own Web presence.

Web-based retailing is growing in popularity, especially for electronic books. With eReaders such as Amazon’s Kindle, Barnes & Noble’s NOOK, and Apple’s highly versatile iPad, the old way of selling books is rapidly becoming a dinosaur. While these changes were occurring in the retail book market, Borders invested heavily to enhance the marketing for traditional book selling. Borders tried to lure customers to its stores with promises of an enriching experience. Borders was also harmed by chaos in its executive ranks, having three regular CEOs and an interim CEO within a period of about two years. As a result of poor strategic decisions and ineffective strategic leadership, Borders suffered net losses of $344 million for 2008 and 2009. It also had compiled a massive debt in a campaign to buy back its stock while trying to keep the price high. All of its actions had the opposite effect.

With the bankruptcy, Borders wants to stay in business if it can reach agreement with its debtors. It plans to close about 200 more stores, and obtain reduced rent by renegotiating its current long leases. But it must do much more and quickly if it is to survive in the new book retail market. At the present time, it is difficult to see how Borders can survive without the capabilities to navigate in this new competitive landscape.

As we see from the Opening Case, Borders was highly unsuccessful because of its inability to compete against other major book retailers, especially in the area of Internet book sales. Therefore, we can conclude that Borders was not competitive (unable to achieve strategic competitiveness). It clearly was unable to earn above-average returns. In fact, it suffered significant net losses and eventually had to declare bankruptcy because of inadequate cash flow and assets that were valued less than its liabilities. Its competitors, Barnes & Noble and Amazon, were more competitive and adjusted more effectively to changes in the book retail market. For example, both firms had eReaders (the NOOK and Kindle, respectively) to sell along with electronic books. They used the strategic management process (see Figure 1.1) as the foundation for the commitments, decisions, and actions they took to pursue strategic competitiveness and above-average terms. Obviously, Borders did not use this process and it cost the firm in major ways, perhaps even its ability to survive. The strategic management process is fully explained in this book. We introduce you to this process in the next few paragraphs.

**Strategic competitiveness** is achieved when a firm successfully formulates and implements a value-creating strategy. A **strategy** is an integrated and coordinated set of commitments and actions designed to exploit core competencies and gain a competitive advantage. When choosing a strategy, firms make choices among competing alternatives as the pathway for deciding how they will pursue strategic competitiveness. In this sense, the chosen strategy indicates what the firm will do as well as what the firm will not do.

As explained in the Opening Case, Borders tried to enrich its traditional approach with more marketing and making its stores more attractive. However, because the number of books sold through large chain store retailers has been declining, this strategy had little chance for success. A recent study conducted to identify the factors that contribute to the success of top corporate performers showed why Borders was unsuccessful. This study found that the top performers were entrepreneurial, market oriented (effective knowledge of the customers’ needs), used valuable competencies, and offered innovative products and services. Borders displayed none of these attributes. It clearly did not understand its market and customers and it was not innovative. Therefore, its lack of success is not surprising. A firm’s strategy also demonstrates how it differs from its competitors. Recently, Ford Motor Company devoted efforts to explain to stakeholders how the company differs from its competitors. The main idea is that Ford claims that it is “greener” and more technically advanced than its competitors, such as General Motors and Chrysler Group LLC (an alliance between Chrysler and Fiat SpA).

A firm has a **competitive advantage** when it implements a strategy that creates superior value for customers and that its competitors are unable to duplicate or find too costly to try to imitate. An organization can be confident that its strategy has resulted in one or more useful competitive advantages only after competitors’ efforts to duplicate its strategy have ceased or failed. In addition, firms must understand that no competitive advantage is permanent. The speed with which competitors are able to acquire the skills needed to duplicate the benefits of a firm’s value-creating strategy determines how long the competitive advantage will last.

**Above-average returns** are returns in excess of what an investor expects to earn from other investments with a similar amount of risk. Risk is an investor’s uncertainty about the economic gains or losses that will result from a particular investment. The most successful companies learn how to effectively manage risk. Effectively managing risks reduces investors’ uncertainty about the results of their investment. Returns are often measured in terms of accounting figures, such as return on assets, return on equity, or return on sales. Alternatively, returns can be measured on the basis of stock market returns, such as monthly returns (the end-of-the-period stock price minus the beginning stock price, divided by the beginning stock price, yielding a percentage return). In smaller, new venture firms, returns are sometimes measured in terms of the amount and
speed of growth (e.g., in annual sales) rather than more traditional profitability measures because new ventures require time to earn acceptable returns (in the form of return on assets and so forth) on investors’ investments. 10

Understanding how to exploit a competitive advantage is important for firms seeking to earn above-average returns. 11 Firms without a competitive advantage or that are not competing in an attractive industry earn, at best, average returns. Average returns are returns equal to those an investor expects to earn from other investments with a similar amount of risk. In the long run, an inability to earn at least average returns results first in decline and, eventually, failure. Failure occurs because investors withdraw their investments from those firms earning less-than-average returns. This is what happened to Borders when it was unable to earn returns. Indeed, it lost money and because of the investors’ lack of confidence in the firm, its stock price fell perilously close to zero.

As we noted above, there are no guarantees of permanent success. This is true for Borders, which enjoyed a considerable amount of success in the 1990s. Even considering
Apple’s excellent current performance, it still must be careful not to become overconfident and continue its quest to be the leader in its markets. (Apple is the topic of a Strategic Focus segment later in this chapter.)

The strategic management process (see Figure 1.1) is the full set of commitments, decisions, and actions required for a firm to achieve strategic competitiveness and earn above-average returns. The firm’s first step in the process is to analyze its external environment and internal organization to determine its resources, capabilities, and core competencies—the sources of its “strategic inputs.” Obviously, Borders’ process failed at this point because it did not understand the market in which it competed. It performed poorly against other large chain-store retailers and failed to foresee the major changes in the market with increasing sales of electronic books.

With the information gained from external and internal analyses, the firm develops its vision and mission and formulates one or more strategies. To implement its strategies, the firm takes actions toward achieving strategic competitiveness and above-average returns. Effective strategic actions that take place in the context of carefully integrated strategy formulation and implementation efforts result in positive outcomes. This dynamic strategic management process must be maintained as ever-changing markets and competitive structures are coordinated with a firm’s continuously evolving strategic inputs.

In the remaining chapters of this book, we use the strategic management process to explain what firms do to achieve strategic competitiveness and earn above-average returns. These explanations demonstrate why some firms consistently achieve competitive success while others fail to do so. As you will see, the reality of global competition is a critical part of the strategic management process and significantly influences firms’ performances. Indeed, learning how to successfully compete in the globalized world is one of the most significant challenges for firms competing in the current century.

Several topics will be discussed in this chapter. First, we describe the current competitive landscape. This challenging landscape is being created primarily by the emergence of a global economy, globalization resulting from that economy, and rapid technological changes. Next, we examine two models that firms use to gather the information and knowledge required to choose and then effectively implement their strategies. The insights gained from these models also serve as the foundation for forming the firm’s vision and mission. The first model (the industrial organization or I/O model) suggests that the external environment is the primary determinant of a firm’s strategic actions. Identifying and then competing successfully in an attractive (i.e., profitable) industry or segment of an industry are the keys to competitive success when using this model. The second model (resource-based) suggests that a firm’s unique resources and capabilities are the critical link to strategic competitiveness. Thus, the first model is concerned primarily with the firm’s external environment while the second model is concerned primarily with the firm’s internal organization. After discussing vision and mission, direction-setting statements that influence the choice and use of strategies, we describe the stakeholders that organizations serve. The degree to which stakeholders’ needs can be met increases when firms achieve strategic competitiveness and earn above-average returns. Closing the chapter are introductions to strategic leaders and the elements of the strategic management process.

The Competitive Landscape

The fundamental nature of competition in many of the world’s industries is changing. The reality is that financial capital continues to be scarce and markets are increasingly volatile. Because of this, the pace of change is relentless and ever-increasing. Even determining the boundaries of an industry has become challenging. Consider, for example, how advances in interactive computer networks and telecommunications have blurred
the boundaries of the entertainment industry. Today, not only do cable companies and satellite networks compete for entertainment revenue from television, but telecommunication companies are moving into the entertainment business through significant improvements in fiber-optic lines.19 Partnerships among firms in different segments of the entertainment industry further blur industry boundaries. For example, MSNBC is co-owned by NBC Universal and Microsoft. In turn, General Electric owns 49 percent of NBC Universal while Comcast owns the remaining 51 percent.20

Other characteristics of the current competitive landscape are noteworthy. Conventional sources of competitive advantage such as economies of scale and huge advertising budgets are not as effective as they once were in terms of helping firms earn above-average returns. Moreover, the traditional managerial mind-set is unlikely to lead a firm to strategic competitiveness. Managers must adopt a new mind-set that values flexibility, speed, innovation, integration, and the challenges that evolve from constantly changing conditions.21 The conditions of the competitive landscape result in a perilous business world, one in which the investments that are required to compete on a global scale are enormous and the consequences of failure are severe.22 Effective use of the strategic management process reduces the likelihood of failure for firms as they encounter the conditions of today’s competitive landscape.

Hypercompetition is a term often used to capture the realities of the competitive landscape. Under conditions of hypercompetition, assumptions of market stability are replaced by notions of inherent instability and change.23 Hypercompetition results from the dynamics of strategic maneuvering among global and innovative combatants.24 It is a condition of rapidly escalating competition based on price-quality positioning, competition to create new know-how and establish first-mover advantage, and competition to protect or invade established product or geographic markets.25 In a hypercompetitive market, firms often aggressively challenge their competitors in the hopes of improving their competitive position and ultimately their performance.26

Several factors create hypercompetitive environments and influence the nature of the current competitive landscape. The emergence of a global economy and technology, specifically rapid technological change, are the two primary drivers of hypercompetitive environments and the nature of today’s competitive landscape.

The Global Economy

A global economy is one in which goods, services, people, skills, and ideas move freely across geographic borders. Relatively unfettered by artificial constraints, such as tariffs, the global economy significantly expands and complicates a firm’s competitive environment.27

Interesting opportunities and challenges are associated with the emergence of the global economy.28 For example, the European Union (composed of several countries) has become one of the world’s largest markets, with 700 million potential customers. “In the past, China was generally seen as a low-competition market and a low-cost producer. Today, China is an extremely competitive market in which local market-seeking MNCs [multinational corporations] must fiercely compete against other MNCs and against those local companies that are more cost effective and faster in product development. While China has been viewed as a country from which to source low-cost goods, lately, many MNCs, such as P&G (Procter and Gamble) and other American companies, are shifting their activities to China to take advantage of the country’s lower cost base and higher productivity.”

The European Union is composed of more than 25 member states including Austria, Lithuania, and Ireland. While it began as a purely economic union, it has evolved into an organization that spans many areas from economic development to environmental policy.
Building strong relationships is an important dimension of Chinese culture. In fact, “Guanxi” (strong relationships in which each party feels obligated to help the other) is a major element of doing business in China. Over time, U.S. companies operating in Chinese markets have learned this lesson. Huawei has learned that Guanxi is also important for doing business in the United States.

Huawei is the largest manufacturer of phone network equipment in China and second in global markets to Sweden’s Ericsson AB. Huawei first invested in the United States in 2001 and has developed a sizable presence in global markets, yet the portion of its total sales revenue from North and South America is negligible. To help build its competitiveness in global markets, it hired John Roese, former Chief Technology Officer at Nortel Networks, to manage its North American R&D activities. It also hired Matt Bross, a former British Telecom executive, to serve as Chief Technology Officer for its U.S. operations. In 2010 it formed Amerilink Telecom Corp, based in Kansas, in an attempt to compete for large U.S. contracts.

Huawei has become a highly innovative company, filing 1,737 patents in 2008 alone. In fact, Fast Company ranked Huawei as the fifth most innovative company in its 2010 listing. The development of major R&D centers (including one in Silicon Valley in the United States) and the development of innovative products are helping Huawei to gain respect from experts in the telecommunications field. It has become a major supplier of telecommunications products such as routers and fiber systems and also has a significant share of the wireless market with its LTE and WiMAX technologies.

Despite these significant successes, Huawei has experienced problems in the U.S. market and with the U.S. government. For example, it tried to acquire several U.S. businesses in 2010 and 2011 without success. In 2010, it bid for 2Wire, a consumer electronics and software firm, and also tried to acquire the business telecom unit of Motorola, but both were sold to other companies. The companies said that they did not believe that Huawei would gain the approval from the U.S. government to make the purchase. In 2011, Huawei tried to acquire 3Leaf, a U.S.-based company that developed networking technology. Despite the fact the 3Leaf was insolvent, the Committee on Foreign Investment in the United States recommended against the acquisition. Members of the U.S. Congress and government officials had concerns about Huawei. Thus, Huawei has not built Guanxi with the U.S. government. Some of the concerns stem from the original linkages between Huawei and the Chinese military and because of prior charges against the company suggesting that it stole proprietary technology. Thus, Huawei has barriers to overcome.

Huawei continues to seek better footing in U.S. markets. For example, the company has asked the U.S. government to conduct a formal investigation of its business with the intent to clear its reputation. In addition, Huawei had a major 10-year anniversary celebration for its U.S. operations. The celebration was held in Santa Clara, California, at its new large R&D center. In the invitation, Huawei described the firm as a local global company. The invitation also explained that it has deepened its commitment to the United States in its first 10 years of operations there, and is a consumer-oriented, responsible corporate citizen in the communities where it has operations. These are the right words to say, but Huawei must also convince U.S. government officials of its positive value to the country. It needs to proactively build relationships with federal and state government officials.
Some have recommended that it invest in lobbyists to help build and support its relationships as do many large U.S. corporations. Regardless, to achieve the level of success in U.S. markets desired by Huawei, it will need to build Guanxi with U.S. government officials, customers, and suppliers.


and Gamble), are actually net exporters of local management talent; they have been dispatching more Chinese abroad than bringing foreign expatriates to China.” 29 China has become the second-largest economy in the world, surpassing Japan. India, the world’s largest democracy, has an economy that also is growing rapidly and now ranks as the fourth largest in the world.30 Simultaneously, many firms in these emerging economies are moving into international markets and are now regarded as multinational firms. This fact is explored in the Strategic Focus on Huawei. The discussion shows that barriers to entering foreign markets still exist, however. Essentially, Huawei must build credibility in the U.S. market, and especially build a positive relationship with stakeholders such as the U.S. government.

The statistics detailing the nature of the global economy reflect the realities of a hypercompetitive business environment and challenge individual firms to think seriously about the markets in which they will compete. Consider the case of General Electric (GE). Although headquartered in the United States, GE expects that as much as 60 percent of its revenue growth through 2015 will be generated by competing in rapidly developing economies (e.g., China and India). The decision to count on revenue growth in emerging economies instead of in developed countries such as the United States and European nations seems quite reasonable in the global economy. GE achieved significant growth in 2010 partly because of signing contracts for large infrastructure projects in China and Russia. GE’s CEO, Jeffrey Immelt, argues that we have entered a new economic era in which the global economy will be more volatile and that most of the growth will come from emerging economies such as Brazil, China, and India.31 Therefore, GE is investing significantly in these emerging economies, in order to improve its competitive position in vital geographic sources of revenue and profitability.

The March of Globalization

Globalization is the increasing economic interdependence among countries and their organizations as reflected in the flow of goods and services, financial capital, and knowledge across country borders.32 Globalization is a product of a large number of firms competing against one another in an increasing number of global economies.

In globalized markets and industries, financial capital might be obtained in one national market and used to buy raw materials in another. Manufacturing equipment bought from a third national market can then be used to produce products that are sold in yet a fourth market. Thus, globalization increases the range of opportunities for companies competing in the current competitive landscape.33

Firms engaging in globalization of their operations must make culturally sensitive decisions when using the strategic management process.34 Additionally, highly globalized firms must anticipate ever-increasing complexity in their operations as goods, services, people, and so forth move freely across geographic borders and throughout different economic markets.
Overall, it is important to note that globalization has led to higher performance standards in many competitive dimensions, including those of quality, cost, productivity, product introduction time, and operational efficiency. In addition to firms competing in the global economy, these standards affect firms competing on a domestic-only basis. The reason is that customers will purchase from a global competitor rather than a domestic firm when the global company’s good or service is superior. Because workers now flow rather freely among global economies, and because employees are a key source of competitive advantage, firms must understand that increasingly, “the best people will come from … anywhere.” Thus, managers have to learn how to operate effectively in a “multi-polar” world with many important countries having unique interests and environments. Firms must learn how to deal with the reality that in the competitive landscape of the twenty-first century, only companies capable of meeting, if not exceeding, global standards typically have the capability to earn above-average returns.

Although globalization offers potential benefits to firms, it is not without risks. Collectively, the risks of participating outside of a firm’s domestic country in the global economy are labeled a “liability of foreignness.”

One risk of entering the global market is the amount of time typically required for firms to learn how to compete in markets that are new to them. A firm’s performance can suffer until this knowledge is either developed locally or transferred from the home market to the newly established global location. Additionally, a firm’s performance may suffer with substantial amounts of globalization. In this instance, firms may over-diversify internationally beyond their ability to manage these extended operations. Overdiversification can have strong negative effects on a firm’s overall performance.

Thus, entry into international markets, even for firms with substantial experience in the global economy, requires effective use of the strategic management process. It is also important to note that even though global markets are an attractive strategic option for some companies, they are not the only source of strategic competitiveness. In fact, for most companies, even for those capable of competing successfully in global markets, it is critical to remain committed to and strategically competitive in both domestic and international markets by staying attuned to technological opportunities and potential competitive disruptions that innovations create.

### Technology and Technological Changes

Technology-related trends and conditions can be placed into three categories: technology diffusion and disruptive technologies, the information age, and increasing knowledge intensity. Through these categories, technology is significantly altering the nature of competition and contributing to unstable competitive environments as a result of doing so.

#### Technology Diffusion and Disruptive Technologies

The rate of technology diffusion, which is the speed at which new technologies become available and are used, has increased substantially over the past 15 to 20 years. Consider the following rates of technology diffusion:

*It took the telephone 35 years to get into 25 percent of all homes in the United States. It took TV 26 years. It took radio 22 years. It took PCs 16 years. It took the Internet 7 years.*

Perpetual innovation is a term used to describe how rapidly and consistently new, information-intensive technologies replace older ones. The shorter product life cycles resulting from these rapid diffusions of new technologies place a competitive premium on being able to quickly introduce new, innovative goods and services into the marketplace.

In fact, when products become somewhat indistinguishable because of the widespread and rapid diffusion of technologies, speed to market with innovative products may be the primary source of competitive advantage (see Chapter 5). Indeed, some argue that the global economy is increasingly driven by or revolves around constant innovations. Not surprisingly, such innovations must be derived from an understanding of global standards and expectations of product functionality. Although some argue that large established
firms may have trouble innovating, evidence suggests that today these firms are developing radically new technologies that transform old industries or create new ones. Apple is an excellent example of a large established firm capable of radical innovation. Also, in order to diffuse the technology and enhance the value of an innovation, additional firms need to be innovative in their use of the new technology, building it into their products.

Another indicator of rapid technology diffusion is that it now may take only 12 to 18 months for firms to gather information about their competitors’ research and development and product decisions. In the global economy, competitors can sometimes imitate a firm’s successful competitive actions within a few days. In this sense, the rate of technological diffusion has reduced the competitive benefits of patents. Today, patents may be an effective way of protecting proprietary technology in a small number of industries such as pharmaceuticals. Indeed, many firms competing in the electronics industry often do not apply for patents to prevent competitors from gaining access to the technological knowledge included in the patent application.

Disruptive technologies—technologies that destroy the value of an existing technology and create new markets—surface frequently in today’s competitive markets. Think of the new markets created by the technologies underlying the development of products such as iPods, iPads, WiFi, and the browser. These types of products are thought by some to represent radical or breakthrough innovations. (We discuss more about radical innovations in Chapter 13.) A disruptive or radical technology can create what is essentially a new industry or can harm industry incumbents. However, some incumbents are able to adapt based on their superior resources, experience, and ability to gain access to the new technology through multiple sources (e.g., alliances, acquisitions, and ongoing internal research).

Clearly, Apple has developed and introduced “disruptive technologies” such as the iPod, and in so doing changed several industries. For example, the iPod and its complementary iTunes have revolutionized how music is sold to and used by consumers. In conjunction with other complementary and competitive products (e.g., Amazon’s Kindle), Apple’s iPad is contributing to and speeding major changes in the publishing industry, moving from hard copies to electronic books. Apple’s new technologies and products are also contributing to the new “information age.” Thus, Apple provides an example of entrepreneurship through technology emergence across multiple industries.

**The Information Age**

Dramatic changes in information technology have occurred in recent years. Personal computers, cellular phones, artificial intelligence, virtual reality, massive databases, and multiple social networking sites are only a few examples of how information is used differently as a result of technological developments. An important outcome of these changes is that the ability to effectively and efficiently access and use information has become an important source of competitive advantage in virtually all industries. Information technology advances have given small firms more flexibility in competing with large firms, if that technology can be efficiently used.

Both the pace of change in information technology and its diffusion will continue to increase. For instance, the number of personal computers in use globally is expected to surpass three billion by 2012. More than 335 million were sold in the United States alone in 2011. The declining costs of information technologies and the increased accessibility to them are also evident in the current competitive landscape. The global proliferation of relatively inexpensive computing power and its linkage on a global scale via computer networks combine to increase the speed and diffusion of information technologies. Thus, the competitive potential of information technologies is now available to companies of all sizes throughout the world, including those in emerging economies.

The Internet is another technological innovation contributing to hypercompetition. Available to an increasing number of people throughout the world, the Internet provides an infrastructure that allows the delivery of information to computers in any location. Access to the Internet on smaller devices such as cell phones is having an ever-growing impact on competition in a number of industries. However, possible changes to Internet
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A popular children’s game is to take the core of an apple after eating it and say “Apple core, Baltimore, who is your friend?” Another child names a “friend” and the first child throws the apple core at him/her. The child who is a target may not want the apple core thrown at her or him. In the world of business, firms clearly do not want to be targeted by Apple’s core with new technology, which is likely in the form of an innovative product. In recent years, Apple has transformed industries with the introduction of new products such as the iPod, iPad (currently causing a transformation), and to some degree, even the iPhone.

Apple has achieved phenomenal success with the introduction of these innovative products. In fact, Steven Jobs was selected by Fortune magazine as the CEO of the first decade of the twenty-first century, based on the fact that Apple under his leadership has transformed four industries, three of them in the most recent decade. In addition, in 2011, Fast Company named Apple the most innovative company, and Fortune ranked Apple as the top company in its annual survey and evaluation of companies based on multiple criteria. In addition, Apple had the second largest market capitalization of all firms in the world. As these data suggest, Apple is one of the top companies in the world based on almost any criterion or set of criteria used. Because of this, Apple is perceived exceptionally well by customers and has what some refer to as “legendary” market power. An executive with one telecommunications company suggested that to negotiate with Apple, one has to start on his knees, implying that you almost have to beg them to partner with your firm. Apple’s growth rate has been phenomenal and its financial performance even more impressive. And, the appeal of Apple’s products is global. For example, Apple has announced the opening of its fifth store in China to handle growing demand for its products. Currently, Apple’s stores in China handle 40,000 people daily, four times the average flow of customers in its U.S. stores.

Although there are many reasons for its success, the primary reason rests with Apple’s new technology development and innovative new products. Apple’s most recent successful launch was the iPad. When it was introduced, analysts projected sales somewhere between 1 to 10 million units. In the first nine months after the iPad’s introduction, Apple sold 15 million of them. As often happens with highly successful innovations, competitors quickly developed and introduced imitative iPads. In fact, competitors sold almost 1 million units during the first year after the iPad’s introduction to the market. One consulting firm announced that 64 different companies introduced a total of 102 different tablets designed to sell to the same market as the iPad. Apple then introduced the iPad 2, which is lighter, faster, and more versatile, yet usually sells for the same price as the original iPad. One executive described the iPad 2 as Secretariat (the famous champion thoroughbred race horse). He suggested that it would lead the imitative competitors’ products by 31 lengths (as Secretariat did in the Belmont Stakes). Apple is expected to retain at least 80 percent of the tablet computer market even with the many imitative products on the market.
Service Providers’ (ISPs) pricing structures could affect the rate of growth of Internet-based applications. Users downloading or streaming high-definition movies, playing video games online, and so forth would be affected the most if ISPs were to base their pricing structure around total usage.

**Increasing Knowledge Intensity**

Knowledge (information, intelligence, and expertise) is the basis of technology and its application. In the competitive landscape of the twenty-first century, knowledge is a critical organizational resource and an increasingly valuable source of competitive advantage. Indeed, starting in the 1980s, the basis of competition shifted from hard assets to intangible resources. For example, “Wal-Mart transformed retailing through its proprietary approach to supply chain management and its information-rich relationships with customers and suppliers.”

Relationships with customers and suppliers are an example of an intangible resource. Knowledge is gained through experience, observation, and inference and is an intangible resource (tangible and intangible resources are fully described in Chapter 3). The value of intangible resources, including knowledge, is growing as a proportion of total shareholder value in today’s competitive landscape. In fact, the Brookings Institution estimates that in tangible resources contribute approximately 85 percent of that value. The probability of achieving strategic competitiveness is enhanced for the firm that develops the ability to capture intelligence, transform it into usable knowledge, and diffuse it rapidly throughout the company. Therefore, firms must develop (e.g., through training programs) and acquire (e.g., by hiring educated and experienced employees) knowledge, integrate it into the organization to create capabilities, and then apply it to gain a competitive advantage.

A strong knowledge base is necessary to create innovations. In fact, firms lacking the appropriate internal knowledge resources are less likely to invest money in research and development. Firms must continue to learn (building their knowledge stock) because knowledge spillovers to competitors are common. There are several ways in which knowledge spillovers occur, including the hiring of professional staff and managers by competitors. Because of the potential for spillovers, firms must move quickly to use their knowledge in productive ways. In addition, firms must build routines that facilitate the diffusion of local knowledge throughout the organization for use everywhere that it has value. Firms are better able to do these things when they have strategic flexibility.

**Strategic flexibility** is a set of capabilities used to respond to various demands and opportunities existing in a dynamic and uncertain competitive environment. Thus, strategic flexibility involves coping with uncertainty and its accompanying risks. Firms should try to develop strategic flexibility in all areas of their operations. However, those working within firms to develop strategic flexibility should understand that the task is not easy, largely because of inertia that can build up over time. A firm’s focus and past core competencies may actually slow change and strategic flexibility.
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To be strategically flexible on a continuing basis and to gain the competitive benefits of such flexibility, a firm has to develop the capacity to learn. Continuous learning provides the firm with new and up-to-date skill sets, which allow it to adapt to its environment as it encounters changes. Firms capable of rapidly and broadly applying what they have learned exhibit the strategic flexibility and the capacity to change in ways that will increase the probability of successfully dealing with uncertain, hypercompetitive environments.

The I/O Model of Above-Average Returns

From the 1960s through the 1980s, the external environment was thought to be the primary determinant of strategies that firms selected to be successful. The industrial organization model of above-average returns explains the external environment’s dominant influence on a firm’s strategic actions. The model specifies that the industry or segment of an industry in which a company chooses to compete has a stronger influence on performance than do the choices managers make inside their organizations. The firm’s performance is believed to be determined primarily by a range of industry properties, including economies of scale, barriers to market entry, diversification, product differentiation, and the degree of concentration of firms in the industry. We examine these industry characteristics in Chapter 2.

Grounded in economics, the I/O model has four underlying assumptions. First, the external environment is assumed to impose pressures and constraints that determine the strategies that would result in above-average returns. Second, most firms competing within an industry or within a segment of that industry are assumed to control similar strategically relevant resources and to pursue similar strategies in light of those resources. Third, resources used to implement strategies are assumed to be highly mobile across firms, so any resource differences that might develop between firms will be short-lived. Fourth, organizational decision makers are assumed to be rational and committed to acting in the firm’s best interests, as shown by their profit-maximizing behaviors. The I/O model challenges firms to find the most attractive industry in which to compete. Because most firms are assumed to have similar valuable resources that are mobile across companies, their performance generally can be increased only when they operate in the industry with the highest profit potential and learn how to use their resources to implement the strategy required by the industry’s structural characteristics.

The five forces model of competition is an analytical tool used to help firms find the industry that is the most attractive for them. The model (explained in Chapter 2) encompasses several variables and tries to capture the complexity of competition. The five forces model suggests that an industry’s profitability (i.e., its rate of return on invested capital relative to its cost of capital) is a function of interactions among five forces: suppliers, buyers, competitive rivalry among firms currently in the industry, product substitutes, and potential entrants to the industry.

Firms use the five forces model to identify the attractiveness of an industry (as measured by its profitability potential) as well as the most advantageous position for the firm to take in that industry, given the industry’s structural characteristics. Typically, the model suggests that firms can earn above-average returns by producing either standardized goods or services at costs below those of competitors (a cost leadership strategy) or by producing differentiated goods or services for which customers are willing to pay a price premium (a differentiation strategy). (The cost leadership and product differentiation strategies are discussed in Chapter 4.) The fact that “... the fast food industry is becoming a ‘zero-sum industry’ as companies battle for the same pool of customers” suggests that fast food giant McDonald’s is competing in a relatively unattractive industry. However, by focusing on product innovations and enhancing existing facilities while buying properties outside the United States at attractive prices for selectively building new stores, McDonald’s is positioned in the fast food (or quick-service) restaurant industry to earn above-average returns.
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As shown in Figure 1.2, the I/O model suggests that above-average returns are earned when firms are able to effectively study the external environment as the foundation for identifying an attractive industry and implementing the appropriate strategy. For example, in some industries, firms can reduce competitive rivalry and erect barriers to entry by forming joint ventures. Because of these outcomes, the joint ventures increase profitability in the industry.75 Companies that develop or acquire the internal skills needed to implement strategies required by the external environment are likely to succeed, while those that do not are likely to fail.76 Hence, this model suggests that returns are determined primarily by external characteristics rather than by the firm’s unique internal resources and capabilities.

Research findings support the I/O model in that approximately 20 percent of a firm’s profitability is explained by the industry in which it chooses to compete. However, this research also shows that 36 percent of the variance in firm profitability can be attributed to the firm’s characteristics and actions.77 These findings suggest that the external environment and a firm’s resources, capabilities, core competencies, and competitive advantages (see Chapter 3) influence the company’s ability to achieve strategic competitiveness and earn above-average returns.

As shown in Figure 1.2, the I/O model assumes that a firm’s strategy is a set of commitments and actions flowing from the characteristics of the industry in which the firm

Figure 1.2  The I/O Model of Above-Average Returns

1. Study the external environment, especially the industry environment.
2. Locate an industry with high potential for above-average returns.
3. Identify the strategy called for by the attractive industry to earn above-average returns.
4. Develop or acquire assets and skills needed to implement the strategy.
5. Use the firm’s strengths (its developed or acquired assets and skills) to implement the strategy.

The External Environment
- The general environment
- The industry environment
- The competitor environment

An Attractive Industry
- An industry whose structural characteristics suggest above-average returns

Strategy Formulation
- Selection of a strategy linked with above-average returns in a particular industry

Assets and Skills
- Assets and skills required to implement a chosen strategy

Strategy Implementation
- Selection of strategic actions linked with effective implementation of the chosen strategy

Superior Returns
- Earning of above-average returns

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has decided to compete. The resource-based model, discussed next, takes a different view of the major influences on a firm’s choice of strategy.

### The Resource-Based Model of Above-Average Returns

The resource-based model assumes that each organization is a collection of unique resources and capabilities. The uniqueness of its resources and capabilities is the basis of a firm’s strategy and its ability to earn above-average returns. The resource-based model assumes that each organization is a collection of unique resources and capabilities. The uniqueness of its resources and capabilities is the basis of a firm’s strategy and its ability to earn above-average returns.78

**Resources** are inputs into a firm’s production process, such as capital equipment, the skills of individual employees, patents, finances, and talented managers. In general, a firm’s resources are classified into three categories: physical, human, and organizational capital. Described fully in Chapter 3, resources are either tangible or intangible in nature.

Individual resources alone may not yield a competitive advantage.79 In fact, resources have a greater likelihood of being a source of competitive advantage when they are formed into a capability. A **capability** is the capacity for a set of resources to perform a task or an activity in an integrative manner. Capabilities evolve over time and must be managed dynamically in pursuit of above-average returns.80 **Core competencies** are resources and capabilities that serve as a source of competitive advantage for a firm over its rivals. Core competencies are often visible in the form of organizational functions. For example, Apple’s R&D function is likely one of its core competencies. There is little doubt that its ability to produce innovative new products that are perceived as valuable in the market—place is a core competence for Apple, as suggested in the earlier Strategic Focus.

According to the resource-based model, differences in firms’ performances across time are due primarily to their unique resources and capabilities rather than the industry’s structural characteristics. This model also assumes that firms acquire different resources and develop unique capabilities based on how they combine and use the resources; that resources and certainly capabilities are not highly mobile across firms; and that the differences in resources and capabilities are the basis of competitive advantage.81 Through continued use, capabilities become stronger and more difficult for competitors to understand and imitate. As a source of competitive advantage, a capability “should be neither so simple that it is highly imitable, nor so complex that it defies internal steering and control.”82

The resource-based model of superior returns is shown in Figure 1.3. This model suggests that the strategy the firm chooses should allow it to use its competitive advantages in an attractive industry (the I/O model is used to identify an attractive industry). Not all of a firm’s resources and capabilities have the potential to be the foundation for a competitive advantage. This potential is realized when resources and capabilities are valuable, rare, costly to imitate, and nonsubstitutable.83 **Resources** are **valuable** when they allow a firm to take advantage of opportunities or neutralize threats in its external environment. They are **rare** when possessed by few, if any, current and potential competitors. **Resources** are **costly to imitate** when other firms either cannot obtain them or are at a cost disadvantage in obtaining them compared with the firm that already possesses them. And they are **nonsubstitutable** when they have no structural equivalents. Many resources can either be imitated or substituted over time. Therefore, it is difficult to achieve and sustain a competitive advantage based on resources alone.84 Individual resources are often integrated to produce integrated configurations in order to build capabilities. These capabilities are more likely to have these four attributes.85 When these four criteria are met, however, resources and capabilities become core competencies.

As noted previously, research shows that both the industry environment and a firm’s internal assets affect that firm’s performance over time.86 Thus, to form a vision and mission, and subsequently to select one or more strategies and determine how to implement them, firms use both the I/O and the resource-based models.87 In fact, these models complement each other in that one (I/O) focuses outside the firm while the other...
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(resource-based) focuses inside the firm. Next, we discuss the forming of the firm's vision and mission—actions taken after the firm understands the realities of its external environment (Chapter 2) and internal organization (Chapter 3).

Vision and Mission

After studying the external environment and the internal organization, the firm has the information it needs to form its vision and a mission (see Figure 1.1). Stakeholders (those who affect or are affected by a firm's performance, as explained later in the chapter) learn a great deal about a firm by studying its vision and mission. Indeed, a key purpose of vision and mission statements is to inform stakeholders of what the firm is, what it seeks to accomplish, and who it seeks to serve.

**Vision**

**Vision** is a picture of what the firm wants to be and, in broad terms, what it wants to ultimately achieve. Thus, a vision statement articulates the ideal description of an organization and gives shape to its intended future. In other words, a vision statement points the firm in...
the direction of where it would like to be in the years to come. An effective vision stretches and challenges people as well. In her book about Steve Jobs, Apple’s phenomenally successful CEO, Carmine Gallo argues that one of the reasons that Apple is so innovative was Jobs’ vision for the company. She suggests that he thought bigger and differently than most people—she describes it as “putting a dent in the universe.” To be innovative, she explains that one has to think differently about their products and customers—“sell dreams not products”—and differently about the story to “create great expectations.” Steve Jobs passed away in October 2011. Apple will be challenged to remain highly innovative without him. Interestingly, many new entrepreneurs are highly optimistic when they develop their ventures.

It is also important to note that vision statements reflect a firm’s values and aspirations and are intended to capture the heart and mind of each employee and, hopefully, many of its other stakeholders. A firm’s vision tends to be enduring while its mission can change with new environmental conditions. A vision statement tends to be relatively short and concise, making it easily remembered. Examples of vision statements include the following:

Our vision is to be the world’s best quick service restaurant. (McDonald’s)

To make the automobile accessible to every American. (Ford Motor Company’s vision when established by Henry Ford)

As a firm’s most important and prominent strategic leader, the CEO is responsible for working with others to form the firm’s vision. Experience shows that the most effective vision statement results when the chief executive officer (CEO) involves a host of stakeholders (e.g., other top-level managers, employees working in different parts of the organization, suppliers, and customers) to develop it. In addition, to help the firm reach its desired future state, a vision statement should be clearly tied to the conditions in the firm’s external environment and internal organization. Moreover, the decisions and actions of those involved with developing the vision, especially the CEO and the other top-level managers, must be consistent with that vision.

Mission

The vision is the foundation for the firm’s mission. A mission specifies the business or businesses in which the firm intends to compete and the customers it intends to serve. The firm’s mission is more concrete than its vision. However, similar to the vision, a mission should establish a firm’s individuality and should be inspiring and relevant to all stakeholders. Together, the vision and mission provide the foundation that the firm needs to choose and implement one or more strategies. The probability of forming an effective mission increases when employees have a strong sense of the ethical standards that guide their behaviors as they work to help the firm reach its vision. Thus, business ethics are a vital part of the firm’s discussions to decide what it wants to become (its vision) as well as who it intends to serve and how it desires to serve those individuals and groups (its mission).

Even though the final responsibility for forming the firm’s mission rests with the CEO, the CEO and other top-level managers often involve more people in developing the mission. The main reason is that the mission deals more directly with product markets and customers, and middle- and first-level managers and other employees have more direct contact with customers and the markets in which they are served. Examples of mission statements include the following:

Be the best employer for our people in each community around the world and deliver operational excellence to our customers in each of our restaurants. (McDonald’s)

Our mission is to be recognized by our customers as the leader in applications engineering. We always focus on the activities customers desire; we are highly motivated and strive to advance our technical knowledge in the areas of material, part design and fabrication technology. (LNP, a GE Plastics Company)

McDonald’s mission statement flows from its vision of being the world’s best quick-service restaurant. LNP’s mission statement describes the business areas (material, part design, and fabrication technology) in which the firm intends to compete.
Some believe that vision and mission statements provide little value. One expert believes, “Most vision statements are either too vague, too broad in scope, or riddled with superlatives.” Clearly, vision and mission statements that are poorly developed do not provide the direction a firm needs to take appropriate strategic actions. Still, as shown in Figure 1.1, a firm’s vision and mission are critical aspects of the strategic inputs required to engage in strategic actions that help to achieve strategic competitiveness and earn above-average returns. Therefore, firms must accept the challenge of forming effective vision and mission statements.

Stakeholders

Every organization involves a system of primary stakeholder groups with whom it establishes and manages relationships. Stakeholders are the individuals, groups, and organizations who can affect the firm’s vision and mission, are affected by the strategic outcomes achieved, and have enforceable claims on the firm’s performance. Claims on a firm’s performance are enforced through the stakeholders’ ability to withhold participation essential to the organization’s survival, competitiveness, and profitability. Stakeholders continue to support an organization when its performance meets or exceeds their expectations. Also, research suggests that firms that effectively manage stakeholder relationships outperform those that do not. Stakeholder relationships can therefore be managed to be a source of competitive advantage.

Although organizations have dependency relationships with their stakeholders, they are not equally dependent on all stakeholders at all times; as a consequence, not every stakeholder has the same level of influence. The more critical and valued a stakeholder’s participation, the greater a firm’s dependency on it. Greater dependence, in turn, gives the stakeholder more potential influence over a firm’s commitments, decisions, and actions. Managers must find ways to either accommodate or insulate the organization from the demands of stakeholders controlling critical resources.

Classifications of Stakeholders

The parties involved with a firm’s operations can be separated into at least three groups. As shown in Figure 1.4, these groups are the capital market stakeholders (shareholders and the major suppliers of a firm’s capital), the product market stakeholders (the firm’s primary customers, suppliers, host communities, and unions representing the workforce), and the organizational stakeholders (all of a firm’s employees, including both non-managerial and managerial personnel).

Each stakeholder group expects those making strategic decisions in a firm to provide the leadership through which its valued objectives will be reached. The objectives of the various stakeholder groups often differ from one another, sometimes placing those involved with a firm’s strategic management process in situations where trade-offs have to be made. The most obvious stakeholders, at least in U.S. organizations, are shareholders—individuals and groups who have invested capital in a firm in the expectation of earning a positive return on their investments. These stakeholders’ rights are grounded in laws governing private property and private enterprise.

In contrast to shareholders, another group of stakeholders—the firm’s customers—prefers that investors receive a minimum return on their investments. Customers could have their interests maximized when the quality and reliability of a firm’s products are improved, but without high prices. High returns to customers, therefore, might come at the expense of lower returns for capital market stakeholders.

Because of potential conflicts, each firm must carefully manage its stakeholders. First, a firm must thoroughly identify and understand all important stakeholders. Second, it must prioritize them in case it cannot satisfy all of them. Power is the most critical criterion in prioritizing stakeholders. Other criteria might include the urgency
of satisfying each particular stakeholder group and the degree of importance of each
to the firm.107

When the firm earns above-average returns, the challenge of effectively managing
stakeholder relationships is lessened substantially. With the capability and flexi-
ble capacity provided by above-average returns, a firm can more easily satisfy multiple stakeholders
simultaneously. When the firm earns only average returns, it is unable to maximize the
interests of all stakeholders. The objective then becomes one of at least minimally satisfy-
ing each stakeholder.

Trade-off decisions are made in light of how important the support of each stake-
holder group is to the firm. For example, environmental groups may be very important
to firms in the energy industry but less important to professional service firms.108 A
firm earning below-average returns does not have the capacity to minimally satisfy all
stakeholders. The managerial challenge in this case is to make trade-offs that minimize
the amount of support lost from stakeholders. Societal values also influence the general
weightings allocated among the three stakeholder groups shown in Figure 1.4. Although
all three groups are served by firms in the major industrialized nations, the priorities
in their service vary because of cultural differences. Next, we present additional details
about each of the three major stakeholder groups.

**Capital Market Stakeholders**

Shareholders and lenders both expect a firm to preserve and enhance the wealth they
have entrusted to it. The returns they expect are commensurate with the degree of risk
accepted with those investments (i.e., lower returns are expected with low-risk invest-
ments while higher returns are expected with high-risk investments). Dissatisfied lend-
ers may impose stricter covenants on subsequent borrowing of capital. Dissatisfied
shareholders may reflect their concerns through several means, including selling their

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**Figure 1.4 The Three Stakeholder Groups**

- **Stakeholders**: People who are affected by a firm’s performance and who have claims on
  its performance.
- **Capital Market Stakeholders**: Shareholders, Major suppliers of capital (e.g., banks)
- **Product Market Stakeholders**: Primary customers, Suppliers, Host communities, Unions
- **Organizational Stakeholders**: Employees, Managers, Nonmanagers

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Institutional investors (e.g., pension funds, mutual funds) often are willing to sell their stock if the returns are not what they desire, or take actions to improve the firm’s performance such as pressuring top managers to improve the governance oversight by the board of directors. Some institutions owning major shares of a firm’s stock may have conflicting views of the actions needed, which can be challenging for managers. This is because some may want an increase in returns in the short term while the others desire a focus on building long-term competitiveness. Managers may have to balance their desires with other shareholders or prioritize the importance of the institutional owners with different goals. Clearly shareholders who hold a large share of stock (sometimes referred to as blockholders—see Chapter 10 for more explanation) are influential, especially in the determination of the firm’s capital structure (i.e., the amount of equity versus the amount of debt used). Often large shareholders prefer that the firm minimize its use of debt because of the risk of debt, its cost, and the possibility that debt holders have first call on the firm’s assets in case of default over the shareholders.

When a firm is aware of potential or actual dissatisfactions among capital market stakeholders, it may respond to their concerns. The firm’s response to stakeholders who are dissatisfied is affected by the nature of its dependency relationship with them (which, as noted earlier, is also influenced by a society’s values). The greater and more significant the dependency relationship is, the more likely a direct and significant response by the firm. Before liquidating, Circuit City took several actions to try to satisfy its capital market stakeholders. For example, it closed stores, changed the top management team, and sought potential buyers. However, none of these actions allowed Circuit City to meet the expectations of its capital market stakeholders, and it declared bankruptcy and went out of business.

Product Market Stakeholders

Some might think that product market stakeholders (customers, suppliers, host communities, and unions) share few common interests. However, all four groups can benefit as firms engage in competitive battles. For example, depending on product and industry characteristics, marketplace competition may result in lower product prices being charged to a firm’s customers and higher prices being paid to its suppliers (the firm might be willing to pay higher supplier prices to ensure delivery of the types of goods and services that are linked with its competitive success).

Customers, as stakeholders, demand reliable products at the lowest possible prices. Suppliers seek loyal customers who are willing to pay the highest sustainable prices for the goods and services they receive. Although all product market stakeholders are important, without customers, the other product market stakeholders are of little value. Therefore, the firm must try to learn about and understand current and potential customers. Host communities want companies willing to be long-term employers and providers of tax revenue without placing excessive demands on public support services. Union officials are interested in secure jobs, under highly desirable working conditions, for employees they represent. Thus, product market stakeholders are generally satisfied when a firm’s profit margin reflects at least a balance between the returns to capital market stakeholders (i.e., the returns lenders and shareholders will accept and still retain their interests in the firm) and the returns in which they share.
Organizational Stakeholders

Employees—the firm’s organizational stakeholders—expect the firm to provide a dynamic, stimulating, and rewarding work environment. As employees, we are usually satisfied working for a company that is growing and actively developing our skills, especially those skills required to be effective team members and to meet or exceed global work standards. Workers who learn how to use new knowledge productively are critical to organizational success. In a collective sense, the education and skills of a firm’s workforce are competitive weapons affecting strategy implementation and firm performance. Strategic leaders are ultimately responsible for serving the needs of organizational stakeholders on a day-to-day basis. In fact, to be successful, strategic leaders must effectively use the firm’s human capital. The importance of human capital to their success is likely why outside directors are more likely to propose layoffs compared to inside strategic leaders, while such insiders are likely to use preventative cost-cutting measures and seek to protect incumbent employees. A highly important means of building employee skills for the global competitive landscape is through international assignments. The process of managing expatriate employees and helping them build knowledge can have significant effects over time on the firm’s ability to compete in global markets.

Strategic Leaders

Strategic leaders are people located in different areas and levels of the firm using the strategic management process to select strategic actions that help the firm achieve its vision and fulfill its mission. Regardless of their location in the firm, successful strategic leaders are decisive, committed to nurturing those around them, and committed to helping the firm create value for all stakeholder groups. In this vein, research evidence suggests that employees who perceive that their CEO is a visionary leader also believe that the CEO leads the firm to operate in ways that are consistent with the values of all stakeholder groups rather than emphasizing only maximizing profits for shareholders. In turn, visionary leadership helps to obtain extra effort by employees, thereby achieving enhanced firm performance. These findings are consistent with the argument that “To regain society’s trust ... business leaders must embrace a way of looking at their role that goes beyond their responsibility to the shareholder to include a civic and personal commitment to their duty as institutional custodians.”

When identifying strategic leaders, most of us tend to think of CEOs and other top-level managers. Clearly, these people are strategic leaders. In the final analysis, CEOs are responsible for making certain their firm effectively uses the strategic management process. Indeed, the pressure on CEOs to manage strategically is stronger than ever. However, many other people help choose a firm’s strategy and then determine the actions for successfully implementing it. The main reason is that the realities of twenty-first-century competition that we discussed earlier in this chapter (e.g., the global economy, globalization, rapid technological change, and the increasing importance of knowledge and people as sources of competitive advantage) are creating a need for those “closest to the action” to be making decisions and determining the actions to be taken. In fact, the most effective CEOs and top-level managers understand how to delegate strategic responsibilities to people throughout the firm who influence the use of organizational resources. In fact, delegation also helps to avoid too much managerial hubris at the top and the problems it causes, especially in situations allowing significant managerial discretion.

Organizational culture also affects strategic leaders and their work. In turn, strategic leaders’ decisions and actions shape a firm’s culture. Organizational culture refers to the complex set of ideologies, symbols, and core values that are shared throughout the firm and that influence how the firm conducts business. It is the social energy that drives—or fails to drive—the organization. For example, Southwest Airlines is known for having a unique and valuable culture. Its culture encourages employees to work hard but also to
have fun while doing so. Moreover, its culture entails respect for others—employees and customers alike. The firm also places a premium on service, as suggested by its commitment to provide POS (Positively Outrageous Service) to each customer.

Some organizational cultures are a source of disadvantage. It is important for strategic leaders to understand, however, that whether the firm’s culture is functional or dysfunctional, their effectiveness is influenced by that culture. The relationship between organizational culture and strategic leaders’ work is reciprocal in that the culture shapes the outcomes of their leadership while their leadership helps shape an ever-evolving organizational culture.

**The Work of Effective Strategic Leaders**

Perhaps not surprisingly, hard work, thorough analyses, a willingness to be brutally honest, a penchant for wanting the firm and its people to accomplish more, and tenacity are prerequisites to an individual’s success as a strategic leader. In addition, strategic leaders must have a strong strategic orientation while simultaneously embracing change in the dynamic competitive landscape we have discussed. In order to deal with this change effectively, strategic leaders must be innovative thinkers and promote innovation in their organization. Promoting innovation is facilitated by a diverse top management team representing different types of expertise and leveraging relationships with external parties. Strategic leaders can best leverage partnerships with external parties and organizations when their organizations are ambidextrous. That is, the organizations simultaneously promote exploratory learning of new and unique forms of knowledge and exploitative learning that adds incremental knowledge to existing knowledge bases, allowing them to better understand and use their existing products. In addition, strategic leaders need to have a global mindset, or what some refer to as an ambicultural approach to management.

Strategic leaders, regardless of their location in the organization, often work long hours, and their work is filled with ambiguous decision situations. However, the opportunities afforded by this work are appealing and offer exciting chances to dream and to act. The following words, given as advice to the late Time Warner chair and co-CEO Steven J. Ross by his father, describe the opportunities in a strategic leader’s work:

*There are three categories of people—the person who goes into the office, puts his feet up on his desk, and dreams for 12 hours; the person who arrives at 5 a.m. and works for 16 hours, never once stopping to dream; and the person who puts his feet up, dreams for one hour, then does something about those dreams.*

The operational term used for a dream that challenges and energizes a company is vision. The most effective strategic leaders provide a vision as the foundation for the firm’s mission and subsequent choice and use of one or more strategies.

**Predicting Outcomes of Strategic Decisions: Profit Pools**

Strategic leaders attempt to predict the outcomes of their decisions before taking efforts to implement them, which is difficult to do. Many decisions that are a part of the strategic management process are concerned with an uncertain future and the firm’s place in that future. As such, managers try to predict the effects on the firm’s profits of strategic decisions that they are considering.

Mapping an industry’s profit pool is something strategic leaders can do to anticipate the possible outcomes of different decisions and to focus on growth in profits rather than strictly growth in revenues. A profit pool entails the total profits earned in an industry at all points along the value chain. (We explain the value chain in Chapter 3 and discuss it further in Chapter 4.) Analyzing the profit pool in the industry may help a firm see something others are unable to see and to understand the primary sources of profits in an industry. There are four steps to identifying profit pools: (1) define the pool’s boundaries,
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(2) estimate the pool’s overall size, (3) estimate the size of the value-chain activity in the pool, and (4) reconcile the calculations.\textsuperscript{137}

For example, McDonald’s might desire to map the quick-service restaurant industry’s profit pools. First, McDonald’s would need to define the industry’s boundaries and, second, estimate its size (which is large, because McDonald’s operates in markets across the globe). The net result of this is that McDonald’s tries to take market share away from competitors such as Burger King and Wendy’s, and growth is more likely in international markets. Armed with information about its industry, McDonald’s could then estimate the amount of profit potential in each part of the value chain (step 3). In the quick-service restaurant industry, marketing campaigns and customer service are likely more important sources of potential profits than are inbound logistics’ activities (see Chapter 3). With an understanding of where the greatest amount of profits are likely to be earned, McDonald’s would then be ready to select the strategy to use to be successful where the largest profit pools are located in the value chain.\textsuperscript{138} As this brief discussion shows, profit pools are a potentially useful tool to help strategic leaders recognize the actions to take to increase the likelihood of increasing profits. Of course, profits made by a firm and in an industry can be partially interdependent on the profits earned in adjacent industries.\textsuperscript{139} For example, profits earned in the energy industry can affect profits in other industries (e.g., airlines). When oil prices are high, it can reduce the profits earned in industries that must use a lot of energy to provide their goods or services.

The Strategic Management Process

As suggested by Figure 1.1, the strategic management process is a rational approach firms use to achieve strategic competitiveness and earn above-average returns. Figure 1.1 also features the topics we examine in this book to present the strategic management process to you.

This book is divided into three parts. In Part 1, we describe what firms do to analyze their external environment (Chapter 2) and internal organization (Chapter 3). These analyses are completed to identify marketplace opportunities and threats in the external environment (Chapter 2) and to decide how to use the resources, capabilities, core competencies, and competitive advantages in the firm’s internal organization to pursue opportunities and overcome threats (Chapter 3). The analyses explained in Chapters 2 and 3 compose the well-known SWOT analyses (strengths, weaknesses, opportunities, threats).\textsuperscript{140} With knowledge about its external environment and internal organization, the firm forms its strategy taking into account the firm’s vision and mission.

The firm’s strategic inputs (see Figure 1.1) provide the foundation for choosing one or more strategies and deciding how to implement them. As suggested in Figure 1.1 by the horizontal arrow linking the two types of strategic actions, formulation and implementation must be simultaneously integrated to successfully use the strategic management process. Integration happens as decision makers think about implementation issues when choosing strategies and as they think about possible changes to the firm’s strategies while implementing a currently chosen strategy.

In Part 2 of this book, we discuss the different strategies firms may choose to use. First, we examine business-level strategies (Chapter 4). A business-level strategy describes the actions a firm takes to exploit its competitive advantage over rivals. A company competing in a single product market (e.g., a locally owned grocery store operating in only one location) has but one business-level strategy while a diversified firm competing in multiple product markets (e.g., General Electric) forms a business-level strategy for each of its businesses. In Chapter 5, we describe the actions and reactions that occur among firms in marketplace competition. Competitors typically respond to and try to anticipate each other’s actions. The dynamics of competition affect the strategies firms choose as well as how they try to implement the chosen strategies.\textsuperscript{141}
For the diversified firm, corporate-level strategy (Chapter 6) is concerned with determining the businesses in which the company intends to compete as well as how to manage its different businesses. Other topics vital to strategy formulation, particularly in the diversified company, include acquiring other businesses and, as appropriate, restructuring the firm’s portfolio of businesses (Chapter 7) and selecting an international strategy (Chapter 8). With cooperative strategies (Chapter 9), firms form a partnership to share their resources and capabilities in order to develop a competitive advantage. Cooperative strategies are becoming increasingly important as firms seek ways to compete in the global economy’s array of different markets.  

To examine actions taken to implement strategies, we consider several topics in Part 3 of the book. First, we examine the different mechanisms used to govern firms (Chapter 10). With demands for improved corporate governance being voiced by many stakeholders in the current business environment, organizations are challenged to learn how to simultaneously satisfy their stakeholders’ different interests. Finally, the organizational structure and actions needed to control a firm’s operations (Chapter 11), the patterns of strategic leadership appropriate for today’s firms and competitive environments (Chapter 12), and strategic entrepreneurship (Chapter 13) as a path to continuous innovation are addressed.

It is important to emphasize that primarily because they are related to how a firm interacts with its stakeholders, almost all strategic management process decisions have ethical dimensions. Organizational ethics are revealed by an organization’s culture; that is to say, a firm’s decisions are a product of the core values that are shared by most or all of a company’s managers and employees. Especially in the turbulent and often ambiguous competitive landscape of the twenty-first century, those making decisions as a part of the strategic management process are challenged to recognize that their decisions affect capital market, product market, and organizational stakeholders differently and to regularly evaluate the ethical implications of their decisions. Decision makers failing to recognize these realities accept the risk of placing their firm at a competitive disadvantage with regard to ethical business practices.

As you will discover, the strategic management process examined in this book calls for disciplined approaches to serve as the foundation for developing a competitive advantage. These approaches provide the pathway through which firms will be able to achieve strategic competitiveness and earn above-average returns. Mastery of this strategic management process will effectively serve you, our readers, and the organizations for which you will choose to work.

**SUMMARY**

- Firms use the strategic management process to achieve strategic competitiveness and earn above-average returns. Strategic competitiveness is achieved when a firm develops and implements a value-creating strategy. Above-average returns (in excess of what investors expect to earn from other investments with similar levels of risk) provide the foundation needed to simultaneously satisfy all of a firm’s stakeholders.

- The fundamental nature of competition is different in the current competitive landscape. As a result, those making strategic decisions must adopt a different mind-set, one that allows them to learn how to compete in highly turbulent and chaotic environments that produce a great deal of uncertainty. The globalization of industries and their markets and rapid and significant technological changes are the two primary factors contributing to the turbulence of the competitive landscape.

- Firms use two major models to help develop their vision and mission and then choose one or more strategies in pursuit of strategic competitiveness and above-average returns. The core assumption of the I/O model is that the firm’s external environment has a large influence on the choice of strategies more than do the firm’s internal resources, capabilities, and core competencies. Thus, the I/O model is used to understand the effects an industry’s characteristics can have on a firm when deciding what strategy or strategies with which to compete against rivals. The logic supporting the I/O model suggests that above-average returns are earned when the firm locates an attractive industry or part of an industry and successfully implements the strategy dictated by that industry’s characteristics. The core assumption of the resource-based model is that the firm’s unique resources, capabilities,
and core competencies have a major influence on selecting and using strategies more than does the firm’s external environment. Above-average returns are earned when the firm uses its valuable, rare, costly-to-imitate, and nonsubstitutable resources and capabilities to compete against its rivals in one or more industries. Evidence indicates that both models yield insights that are linked to successfully selecting and using strategies. Thus, firms want to use their unique resources, capabilities, and core competencies as the foundation to engage in one or more strategies that allow them to effectively compete against rivals.

- Vision and mission are formed to guide the selection of strategies based on the information from the analyses of the firm’s internal and external environments. Vision is a picture of what the firm wants to be, and, in broad terms, what it wants to ultimately achieve. Flowing from the vision, the mission specifies the business or businesses in which the firm intends to compete and the customers it intends to serve. Vision and mission provide direction to the firm and signal important descriptive information to stakeholders.

- Stakeholders are those who can affect, and are affected by, a firm’s strategic outcomes. Because a firm is dependent on the continuing support of stakeholders (shareholders, customers, suppliers, employees, host communities, etc.), they have enforceable claims on the company’s performance. When earning above-average returns, a firm has the resources it needs to at minimum simultaneously satisfy the interests of all stakeholders. However, when earning only average returns, the firm must carefully manage its stakeholders in order to retain their support. A firm earning below-average returns must minimize the amount of support it loses from unsatisfied stakeholders.

- Strategic leaders are people located in different areas and levels of the firm using the strategic management process to help the firm achieve its vision and fulfill its mission. In general, CEOs are responsible for making certain that their firms properly use the strategic management process. The effectiveness of the strategic management process is increased when it is grounded in ethical intentions and behaviors. The strategic leader’s work demands decision trade-offs, often among attractive alternatives. It is important for all strategic leaders and especially the CEO and other members of the top-management team to conduct thorough analyses of conditions facing the firm, be brutally and consistently honest, and work jointly to select and implement the correct strategies.

- Strategic leaders predict the potential outcomes of their strategic decisions. To do this, they must first calculate profit pools in their industry (and adjacent industries as appropriate) that are linked to value chain activities. Predicting the potential outcomes of their strategic decisions reduces the likelihood of the firm formulating and implementing ineffective strategies.

**REVIEW QUESTIONS**

1. What are strategic competitiveness, strategy, competitive advantage, above-average returns, and the strategic management process?

2. What are the characteristics of the current competitive landscape? What two factors are the primary drivers of this landscape?

3. According to the I/O model, what should a firm do to earn above-average returns?

4. What does the resource-based model suggest a firm should do to earn above-average returns?

5. What are vision and mission? What is their value for the strategic management process?

6. What are stakeholders? How do the three primary stakeholder groups influence organizations?

7. How would you describe the work of strategic leaders?

8. What are the elements of the strategic management process? How are they interrelated?

**EXPERIENTIAL EXERCISES**

**EXERCISE 1: STAKEHOLDER ANALYSIS, STRATEGIC PLANNING, AND STRATEGIC LEADERSHIP**

Every organization relies on its own unique bundle of organizational stakeholders. Each one of the relationships between the organization and its stakeholders is influential in its ability to serve its mission and achieve above-average profits in the for-profit sector, or to create value in the not-for-profit sector. However, there are many ways that stakeholder management differs between the for-profit and not-for-profit worlds. It is easy to think of a for-profit firm that has product market stakeholders, such as customers, who can add or subtract their support by their decision of whether or not to purchase the firm’s products or services. But who is the customer for a not-for-profit, and are the categories of product, market, organization, and capital market stakeholders very different from the for-profit arena? This exercise challenges you to uncover some of the more influential ways in which this is so.
Part One
In this exercise, you will be working in teams of approximately four students per team.

1. Decide which not-for-profit organization you wish to analyze. If you would like assistance in identifying a not-for-profit organization, a good Web source is the IRS; you may search for charities at http://www.irs.gov/app/pub-78/.

2. Determine two or three key strategic initiatives of this not-for-profit organization. Most not-for-profits, particularly well-known ones, are good about posting their strategic plans on their Web sites.

3. Now perform an analysis, such as a macroenvironmental analysis, and list all known or expected stakeholders for the organization. You should place them in the context of product, market, and organizational stakeholders.

Part Two
Now you are ready to start thinking critically about the organization and the challenges it faces among its stakeholders as it attempts to roll out its strategic initiatives.

1. For each strategic initiative that the organization has announced, analyze each stakeholder for the organization, and list areas in which the proposed strategy is likely to be supported, or not, by that particular stakeholder.

2. Organize your listing so as to be able to present to the class a summary of those strategies upon which expected support is likely to be gained and those strategies upon which support is likely to be discouraged.

3. Present to the class your recommendation for how the organization should proceed. For instance, if perceived support is critical to the successful strategic initiative but the strategy is likely to be viewed negatively by the stakeholder, provide some potential actions that the organization might take to mitigate the negative reaction or, alternatively, that might gain the stakeholders’ support.

Conflicts are normal among organizational stakeholders, and deciding which must be attended to and at which time for which strategic action is a critical strategic leadership activity for every firm.

EXERCISE 2: CRAFTING A PERSONAL VISION AND MISSION STATEMENT
Drawing on an analysis of internal and external constraints, a firm creates a mission and vision as a cornerstone of its strategy. You can do the same for yourself as an individual. A personal vision will be a broad statement of your intended future, whereas a personal mission statement will emphasize your individuality and inspire you to achieve and be relevant to all of your particular stakeholders. Together they form the foundation for the strategies that you will choose to achieve for your future desired state. The real goal of this assignment is for you to focus on you.

To get started, you may want to view some Web resources, such as the blog offered by Franklin Covey (http://www.franklincovey.com/blog/tag/mission-statement-builder) or “Life on Purpose: 15 Questions to Discover Your Personal Mission” by Tina Su (http://thinksimplenow.com/happiness/life-on-purpose-15-questions-to-discover-your-personal-mission/). You could also do a Web search on personal mission statements, which will reveal a multitude of resources.

Part One
To get started on this assignment, you need to take an inventory of sorts about who you are and who you aspire to be. Therefore, begin rating yourself along the following dimensions (this is not an all-inclusive list; add as you see fit to best describe you):

- Identify your positive personality traits. Describe your character.
- Identify your beliefs and values.
- Identify your passion and talents.

Part Two
Craft your own personal vision and mission statements. You will have one vision statement and one mission statement. Each should be brief. Ideally, the vision statement will be one sentence and the mission statement will be three or four sentences, but these are just guidelines and not hard-and-fast rules.

Part Three
The instructor will ask for volunteers to share their personal statements. The class should be prepared to address the following:

- How difficult was the process, particularly the introspection?
- How did you go about deciding upon your final set of values, beliefs, passions, etc.?
- How different were your final personal statements from what you started with?
- Does this process have value?
- How flexible should these statements be; should they be reviewed and adapted often?
- What are your thoughts, now, about corporate vision and mission statements? Is there real value here for stakeholders?

VIDEO CASE
BRAZIL: AN EMERGING ECONOMY WITH STRATEGIC COMPETITIVENESS
In a world of stagnant growth, Brazil’s economy is growing at a rate of 7 percent, which is three times faster than the U.S. growth rate. A country rich in natural resources and sophisticated in hydropower and biofuels, Brazil has emerged with strategic competitiveness. Being one of the greenest economies, Brazil is one of the largest producers of iron ore and one of the leading exporters of many popular commodities. After surviving historic financial collapse, Brazil has risen to have a strong manufacturing base, and the country’s poor now have more purchasing power.
Be prepared to discuss the following concepts and questions in class:

**Concepts**
- Strategic competitiveness
- Strategy
- Hypercompetition
- Global economy
- Resources
- Capabilities
- Core competencies
- Stakeholders
- Strategic leaders

**Questions**
1. How is Brazil a strategic competitor?
2. What is Brazil’s strategy?
3. Is Brazil a hypercompetitor?
4. What impact does Brazil have on the global economy?
5. What resources, capabilities, and core competencies does Brazil have?
6. Identify and explain the stakeholders associated with Brazil’s thriving economy.
7. Describe Lula as a strategic leader. What strategies do you think he should employ to handle Brazil’s latest issues?

**Notes**

59. A. Capaldo, 2007, Network structure and innovation: The leveraging of a dual network as a distinctive relational capability,


Part 1: Strategic Management Inputs


133. J. A. Byrne, 2005, Great work if you can get it, Fast Company, April, 14.


Studying this chapter should provide you with the strategic management knowledge needed to:

1. Explain the importance of analyzing and understanding the firm’s external environment.
2. Define and describe the general environment and the industry environment.
3. Discuss the four activities of the external environmental analysis process.
4. Name and describe the general environment’s seven segments.
5. Identify the five competitive forces and explain how they determine an industry’s profit potential.
6. Define strategic groups and describe their influence on the firm.
7. Describe what firms need to know about their competitors and different methods (including ethical standards) used to collect intelligence about them.
The explosion that led to the subsequent sinking of the oil and gas drilling platform on April 20, 2010, sent ripples not only across the Gulf of Mexico but also had a huge influence on BP and its two subcontractors, Transocean and Halliburton. The Deepwater Horizon spill was the largest accidental offshore spill in history, at 206 million gallons. In comparison, the 1989 Exxon Valdez tanker wreck spilled 11.3 million gallons of oil. However, this was not BP’s only large well-publicized disaster. In 2006 there was an environmental spill in Alaska, and in 2005 there was the largest refinery explosion in Texas City, Texas, which killed 15 people. These events, especially the Deepwater Horizon disaster, have put BP in the crosshairs not only of regulators and government officials but also environmentalists. Furthermore, these events have enabled doubts about its legitimacy with critical stakeholders on Wall Street, and also influenced other industry participants (especially in the southeastern and southwestern states associated with offshore drilling in the Gulf of Mexico) and its customers. One immediate outcome of the disaster was the replacement of Tony Hayward, CEO at the time of the disaster, with Robert Dudley, on July 10, 2010. Additionally, BP announced a $32 billion charge realized on its 2010 balance sheet relative to past and current expenses associated with the disaster.

The strategic actions (see Figure 1.1) that BP will take relative to this disaster and to position for future success will be influenced by continuing pressures from its external environment. One of the main challenges for the firm’s strategic leader (Robert Dudley) is to understand what the external environment’s effects are on the firm and to predict how its future strategic actions might lead to success.

In the future, BP and all the other oil and gas firms focused on extracting such fuels should expect regulatory change in the political/legal segment of the general environment (the general environment and all of its segments are discussed in this chapter). In August 2010, President Obama appointed a federal commission to investigate the Deepwater Horizon oil spill. Their report, issued in January 2011, concluded that government oversight of the industry needed to be fundamentally reformed and that oil company practices needed to improve dramatically. One co-chairman of that commission, William Reilly, former head of the Environmental Protection Agency, suggested that even with all techniques learned after the Exxon Valdez disaster, and increased technology, the oil capture was rather pathetic; “they collected 5 or 6% of what was spilled.” Because of this oversight commission, along with congressional hearings on the report, it is virtually assured that more regulatory and safety inspections of offshore drilling platforms and operations will be undertaken, both from a company standpoint and the government agency responsible for such inspections, the Bureau of Ocean Energy Management, Regulation and Enforcement (BOEMRE). Certainly one of the effects is that regulation of drilling permits has become more intense, and in fact, very few have been approved since the Deepwater Horizon disaster.

The economic segment of the general environment will continue to produce demand for energy, especially with the rise of emerging markets such as China and India; thus exploration for hydrocarbon products will continue. Although demand for energy will
As described in the Opening Case and suggested by research, the external environment affects a firm’s strategic actions. For example, British Petroleum (BP) seeks to expand its oil reserves after the Deepwater Horizon oil and gas drilling platform disaster in the Gulf of Mexico by forming joint ventures in Russia with Rosneft Corporation, and in India with Reliance Industries. In addition, it is clear that BP’s strategic actions are affected by conditions in other segments of its general environment, such as the political/legal, social/cultural, and physical environment segments. As we explain in this chapter, a firm’s external environment creates both opportunities (e.g., the opportunity for BP to enter other global markets) and threats (e.g., the possibility that additional regulations in its markets will reduce opportunities to extract oil and gas). Collectively, opportunities and threats affect a firm’s strategic actions.
Regardless of the industry in which they compete, the external environment influences firms as they seek strategic competitiveness and above-average returns. This chapter focuses on how firms analyze their external environment. The understanding of conditions in its external environment that the firm gains by analyzing that environment is matched with knowledge about its internal organization (discussed in the next chapter) as the foundation for forming the firm’s vision, developing its mission, and identifying and implementing strategic actions (see Figure 1.1).

As noted in Chapter 1, the environmental conditions in the current global economy differ from historical conditions. For example, technological changes and the continuing growth of information gathering and processing capabilities increase the need for firms to develop effective competitive actions on a timely basis. (In slightly different words, firms have little time to correct errors when implementing their competitive actions.) The rapid sociological changes occurring in many countries affect labor practices and the nature of products demanded by increasingly diverse consumers. Governmental policies and laws also affect where and how firms choose to compete. In addition, changes to nations’ financial regulatory systems that were enacted in 2010 and beyond are expected to increase the complexity of organizations’ financial transactions.

Viewed in their totality, the conditions that affect firms today indicate that for most organizations, their external environment is filled with uncertainty. To successfully deal with this uncertainty and to achieve strategic competitiveness and thrive, firms must be aware of and fully understand the different segments of the external environment.

Firms understand the external environment by acquiring information about competitors, customers, and other stakeholders to build their own base of knowledge and capabilities. On the basis of the new information, firms take actions, such as building new capabilities and core competencies, in hopes of buffering themselves from any negative environmental effects and to pursue opportunities as the basis for better serving their stakeholders’ needs. A firm’s strategic actions are influenced by the conditions in the three parts (the general, industry, and competitor) of its external environment (see Figure 2.1).
The General, Industry, and Competitor Environments

The general environment is composed of dimensions in the broader society that influence an industry and the firms within it. We group these dimensions into seven environmental segments: demographic, economic, political/legal, sociocultural, technological, global, and physical. Examples of elements analyzed in each of these segments are shown in Table 2.1.

Firms cannot directly control the general environment’s segments. The recent bankruptcy filings by General Motors and Chrysler Corporation highlight this fact. These firms could not directly control various parts of their external environment, including the economic and political/legal segments; however, these segments are influencing the actions the firms are taking, including Chrysler’s alliance with Fiat. Because firms cannot directly control the segments of their external environment, successful ones learn how to gather the information needed to understand all segments and their implications for selecting and implementing the firm’s strategies.

The industry environment is the set of factors that directly influences a firm and its competitive actions and responses; the threat of new entrants, the power of suppliers, the power of buyers, the threat of product substitutes, and the intensity of rivalry among competitors. In total, the interactions among these five factors determine an industry’s profit potential; in turn, the industry’s profit potential influences the choices each firm makes about its strategic actions. The challenge for a firm is to locate a position within an industry where it can favorably influence the five factors or where it can successfully defend against their influence. The greater a firm’s capacity to favorably influence its industry environment, the greater the likelihood that the firm will earn above-average returns.

Table 2.1 The General Environment: Segments and Elements

<table>
<thead>
<tr>
<th>Demographic segment</th>
<th>Economic segment</th>
<th>Political/Legal segment</th>
<th>Sociocultural segment</th>
<th>Technological segment</th>
<th>Global segment</th>
<th>Physical environment segment</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Population size</td>
<td>• Inflation rates</td>
<td>• Antitrust laws</td>
<td>• Women in the workforce</td>
<td>• Product innovations</td>
<td>• Important political events</td>
<td>• Energy consumption</td>
</tr>
<tr>
<td>• Age structure</td>
<td>• Interest rates</td>
<td>• Taxation laws</td>
<td>• Workforce diversity</td>
<td>• Applications of knowledge</td>
<td>• Critical global markets</td>
<td>• Practices used to develop energy sources</td>
</tr>
<tr>
<td>• Geographic distribution</td>
<td>• Trade deficits or surpluses</td>
<td>• Deregulation philosophies</td>
<td>• Attitudes about the quality of work life</td>
<td>• Trends in technology and innovation</td>
<td>• Critical global markets</td>
<td>• Renewable energy efforts</td>
</tr>
<tr>
<td></td>
<td>• Budget deficits or surpluses</td>
<td></td>
<td></td>
<td></td>
<td>• Newly industrialized countries</td>
<td>• Minimizing a firm’s environmental footprint</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>• New different cultural and institutional attributes</td>
<td>• Energy consumption</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>• Availability of water as a resource</td>
<td>• Practices used to develop energy sources</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>• Producing environmentally friendly products</td>
<td>• Renewable energy efforts</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>• Reacting to natural or man-made disasters</td>
<td>• Minimizing a firm’s environmental footprint</td>
</tr>
</tbody>
</table>
How companies gather and interpret information about their competitors is called competitor analysis. Understanding the firm’s competitor environment complements the insights provided by studying the general and industry environments. This means, for example, that BP wants to learn as much as it can about its major competitors—such as Exxon-Mobil and Royal Dutch Shell plc—while also learning about its general and industry environments.

Analysis of the general environment is focused on environmental trends while an analysis of the industry environment is focused on the factors and conditions influencing an industry’s profitability potential and an analysis of competitors is focused on predicting competitors’ actions, responses, and intentions. In combination, the results of these three analyses influence the firm’s vision, mission, and strategic actions. Although we discuss each analysis separately, performance improves when the firm integrates the insights provided by analyses of the general environment, the industry environment, and the competitor environment.

**External Environmental Analysis**

Most firms face external environments that are highly turbulent, complex, and global—conditions that make interpreting those environments difficult. To cope with often ambiguous and incomplete environmental data and to increase understanding of the general environment, firms engage in external environmental analysis. This analysis has four parts: scanning, monitoring, forecasting, and assessing (see Table 2.2). Analyzing the external environment is a difficult, yet significant, activity.

Identifying opportunities and threats is an important objective of studying the general environment. An **opportunity** is a condition in the general environment that, if exploited effectively, helps a company achieve strategic competitiveness. For example, recent market research results suggested to Procter & Gamble (P&G) after its acquisition of Gillette, a shaving products company, that an increasing number of men across the globe are interested in fragrances and skin care products. To take advantage of this opportunity, P&G is reorienting toward beauty products to better serve both men and women. The change constitutes an organization change focused on combining product categories rather than its typical organization around a specific branded product.

A **threat** is a condition in the general environment that may hinder a company’s efforts to achieve strategic competitiveness. Microsoft is currently experiencing a severe external threat as smartphones are expected to surpass personal computer (PC) sales in the near future. Although Microsoft has a smartphone operating system, Apple, Google, and Research in Motion (BlackBerry phones) have operating platforms that are much more popular than those using Microsoft’s platform. Although PC growth will continue to expand, it is not growing at the rate that smartphones are, and possible substitution may happen between PCs, smartphones, and additional devices, such as Apple’s iPad and Amazon’s Kindle.

<table>
<thead>
<tr>
<th><strong>Table 2.2</strong> Components of the External Environmental Analysis</th>
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</thead>
<tbody>
<tr>
<td><strong>Scanning</strong>&lt;br&gt;• Identifying early signals of environmental changes and trends</td>
</tr>
<tr>
<td><strong>Monitoring</strong>&lt;br&gt;• Detecting meaning through ongoing observations of environmental changes and trends</td>
</tr>
<tr>
<td><strong>Forecasting</strong>&lt;br&gt;• Developing projections of anticipated outcomes based on monitored changes and trends</td>
</tr>
<tr>
<td><strong>Assessing</strong>&lt;br&gt;• Determining the timing and importance of environmental changes and trends for firms’ strategies and their management</td>
</tr>
</tbody>
</table>

An **opportunity** is a condition in the general environment that if exploited effectively, helps a company achieve strategic competitiveness.

A **threat** is a condition in the general environment that may hinder a company’s efforts to achieve strategic competitiveness.
similar devices. The main software platform is needed to assure other software producers will develop applications for the platform. Apple has large numbers of applications being developed, and Google’s Android system software applications are rapidly increasing as well. As such, Microsoft is in a severe catch-up position relative to its competition. It recently formed a joint venture with Nokia Corporation to establish a firmer platform for its existing software using Nokia’s large potential smartphone base. However, this threat remains until this opportunity is realized.\textsuperscript{18}

Firms use several sources to analyze the general environment, including a wide variety of printed materials (such as trade publications, newspapers, business publications, and the results of academic research and public polls), trade shows and suppliers, customers, and employees of public-sector organizations. People in boundary-spanning positions can obtain a great deal of this type of information. Salespersons, purchasing managers, public relations directors, and customer service representatives, each of whom interacts with external constituents, are examples of boundary-spanning positions.

**Scanning**

Scanning entails the study of all segments in the general environment. Through scanning, firms identify early signals of potential changes in the general environment and detect changes that are already under way.\textsuperscript{19} Scanning often reveals ambiguous, incomplete, or unconnected data and information. Thus, environmental scanning is challenging but critically important for firms, especially those competing in highly volatile environments.\textsuperscript{20} In addition, scanning activities must be aligned with the organizational context; a scanning system designed for a volatile environment is inappropriate for a firm in a stable environment.\textsuperscript{21}

Many firms use special software to help them identify events that are taking place in the environment and that are announced in public sources. For example, news event detection uses information-based systems to categorize text and reduce the trade-off between an important missed event and false alarm rates.\textsuperscript{22} The Internet provides significant opportunities for scanning. Amazon.com, for example, records significant information about individuals visiting its Web site, particularly if a purchase is made. Amazon then welcomes these customers by name when they visit the Web site again. The firm sends messages to customers about specials and new products similar to those they purchased in previous visits. A number of other companies such as Netflix also collect demographic data about their customers in an attempt to identify their unique preferences (demographics is one of the segments in the general environment).

Philip Morris International continuously scans segments of its external environment to detect current conditions and to anticipate changes that might take place in different segments. For example, PMI always studies various nations’ tax policies on cigarettes (these policies are part of the political/legal segment). The reason for this is that raising cigarette taxes might reduce sales while lowering these taxes might increase sales.

**Monitoring**

When monitoring, analysts observe environmental changes to see if an important trend is emerging from among those spotted through scanning.\textsuperscript{23} Critical to successful monitoring is the firm’s ability to detect meaning in environmental events and trends. For example, Tesco, the United Kingdom’s largest retailer, plans to add Turkish, Sri Lankan, Latin, Filipino, African, and South African cuisine to its food offerings. One analyst noted, “Britain has become one of the most ethnically diverse nations on earth, and there is a very strong, growing demand by those who have settled here to buy food from their homelands.”\textsuperscript{24} Tesco already sells Asian, Oriental, Afro-Caribbean, Kosher, Polish, and Halal foods. Continual monitoring of these trends is necessary for a large retailer such as Tesco to maintain the right balance among its products.
Effective monitoring requires the firm to identify important stakeholders and understand its reputation among these stakeholders as the foundation for serving their unique needs.\textsuperscript{25} (Stakeholders’ unique needs are described in Chapter 1.) Scanning and monitoring are particularly important when a firm competes in an industry with high technological uncertainty.\textsuperscript{26} Scanning and monitoring can provide the firm with information; they also serve as a means of importing knowledge about markets and about how to successfully commercialize new technologies the firm has developed.\textsuperscript{27}

**Forecasting**

Scanning and monitoring are concerned with events and trends in the general environment at a point in time. When forecasting, analysts develop feasible projections of what might happen, and how quickly, as a result of the changes and trends detected through scanning and monitoring.\textsuperscript{28} For example, analysts might forecast the time that will be required for a new technology to reach the marketplace, the length of time before different corporate training procedures are required to deal with anticipated changes in the composition of the workforce, or how much time will elapse before changes in governmental taxation policies affect consumers’ purchasing patterns.

Forecasting events and outcomes accurately is challenging. Forecasting demand for new technological products is difficult because technology trends are continually driving product life cycles shorter. This is particularly difficult for a firm like Intel, whose products go into many customers’ technological products, which are consistently updated. Increasing the difficulty, each new wafer fabrication or silicone chip technology production plant that Intel invests in becomes significantly more expensive for each generation of chip products. Having tools that allow better forecasting of electronic product demand is increasingly important.\textsuperscript{29}

During an economic downturn, forecasting becomes more difficult and more important. For example, Procter & Gamble (P&G), Unilever, and Colgate-Palmolive, which primarily sell branded products, have been pushed by retailers to lower their prices, while at the same time these retailers are selling lower-priced, private-label goods. Thus, these consumer product companies are forecasting the effects of the two trends noted as they seek to project demand. Fortunately, these consumer product companies are seeing demand increase for branded products as the economy improves.\textsuperscript{30}

**Assessing**

The objective of assessing is to determine the timing and significance of the effects of environmental changes and trends that have been identified.\textsuperscript{31} Through scanning, monitoring, and forecasting, analysts are able to understand the general environment. Going a step further, the intent of assessment is to specify the implications of that understanding. Without assessment, the firm is left with data that may be interesting but of unknown competitive relevance. Even if formal assessment is inadequate, the appropriate interpretation of that information is important.

How accurate senior executives are concerning their competitive environments may be less important for strategy and corresponding organizational changes than correctly interpreting environmental trends. Thus, although gathering and organizing information is important, appropriately interpreting that intelligence to determine if an identified trend in the external environment is an opportunity or threat is paramount.\textsuperscript{32}

**Segments of the General Environment**

The general environment is composed of segments that are external to the firm (see Table 2.1). Although the degree of impact varies, these environmental segments affect all industries and the firms competing in them. The challenge to each firm is to scan, monitor, forecast, and assess the elements in each segment to determine their effects on the
Part 1: Strategic Management Inputs

firm. Effective scanning, monitoring, forecasting, and assessing are vital to the firm’s efforts to recognize and evaluate opportunities and threats.

The Demographic Segment

The demographic segment is concerned with a population’s size, age structure, geographic distribution, ethnic mix, and income distribution. Demographic segments are commonly analyzed on a global basis because of their potential effects across countries’ borders and because many firms compete in global markets.

Population Size

The world’s population doubled (from 3 billion to 6 billion) between 1959 and 1999. Current projections suggest that population growth will continue in the twenty-first century, but at a slower pace. The U.S. Census Bureau projects that the world’s population will be 9 billion by 2040. By 2050, India is expected to be the most populous nation in the world (with over 1.8 billion people). China, the United States, Indonesia, and Pakistan are predicted to be the next four most populous nations in 2050. Firms seeking to find growing markets in which to sell their goods and services want to recognize the market potential that may exist for them in these five nations.

While observing the population of different nations and regions of the world, firms also want to study changes occurring within different populations to assess their strategic implications. For example, in 2011, 25 percent of Japan’s citizens were 65 or older, while the United States and China will not reach this level until 2036. Aging populations are a significant problem for countries because of the need for workers and the burden of funding retirement programs. In Japan and other countries, employees are urged to work longer to overcome these problems. Interestingly, the United States has a higher birthrate and significant immigration, placing it in a better position than Japan and other European nations.

Age Structure

As noted earlier, in Japan and other countries, the world’s population is rapidly aging. In North America and Europe, millions of baby boomers are approaching retirement. However, even in developing countries with large numbers of people under the age of 35, birth rates have been declining sharply. In China, for example, by 2040 there will be more than 400 million people over the age of 60. The more than 90 million baby boomers in North America may postpone retirement given the recent financial crisis. In fact, data now suggest that baby boomers (those born between 1946 and 1965) are struggling to meet their retirement goals and are uncertain if they will actually be able to retire as originally expected. This is partly because of declines in the value of their homes as well as declines in their other retirement investments—a number of baby boomers “are being forced to postpone retirement, find cheaper housing, and cut living expenses” due to a decline in their retirement assets between 2007 and 2009. The possibility of future declines is creating uncertainty for baby boomers about how to invest and when they might be able to retire. On the other hand, delayed retirements by baby boomers with value-creating skills may facilitate firms’ efforts to successfully implement their strategies. Moreover, delayed retirements may allow companies to think of creative ways for skilled, long-time employees to impart their accumulated knowledge to younger employees as they work a bit longer than originally anticipated.
Chapter 2: The External Environment: Opportunities, Threats, Industry Competition, and Competitor Analysis

Geographic Distribution
For decades, the U.S. population has been shifting from the north and east to the west and south. Firms should consider the effects of this shift in demographics as well. For example, Florida is the U.S. state with the largest percentage of its population (17.6 percent) 65 years or older. Thus, companies providing goods and services that are targeted to senior citizens might pay close attention to this group’s geographic preference for states in the south (such as Florida) and the southwest (such as Texas). Similarly, the trend of relocating from metropolitan to nonmetropolitan areas continues in the United States. These trends are changing local and state governments’ tax bases. In turn, business firms’ decisions regarding location are influenced by the degree of support that different taxing agencies offer as well as the rates at which these agencies tax businesses.

Geographic distribution patterns are not identical throughout the world. For example, in China, 60 percent of the population lives in rural areas; however, the growth is in urban communities such as Shanghai (with a current population in excess of 18 million) and Beijing (over 15 million). These data suggest that firms seeking to sell their products in China should recognize the growth in metropolitan areas rather than in rural areas. Larger cities are expected to generate more growth in GDP per person than smaller cities and also attract more human capital—people with talent to produce economic growth.

Ethnic Mix
The ethnic mix of countries’ populations continues to change. For example, Hispanics are now the largest ethnic minority (16 percent) in the United States, representing more than 50 million of the total U.S. population of 308 million. In fact, the U.S. Hispanic market is the third largest “Latin American” economy behind Brazil and Mexico. Spanish is now the dominant language in parts of U.S. states such as Texas, California, Florida, and New Mexico. Given these facts, some firms might want to assess the degree to which their goods or services could be adapted to serve the unique needs of Hispanic consumers. This is particularly appropriate for companies competing in consumer sectors such as grocery stores, movie studios, financial services, and clothing stores.

Changes in the ethnic mix also affect a workforce’s composition. In the United States, for example, the population and labor force will continue to diversify, as immigration accounts for a sizable part of growth. Projections are that the combined Latino and Asian population shares will increase to more than 20 percent of the total U.S. population by 2014. Interestingly, much of this immigrant workforce is bypassing high-cost coastal cities and settling in smaller rural towns. Many of these workers are in low-wage, labor-intensive industries such as construction, food service, lodging, and landscaping. For this reason, if border security is tightened, these industries will likely face labor shortages. In addition, well-trained medical and technical personnel have difficulties migrating to the United States even when their skills are in demand. U.S. migration policies have not maintained the same fluidity as global trade agreements; U.S. trade policies have been liberalized while U.S. immigration policies have been tightened.

Income Distribution
Understanding how income is distributed within and across populations informs firms of different groups’ purchasing power and discretionary income. Studies of income distributions suggest that although living standards have improved over time, variations exist within and between nations. Of interest to firms are the average incomes of households and individuals. For instance, the increase in dual-career couples has had a notable effect on average incomes. Although real income has been declining in general in some nations, the household income of dual-career couples has increased, especially in the United States. These figures yield strategically relevant information for firms. For instance, research indicates that whether an employee is part of a dual-career couple can strongly influence the willingness of the employee to accept an international assignment. However, because of the worldwide economic downturn, many companies were still
pursuing international assignments but changing them to avoid some of the additional costs of funding expatriates abroad.  

The growth of the economy in China has drawn many firms, not only for the low-cost production, but also because of the large potential demand for products, given its large population base. However, the amount of China’s gross domestic product that makes up domestic consumption is the lowest of any major economy at less than one-third. In comparison, India’s domestic consumption of consumer goods accounts for two-thirds of its economy, or twice China’s level. As such, many western multinationals are considering entering India as a consumption market as its middle class grows extensively. Although India as a nation has poor infrastructure, its consumers are in a far better position to spend. Furthermore, the urban-rural income difference has been declining in India more rapidly than in China. Because of situations like this, paying attention to the differences between markets based on income distribution can be very important. Of course, the recent global financial crisis may affect the size of the world’s “middle class.”

**The Economic Segment**

The economic environment refers to the nature and direction of the economy in which a firm competes or may compete. In general, firms seek to compete in relatively stable economies with strong growth potential. Because nations are interconnected as a result of the global economy, firms must scan, monitor, forecast, and assess the health of their host nation and the health of the economies outside their host nation.

As firms compete during the second decade of the twenty-first century, the world’s economic environment is quite uncertain. Some businesspeople are even beginning to question the ability of economists to provide valid and reliable predictions about trends to anticipate in the world’s economic environment. The lack of confidence in predictions from those specializing in providing such predictions complicates firms’ efforts to understand the conditions they might face during future competitive battles.

In terms of specific economic environments, companies competing in Japan or desiring to do so might carefully evaluate the economic impact of the earthquake, subsequent tsunami, and radiation leaks at the nuclear power generation plants in Sendai. Although the crisis in Japan is country specific, its ripple effects have been felt around the globe. For example, many industries that source inputs from Japan, such as electronic gear and auto parts, have had to close plants for short periods due to lack of critical inputs.

Because of its acknowledged economic growth, a number of companies are evaluating the possibility of entering Russia to compete or, for those already competing in that nation, to expand the scope of their operations. However, “there is no denying that doing business in Russia is not for the faint at heart.” This unique, challenging, and sometimes difficult-to-understand business environment presents significant risks in doing business in Russia. This challenging environment can also be an advantage because it serves as an entry barrier to limit the number of companies willing to enter and learn how to operate effectively to reap the returns. Another country with growth opportunities is Vietnam, as firms across the globe take note of how their government reforms and economic decentralization are creating opportunities for investment for sourcing, as well as their developing consumer market.

**The Political/Legal Segment**

The political/legal segment is the arena in which organizations and interest groups compete for attention, resources, and a voice in overseeing the body of laws and regulations guiding interactions among nations as well as between firms and various local governmental agencies.
information), they often influence a firm’s strategic actions. For example, less-restrictive regulations on firms’ actions are a product of the recent global trend toward privatization of government-owned or government-regulated firms. Much privatization in recent years has been driven by government budget concerns and the need to raise funds by selling government owned firms to reduce deficits. Some believe that the transformation from state-owned to private firms occurring in multiple nations has substantial implications for the competitive landscapes in a number of countries and across multiple industries.

Firms must carefully analyze new political administration’s business-related policies and philosophies. Antitrust laws, taxation laws, industries chosen for deregulation, labor training laws, and the degree of commitment to educational institutions are areas in which an administration’s policies can affect the operations and profitability of industries and individual firms across the globe. For example, President Obama’s administration has sought to pursue policies with the intention of reducing the amount of work U.S. companies outsource to firms. This policy could affect information technology outsourcing firms based in countries such as India. When President Obama visited India in 2010, he bypassed visiting Bangalore, which is an outsourcing and technology center and economic hotspot in India. The introduction of legislation in the U.S. Congress during the early tenure of the Obama administration suggested at least some support for these stated intentions. However, the legislation has not been enacted and has less likelihood of passing since the 2010 midterm elections.

To deal with issues such as those we are describing, firms develop a political strategy to influence governmental policies that might affect them. Some argue that developing an effective political strategy is essential to the restructured General Motors’ efforts to achieve strategic competitiveness since it received government funding during the economic downturn. In addition, the effects of global governmental policies (e.g., those related to firms in India that are engaging in IT outsourcing work) on a firm’s competitive position increase the need for firms to form an effective political strategy.

Firms competing in the global economy encounter an interesting array of political/legal questions and issues. For example, the European sovereign-debt crisis has destabilized the European Union. Starting with Greece and moving on to Ireland, Portugal, and Spain, economies weakened by large public debt burdens have caused fiscal policies to be much more restrictive, and still government debt is at sky-high levels which increases bond rates. The debt crisis has put many banks at risk and discourages investment because consumer consumption is likely to be limited. Another crisis in the Middle East and throughout the Arab world is the political revolutions in country after country demanding political reform. Starting with Tunisia and proceeding to Egypt, Libya, Bahrain, Syria, and other states in the region, there is significant turmoil, which has led to a temporary increase in world oil prices. These are political events which create uncertainty in the world’s business affairs and make decision making more difficult.

The Sociocultural Segment

The sociocultural segment is concerned with a society’s attitudes and cultural values. Because attitudes and values form the cornerstone of a society, they often drive demographic, economic, political/legal, and technological conditions and changes.

Societies’ attitudes and cultural values appear to be undergoing possible changes at the start of the second decade of the twenty-first century. In the United States, attitudes and values about health care are an area in which sociocultural changes might occur. Specifically, while the United States has the highest overall health care expenditure as well as the highest expenditure per capita of any country in the world, millions of the nation’s citizens lack health insurance. Although health care
reform legislation was passed in the early part of the Obama administration, it continues to be a bone of contention—especially since the 2010 midterm elections—with attempts made to repeal it and many states filing lawsuits. Continuing changes to the nature of health care policies can have a significant effect on business firms, so they must carefully examine trends regarding health care in order to anticipate the effects on their operations.

As the U.S. labor force has increased, it has become more diverse, as significantly more women and minorities from a variety of cultures enter the workplace. In 1993, the total U.S. workforce was slightly less than 130 million; in 2005, it was slightly greater than 148 million. It is predicted to grow to more than 192 million by 2050. In the same year, 2050, the U.S. workforce is forecast to be composed of 48 percent female workers, 11 percent Asian American workers, 14 percent African American workers and 24 percent Hispanic workers. The growing gender, ethnic, and cultural diversity in the workforce creates challenges and opportunities, including combining the best of both men’s and women’s traditional leadership styles. Although diversity in the workforce has the potential to improve performance, research indicates that management of diversity initiatives is required in order to reap these organizational benefits. Human resource practitioners are trained to successfully manage diversity issues to enhance positive outcomes.

Another manifestation of changing attitudes toward work is the continuing growth of contingency workers (part-time, temporary, and contract employees) throughout the global economy. This trend is significant in several parts of the world, including Canada, Japan, Latin America, Western Europe, and the United States. In the United States, the fastest growing group of contingency workers is those with 15 to 20 years of work experience. The layoffs resulting from the recent global crisis and the loss of retirement income of numerous “baby boomers”—many of whom feel they must work longer to recover losses to their retirement portfolios—are a key reason for this. Companies interested in hiring on a temporary basis may benefit by gaining access to the long-term work experiences of these newly available workers. Also, temporary workers are the first to be employed as the economy revives after a downturn.

Although the lifestyle and workforce changes referenced previously reflect the values of the U.S. population, each country and culture has unique values and trends. National cultural values affect behavior in organizations and thus also influence organizational outcomes such as differences in CEO compensation. Likewise, the national culture influences to a large extent the internationalization strategy that firms pursue relative to one’s home country. Knowledge sharing is important for dispersing new knowledge in organizations and increasing the speed in implementing innovations. Personal relationships are especially important in China as guanxi (personal connections) has become a way of doing business within the country and for individuals to advance their careers in what is becoming a more open market society. Understanding the importance of guanxi is critical for foreign firms doing business in China.

The Technological Segment

Pervasive and diversified in scope, technological changes affect many parts of societies. These effects occur primarily through new products, processes, and materials. The technological segment includes the institutions and activities involved in creating new knowledge and translating that knowledge into new outputs, products, processes, and materials. Given the rapid pace of technological change and risk of disruption, it is vital for firms to thoroughly study the technological segment. The importance of these efforts is suggested by the finding that early adopters of new technology often achieve higher market shares and earn higher returns. Thus, both large and small firms should continuously scan the external environment to identify potential substitutes for technologies that are in current use, as well as to identify newly emerging technologies from which their firm could derive competitive advantage.

As a significant technological development, the Internet has become a remarkable capability to provide information easily, quickly, and effectively to an ever-increasing
percentage of the world’s population. Companies continue to study the Internet’s capabilities to anticipate how it may allow them to create more value for customers in the future and to anticipate future trends.

In spite of the Internet’s far-reaching effects, wireless communication technology is becoming the next significant technological opportunity for companies to apply when pursuing strategic competitiveness. Handheld devices and other wireless communications equipment are used to access a variety of network-based services. The use of handheld computers with wireless network connectivity, Web-enabled mobile phone handsets, and other emerging platforms (e.g., consumer Internet-access devices such as the iPhone and iPad) has increased substantially and should soon become the dominant form of communication and commerce.68

For example, eBay’s iPhone application has become “by far the largest mobile-commerce application in the world,” going from $600 million in volume in 2009 to between $1.5 billion and $2 billion in 2010.69 Amazon’s Kindle is not only a reader but also provides access to the Internet. With each new version of mobile devices such as the iPhone, iPad, and Kindle, amazing additional functionalities and software applications are added.

**The Global Segment**

The global segment includes relevant new global markets, existing markets that are changing, important international political events, and critical cultural and institutional characteristics of global markets.70 There is little doubt that markets are becoming more global and that consumers as well as companies throughout the world accept this fact. Consider the automobile industry. The global auto industry is one in which an increasing number of people believe that because “we live in a global community,” consumers in multiple nations are willing to buy cars and trucks “from whatever area of the world.”71

When studying the global segment, firms (including automobile manufacturers) should recognize that globalization of business markets may create opportunities to enter new markets as well as threats that new competitors from other economies may also enter their market. This is both an opportunity and a threat for the world’s automobile manufacturers—worldwide production capacity is now a potential threat to all global companies where entering another market to sell a company’s products appears to be an opportunity. In China, for example, even though car sales surged 37 percent in 2010, it is expected that by 2015 they will reach production overcapacity and have a glut of extra cars. Because of the global economic slowdown, in order to increase sales many car companies want to enter foreign markets. This has led to overcapacity worldwide. To add to the problem in China, labor unions have organized strikes to demand higher wages. For example at Toyota Motor Corporation and Honda Motor Corporation, as young workers coming from rural areas into urban areas are settling down to permanent work, they expect higher wages. This signals that China is no longer a “bargain-basement market for placid workers.” This is especially problematic for foreign automakers because by 2017 J. D. Power projects Chinese brands will account for 45 percent of the country’s passenger-vehicle market.72

The markets from which firms generate sales and income are one indication of the degree to which they are participating in the global economy. For example, H. J. Heinz Company, a large global food producer, is acquiring a stake in Coniexpress S. A. Industrias Alimenticias, a leading Brazilian manufacturer of tomato-based products, ketchup, condiments, and vegetables. The full fiscal year 2011, which ends April 27, is expected to have a sales growth of 2 to 3 percent, while sales in emerging economies such as its Asia-Pacific area grew 16.8 percent and the rest of the world outside its main North-American group grew 14.5 percent. Thus, much of Heinz’s sales growth and its profit margins are coming from emerging markets.73 Likewise, much of SABMiller’s growth in beer is coming from emerging economies. For example, at the 2010 World Cup, its purchase of Castle Lager allowed it to sell an extra 30 million bottles. Similar acquisitions of India’s Narang and Columbia’s Bavaria brands are part of its $17 billion string of acquisitions since 1999, leading to its increased sales growth in emerging markets.74 Citigroup’s CEO, Vikram S. Pandit, has steered his large financial
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service company through the financial crisis with the help of a $45 billion taxpayer-funded loan. However, Pandit sees much opportunity in developing markets, and as such, half of Citigroup’s profit comes from developing countries. For instance, in Latin America and Asia the bank increased its assets by $470 billion in 2010, an increase of 16 percent, by adding customers in countries such as Brazil, Mexico, and India. Thus, for these companies and so many others, understanding the conditions of today’s global segment and being able to predict future conditions are critical to their success.

The global segment presents firms with both opportunities and threats or risks. Because of the threats and risks, some firms choose to take a more cautious approach to competing in international markets. These firms participate in what some refer to as globalfocusing. Globalfocusing often is used by firms with moderate levels of international operations who increase their internationalization by focusing on global niche markets. In this way, they build on and use their special competencies and resources while limiting their risks within the niche market. Another way in which firms limit their risks in international markets is to focus their operations and sales in one region of the world. In this way, they can build stronger relationships in and knowledge of their markets. As they build these strengths, rivals find it more difficult to enter their markets and compete successfully.

In all instances, firms competing in global markets should recognize their sociocultural and institutional attributes. Furthermore, Korean ideology emphasizes communitarianism, a characteristic of many Asian countries. Korea’s approach differs from those of Japan and China, however, in that it focuses on inhwa, or harmony. Inhwa is based on a respect of hierarchical relationships and obedience to authority. Alternatively, the approach in China stresses guanxi—personal relationships or good connections—atwhile in Japan, the focus is on wa, or group harmony and social cohesion. The institutional context of China suggests a major emphasis on centralized planning by the government. The Chinese government provides incentives to firms to develop alliances with foreign firms having sophisticated technology in hopes of building knowledge and introducing new technologies to the Chinese markets over time. As such, it is important to analyze the strategic intent of foreign firms when pursuing alliances and joint ventures abroad, especially where the local partners are receiving technology which may in the long run reduce the foreign firms’ advantages.

**The Physical Environment Segment**

The physical environment segment refers to potential and actual changes in the physical environment and business practices that are intended to positively respond to and deal with those changes. Concerned with trends oriented to sustaining the world’s physical environment, firms recognize that ecological, social, and economic systems interactively influence what happens in this particular segment.

There are many parts or attributes of the physical environment that firms should consider as they try to identify trends in this segment. Some argue that global warming is a trend firms and nations should carefully examine in efforts to predict any potential effects on the global society as well as on their business operations. Investors are seeking to take advantage of this trend, calling it “green alpha,” by looking to profit by increasing environmental sustainability. Energy consumption is another part of the physical environment that concerns both organizations and nations. In Canada, for example, a representative of the Energy Council of Canada said: “The electricity sector right now is 75 percent clean, and the idea is that over a well-defined period of time we’ll be a 90 percent clean electricity sector.” Most of this clean power generation comes from hydroelectric produced electricity.

Because of increasing concern about sustaining the quality of the physical environment, a number of companies are developing environmentally friendly policies. Indra K. Nooyi, CEO of PepsiCo, is pursuing a strategy called “capital performance with purpose.” This strategy links green efforts in all businesses to the bottom line. Through this approach, PepsiCo hopes to create technologies that can be replicated across its multiple facilities, thereby creating large savings. For example, Frito-Lay, a PepsiCo business unit, operates the world’s seventh-largest private delivery fleet. In large urban areas it is
FIRMS’ EFFORTS TO TAKE CARE OF THE PHYSICAL ENVIRONMENT IN WHICH THEY COMPETE

The number of companies throughout the world that recognize that they compete within the confines of the physical environment and that they are expected to reduce the negative effect of their operations on the physical environment while competing continues to increase. Also, consumers concerned about the physical environment value this trend.

Producing and selling additional “green” (i.e., environmentally friendly) products is one company response to this trend. Siemens AG, a large diversified engineering firm similar to General Electric in the United States, was traumatized by a global bribery scandal that led to a new outside CEO, Peter Losch, being appointed. His leadership led to a significant restructuring effort. While Losch divested telecommunication and information technology businesses, he increased the focus on selling sustainability oriented products to both consumers and industrial customers, including everything from light bulbs to high-speed trains to factory controls.

Siemens generates $38 billion in sales from wind power, solar energy, and energy-conserving electricity grids. It claims to be the lead offshore wind turbine producer, and about one quarter of its 400,000 employees are what Siemens calls “green-collar workers” that are focused on sustainability products. This approach has allowed Siemens’ stock to surge 47 percent in 2009, almost twice the gain that GE’s stock achieved in the same period. Interestingly, GE has also made a significant emphasis on the green consciousness of its sales orientation.

In addition to products, companies across the globe are committing to or increasing their commitment to environmental sustainability. McDonald’s, for example, has pursued green restaurant design, sustainable packaging, and waste management, and seeks to improve energy efficiency to reduce its environmental footprint. More importantly, it has required its supply chain to strive to meet sustainability goals. For example, Cargill, Inc., a large basic food producer, has been recognized by McDonald’s as a “Global Best of Green” supplier.

McDonald’s is one of Cargill’s largest customers, and Cargill partners with them “in every area from menu development, to restaurant operations and risk management solutions.” McDonald’s supports an annual sustainability conference in which it challenges its suppliers to meet “best practices” to improve environmental sustainability. For instance, Cargill invested millions to install anaerobic reactors at all of its largest beef and pork processing plants. Through this process, Cargill reclaims methane from wastewater lagoons and converts it to fuel the plants’ boilers. This process has reduced 30 percent of the natural gas demand at 11 meat plants. Cargill estimates that this process has reduced greenhouse gas emissions by more than 1.3 million metric tons over the last four years: “It reduces pollution, increases our renewable energy and cuts costs.”

Procter & Gamble (P&G) recently announced increased targets for its 2012 sustainability goals. Among the goals are those to (1) “develop and market at least $50 billion in cumulative sales of sustainable innovation
products, (2) deliver a 20 percent reduction (per unit of production) in carbon dioxide emissions, energy consumption, water usage and disposed waste from P&G plants, and (3) enable 300 million children to Live, Learn and Thrive by delivering three billion liters of clean water through P&G’s Children’s Safe Drinking Water program. Also critical to a firm’s choices of strategic actions to take is an understanding of its industry and its competitors; we consider these issues next.

Although many forces are pushing firms to become greener, not all the “green” claims of products on store shelves are valid. According to a recent study reported in the Wall Street Journal, 95 percent of consumer products examined committed at least one offense of “green washing,” a term used to describe unproven environmental claims. Both TerraChoice and Underwriters Laboratories offer green-certification programs, which could benefit many manufacturers who seek to have third-party verification of their green or environmentally friendly claims.

Although there are many firms whose claims are not verified, the examples noted above signify a growing commitment by firms around the globe in response to emerging trends in the physical environment segment. In addition to positively responding to the observed trends in this segment of the general environment, there is some evidence that firms engaging in these types of behaviors outperform those failing to do so, as the Siemens example illustrates. This emerging evidence suggests that these behaviors benefit companies, their stakeholders, and the physical environment in which they operate.


Putting in an all-electric fleet of delivery trucks that it estimates will save 500,000 gallons of diesel fuel a year, curbing greenhouse emissions by 75 percent over combustion engines. This conversion also expects to save $700,000 in maintenance costs.

We discuss other firms’ efforts to “reduce their environmental footprint” and to be good stewards of the physical environment as a result of doing so in the preceding Strategic Focus. As we note, the number of “green” products companies are producing continues to increase.

As our discussion of the general environment shows, identifying anticipated changes and trends among external elements is a key objective of analyzing the firm’s general environment. With a focus on the future, the analysis of the general environment allows firms to identify opportunities and threats. It is necessary to have a top management team with the experience, knowledge, and sensitivity required to effectively analyze this segment of the environment. Also critical to a firm’s choices of strategic actions to take is an understanding of its industry environment and its competitors; we consider these issues next.

Industry Environment Analysis

An industry is a group of firms producing products that are close substitutes. In the course of competition, these firms influence one another. Typically, industries include a rich mixture of competitive strategies that companies use in pursuing above-average returns. In part, these strategies are chosen because of the influence of an industry’s characteristics.

An industry is a group of firms producing products that are close substitutes.
Compared with the general environment, the industry environment has a more direct effect on the firm’s strategic competitiveness and ability to earn above-average returns. An industry’s profit potential is a function of five forces of competition: the threats posed by new entrants, the power of suppliers, the power of buyers, product substitutes, and the intensity of rivalry among competitors (see Figure 2.2).

The five forces model of competition expands the arena for competitive analysis. Historically, when studying the competitive environment, firms concentrated on companies with which they competed directly. However, firms must search more broadly to recognize current and potential competitors by identifying potential customers as well as the firms serving them. For example, the communications industry is now broadly defined as encompassing media companies, telecoms, entertainment companies, and companies producing devices such as smartphones. In such an environment, firms must study many other industries to identify firms with capabilities (especially technology-based capabilities) that might be the foundation for producing a good or a service that can compete against what they are producing. Using this perspective finds firms focusing on customers and their needs rather than on specific industry boundaries to define markets.

When studying the industry environment, firms must also recognize that suppliers can become a firm’s competitors (by integrating forward) as can buyers (by integrating backward). For example, several firms have integrated forward in the pharmaceutical industry by acquiring distributors or wholesalers. In addition, firms choosing to enter a new market and those producing products that are adequate substitutes for existing products can become a company’s competitors. Next, we examine the five forces the firm analyzes to understand the profitability potential within the industry (or a segment of an industry) in which it competes or may choose to compete.

**Threat of New Entrants**

Identifying new entrants is important because they can threaten the market share of existing competitors. One reason new entrants pose such a threat is that they bring additional production capacity. Unless the demand for a good or service is increasing, additional capacity holds consumers’ costs down, resulting in less revenue and lower returns for

![Figure 2.2 The Five Forces of Competition Model](https://example.com/figure2.2.png)
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competing firms. Often, new entrants have a keen interest in gaining a large market share. As a result, new competitors may force existing firms to be more efficient and to learn how to compete on new dimensions (e.g., using an Internet-based distribution channel).

The likelihood that firms will enter an industry is a function of two factors: barriers to entry and the retaliation expected from current industry participants. Entry barriers make it difficult for new firms to enter an industry and often place them at a competitive disadvantage even when they are able to enter. As such, high entry barriers tend to increase the returns for existing firms in the industry and may allow some firms to dominate the industry. Thus, firms competing successfully in an industry want to maintain high entry barriers in order to discourage potential competitors from deciding to enter the industry.

**Barriers to Entry**

Firms competing in an industry (and especially those earning above-average returns) try to develop entry barriers to thwart potential competitors. For example, the server market is hypercompetitive and dominated by IBM, Hewlett-Packard, and Dell. Historically, the scale economies these firms have developed by operating efficiently and effectively have created significant entry barriers, causing potential competitors to think very carefully about entering the server market to compete against them. Oracle, primarily a software-oriented company, acquired Sun Microsystems, which is primarily a server hardware company, to overcome the barriers to entry that exist in this industry. Oracle intends to preload Oracle software into its new server line. “Hardware makers such as Dell and HP are getting into software, and software companies like Oracle are getting into hardware”; these “companies want to create the integrated hardware and software systems that can satisfy a corporate customer’s every IT need.” The degree of success Oracle will achieve as a result of its decision to enter the server market via an acquisition remains uncertain.

Several kinds of potentially significant entry barriers may discourage competitors from entering a market.

**Economies of Scale**

Economies of scale are derived from incremental efficiency improvements through experience as a firm grows larger. Therefore, the cost of producing each unit declines as the quantity of a product produced during a given period increases. This is the case for IBM, Hewlett-Packard, and Dell in the server market, as previously described.

Economies of scale can be developed in most business functions, such as marketing, manufacturing, research and development, and purchasing. Increasing economies of scale enhances a firm’s flexibility. For example, a firm may choose to reduce its price and capture a greater share of the market. Alternatively, it may keep its price constant to increase profits. In so doing, it likely will increase its free cash flow, which is very helpful during financially challenging times.

New entrants face a dilemma when confronting current competitors’ scale economies. Small-scale entry places them at a cost disadvantage. Given the size of Sun Microsystems relative to the three major competitors in the server market, Oracle has found it difficult to compete against its scale advantaged competitors. Additionally, large-scale entry through such an acquisition, in which the new entrant manufactures large volumes of a product to gain economies of scale, risks strong competitive retaliation.

Some competitive conditions reduce the ability of economies of scale to create an entry barrier. Many companies now customize their products for large numbers of small customer groups. Customized products are not manufactured in the volumes necessary to achieve economies of scale. Customization is made possible by flexible manufacturing systems (this point is discussed further in Chapter 4). In fact, the new manufacturing technology facilitated by advanced information systems has allowed the development of mass customization in an increasing number of industries. Although it is not appropriate for all products and implementing it can be challenging, mass customization has become increasingly common in manufacturing products. Online ordering has enhanced the
ability of customers to obtain customized products. Companies manufacturing customized products learn how to respond quickly to customers’ needs in lieu of developing scale economies.

**Product Differentiation** Over time, customers may come to believe that a firm’s product is unique. This belief can result from the firm’s service to the customer, effective advertising campaigns, or being the first to market a good or service. The Coca-Cola Company and PepsiCo have established strong brands in the soft drink market. These brands compete with each other not only in the United States but around the world. Because each has used a great deal of resources building their brands, customer loyalty is strong. These companies battle each other for market leadership, which has changed back and forth over the years. Although Diet Coke is currently the lead brand in the soft drink market, PepsiCo is leading the way in regard to innovation in social media, such as advertising on Facebook and Twitter as well as other approaches through the Internet.

When considering entry into the soft drink market, a company needs to pause to examine how one can overcome the brand image and consumer loyalty to these two giants in this global industry. One needs significant resources to capture market share, although many firms are doing so that have the resources to produce private label products such as Walmart.

Companies such as Procter & Gamble (P&G) and Colgate-Palmolive spend a great deal of money on advertising and product development to convince potential customers of their products’ distinctiveness and of the value buying their brands provides. Customers valuing a product’s uniqueness tend to become loyal to both the product and the company producing it. In turn, customer loyalty is an entry barrier for firms thinking of entering an industry and competing against the likes of P&G and Colgate. To compete against firms offering differentiated products to individuals who have become loyal customers, new entrants often allocate many resources. To combat the perception of uniqueness, new entrants frequently offer products at lower prices. This decision, however, may result in lower profits or even losses.

**Capital Requirements** Competing in a new industry requires a firm to have resources to invest. In addition to physical facilities, capital is needed for inventories, marketing activities, and other critical business functions. Even when a new industry is attractive, the capital required for successful market entry may not be available to pursue the market opportunity. For example, defense industries are difficult to enter because of the substantial resource investments required to be competitive. In addition, because of the high knowledge requirements of the defense industry, a firm might acquire an existing company as a means of entering this industry, but it must have access to the capital necessary to do this. Obviously, Oracle had the capital required to acquire Sun Microsystems as a foundation for entering the server market.

**Switching Costs** Switching costs are the one-time costs customers incur when they buy from a different supplier. The costs of buying new ancillary equipment and of retraining employees, and even the psychic costs of ending a relationship, may be incurred in switching to a new supplier. In some cases, switching costs are low, such as when the consumer switches to a different brand of soft drink. Switching costs can vary as a function of time. For example, in terms of credit hours toward graduation, the cost to a student to transfer from one university to another as a freshman is much lower than it is when the student is entering the senior year.

Occasionally, a decision made by manufacturers to produce a new, innovative product creates high switching costs for the final consumer. Customer loyalty programs, such as airlines’ frequent flyer miles, are intended to increase the customer’s switching costs. If switching costs are high, a new entrant must offer either a substantially lower price or
a much better product to attract buyers. Usually, the more established the relationships between parties, the greater the switching costs.

**Access to Distribution Channels** Over time, industry participants typically develop effective means of distributing products. Once a relationship with its distributors has been built a firm will nurture it, thus creating switching costs for the distributors. Access to distribution channels can be a strong entry barrier for new entrants, particularly in consumer nondurable goods industries (e.g., in grocery stores where shelf space is limited) and in international markets. New entrants have to persuade distributors to carry their products, either in addition to or in place of those currently distributed. Price breaks and cooperative advertising allowances may be used for this purpose; however, those practices reduce the new entrant’s profit potential. Interestingly, access to distribution is less of a barrier for products that can be sold on the Internet.

**Cost Disadvantages Independent of Scale** Sometimes, established competitors have cost advantages that new entrants cannot duplicate. Proprietary product technology, favorable access to raw materials, desirable locations, and government subsidies are examples. Successful competition requires new entrants to reduce the strategic relevance of these factors. Delivering purchases directly to the buyer can counter the advantage of a desirable location; new food establishments in an undesirable location often follow this practice.

**Government Policy** Through licensing and permit requirements, governments can also control entry into an industry. Liquor retailing, radio and TV broadcasting, banking, and trucking are examples of industries in which government decisions and actions affect entry possibilities. Also, governments often restrict entry into some industries because of the need to provide quality service or the need to protect jobs. Alternatively, deregulation of industries, exemplified by the airline and utilities industries in the United States, allows more firms to enter. However, some of the most publicized government actions are those involving antitrust. Often the Antitrust Division of the Justice Department or the Federal Trade Commission will disallow a merger because it creates a firm that is too dominant in an industry and would thus create unfair competition. Such a negative ruling would obviously be an entry barrier for the acquiring firm.

**Expected Retaliation** Companies seeking to enter an industry also anticipate the reactions of firms in the industry. An expectation of swift and vigorous competitive responses reduces the likelihood of entry. Vigorous retaliation can be expected when the existing firm has a major stake in the industry (e.g., it has fixed assets with few, if any, alternative uses), when it has substantial resources, and when industry growth is slow or constrained. For example, any firm attempting to enter the airline industry at the current time can expect significant retaliation from existing competitors due to overcapacity.

Locating market niches not being served by incumbents allows the new entrant to avoid entry barriers. Small entrepreneurial firms are generally best suited for identifying and serving neglected market segments. When Honda first entered the U.S. motorcycle market, it concentrated on small-engine motorcycles, a market that firms such as Harley-Davidson ignored. By targeting this neglected niche, Honda avoided competition. After consolidating its position, Honda used its strength to attack rivals by introducing larger motorcycles and competing in the broader market. Competitive actions and competitive responses between firms such as Honda and Harley-Davidson are discussed more fully in Chapter 5.

**Bargaining Power of Suppliers** Increasing prices and reducing the quality of their products are potential means suppliers use to exert power over firms competing within an industry. If a firm is unable to
recover cost increases by its suppliers through its own pricing structure, its profitability is reduced by its suppliers’ actions. A supplier group is powerful when

■ It is dominated by a few large companies and is more concentrated than the industry to which it sells.
■ Satisfactory substitute products are not available to industry firms.
■ Industry firms are not a significant customer for the supplier group.
■ Suppliers’ goods are critical to buyers’ marketplace success.
■ The effectiveness of suppliers’ products has created high switching costs for industry firms.
■ It poses a credible threat to integrate forward into the buyers’ industry. Credibility is enhanced when suppliers have substantial resources and provide a highly differentiated product.

The airline industry is one in which suppliers’ bargaining power is changing. Though the number of suppliers is low, the demand for major aircraft is also relatively low. Boeing and Airbus aggressively compete for orders of major aircraft, creating more power for buyers in the process. When a large airline signals that it might place a “significant” order for wide-body airliners which either Airbus or Boeing might produce, both companies are likely to battle for the business and include a financing arrangement, highlighting the buyer’s power in the potential transaction.

**Bargaining Power of Buyers**

Firms seek to maximize the return on their invested capital. Alternatively, buyers (customers of an industry or a firm) want to buy products at the lowest possible price—the point at which the industry earns the lowest acceptable rate of return on its invested capital. To reduce their costs, buyers bargain for higher quality, greater levels of service, and lower prices. These outcomes are achieved by encouraging competitive battles among the industry’s firms. Customers (buyer groups) are powerful when

■ They purchase a large portion of an industry’s total output.
■ The sales of the product being purchased account for a significant portion of the seller’s annual revenues.
■ They could switch to another product at little, if any, cost.
■ The industry’s products are undifferentiated or standardized, and the buyers pose a credible threat if they were to integrate backward into the sellers’ industry.

Consumers armed with greater amounts of information about the manufacturer’s costs and the power of the Internet as a shopping and distribution alternative have increased bargaining power in many industries. One reason for this shift is that individual buyers incur virtually zero switching costs when they decide to purchase from one manufacturer rather than another or from one dealer as opposed to any other.

**Threat of Substitute Products**

Substitute products are goods or services from outside a given industry that perform similar or the same functions as a product that the industry produces. For example, as a sugar substitute, NutraSweet (and other sugar substitutes) places an upper limit on sugar manufacturers’ prices—NutraSweet and sugar perform the same function, though with different characteristics. Other product substitutes include e-mail and fax machines instead of overnight deliveries, plastic containers rather than glass jars, and tea instead of coffee. Newspaper firms have experienced significant circulation declines over the past decade or more. The declines are due to substitute outlets for news including Internet sources, cable television news channels, and e-mail and cell phone alerts. Likewise, satellite TV and cable and telecommunication companies provide substitute services for basic media services such as television, Internet, and phone. However, as illustrated in the Strategic Focus, the possible switching is becoming more complicated as consumer
In the Internet era, as media content has moved from a paper, tape, and film (or analog) world to a digital world based on Internet technology, new industry structures are emerging as firms begin to utilize that technology and create commercial opportunities. This process of new technology creation, utilization, and commercialization ultimately leads to changes in organizational patterns, and in particular, strategic alliances and mergers and acquisitions as firms restructure themselves around the utilization and commercial opportunities being created.

At the base of this new digital world are firms that offer digital services. In particular focusing on television subscribers, there are about 64 million cable TV households and 32.5 million satellite consumers. However, although starting at a lower base, telecom TV homes are growing at an increased rate relative to satellite and cable providers. In 2011 telecom television providers are at 8.5 million but are projected to be at 16 million by 2014. Each of these providers is seeking to bundle their services to provide not only television but also broadband and telecommunication services. Many telecom providers are also reaching/pursuing mobile phone services, especially as the penetration rate of landlines is decreasing and mobile phones are increasing.

Industry convergence is also being felt by device producers such as Apple and other PC makers such as Dell and HP. Apple has produced a smartphone, the iPhone, which has sparked all other device makers to try to produce similar products. Such products now are offered by all of the mobile phone producers, including Nokia, Samsung, and Motorola, among others. Not only do the smartphones provide telephone and texting capabilities but also increasingly numerous multimedia applications, including music and video as well as GPS services and general Internet searches. There are new applications almost every day. The opportunities here globally are even more significant than the purchases of personal computers because the price is lower.

The battle for a software platform among these smartphones is also important. The iPhone platform produced by Apple is currently in the lead, but Google has been catching up through its Android platform. Although Microsoft is behind, Nokia has recently moved to adopt the Microsoft platform. Research in Motion’s (RIM) platform is also competing but is behind the Apple and Google platforms. RIM has been in the lead among business customers, but this lead is being eroded as well by Apple and Google platforms. The larger the base of users in these platforms the more draw there is for independent software producers to create new application uses for an increasing variety of smartphones, which draws more consumers to the platform and the company’s devices.

The platform is also important in the home, where there is a battle for control of the set-top box, which manages the media content available through televisions and other home devices such as the personal computer. Again, Apple TV, Google TV, and firms such as Netflix and Hulu are competing for this base, as are cable companies through video on demand (VOD) services.

Finally, firms that actually produce the media—musicians, news organizations and newspapers, television and movie producers, and publishers—want to make sure that their content is available through all sources. Now, that means mobile as well as home devices,
where they can gain access to advertising dollars, which have been the traditional ways of profiting from media. For example, people are going to movies in theaters less than they used to, even with increased use of technology such as three dimensions (3D). More and more people are watching media at home through big screen televisions and via VOD services, which are available not only in the home but on mobile devices, netbooks, laptops, and desktop PCs.

This convergence among players has led to acquisitions between buyers and suppliers and competitors as well as multiple relationships and strategic partnerships through strategic alliances, which have become the norm as firms compete to take advantage of the resources available. A recent trend has been to partner with social network firms such as Twitter and Facebook in order to better utilize social media and gain new advertising dollars. This convergence makes competitor analysis much more difficult than it used to be because it is difficult to say who is a competitor, who is a supplier, who is a buyer, and who is a new entrant into the industry, and what products, services, and processes will be substituted next as the industry structure evolves. One day a firm provides a complementary product such as software to hardware producers, and the next day the complementor (formally defined later in the chapter) makes an acquisition, as Oracle did of Sun Microcomputers, and becomes a competitor to other server producers such as Dell, HP, and IBM. Competitor analysis must take into consideration the technological changes which lead to the utilization and commercialization of technologies. It also must ultimately examine how such technological changes will lead to convergence of competitors or other firms and associated organizational changes through alliances and acquisitions and the possible re-creation of a new set of industry competitors, buyers, and suppliers.


demand for content changes through increasing use of mobile devices such as tablets and smartphones. Tablets such as the iPad are reducing the number of PCs sold and this is curtailing the growth of PC producers such as Taiwan’s Acer Computers, at least until they can come out with their own successful tablet product. These products are increasingly popular, especially among younger and technologically savvy people, and as product substitutes they have significant potential to continue to reduce traditional media sources such as newspaper circulation sales.

In general, product substitutes present a strong threat to a firm when customers face few, if any, switching costs and when the substitute product’s price is lower or its quality and performance capabilities are equal to or greater than those of the competing product. Differentiating a product along dimensions that customers value (such as quality, service after the sale, and location) reduces a substitute’s attractiveness.

**Intensity of Rivalry among Competitors**

Because an industry’s firms are mutually dependent, actions taken by one company usually invite competitive responses. In many industries, firms actively compete against one another. Competitive rivalry intensifies when a firm is challenged by a competitor’s actions or when a company recognizes an opportunity to improve its market position.
Firms within industries are rarely homogeneous; they differ in resources and capabilities and seek to differentiate themselves from competitors. Typically, firms seek to differentiate their products from competitors’ offerings in ways that customers value and in which the firms have a competitive advantage. Common dimensions on which rivalry is based include price, service after the sale, and innovation.

Next, we discuss the most prominent factors that experience shows to affect the intensity of firms’ rivalries.

**Numerous or Equally Balanced Competitors**

Intense rivalries are common in industries with many companies. With multiple competitors, it is common for a few firms to believe they can act without eliciting a response. However, evidence suggests that other firms generally are aware of competitors’ actions, often choosing to respond to them. At the other extreme, industries with only a few firms of equivalent size and power also tend to have strong rivalries. The large and often similar-sized resource bases of these firms permit vigorous actions and responses. The competitive battles between Airbus and Boeing exemplify intense rivalry between relatively equal competitors, especially as airlines place bids for the new wide-body planes they are producing. Coca-Cola and PepsiCo have a strong rivalry in drink products as consumers demand not only great taste but real health benefits.

**Slow Industry Growth**

When a market is growing, firms try to effectively use resources to serve an expanding customer base. Growing markets reduce the pressure to take customers from competitors. However, rivalry in no-growth or slow-growth markets (slow change) becomes more intense as firms battle to increase their market shares by attracting competitors’ customers. For example, there is a growing trend for health care of baby boomers, who are now reaching age 65. Growth can be realized by managed-care firms like WellPoint Inc. and Aetna Inc. without strong rivalry. The same is true for home health care, but as regulation becomes more prominent in this industry, growth is likely to slow and rivalry increase.

Typically, battles to protect market share are fierce. Certainly, this has been the case in the airline industry and in the fast-food industry as McDonald’s, Wendy’s, and Burger King try to win each other’s customers. The instability in the market that results from these competitive engagements may reduce the profitability for all firms engaging in such battles.

**High Fixed Costs or High Storage Costs**

When fixed costs account for a large part of total costs, companies try to maximize the use of their productive capacity. Doing so allows the firm to spread costs across a larger volume of output. However, when many firms attempt to maximize their productive capacity, excess capacity is created on an industry-wide basis. To then reduce inventories, individual companies typically cut the price of their product and offer rebates and other special discounts to customers. However, these practices, common in the automobile manufacturing industry in the recent past, often intensify competition. The pattern of excess capacity at the industry level followed by intense rivalry at the firm level is observed frequently in industries with high storage costs. Perishable products, for example, lose their value rapidly with the passage of time. As their inventories grow, producers of perishable goods often use pricing strategies to sell products quickly.
Lack of Differentiation or Low Switching Costs
When buyers find a differentiated product that satisfies their needs, they frequently purchase the product loyally over time. Industries with many companies that have successfully differentiated their products have less rivalry, resulting in lower competition for individual firms. Firms that develop and sustain a differentiated product that cannot be easily imitated by competitors often earn higher returns. However, when buyers view products as commodities (i.e., as products with few differentiated features or capabilities), rivalry intensifies. In these instances, buyers’ purchasing decisions are based primarily on price and, to a lesser degree, service. Personal computers are a commodity product. Thus, the rivalry between Dell, Hewlett-Packard, Lenovo, and other computer manufacturers is strong and these companies are always trying to find ways to differentiate their offerings (Hewlett-Packard now pursues product design as a means of differentiation). Apple has been able to maintain a differentiation strategy through ease of use of its software applications and its integration capabilities with other software platforms.

High Strategic Stakes
Competitive rivalry is likely to be high when it is important for several of the competitors to perform well in the market. For example, although it is diversified and is a market leader in other businesses, Samsung has targeted market leadership in the consumer electronics market and is doing quite well. This market is quite important to Sony and other major competitors, such as Hitachi, Matsushita, NEC, and Mitsubishi, suggesting that rivalry among these competitors will remain strong.

High strategic stakes can also exist in terms of geographic locations. For example, Japanese automobile manufacturers are committed to a significant presence in the U.S. marketplace because it is the world’s largest single market for automobiles and trucks. Due to the high stakes involved in the United States for both Japanese and U.S. manufacturers, rivalry among the global firms from these two countries is intense. With the excess capacity in this industry we mentioned earlier in this chapter, there is every reason to believe that the rivalry among global automobile manufacturers will remain intense in the foreseeable future.

High Exit Barriers
Sometimes companies continue competing in an industry even though the returns on their invested capital are low or negative. Firms making this choice likely face high exit barriers, which include economic, strategic, and emotional factors causing them to remain in an industry when the profitability of doing so is questionable. Exit barriers are especially high in the airline industry. Although earning even average returns is difficult for these firms, they face substantial exit barriers, such as their ownership of specialized assets (e.g., large aircraft). Common exit barriers include the following:

- Specialized assets (assets with values linked to a particular business or location)
- Fixed costs of exit (such as labor agreements)
- Strategic interrelationships (relationships of mutual dependence, such as those between one business and other parts of a company’s operations, including shared facilities and access to financial markets)
- Emotional barriers (aversion to economically justified business decisions because of fear for one’s own career, loyalty to employees, and so forth)
- Government and social restrictions (often based on government concerns for job losses and regional economic effects; more common outside the United States)

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

Analysis of the five forces in the industry allows the firm to determine the industry’s attractiveness in terms of the potential to earn adequate or superior returns. In general, the stronger competitive forces are, the lower the profit potential for an industry’s firms. An unattractive industry has low entry barriers, suppliers and buyers with strong bargaining positions, strong competitive threats from product substitutes, and intense rivalry among competitors. These industry characteristics make it difficult for firms to achieve strategic competitiveness and earn above-average returns. Alternatively, an attractive industry has high entry barriers, suppliers and buyers with little bargaining power, few competitive threats from product substitutes, and relatively moderate rivalry. Next, we explain strategic groups as an aspect of industry competition.

**Strategic Groups**

A set of firms that emphasize similar strategic dimensions and use a similar strategy is called a **strategic group**. The competition between firms within a strategic group is greater than the competition between a member of a strategic group and companies outside that strategic group. Therefore, intrastrategic group competition is more intense than interstrategic group competition. In fact, more heterogeneity is evident in the performance of firms within strategic groups than across the groups. The performance leaders within groups are able to follow strategies similar to those of other firms in the group and yet maintain strategic distinctiveness to gain and sustain a competitive advantage.

The extent of technological leadership, product quality, pricing policies, distribution channels, and customer service are examples of strategic dimensions that firms in a strategic group may treat similarly. Thus, membership in a particular strategic group defines the essential characteristics of the firm’s strategy.

The notion of strategic groups can be useful for analyzing an industry’s competitive structure. Such analyses can be helpful in diagnosing competition, positioning, and the profitability of firms within an industry. High mobility barriers, high rivalry, and low resources among the firms within an industry limit the formation of strategic groups. However, research suggests that after strategic groups are formed, their membership remains relatively stable over time, although recent research does examine how change occurs. Using strategic groups to understand an industry’s competitive structure requires the firm to plot companies’ competitive actions and competitive responses along strategic dimensions such as pricing decisions, product quality, distribution channels, and so forth. This type of analysis shows the firm how certain companies are competing similarly in terms of how they use similar strategic dimensions.

Strategic groups have several implications. First, because firms within a group offer similar products to the same customers, the competitive rivalry among them can be intense. The more intense the rivalry, the greater the threat to each firm’s profitability. Second, the strengths of the five industry forces differ across strategic groups. Third, the closer the strategic groups are in terms of their strategies, the greater is the likelihood of rivalry between the groups.

**Competitor Analysis**

The competitor environment is the final part of the external environment requiring study. Competitor analysis focuses on each company against which a firm directly competes.
Chapter 2: The External Environment: Opportunities, Threats, Industry Competition, and Competitor Analysis

For example, Coca-Cola and PepsiCo, Home Depot and Lowe’s, and Boeing and Airbus are keenly interested in understanding each other’s objectives, strategies, assumptions, and capabilities. Indeed, intense rivalry creates a strong need to understand competitors. In a competitor analysis, the firm seeks to understand the following:

- What drives the competitor, as shown by its future objectives
- What the competitor is doing and can do, as revealed by its current strategy
- What the competitor believes about the industry, as shown by its assumptions
- What the competitor’s capabilities are, as shown by its strengths and weaknesses

Information about these four dimensions helps the firm prepare an anticipated response profile for each competitor (see Figure 2.3). The results of an effective competitor analysis help a firm understand, interpret, and predict its competitors’ actions and responses. Understanding the actions of competitors clearly contributes to the firm’s ability to compete successfully within the industry. Interestingly, research suggests that executives often fail to analyze competitors’ possible reactions to competitive actions their firm takes, placing their firm at a potential competitive disadvantage as a result.

Critical to an effective competitor analysis is gathering data and information that can help the firm understand its competitors’ intentions and the strategic implications resulting from them. Useful data and information combine to form competitor intelligence, the set of data and information the firm gathers to better understand and anticipate competitors’ objectives, strategies, assumptions, and capabilities. In competitor analysis, the firm gathers intelligence not only about its competitors, but also regarding public policies in countries around the world. Such intelligence facilitates an understanding of the

Figure 2.3 Competitor Analysis Components

Future Objectives
- How do our goals compare with our competitors’ goals?
- Where will emphasis be placed in the future?
- What is the attitude toward risk?

Current Strategy
- How are we currently competing?
- Does their strategy support changes in the competitive structure?

Assumptions
- Do we assume the future will be volatile?
- Are we operating under a status quo?
- What assumptions do our competitors hold about the industry and themselves?

Capabilities
- What are our strengths and weaknesses?
- How do we rate compared to our competitors?

Response
- What will our competitors do in the future?
- Where do we hold an advantage over our competitors?
- How will this change our relationship with our competitors?
strategic posture of foreign competitors. Through effective competitive and public policy intelligence, the firm gains the insights needed to make effective strategic decisions on how to compete against its rivals.

When asked to describe competitive intelligence, it seems that a number of people respond with phrases such as “competitive spying” and “corporate espionage.” These phrases denote the fact that competitive intelligence is an activity that appears to involve trade-offs. According to some, the reason for this is that “what is ethical in one country is different from what is ethical in other countries.” This position implies that the rules of engagement to follow when gathering competitive intelligence change in different contexts. However, firms avoid the possibility of legal entanglements and ethical quandaries only when their competitive intelligence gathering methods are governed by a strict set of legal and ethical guidelines. This means that ethical behavior and actions as well as the mandates of relevant laws and regulations should be the foundation on which a firm’s competitive intelligence-gathering process is formed. We address this matter in greater detail in the next section.

When gathering competitive intelligence, firms must also pay attention to the complementors of its products and strategy. Complementors are companies or networks of companies that sell complementary goods or services that are compatible with the focal firm’s good or service. When a complementor’s good or service adds value to the sale of the focal firm’s good or service, it is likely to create value for the focal firm.

There are many examples of firms whose good or service complements other companies’ offerings. For example, firms manufacturing affordable home photo printers complement other companies’ efforts to sell digital cameras. Intel and Microsoft are perhaps the most widely recognized complementors. The Microsoft slogan “Intel Inside” demonstrates the relationship between two firms who do not directly buy from or sell to each other but whose products have a strong complementary relationship. Alliances among airline operations (e.g., the Star Alliance and the SkyTeam Alliance) find these companies sharing their route structures and customer loyalty programs as means of complementing each others’ operations. (Each alliance is a network of complementors.) Recently, Continental Airlines announced that it was leaving the SkyTeam Alliance to join the Star Alliance. The primary reason for this change was to provide greater global coverage to Continental’s customers by combining its routes with those of the other members of the Star Alliance. In essence, Continental’s conclusion was that the complementors of the Star Alliance created more value for its customers than did its complementors in the SkyTeam Alliance. Ultimately, Continental merged with United Airlines, a key Star Alliance member.

As our discussion shows, complementors expand the set of competitors firms must evaluate when completing a competitor analysis. For example, as illustrated in the Strategic Focus, sometimes complementors change, as in the purchase of Sun Microsystems by Oracle. After the acquisition Oracle was no longer a complementor of Dell and HP, but a competitor. Similarly, Intel and Microsoft analyze each other’s actions in that those actions might either help each firm gain a competitive advantage or damage each firm’s ability to exploit a competitive advantage.

**Ethical Considerations**

Firms must follow relevant laws and regulations as well as carefully articulated ethical guidelines when gathering competitor intelligence. Industry associations often develop lists of these practices that firms can adopt. Practices considered both legal and ethical include (1) obtaining publicly available information (e.g., court records, competitors’ help-wanted advertisements, annual reports, financial reports of publicly
held corporations, and Uniform Commercial Code filings), and (2) attending trade fairs and shows to obtain competitors’ brochures, view their exhibits, and listen to discussions about their products. In contrast, certain practices (including blackmail, trespassing, eavesdropping, and stealing drawings, samples, or documents) are widely viewed as unethical and often are illegal.

Some competitor intelligence practices may be legal, but a firm must decide whether they are also ethical, given the image it desires as a corporate citizen. Especially with electronic transmissions, the line between legal and ethical practices can be difficult to determine. For example, a firm may develop Web site addresses that are similar to those of its competitors and thus occasionally receive e-mail transmissions that were intended for those competitors. The practice is an example of the challenges companies face in deciding how to gather intelligence about competitors while simultaneously determining how to prevent competitors from learning too much about them. To deal with these challenges, firms should establish principles and take actions that are consistent with them. Many firms follow the Strategy and Competitive Intelligence Professionals, a professional association, code of professional practice and ethics dealing with this issue.127

Open discussions of intelligence-gathering techniques can help a firm ensure that employees, customers, suppliers, and even potential competitors understand its convictions to follow ethical practices for gathering competitor intelligence. An appropriate guideline for competitor intelligence practices is to respect the principles of common morality and the right of competitors not to reveal certain information about their products, operations, and strategic intentions.128

**Summary**

- The firm’s external environment is challenging and complex. Because of the external environment’s effect on performance, the firm must develop the skills required to identify opportunities and threats existing in that environment.
- The external environment has three major parts: (1) the general environment (elements in the broader society that affect industries and their firms), (2) the industry environment (factors that influence a firm, its competitive actions and responses, and the industry’s profit potential), and (3) the competitor environment (in which the firm analyzes each major competitor’s future objectives, current strategies, assumptions, and capabilities).
- The external environmental analysis process has four steps: scanning, monitoring, forecasting, and assessing. Through environmental analyses, the firm identifies opportunities and threats.
- The general environment has seven segments: demographic, economic, political/legal, sociocultural, technological, global, and physical. For each segment, the firm has to determine the strategic relevance of environmental changes and trends.
- Compared with the general environment, the industry environment has a more direct effect on the firm’s strategic actions. The five forces model of competition includes the threat of entry, the power of suppliers, the power of buyers, product substitutes, and the intensity of rivalry among competitors. By studying these forces, the firm finds a position in an industry where it can influence the forces in its favor or where it can buffer itself from the power of the forces in order to achieve strategic competitiveness and earn above-average returns.
- Industries are populated with different strategic groups. A strategic group is a collection of firms following similar strategies along similar dimensions. Competitive rivalry is greater within a strategic group than between strategic groups.
- Competitor analysis informs the firm about the future objectives, current strategies, assumptions, and capabilities of the companies with which it competes directly. A thorough analysis examines complementors that sustain a competitor’s strategy and major networks or alliances in which competitors participate. When analyzing competitors, the firm should also identify and carefully monitor major actions taken by firms with performance below the industry norm.
- Different techniques are used to create competitor intelligence: the set of data, information, and knowledge that allows the firm to better understand its competitors and thereby predict their likely strategic and tactical actions. Firms should use only legal and ethical practices to gather intelligence. The Internet enhances firms’ capabilities to gather insights about competitors and their strategic intentions.
REVIEW QUESTIONS

1. Why is it important for a firm to study and understand the external environment?
2. What are the differences between the general environment and the industry environment? Why are these differences important?
3. What is the external environmental analysis process (four steps)? What does the firm want to learn when using this process?
4. What are the seven segments of the general environment? Explain the differences among them.
5. How do the five forces of competition in an industry affect its profit potential? Explain.
6. What is a strategic group? Of what value is knowledge of the firm’s strategic group in formulating that firm’s strategy?
7. What is the importance of collecting and interpreting data and information about competitors? What practices should a firm use to gather competitor intelligence and why?

EXPERIENTIAL EXERCISES

EXERCISE 1: STRATEGIC GROUP MAPPING
If a given set of firms emphasize similar strategic dimensions and use a similar strategy, these firms can be said to reside in the same strategic group. Other common definitions of strategic groups typically argue that the firms in a given industry follow similar strategies such as pricing, degree of specialization, research and development commitment, or the like. It is also likely that firms operating in a given industry may have very different profitability profiles, which begs the question of why if one firm is most profitable don’t all the others in that industry attempt to move into the same strategic group as the industry leader?

Part One

1. Form teams and pick an industry the team finds interesting. A list of industries and industry leaders may be found at Yahoo! Finance (http://biz.yahoo.com/ic/ind_index.html).
2. Investigate this industry in order to create a strategic group map. You must pick the two dimensions for your map that best represent the key success factors in this industry (e.g., R&D investments, pricing, geographic reach, etc.).
3. For each firm listed on your map, investigate its overall financial performance, not only historically but also its five-year growth forecast. (This information is also available at Yahoo! Finance and other locations).

Part Two

Prepare a presentation to the class that discusses your findings and that answers the following key issues or questions:

1. Who are the most direct competitors and on what basis do they mostly compete (i.e., why did you choose the competitive dimensions that you did)?
2. How does profitability stack up between strategic groups? Which groups are most profitable and why?
3. What would it take for a firm to move from an underperforming (profitability-wise) strategic group to a more profitable strategic group? How likely is it that this could happen?

4. Think about one of the firms in a particular strategic group. Are there any opportunities for this firm that you see because of your strategic group mapping?
5. What conclusions can you reach about why some firms end up where they do among various strategic groups?

EXERCISE 2: WHAT DOES THE FUTURE LOOK LIKE?
A critical ingredient to studying the general environment is identifying opportunities and threats. An opportunity is a condition in the environment that, if exploited, helps a company achieve strategic competitiveness. In order to identify opportunities, you must be aware of trends that affect the world around us now or that are projected to do so in the future.

Thomas Frey, senior futurist at the DaVinci Institute, believes that the chaotic nature of interconnecting trends and the vast array of possibilities that arise from them are somewhat akin to watching a spinning compass needle. From the way we use phones, e-mail, or recruit new workers to organizations, the climate for business is changing and shifting dramatically, and at rapidly increasing rates. Sorting these trends out and making sense of them provides the basis for opportunity decision making. Which ones will dominate and which ones will fade? Understanding this is crucial for business success.

Your challenge (either individually or as a group) is to identify a trend, technology, entertainment, or design that is likely to alter the way in which business is conducted in the future. Once you have identified this, be prepared to discuss:

Which of the six dimensions of the general environment will this affect (may be more than one)?

- Describe the impact.
- List some business opportunities that will come from this.
- Identify some existing organizations that stand to benefit.
- What, if any, are the ethical implications?

You should consult a wide variety of sources. For example, the Gartner Group and McKinsey & Company both produce market research and forecasts for business. There are also a host of Web
forecasting tools and addresses such as TED (technology, entertainment, design, where you can find videos of their discussions; see www.ted.com), which hosts an annual conference for path-breaking new ideas. Similarly, the DaVinci Institute, Institute for Global Futures, and a wide host of others have their own unique vision for tomorrow’s environment.

**VIDEO CASE**

**THE NEED TO EXAMINE THE EXTERNAL ENVIRONMENT: DISASTER IN THE GULF ONE YEAR LATER**

The Gulf Coast oil spill disaster not only resulted in oil and tar balls washing up on local beaches but contributed to the evaporation of the wedding business on the beach. In one family business, 85 percent of the business and $90,000 cash were lost while they only received $20,000 in emergency payments. A year later, resentful wedding business owners are still living day to day. They contend that British Petroleum (BP), which owned the Deepwater Horizon oil rig where the explosion and subsequent leak occurred, has not fulfilled its obligations to them and their true losses won’t ever be recovered. With government intervention, the $20 billion fund established by BP has only paid out $3.8 billion. Government attorney, Kenneth Feinberg, emphasizes that 200,000 claimants have been compensated in nine months.

Be prepared to discuss the following concepts and questions in class:

**Concepts**
- The external environment
- External environmental analysis

**Questions**

1. What external environment (general, industry, and competitive) segments do you think BP considered or didn’t consider prior to their drilling off the Gulf Coast? What should the wedding business owners now consider in their external environment?
2. How should BP have handled an external environmental analysis and what environmental changes and trends (opportunities and threats) might they have discovered?
3. Analyze BP using the five forces of competition model to determine the industry’s current attractiveness in terms of profit potential.
4. Who might be in BP’s strategic group and why?
5. What would a competitor of BP now discover about them in a competitor analysis?

**NOTES**

11. A. P. Kellogg & J. Bennett, 2009, Chrysler’s bankruptcy deals blow to


73. 2011, Heinz agrees to acquire 80% stake in a leading Brazilian food company; Heinz also reports strong third-quarter results with EPS of $0.84 on higher sales, led by emerging markets, top 15 brands and North American consumer products, Business Wire, March 3.


98. N. Zmuda & K. Patel, 2010, Pass or fail, Pepsi’s Refresh will be case for marketing textbooks, Advertising Age, February 8, 1–18.


103. G. Winalow, 2011, Map to TV everywhere, Broadcasting & Cable, February 14, 23.


119. Porter, Competitive Strategy, 49.


Studying this chapter should provide you with the strategic management knowledge needed to:

1. Explain why firms need to study and understand their internal organization.
2. Define value and discuss its importance.
3. Describe the differences between tangible and intangible resources.
4. Define capabilities and discuss their development.
5. Describe four criteria used to determine whether resources and capabilities are core competencies.
6. Explain how firms analyze their value chain for the purpose of determining where they are able to create value when using their resources, capabilities, and core competencies.
7. Define outsourcing and discuss reasons for its use.
8. Discuss the importance of identifying internal strengths and weaknesses.
9. Discuss the importance of avoiding core rigidities.
Fred DeLuca and his business partner, Dr. Peter Buck, opened their first submarine sandwich shop in Bridgeport, CT, in 1965 (DeLuca was 17 years old at the time). With a total of close to 35,000 units located in 98 different countries, Subway restaurants are now available to consumers in convenient locations throughout the world. The fact that Subway has a larger number of locations than McDonald’s suggests the success this firm is having as well as the breadth and depth of its market presence. Subway believes that its stores are the “leading choice for people seeking quick, nutritious meals that the whole family can enjoy.”

A number of factors support privately owned Subway’s continuing growth and success, including the fact that in the United States, the recent challenging economic climate found even affluent customers choosing to dine at quick-service restaurants such as Subway and McDonald’s rather than spending some of their disposable income to eat in more expensive restaurants. However, much more than the influence of the economic environment (an influence from the external environment that we examined in Chapter 2) affects Subway’s success. The way Subway uses its resources and capabilities as the foundation for core competencies (defined in Chapter 1, core competencies are capabilities that serve as a potential source of competitive advantage for a firm over its rivals) demonstrates the value of understanding a firm’s internal organization (this chapter’s subject). A high-quality product, excellent customer service, and continuously finding superior locations for its stores are core competencies for Subway.

Subway’s slogan, “Eat Fresh,” describes what it believes customers can do when eating there. To produce the products that allow customers to “Eat Fresh,” Subway bakes its own bread and offers a consistent set of fresh ingredients (meats, cheeses, and condiments) as choices so customers can customize their order. The products available to Subway customers are both healthy as measured by caloric intake and nutritious as measured by several indicators, such as protein count. The fact that 24.2 percent of those recently surveyed “completely trust” Subway’s nutritional claims suggests that its products are creating value for customers. This percentage is double the percentage of the second-most trusted set of nutritional claims (claims offered by Chick-fil-A restaurants). In 2011, Subway received the MenuMasters’ Award given by Nation’s Restaurant News in the “Healthy Innovations” category for its “Build Your Better Breakfast” that was introduced in 2010. These recognitions suggest that Subway’s core competence of high-quality foods may indeed be a competitive advantage for the firm.

In terms of customer service, Subway uses its resources to provide continuous training to its franchisees and those working within those units. These efforts are geared to providing standardized yet customized and supportive experiences to customers. Evidence that its customer service is a core competence and potentially a competitive advantage is suggested by the fact that in 2010, Subway was selected for the second consecutive year as “number one” by consumers in the “most popular,” “top service,” and the “healthy options” categories that are part of Zagat’s Fast-Food Survey.
The location of its units is Subway’s third core competence and possible competitive advantage. The firm uses its resources to find the best locations in the world for its units. In the words of a Subway official: “We’re continually looking at just about any opportunity for someone to buy a sandwich, wherever that might be . . . [In this sense], the non-traditional [location] is becoming the traditional.” An appliance store in Brazil, an automobile showroom in California, a zoo in Taiwan, and a Goodwill store in South Carolina are some of the unusual locations for Subway units. Interestingly, at the end of 2010, Subway had units in countries (such as Tanzania, Bolivia, and Afghanistan) where McDonald’s did not, suggesting the firm’s commitment to “non-traditional” locations.


As discussed in the first two chapters, several factors in the global economy, including the rapid development of the Internet’s capabilities and globalization in general have made it increasingly difficult for firms to find ways to develop sustainable competitive advantages. Increasingly, innovation appears to be a vital path to efforts to develop such advantages. Subway’s introductions of a full breakfast menu and a line of pizza offerings are examples of product innovations this firm introduced recently as part of its efforts to develop a competitive advantage. Of course, Subway’s competitors remain committed to innovation as well. McDonald’s frozen strawberry-lemonade is an example of a recent product innovation from this firm.

As is the case for Subway and McDonald’s, among many firms, Campbell Soup Co. is emphasizing innovation to increase its competitiveness relative to rivals such as General Mills Inc. and those producing lower-priced store brands. The contents of Campbell’s well-known condensed soups have been changed to enhance their flavor and the soups are now being offered in microwaveable containers as well as in cans. Overall, Campbell’s CEO is committed to the firm pursuing innovations in terms of its core categories—simple meals, healthy beverages, and baked snacks—as the source of its success. At General Motors, efforts are underway to reduce the “drag” the firm’s bureaucracy creates on innovation. According to a company official, “GM still wastes millions of dollars developing engines and vehicle variants that interest few customers.” To remedy this problem, GM is making changes with the intention of having the “right people and the right engineers on the right priorities and products, not just do the most vehicles possible.”

People are an especially critical resource for helping organizations learn how to continuously innovate as a means of achieving successful growth. This is the case at 3M, where the director of global compensation says that harnessing the innovative powers of the firm’s employees is the means for rekindling growth. At 3M and other companies, people who are able to facilitate their firm’s efforts to innovate are themselves a valuable resource with the potential to be a competitive advantage. A sign of the times is the fact that a global labor market now exists as firms seek talented individuals to add to their fold. As Richard Florida argues, “[W]herever talent goes, innovation, creativity, and economic growth are sure to follow.”

To identify and successfully use resources over time, those leading firms need to think constantly about how to manage resources for the purpose of increasing the value their goods or services create for customers as compared to the value rivals’ products create. As this chapter shows, firms achieve strategic competitiveness and earn above-average returns by acquiring, bundling, and leveraging their resources for the purpose of...
Chapter 3: The Internal Organization: Resources, Capabilities, Core Competencies, and Competitive Advantages

taking advantage of opportunities in the external environment in ways that create value for customers.11

Even if the firm develops and manages resources in ways that create core competencies and competitive advantages, competitors will eventually learn how to duplicate the benefits of any firm’s value-creating strategy; thus all competitive advantages have a limited life.12 Because of this, the question of duplication of a competitive advantage is not if it will happen, but when. In general, a competitive advantage’s sustainability is a function of three factors: (1) the rate of core competence obsolescence because of environmental changes, (2) the availability of substitutes for the core competence, and (3) the imitability of the core competence.13 For all firms, the challenge is to effectively manage current core competencies while simultaneously developing new ones.14 Only when firms are able to do this can they expect to achieve strategic competitiveness, earn above-average returns, and remain ahead of competitors (see Chapter 5).

We studied the general, industry, and competitor environments in Chapter 2. Armed with knowledge about the realities and conditions of their external environment, firms have a better understanding of marketplace opportunities and the characteristics of the competitive environment in which those opportunities exist. In this chapter, we focus on the firm itself. By analyzing its internal organization, a firm determines what it can do. Matching what a firm can do (a function of its resources, capabilities, and core competencies in the internal organization) with what it might do (a function of opportunities and threats in the external environment) is a process that yields insights the firm requires to select its strategies.

We begin this chapter by briefly describing conditions associated with analyzing the firm’s internal organization. We then discuss the roles of resources and capabilities in developing core competencies, which are the sources of the firm’s competitive advantages. Included in this discussion are the techniques firms use to identify and evaluate resources and capabilities and the criteria for identifying core competencies from among them. Resources by themselves typically are not competitive advantages; in fact, resources create value when the firm uses them to form capabilities, some of which become core competencies, and hopefully competitive advantages. Because of the relationship among resources, capabilities, and core competencies, we also discuss the value chain and examine four criteria firms use to determine if their capabilities are core competencies and as such, sources of competitive advantage.15 The chapter closes with cautionary comments about outsourcing and the need for firms to prevent their core competencies from becoming core rigidities. The existence of core rigidities indicates that the firm is too anchored to its past, which prevents it from continuously developing new capabilities and core competencies.

Analyzing the Internal Organization

The Context of Internal Analysis

One of the conditions associated with analyzing a firm’s internal organization is the reality that in today’s global economy, some of the resources that were traditionally critical to firms’ efforts to produce, sell, and distribute their goods or services such as labor costs, access to financial resources and raw materials, and protected or regulated markets are still important; but, it is now less likely that these resources will become core competencies and possibly competitive advantages.16 An important reason for this is that an increasing number of firms are using their resources to form core competencies through which they successfully implement an international strategy (discussed in Chapter 8) as a means of overcoming the advantages created by these more traditional resources.

The Volkswagen Group has established “Strategy 2018” as its international strategy. The firm, which sells its products in over 150 countries, employs 400,000 people to operate
Part 1: Strategic Management Inputs

its 62 production plants located in 15 European countries. By using its resources to form technological and innovation capabilities, Volkswagen intends to create superior customer service and product quality as core competencies on which it will rely to implement its international strategy.\(^\text{17}\)

Increasingly, those analyzing their firm’s internal organization should use a **global mind-set** to do so. A **global mind-set** is the ability to analyze, understand, and manage an internal organization in ways that are not dependent on the assumptions of a single country, culture, or context.\(^\text{18}\) Because they are able to span artificial boundaries, those with a global mind-set recognize that their firms must possess resources and capabilities that allow understanding of and appropriate responses to competitive situations that are influenced by country-specific factors and unique cultures. Using a global mind-set to analyze the internal organization has the potential to significantly help the firm in its efforts to outperform rivals.\(^\text{19}\) A global mind-set was used to develop Volkswagen Group’s “Strategy 2018.”

Finally, analyzing the firm’s internal organization requires that evaluators examine the firm’s entire portfolio of resources and capabilities. This perspective suggests that individual firms possess at least some resources and capabilities that other companies do not—at least not in the same combination. Resources are the source of capabilities, some of which lead to the development of core competencies; in turn, some core competencies may lead to a competitive advantage for the firm.\(^\text{20}\) Understanding how to leverage the firm’s unique bundle of resources and capabilities is a key outcome decision makers seek when analyzing the internal organization.\(^\text{21}\) Figure 3.1 illustrates the relationships among

**Figure 3.1** Components of an Internal Analysis
resources, capabilities, core competencies, and competitive advantages and shows how their integrated use can lead to strategic competitiveness. As we discuss next, firms use the assets in their internal organization to create value for customers.

**Creating Value**

Firms use their resources as the foundation for producing goods or services that will create value for customers. Value is measured by a product’s performance characteristics and by its attributes for which customers are willing to pay. Firms create value by innovatively bundling and leveraging their resources to form capabilities and core competencies. Firms with a competitive advantage create more value for customers than do competitors. Walmart uses its “every day low price” approach to doing business (an approach that is grounded in the firm’s core competencies, such as information technology and distribution channels) to create value for those seeking to buy products at a low price compared to competitors’ prices for those products. Mattress manufacturer E. S. Kluft & Company creates value for customers interested in buying what the firm says is the “best mattress in the world.” Each of the firm’s products is made by hand by skilled craftsmen. Thus, human capital is a core competence and likely the source of a competitive advantage for E. S. Kluft. (The firm’s upper-end mattress sells for $50,000 per unit.) The stronger these firms’ core competencies, the greater the amount of value they’re able to create for their customers.

Ultimately, creating value for customers is the source of above-average returns for a firm. What the firm intends regarding value creation affects its choice of business-level strategy (see Chapter 4) and its organizational structure (see Chapter 11). In Chapter 4’s discussion of business-level strategies, we note that value is created by a product’s low cost, by its highly differentiated features, or by a combination of low cost and high differentiation, compared with competitors’ offerings. A business-level strategy is effective only when it is grounded in exploiting the firm’s capabilities and core competencies. Thus, the successful firm continuously examines the effectiveness of current capabilities and core competencies while thinking about the capabilities and competencies it will require for future success.

At one time, the firm’s efforts to create value were largely oriented to understanding the characteristics of the industry in which it competed and, in light of those characteristics, determining how it should be positioned relative to competitors. This emphasis on industry characteristics and competitive strategy underestimated the role of the firm’s resources and capabilities in developing core competencies as the source of competitive advantages. In fact, core competencies, in combination with product-market positions, are the firm’s most important sources of competitive advantage. A firm’s core competencies, integrated with an understanding of the results of studying the conditions in the external environment, should drive the selection of strategies. As Clayton Christensen noted, “Successful strategists need to cultivate a deep understanding of the processes of competition and progress and of the factors that undergird each advantage. Only thus will they be able to see when old advantages are poised to disappear and how new advantages can be built in their stead.” By emphasizing core competencies when selecting and implementing strategies, companies learn to compete primarily on the basis of firm-specific differences. However, while doing so they must be simultaneously aware of how things are changing in the external environment.

**The Challenge of Analyzing the Internal Organization**

The strategic decisions managers make about their firm’s internal organization are non-routine, have ethical implications, and significantly influence the firm’s ability to earn above-average returns. These decisions involve choices about the resources the firm needs to collect and how to best manage them.
Making decisions involving the firm’s assets—identifying, developing, deploying, and protecting resources, capabilities, and core competencies—may appear to be relatively easy. However, this task is as challenging and difficult as any other with which managers are involved; moreover, the task is increasingly internationalized. Some believe that the pressure on managers to pursue only decisions that help the firm meet the quarterly earnings expected by market analysts makes it difficult to accurately examine the firm’s internal organization.

The challenge and difficulty of making effective decisions are implied by preliminary evidence suggesting that one-half of organizational decisions fail. Sometimes, mistakes are made as the firm analyzes conditions in its internal organization. Managers might, for example, think a capability is a core competence when it is not. This may have been the case at Polaroid Corporation as decision makers continued to believe that the capabilities it used to build its instant film cameras were highly relevant at the time its competitors were developing and using the capabilities required to introduce digital cameras. In this instance, Polaroid’s decision makers may have concluded that superior manufacturing was a core competence as was the firm’s ability to innovate in terms of creating value-adding features for its instant cameras. If a mistake is made when analyzing and managing the firm’s resources, such as appears to have been the case some years ago at Polaroid, decision makers must have the confidence to admit it and take corrective actions.

A firm can improve by studying its mistakes; in fact, the learning generated by making and correcting mistakes can be important to efforts to create new capabilities and core competencies. Today, a substantially slimmed-down Polaroid is introducing a number of new products, including GL20 Camera Glasses. These glasses include a built-in camera and dual LCDs that appear to cover individuals’ eyes when wearing the oversized glasses. These products are based on ideas advanced by Lady Gaga, who is now Polaroid’s creative director. Thus, Polaroid may be developing marketing and product design as capabilities and hopefully core competencies as the source of hoped-for competitive success.

As we discuss next, three conditions—uncertainty, complexity, and intraorganizational conflict—affect managers as they analyze the internal organization and make decisions about resources (see Figure 3.2).}

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**Figure 3.2** Conditions Affecting Managerial Decisions about Resources, Capabilities, and Core Competencies

<table>
<thead>
<tr>
<th>Conditions</th>
<th>Description</th>
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</thead>
<tbody>
<tr>
<td>Uncertainty</td>
<td>Uncertainty exists about the characteristics of the firm’s general and industry environments and customers’ needs.</td>
</tr>
<tr>
<td>Complexity</td>
<td>Complexity results from the interrelationships among conditions shaping a firm.</td>
</tr>
<tr>
<td>Intraorganizational Conflicts</td>
<td>Intraorganizational conflicts may exist among managers making decisions as well as among those affected by the decisions.</td>
</tr>
</tbody>
</table>
Managers face uncertainty because of a number of issues, including those of new proprietary technologies, rapidly changing economic and political trends, transformations in societal values, and shifts in customers’ demands. Environmental uncertainty increases the complexity and range of issues to examine when studying the internal environment. Consider how uncertainty affects how to use resources at Peabody Energy Corp.

Peabody is the world’s largest private-sector coal company. The firm’s coal products fuel approximately 11 percent of all U.S. electricity generation and 2 percent of worldwide electricity. But the firm faces a great deal of uncertainty with respect to how it might best use its resources today to prepare for its future. One reason for this is that at least for some, coal is thought of as a “dirty fuel.” Partly to reduce the uncertainty the firm faces because of this, Peabody is using some of its resources to build a “clean” coal-fired plant and has signed two agreements to develop clean coal in China. As a proponent of strong emissions standards, Peabody’s leaders argue for more use of “clean coal.” One of these agreements calls for Peabody and its partners to develop a green coal energy campus, including a 1200-MW power plant that will capture CO₂ and convert it into green building materials. Obviously, the complexity of the decisions Peabody is making to reduce uncertainty (such as working with partners in China) is quite significant. Biases about how to cope with uncertainty affect decisions made about how to manage the firm’s resources and capabilities to form core competencies. For example, Peabody’s CEO strongly believes in coal’s future, suggesting that automobiles capable of burning coal could be built. Finally, intraorganizational conflict may surface when decisions are made about the core competencies a firm should develop and nurture. Conflict might surface in Peabody about the degree to which resources and capabilities should be used to form core competencies to support current coal technologies relative to the building of core competencies to support newer “clean technologies.”

In making decisions affected by these three conditions, judgment is required. Judgment is the capability of making successful decisions when no obviously correct model or rule is available or when relevant data are unreliable or incomplete. In such situations, decision makers must be aware of possible cognitive biases, such as overconfidence. Individuals who are too confident in the decisions they make about how to use the firm’s resources may fail to fully evaluate contingencies that could affect those decisions.

When exercising judgment, decision makers often take intelligent risks. In the current competitive landscape, executive judgment can become a valuable capability. One reason is that, over time, effective judgment that decision makers demonstrate allows a firm to build a strong reputation and retain the loyalty of stakeholders whose support is linked to above-average returns.

As we discuss in the Strategic Focus, finding individuals who can make the most successful decisions about using the organization’s resources is challenging. Being able to do this is important because the quality of leaders’ decisions regarding resources and their management affect a firm’s ability to achieve strategic competitiveness. Individuals holding these key decision-making positions are called strategic leaders. Discussed fully in Chapter 12, for our purposes in this chapter we can think of strategic leaders as individuals with an ability to make effective decisions when examining the firm’s resources, capabilities, and core competencies for the purpose of making choices about their use.

Next, we consider the relationships among a firm’s resources, capabilities, and core competencies. While reading these sections of materials, keep in mind that organizations have more resources than capabilities and more capabilities than core competencies.
As we note in Chapter 12, a firm’s upper-level managers such as the CEO and members of the top management team may be well compensated. This is particularly the case when a firm’s board of directors believes that those individuals are or that they have the potential to be excellent decision makers capable of effectively using the company’s resources, capabilities, and core competencies for the purpose of earning above-average returns. As evidence for this, consider that between 2009 and 2010, the median value of salaries, bonuses, and long-term incentive packages for CEOs of 350 major U.S. companies increased 11 percent to $9.3 million.

Sometimes CEOs experience a reasonable amount of success using a firm’s resources, as is the case for Judy McGrath, now the former CEO of Viacom Inc.’s MTV Networks. McGrath’s leadership was instrumental in developing the MTV brand and its iconoclastic roots through which teenagers, the firm’s target customer, were urged to tell their parents, “I want my MTV!” In other instances, an individual’s tenure can be short lived, as is the case for Christina Norman, former CEO of the Oprah Winfrey Network (OWN). Just four months after launching the new network’s programs, Norman was removed by OWN’s board of directors, which concluded that the firm’s resources were not being used effectively to develop attractive television programs.

Gap Inc. offers clothing through several brands, including Gap, Old Navy, and Banana Republic. Today, the firm’s CEO says that he has a “high sense of urgency” to essentially stop years of bleeding with the firm’s namesake brand. Other decisions the CEO is making are related to using the firm’s resources to cut bureaucracy so that Gap clothes can reach stores much faster. Additionally, he decided to remove Gap’s top designer after “four years of lackluster results.” In commenting about the designer’s departure, analysts noted that the designer had brought a “needed coolness factor” to Gap clothes but that at the same time, he failed to find a way to use the firm’s design-related resources and capabilities to “deliver consistent takes on trends.”

Other strategic leaders in different companies are currently making decisions about how to use their firm’s resources. For example, leaders at Advance Publications Inc., parent company of Condé Nast, a publisher of multiple magazines such as Vogue, GQ, Golf Digest, Bon Appetit, Conde Nast Traveler, and Wired among others, has decided to invest $500 million of its financial resources (a tangible resource) in digital properties as a way of stimulating growth. Cisco CEO John Chambers recently announced that the firm’s internal decision-making processes were being reorganized as a foundation for making tough decisions as to “where to shut off spending to preserve profitability.” Thus, some of the upcoming decisions by Cisco’s strategic leaders will result in different allocations of the firm’s resources. Finally, after assuming the position of CEO for Hewlett-Packard (H-P), Meg Whitman (former eBay CEO) prepared to deal with challenges the firm faced, some of which were at least partly a result of Leo Apotheker’s short 11-month tenure as H-P’s CEO. In this regard, some analysts concluded that H-P faced a “strategic direction” crisis at the time of Whitman’s appointment. The view that “numerous questions remain over H-P’s strategy, including its plan to possibly spin off its mainstay personal-computer business” demonstrate the potential strategic
direction crisis. Whitman pledged to carefully study the possible divestment of H-P’s PC business as she sought to make decisions that would improve the firm’s competitiveness.

All of these decisions concerning the use of firms’ resources are being made under conditions of uncertainty about a number of factors, including customers’ preferences, global economic conditions, and potential changes in various nations’ business-related regulations. Time will tell if the resource-related decisions made by the strategic leaders we mention here will have the hoped-for effect of contributing positively to each firm’s efforts to earn above-average returns.


Resources, Capabilities, and Core Competencies

Resources, capabilities, and core competencies are the foundation of competitive advantage. Resources are bundled to create organizational capabilities. In turn, capabilities are the source of a firm’s core competencies, which are the basis of establishing competitive advantages. We show these relationships in Figure 3.1. Here, we define and provide examples of these building blocks of competitive advantage.

Resources

Broad in scope, resources cover a spectrum of individual, social, and organizational phenomena. By themselves, resources do not allow firms to create value for customers as the foundation for earning above-average returns. Indeed, resources are combined to form capabilities. Subway links its fresh ingredients with several other resources including the continuous training it provides to those running the firm’s units as the foundation for customer service as a capability; as explained in the Opening Case, customer service is also a core competence for Subway. As its sole distribution channel, the Internet is a resource for Amazon.com. The firm uses the Internet to sell goods at prices that typically are lower than those offered by competitors selling the same goods through what are more costly brick-and-mortar storefronts. By combining other resources (such as access to a wide product inventory), Amazon has developed a reputation for excellent customer service. Amazon’s capability in terms of customer service is a core competence as well in that the firm creates unique value for customers through the services it provides to them. Amazon also uses its technological core competence to offer AWS (Amazon Web Services), services through which businesses can rent computing power from Amazon at a cost of pennies per hour. In the words of the leader of this effort, “AWS makes it possible for anyone with an Internet connection and a credit card to access the same kind of world-class computing systems that Amazon uses to run its $34 billion-a-year retail operation.”

Some of a firm’s resources (defined in Chapter 1 as inputs to the firm’s production process) are tangible while others are intangible. Tangible resources are assets that can be observed and quantified.
Intangible resources include assets that are rooted deeply in the firm’s history, accumulate over time, and are relatively difficult for competitors to analyze and imitate.

be observed and quantified. Production equipment, manufacturing facilities, distribution centers, and formal reporting structures are examples of tangible resources. Subway’s food ingredients are a tangible resource. Intangible resources are assets that are rooted deeply in the firm’s history and have accumulated over time. Because they are embedded in unique patterns of routines, intangible resources are difficult for competitors to analyze and imitate. Knowledge, trust between managers and employees, managerial capabilities, organizational routines (the unique ways people work together), scientific capabilities, the capacity for innovation, brand name, the firm’s reputation for its goods or services and how it interacts with people (such as employees, customers, and suppliers), and organizational culture are intangible resources. The routines Subway uses to develop and use its training procedures are an example of an intangible resource.

The four primary categories of tangible resources are financial, organizational, physical, and technological (see Table 3.1). The three primary categories of intangible resources are human, innovation, and reputational (see Table 3.2).

### Tangible Resources

As tangible resources, a firm’s borrowing capacity and the status of its physical facilities are visible. The value of many tangible resources can be established through financial statements, but these statements do not account for the value of all the firm’s assets, because they disregard some intangible resources. The value of tangible resources is also constrained because they are hard to leverage—it is difficult to derive additional business or value from a tangible resource. For example, an airplane is a tangible resource,

### Table 3.1 Tangible Resources

| Financial Resources                  | • The firm’s capacity to borrow  
|                                     | • The firm’s ability to generate funds through internal operations |
| Organizational Resources            | • Formal reporting structures |
| Physical Resources                  | • The sophistication of a firm’s plant and equipment and the attractiveness of its location  
|                                     | • Distribution facilities  
|                                     | • Product inventory |
| Technological Resources             | • Availability of technology-related resources such as copyrights, patents, trademarks, and trade secrets |


### Table 3.2 Intangible Resources

| Human Resources                      | • Knowledge  
|                                     | • Trust  
|                                     | • Skills  
|                                     | • Abilities to collaborate with others |
| Innovation Resources                 | • Ideas  
|                                     | • Scientific capabilities  
|                                     | • Capacity to innovate |
| Reputational Resources               | • Brand name  
|                                     | • Perceptions of product quality, durability, and reliability  
|                                     | • Positive reputation with stakeholders such as suppliers and customers |

Chapter 3: The Internal Organization: Resources, Capabilities, Core Competencies, and Competitive Advantages

but “You can’t use the same airplane on five different routes at the same time. You can’t put the same crew on five different routes at the same time. And the same goes for the financial investment you’ve made in the airplane.”

Although production assets are tangible, many of the processes necessary to use these assets are intangible. Thus, the learning and potential proprietary processes associated with a tangible resource, such as manufacturing facilities, can have unique intangible attributes, such as quality control processes, unique manufacturing processes, and technologies that develop over time.

Intangible Resources

Compared to tangible resources, intangible resources are a superior source of capabilities and subsequently, core competencies. In fact, in the global economy, “the success of a corporation lies more in its intellectual and systems capabilities than in its physical assets. [Moreover], the capacity to manage human intellect—and to convert it into useful products and services—is fast becoming the critical executive skill of the age.”

Because intangible resources are less visible and more difficult for competitors to understand, purchase, imitate, or substitute for, firms prefer to rely on them rather than on tangible resources as the foundation for their capabilities. In fact, the more unobservable (i.e., intangible) a resource is, the more valuable that resource is to create capabilities. Another benefit of intangible resources is that, unlike most tangible resources, their use can be leveraged. For instance, sharing knowledge among employees does not diminish its value for any one person. To the contrary, two people sharing their individualized knowledge sets often can be leveraged to create additional knowledge that, although new to each individual, contributes to performance improvements for the firm.

Reputational resources (see Table 3.2) are important sources of a firm’s capabilities and core competencies. Indeed, some argue that a positive reputation can even be a source of competitive advantage. Earned through the firm’s actions as well as its words, a value-creating reputation is a product of years of superior marketplace competence as perceived by stakeholders. A reputation indicates the level of awareness a firm has been able to develop among stakeholders and the degree to which they hold the firm in high esteem.

A well-known and highly valued brand name is a specific reputational resource. A continuing commitment to innovation and aggressive advertising facilitates firms’ efforts to take advantage of the reputation associated with their brands. Harley-Davidson has a reputation for producing and servicing high-quality motorcycles with unique designs. Because of the desirability of its reputation, the company also produces a wide range of accessory items that it sells on the basis of its reputation for offering unique products with high quality. Sunglasses, jewelry, belts, wallets, shirts, slacks, belts, and hats are just a few of the large variety of accessories customers can purchase from a Harley-Davidson dealer or from its online store.

Capabilities

The firm combines individual tangible and intangible resources to create capabilities. In turn, capabilities are used to complete the organizational tasks required to produce,
distribute, and service the goods or services the firm provides to customers for the purpose of creating value for them. As a foundation for building core competencies and hopefully competitive advantages, capabilities are often based on developing, carrying, and exchanging information and knowledge through the firm’s human capital. Hence, the value of human capital in developing and using capabilities and, ultimately, core competencies cannot be overstated. At IBM, for example, human capital is critical to forming and using the firm’s capabilities for long-term customer relationships and deep scientific and research skills, and the breadth of the firm’s technical skills in hardware, software, and services.

As illustrated in Table 3.3, capabilities are often developed in specific functional areas (such as manufacturing, R&D, and marketing) or in a part of a functional area (e.g., advertising). Table 3.3 shows a grouping of organizational functions and the capabilities that some companies are thought to possess in terms of all or parts of those functions.

### Core Competencies

Defined in Chapter 1, core competencies are capabilities that serve as a source of competitive advantage for a firm over its rivals. Core competencies distinguish a company competitively and reflect its personality. Core competencies emerge over time through an organizational process of accumulating and learning how to deploy different resources and capabilities. As the capacity to take action, core competencies are "crown jewels of a company," the activities the company performs especially well compared to competitors and through which the firm adds unique value to the goods or services it sells to customers.

#### Table 3.3 Examples of Firms’ Capabilities

<table>
<thead>
<tr>
<th>Functional Areas</th>
<th>Capabilities</th>
<th>Examples of Firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Distribution</td>
<td>• Effective use of logistics management techniques</td>
<td>• Walmart</td>
</tr>
<tr>
<td>Human Resources</td>
<td>• Motivating, empowering, and retaining employees</td>
<td>• Microsoft</td>
</tr>
<tr>
<td>Management Information Systems</td>
<td>• Effective and efficient control of inventories through point-of-purchase data collection methods</td>
<td>• Walmart</td>
</tr>
<tr>
<td>Marketing</td>
<td>• Effective promotion of brand-name products</td>
<td>• Procter &amp; Gamble</td>
</tr>
<tr>
<td></td>
<td>• Effective customer service</td>
<td>• Ralph Lauren Corp.</td>
</tr>
<tr>
<td></td>
<td>• Innovative merchandising</td>
<td>• McKinsey &amp; Co.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Nordstrom Inc.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Crate &amp; Barrel</td>
</tr>
<tr>
<td>Management</td>
<td>• Ability to envision the future of clothing</td>
<td>• Hugo Boss</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Zara</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>• Design and production skills yielding reliable products</td>
<td>• Komatsu</td>
</tr>
<tr>
<td></td>
<td>• Product and design quality</td>
<td>• Witt Gas Technology</td>
</tr>
<tr>
<td></td>
<td>• Miniaturization of components and products</td>
<td>• Sony</td>
</tr>
<tr>
<td>Research &amp; Development</td>
<td>• Innovative technology</td>
<td>• Caterpillar</td>
</tr>
<tr>
<td></td>
<td>• Development of sophisticated elevator control solutions</td>
<td>• Otis Elevator Co.</td>
</tr>
<tr>
<td></td>
<td>• Rapid transformation of technology into new products and processes</td>
<td>• Chaparral Steel</td>
</tr>
<tr>
<td></td>
<td>• Digital technology</td>
<td>• Thomson Consumer Electronics</td>
</tr>
</tbody>
</table>
Innovation is thought to be a core competence at Apple. As a capability, R&D activities are the source of this core competence. More specifically, the way Apple has combined some of its tangible (e.g., financial resources and research laboratories) and intangible (e.g., scientists and engineers and organizational routines) resources to complete research and development tasks creates a capability in R&D. By emphasizing its R&D capability, Apple is able to innovate in ways that create unique value for customers in the form of the products it sells, suggesting that innovation is a core competence for Apple.

Excellent customer service in its retail stores is another of Apple’s core competencies. In this instance, unique and contemporary store designs (a tangible resource) are combined with knowledgeable and skilled employees (an intangible resource) to provide superior service to customers. A number of carefully developed training and development procedures are capabilities on which Apple’s core competence of excellent customer service is based. The procedures that are capabilities include “...intensive control of how employees interact with customers, scripted training for on-site tech support and consideration of every store detail down to the pre-loaded photos and music on demo devices.”

Consumer products giant Procter & Gamble (P&G) sells branded products that it believes are of superior quality and value to customers located in more than 180 countries. Generating approximately $80 billion in annual sales revenue, P&G has numerous tangible and intangible resources that are used to form capabilities, some of which are core competencies. We examine the relationship between some of the firm’s capabilities and competencies in the Strategic Focus. Interestingly, even in light of its size and scale (in terms of the number of products sold and the firm’s encompassing geographic reach), P&G apparently has five core competencies (labeled core strengths by the firm).

**Strategic Focus**

*Procter & Gamble: Using Capabilities and Core Competencies to Create Value for Customers*

Guided by its slogan of “Touching lives, improving life,” Procter & Gamble (P&G) is known throughout the world for its stable of consumer brands. Organized within two global business units (Beauty & Grooming and Household Care), Crest, CoverGirl, Herbal Essences, Ivory, Bold, and Bounce are just a few of the more than 250 branded products the firm’s 127,000 employees produce in facilities located in approximately 80 countries. Twenty-four of this firm’s branded product lines generate at least $1 billion in annual sales. Estimates are that on average, every person in the world spends $12 annually to buy P&G products. The firm’s new CEO wants to increase this annual average expenditure to $14 per person by 2015. Additionally, he wants the firm’s annual sales revenue to grow to $100 billion from today’s roughly $80 billion mark, and for the number of P&G customers to increase to 5 billion from the current 4.2 billion. How are these objectives to be reached? According to company officials and analysts, in part these objectives are to be reached through plans that are now in place to move quickly and broadly into developing countries such as China and India and to produce products that will appeal to new but lower-income customers. Of course, efforts will simultaneously continue to satisfy the needs of P&G’s huge stable of current customers. These intended actions appear to support the view that P&G is a very effective competitor that continuously seeks growth through its competitive actions.
P&G relies on its capabilities and core competencies to satisfy current customers and to develop products to serve the needs of new customers. Typically, P&G likes to use its capabilities and competencies to grow organically rather than through mergers and acquisitions or through cooperative relationships. In the words of a previous P&G CEO: “Organic growth is more valuable because it comes from your core competencies. Organic growth exercises your innovation muscle. If you use it, it gets stronger.” Cutting-edge technology, supply chain management skills, marketing and advertising expertise, a broad product portfolio, and research and development skills with respect to fats, oils, skin chemistry, surfactants, and emulsifiers are a few of P&G’s highly-regarded capabilities. All of these capabilities, which result from combinations of the firm’s tangible and intangible resources, allow P&G to perform tasks that must be completed to produce, sell, distribute, and service its branded products.

Taking this a step farther, we discover that these capabilities contribute to the firm’s five core competencies (called core strengths by P&G). For example, R&D capabilities are foundational to P&G’s innovation core competence. Similarly, the firm’s marketing and advertising skills contribute to its consumer understanding and brand-building core competencies. The supply chain management capability is critical to the go-to-market core competence (a competence through which P&G “reaches retailers and consumers at the right place and time”) and to the scale competence (a competence allowing P&G to be efficient and to create value for customers as a result). Thus, we see how some of P&G’s capabilities are linked to one or more of the firm’s five core competencies. From an operational perspective, these core competencies are activities P&G performs especially well relative to competitors and through which the firm is able to create unique value for customers.


Building Core Competencies

Two tools help firms identify their core competencies. The first consists of four specific criteria of sustainable competitive advantage that can be used to determine which capabilities are core competencies. Because the capabilities shown in Table 3.3 have satisfied these four criteria, they are core competencies. The second tool is the value chain analysis. Firms use this tool to select the value-creating competencies that should be maintained, upgraded, or developed and those that should be outsourced.

The Four Criteria of Sustainable Competitive Advantage

Capabilities that are valuable, rare, costly to imitate, and nonsubstitutable are core competencies (see Table 3.4). In turn, core competencies can lead to competitive advantages for the firm over its rivals. Capabilities failing to satisfy the four criteria are not core competencies, meaning that although every core competence is a capability, not every capability is a core competence. In slightly different words, for a capability to be a core competence, it must be valuable and unique from a customer’s point of view. For a core competence to be a potential source of competitive advantage, it must be inimitable and nonsubstitutable by competitors. A sustainable competitive advantage exists only when competitors cannot duplicate the benefits of a firm’s strategy or when they lack the resources to attempt imitation.

For some period of time, the firm may have a core competence by using capabilities that are valuable and rare, but imitable. For example, some firms are trying to develop a core competence and potentially a competitive advantage by out-greening their competitors.
(Interestingly, developing a “green” core competence can contribute to the firm’s efforts to earn above-average returns while benefitting the broader society.) Since 2005, Walmart has used its resources in ways that have allowed it to reduce its stores’ carbon footprint by more than 10 percent and the carbon footprint of its trucking fleet by several times this percentage. Additionally, progress is being made toward the firm’s goal of zero waste going to landfills from its operations. A reduction of its waste by 81 percent in California suggests that this goal may be attainable. 76 Competitor Target is also using its resources and capabilities for the purpose of forming a “green” core competence. “Environmental sustainability is integrated throughout our businesses—from the way we build our stores to the products on our shelves,” the store says. Packaging its Archer Farms Balanced Potato Crisps in bags that are manufactured with 25 percent renewable plant-based plastic is one example of actions Target is taking to be environmentally sustainable.

The length of time a firm can expect to create value by using its core competencies is a function of how quickly competitors can successfully imitate a good, service, or process. Value-creating core competencies may last for a relatively long period of time only when all four of the criteria we discuss next are satisfied. Thus, either Walmart or Target would know that it has a core competence and possibly a competitive advantage in terms of green practices if the way the firm uses its resources to complete these practices satisfies the four criteria.

### Valuable Capabilities

- Help a firm neutralize threats or exploit opportunities

### Rare Capabilities

- Are not possessed by many others

### Costly-to-Imitate Capabilities

- Historical: A unique and a valuable organizational culture or brand name
- Ambiguous cause: The causes and uses of a competence are unclear
- Social complexity: Interpersonal relationships, trust, and friendship among managers, suppliers, and customers

### Nonsubstitutable Capabilities

- No strategic equivalent

Value-creating core competencies may last for a relatively long period of time only when all four of the criteria we discuss next are satisfied. Thus, either Walmart or Target would know that it has a core competence and possibly a competitive advantage in terms of green practices if the way the firm uses its resources to complete these practices satisfies the four criteria.

**Valuable**

Valuable capabilities allow the firm to exploit opportunities or neutralize threats in its external environment. By effectively using capabilities to exploit opportunities or neutralize threats, a firm creates value for customers. For publishers, e-books are both an opportunity (to sell books through a different distribution channels) and a threat (a reduction in publishers’ ability to sell books through traditional channels such as physical storefronts). To neutralize the possibility/threat of lower sales revenue from traditional channels, publishers such as Penguin Group are trying to determine how to take advantage of the opportunities digital technologies create to transform their businesses. In partnership with other companies, Penguin sees using the Internet to sell directly to customers as an opportunity to create value for customers. “Penguin is one of three major publishers backing a new Web venture . . . that will highlight new titles and authors, and sell books directly to consumers. The site, Bookish.com is expected to launch” in the summer of 2011. 77

**Rare**

Rare capabilities are capabilities that few, if any, competitors possess. A key question to be answered when evaluating this criterion is, “How many rival firms possess these valuable capabilities?” Capabilities possessed by many rivals are unlikely to become core competencies for any of the involved firms. Instead, valuable but common (i.e., not rare) capabilities are sources of competitive parity. 78 Competitive advantage results only when firms develop and exploit valuable capabilities that become core competencies and that differ from those shared with competitors. It is possible that Walmart and Target might reach competitive parity with their sustainability/green initiatives given that the capabilities used to complete green-oriented tasks are valuable but may not be rare.
Costly to Imitate

Costly-to-imitate capabilities are capabilities that other firms cannot easily develop. Capabilities that are costly to imitate are created because of one reason or a combination of three reasons (see Table 3.4). First, a firm sometimes is able to develop capabilities because of unique historical conditions. As firms evolve, they often acquire or develop capabilities that are unique to them. A firm with a unique and valuable organizational culture that emerged in the early stages of the company’s history “may have an imperfectly imitable advantage over firms founded in another historical period;” one in which less valuable or less competitively useful values and beliefs strongly influenced the development of the firm’s culture. Briefly discussed in Chapter 1, organizational culture is a set of values that are shared by members in the organization. We explain this in greater detail in Chapter 12. An organizational culture is a source of advantage when employees are held together tightly by their belief in it. With its emphasis on cleanliness, consistency, and service and the training that reinforces the value of these characteristics, McDonald’s culture is thought by some to be a core competence and a competitive advantage. The same appears to be the case for Mustang Engineering (an engineering and project management firm based in Houston, Texas). Established as a place where people are expected to take care of people, Mustang offers “a company culture that we believe is unique in the industry. Mustang is a work place with a family feel. A client once described Mustang as a world-class company with a mom-and-pop culture.”

A second condition of being costly to imitate occurs when the link between the firm’s core competencies and its competitive advantage is causally ambiguous. In these instances, competitors can’t clearly understand how a firm uses its capabilities that are core competencies as the foundation for competitive advantage. As a result, firms are uncertain about the capabilities they should develop to duplicate the benefits of a competitor’s value-creating strategy. For years, firms tried to imitate Southwest Airlines’ low-cost strategy but most have been unable to do so, primarily because they can’t duplicate this firm’s unique culture.

Social complexity is the third reason that capabilities can be costly to imitate. Social complexity means that at least some, and frequently many, of the firm’s capabilities are the product of complex social phenomena. Interpersonal relationships, trust, friendships among managers and between managers and employees, and a firm’s reputation with suppliers and customers are examples of socially complex capabilities. Southwest Airlines is careful to hire people who fit with its culture. This complex interrelationship between the culture and human capital adds value in ways that other airlines cannot, such as jokes on flights by the flight attendants or the cooperation between gate personnel and pilots.

Nonsubstitutable

Nonsubstitutable capabilities are capabilities that do not have strategic equivalents. This final criterion “is that there must be no strategically equivalent valuable resources that are themselves either not rare or imitable. Two valuable firm resources (or two bundles of firm resources) are strategically equivalent when they each can be separately exploited to implement the same strategies.” In general, the strategic value of capabilities increases as they become more difficult to substitute. The more intangible and hence invisible capabilities are, the more difficult it is for firms to find substitutes and the greater the challenge is to competitors trying to imitate a firm’s value-creating strategy. Firm-specific knowledge and trust-based working relationships between managers and nonmanagerial personnel, such as existed for years at Southwest Airlines, are examples of capabilities that are difficult to identify and for which finding a substitute is challenging. However, causal ambiguity may make it difficult for the firm to learn as well and may stifle progress, because the firm may not know how to improve processes that are not easily codified and thus are ambiguous.

In summary, only using valuable, rare, costly-to-imitate, and nonsubstitutable capabilities has the potential for the firm to create sustainable competitive advantages. Table 3.5 shows the competitive consequences and performance implications resulting from...
combinations of the four criteria of sustainability. The analysis suggested by the table helps managers determine the strategic value of a firm’s capabilities. The firm should not emphasize capabilities that fit the criteria described in the first row in the table (i.e., resources and capabilities that are neither valuable nor rare and that are imitable and for which strategic substitutes exist). Capabilities yielding competitive parity and either temporary or sustainable competitive advantage, however, will be supported. Some competitors such as Coca-Cola and PepsiCo and Boeing and Airbus may have capabilities that result in competitive parity. In such cases, the firms will nurture these capabilities while simultaneously trying to develop capabilities that can yield either a temporary or sustainable competitive advantage.

**Value Chain Analysis**

Value chain analysis allows the firm to understand the parts of its operations that create value and those that do not. Understanding these issues is important because the firm earns above-average returns only when the value it creates is greater than the costs incurred to create that value. The value chain is a template that firms use to analyze their cost position and to identify the multiple means that can be used to facilitate implementation of a chosen strategy. Today’s competitive landscape demands that firms examine their value chains in a global rather than a domestic-only context. In particular, activities associated with supply chains should be studied within a global context.

We show a model of the value chain in Figure 3.3. As depicted in the model, a firm’s value chain is segmented into value chain activities and support functions. Value chain activities are activities or tasks the firm completes in order to produce products and then sell, distribute, and service those products in ways that create value for customers. Support functions include the activities or tasks the firm completes in order to support the work being done to produce, sell, distribute, and service the products the firm is producing. A firm can develop a capability and/or a core competence in any of the value chain activities and in any of the support functions. When it does so, it has established an ability to create value for customers. In fact, as shown in Figure 3.3, customers are the ones firms seek to serve when using value chain analysis to identify their capabilities and core competencies. When using their unique core competencies to create unique value for customers that competitors cannot duplicate, firms have established one or more competitive advantages. This appears to be the case for P&G as it relies on the five core competencies described earlier in a Strategic Focus to produce unique, high-quality branded products that are sold to customers throughout the world.

The activities associated with each part of the value chain are shown in Figure 3.4 while the activities that are part of the tasks firms complete when dealing with support functions appear in Figure 3.5. All items in both figures should be evaluated relative to competitors’
Figure 3.3 A Model of the Value Chain


Figure 3.4 Creating Value through Value Chain Activities

Chapter 3: The Internal Organization: Resources, Capabilities, Core Competencies, and Competitive Advantages

To become a core competence and a source of competitive advantage, a capability must allow the firm (1) to perform an activity in a manner that provides value superior to that provided by competitors, or (2) to perform a value-creating activity that competitors cannot perform. Only under these conditions does a firm create value for customers and have opportunities to capture that value.

Creating value for customers by completing activities that are part of the value chain often requires building effective alliances with suppliers (and sometimes others to which the firm outsources activities, as discussed in the next section) and developing strong positive relationships with customers. When firms have such strong positive relationships with suppliers and customers, they are said to have "social capital." The relationships themselves have value because they produce knowledge transfer and access to resources that a firm may not hold internally. To build social capital whereby resources such as knowledge are transferred across organizations requires trust between the parties. The partners must trust each other in order to allow their resources to be used in such a way that both parties will benefit over time and neither party will take advantage of the other. Trust and social capital usually evolve over time with repeated interactions but firms can also establish special means to jointly manage alliances that promote greater trust with the outcome of enhanced benefits for both partners.

Evaluating a firm’s capability to execute its value chain activities and support functions is challenging. Earlier in the chapter, we noted that identifying and assessing the value of a firm’s resources and capabilities requires judgment. Judgment is equally necessary when using value chain analysis, because no obviously correct model or rule is universally available to help in the process.
What should a firm do about value chain activities and support functions in which its resources and capabilities are not a source of core competence? Outsourcing is one solution to consider.

**Outsourcing**

Concerned with how components, finished goods, or services will be obtained, **outsourcing** is the purchase of a value-creating activity or a support function activity from an external supplier. Not-for-profit agencies as well as for-profit organizations actively engage in outsourcing. Firms engaging in effective outsourcing increase their flexibility, mitigate risks, and reduce their capital investments. In multiple global industries, the trend toward outsourcing continues at a rapid pace. Moreover, in some industries virtually all firms seek the value that can be captured through effective outsourcing. As with other strategic management process decisions, careful analysis is required before the firm decides to outsource. And if outsourcing is to be used, firms must recognize that only activities where they cannot create value or where they are at a substantial disadvantage compared to competitors should be outsourced.

Outsourcing can be effective because few, if any, organizations possess the resources and capabilities required to achieve competitive superiority in all value chain activities and support functions. For example, research suggests that few companies can afford to develop internally all the technologies that might lead to competitive advantage. By nurturing a smaller number of capabilities, a firm increases the probability of developing core competencies and achieving a competitive advantage because it does not become overextended. In addition, by outsourcing activities in which it lacks competence, the firm can fully concentrate on those areas in which it can create value.

The consequences of outsourcing cause additional concerns. For the most part, these concerns revolve around the potential loss in firms’ innovative ability and the loss of jobs within companies that decide to outsource some of their work activities to others. Thus, innovation and technological uncertainty are two important issues to consider when making outsourcing decisions. However, firms can also learn from outsourcing suppliers how to increase their own innovation capabilities.

Companies must be aware of these issues and be prepared to fully consider the concerns about opportunities from outsourcing suggested by different stakeholders (e.g., employees). The opportunities and concerns may be especially significant when firms outsource activities or functions to a foreign supply source (often referred to as offshoring). Bangalore and Belfast are the newest hotspots for technology outsourcing, competing with major operations in other nations such as China. Yet, IBM recently made the decision to keep outsourced activities in the United States instead of moving them to a foreign location.

**Competencies, Strengths, Weaknesses, and Strategic Decisions**

By analyzing the internal organization, firms are able to identify their strengths and weaknesses in resources, capabilities, and core competencies. For example, if a firm has weak capabilities or does not have core competencies in areas required to achieve a competitive
advantage, it must acquire those resources and build the capabilities and competencies needed. Alternatively, the firm could decide to outsource a function or activity where it is weak in order to improve its ability to use its remaining resources to create value. 107

In considering the results of examining the firm’s internal organization, managers should understand that having a significant quantity of resources is not the same as having the “right” resources. The “right” resources are those with the potential to be formed into core competencies as the foundation for creating value for customers and developing competitive advantages as a result of doing so. Interestingly, decision makers sometimes become more focused and productive when seeking to find the right resources when the firm’s total set of resources is constrained. 108

Tools such as outsourcing help the firm focus on its core competencies as the source of its competitive advantages. However, evidence shows that the value-creating ability of core competencies should never be taken for granted. Moreover, the ability of a core competence to be a permanent competitive advantage can’t be assumed. The reason for these caution is that all core competencies have the potential to become core rigidities. 109 Typically, events occurring in the firm’s external environment create conditions through which core competencies can become core rigidities, generate inertia, and stifle innovation. “Often the flip side, the dark side, of core capabilities is revealed due to external events when new competitors figure out a better way to serve the firm’s customers, when new technologies emerge, or when political or social events shift the ground underneath.”110

Historically, Borders Group Inc. relied on its large storefronts that were conveniently located for customers to visit and browse through books and magazines in a pleasant atmosphere as sources of its competitive success. Over the past decade or so, though, digital technologies (part of the firm’s external environment) rapidly changed customers’ shopping patterns for reading materials. Discussed earlier in the chapter, Amazon.com’s use of the Internet significantly changed the competitive landscape for Borders and similar competitors such as Barnes & Noble. It is possible that Borders’ core competencies of store locations and a desirable physical environment for customers became core rigidities for this firm, eventually leading to the filing of bankruptcy in early 2011 and subsequent liquidation.111 Managers studying the firm’s internal organization are responsible for making certain that core competencies do not become core rigidities.

After studying its external environment to determine what it might choose to do (as explained in Chapter 2) and its internal organization to understand what it can do (as explained in this chapter), the firm has the information required to select a business-level strategy that it will use to compete against rivals. We describe different business-level strategies in the next chapter.

SUMMARY

■ In the current competitive landscape, the most effective organizations recognize that strategic competitiveness and above-average returns result only when core competencies (identified by studying the firm’s internal organization) are matched with opportunities (determined by studying the firm’s external environment).

■ No competitive advantage lasts forever. Over time, rivals use their own unique resources, capabilities, and core competencies to form different value-creating propositions that duplicate the focal firm’s ability to create value for customers. Because competitive advantages are not permanently sustainable, firms must exploit their current advantages while simultaneously using their resources and capabilities to form new advantages that can lead to future competitive success.

■ Effectively managing core competencies requires careful analysis of the firm’s resources (inputs to the production process) and capabilities (resources that have been purposely integrated to achieve a specific task or set of tasks). The knowledge the firm’s human capital possesses is among the most significant of an organization’s capabilities and ultimately provides the base for most competitive advantages. The firm must create an organizational culture that allows...
people to integrate their individual knowledge with that held by others so that, collectively, the firm has a significant amount of value-creating organizational knowledge.

- Capabilities are a more likely source of core competence and subsequently of competitive advantages than are individual resources. How a firm nurtures and supports its capabilities so they can become core competencies is less visible to rivals, making efforts to understand and imitate the focal firm’s capabilities difficult.
- Only when a capability is valuable, rare, costly to imitate, and nonsubstitutable is it a core competence and a source of competitive advantage. Over time, core competencies must be supported, but they cannot be allowed to become core rigidities. Core competencies are a source of competitive advantage only when they allow the firm to create value by exploiting opportunities in its external environment. When this is no longer possible, the company shifts its attention to forming other capabilities that satisfy the four criteria of a sustainable competitive advantage.
- Value chain analysis is used to identify and evaluate the competitive potential of resources and capabilities. By studying their skills relative to those associated with value chain activities and support functions, firms can understand their cost structure and identify the activities through which they can create value.
- When the firm cannot create value in either a value chain activity or a support function, outsourcing is considered. Used commonly in the global economy, outsourcing is the purchase of a value-creating activity from an external supplier. The firm should outsource only to companies possessing a competitive advantage in terms of the particular primary or support activity under consideration. In addition, the firm must continuously verify that it is not outsourcing activities from which it could create value.

**Review Questions**

1. Why is it important for a firm to study and understand its internal organization?
2. What is value? Why is it critical for the firm to create value? How does it do so?
3. What are the differences between tangible and intangible resources? Why is it important for decision makers to understand these differences? Are tangible resources more valuable for creating capabilities than are intangible resources, or is the reverse true? Why?
4. What are capabilities? How do firms create capabilities?
5. What four criteria must capabilities satisfy for them to become core competencies? Why is it important for firms to use these criteria to evaluate their capabilities’ value-creating potential?
6. What is value chain analysis? What does the firm gain by successfully using this tool?
7. What is outsourcing? Why do firms outsource? Will outsourcing’s importance grow in the future? If so, why?
8. How do firms identify internal strengths and weaknesses? Why is it vital that managers have a clear understanding of their firm’s strengths and weaknesses?
9. What are core rigidities? What does it mean to say that each core competence could become a core rigidity?

**Experiential Exercises**

**Exercise 1: What Makes a Great Outsourcing Firm?**

The focus of this chapter is on understanding how firm resources and capabilities serve as the cornerstone for competencies and, ultimately, a competitive advantage. However, when firms cannot create value in either a primary or support activity, outsourcing becomes a potential strategy. Yet with the recession that began in 2007, there seems to be a shift occurring. According to the International Association of Outsourcing Professionals (IAOP) at their 2010 annual conference, their members reported a 24 percent increase from their 2009 business volumes. Their report goes on to suggest that significant trends are emerging. The IAOP research finds a focus on risk arbitrage to keep flexibility and adaptability forefront (just think Japanese earthquake, social media revolution); that cloud computing is reinventing outsourcing, which allows companies to “rent” computing resources rather than invest themselves; and that allshoring is occurring all over the world, with rural U.S. areas competing with China and India for outsourcing contracts. All of their trends may be found at the following address: http://www.iaop.org/Firmbuilder/Articles/34/175/3185 from the report titled “The 2011 Global Outsourcing 100: Transforming the Corporation”.

During that same 2010 conference, the IAOP announced its Global Outsourcing 100, which represents the world’s best
outsourcing service providers. The evaluation process mirrors
that employed by many top customers and considers four key
criteria: (1) size and growth in revenue, employees, centers,
and countries served; (2) customer experience as demonstrated
through the value being created at the company’s top customers;
(3) depth and breadth of competencies as demonstrated through
industry recognition, relevant certifications, and investment
in the development of people, processes, and technologies; and
(4) management capabilities as reflected in the experience and
accomplishments of the organization’s top leaders and invest-
ment in management systems that ensure outsourcing success.
Here are the first 10 companies on the 2010 list, in alphabetical
order.

1. Accenture
2. Aditya Birla Minacs
3. Advanced Technology Services
4. Aegis
5. Amdocs
6. Aon Hewitt
7. API Outsourcing
8. ARAMARK
9. Artezio
10. Auriga

With a team, pick one of the Top 100 Global best
outsourcing firms to analyze from the list on the IAOP Web site at http://www
.iap.org/Content/23/196/3117 (a new list is published annually
in Fortune magazine and updated on the IAOP site). Prepare a
brief presentation formed around the contents of the chapter that
addresses at a minimum the following questions:

■ Why was this company chosen to be in the top 100? What
has been the company’s history as regards outsourcing as
a source of revenue?
■ How does the firm describe, or imply, its value proposition?
■ What unique competitive advantage does the firm exhibit?
Do you consider this to be a sustainable competitive advan-
tage? Utilize the four criteria of sustainable competitive
advantage as your guide.

EXERCISE 2: VRIO ANALYSIS—IS THE FIRM’S
ADVANTAGE SUSTAINABLE?
In this chapter, the concepts of sustainable competitive advantage
and how firms can use their unique bundle of resources to achieve
such an advantage were introduced. Remember that a sustain-
able competitive advantage can only be present if competitors
are unsuccessful in duplicating the firm’s benefit or the competitor
is unable to acquire the resources necessary to imitate.
However, discovering if a competitive advantage is sustain-
able or merely temporary can be difficult for managers. According
to the Business Insider War Room online magazine (http://www
.businessinsider.com/warroom), there are 6 critical ingredients
to achieve a sustainable competitive advantage: (1) real intel-
llectual property; (2) a dynamic rather than a single product line;
(3) dramatic cost improvement capabilities; (4) a proven team with
inside relationships; (5) a lock on the customer or market; and
(6) strong focus and differentiation.
In your teams, prepare for class discussion an analysis of
a Fortune 500 company that your team finds interesting (the
2011 list may be viewed at CNNMoney, http://money.cnn.com/
magazines/fortune/fortune500/2011/full_list/). Your team should
be prepared, at a minimum, to address the following issues:

1. How does the firm describe its value proposition?
2. List each of the firm’s capabilities as represented by your text
in Table 3.4.
3. Prepare a list for your firm that replicates the columns repre-
sented in Table 3.5.
4. What do you consider to be the firm’s core competencies?
5. Do you consider this firm to possess a sustainable competitive
advantage, and if so, do you believe this to be sustainable in
the future?
6. Categorize the firm’s performance over the past few years.

VIDEO CASE

ORGANIZATIONAL CULTURE CREATES
STRATEGIC COMPETITIVENESS
Tony Shay/CEO/Zappos.com
Zappos.com, an online shoe retailer, has been listed in Fortune
magazine’s 100 best companies to work for over the past two years
because employees feel empowered and respected. Recognized
as a thriving company due to its unique organizational culture, from
its untimed and unscripted call centers to “bald and blue” days,
Zappos gives its employees the opportunity to shine in the work-
place. Tony Shay, CEO, believes that Zappos is making the world
a better place by allowing employees to be happy and to look at
their job as a place to be for life. By receiving job security and ben-
efits on par with competitors, Zappos employees remain dedicated
to promoting branding opportunities with every customer. As a
result, Amazon.com willingly purchased Zappos for $1.2 billion.

Be prepared to discuss the following concepts and ques-
tions in class:

Concepts
■ Value
■ Resources, capabilities, and core competencies
■ Sustainable competitive advantage
■ Value chain
■ Outsourcing

Questions
1. How is Zappos’ organizational culture creating value?
2. What resources and resulting capabilities and core competen-
cies do you see within the Zappos organization that gives it
strategic competitiveness?
3. Will Zappos’ competitive advantage be sustainable?
4. What value chain activities performed by Zappos help to cre-
ate value for its customers?
5. Why do you think Zappos is not outsourcing its call centers?


84. Barney, Firm resources, 111.


PART 2
Strategic Actions: Strategy Formulation

4. Business-Level Strategy, 100
5. Competitive Rivalry and Competitive Dynamics, 130
6. Corporate-Level Strategy, 162
7. Merger and Acquisition Strategies, 192
8. International Strategy, 224
9. Cooperative Strategy, 260
Studying this chapter should provide you with the strategic management knowledge needed to:

1. Define business-level strategy.
2. Discuss the relationship between customers and business-level strategies in terms of who, what, and how.
3. Explain the differences among business-level strategies.
4. Use the five forces of competition model to explain how above-average returns can be earned through each business-level strategy.
5. Describe the risks of using each of the business-level strategies.
Starbucks changed how people in the United States ordered coffee, how much they paid for it, and how and where they drank it. In other words, this company changed the way that Americans experienced their cup of “joe.” They now drink coffee in many places, such as in coffee shops while using Wi-Fi, or on trains and subways, ordering grandes, lattes, and other once strange-sounding names. Most of all, they are willing to pay more than $4 for a cup of “joe.” With thousands of stores on street corners, in retail outlets in shopping malls, and in bookstores, among other locations, Starbucks seemed almost on its way toward becoming a generic name for a cup of coffee. It had become one of the “darlings” of Wall Street because almost every action it took appeared to be successful.

But, on the way to the bank, something happened in 2008. A major recession occurred and consumers were less willing to pay the high prices for a premium cup of coffee, leading to a reduction in same-store sales for the first time in Starbucks’ history. In addition, competitors (e.g., McDonald’s) started to eat away at Starbucks’ market share. Finally, Starbucks appeared to be unable to control the quality of the “experience” across the thousands of stores. In short, Starbucks started to lose its “differentiation” and its luster. Howard Schultz stepped up to take over the CEO position again, and shortly thereafter he announced major changes. For one, he announced that Starbucks was closing 900 poorly performing stores in the United States. In addition, Schultz announced that the firm would regain its focus on innovation.

With more than 17,000 stores globally, Starbucks was on the move again in 2011. For example, it has regained its emphasis on innovation by introducing several new products, such as its instant coffee, Via. Although originally Starbucks’ customers questioned the sale of instant coffee, Via has been highly successful with sales growing to more than $200 million annually in only two years after its introduction. Starbucks celebrated its 40th anniversary with a new brand/logo, in which the name of the company was deleted. Although some questioned this move, others think it will have a neutral to positive impact. Essentially, the Starbucks name was removed to allow the company to introduce new products well beyond coffee, which has become synonymous with the product.

Starbucks also announced an agreement with Green Mountain to distribute Starbucks coffee pods for use with that company’s Keurig single cup coffee brewing system. A significant part of Starbucks’ growth goals target China and India. In 2001, Starbucks had 430 stores in China with plans to have 1,500 stores operating in the country by 2015. Additionally, Starbucks signed an agreement with Tata Coffee in India to buy coffee beans and to open stores in hotels and other Tata-affiliated retail stores in India. Along with these developments, Starbucks now allows customers to pay for their purchases with their iPhones. Starbucks continues to display environmental consciousness with the goal of recycling all of its used paper cups. Finally, it continues to offer all of its employees, full-time and part-time, health insurance that costs the company about $250 million annually.

Therefore, Starbucks has stepped up to differentiate the firm from all competitors and many other companies operating in other industries as well.
Part 2: Strategic Actions: Strategy Formulation

Increasingly important to firm success, strategy is concerned with making choices among two or more alternatives. As we noted in Chapter 1, when choosing a strategy, the firm decides to pursue one course of action instead of others. The choices are influenced by opportunities and threats in the firm’s external environment (see Chapter 2) as well as the nature and quality of the resources, capabilities, and core competencies in its internal organization (see Chapter 3). As we see in the Opening Case, Starbucks was once a huge leader in its industry but began to suffer from poor economic times and from competition. It had lost most of its differentiation. Even firms such as McDonald’s, not known for offering premium products, began providing premium coffee drinks at a much lower price than Starbucks. As a result, Starbucks sales quit growing and began shrinking at many of its stores. Since that time, Starbucks has taken major steps to regain its differentiation. It closed almost 900 stores and became more innovative, introducing several new products (e.g., Via) and new processes (e.g., allowing payments with an iPhone). Starbucks appears to have recaptured its luster and lead among competitors using its differentiated strategy.

The fundamental objective of using any type of strategy (see Figure 1.1) is to gain strategic competitiveness and earn above-average returns. Strategies are purposeful, precede the taking of actions to which they apply, and demonstrate a shared understanding of the firm’s vision and mission. Starbucks’ decisions to form an alliance with Green Mountain to offer coffee pods for the Keurig Brewing systems and to enter India’s market were quite purposeful. An effectively formulated strategy marshals, integrates, and allocates the firm’s resources, capabilities, and competencies so that it will be properly aligned with its external environment. A properly developed strategy also rationalizes the firm’s vision and mission along with the actions taken to achieve them. Information about a host of variables including markets, customers, technology, worldwide finance, and the changing world economy must be collected and analyzed to properly form and use strategies. In the final analysis, sound strategic choices that reduce uncertainty regarding outcomes are the foundation for building successful strategies.

Business-level strategy, this chapter’s focus, is an integrated and coordinated set of commitments and actions the firm uses to gain a competitive advantage by exploiting core competencies in specific product markets. Business-level strategy indicates the choices the firm has made about how it intends to compete in individual product markets. The choices are important because long-term performance is linked to a firm’s strategies. Given the complexity of successfully competing in the global economy, the choices about how the firm will compete can be difficult. For example, MySpace, a social networking site, was the largest networking site in 2006 with approximately 50 million users. But, within two years, it lost the lead to a fast-developing social networking site, Facebook. Facebook quickly enlarged its market share with more than 600 million users in 2011, while MySpace had only about 34 million users. Facebook has made several major competitive moves in recent years challenging MySpace to further adjust or fine-tune its strategy as it engages its major competitor in various competitive battles.

Every firm must form and use a business-level strategy. However, every firm may not use all the strategies—corporate-level, merger and acquisition, international, and
cooperative—that we examine in Chapters 6 through 9. A firm competing in a single-product market area in a single geographic location does not need a corporate-level strategy to deal with product diversity or an international strategy to deal with geographic diversity. In contrast, a diversified firm will use one of the corporate-level strategies as well as a separate business-level strategy for each product market area in which it competes. Every firm—from the local dry cleaner to the multinational corporation—must develop and use at least one business-level strategy. Thus business-level strategy is the core strategy—the strategy that the firm forms to describe how it intends to compete in a product market.14

We discuss several topics to examine business-level strategies. Because customers are the foundation of successful business-level strategies and should never be taken for granted,15 we present information about customers that is relevant to business-level strategies. In terms of customers, when selecting a business-level strategy the firm determines (1) who will be served, (2) what needs those target customers have that it will satisfy, and (3) how those needs will be satisfied. Selecting customers and deciding which of their needs the firm will try to satisfy, as well as how it will do so, are challenging tasks. Global competition has created many attractive options for customers, thus making it difficult to determine the strategy to best serve them.16 Effective global competitors have become adept at identifying the needs of customers in different cultures and geographic regions as well as learning how to quickly and successfully adapt the functionality of a firm’s good or service to meet those needs.

Descriptions of the purpose of business-level strategies—and of the five business-level strategies—follow the discussion of customers. The five strategies we examine are called generic because they can be used in any organization competing in any industry.17 Our analysis describes how effective use of each strategy allows the firm to favorably position itself relative to the five competitive forces in the industry (see Chapter 2). In addition, we use the value chain (see Chapter 3) to show examples of the primary and support activities necessary to implement specific business-level strategies. Because no strategy is risk-free,18 we also describe the different risks the firm may encounter when using these strategies. In Chapter 11, we explain the organizational structures and controls linked with the successful use of each business-level strategy.

Customers: Their Relationship with Business-Level Strategies

Strategic competitiveness results only when the firm satisfies a group of customers by using its competitive advantages as the basis for competing in individual product markets.19 A key reason firms must satisfy customers with their business-level strategy is that returns earned from relationships with customers are the lifeblood of all organizations.20

The most successful companies try to find new ways to satisfy current customers and/or to meet the needs of new customers. Being able to do this can be even more difficult when firms and consumers face challenging economic conditions. During such times, firms may decide to reduce their workforce to control costs. This can lead to problems, however, when having fewer employees makes it more difficult for companies to meet individual customers’ needs and expectations. In these instances, some suggest that firms should follow several courses of action, including paying extra attention to their best customers and developing a flexible workforce by cross-training employees so they can undertake a variety of responsibilities on their jobs. Amazon.com, insurer USAA, and Lexus have been identified as “customer service champions” because they devote extra care and attention to customer service especially during challenging economic times.21
Effectively Managing Relationships with Customers

The firm’s relationships with its customers are strengthened when it delivers superior value to them. Strong interactive relationships with customers often provide the foundation for the firm’s efforts to profitably serve customers’ unique needs.

As the following statement shows, Caesar’s Entertainment (the world’s largest provider of branded casino entertainment) is committed to providing superior value to customers: “Caesar’s Entertainment is focused on building loyalty and value with its customers through a unique combination of great service, excellent products, unsurpassed distribution, operational excellence and technology leadership.” Importantly, as Caesar’s appears to anticipate, delivering superior value often results in increased customer loyalty. In turn, customer loyalty has a positive relationship with profitability. However, more choices and easily accessible information about the functionality of firms’ products are creating increasingly sophisticated and knowledgeable customers, making it difficult to earn their loyalty.

A number of companies have become skilled at the art of managing all aspects of their relationship with their customers. For example, Amazon.com is widely recognized for the quality of information it maintains about its customers, the services it renders, and its ability to anticipate customers’ needs. Using the information it has, Amazon tries to serve what it believes are the unique needs of each customer; and it has a strong reputation for being able to successfully do this.

As we discuss next, firms’ relationships with customers are characterized by three dimensions. Companies such as Caesar and Amazon.com understand these dimensions and manage their relationships with customers in light of them.

Reach, Richness, and Affiliation

The reach dimension of relationships with customers is concerned with the firm’s access and connection to customers. In general, firms seek to extend their reach, adding customers in the process of doing so.

Reach is an especially critical dimension for social networking sites such as Facebook and MySpace in that the value these firms create for users is to connect them with others. As noted earlier, traffic to MySpace has been declining in recent years; at the same time, the number of Facebook users has been dramatically increasing in the United States and abroad. As a result, Facebook had more than 600 million users in 2011, almost 1800 percent more than MySpace. Reach is also important to Netflix. Fortunately for this firm, recent results indicate that its reach continues to expand: “Netflix ended 2010 with approximately 20.01 million total subscribers, representing a 17.2 percent increase over the end of 2009.”

Richness, the second dimension of firms’ relationships with customers, is concerned with the depth and detail of the two-way flow of information between the firm and the customer. The potential of the richness dimension to help the firm establish a competitive advantage in its relationship with customers leads many firms to offer online services in order to better manage information exchanges with their customers. Broader and deeper information-based exchanges allow firms to better understand their customers and their needs. Such exchanges also enable customers to become more knowledgeable about how the firm can satisfy them. Internet technology and e-commerce transactions have substantially reduced the costs of meaningful information exchanges with current and potential customers.
Chapter 4: Business-Level Strategy

As we have noted, Amazon is a leader in using the Internet to build relationships with customers. In fact, it bills itself as the most “customer-centric company” on earth. Amazon and other firms use rich information from customers to help them develop innovative new products that better satisfy customers’ needs.  

Affiliation, the third dimension, is concerned with facilitating useful interactions with customers. Viewing the world through the customer’s eyes and constantly seeking ways to create more value for the customer have positive effects in terms of affiliation. This approach enhances customer satisfaction and produces fewer customer complaints. In fact, for services, customers often do not complain when dissatisfied; instead they simply go to competitors for their service needs. 

Internet navigators such as Microsoft’s MSN Autos help online clients find and sort information. MSN Autos provides data and software to prospective car buyers that enable them to compare car models along multiple objective specifications. A prospective buyer who has selected a specific car based on comparisons of different models can then be linked to dealers that meet the customer’s needs and purchasing requirements. Information about other relevant issues such as financing and insurance and even local traffic patterns is also available at the site. Because its revenues come not from the final customer or end user but from other sources (such as advertisements on its Web site, hyperlinks, and associated products and services), MSN Autos represents the customer’s interests, a service that fosters affiliation.

As we discuss next, effectively managing customer relationships (along the dimensions of reach, richness, and affiliation) helps the firm answer questions related to the issues of who, what, and how.

Who: Determining the Customers to Serve

Deciding who the target customer is that the firm intends to serve with its business-level strategy is an important decision. Companies divide customers into groups based on differences in the customers’ needs (needs are discussed further in the next section) to make this decision. Dividing customers into groups based on their needs is called market segmentation, which is a process that clusters people with similar needs into individual and identifiable groups. In the animal food products business, for example, the food-product needs of owners of companion pets (e.g., dogs and cats) differ from the needs for food and health-related products of those owning production animals (e.g., livestock). A subsidiary of Colgate-Palmolive, Hill’s Pet Nutrition sells food products for pets. In fact, the company’s mission is “to help enrich and lengthen the special relationship between people and their pets.” Thus, Hill’s Pet Nutrition targets the needs of different segments of customers with the food products it sells for animals.

Almost any identifiable human or organizational characteristic can be used to subdivide a market into segments that differ from one another on a given characteristic. Common characteristics on which customers’ needs vary are illustrated in Table 4.1.

<table>
<thead>
<tr>
<th>Table 4.1 Basis for Customer Segmentation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Consumer Markets</strong></td>
</tr>
<tr>
<td>1. Demographic factors (age, income, sex, etc.)</td>
</tr>
<tr>
<td>2. Socioeconomic factors (social class, stage in the family life cycle)</td>
</tr>
<tr>
<td>3. Geographic factors (cultural, regional, and national differences)</td>
</tr>
<tr>
<td>4. Psychological factors (lifestyle, personality traits)</td>
</tr>
<tr>
<td>5. Consumption patterns (heavy, moderate, and light users)</td>
</tr>
<tr>
<td>6. Perceptual factors (benefit segmentation, perceptual mapping)</td>
</tr>
<tr>
<td><strong>Industrial Markets</strong></td>
</tr>
<tr>
<td>1. End-use segments (identified by SIC code)</td>
</tr>
<tr>
<td>2. Product segments (based on technological differences or production economics)</td>
</tr>
<tr>
<td>3. Geographic segments (defined by boundaries between countries or by regional differences within them)</td>
</tr>
<tr>
<td>4. Common buying factor segments (cut across product market and geographic segments)</td>
</tr>
<tr>
<td>5. Customer size segments</td>
</tr>
</tbody>
</table>

What: Determining Which Customer Needs to Satisfy

After the firm decides who it will serve, it must identify the targeted customer group’s needs that its goods or services can satisfy. In a general sense, needs (what) are related to a product’s benefits and features. Successful firms learn how to deliver to customers what they want, when they want it. Having close and frequent interactions with both current and potential customers helps the firm identify those individuals’ and groups’ current and future needs.

From a strategic perspective, a basic need of all customers is to buy products that create value for them. The generalized forms of value that goods or services provide are either low cost with acceptable features or highly differentiated features with acceptable cost. In the recent global financial crisis, companies across industries recognized their customers’ needs to feel as secure as possible when making purchases. Allowing customers to return their cars if they lose their job within 12 months of the purchase is how Hyundai Motors decided to address this consumer need, creating value in the form of security.

The most effective firms continuously strive to anticipate changes in customers’ needs. The firm that fails to anticipate and certainly to recognize changes in its customers’ needs may lose its customers to competitors whose products can provide more value to the focal firm’s customers. It is also recognized that consumer needs and desires have been changing in recent years. For example, more consumers desire to have an experience rather than to simply purchase a good or service. As a result, one of Starbucks’ goals has been to provide an experience, not just a cup of coffee. Customers also prefer to receive customized goods and services. Again, Starbucks has been doing this for some time, allowing customers to design their own drinks, within their menus (which have become rather extensive over time). They also demand fast service. Consumers in the United States have been known for their impatience, but rapid service is now expected by most consumers. Unhappy consumers lead to lost sales, theirs and others who learn of their dissatisfaction. Therefore, it is important to maintain customer satisfaction by meeting and satisfying their needs.

How: Determining Core Competencies Necessary to Satisfy Customer Needs

After deciding who the firm will serve and the specific needs of those customers, the firm is prepared to determine how to use its capabilities and competencies to develop products that can satisfy the needs of its target customers. As explained in Chapters 1 and 3, core competencies are resources and capabilities that serve as a source of competitive advantage for the firm over its rivals. Firms use core competencies (how) to implement value-creating strategies and thereby satisfy customers’ needs. Only those firms with the capacity to continuously improve, innovate, and upgrade their competencies can expect to meet and hopefully exceed customers’ expectations across time. Firms must continuously upgrade their capabilities to ensure that they maintain the advantage over their rivals by providing customers with a superior product. Often these capabilities are difficult for competitors to imitate partly because they are constantly being upgraded but also because they are integrated and used as configurations of capabilities to perform an important activity (e.g., R&D).

Companies draw from a wide range of core competencies to produce goods or services that can satisfy customers’ needs. For example, Merck is a large pharmaceutical firm well-known for its R&D capabilities. In recent times, Merck has been building on these capabilities by investing heavily in R&D. In 2011, for example, Merck invested $8.5 billion to conduct research and identify major new drugs. These new drugs are intended to meet the needs of consumers and to sustain Merck’s competitive advantage in the industry.

SAS Institute is the world’s largest privately owned software company and is the leader in business intelligence and analytics. Customers use SAS programs for data warehousing, data mining, and decision support purposes. SAS serves 50,000 sites in 100
countries and serves 93 percent of the top Fortune 100 firms. Allocating approximately 24 percent of revenues to research and development (R&D), a percentage that exceeds percentages allocated by its competitors, SAS relies on its core competence in R&D to satisfy the data-related needs of such customers as the U.S. Census Bureau and a host of consumer goods firms (e.g., hotels, banks, and catalog companies). 44

Sometimes, firms may find it necessary to use their core competencies as the foundation for producing new goods or services for new customers. This may be the case for some small automobile parts suppliers in the United States. Given that U.S. auto production in recent years declined about a third from more typical levels, a number of these firms are seeking to diversify their operations, perhaps exiting the auto parts supplier industry as a result of doing so. Some analysts believe that the first rule for these small manufacturers is to determine how their current capabilities and competencies might be used to produce value-creating products for different customers. One analyst gave the following example of how this might work: “There may be no reason that a company making auto door handles couldn’t make ball-and-socket joints for artificial shoulders.”45

Our discussion about customers shows that all organizations must use their capabilities and core competencies (the how) to satisfy the needs (the what) of the target group of customers (the who) the firm has chosen to serve. Next, we describe the different business-level strategies that are available to firms to use to satisfy customers as the foundation for earning above-average returns.

The Purpose of a Business-Level Strategy

The purpose of a business-level strategy is to create differences between the firm’s position and those of its competitors.46 To position itself differently from competitors, a firm must decide whether it intends to perform activities differently or to perform different activities. Strategy defines the path which provides the direction of actions to be taken by leaders of the organization. 47 In fact, “choosing to perform activities differently or to perform different activities than rivals” is the essence of business-level strategy.48 Thus, the firm’s business-level strategy is a deliberate choice about how it will perform the value chain’s primary and support activities to create unique value. Indeed, in the current complex competitive landscape, successful use of a business-level strategy results from the firm learning how to integrate the activities it performs in ways that create superior value for customers.

Firms develop an activity map to show how they integrate the activities they perform. We show the Southwest Airlines activity map in Figure 4.1. The manner in which Southwest has integrated its activities is the foundation for the successful use of its primary cost leadership strategy (this strategy is discussed later in the chapter) but also includes differentiation through the unique services provided to customers. The tight integration among Southwest’s activities is a key source of the firm’s ability to at least historically operate more profitably than its competitors.

As shown in Figure 4.1, Southwest Airlines has configured the activities it performs into six strategic themes—limited passenger service; frequent, reliable departures; lean, highly productive ground and gate crews; high aircraft utilization; very low ticket prices; and short-haul, point-to-point routes between mid-sized cities and secondary airports. Individual clusters of tightly linked activities make it possible for the outcome of a strategic theme to be achieved. For example, no meals, no seat assignments, and no baggage transfers form a cluster of individual activities that support the strategic theme of limited passenger service (see Figure 4.1).

Southwest’s tightly integrated activities make it difficult for competitors to imitate the firm’s cost leadership strategy. The firm’s unique culture and customer service, both of which are sources of competitive advantages, are features that rivals have been unable to imitate, although some have tried and largely failed (e.g., U.S. Airways’ MetroJet
subsidiary, United Airlines’ United Shuttle, Delta’s Song, and Continental Airlines’ Continental Lite). Hindsight shows that these competitors offered low prices to customers, but weren’t able to operate at costs close to those of Southwest or to provide customers with any notable sources of differentiation, such as a unique experience while in the air. The key to Southwest’s success has been its ability to continuously reduce its costs while providing customers with acceptable levels of differentiation such as an engaging culture. Firms using the cost leadership strategy must understand that in terms of sources of differentiation that accompany the cost leader’s product, the customer defines acceptable. Fit among activities is a key to the sustainability of competitive advantage for all firms, including Southwest Airlines. Strategic fit among the many activities is critical for competitive advantage. It is more difficult for a competitor to match a configuration of integrated activities than to imitate a particular activity such as sales promotion, or a process technology.\(^{49}\)

**Types of Business-Level Strategies**

Firms choose from among five business-level strategies to establish and defend their desired strategic position against competitors: cost leadership, differentiation, focused cost leadership, focused differentiation, and integrated cost leadership/differentiation (see Figure 4.2). Each business-level strategy helps the firm to establish and exploit a particular competitive advantage within a particular competitive scope. How firms integrate the activities they perform within each different business-level strategy demonstrates how they differ from one another.\(^{50}\) For example, firms have different activity maps, and thus, a Southwest Airlines activity map differs from those of competitors JetBlue, Continental, American Airlines, and so forth. Superior integration of activities increases the likelihood of being able to gain an advantage over competitors and to earn above-average returns.
Chapter 4: Business-Level Strategy

When selecting a business-level strategy, firms evaluate two types of potential competitive advantages: "lower cost than rivals, or the ability to differentiate and command a premium price that exceeds the extra cost of doing so." Having lower cost derives from the firm’s ability to perform activities differently than rivals; being able to differentiate indicates the firm’s capacity to perform different (and valuable) activities. Thus, based on the nature and quality of its internal resources, capabilities, and core competencies, a firm seeks to form either a cost competitive advantage or a distinctiveness competitive advantage as the basis for implementing its business-level strategy.

Two types of target markets are broad market and narrow market segment(s) (see Figure 4.2). Firms serving a broad market seek to use their capabilities to create value for customers on an industry-wide basis. A narrow market segment means that the firm intends to serve the needs of a narrow customer group. With focus strategies, the firm “selects a segment or group of segments in the industry and tailors its strategy to serving them to the exclusion of others.” Buyers with special needs and buyers located in specific geographic regions are examples of narrow customer groups. As shown in Figure 4.2, a firm could also strive to develop a combined low cost/distinctiveness value creation approach as the foundation for serving a target customer group that is larger than a narrow market segment but not as comprehensive as a broad (or industry-wide) customer group. In this instance, the firm uses the integrated cost leadership/differentiation strategy.

None of the five business-level strategies shown in Figure 4.2 is inherently or universally superior to the others. The effectiveness of each strategy is contingent both on...
the opportunities and threats in a firm’s external environment and on the strengths and weaknesses derived from the firm’s resource portfolio. It is critical, therefore, for the firm to select a business-level strategy that is based on a match between the opportunities and threats in its external environment and the strengths of its internal organization as shown by its core competencies. After the firm chooses its strategy, it should consistently emphasize actions that are required to successfully use it. Walmart’s continuous emphasis on driving its costs lower is thought to be a key to the firm’s effective cost leadership strategy.

**Cost Leadership Strategy**

The cost leadership strategy is an integrated set of actions taken to produce goods or services with features that are acceptable to customers at the lowest cost, relative to those of competitors. Firms using the cost leadership strategy commonly sell standardized goods or services (but with competitive levels of differentiation) to the industry’s most typical customers. Process innovations, which are newly designed production and distribution methods and techniques that allow the firm to operate more efficiently, are critical to successful use of the cost leadership strategy.

As noted, cost leaders’ goods and services must have competitive levels of differentiation that create value for customers. For example, in recent years Kia Motors has emphasized the design of its cars in the U.S. market as a source of differentiation while implementing a cost leadership strategy. Called “cheap chic,” some analysts had a positive view of this decision, saying that “When they’re done, Kia’s cars will still be low-end (in price), but they won’t necessarily look like it.” It is important for firms using the cost leadership strategy to not only concentrate on reducing costs because it could result in the firm efficiently producing products that no customer wants to purchase. In fact, such extremes could limit the potential for important process innovations and lead to employment of lower-skilled workers, poor conditions on the production line, accidents, and a poor quality of work life for employees.

As shown in Figure 4.2, the firm using the cost leadership strategy targets a broad customer segment or group. Cost leaders concentrate on finding ways to lower their costs relative to competitors by constantly rethinking how to complete their primary and support activities to reduce costs still further while maintaining competitive levels of differentiation.

For example, cost leader Greyhound Lines Inc. continues to seek ways to reduce the costs it incurs to provide bus service while offering customers an acceptable level of differentiation. Greyhound offers additional services to customers trying to enhance the value of the experience customers have while they pay low prices for their service package. Interestingly, a number of customers now “insist on certain amenities that they receive on planes and trains—such as Internet access and comfortable seats, not to mention cleanliness.” To maintain competitive levels of differentiation while using the cost leadership strategy, Greyhound recently started using over 100 “motor coaches” that have leather seats, additional legroom, Wi-Fi access, and power outlets in every row.

Greyhound enjoys economies of scale by serving more than 25 million passengers annually with about 2,300 destinations in the United States and almost 1,300 daily departures. These scale economies allow the firm to keep its costs low while offering some of the differentiated services today’s customers seek from the company. Demonstrating the firm’s commitment to the physical environment segment of the general environment is the fact that “one Greyhound bus takes an average of 34 cars off the road.”

As primary activities, inbound logistics (e.g., materials handling, warehousing, and inventory control) and outbound logistics (e.g., collecting, storing, and distributing products to customers) often account for significant portions of the total cost to product...
some goods and services. Research suggests that having a competitive advantage in logistics creates more value with a cost leadership strategy than with a differentiation strategy. Thus, cost leaders seeking competitively valuable ways to reduce costs may want to concentrate on the primary activities of inbound logistics and outbound logistics. In so doing many firms choose to outsource their manufacturing operations to low-cost firms with low-wage employees (e.g., China). However, care must be taken because outsourcing also makes the firm more dependent on firms over which they have little control. At best, it creates interdependencies between the outsourcing firm and the suppliers. If dependencies become too great, it gives the supplier more power with which the supplier may increase prices of the goods and services provided. Such actions could harm the firm’s ability to maintain a low-cost competitive advantage.

Cost leaders also carefully examine all support activities to find additional potential cost reductions. Developing new systems for finding the optimal combination of low cost and acceptable levels of differentiation in the raw materials required to produce the firm’s goods or services is an example of how the procurement support activity can facilitate successful use of the cost leadership strategy.

Big Lots Inc. uses the cost leadership strategy. With its vision of being “The World’s Best Bargain Place,” Big Lots is the largest closeout retailer in the United States with annual sales of over $5 billion from more than 1,400 stores with approximately 13,000 employees. For Big Lots, closeout goods are brand-name products sold by other retailers provided for sale at substantially lower prices.

As described in Chapter 3, firms use value-chain analysis to identify the parts of the company’s operations that create value and those that do not. Figure 4.3 demonstrates the primary and support activities that allow a firm to create value through the cost leadership strategy. Companies unable to link the activities shown in this figure through the activity map they form typically lack the core competencies needed to successfully use the cost leadership strategy.

Effective use of the cost leadership strategy allows a firm to earn above-average returns in spite of the presence of strong competitive forces (see Chapter 2). The next sections (one for each of the five forces) explain how firms implement a cost leadership strategy.

**Rivalry with Existing Competitors**

Having the low-cost position is valuable to deal with rivals. Because of the cost leader’s advantageous position, rivals hesitate to compete on the basis of price, especially before evaluating the potential outcomes of such competition. As described in the Strategic Focus, Walmart has been known for its ability to maintain very low costs, thereby creating value for customers. However, the changes it made to attract upscale customers made its low-cost position vulnerable to rivals. Dollar Store, Amazon.com, and others took advantage of the opportunity. Amazon appears to have become a low-cost leader, and the Dollar Stores provide low costs and easy access for customers. Both of these rivals have begun to siphon off Walmart customers. Because of Walmart’s unprecedented loss of sales and market position, it has started to fight back by returning to its former strategy and is implementing new competitive actions as well (e.g., building new express stores).

The degree of rivalry present is based on a number of different factors such as size and resources of rivals, their dependence on the particular market, and location and prior competitive interactions, among others. Firms may also take actions to reduce the amount of rivalry that they face. For example, firms sometimes form joint ventures to reduce rivalry and increase the amount of profitability enjoyed by firms in the industry.

In the past, rivals such as Costco and Target hesitated to compete directly with Walmart strictly on the basis of costs and, subsequently, prices to consumers. Yet, given Walmart’s changes, its prices on some products are only slightly below the prices of similar goods at Target. Walmart’s changes then also provided an opportunity for Target and Costco. Walmart saw the error in its new direction and has vowed to return to its cost leadership strategy of providing the lowest prices on all goods sold.
Walmart, Dollar Stores, and Amazon: Who is Buying Whose Lunch?

Walmart is the largest retailer in the world and has used its economies of scale and distribution system to drive costs exceptionally low. As such, it has been the market leader in low prices for retail goods for many years. However, recently Walmart’s same store sales have been declining and those of rivals Family Dollar and Amazon (among others) have been increasing. What happened?

Well, Walmart decided to change its strategy at the margin with the intent of trying to attract more upscale customers. For example, it introduced organic foods, remodeled some stores making the aisles wider and less cluttered, and reduced the variety of products offered. In so doing, its prices also increased on some goods. In fact, on some goods, its prices were not much below those of its rival Target. Additionally, the new strategy appeared designed to take market share away from Target. However, in making this aggressive move to attract Target’s customers and other new ones as well, Walmart deviated from its cost leadership strategy and was not protecting its flank.

Walmart’s actions provided an opening to several of its rivals. For example, online competitors were allowed to gain a cost/price advantage. One author tells of an experience where he was searching for a new Waste-King garbage disposal (his quit working). He found that Amazon.com offered it for a price that was 20 percent lower than the price it was sold at Walmart. Interestingly, Amazon’s sales increased by 40 percent in 2010. At the same time, Family Dollar and some similar rivals have been cleaning up their stores, stocking more name-brand products, and keeping their prices low. By doing so, they attracted former Walmart customers because of their low prices and convenience. Family Dollar, Dollar Tree, and Dollar General all experienced increased sales revenues and are adding hundreds of new stores.

Walmart realized that it made a mistake. As a result, it has begun to add products back into stores that were eliminated earlier. Additionally, it is focused heavily on keeping its costs and prices low. Finally, Walmart is opening 40 new express stores of only slightly more than 14,000 square feet. Yet analysts question if these actions will be adequate to win back customers that were lost. First, 40 express stores will not offer much competition to the thousands of dollar stores. Also, it must attract customers back with lower prices and/or more product variety than offered by competitors. Only meeting their low prices may be inadequate to get customers to change if they are satisfied with their current stores. Time will tell if Walmart will be able to recapture its cost leadership position in the market after giving it up to rivals.

Bargaining Power of Buyers (Customers)

Powerful customers can force a cost leader to reduce its prices, but not below the level at which the cost leader’s next-most-efficient industry competitor can earn average returns. Although powerful customers might be able to force the cost leader to reduce prices even below this level, they probably would choose not to do so. Prices that are low enough to prevent the next-most-efficient competitor from earning average returns would force that firm to exit the market, leaving the cost leader with less competition and in an even stronger position. Customers would thus lose their power and pay higher prices if they were forced to purchase from a single firm operating in an industry without rivals.

Buyers can also develop a counterbalancing power to the customers’ power by carefully analyzing and understanding each of their customers. To help in obtaining information and understanding the customers, buyers can participate in customers’ networks. In so doing, they share information, build trust, and participate in joint problem-solving with their customers. In turn, they use the information obtained to provide a product that provides superior value to customers by most effectively satisfying their needs.

Bargaining Power of Suppliers

The cost leader operates with margins greater than those of competitors. Cost leaders want to constantly increase their margins by driving their costs lower. Among other benefits, higher gross margins relative to those of competitors make it possible for the cost leader to absorb its suppliers’ price increases. When an industry faces substantial increases in the cost of its supplies, only the cost leader may be able to pay the higher prices and
continue to earn either average or above-average returns. Alternatively, a powerful cost leader may be able to force its suppliers to hold down their prices, which would reduce the suppliers’ margins in the process. Walmart lost its way in this regard. By reducing the number and type of products sold in Walmart stores, it reduced its bargaining power with several suppliers. In so doing, it was unable to gain the best (lowest) prices on goods relative to its competitors. Thus, Amazon and the Dollar Stores began winning market share from Walmart by offering lower prices.

The fact remains that Walmart is the largest retailer in North America, thus giving the firm a great deal of power with its suppliers. Walmart is the largest supermarket operator in the United States and its Sam’s Club division is the second largest warehouse club in the United States. Collectively, this sales volume and the market penetration it suggests (over 100 million people visit a Walmart store each week) still allow Walmart to obtain low prices from its suppliers.

Some firms create dependencies on suppliers by outsourcing whole functions. They do so to reduce their overall costs. They may outsource these activities to reduce their costs because of earnings pressures from stakeholders (e.g., institutional investors who own a major stock holding in the company) in the industry. Often when there is such earnings pressure, the firm may see foreign suppliers whose costs are also lower, providing the capability to offer the goods at lower prices. Yet, when firms outsource, particularly to a foreign supplier, they also need to invest time and effort into building a good relationship, hopefully developing trust between the firms.

Potential Entrants
Through continuous efforts to reduce costs to levels that are lower than competitors’, a cost leader becomes highly efficient. Because increasing levels of efficiency (e.g., economies of scale) enhance profit margins, they serve as a significant entry barrier to potential competitors. New entrants must be willing to accept no-better-than-average returns until they gain the experience required to approach the cost leader’s efficiency. To earn even average returns, new entrants must have the competencies required to match the cost levels of competitors other than the cost leader. The low profit margins (relative to margins earned by firms implementing the differentiation strategy) make it necessary for the cost leader to sell large volumes of its product to earn above-average returns. However, firms striving to be the cost leader must avoid pricing their products so low that their ability to operate profitably is reduced, even though volume increases.

Product Substitutes
Compared with its industry rivals, the cost leader also holds an attractive position in terms of product substitutes. A product substitute becomes an issue for the cost leader when its features and characteristics, in terms of cost and differentiated features, are potentially attractive to the firm’s customers. When faced with possible substitutes, the cost leader has more flexibility than its competitors. To retain customers, it can reduce the price of its good or service. With still lower prices and competitive levels of differentiation, the cost leader increases the probability that customers prefer its product rather than a substitute.

Competitive Risks of the Cost Leadership Strategy
The cost leadership strategy is not risk free. One risk is that the processes used by the cost leader to produce and distribute its good or service could become obsolete because of competitors’ innovations. These innovations may allow rivals to produce at costs lower than those of the original cost leader, or to provide additional differentiated features without increasing the product’s price to customers.

A second risk is that too much focus by the cost leader on cost reductions may occur at the expense of trying to understand customers’ perceptions of “competitive levels of differentiation.” Walmart, for example, has been criticized for having too few salespeople available to help customers and too few individuals at checkout registers. These complaints
suggest that there might be a discrepancy between how Walmart’s customers define “minimal levels of service” and the firm’s attempts to drive its costs increasingly lower.

Imitation is a final risk of the cost leadership strategy. Using their own core competencies, competitors sometimes learn how to successfully imitate the cost leader’s strategy. When this happens, the cost leader must increase the value its good or service provides to customers. Commonly, value is increased by selling the current product at an even lower price or by adding differentiated features that create value for customers while maintaining price.

**Differentiation Strategy**

The differentiation strategy is an integrated set of actions taken to produce goods or services (at an acceptable cost) that customers perceive as being different in ways that are important to them.  

While cost leaders serve a typical customer in an industry, differentiators target customers for whom value is created by the manner in which the firm’s products differ from those produced and marketed by competitors. Product innovation, which is “the result of bringing to life a new way to solve the customer’s problem—through a new product or service development—that benefits both the customer and the sponsoring company” is critical to successful use of the differentiation strategy.

Firms must be able to produce differentiated products at competitive costs to reduce upward pressure on the price that customers pay. When a product’s differentiated features are produced at noncompetitive costs, the price for the product may exceed what the firm’s target customers are willing to pay. If the firm has a thorough understanding of what its target customers value, the relative importance they attach to the satisfaction of different needs, and for what they are willing to pay a premium, the differentiation strategy can be effective in helping it earn above-average returns. Of course, to achieve these returns, the firm must apply its knowledge capital (knowledge held by its employees and managers) to provide customers with a differentiated product that provides them with superior value.

Through the differentiation strategy, the firm produces nonstandardized (that is, distinctive) products for customers who value differentiated features more than they value low cost. For example, superior product reliability and durability and high-performance sound systems are among the differentiated features of Toyota Motor Corporation’s Lexus products. However, Lexus offers its vehicles to customers at a competitive purchase price relative to other luxury automobiles. As with Lexus products, a product’s unique attributes, rather than its purchase price, provide the value for which customers are willing to pay.

To maintain success with the differentiation strategy results, the firm must consistently upgrade differentiated features that customers value and/or create new valuable features (innovate) without significant cost increases. This approach requires firms to constantly change their product lines. These firms may also offer a portfolio of products that complement each other, thereby enriching the differentiation for the customer and perhaps satisfying a portfolio of consumer needs. Because a differentiated product satisfies customers’ unique needs, firms following the differentiation strategy are able to charge premium prices. The ability to sell a good or service at a price that substantially exceeds the cost of creating its differentiated features allows the firm to outperform rivals and earn above-average returns. Rather than costs, a firm using the differentiation strategy primarily concentrates on investing in and developing features that differentiate a product in ways that create value for customers. Overall, a firm using the differentiation strategy seeks to be different from its competitors on as many dimensions as possible.
The less similarity between a firm’s goods or services and those of competitors, the more buffered it is from rivals’ actions. Commonly recognized differentiated goods include Toyota’s Lexus, Ralph Lauren’s wide array of product lines, Caterpillar’s heavy-duty earth-moving equipment, and McKinsey & Co.’s differentiated consulting services.

A good or service can be differentiated in many ways. Unusual features, responsive customer service, rapid product innovations and technological leadership, perceived prestige and status, different tastes, and engineering design and performance are examples of approaches to differentiation. While the number of ways to reduce costs may be finite, virtually anything a firm can do to create real or perceived value is a basis for differentiation. Consider product design as a case in point. Because it can create a positive experience for customers, design is an important source of differentiation (even for cost leaders seeking to find ways to add functionalities to their low-cost products as a way of differentiating their products from competitors) and hopefully, for firms emphasizing it, of competitive advantage. Apple is often cited as the firm that sets the standard in design, with the iPod and the iPhone demonstrating Apple’s product design capabilities.

The value chain can be analyzed to determine if a firm is able to link the activities required to create value by using the differentiation strategy. Examples of primary value chain activities and support functions that are commonly used to differentiate a good or service are shown in Figure 4.4. Companies without the skills needed to link...
these activities cannot expect to successfully use the differentiation strategy. Next, we explain how firms using the differentiation strategy can successfully position themselves in terms of the five forces of competition (see Chapter 2) to earn above-average returns.

**Rivalry with Existing Competitors**
Customers tend to be loyal purchasers of products differentiated in ways that are meaningful to them. As their loyalty to a brand increases, customers’ sensitivity to price increases is reduced. The relationship between brand loyalty and price sensitivity insulates a firm from competitive rivalry. Thus, Bose is insulated from intense rivalry as long as customers continue to perceive that its stereo equipment offers superior sound quality at a competitive purchase price. Bose has a strong positive reputation for high-quality and unique products. Thus, reputations can sustain the competitive advantage of firms following a differentiation strategy.90

**Bargaining Power of Buyers (Customers)**
The distinctiveness of differentiated goods or services reduces customers’ sensitivity to price increases. Customers are willing to accept a price increase when a product still satisfies their perceived unique needs better than does a competitor’s offering. Thus, the golfer whose needs are specifically satisfied by Callaway golf clubs will likely continue buying those products even if their cost increases. Similarly, the customer who has been highly satisfied with a Louis Vuitton wallet will probably replace that wallet with another one made by the same company even though the purchase price is higher than the original one. Purchasers of brand-name food items (e.g., Heinz ketchup and Kleenex tissues) accept price increases in those products as long as they continue to perceive that the product satisfies their distinctive needs at an acceptable cost. In all of these instances, the customers are relatively insensitive to price increases because they do not think that an acceptable product alternative exists.

**Bargaining Power of Suppliers**
Because the firm using the differentiation strategy charges a premium price for its products, suppliers must provide high-quality components, driving up the firm’s costs. However, the high margins the firm earns in these cases partially insulate it from the influence of suppliers in that higher supplier costs can be paid through these margins.91 Alternatively, because of buyers’ relative insensitivity to price increases, the differentiated firm might choose to pass the additional cost of supplies on to the customer by increasing the price of its unique product.

**Potential Entrants**
Customer loyalty and the need to overcome the uniqueness of a differentiated product present substantial barriers to potential entrants. Entering an industry under these conditions typically demands significant investments of resources and patience while seeking customers’ loyalty.

**Product Substitutes**
Firms selling brand-name goods and services to loyal customers are positioned effectively against product substitutes. In contrast, companies without brand loyalty face a higher probability of their customers switching either to products which offer differentiated features that serve the same function (particularly if the substitute has a lower price) or to products that offer more features and perform more attractive functions.

**Competitive Risks of the Differentiation Strategy**
One risk of the differentiation strategy is that customers might decide that the price differential between the differentiator’s product and the cost leader’s product is too large. In this instance, a firm may be offering differentiated features that exceed target customers’ needs. The firm then becomes vulnerable to competitors that are able to offer customers a combination of features and price that is more consistent with their needs.
This risk is generalized across a number of companies producing different types of products during an economic recession—a time when sales of luxury goods (e.g., jewelry and leather goods) often suffer. The decline was expected to be more severe in the United States compared to Europe and Japan. A decision made during the last economic recession by Coach Inc., a maker of high-quality, luxurious accessories and gifts for women and men, demonstrates one firm’s reaction to the predicted decline in the sales of luxury goods. With an interest in providing products to increasingly cost-conscious customers without “cheapening” the firm’s image, Coach introduced a new line of its products called “Poppy”; the average price of items in this line is approximately 20 percent lower than the average price of Coach’s typical products.

Another risk of the differentiation strategy is that a firm’s means of differentiation may cease to provide value for which customers are willing to pay. A differentiated product becomes less valuable if imitation by rivals causes customers to perceive that competitors offer essentially the same good or service, but at a lower price. A third risk of the differentiation strategy is that experience can narrow customers’ perceptions of the value of a product’s differentiated features. For example, customers having positive experiences with generic tissues may decide that the differentiated features of the Kleenex product are not worth the extra cost. To counter this risk, firms must continue to meaningfully differentiate their product (e.g., through innovation) for customers at a price they are willing to pay.

Counterfeiting is the differentiation strategy’s fourth risk. “Counterfeits are those products bearing a trademark that is identical to or indistinguishable from a trademark registered to another party, thus infringing the rights of the holder of the trademark.” Companies such as Hewlett-Packard must take actions to deal with the problems counterfeit goods create for firms whose rights are infringed upon next.

Focus Strategies

The focus strategy is an integrated set of actions taken to produce goods or services that serve the needs of a particular competitive segment. Thus, firms use a focus strategy when they utilize their core competencies to serve the needs of a particular industry segment or niche to the exclusion of others. Examples of specific market segments that can be targeted by a focus strategy include (1) a particular buyer group (e.g., youths or senior citizens), (2) a different segment of a product line (e.g., products for professional painters or the do-it-yourself group), or (3) a different geographic market (e.g., northern or southern Italy by using a foreign subsidiary).

There are many specific customer needs firms can serve by using a focus strategy. For example, Los Angeles–based investment banking firm Greif & Company positions itself as “The Entrepreneur’s Investment Bank.” Greif & Company is a leader in providing merger and acquisition advice to medium-sized businesses located in the western United States. Goya Foods is the largest U.S.-based Hispanic-owned food company in the United States. Segmenting the Hispanic market into unique groups, Goya offers more than 1,600 products to consumers. The firm seeks “to be the be-all for the Latin community.” By successfully using a focus strategy, firms such as these gain a competitive advantage in specific market niches or segments, even though they do not possess an industry-wide competitive advantage.

Although the breadth of a target is clearly a matter of degree, the essence of the focus strategy “is the exploitation of a narrow target’s differences from the balance of the industry.” Firms using the focus strategy intend to serve a particular segment of an industry more effectively than can industry-wide competitors. They succeed when they effectively serve a segment whose unique needs are so specialized that broad-based competitors choose not to serve that segment or when they satisfy the needs of a segment being served poorly by industry-wide competitors.

Firms can create value for customers in specific and unique market segments by using the focused cost leadership strategy or the focused differentiation strategy.
Focused Cost Leadership Strategy

Based in Sweden, IKEA, a global furniture retailer with locations in 24 countries and sales revenue of 21.1 billion euros in 2008, uses the focused cost leadership strategy. Young buyers desiring style at a low cost are IKEA’s target customers. For these customers, the firm offers home furnishings that combine good design, function, and acceptable quality with low prices. According to the firm, “Low cost is always in focus. This applies to every phase of our activities.”

IKEA emphasizes several activities to keep its costs low. For example, instead of relying primarily on third-party manufacturers, the firm’s engineers design low-cost, modular furniture ready for assembly by customers. To eliminate the need for sales associates or decorators, IKEA positions the products in its stores so that customers can view different living combinations (complete with sofas, chairs, tables, etc.) in a single room-like setting, which helps the customer imagine how furniture will look in the home. A third practice that helps keep IKEA’s costs low is requiring customers to transport their own purchases rather than providing delivery service.

Although it is a cost leader, IKEA also offers some differentiated features that appeal to its target customers, including its unique furniture designs, in-store playrooms for children, wheelchairs for customer use, and extended hours. IKEA believes that these services and products “are uniquely aligned with the needs of [its] customers, who are young, are not wealthy, are likely to have children (but no nanny), and, because they work, have a need to shop at odd hours.” Thus, IKEA’s focused cost leadership strategy also includes some differentiated features with its low-cost products.

Focused Differentiation Strategy

Other firms implement the focused differentiation strategy. As noted earlier, there are many dimensions on which firms can differentiate their good or service. For example, the new generation of lunch trucks populating cities such as New York, San Francisco, Los Angeles, and even College Station, Texas, use the focused differentiation strategy. Serving “high-end fare such as grass-fed hamburgers, escargot and crème brûlée,” highly trained chefs and well-known restaurateurs own and operate many of these trucks. In fact, “the new breed of lunch truck is aggressively gourmet, tech-savvy and politically correct.” Selling sustainably harvested fish tacos in a vehicle that is fueled by vegetable oil, the Green Truck, located in Los Angeles, demonstrates these characteristics. Moreover, the owners of these trucks often use Twitter and Facebook to inform customers of their locations as they move from point to point in their focal city.

Denver-based Kazoo Toys uses the focused differentiation strategy to create value for parents and children interested in purchasing unique toys while simultaneously having access to unique services. Kazoo offers more than 60,000 distinctive toys. With a focus strategy, firms such as Kazoo Toys must be able to complete various primary value chain activities and support functions in a competitively superior manner to develop and sustain a competitive advantage and earn above-average returns. The activities required to use the focused cost leadership strategy are virtually identical to those of the industry-wide cost leadership strategy (see Figure 4.3), and activities required to use the focused differentiation strategy are largely identical to those of the industry-wide differentiation strategy (see Figure 4.4). Similarly, the manner in which each of the two focus strategies allows a firm to deal successfully with the five competitive forces parallels those of
the two broad strategies. The only difference is in the firm’s competitive scope; the firm focuses on a narrow industry segment. Thus, Figures 4.3 and 4.4 and the text describing the five competitive forces also explain the relationship between each of the two focus strategies and competitive advantage.

**Competitive Risks of Focus Strategies**

With either focus strategy, the firm faces the same general risks as does the company using the cost leadership or the differentiation strategy, respectively, on an industry-wide basis. However, focus strategies have three additional risks.

First, a competitor may be able to focus on a more narrowly defined competitive segment and thereby “out-focus” the focuser. This would happen if another firm found a way to offer IKEA’s customers (young buyers interested in stylish furniture at a low cost) additional sources of differentiation while charging the same price or to provide the same service with the same sources of differentiation at a lower price. Second, a company competing on an industry-wide basis may decide that the market segment served by the firm using a focus strategy is attractive and worthy of competitive pursuit. For example, women’s clothiers such as Chico’s, Ann Taylor, and Liz Claiborne might conclude that the profit potential in the narrow segment being served by Anne Fontaine is attractive and decide to design and sell competitively similar clothing items. Initially, Anne Fontaine designed and sold only white shirts for women. However, the shirts were distinctive. They were quite differentiated on the basis of their design, craftsmanship, and high quality of raw materials. The third risk involved with a focus strategy is that the needs of customers within a narrow competitive segment may become more similar to those of industry-wide customers as a whole over time. As a result, the advantages of a focus strategy are either reduced or eliminated. At some point, for example, the needs of Anne Fontaine’s customers for high-quality, uniquely designed white shirts could dissipate. If this were to happen, Anne Fontaine’s customers might choose to buy white shirts from chains such as Liz Claiborne that sell clothing items with some differentiation, but at a lower cost.

**Integrated Cost Leadership/Differentiation Strategy**

Most consumers have high expectations when purchasing a good or service. In general, it seems that most consumers want to pay a low price for products with somewhat highly differentiated features. Because of these customer expectations, a number of firms engage in primary value chain activities and support functions that allow them to simultaneously pursue low cost and differentiation. Firms seeking to do this use the **integrated cost leadership/differentiation strategy**. The objective of using this strategy is to efficiently produce products with some differentiated features. Efficient production is the source of maintaining low costs while differentiation is the source of creating unique value. Firms that successfully use the integrated cost leadership/differentiation strategy usually adapt quickly to new technologies and rapid changes in their external environments. Simultaneously concentrating on developing two sources of competitive advantage (cost and differentiation) increases the number of primary and support activities in which the firm must become competent. Such firms often have strong networks with external parties that perform some of the primary and support activities. In turn, having skills in a larger number of activities makes a firm more flexible.

Concentrating on the needs of its core customer group (higher-income, fashion-conscious discount shoppers), Target Stores uses an integrated cost leadership/differentiation strategy as shown by its “Expect More. Pay Less” brand promise. Target’s annual report describes this strategy: “Our enduring ‘Expect More. Pay Less’ brand promise helped us to deliver greater convenience, increased savings and a more personalized shopping experience.” In 2010, Target remodeled 341 stores and provided a greater assortment of merchandise to include more grocery items and innovative products. It added more privately branded products to offer lower prices, created new mobile applications, and introduced distinctive Web strategies to continue to differentiate the services provided to customers.
European-based Zara, which pioneered “cheap chic” in clothing apparel, is another firm using the integrated cost leadership/differentiation strategy. Zara offers current and desirable fashion goods at relatively low prices. To implement this strategy effectively requires sophisticated designers and means of managing costs, which fits Zara’s capabilities. Zara can design and begin manufacturing a new fashion in three weeks, which suggests a highly flexible organization that can adapt easily to changes in the market or with competitors.109

Li Ning was an Olympic Gold medalist for China in the 1980s. In 1991, he started the Li Ning Company, which manufactures and markets sportswear. Early in the twenty-first century, the company experienced significant growth and became the number two company in China’s sportswear market behind market leader Nike. It took over the number two position from Adidas. The company has achieved its growth and success by selling cheaper sportswear products in the smaller cities in China. Nike and Adidas are the leaders in the larger city markets, but Li Ning has done well, with more than 7,900 stores in China at the end of 2010, a 9.2 percent increase over 2009. Its total revenues have grown to $1.2 billion, an increase of more than 400 percent since 2005.

However, Li Ning is not satisfied with this position. It has taken several actions to capture greater market share and to compete in different market segments. It has enhanced its investment in R&D and is developing upscale products to compete with Nike and Adidas. However, these products will still be priced 15 to 20 percent below their Nike and Adidas products. The company is always working on building its brand name to allow it to compete in these markets as well. In addition, Li Ning has recently moved into the U.S. market, where it will face significant competition from other brand name sportswear companies. Its goal is to have 20 percent of its total revenue from sales in international markets by 2018. It is targeting its products for professional athletes and ordinary consumers. In the United States, Li Ning’s products are sold through the Champs Sports and Eastbay units of Foot Locker. Li Ning has signed endorsement deals with NBA star Shaquille O’Neal and the second pick in the 2010 NBA Draft, Evan Turner.

Although Li Ning is seemingly taking the right actions to capture new market share, it faces substantial competition in the United States and even in China. For example, both Nike and Adidas plan to expand the sales of their products in the smaller Chinese cities, the bedrock of Li Ning’s business in China. In addition, it will be exceptionally challenging to capture U.S. market share from companies such as Nike, as they are embedded in those markets. Perhaps it can do so by providing quality products at cheaper prices.

Flexibility is required for firms to complete primary value chain activities and support functions in ways that allow them to use the integrated cost leadership/differentiation strategy in order to produce somewhat differentiated products at relatively low costs. Chinese auto manufacturers have developed a means of product design that provides a flexible architecture that allows low-cost manufacturing but also car designs that are differentiated from competitors. Flexible manufacturing systems, information networks, and total quality management systems are three sources of flexibility that are particularly useful for firms trying to balance the objectives of continuous cost reductions and continuous enhancements to sources of differentiation as called for by the integrated strategy.

The Li Ning Company is implementing an integrated cost leadership/differentiated strategy. The company entered the market and grew large using a cost leadership strategy. It is now seeking to enter the upscale markets in China, in which it will compete with Nike and Adidas. It is also entering the U.S. market, in which it will compete against both of these firms and other brand-name sportswear producers. Thus, it will encounter significant challenges. In fact, it may end up “stuck in the middle” and not compete effectively in any markets. Perhaps its opportunity is to provide high-quality brand-name goods for a lower price than its “upscale” competitors.

**Flexible Manufacturing Systems**

A flexible manufacturing system (FMS) increases the “flexibilities of human, physical, and information resources” that the firm integrates to create relatively differentiated products at relatively low costs. A significant technological advance, FMS is a computer-controlled process used to produce a variety of products in moderate, flexible quantities with a minimum of manual intervention. Often the flexibility is derived from modularization of the manufacturing process (and sometimes other value chain activities as well). The goal of an FMS is to eliminate the “low cost versus product variety” trade-off that is inherent in traditional manufacturing technologies. Firms use an FMS to change quickly and easily from making one product to making another. Used properly, an FMS allows the firm to respond more effectively to changes in its customers’ needs, while retaining low-cost advantages and consistent product quality. Because an FMS also enables the firm to reduce the lot size needed to manufacture a product efficiently, the firm’s capacity to serve the unique needs of a narrow competitive scope is higher. In industries of all types, effective mixes of the firm’s tangible assets (e.g., machines) and intangible assets (e.g., people’s skills) facilitate implementation of complex competitive strategies, especially the integrated cost leadership/differentiation strategy.

**Information Networks**

By linking companies with their suppliers, distributors, and customers, information networks provide another source of flexibility. These networks, when used effectively, help the firm satisfy customer expectations in terms of product quality and delivery speed. Earlier, we discussed the importance of managing the firm’s relationships with its customers in order to understand their needs. Customer relationship management (CRM) is one form of an information-based network process that firms use for this purpose. An effective CRM system provides a 360-degree view of the company’s relationship with customers, encompassing all contact points, business processes, and communication media and sales channels. The firm can then use this information to determine the trade-offs its customers are willing to make between differentiated features and low cost—an assessment that is vital for companies using the integrated cost leadership/differentiation strategy. Such systems help firms to monitor their markets and stakeholders and allow them to better predict future scenarios. This capability helps firms to adjust their strategies to be better prepared for the future. Thus, to make comprehensive strategic decisions with effective knowledge of the organization’s context, good information flow is essential. Better quality managerial decisions require accurate information on the firm’s environment.
Total Quality Management Systems

Total quality management (TQM) is a managerial process that emphasizes an organization’s commitment to the customer and to continuous improvement of all processes through problem-solving approaches based on empowerment of employees. Firms develop and use TQM systems to (1) increase customer satisfaction, (2) cut costs, and (3) reduce the amount of time required to introduce innovative products to the marketplace.

Firms able to simultaneously reduce costs while enhancing their ability to develop innovative products increase their flexibility, an outcome that is particularly helpful to firms implementing the integrated cost leadership/differentiation strategy. Exceeding customers’ expectations regarding quality is a differentiating feature, and eliminating process inefficiencies to cut costs allows the firm to offer that quality to customers at a relatively low price. Thus, an effective TQM system helps the firm develop the flexibility needed to identify opportunities to simultaneously increase differentiation and reduce costs. Yet, TQM systems are available to all competitors. So they may help firms maintain competitive parity, but rarely alone will they lead to a competitive advantage.

Competitive Risks of the Integrated Cost Leadership/Differentiation Strategy

The potential to earn above-average returns by successfully using the integrated cost leadership/differentiation strategy is appealing. However, it is a risky strategy, because firms find it difficult to perform primary value chain activities and support functions in ways that allow them to produce relatively inexpensive products with levels of differentiation that create value for the target customer. Moreover, to properly use this strategy across time, firms must be able to simultaneously reduce costs incurred to produce products (as required by the cost leadership strategy) while increasing products’ differentiation (as required by the differentiation strategy).

Firms that fail to perform the primary and support activities in an optimum manner become “stuck in the middle.” Being stuck in the middle means that the firm’s cost structure is not low enough to allow it to attractively price its products and that its products are not sufficiently differentiated to create value for the target customer. These firms will not earn above-average returns and will earn average returns only when the structure of the industry in which it competes is highly favorable. Thus, companies implementing the integrated cost leadership/differentiation strategy must be able to produce products that offer the target customer some differentiated features at a relatively low cost/price.

Firms can also become stuck in the middle when they fail to successfully implement either the cost leadership or the differentiation strategy. In other words, industry-wide competitors too can become stuck in the middle. Trying to use the integrated strategy is costly in that firms must pursue both low costs and differentiation. This is the challenge for the Li Ning Company. If it can offer high-quality goods desired by consumers at lower prices, however, it may be able to capture market share from the leaders, such as Nike.

Firms may need to form alliances with other firms to achieve differentiation, yet alliance partners may extract prices for the use of their resources that make it difficult to meaningfully reduce costs. Firms may be motivated to make acquisitions to maintain their differentiation through innovation or to add products to their portfolio not offered by competitors. Research suggests that firms using “pure strategies,” either cost leadership or differentiation, often outperform firms attempting to use a “hybrid strategy” (i.e., integrated cost leadership/differentiation strategy). This research suggests the risky nature of using an integrated strategy. However, the integrated strategy is becoming more common and perhaps necessary in many industries because of technological advances and global competition. This strategy often requires a long-term perspective to make it work effectively, and therefore requires dedicated owners that allow the implementation of a long-term strategy that can require several years to produce positive returns.
SUMMARY

A business-level strategy is an integrated and coordinated set of commitments and actions the firm uses to gain a competitive advantage by exploiting core competencies in specific product markets. Five business-level strategies (cost leadership, differentiation, focused cost leadership, focused differentiation, and integrated cost leadership/differentiation) are examined in the chapter.

Customers are the foundation of successful business-level strategies. When considering customers, a firm simultaneously examines three issues: who, what, and how. These issues, respectively, refer to the customer groups to be served, the needs those customers have that the firm seeks to satisfy, and the core competencies the firm will use to satisfy customers’ needs. Increasing segmentation of markets throughout the global economy creates opportunities for firms to identify more distinctive customer needs they can serve with one of the business-level strategies.

Firms seeking competitive advantage through the cost leadership strategy produce no-frills, standardized products for an industry’s typical customer. However, these low-cost products must be offered with competitive levels of differentiation. Above-average returns are earned when firms continuously emphasize efficiency such that their costs are lower than those of their competitors, while providing customers with products that have acceptable levels of differentiated features.

Competitive risks associated with the cost leadership strategy include (1) a loss of competitive advantage to newer technologies, (2) a failure to detect changes in customers’ needs, and (3) the ability of competitors to imitate the cost leader’s competitive advantage through their own distinct strategic actions.

Through the differentiation strategy, firms provide customers with products that have different (and valued) features. Differentiated products must be sold at a cost that customers believe is competitive relative to the product’s features as compared to the cost/feature combinations available from competitors’ goods. Because of their distinctiveness, differentiated goods or services are sold at a premium price. Products can be differentiated on any dimension that some customer group values. Firms using this strategy seek to differentiate their products from competitors’ goods or services on as many dimensions as possible. The less similarity to competitors’ products, the more buffered a firm is from competition with its rivals.

Risks associated with the differentiation strategy include (1) a customer group’s decision that the differences between the differentiated product and the cost leader’s goods or services are no longer worth a premium price, (2) the inability of a differentiated product to create the type of value for which customers are willing to pay a premium price, (3) the ability of competitors to provide customers with products that have features similar to those of the differentiated product, but at a lower cost, and (4) the threat of counterfeiting, whereby firms produce a cheap imitation of a differentiated good or service.

Through the cost leadership and the differentiated focus strategies, firms serve the needs of a narrow competitive segment (e.g., a buyer group, product segment, or geographic area). This strategy is successful when firms have the core competencies required to provide value to a specialized market segment that exceeds the value available from firms serving customers on an industry-wide basis.

The competitive risks of focus strategies include (1) a competitor’s ability to use its core competencies to “outfocus” the focuser by serving an even more narrowly defined market segment, (2) decisions by industry-wide competitors to focus on a customer group’s specialized needs, and (3) a reduction in differences of the needs between customers in a narrow market segment and the industry-wide market.

Firms using the integrated cost leadership/differentiation strategy strive to provide customers with relatively low-cost products that also have valued differentiated features. Flexibility is required for firms to learn how to use primary value chain activities and support functions in ways that allow them to produce differentiated products at relatively low costs. The primary risk of this strategy is that a firm might produce products that do not offer sufficient value in terms of either low cost or differentiation. In such cases, the company becomes “stuck in the middle.” Firms stuck in the middle compete at a disadvantage and are unable to earn more than average returns.

REVIEW QUESTIONS

1. What is a business-level strategy?
2. What is the relationship between a firm’s customers and its business-level strategy in terms of who, what, and how? Why is this relationship important?
3. What are the differences among the cost leadership, differentiation, focused cost leadership, focused differentiation, and integrated cost leadership/differentiation business-level strategies?
4. How can each one of the business-level strategies be used to position the firm relative to the five forces of competition in a way that helps the firm earn above-average returns?
5. What are the specific risks associated with using each business-level strategy?
EXPERIENTIAL EXERCISES

EXERCISE 1: MARKET SEGMENTATION THROUGH BRANDING
The "who" in a firm’s target market is an extremely important decision. As discussed in the chapter, firms divide customers into groups based upon differences in customer needs, which is the heart of market segmentation. For example, if you owned a restaurant and your target market was college-aged students, your strategy would be very different than if your target market was business professionals.

In this exercise, your team will be identifying market segmentation strategies used by various companies. Remember that market segmentation “is a process used to cluster people with similar needs into individual and identifiable groups.”

Part One
Your team should select an advertised and prominent brand. You may choose a business or consumer product. However, you should choose a brand widely known and widely advertised. Once you have chosen the brand, find and collect at least four instances of this brand being advertised in print or digital media. Find your four or more instances from different publications, if possible.

Part Two
Assemble a poster with the images you collected from your research. Be prepared to present your findings to the class as regards:
1. Why did you choose this brand?
2. Review each of the criteria discussed in Table 4.1 for either your consumer market or industrial market.

EXERCISE 2: CREATE A BUSINESS-LEVEL STRATEGY
This assignment brings together elements from the previous chapters. Accordingly, you and your team will create a business-level strategy for a firm of your own creation. The instructor will assign you an industry from which you will create a strategy for entering that industry using one of the five potential business-level strategies.

Each team is assigned one of the business-level strategies described in the chapter:
- Cost leadership
- Differentiation
- Focused cost leadership
- Focused differentiation
- Integrated cost leadership/differentiation

Part One
Research your industry and describe the general environment and the industry. Using the dimensions of the general environment, identify some factors for each dimension that are influential for your industry. Next, describe the industry environment using the Five Forces model. Database services like Mint Global, Datamonitor, or IBIS World can be helpful in this regard. If those are not available to you, consult your local librarian for assistance. You should be able to clearly articulate the opportunities and the threats that exist.

Part Two
Create a poster the business-level strategy assigned to your team. Be prepared to describe the following:
- Mission statement
- Description of your target customer
- Picture of your business. Where is it located (downtown, suburb, rural, etc.)?
- Describe trends that provide opportunities and threats for your intended strategy.
- List the resources, both tangible and intangible, required to compete successfully in this market.
- How will you go about creating a sustainable competitive advantage?

VIDEO CASE

DIFFERENTIATION STRATEGY IN TOUGH ECONOMIC TIMES
Howard Schultz/CEO/Starbucks
Starbucks, 17,000 stores strong worldwide, offers 70,000 different ways to order coffee. Unfortunately, Starbucks has announced the closing of 900 underperforming stores in the United States and will cut more than 1,000 jobs. Howard Schultz, Starbucks CEO, admits that Starbucks may have grown too big too fast given today’s economy, and a business plan was not in place for the severity of the economic downturn. During this time, competitors like Dunkin Donuts are offering an upgraded coffee experience at a lower cost. However, Schultz maintains that Starbucks will not cut corners but will reduce waste to save the company more than $400 million and continue to sell more than a cup of coffee.

Be prepared to discuss the following concepts and questions in class:

Concepts
- Business-level strategy
- Managing relationship with customers
- Market segmentation
- Differentiation strategy
- Five forces of competition
Questions

1. Describe Starbucks' business-level strategy.
2. How is Starbucks managing its relationship with customers?
3. How would you describe the market segment(s) that Starbucks serves?
4. Is the differentiation strategy appropriate for Starbucks, now or in the future? Why or why not?
5. Using the five forces model of competition, how should Starbucks plan to position itself in these economic times?

NOTES

49. Porter, What is strategy?
52. Porter, What is strategy?, 62.
79. Chapter 4: Business-Level Strategy
small-to medium sized firms, Strategic Entrepreneurship Journal, 5: 81–100.


100. Ibid., 15–16.


111. R. Sanchez, 1995, Strategic flexibility in product competition, Strategic Management Journal, 16 (Special Issue): 140.


123. A. Keramati & A. Albadvi, 2009, Exploring the relationship between use of information technology in total quality management

125. Ibid., 17.


Studying this chapter should provide you with the strategic management knowledge needed to:

1. Define corporate-level strategy and discuss its purpose.
2. Describe different levels of diversification with different corporate-level strategies.
3. Explain three primary reasons firms diversify.
4. Describe how firms can create value by using a related diversification strategy.
5. Explain the two ways value can be created with an unrelated diversification strategy.
6. Discuss the incentives and resources that encourage diversification.
7. Describe motives that can encourage managers to overdiversify a firm.
GENERAL ELECTRIC: THE QUINTESSENTIAL DIVERSIFIED FIRM

It would almost be easier to list the industries in which General Electric (GE) does not compete than to list those in which it sells products. GE competes in 16 different industries: appliances, aviation, consumer electronics, electrical distribution, energy, entertainment, finance, gas, health care, lighting, locomotives, oil, software, water, weapons, and wind turbines. As one can see from this list, these industries are quite diverse. Yet, there are similarities among several of them. In fact, GE’s businesses are grouped in four divisions: GE Capital, GE Energy, GE Technology Infrastructure, and GE Home & Business Solutions. In recent years, more than 50 percent of GE’s annual revenue has come from its financial services businesses. Thus, it could be labeled a services company with a strong industrial component. In 2011 (based on 2010 data), GE was ranked the sixth largest corporation in the Fortune 500. It is the only company that was listed in the initial Dow Jones Industrial Average in 1896 that remains on it today. For the last 119 years, GE has achieved an average annual increase in its stock value of 5.8 percent.

These data suggest that GE has an impressive history and has experienced a significant amount of success. It is one of the few widely diversified firms to achieve such success. GE is a highly influential global corporation. Its CEO, Jeffrey Immelt, was selected by President Obama to chair an advisory group on economic and job creation concerns. However, GE has experienced some “bumps in the road” along the way. This is to be expected because it is difficult to manage a large, widely diversified set of businesses.

For example, it has been criticized for its control over media it owns, such as NBC. GE has restricted NBC reporters from reporting on certain content that is critical of GE. Additionally, in the past GE was criticized for the poor environmental records of some of its businesses. Finally, it had reductions in stock value during the first decade of the twenty-first century.

GE has bounced back from these problems. It has worked hard to overcome and correct its environmental problems. Today, it is a major player in the “clean energy” industry, such as wind turbines and solar power. GE is also beginning to experience strong growth from its investments in emerging economies such China and Brazil. In both of these countries, GE has made major business investments working with local partners and has developed R&D centers as well. A common strategy to achieve growth (and diversification) for GE over the years has been mergers and acquisitions. For example, in 2011, GE acquired a French company, Converteam, for $3.2 billion. This company will provide support equipment for GE’s wind turbine business. In 2010 and in the first few months of 2011, GE spent more than $11 billion on acquisitions to add to its repertoire of energy businesses.
Our discussions of business-level strategies (Chapter 4) and the competitive rivalry and competitive dynamics associated with them (Chapter 5) have concentrated on firms competing in a single industry or product market. In this chapter, we introduce you to corporate-level strategies, which are strategies firms use to diversify their operations from a single business competing in a single market into several product markets—most commonly, into several businesses. Thus, a corporate-level strategy specifies actions a firm takes to gain a competitive advantage by selecting and managing a group of different businesses competing in different product markets. Corporate-level strategies help companies to select new strategic positions—positions that are expected to increase the firm’s value. As explained in the Opening Case, General Electric competes in 16 widely diverse industries.

As is the case with GE, firms use corporate-level strategies as a means to grow revenues and profits, but there can be different strategic intents in addition to growth. Firms can pursue defensive or offensive strategies that realize growth but have different strategic intents. Firms can also pursue market development by moving into different geographic markets (this approach will be discussed in Chapter 8). Firms can acquire competitors (horizontal integration) or buy a supplier or customer (vertical integration). These strategies will be discussed in Chapter 7. The basic corporate strategy, the topic of this chapter, focuses on diversification.

The decision to take actions to pursue growth is never a risk-free choice for firms. Indeed, as the Opening Case explored, GE experienced difficulty in its media businesses, especially NBC, and its environmental record suffered. In one case, it tried to control NBC too much, trying to protect the firm. In so doing, it created questions about the objectivity of NBC’s reporting. Its environmental record likely suffered because of the lack of adequate oversight and the strong interest in producing returns for the shareholders. Effective firms carefully evaluate their growth options (including the different corporate-level strategies) before committing firm resources to any of them.

Because the diversified firm operates in several different and unique product markets and likely in several businesses, it forms two types of strategies: corporate-level (or company-wide) and business-level (or competitive). Corporate-level strategy is concerned with two key issues: in what product markets and businesses the firm should compete and how corporate headquarters should manage those businesses. For the diversified corporation, a business-level strategy (see Chapter 4) must be selected for each of the businesses in which the firm has decided to compete. In this regard, each of GE’s product divisions uses different business-level strategies; while most focus on differentiation, its consumer electronics business has products that compete in market niches to include some that are intended to serve the average income consumer. Thus, cost must also be an issue along with some level of quality.

As is the case with a business-level strategy, a corporate-level strategy is expected to help the firm earn above-average returns by creating value. Some suggest that few corporate-level strategies actually create value. As the Opening Case indicates, realizing value through a corporate strategy can be achieved but it is challenging to do so. In fact, GE is one of the few widely diversified and large firms that has been successful over time.

Evidence suggests that a corporate-level strategy’s value is ultimately determined by the degree to which “the businesses in the portfolio are worth more under the management of the company than they would be under any other ownership.” Thus, an effective corporate-level strategy creates, across all of a firm’s businesses, aggregate returns that exceed what those returns would be without the strategy and contributes to the firm’s strategic competitiveness and its ability to earn above-average returns.

Product diversification, a primary form of corporate-level strategies, concerns the scope of the markets and industries in which the firm competes as well as “how managers buy, create and sell different businesses to match skills and strengths with opportunities presented to the firm.” Successful diversification is expected to reduce variability in the firm’s profitability as earnings are generated from different businesses. Diversification can also provide firms with the flexibility to shift their investments to markets where the greatest returns are possible rather than being dependent on only one or a few markets. Because firms incur development and monitoring costs when diversifying, the ideal portfolio of businesses balances diversification’s costs and benefits. CEOs and their top-management teams are responsible for determining the best portfolio for their company.

We begin this chapter by examining different levels of diversification (from low to high). After describing the different reasons firms diversify their operations, we focus on two types of related diversification (related diversification signifies a moderate to high level of diversification for the firm). When properly used, these strategies help create value in the diversified firm, either through the sharing of resources (the related constrained strategy) or the transferring of core competencies across the firm’s different businesses (the related linked strategy). We then discuss unrelated diversification, which is another corporate-level strategy that can create value. The chapter then shifts to the topic of incentives and resources that may stimulate diversification which is value neutral. However, managerial motives to diversify, the final topic in the chapter, can actually destroy some of the firm’s value.

Levels of Diversification

Diversified firms vary according to their level of diversification and the connections between and among their businesses. Figure 6.1 lists and defines five categories of businesses according to increasing levels of diversification. The single- and dominant-business categories denote relatively low levels of diversification; more fully diversified firms are classified into related and unrelated categories. A firm is related through its diversification when its businesses share several links; for example, businesses may share products (goods or services), technologies, or distribution channels. The more links among businesses, the more “constrained” is the relatedness of diversification. “Unrelated” refers to the absence of direct links between businesses.

Low Levels of Diversification

A firm pursuing a low level of diversification uses either a single- or a dominant-business, corporate-level diversification strategy. A single-business diversification strategy is a corporate-level strategy wherein the firm generates 95 percent or more of its sales revenue from its core business area. For example, Wm. Wrigley Jr. Company, the world’s largest producer of chewing and bubble gums, historically used a single-business strategy while operating in relatively few product markets. Wrigley’s trademark chewing gum brands include Spearmint, Doublemint, and Juicy Fruit, although the firm produces other products as well. Sugar-free Extra, which currently holds the largest share of the U.S. chewing gum market, was introduced in 1984.
In 2005, Wrigley shifted from its traditional focused strategy when it acquired the confectionary assets of Kraft Foods Inc., including the well-known brands Life Savers and Altoids. As Wrigley expanded, it may have intended to use the dominant-business strategy with the diversification of its product lines beyond gum; however, Wrigley was acquired in 2008 by Mars, a privately held global confection company (the maker of Snickers and M&Ms).\(^\text{16}\)

With the dominant-business diversification strategy, the firm generates between 70 and 95 percent of its total revenue within a single business area. United Parcel Service (UPS) uses this strategy. Recently UPS generated 60 percent of its revenue from its U.S. package delivery business and 22 percent from its international package business, with the remaining 18 percent coming from the firm’s non-package business.\(^\text{17}\) Though the U.S. package delivery business currently generates the largest percentage of UPS’s sales revenue, the firm anticipates that in the future its other two businesses will account for the majority of revenue growth. This expectation suggests that UPS may become more diversified, both in terms of its goods and services and in the number of countries in which those goods and services are offered.

Firms that focus on one or very few businesses and markets can earn positive returns, because they develop capabilities useful for these markets and can provide superior service to their customers. Additionally, there are fewer challenges in managing one or a very small set of businesses, allowing them to gain economies of scale and efficiently use their resources.\(^\text{18}\) Family-owned and controlled businesses are commonly less diversified. They prefer the focus because the family’s reputation is related closely to that of the business. Thus, family members prefer to provide quality goods and services which a focused strategy better allows.\(^\text{19}\)
Chapter 6: Corporate-Level Strategy

The Publicis Groupe uses a related constrained diversified strategy with three major groups of businesses, each in a highly related but unique market area: advertising, media, and digital. Publicis is the third largest communications company in the world. It is a leader in digital communications, the second largest global media business, and the global leader in digital operations. Furthermore, it is the world leader in health care communications. Publicis’s financial performance in 2010 outpaced analysts’ expectations. It achieved an organic growth rate of 8.3 percent in revenues over 2009, and an increase in its profits of 31 percent.

Publicis invested early in digital technology and in emerging markets. Both decisions are paying off today. The digital revolution has changed advertising. In fact, digital technology now allows the customization of a message to a specific customer (or customer type) at a specific point in time. This is significantly different from ads targeted for a mass audience. Publicis Digital business provides the tools for use by its advertising businesses, thereby sharing resources and capabilities. Because emerging economies are largely driving the economic growth globally, Publicis plans to increase its investments and business in the largest emerging markets such as China and Brazil. In fact, the firm expects that revenues from these high-growth regions will represent 30 percent of the firm’s total revenues in the near future.

In support of its continuing related diversification efforts, in 2011 Publicis developed a new performance marketing agency called Performics France. It will also launch this service internationally. The agency offers the Publicis Webformance toolkit to companies, allowing them to make the most effective use of online advertising, e-commerce, and mobile communications. The agency helps firms learn how to best use Google and Facebook platforms. This agency will especially target small and medium-sized businesses.

An example of the value being created at Publicis is shown by the fact that General Motors shifted its advertising account for Chevrolet from a firm that had it for 96 years to Publicis in late 2010. This change represented a major coup for Publicis. The firm’s strong global presence, especially in China, a market of considerable importance to GM, and its strong digital capabilities helped Publicis win the account. The future looks to be bright, indeed, for Publicis.

Moderate and High Levels of Diversification

A firm generating more than 30 percent of its revenue outside a dominant business and whose businesses are related to each other in some manner uses a related diversification corporate-level strategy. When the links between the diversified firm’s businesses are rather direct, a related constrained diversification strategy is being used. Campbell Soup, Procter & Gamble, and Merck & Company all use a related constrained strategy, as do some large cable companies. With a related constrained strategy, a firm shares resources and activities between its businesses.

Clearly, the Publicis Groupe uses a related constrained strategy, deriving value from the potential synergy across its various groups, especially the digital capabilities in its advertising business. Given its recent performance, the related constrained strategy has created value for Publicis customers and its shareholders.

The diversified company with a portfolio of businesses that have only a few links between them is called a mixed related and unrelated firm and is using the related linked diversification strategy (see Figure 6.1). As displayed in the Opening Case, GE uses this corporate-level diversification strategy. Compared with related constrained firms, related linked firms share fewer resources and assets between their businesses, concentrating instead on transferring knowledge and core competencies between the businesses. GE has four strategic business units (see Chapter 11 for a definition of SBU’s) it calls “divisions,” each composed of related businesses. There are no relationships among the strategic business units, only within them. As with firms using each type of diversification strategy, companies implementing the related linked strategy constantly adjust the mix in their portfolio of businesses as well as make decisions about how to manage these businesses. Managing a diversified firm such as GE is highly challenging, but GE appears to have been well managed over the years given its success.

A highly diversified firm that has no relationships between its businesses follows an unrelated diversification strategy. United Technologies, Textron, Samsung, and Hutchison Whampoa Limited (HWL) are examples of firms using this type of corporate-level strategy. Commonly, firms using this strategy are called conglomerates. HWL is a leading international corporation with five businesses: ports and related services; property and hotels; retail; energy, infrastructure, investments and others; and telecommunications. These businesses are not related to each other, and the firm makes no efforts to share activities or to transfer core competencies between or among them. Each of these five businesses is quite large; for example, the retailing arm of the retail and manufacturing business has more than 9,300 stores in 33 countries. Groceries, cosmetics, electronics, wine, and airline tickets are some of the product categories featured in these stores. This firm’s size and diversity suggest the challenge of successfully managing the unrelated diversification strategy. However, Hutchison’s CEO Li Ka-shing has been successful at not only making smart acquisitions, but also at divesting businesses with good timing.

Reasons for Diversification

A firm uses a corporate-level diversification strategy for a variety of reasons (see Table 6.1). Typically, a diversification strategy is used to increase the firm’s value by improving its overall performance. Value is created either through related diversification or through unrelated diversification when the strategy allows a company’s businesses to increase revenues or reduce costs while implementing their business-level strategies.

Other reasons for using a diversification strategy may have nothing to do with increasing the firm’s value; in fact, diversification can have neutral effects or even reduce
Chapter 6: Corporate-Level Strategy

A firm’s value. Value-neutral reasons for diversification include a desire to match and thereby neutralize a competitor’s market power (such as to neutralize another firm’s advantage by acquiring a similar distribution outlet). Decisions to expand a firm’s portfolio of businesses to reduce managerial risk can have a negative effect on the firm’s value. Greater amounts of diversification reduce managerial risk in that if one of the businesses in a diversified firm fails, the top executive of that business does not risk total failure by the corporation. As such, this reduces the top executives’ employment risk.

In addition, because diversification can increase a firm’s size and thus managerial compensation, managers have motives to diversify a firm to a level that reduces its value. 22 Diversification rationales that may have a neutral or negative effect on the firm’s value are discussed later in the chapter.

Operational relatedness and corporate relatedness are two ways diversification strategies can create value (see Figure 6.2). Studies of these independent relatedness dimensions show the importance of resources and key competencies. 23 The figure’s vertical dimension depicts opportunities to share operational activities between businesses (operational relatedness) while the horizontal dimension suggests opportunities for transferring corporate-level core competencies (corporate relatedness). The firm with a strong capability in managing operational synergy, especially in sharing assets between its businesses, falls in the upper left quadrant, which also represents vertical sharing of assets through vertical integration. The lower right quadrant represents a highly developed corporate capability for transferring one or more core competencies across businesses.

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<th>Table 6.1 Reasons for Diversification</th>
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<td><strong>Value-Creating Diversification</strong></td>
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<tr>
<td>■ Economies of scope (related diversification)</td>
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<td>• Sharing activities</td>
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<td>• Transferring core competencies</td>
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<td>■ Market power (related diversification)</td>
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<td>• Blocking competitors through multipoint competition</td>
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<td>■ Financial economies (unrelated diversification)</td>
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<td>• Efficient internal capital allocation</td>
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<td>• Business restructuring</td>
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<td><strong>Value-Neutral Diversification</strong></td>
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This capability is located primarily in the corporate headquarters office. Unrelated diversification is also illustrated in Figure 6.2 in the lower left quadrant. Financial economies (discussed later), rather than either operational or corporate relatedness, are the source of value creation for firms using the unrelated diversification strategy.

### Value-Creating Diversification: Related Constrained and Related Linked Diversification

With the related diversification corporate-level strategy, the firm builds upon or extends its resources and capabilities to build a competitive advantage by creating value for customers. The company using the related diversification strategy wants to develop and exploit economies of scope between its businesses. Available to companies operating in multiple product markets or industries, economies of scope are cost savings that the firm creates by successfully sharing some of its resources and capabilities or transferring one or more corporate-level core competencies that were developed in one of its businesses to another of its businesses.
As illustrated in Figure 6.2, firms seek to create value from economies of scope through two basic kinds of operational economies: sharing activities (operational relatedness) and transferring corporate-level core competencies (corporate relatedness). The difference between sharing activities and transferring competencies is based on how separate resources are jointly used to create economies of scope. To create economies of scope tangible resources, such as plant and equipment or other business-unit physical assets, often must be shared. Less tangible resources, such as manufacturing know-how and technological capabilities, can also be shared. However, know-how transferred between separate activities with no physical or tangible resource involved is a transfer of a corporate-level core competence, not an operational sharing of activities.

**Operational Relatedness: Sharing Activities**

Firms can create operational relatedness by sharing either a primary activity (such as inventory delivery systems) or a support activity (such as purchasing practices)—see Chapter 3’s discussion of the value chain. Firms using the related constrained diversification strategy share activities in order to create value. Procter & Gamble (P&G) uses this corporate-level strategy. P&G’s paper towel business and baby diaper business both use paper products as a primary input to the manufacturing process. The firm’s paper production plant produces inputs for both businesses and is an example of a shared activity. In addition, because they both produce consumer products, these two businesses are likely to share distribution channels and sales networks.

Activity sharing is also risky because ties among a firm’s businesses create links between outcomes. For instance, if demand for one business’s product is reduced, it may not generate sufficient revenues to cover the fixed costs required to operate the shared facilities. These types of organizational difficulties can reduce activity-sharing success. Additionally, activity sharing requires careful coordination between the businesses involved. The coordination challenges must be managed effectively for the appropriate sharing of activities.

Although activity sharing across businesses is not risk-free, research shows that it can create value. For example, studies of acquisitions of firms in the same industry (horizontal acquisitions), such as the banking industry and software, found that sharing resources and activities and thereby creating economies of scope contributed to post-acquisition increases in performance and higher returns to shareholders. Additionally, firms that sold off related units in which resource sharing was a possible source of economies of scope have been found to produce lower returns than those that sold off businesses unrelated to the firm’s core business. Still other research discovered that firms with closely related businesses have lower risk. These results suggest that gaining economies of scope by sharing activities across a firm’s businesses may be important in reducing risk and in creating value. Further, more attractive results are obtained through activity sharing when a strong corporate headquarters office facilitates it.

**Corporate Relatedness: Transferring of Core Competencies**

Over time, the firm’s intangible resources, such as its know-how, become the foundation of core competencies. Corporate-level core competencies are complex sets of resources and capabilities that link different businesses, primarily through managerial and technological knowledge, experience, and expertise. Firms seeking to create value through corporate relatedness use the related linked diversification strategy as exemplified by GE.

In at least two ways, the related linked diversification strategy helps firms to create value. First, because the expense of developing a core competence has already been incurred in one of the firm’s businesses, transferring this competence to a second...
business eliminates the need for that business to allocate resources to develop it. Such is the case at Hewlett-Packard (HP), where the firm transferred its competence in ink printers to high-end copiers. Rather than the standard laser printing technology in most high-end copiers, HP is using ink-based technology. One manager liked the product because, as he noted, “We are able to do a lot better quality at less price.” This capability gives HP the opportunity to sell more ink products and create higher profit margins.

Resource intangibility is a second source of value creation through corporate relatedness. Intangible resources are difficult for competitors to understand and imitate. Because of this difficulty, the unit receiving a transferred corporate-level competence often gains an immediate competitive advantage over its rivals.

A number of firms have successfully transferred one or more corporate-level core competencies across their businesses. Virgin Group Ltd. transfers its marketing core competence across airlines, cosmetics, music, drinks, mobile phones, health clubs, and a number of other businesses. Honda has developed and transferred its competence in engine design and manufacturing among its businesses making products such as motorcycles, lawnmowers, and cars and trucks. Company officials state that Honda is a major manufacturer of engines and is focused on providing products for all forms of human mobility.

One way managers facilitate the transfer of corporate-level core competencies is by moving key people into new management positions. However, the manager of an older business may be reluctant to transfer key people who have accumulated knowledge and experience critical to the business’s success. Thus, managers with the ability to facilitate the transfer of a core competence may come at a premium, or the key people involved may not want to transfer. Additionally, the top-level managers from the transferring business may not want the competencies transferred to a new business to fulfill the firm’s diversification objectives. Research also suggests too much dependence on outsourcing can lower the usefulness of core competencies and thereby reduce their useful transferability to other business units in the diversified firm.

**Market Power**

Firms using a related diversification strategy may gain market power when successfully using a related constrained or related linked strategy. Market power exists when a firm is able to sell its products above the existing competitive level or to reduce the costs of its primary and support activities below the competitive level, or both. Mars’ acquisition of the Wrigley assets was part of its related constrained diversification strategy and added market share to the Mars/Wrigley integrated firm, as it realized 14.4 percent of the market share. This catapulted Mars/Wrigley above Cadbury and Nestlé, which had 10.1 and 7.7 percent of the market share, respectively, at the time and left Hershey with only 5.5 percent of the market.

In addition to efforts to gain scale as a means of increasing market power, as Mars did when it acquired Wrigley, firms can create market power through multipoint competition and vertical integration. Multipoint competition exists when two or more diversified firms simultaneously compete in the same product areas or geographical markets. UPS and FedEx in two markets, overnight delivery and ground shipping, illustrate multipoint competition. UPS has moved into overnight delivery, FedEx’s stronghold; FedEx has been buying trucking and
ground shipping assets to move into ground shipping, UPS’s stronghold. Moreover, geographic competition for markets increases. The strongest shipping company in Europe is DHL. All three competitors (UPS, FedEx, and DHL) are moving into large foreign markets to either gain a stake or to expand their existing share. If one of these firms successfully gains strong positions in several markets while competing against its rivals, its market power may increase. Interestingly, DHL had to exit the U.S. market because it was too difficult to compete against UPS and FedEx, which are dominant in the United States.

Some firms using a related diversification strategy engage in vertical integration to gain market power. **Vertical integration** exists when a company produces its own inputs (backward integration) or owns its own source of output distribution (forward integration). In some instances, firms partially integrate their operations, producing and selling their products by using company businesses as well as outside sources. 46

Vertical integration is commonly used in the firm’s core business to gain market power over rivals. Market power is gained as the firm develops the ability to save on its operations, avoid market costs, improve product quality, possibly protect its technology from imitation by rivals, and potentially exploit underlying capabilities to handle special resources (e.g., sophisticated chemicals or technologies). 47 Market power also is created when firms have strong ties between their assets for which no market prices exist. Establishing a market price would result in high search and transaction costs, so firms seek to vertically integrate rather than remain separate businesses. 48

Vertical integration has its limitations. For example, an outside supplier may produce the product at a lower cost. As a result, internal transactions from vertical integration may be expensive and reduce profitability relative to competitors. 49 Also, bureaucratic costs can be present with vertical integration. 50 Because vertical integration can require substantial investments in specific technologies, it may reduce the firm’s flexibility, especially when technology changes quickly. Finally, changes in demand create capacity balance and coordination problems. If one business is building a part for another internal business but achieving economies of scale requires the first division to manufacture quantities that are beyond the capacity of the internal buyer to absorb, it would be necessary to sell the parts outside the firm as well as to the internal business. Thus, although vertical integration can create value, especially through market power over competitors, it is not without risks and costs. 51

As noted in the Strategic Focus, Google is diversifying into new markets that allow it to engage in multipoint competition. For example, Google is competing with Microsoft and Apple now in several markets. All of its competitors know that Google is a formidable rival with significant resources to invest in the competition. As such, the competitors have reacted, some with substantive actions and others in less positive ways. For example, Apple acquired Siri, a small voice search firm, to help it compete with Google’s search business. 52 As noted in the Strategic Focus, Microsoft filed a complaint with the EU about potential antitrust violations by Google. Yahoo! has undertaken advertising that criticizes Google, and Facebook hired a public relations firm to plant negative stories in the press about Google. 53 Some of Google’s diversification moves represent a form of vertical integration because the new business areas build on the company’s substantial search business (forward integration).

Although Google appears to be increasing its vertical integration, many manufacturing firms have been reducing vertical integration as a means of gaining market power. 54 In fact, deintegration is the focus of most manufacturing firms, such as Intel and Dell, and even some large auto companies, such as Ford and General Motors, as they develop independent supplier networks. 55 Flextronics, an electronics contract manufacturer, represents a new breed of large contract manufacturers that is helping to foster this revolution in supply-chain management. 56 Such firms often manage their customers’ entire product lines and offer services ranging from inventory management to delivery and after-sales service.
Google dominates the Internet search engine business and as a result has substantial market power. In fact, approximately 96 percent of its current annual revenue is derived from advertising on this medium. In fact, given Google’s search engine advertising 2010 revenue of $29.32 billion, a considerable amount of revenue comes from Google’s (approximately $29.15 billion in 2010). Google also has significant cash reserves and invests heavily in R&D. For example, its R&D expenditures in 2010 were approximately 12.6 percent of revenues, a considerable amount especially for a service firm. At the end of 2010, Google also had about $35 billion in cash holdings. The R&D and cash provide opportunities for the firm to diversify into new markets, which is an obvious goal. In fact, in recent times, Google has been diversifying partly through acquisitions (using its cash reserves) and through internal development (e.g., R&D).

In fact, Google is diversifying in several ways that extend the services it provides. Commonly, the services are partly related to the current ones offered, but some under consideration could lead the firm toward a related link type of diversification strategy. Some of the new services create multipoint competition with prominent competitors (e.g., Microsoft, Facebook), and some appear to represent a form of vertical integration. For example, Google is developing a subscription service for publishers and consumers that will represent a “plug and play.” Google managers are negotiating with the National Basketball Association, movie studios, and celebrities for features on its video platform. Google appears to be developing YouTube to operate like a network in that it presents a variety of topics such as entertainment, news and politics, and sports.

Because of Google’s new market entries in recent years, it has “locked horns” with such substantial competitors as Microsoft (e.g., office software, browsers, smartphones, Internet access, and e-mail), Apple (e.g., search services, smartphones), Netflix (movie distribution), Yahoo! and AOL (media sites, news), and Facebook (social media). All of these competitors watch Google’s moves closely and often react with moves of their own. Microsoft has perhaps been the most vocal and engaged in the strongest responses. In fact, Microsoft filed a complaint with the EU claiming that Google violated antitrust laws/regulations. Of course, such reactions by Microsoft are interesting in that it has itself been the target of claims that the firm engaged in anticompetitive practices.

Google recently increased its competition with Apple by introducing mobile applications run on devices powered by its Android software. Consumers can install the mobile apps through an Internet browser instead of on their devices. Google is also reportedly developing its own “Groupon knockoff” in which special deals (coupons) are offered to customers for local businesses products. This competes with Groupon but also eBay and Amazon to a degree.

Google is a competitor that even huge and resourceful corporations have learned to respect and fear.

Simultaneous Operational Relatedness and Corporate Relatedness

As Figure 6.2 suggests, some firms simultaneously seek operational and corporate relatedness to create economies of scope. The ability to simultaneously create economies of scope by sharing activities (operational relatedness) and transferring core competencies (corporate relatedness) is difficult for competitors to understand and learn how to imitate. However, if the cost of realizing both types of relatedness is not offset by the benefits created, the result is diseconomies because the cost of organization and incentive structure is very expensive.

Walt Disney Co. uses a related diversification strategy to simultaneously create economies of scope through operational and corporate relatedness. Within the firm’s Studio Entertainment business, for example, Disney can gain economies of scope by sharing activities among its different movie distribution companies such as Touchstone Pictures, Hollywood Pictures, and Dimension Films. Broad and deep knowledge about its customers is a capability on which Disney relies to develop corporate-level core competencies in terms of advertising and marketing. With these competencies, Disney is able to create economies of scope through corporate relatedness as it cross-sells products that are highlighted in its movies through the distribution channels that are part of its Parks and Resorts and Consumer Products businesses. Thus, characters created in movies become figures that are marketed through Disney’s retail stores (which are part of the Consumer Products business). In addition, themes established in movies become the source of new rides in the firm’s theme parks, which are part of the Parks and Resorts business and provide themes for clothing and other retail business products.

Thus, Walt Disney Co. has been able to successfully use related diversification as a corporate-level strategy through which it creates economies of scope by sharing some activities and by transferring core competencies. However, it can be difficult for investors to actually observe the value created by a firm (such as Walt Disney Co.) as it shares activities and transfers core competencies. For this reason, the value of the assets of a firm using a diversification strategy to create economies of scope often is discounted by investors.

Unrelated Diversification

Firms do not seek either operational relatedness or corporate relatedness when using the unrelated diversification corporate-level strategy. An unrelated diversification strategy (see Figure 6.2) can create value through two types of financial economies. Financial economies are cost savings realized through improved allocations of financial resources based on investments inside or outside the firm.

Efficient internal capital allocations can lead to financial economies. Efficient internal capital allocations reduce risk among the firm’s businesses—for example, by leading to the development of a portfolio of businesses with different risk profiles. The second type of financial economy concerns the restructuring of acquired assets. Here, the diversified firm buys another company, restructures that company’s assets in ways that allow it to operate more profitably, and then sells the company for a profit in the external market.

Next, we discuss the two types of financial economies in greater detail.

Efficient Internal Capital Market Allocation

In a market economy, capital markets are thought to efficiently allocate capital. Efficiency results as investors take equity positions (ownership) with high expected future cashflow values. Capital is also allocated through debt as shareholders and debt holders try to improve the value of their investments by taking stakes in businesses with high growth and profitability prospects.
In large diversified firms, the corporate headquarters office distributes capital to its businesses to create value for the overall corporation. The nature of these distributions may generate gains from internal capital market allocations that exceed the gains that would accrue to shareholders as a result of capital being allocated by the external capital market. Because those in a firm’s corporate headquarters generally have access to detailed and accurate information regarding the actual and prospective performance of the company’s portfolio of businesses, they have the best information to make capital distribution decisions.

Compared with corporate office personnel, external investors have relatively limited access to internal information and can only estimate the performances of individual businesses as well as their future prospects. Moreover, although businesses seeking capital must provide information to potential suppliers (such as banks or insurance companies), firms with internal capital markets may have at least two informational advantages. First, information provided to capital markets through annual reports and other sources may not include negative information, instead emphasizing positive prospects and outcomes. External sources of capital have limited ability to understand the operational dynamics of large organizations. Even external shareholders who have access to information have no guarantee of full and complete disclosure. Second, although a firm must disseminate information, that information also becomes simultaneously available to the firm’s current and potential competitors. With insights gained by studying such information, competitors might attempt to duplicate a firm’s value-creating strategy. Thus, an ability to efficiently allocate capital through an internal market may help the firm protect the competitive advantages it develops while using its corporate-level strategy as well as its various business-unit-level strategies.

If intervention from outside the firm is required to make corrections to capital allocations, only significant changes are possible, such as forcing the firm into bankruptcy or changing the top management team. Alternatively, in an internal capital market, the corporate headquarters office can fine-tune its corrections, such as choosing to adjust managerial incentives or suggesting strategic changes in one of the firm’s businesses. Thus, capital can be allocated according to more specific criteria than is possible with external market allocations. Because it has less accurate information, the external capital market may fail to allocate resources adequately to high-potential investments. The corporate headquarters office of a diversified company can more effectively perform such tasks as disciplining underperforming management teams through resource allocations. GE (discussed in the Opening Case) has done an exceptionally good job of allocating capital across its many businesses. Although a related linked firm, it differentially allocates capital across its four major strategic business units. GE Capital has produced the greatest returns for GE over the last few decades (until the latest financial crisis) and thus has received a healthy amount of capital from internal allocations.

Large, highly diversified businesses often face what is known as the “conglomerate discount.” This discount results from analysts not knowing how to value a vast array of large businesses with complex financial reports. To overcome this discount, many unrelated diversified or industrial conglomerates have sought to establish a brand for the parent company. For instance, United Technologies initiated a brand development approach with the slogan “United Technologies. You can see everything from here.” United Technologies suggested that its earnings multiple (PE ratio) compared to its stock price is only average even though its performance has been better than other conglomerates in its group. It is hoping that the “umbrella” brand advertisement will raise its PE to a level comparable to its competitors. In another attempt to sway investors on the value of a large diversified company, United Technologies CEO Louis Chenevert stated that “... our future success depends on our ability to innovate—to find new and better ways to serve our customers. And, our ability to innovate relies on our ability to leverage the power of diverse inputs.”
In spite of the challenges associated with it, a number of corporations continue to use the unrelated diversification strategy, especially in Europe and in emerging markets. Siemens, for example, is a large German conglomerate with a highly diversified approach. Its former CEO argued that “When you are in an up-cycle and the capital markets have plenty of opportunities to invest in single-industry companies … investors savor those opportunities. But when things change pure plays go down faster than you can look.”68 In economic downturns, diversification can help some companies improve future performance.69

The Achilles’ heel for firms using the unrelated diversification strategy in a developed economy is that competitors can imitate financial economies more easily than they can replicate the value gained from the economies of scope developed through operational relatedness and corporate relatedness. This issue is less of a problem in emerging economies, where the absence of a “soft infrastructure” (including effective financial intermediaries, sound regulations, and contract laws) supports and encourages use of the unrelated diversification strategy.70 In fact, in emerging economies such as those in Korea, India, and Chile, research has shown that diversification increases the performance of firms affiliated with large diversified business groups.71

**Restructuring of Assets**

Financial economies can also be created when firms learn how to create value by buying, restructuring, and then selling the restructured companies’ assets in the external market.72 As in the real estate business, buying assets at low prices, restructuring them, and selling them at a price that exceeds their cost generates a positive return on the firm’s invested capital.

Unrelated diversified companies that pursue this strategy try to create financial economies by acquiring and restructuring other companies’ assets but it involves significant trade-offs. For example, Danaher’s success requires a focus on mature manufacturing businesses because of the uncertainty of demand for high-technology products.73 In high-technology businesses, resource allocation decisions are highly complex, often creating information-processing overload on the small corporate headquarters offices that are common in unrelated diversified firms. High-technology businesses are often human-resource dependent; these people can leave or demand higher pay and thus appropriate or deplete the value of an acquired firm.74

Buying and then restructuring service-based assets so they can be profitably sold in the external market is also difficult. Sales in such instances are often a product of close personal relationships between a client and the representative of the firm being restructured. Thus, for both high-technology firms and service-based companies, relatively few tangible assets can be restructured to create value and sell profitably. It is difficult to restructure intangible assets such as human capital and effective relationships that have evolved over time between buyers (customers) and sellers (firm personnel). Care must be taken in an economic downturn to restructure and buy and sell at appropriate times. A downturn can present opportunities but also some risks. Ideally, executives will follow a strategy of buying businesses when prices are lower, such as in the midst of a recession, and selling them at late stages in an expansion.75
Value-Neutral Diversification: Incentives and Resources

The objectives firms seek when using related diversification and unrelated diversification strategies all have the potential to help the firm create value by using a corporate-level strategy. However, these strategies, as well as single- and dominant-business diversification strategies, are sometimes used with value-neutral rather than value-creating objectives in mind. As we discuss next, different incentives to diversify sometimes exist, and the quality of the firm’s resources may permit only diversification that is value neutral rather than value creating.

Incentives to Diversify

Incentives to diversify come from both the external environment and a firm’s internal environment. External incentives include antitrust regulations and tax laws. Internal incentives include low performance, uncertain future cash flows, and the pursuit of synergy and reduction of risk for the firm.

Antitrust Regulation and Tax Laws

Government antitrust policies and tax laws provided incentives for U.S. firms to diversify in the 1960s and 1970s. Antitrust laws prohibiting mergers that created increased market power (via either vertical or horizontal integration) were stringently enforced during that period. Merger activity that produced conglomerate diversification was encouraged primarily by the Celler-Kefauver Antimerger Act (1950), which discouraged horizontal and vertical mergers. As a result, many of the mergers during the 1960s and 1970s were “conglomerate” in character, involving companies pursuing different lines of business. Between 1973 and 1977, 79.1 percent of all mergers were conglomerate in nature.

During the 1980s, antitrust enforcement lessened, resulting in more and larger horizontal mergers (acquisitions of target firms in the same line of business, such as a merger between two oil companies). In addition, investment bankers became more open to the kinds of mergers facilitated by regulation changes; as a consequence, takeovers increased to unprecedented numbers. The conglomerates, or highly diversified firms, of the 1960s and 1970s became more “focused” in the 1980s and early 1990s as merger constraints were relaxed and restructuring was implemented.

In the late 1990s and early 2000s, antitrust concerns emerged again with the large volume of mergers and acquisitions (see Chapter 7). Mergers are now receiving more scrutiny than they did in the 1980s and through the early 1990s.

The tax effects of diversification stem not only from corporate tax changes, but also from individual tax rates. Some companies (especially mature ones) generate more cash from their operations than they can reinvest profitably. Some argue that free cash flows (liquid financial assets for which investments in current businesses are no longer economically viable) should be redistributed to shareholders as dividends. However, in the 1960s and 1970s, dividends were taxed more heavily than were capital gains. As a result, before 1980, shareholders preferred that firms use free cash flows to buy and build companies in high-performance industries. If the firm’s stock value appreciated over the long term, shareholders might receive a better return on those funds than if the funds had been redistributed as dividends, because returns from stock sales would be taxed more lightly than would dividends.

Under the 1986 Tax Reform Act, however, the top individual ordinary income tax rate was reduced from 50 to 28 percent, and the special capital gains tax was changed to treat capital gains as ordinary income. These changes created an incentive for shareholders to stop encouraging firms to retain funds for purposes of diversification. These tax law changes also influenced an increase in divestitures of unrelated business units.
after 1984. Thus, while individual tax rates for capital gains and dividends created a shareholder incentive to increase diversification before 1986, they encouraged lower diversification after 1986, unless it was funded by tax-deductible debt. The elimination of personal interest deductions, as well as the lower attractiveness of retained earnings to shareholders, could prompt the use of more leverage by firms (interest expenses charged to firms are tax deductible).

Corporate tax laws also affect diversification. Acquisitions typically increase a firm’s depreciable asset allowances. Increased depreciation (a non-cash-flow expense) produces lower taxable income, thereby providing an additional incentive for acquisitions. Before 1986, acquisitions may have been the most attractive means for securing tax benefits, but the 1986 Tax Reform Act diminished some of the corporate tax advantages of diversification. More recent changes recommended by the Financial Accounting Standards Board eliminated the “pooling of interests” method to account for the acquired firm’s assets and it also eliminated the write-off for research and development in process, and thus reduced some of the incentives to make acquisitions, especially acquisitions in related high-technology industries (these changes are discussed further in Chapter 7).

Although federal regulations were partially loosened in the 1980s and then retightened in the late 1990s, a number of industries experienced increased merger activity due to industry-specific deregulation, including banking, telecommunications, oil and gas, and electric utilities. For instance, in banking the Garns–St. Germain Deposit Institutions Act of 1982 (GDIA) and the Competitive Equality Banking Act of 1987 (CEBA) reshaped the acquisition frequency in banking by relaxing the regulations that limited interstate bank acquisitions. Regulation changes have also affected convergence between media and telecommunications industries, which has allowed a number of mergers, such as the successive Time Warner and AOL mergers. The Federal Communications Commission (FCC) made a highly contested ruling “allowing broadcasters to own TV stations that reach 45 percent of U.S. households (up from 35 percent), own three stations in the largest markets (up from two), and own a TV station and newspaper in the same town.”

Thus, regulatory changes such as the ones we have described create incentives or disincentives for diversification. Interestingly, European antitrust laws have historically been more strict regarding horizontal mergers than those in the United States, but more recently have become similar.

Low Performance
Some research shows that low returns are related to greater levels of diversification. If “high performance eliminates the need for greater diversification,” then low performance may provide an incentive for diversification. In 2005, eBay acquired Skype for $3.1 billion in hopes that it would create synergies and improve communication between buyers and sellers. However, within three years, eBay decided to sell Skype because it has failed to increase cash flow for its core e-commerce business and the expected synergies were not realized. In 2011, eBay sold Skype to Microsoft for $8.5 billion. Although analysts thought the premium paid by Microsoft may have been too high, one review in the Financial Times suggested that Skype could play a prominent role in Microsoft’s multimedia strategy. Thus, the potential synergies between Skype and Microsoft may be greater than those with eBay. The poor performance may be because of errors made by top managers (such as eBay’s original acquisition of Skype), and thus lead to divestitures similar to eBay’s action.

Research evidence and the experience of a number of firms suggest that an overall curvilinear relationship, as illustrated in Figure 6.3, may exist between diversification and performance. Although low performance can be an incentive to diversify, firms that are more broadly diversified compared to their competitors may have overall lower performance.
Uncertain Future Cash Flows

As a firm’s product line matures or is threatened, diversification may be an important defensive strategy. Smaller firms and companies in mature or maturing industries sometimes find it necessary to diversify for long-term survival. For example, music retailers began to diversify as CD sales started to decline. By the end of 2009, CD sales had declined by about 50 percent from their peak. Best Buy started to sell musical instruments in 2008 in response to the decline in CD sales. The musical instrument industry accumulated sales revenues of $5.9 billion in 2009. Best Buy continues to sell music CDs but adds other products to make up for the loss in revenue from CDs.

Diversifying into other product markets or into other businesses can reduce the uncertainty about a firm’s future cash flows. Merck decided to expand into the biosimilars business (production of drugs that are similar to approved drugs) in hopes of stimulating its prescription drug business due to lower expected results as many of its drug patents expire. Thus, in 2009 it purchased Insmed’s portfolio of follow-on biologics for $130 million. It will carry out the development of biologics that prevent infections in cancer patients receiving chemotherapy. One such drug, INS-19, is in late-stage trials, while INS-20 is in early-stage development.

Synergy and Firm Risk Reduction

Diversified firms pursuing economies of scope often have investments that are too inflexible to realize synergy between business units. As a result, a number of problems may arise. Synergy exists when the value created by business units working together exceeds the value that those same units create working independently. But as a firm increases its relatedness between business units, it also increases its risk of corporate failure, because synergy produces joint interdependence between businesses that constrains the firm’s flexibility to respond. This threat may force two basic decisions.

First, the firm may reduce its level of technological change by operating in environments that are more certain. This behavior may make the firm risk averse and thus uninterested in pursuing new product lines that have potential but are not proven.
Alternatively, the firm may constrain its level of activity sharing and forgo potential benefits of synergy. Either or both decisions may lead to further diversification. The former likely leads to related diversification into industries in which more certainty exists. The latter may produce additional, but unrelated, diversification. Research suggests that a firm using a related diversification strategy is more careful in bidding for new businesses, whereas a firm pursuing an unrelated diversification strategy may be more likely to overprice its bid, because an unrelated bidder is less likely to have full information about the acquired firm. However, firms using either a related or an unrelated diversification strategy must understand the consequences of paying large premiums. In the situation with eBay, former CEO Meg Whitman received heavy criticism for paying such a high price for Skype, especially when the firm did not realize the synergies it was seeking. Alternatively, it sold Skype six years later at 175 percent of the price at which eBay purchased the business. The question now is whether Microsoft paid too high a premium to achieve positive returns from the acquisition of Skype.

**Resources and Diversification**

As already discussed, firms may have several value-neutral incentives as well as value-creating incentives (such as the ability to create economies of scope) to diversify. However, even when incentives to diversify exist, a firm must have the types and levels of resources and capabilities needed to successfully use a corporate-level diversification strategy. Although both tangible and intangible resources facilitate diversification, they vary in their ability to create value. Indeed, the degree to which resources are valuable, rare, difficult to imitate, and nonsubstitutable (see Chapter 3) influences a firm’s ability to create value through diversification. For instance, free cash flows are a tangible financial resource that may be used to diversify the firm. However, compared with diversification that is grounded in intangible resources, diversification based on financial resources only is more visible to competitors and thus more imitable and less likely to create value on a long-term basis. Tangible resources usually include the plant and equipment necessary to produce a product and tend to be less-flexible assets. Any excess capacity often can be used only for closely related products, especially those requiring highly similar manufacturing technologies. For example, large computer makers such as Dell and Hewlett-Packard have underestimated the demand for tablet computers, especially Apple’s iPad. Apple developed the iPad and may expect it to eventually replace the personal computer (PC). In fact, H-P’s and Dell’s sales of their PCs have been declining since the introduction of the iPad. Apple expects to sell 70 million iPads in 2011 and analysts project sales of the iPad to reach 246 million in 2014. HP and Dell likely need to diversify their product lines.

Excess capacity of other tangible resources, such as a sales force, can be used to diversify more easily. Again, excess capacity in a sales force is more effective with related diversification, because it may be utilized to sell similar products. The sales force would be more knowledgeable about related-product characteristics, customers, and distribution channels. Tangible resources may create resource interrelationships in production, marketing, procurement, and technology, defined earlier as activity sharing. Intangible resources are more flexible than tangible physical assets in facilitating diversification. Although the sharing of tangible resources may induce diversification, intangible resources such as tacit knowledge could encourage even more diversification.

Sometimes, however, the benefits expected from using resources to diversify the firm for either value-creating or value-neutral reasons are not gained. For example, Sara Lee executives found that they could not realize synergy between elements of its diversified portfolio, and subsequently shed businesses accounting for 40 percent of company revenue to focus on food and food-related products and more readily achieve synergy.
Value-Reducing Diversification: Managerial Motives to Diversify

Managerial motives to diversify can exist independent of value-neutral reasons (i.e., incentives and resources) and value-creating reasons (e.g., economies of scope). The desire for increased compensation and reduced managerial risk are two motives for top-level executives to diversify their firm beyond value-creating and value-neutral levels. In slightly different words, top-level executives may diversify a firm in order to diversify their own employment risk, as long as profitability does not suffer excessively.

Diversification provides additional benefits to top-level managers that shareholders do not enjoy. Research evidence shows that diversification and firm size are highly correlated, and as firm size increases, so does executive compensation. Because large firms are complex, difficult-to-manage organizations, top-level managers commonly receive substantial levels of compensation to lead them. Greater levels of diversification can increase a firm’s complexity, resulting in still more compensation for executives to lead an increasingly diversified organization. Governance mechanisms, such as the board of directors, monitoring by owners, executive compensation practices, and the market for corporate control, may limit managerial tendencies to overdiversify. These mechanisms are discussed in more detail in Chapter 10.

In some instances, though, a firm’s governance mechanisms may not be strong, resulting in a situation in which executives may diversify the firm to the point that it fails to earn even average returns. The loss of adequate internal governance may result in poor relative performance, thereby triggering a threat of takeover. Although takeovers may improve efficiency by replacing ineffective managerial teams, managers may avoid takeovers through defensive tactics, such as “poison pills,” or may reduce their own exposure with “golden parachute” agreements. Therefore, an external governance threat, although restraining managers, does not flawlessly control managerial motives for diversification.

Most large publicly held firms are profitable because the managers leading them are positive stewards of firm resources, and many of their strategic actions, including those related to selecting a corporate-level diversification strategy, contribute to the firm’s success. As mentioned, governance mechanisms should be designed to deal with exceptions to the managerial norms of making decisions and taking actions that will increase the firm’s ability to earn above-average returns. Thus, it is overly pessimistic to assume that managers usually act in their own self-interest as opposed to their firm’s interest.

Top-level executives’ diversification decisions may also be held in check by concerns for their reputation. If a positive reputation facilitates development and use of managerial power, a poor reputation may reduce it. Likewise, a strong external market for managerial talent may deter managers from pursuing inappropriate diversification. In addition, a diversified firm may police other firms by acquiring those that are poorly managed in order to restructure its own asset base. Knowing that their firms could be acquired if they are not managed successfully encourages executives to use value-creating, diversification strategies.

As shown in Figure 6.4, the level of diversification that can be expected to have the greatest positive effect on performance is based partly on how the interaction of resources, managerial motives, and incentives affects the adoption of particular diversification strategies. As indicated earlier, the greater the incentives and the more flexible the resources, the higher the level of expected diversification. Financial resources (the most flexible) should have a stronger relationship to the extent of diversification than either tangible or intangible resources. Tangible resources (the most inflexible) are useful primarily for related diversification.
As discussed in this chapter, firms can create more value by effectively using diversification strategies. However, diversification must be kept in check by corporate governance (see Chapter 10). Appropriate strategy implementation tools, such as organizational structures, are also important (see Chapter 11).

We have described corporate-level strategies in this chapter. In the next chapter, we discuss mergers and acquisitions as prominent means for firms to diversify and to grow profitably. These trends toward more diversification through acquisitions, which have been partially reversed due to restructuring (see Chapter 7), indicate that learning has taken place regarding corporate-level diversification strategies. Accordingly, firms that diversify should do so cautiously, choosing to focus on relatively few, rather than many, businesses. In fact, research suggests that although unrelated diversification has decreased, related diversification has increased, possibly due to the restructuring that continued into the 1990s and early twenty-first century. This sequence of diversification followed by restructuring is now taking place in Europe and other places such as Korea, mirroring actions of firms in the United States and the United Kingdom. Firms can improve their strategic competitiveness when they pursue a level of diversification that is appropriate for their resources (especially financial resources) and core competencies and the opportunities and threats in their country’s institutional and competitive environments.

Figure 6.4 Summary Model of the Relationship between Diversification and Firm Performance

SUMMARY

The primary reason a firm uses a corporate-level strategy to become more diversified is to create additional value. Using a single- or dominant-business corporate-level strategy may be preferable to seeking a more diversified strategy, unless a corporation can develop economies of scope or financial economies between businesses, or unless it can obtain market power through additional levels of diversification. Economies of scope and market power are the main sources of value creation when the firm diversifies by using a corporate-level strategy with moderate to high levels of diversification.

The related diversification corporate-level strategy helps the firm create value by sharing activities or transferring competencies between different businesses in the company’s portfolio.

Sharing activities usually involves sharing tangible resources between businesses. Transferring core competencies involves transferring core competencies developed in one business to another business. It also may involve transferring competencies between the corporate headquarters office and a business unit.

Sharing activities is usually associated with the related constrained diversification corporate-level strategy. Activity sharing is costly to implement and coordinate, may create unequal benefits for the divisions involved in the sharing, and can lead to fewer managerial risk-taking behaviors.

Transferring core competencies is often associated with related linked (or mixed related and unrelated) diversification, although firms pursuing both sharing activities and transferring core competencies can also use the related linked strategy.

Efficiently allocating resources or restructuring a target firm’s assets and placing them under rigorous financial controls are two ways to accomplish successful unrelated diversification. Firms using the unrelated diversification strategy focus on creating financial economies to generate value.

Diversification is sometimes pursued for value-neutral reasons. Incentives from tax and antitrust government policies, performance disappointments, or uncertainties about future cash flow are examples of value-neutral reasons that firms may choose to become more diversified.

Managerial motives to diversify (including to increase compensation) can lead to overdiversification and a subsequent reduction in a firm’s ability to create value. Evidence suggests, however, that many top-level executives seek to be good stewards of the firm’s assets and avoid diversifying the firm in ways that destroy value.

Managers need to pay attention to their firm’s internal organization and its external environment when making decisions about the optimum level of diversification for their company. Of course, internal resources are important determinants of the direction that diversification should take. However, conditions in the firm’s external environment may facilitate additional levels of diversification, as might unexpected threats from competitors.

REVIEW QUESTIONS

1. What is corporate-level strategy and why is it important?
2. What are the different levels of diversification firms can pursue by using different corporate-level strategies?
3. What are three reasons firms choose to diversify their operations?
4. How do firms create value when using a related diversification strategy?
5. What are the two ways to obtain financial economies when using an unrelated diversification strategy?
6. What incentives and resources encourage diversification?
7. What motives might encourage managers to overdiversify their firm?

EXPERIENTIAL EXERCISES

EXERCISE 1: WHAT’S MY CORPORATE-LEVEL STRATEGY AND HOW DID I GET THIS WAY?

Your text defines corporate-level strategy as “actions a firm takes to gain a competitive advantage by selecting and managing a group of different businesses competing in different product markets.” However, these actions are dynamic and longitudinal—they evolve over time. How did General Electric or Ford Motor Company or IBM arrive at the corporate-level strategies they use today, and what are those strategies?

Part One

Form teams of four or five students and select a publicly traded firm, preferably one that has been in existence for a few decades. A comprehensive listing of all U.S. publicly traded firms may be found at the Investor Guide Web site (http://www.investorguide.com/stocklist.php) as well as links to each firm’s homepage and other financial data. You will also want to access the firm’s SEC filings, which could be available at your library or through the Securities and Exchange Commission’s Web site at http://www.sec.gov/edgar.shtml.
Part Two
Complete a poster that can be displayed in class. Your poster should represent the firm and its evolution as far back in its history as you can get on one poster. The goal is to highlight the firm’s beginnings, its acquisitions and divestiture activity, and its movement from one corporate-level strategy to another. You will need to do some extensive research on the firm to identify common linkages between operating units.

Be prepared to answer the following questions:

- How has the firm’s corporate-level strategy evolved over time?
- What is the current corporate-level strategy and what links, if any, exist between operating units?
- Critique the current corporate-level strategy (e.g., too much diversification, too little, just right, and why).

Exercise 2: How Does the Firm’s Portfolio Stack Up?
The Boston Consulting Group (BCG) product portfolio matrix has been around for decades and was introduced by the BCG as a way for firms to understand the priorities that should be given to various segments within their mix of businesses. It is based on a matrix with two vertices: firm market share and projected market growth rate:

Each firm therefore can categorize its business units as follows:

- Stars: High growth and high market share. These business units generate large amounts of cash but also use large amounts of cash. These are often the focus of the firm’s priorities as this segment has a potentially bright future.
- Cash cows: Low market growth coupled with high market share. Profits and cash generated are high, need for new cash is low. Provides a foundation for the firm from which it can launch new initiatives.
- Dogs: Low market growth and low market share. This is usually a situation the firms seek to avoid. These units are quite often the target of a turnaround plan or liquidation effort.
- Question marks: High market growth but low market share. It is difficult to say what the firm should do in this quadrant and creates a need to move strategically because of high demands on cash due to market needs yet low cash returns because of the low firm market share.

Using this matrix to analyze a firm’s corporate-level strategy or the way in which it rewards and prioritizes its business units has come under some criticism. For one, market share is not the only way in which a firm should view success or potential success; second, market growth is not the only indicator for the attractiveness of a market; and third, sometimes “dogs” can earn as much cash as “cows.”

Part One
Select a publicly traded firm that has a diversified corporate-level strategy. The more unrelated the segments, the better.

Part Two
Analyze the firm utilizing the BCG matrix. In order to do this, you will need to develop market share ratings for each operating unit and assess the overall market attractiveness for that segment.
THE ROAD TO DIVERSIFICATION
Barry Diller/Senior Executive/IAC

Barry Diller, once the chairman and CEO of Paramount Pictures and Fox and intrigued by interactive commerce, purchased QVC only to lose it in other business acquisition attempts, particularly his bid to purchase Paramount. Losing the bid to own Paramount as well as other organizations, Barry Diller purchased QVC competitor HSN and began an interactive conglomerate from financial services to matchmaking services such as match.com. Along the way, Diller discovered that his many businesses related to one another and united all his brands under one corporate headquarters. Barry Diller, driven by vision and the ability to grasp new and difficult concepts, insists that IAC/InterActiveCorp is a brand-by-brand endless multiproduct company similar to Procter & Gamble.

Be prepared to discuss the following concepts and questions in class:

CONCEPTS
- Corporate-level strategy
- Levels of diversification
- Value-creating diversification
- Operational and corporate relatedness
- Related and unrelated diversification
- Motivations to overdiversify

QUESTIONS
1. Describe Diller's corporate-level strategy.
2. Describe IAC's level of diversification.
3. What do you think was Diller's reason to diversify?
4. Is Diller's approach value-creating diversification? Why or why not?
5. Explain how IAC businesses and brands are related. Do they have related diversification?
6. Is Diller in a position to overdiversify?

NOTES
16. P. Gogol, N. Amidt, & J. Crown, 2008, A bittersweet deal for Wrigley: Selling the family business wasn’t William Wrigley Jr.’s plan, but the Mars offer was too good to refuse, BusinessWeek, May 12, 34.


61. Porter, *Competitive Advantage*.


Studying this chapter should provide you with the strategic management knowledge needed to:

1. Explain the popularity of merger and acquisition strategies in firms competing in the global economy.
2. Discuss reasons why firms use an acquisition strategy to achieve strategic competitiveness.
3. Describe seven problems that work against achieving success when using an acquisition strategy.
4. Name and describe the attributes of effective acquisitions.
5. Define the restructuring strategy and distinguish among its common forms.
6. Explain the short- and long-term outcomes of the different types of restructuring strategies.
When Microsoft announced that it would acquire Skype Global S.à.r.l., the leading Internet telecommunications company, for $8.5 billion, there were both positive and negative attributions about the deal in the media. Using Skype telecommunication software, family, friends, and colleagues can call free with messaging, voice, and video services. Additionally, at a very low cost, they can call landlines or mobiles virtually worldwide. Skype also recently introduced group videos, allowing groups of more than two to communicate more effectively whenever they are apart.

Skype has an interesting history. It was purchased by eBay in September 2005 as a way to bolster its Internet auction site through better communications. However, the service did not function as strategically designed, and in November 2009 eBay sold the service in a spin-off to an investment group led by Silver Lake, a private equity firm. During the 18 months of Silver Lake’s leadership, calling minutes increased by 150 percent and there was significant growth in the overall number of users. Silver Lake recruited an outstanding senior management team who facilitated this growth.

Skype was founded in 2003 and based in Luxembourg. Because it was founded and headquartered outside the United States, Microsoft was able to use cash that was not repatriated into the United States to pay for the deal. In so doing, it avoided paying U.S. income tax. Those who have complained about the price that Microsoft paid suggest that they should have done it earlier because eBay sold 18 months ago for just $2.75 billion to Silver Lake. However, under its new leadership, Skype gained 145 million new customers per month. As such, the $8.5 billion represents a cost of $14.70 per customer. Comparatively, when Skype was bought by eBay in 2005, eBay paid $45.60 per user. Although Skype’s acquisition price went up, its price per user has gone down relative to its previous purchase. Previously, Microsoft invested in Facebook when it had only 100 million users, which worked out to $1.50 per user, at an overall price of $15 billion. The view is positive about Microsoft’s investment in Facebook. Comparatively, Microsoft paid less than eBay for Skype, and its eBay investment also seems very favorable.

Whether Microsoft will be able to utilize the service and integrate it into its focus on business customers relative to the consumer focus of Skype remains to be seen. The second challenge is whether Microsoft will be able to incorporate the Skype service into its various devices and software platforms. A high priority will be to integrate Skype with Windows for smartphones. This is an effort to compete with Apple’s iPhone and Google’s Android operating systems. There is also a defensive rationale: “If Microsoft did not buy Skype it may end up in the hands of a competitor such as Google who might be able to use it to strengthen its ecosystem at the expense of Microsoft.”
Google also has been pursuing an acquisition strategy, although Google’s approach is usually to acquire earlier-stage companies than Microsoft’s deal to acquire Skype. Google purchased YouTube for $1.6 billion in 2006, just 20 months after YouTube’s founders registered the YouTube.com domain name. Its monthly audience has mushroomed from 344 to 500 million unique users. Much of their efforts have translated into “more and more money.” In another acquisition, Google paid $3.2 billion for DoubleClick, Inc. With DoubleClick, Google’s goal was to move from search advertising to the much larger market of display ads. DoubleClick’s expertise was in producing graphical ads that appear on tops and sides of Web pages. After the acquisition of DoubleClick, Google’s stock price soared. Its display ad sales brought in $2.5 billion annually as of October 2010. Additionally, although Google had offered $4 billion for Groupon, which produces daily promotion ads in large communities around the world, its offer was rejected. Groupon is considering an initial public offering (IPO) instead.

Facebook has a somewhat different approach to acquisitions. It recently bought Snaptu. Snaptu provides application software for services such as Facebook, Twitter, and LinkedIn, which allows these services to be featured on phones. Facebook has made 11 acquisitions since 2007; however, almost none of the acquired companies’ services have survived as independent businesses. Their Web sites are often shut down, and the human capital, the employees and software engineers, become Facebook employees. Because Facebook is not a publicly traded company, it is difficult to tell how well these acquired companies have been integrated into Facebook. It is apparent, though, that the employees are utilized to improve Facebook’s capabilities and develop new businesses. Online social networks, such as Facebook, have caused Procter & Gamble (P&G) to reallocate their advertising resources away from television and to more digital formats. Through advertising on Facebook, Amazon has become one of the top 10 retailers for Pampers (a P&G diaper brand). Online commerce is thus moving into a consumer-oriented retail phase, of which many companies such as Facebook and Amazon are seeking to take advantage. Acquisitions are a quick way to move into the space that these tech giants see evolving, such as Microsoft seeking to broaden its communication base, Google expanding beyond search to experiment with new models of advertising, and Facebook’s attempts to learn from the human capital that they are able to acquire.


We examined corporate-level strategy in Chapter 6, focusing on types and levels of product diversification strategies that firms derive from their core competencies to create competitive advantages and value for stakeholders. As noted in that chapter, diversification allows a firm to create value by productively using excess resources. 1 In this chapter, we explore merger and acquisition strategies. Firms throughout the world use these strategies, often in concert with diversification strategies, to become more diversified. As noted in the Opening Case, merger and acquisition strategies remain popular as a source of firm growth and, hopefully, of above-average returns.

Most corporations are very familiar with merger and acquisition strategies. For example, the latter half of the twentieth century found major companies using these strategies to grow and to deal with the competitive challenges in their domestic markets as well as those emerging from global competitors. Today, smaller firms also use merger and acquisition strategies to grow in their existing markets and to enter new markets. 2

Not unexpectedly, some mergers and acquisitions fail to reach their promise. Accordingly, explaining how firms can successfully use merger and acquisition strategies to create stakeholder value 4 is a key purpose of this chapter. To do this, we first explain the continuing popularity of merger and acquisition strategies as a choice firms evaluate when seeking growth and strategic competitiveness. As part of this explanation, we
describe the differences between mergers, acquisitions, and takeovers. We next discuss specific reasons firms choose to use acquisition strategies and some of the problems organizations may encounter when implementing them. We then describe the characteristics associated with effective acquisitions before closing the chapter with a discussion of different types of restructuring strategies. Restructuring strategies are commonly used to correct or deal with the results of ineffective mergers and acquisitions.

The Popularity of Merger and Acquisition Strategies

Merger and acquisition (M&A) strategies have been popular among U.S. firms for many years. Some believe that these strategies played a central role in the restructuring of U.S. businesses during the 1980s and 1990s and that they continue generating these types of benefits in the twenty-first century.5

Although popular, and appropriately so, as a means of growth with the potential to lead to strategic competitiveness, it is important to emphasize that changing conditions in the external environment influence the type of M&A activity firms pursue. During the recent financial crisis, tightening credit markets made it more difficult for firms to complete “megadeals” (those costing $10 billion or more). However, the flow of deals picked up in 2011 in the United States, where first-quarter deal volume rose a healthy 45 percent to $290.8 billion, compared with $200.6 billion” in 2010; “Europe saw a volume increase in the quarter, though not by as much as in the U.S., as worries over the health of government finances in the region lingered.” Additionally, a relatively weak currency, such as the U.S. dollar, increases the interest of firms from other nations with a strong currency to pursue cross-border acquisitions in the country where the currency is weaker.7

In the final analysis, firms use merger and acquisition strategies to improve their ability to create more value for all stakeholders, including shareholders. As suggested by Figure 1.1, this reasoning applies equally to all of the other strategies (e.g., business-level, corporate-level, international, and cooperative) a firm may formulate and then implement. However, evidence suggests that using merger and acquisition strategies in ways that consistently create value is challenging. This is particularly true for acquiring firms in that some research results indicate that shareholders of acquired firms often earn above-average returns from acquisitions, while shareholders of acquiring firms typically earn returns that are close to zero.8 Moreover, in approximately two-thirds of all acquisitions, the acquiring firm’s stock price falls immediately after the intended transaction is announced. This negative response reflects investors’ skepticism about the likelihood that the acquirer will be able to achieve the synergies required to justify the premium.9 Premiums can sometimes appear to be excessive, as in the acquisition of National Semiconductor by Texas Instruments. One analyst suggested that the 85 percent premium “indicated the level of confidence TI execs have in both the purchase and the ability to rapidly boost the flagging growth rate of National’s product sales.”10 Obviously, creating the amount of value required to account for this type of premium is not going to be easy. Overall then, those leading firms that are using merger and acquisition strategies must recognize that creating more value for their stakeholders by doing so is indeed difficult.11

Mergers, Acquisitions, and Takeovers: What Are the Differences?

A merger is a strategy through which two firms agree to integrate their operations on a relatively coequal basis. Recently, United and Continental Airlines received government approval of their proposed “merger of equals.” The new carrier, which will operate under the United name but with the Continental livery, logo and colors, arguably will
be the most balanced U.S. major airline in terms of regions served, mix of domestic and international flying, and hub geography.”

Even though the transaction between United and Continental appears to be a merger, the reality is that few true mergers actually take place. The main reason for this is that one party to the transaction is usually dominant in regard to various characteristics such as market share, size, or value of assets. Interestingly, although United is the larger carrier, Jeff Smisek, CEO of Continental, will serve as CEO of the combined firm.

An acquisition is a strategy through which one firm buys a controlling, or 100 percent, interest in another firm with the intent of making the acquired firm a subsidiary business within its portfolio. After completing the transaction, the management of the acquired firm reports to the management of the acquiring firm.

Although most of the mergers that are completed are friendly in nature, acquisitions can be friendly or unfriendly. A takeover is a special type of acquisition wherein the target firm does not solicit the acquiring firm’s bid; thus, takeovers are unfriendly acquisitions. For example, in March 2011, Valeant Pharmaceuticals proposed a hostile takeover of Cephalon, which was not approved by Cephalon’s board. Valeant was focused on obtaining rights to a drug that Cephalon was producing for narcolepsy, a disorder that causes excessive sleepiness. The drug, Provigil, was soon to lose its patent rights and would become a target of generic drugmakers. Because Valeant’s offer was rejected by Cephalon’s board, Valeant sought to vote out the board of directors of Cephalon. The deal ultimately fell apart, however, when Teva Pharmaceuticals struck a $6.8 billion friendly deal with Cephalon a few weeks later, forcing Valeant to withdraw its lower offer.

Research evidence reveals that “pre-announcement returns” of hostile takeovers “are largely anticipated and associated with a significant increase in the bidder’s and target’s share prices.” This evidence provides a rationale why some firms are willing to pursue buying another company even when that firm is not interested in being bought. Often, determining the price the acquiring firm is willing to pay to “take over” the target firm is the core issue in these transactions. In Valeant Pharmaceuticals’ takeover attempt of Cephalon, Valeant’s offer was $5.8 billion, or $73 a share, and represented a 24.5 percent premium. However, as noted above, Cephalon was purchased by Teva for $6.8 billion, or $81.50 a share, a premium of 39 percent.

On a comparative basis, acquisitions are more common than mergers and takeovers. Accordingly, we focus the remainder of this chapter’s discussion on acquisitions.

### Reasons for Acquisitions

In this section, we discuss reasons firms decide to acquire another company. Although each reason can provide a legitimate rationale, acquisitions are not always as successful as the involved parties want them to be. Later in the chapter, we examine problems firms may encounter when seeking growth and strategic competitiveness through acquisitions.

#### Increased Market Power

Achieving greater market power is a primary reason for acquisitions. Defined in Chapter 6, market power exists when a firm is able to sell its goods or services above competitive levels or when the costs of its primary or support activities are lower than those of its competitors. Market power usually is derived from the size of the firm and its resources and capabilities to compete in the marketplace; it is also affected by the firm’s share of the market. Therefore, most acquisitions that are designed to achieve greater market power entail buying a competitor, a supplier, a distributor, or a business in a highly related industry to allow the exercise of a core competence and to gain competitive advantage in the acquiring firm’s primary market.
If a firm achieves enough market power, it can become a market leader, which is the goal of many firms. For example, in March 2011, AT&T made a surprising announcement that it was acquiring T-Mobile USA from Deutsche Telekom AG for $39 billion. This acquisition would put AT&T in the lead market share position of wireless service providers in the United States. Sprint was surprised because they were seeking to make a deal with T-Mobile as well. It remains to be seen whether the U.S. government will approve the acquisition; many experts suggest that the second and fourth largest providers face a "rocky path to approval and at a minimum will require large divestitures." Not only would AT&T’s customers increase by a third, but the cell towers and wireless spectrum that T-Mobile provides would largely resolve congestion problems that have given AT&T a bad name.17

Next, we discuss how firms use horizontal, vertical, and related types of acquisitions to increase their market power.

**Horizontal Acquisitions**

The acquisition of a company competing in the same industry as the acquiring firm is a horizontal acquisition. Horizontal acquisitions increase a firm’s market power by exploiting cost-based and revenue-based synergies.18 For instance, the AT&T and T-Mobile acquisition noted above brings together two large players that would comprise the largest wireless carrier in the United States, surpassing the size of Verizon Wireless, a joint venture between Verizon and Vodafone.

Research suggests that horizontal acquisitions result in higher performance when the firms have similar characteristics,19 such as strategy, managerial styles, and resource allocation patterns. Similarities in these characteristics, as well as previous alliance management experience, support efforts to integrate the acquiring and the acquired firm. Horizontal acquisitions are often most effective when the acquiring firm integrates the acquired firm’s assets with its own assets, but only after evaluating and divesting excess capacity and assets that do not complement the newly combined firm’s core competencies.20

**Vertical Acquisitions**

A vertical acquisition refers to a firm acquiring a supplier or distributor of one or more of its goods or services.21 Through a vertical acquisition, the newly formed firm controls additional parts of the value chain (see Chapters 3 and 6),22 which is how vertical acquisitions lead to increased market power.

Larry Ellison, CEO of Oracle Corporation, has been pursuing many acquisitions of other software firms, most of which were horizontal acquisitions. However, he has also orchestrated vertical acquisitions. For example, Oracle acquired Sun Microsystems, a computer hardware producer (backward vertical integration), in 2010. With the deal Sun also gained significant software expertise that is important for developing cloud computing expertise (see Strategic Focus in Chapter 5). Oracle has also made vertical acquisitions of producers in particular markets that facilitate distribution into industries in which it does not have a strong presence; for example, Oracle “got into healthcare through its purchase of Relsys, a maker of analytics applications for the life sciences industry.”23
Related Acquisitions

Acquiring a firm in a highly related industry is called a related acquisition. Through a related acquisition, firms seek to create value through the synergy that can be generated by integrating some of their resources and capabilities. For example, Amazon has been acquiring a set of related businesses to build its retail services beyond books, music, DVDs, and appliances. It recently acquired an online entertainment business, LOVEFiLM International, known as the Netflix of Europe, at a price of $555 million. This is an important move for Amazon as DVD sales make up about 20 percent of its revenues, and online video delivery is likely to displace much of this revenue in the future.24

Horizontal, vertical, and related acquisitions that firms complete to increase their market power are subject to regulatory review as well as to analysis by financial markets.25 For example, as noted earlier, the acquisition of T-Mobile by AT&T is sure to receive scrutiny by the Federal Trade Commission and Antitrust Division of the Justice Department, which approves proposed mergers.26 Thus, firms seeking growth and market power through acquisitions must understand the political/legal segment of the general environment (see Chapter 2) in order to successfully use an acquisition strategy.

Overcoming Entry Barriers

Barriers to entry (introduced in Chapter 2) are factors associated with a market or with the firms currently operating in it that increase the expense and difficulty new firms encounter when trying to enter that particular market. For example, well-established competitors may have economies of scale in the manufacture or service of their products. In addition, enduring relationships with customers often create product loyalties that are difficult for new entrants to overcome. When facing differentiated products, new entrants typically must spend considerable resources to advertise their products and may find it necessary to sell below competitors’ prices to entice new customers.

Facing the entry barriers that economies of scale and differentiated products create, a new entrant may find acquiring an established company to be more effective than entering the market as a competitor offering a product that is unfamiliar to current buyers. In fact, the higher the barriers to market entry, the greater the probability that a firm will acquire an existing firm to overcome them.

As this discussion suggests, a key advantage of using an acquisition strategy to overcome entry barriers is that the acquiring firm gains immediate access to a market. This advantage can be particularly attractive for firms seeking to overcome entry barriers associated with entering international markets.27 Large multinational corporations from developed economies seek to enter emerging economies such as Brazil, Russia, India, and China (BRIC) because they are among the fastest-growing economies in the world.28 As discussed next, completing a cross-border acquisition of a local target allows a firm to quickly enter fast-growing economies such as these.

Cross-Border Acquisitions

Acquisitions made between companies with headquarters in different countries are called cross-border acquisitions.29 The purchase of U.K. carmakers Jaguar and Land Rover by India’s Tata Motors is an example of a cross-border acquisition.

There are other interesting changes taking place in terms of cross-border acquisition activity. Historically, North American and European companies were the most active acquirers of companies outside their domestic markets. However, the current global competitive landscape is one in which firms from other nations may use an acquisition strategy more frequently than do their counterparts in North America and Europe. In this regard, Chinese companies, in particular, are well positioned for cross-border acquisitions. Chinese corporations are well capitalized with strong balance sheets and cash reserves, and they have learned from their past failures, as indicated in the Strategic Focus.30 In the Strategic Focus, we also describe recent cross-border acquisitions by some Indian and Brazilian companies and how their approaches differ. As you will see, many of the deals cited are horizontal acquisitions through which the acquiring companies seek to increase their market power.
Historically, large multinational firms from North America and Europe have pursued international acquisitions in emerging and developing countries in order to establish stronger economies of scale for domestic brands as well as provide opportunities for sourcing of scarce resources. Although the Spanish economy is in the doldrums, Spanish firms have used this strategy relatively recently to expand, first into Latin America and then into other European countries. Telefónica and Banco Santander are Spanish companies that have extended their reach, especially through cross-border acquisitions. For instance, Telefónica is now the world’s fifth largest telecommunication provider in terms of revenue, and Santander is the fourth largest bank on the same metric and has become Latin America’s largest retail bank.

Like many Spanish firms, many emerging economy firms are seeking to build a global footprint through acquisitions. For example, after China was accepted into the World Trade Organization in 2000, many Chinese cross-border mergers and acquisitions were attempted. However, many Chinese companies who made cross-border acquisitions saw them end in failure in their first attempts. In 2003, there was $1.6 billion spent on acquisitions, which swelled to $18.2 billion by 2006. However, TLC Corporation’s acquisition of France’s Thomson Electronics, SAIC’s takeover of South Korea’s SsangYong Motor Company, Ping An’s investment in the Belgium-Dutch financial services group Fortis, and Ningbo Bird’s strategic partnership with France’s Sajan ended in stunning failures, where the Chinese either pulled out or had to sell off much of their acquired assets. The Chinese, however, have learned from their mistakes. Instead of buying global brands, sales networks, and goodwill in branded products, they are now mainly trying to acquire concrete assets such as mineral deposits, state of the art technologies, or R&D facilities. This strategy was encouraged by the government after pulling back from the failed acquisitions just mentioned. As the economy around the world depreciated assets and as the RMB (China’s currency) appreciated relative to developed economies, the strategy focused on hard assets because it made better investing sense rather than seeking to buy established branded products, in which they did not always have managerial capability to realize successful performance. This was signaled by the third largest PC maker, Lenovo (acquired from IBM), after HP and Dell, was taken over by Taiwan’s Acer Computer as Lenovo slipped to fourth in worldwide market share.

Another major emerging market, India, is pursuing cross-border acquisitions as well. To highlight the difference between M&A activity of Chinese versus Indian firms, focusing on acquisitions in the agricultural input sector is illustrative. China National Chemical Corporation (ChemChina) and United Phosphorus (UPL) have different strategies in expanding globally and securing supplies. Both countries have major food consumption needs because of their large populations. ChemChina is mostly a state-owned firm, and therefore...
has the backing of the government in terms of its capital endowment. As such, ChemChina is quite aggressive in its consolidation activity through acquisition. It acquired the Israeli company, Makhteshim Agan Industries, the world’s largest maker of generic pesticides, for $2.4 billion in January 2010. UPL, on the other hand, purchased a fungicide business from DuPont using a much smaller acquisition approach. UPL is very careful in terms of its valuation. One analyst was quoted as saying, “They never acquire something unless it meets their criteria for a 3- to 4-year payback period.” If the valuations are not in their favor, they won’t make the acquisition. India recorded 554 cross-border deals worth $54.9 billion, which equals 80 percent of the total share of 2010 deals. As noted by Ernst & Young, there were 13 deals worth over $1 billion each, with only two such deals recorded in 2009. In 2010, 263 were outbound FDI deals worth $32.4 billion. This represents 47 percent of the 2010 flow of deals, whereas these were only six percent of such deals in 2009.

Brazil is another country with a large emerging economy whose companies have significant acquisition activity. In 2010, Marfrig, a Brazilian meat packer, acquired Keystone Foods for $1.25 billion. Keystone is a top supplier to American fast food chains such as Subway and McDonald’s. JBS, now the world’s largest meat packer, bought Pilgrim’s Pride for $800 million as well as Swift for $1.4 billion. Both of these firms are meat packing operations, which gives JBS a significant exposure in the United States. These acquisitions in large part were made possible by Brazil’s national development bank (BNDES), which supports Brazilian firms in developing their international operations. Petrobras, the government-owned oil monopoly, bought a significant interest in Devon Energy’s stake in the Gulf of Mexico’s Cascade field.

Banco do Brasil, a large mostly government-owned Brazilian bank, received a license to open branch banks across the United States and has also begun acquisitions by acquiring a small, Florida-based lender, EuroBank. Banco do Brasil has a presence in 23 countries besides Brazil.

Although acquisitions allow emerging market economies to enter foreign developed country markets as well as industries outside their domestic market, such acquisitions come at a price. The research suggests that emerging economy firms pay a higher premium than other firms. Perhaps these firms feel they have to pay this premium in order to win the deal and persuade regulators that they are not a threat, especially in industries which domestic politics indicate are strategic. For instance, Potash Corporation, a large agro-input firm in Canada, was sought by BHP Billiton, an Australian natural resources firm. However, the deal was quashed by regulatory analysts because it was seen by the Canadian government as a “strategic industry” for their agricultural needs. Much of the research suggests that government ownership leads firms to overpay and that the overpayment reduces value for minority shareholders (nongovernment shareholders). However, much of the deal activity is driven by large reserves in the domestic emerging economies because their currencies have been appreciating relative to the U.S. dollar and the Euro. Many of these acquisitions are also becoming less focused on infrastructure development and more on consumer market acquisitions because the firms can not only extend their power into developed companies, but they can restore technology into their own domestic market, where a large middle class is emerging with consumers having more buying power. It is expected that this trend of acquisitions from emerging economy to developed economy will continue. In 2010, for example, 16 percent of the deals in the United States were from emerging economy participants.

As noted in the Strategic Focus, firms headquartered in India are also completing more cross-border acquisitions than in the past. The weak U.S. dollar and more favorable government policies toward cross-border acquisitions are supporting Indian companies’ desire to rapidly become more global, although in some cases they are more careful than other emerging market counterparts, such as those found in China.31 In addition to rapid market entry, Indian companies typically seek access to product innovation capabilities and new brands and distribution channels when acquiring firms outside their domestic market.

Firms using an acquisition strategy to complete cross-border acquisitions should understand that these transactions are not risk free. For example, firms seeking to acquire companies in China must recognize that China remains a challenging environment for foreign investors. Political and legal obstacles make acquisitions in China risky and difficult.32 Due diligence is problematic as well because corporate governance and transparency of financial statements are often obscure. Thus, firms must carefully study the risks as well as the potential benefits when contemplating cross-border acquisitions.

**Cost of New Product Development and Increased Speed to Market**

Developing new products internally and successfully introducing them into the marketplace often requires significant investment of a firm’s resources, including time, making it difficult to quickly earn a profitable return.33 Because an estimated 88 percent of innovations fail to achieve adequate returns, firm managers are also concerned with achieving adequate returns from the capital invested to develop and commercialize new products. Potentially contributing to these less-than-desirable rates of return is the successful imitation of approximately 60 percent of innovations within four years after the patents are obtained. These types of outcomes may lead managers to perceive internal product development as a high-risk activity.34

Acquisitions are another means a firm can use to gain access to new products and to current products that are new to the firm. Compared with internal product development processes, acquisitions provide more predictable returns as well as faster market entry. Returns are more predictable because the performance of the acquired firm’s products can be assessed prior to completing the acquisition.35,36

Medtronic is the world’s largest medical device maker with $15.8 billion in sales. While most pharmaceutical firms invent many of their products internally, most of Medtronic’s products are acquired from surgeons or other outside inventors. Research confirms that it can be a good strategy to buy early stage products, especially if you have strong R&D capability, even though there is risk and uncertainty in doing so.37

A number of pharmaceutical firms use an acquisition strategy besides internal development because of the cost of new product development. Acquisitions can enable firms to enter markets quickly and to increase the predictability of returns on their investments. This strategy is exemplified by Teva Pharmaceuticals’ friendly acquisition of Cephalon noted earlier in the chapter.

**Lower Risk Compared to Developing New Products**

Because the outcomes of an acquisition can be estimated more easily and accurately than the outcomes of an internal product development process, managers may view acquisitions as being less risky.38 However, firms should exercise caution when using acquisitions to reduce their risks relative to the risks the firm incurs when developing new products internally. Indeed, even though research suggests acquisition strategies are a common means of avoiding risky internal ventures (and therefore risky R&D investments), acquisitions may also become a substitute for innovation. Accordingly, acquisitions should always be strategic rather than defensive in nature. Thus, Teva’s
acquisition of Cephalon should be driven by strategic factors (e.g., cost and revenue synergies) instead of by defensive reasons (e.g., to gain sales revenue in the short term that will compensate for the revenue that will be lost when Lipitor goes off patent). Moreover, Teva should not reduce its emphasis on increasing the productivity from its R&D expenditures as a result of acquiring Cephalon.

**Increased Diversification**

Acquisitions are also used to diversify firms. Based on experience and the insights resulting from it, firms typically find it easier to develop and introduce new products in markets they are currently serving. In contrast, it is difficult for companies to develop products that differ from their current lines for markets in which they lack experience. Thus, it is relatively uncommon for a firm to develop new products internally to diversify its product lines.

For example, Xerox purchased Affiliated Computer Services, an outsourcing firm, to bolster its services business. Xerox is seen primarily as a hardware technology company, selling document management equipment. However, over time, Xerox has sought to diversify into helping firms to manage business processes and technology services. As such, through this acquisition it seeks to have more and more of its business in the technology service sector. Ursula Burns, who became CEO of Xerox in 2009, indicated that Xerox is helping firms to focus on their real business while Xerox “takes care of the document-intensive business processes behind the scenes.”

Acquisition strategies can be used to support use of both unrelated and related diversification strategies (see Chapter 6). For example, United Technologies Corp. (UTC) uses acquisitions as the foundation for implementing its unrelated diversification strategy. Since the mid-1970s, it has been building a portfolio of stable and noncyclical businesses, including Otis Elevator Co. (elevators, escalators, and moving walkways) and Carrier Corporation (heating and air conditioning systems) in order to reduce its dependence on the volatile aerospace industry. Pratt & Whitney (aircraft engines), Hamilton Sundstrand (aerospace and industrial systems), Sikorsky (helicopters), UTC Fire & Security (fire safety and security products and services), and UTC Power (fuel cells and power systems) are the other businesses in which UTC competes as a result of using its acquisition strategy. While each business UTC acquires manufactures industrial and/or commercial products, many have a relatively low focus on technology (e.g., elevators, air conditioners, and security systems).

In contrast to UTC, Cisco Systems pursues related acquisitions. Historically, these acquisitions have helped the firm build its network components business that is focused on producing network backbone hardware. In 2009, however, Cisco purchased IronPort Systems Inc., a company focused on producing security software for networks. This acquisition helped Cisco diversify its operations beyond its original expertise in network hardware and network management software into network security software. More recent acquisitions have focused on software to facilitate video conferences (the Tandberg acquisition) and helping client firms manage cloud computing applications (the newScale acquisition).

Firms using acquisition strategies should be aware that, in general, the more related the acquired firm is to the acquiring firm, the greater is the probability the acquisition will be successful. Thus, horizontal acquisitions and related acquisitions tend to contribute more to the firm’s strategic competitiveness than do acquisitions of companies operating in product markets that are quite different from those in which the acquiring firm competes, although complementary acquisitions in different industries can help expand a firm’s capabilities.
**Reshaping the Firm’s Competitive Scope**

As discussed in Chapter 2, the intensity of competitive rivalry is an industry characteristic that affects the firm’s profitability. To reduce the negative effect of an intense rivalry on their financial performance, firms may use acquisitions to lessen their dependence on one or more products or markets. Reducing a company’s dependence on specific markets shapes the firm’s competitive scope.

Each time UTC enters a new business (such as UTC Power, the firm’s latest business segment), the corporation reshapes its competitive scope. In a more subtle manner, P&G’s acquisition of Gillette reshaped its competitive scope by giving P&G a stronger presence in some products for whom men are the target market. Xerox’s purchase of Affiliated Computer Services likewise has reshaped Xerox’s competitive scope to focus more on services, and Cisco has become more focused on software through its latest acquisitions. Thus, using an acquisition strategy reshaped the competitive scope of each of these firms.

**Learning and Developing New Capabilities**

Firms sometimes complete acquisitions to gain access to capabilities they lack. For example, acquisitions may be used to acquire a special technological capability. Research shows that firms can broaden their knowledge base and reduce inertia through acquisitions. For example, research suggests that firms increase the potential of their capabilities when they acquire diverse talent through cross-border acquisitions. Of course, firms are better able to learn these capabilities if they share some similar properties with the firm’s current capabilities. Thus, firms should seek to acquire companies with different but related and complementary capabilities in order to build their own knowledge base.

A number of large pharmaceutical firms are acquiring the ability to create “large molecule” drugs, also known as biological drugs, by buying biotechnology firms. Thus, these firms are seeking access to both the pipeline of possible drugs and the capabilities that these firms have to produce them. Such capabilities are important for large pharmaceutical firms because these biological drugs are more difficult to duplicate by chemistry alone (the historical basis on which most pharmaceutical firms have expertise). Biotech firms are focused on DNA research and have a biology base rather than a chemistry base. As an example, Sanofi-Aventis acquired Genzyme for $20 billion. Sanofi’s hope is that the biotech company (Genzyme) will help it keep rare-disease drugs in the pipeline without losing sales to more generic competition (those drugs that have lost patent protection). It is critical in an acquisition such as this that Sanofi keep experimental drug projects moving forward, and this requires that science-based and research-oriented employees stay in the merged firm. Sanofi hopes to transfer Genzyme’s expertise in genetics and biomarkers back to Sanofi. Such biomarkers “are biological substances in the body that help show the body is responding to disease and medication.” If the acquisition is successful, there is added competitive advantage. Biological drugs must clear more regulatory hurdles which, when accomplished, add more to the advantage the acquiring firm develops through such acquisitions.

**Problems in Achieving Acquisition Success**

Acquisition strategies based on reasons described in this chapter can increase strategic competitiveness and help firms earn above-average returns. However, even when pursued for value-creating reasons, acquisition strategies are not problem-free. Reasons for the use of acquisition strategies and potential problems with such strategies are shown in Figure 7.1.
Research suggests that perhaps 20 percent of all mergers and acquisitions are successful, approximately 60 percent produce disappointing results, and the remaining 20 percent are clear failures; evidence on technology acquisitions reports even higher failure rates. In general, though, companies appear to be increasing their ability to effectively use acquisition strategies. One analyst suggests that “Accenture research and subsequent work with clients show that half of large corporate mergers create at least marginal returns—an improvement from a decade ago, when many studies concluded that as many as three-quarters of all mergers destroyed shareholder value as measured two years after the merger announcement.” Greater acquisition success accrues to firms able to (1) select the “right” target, (2) avoid paying too high a premium (doing appropriate due diligence), and (3) effectively integrate the operations of the acquiring and target firms. In addition, retaining the target firm’s human capital, as illustrated by

![Figure 7.1 Reasons for Acquisitions and Problems in Achieving Success](image-url)
Facebook’s approach described in the opening case, is foundational to efforts by employees of the acquiring firm to fully understand the target firm’s operations and the capabilities on which those operations are based. The Sanofi-Aventis acquisition of Genzyme noted above is an example of the importance of retaining the right employees. As shown in Figure 7.1, several problems may prevent successful acquisitions.

**Integration Difficulties**

The importance of a successful integration should not be underestimated. As suggested by a researcher studying the process, “Managerial practice and academic writings show that the post-acquisition integration phase is probably the single most important determinant of shareholder value creation (and equally of value destruction) in mergers and acquisitions.”

Although critical to acquisition success, firms should recognize that integrating two companies following an acquisition can be quite difficult. Melding two corporate cultures, linking different financial and control systems, building effective working relationships (particularly when management styles differ), and resolving problems regarding the status of the newly acquired firm’s executives are examples of integration challenges firms often face.

Integration is complex and involves a large number of activities, which if overlooked can lead to significant difficulties. For example, when United Parcel Service (UPS) acquired Mail Boxes Etc., a large retail shipping chain, it appeared to be a merger that would generate benefits for both firms. The problem is that most of the Mail Boxes Etc. outlets were owned by franchisees. Following the merger, the franchisees lost the ability to deal with other shipping companies such as FedEx, which reduced their competitiveness. Furthermore, franchisees complained that UPS often built company-owned shipping stores close by franchisee outlets of Mail Boxes Etc. Additionally, a culture clash evolved between the free-wheeling entrepreneurs who owned the franchises of Mail Boxes Etc. and the efficiency-oriented corporate approach of the UPS operation, which focused on managing a large fleet of trucks and an information system to efficiently pick up and deliver packages. Also, Mail Boxes Etc. was focused on retail traffic, whereas UPS was focused more on the logistics of wholesale pickup and delivery. Although 87 percent of Mail Boxes Etc. franchisees decided to rebrand under the UPS name, many formed an owner’s group and even filed suit against UPS in regard to the unfavorable nature of the franchisee contract.

**Inadequate Evaluation of Target**

*Due diligence* is a process through which a potential acquirer evaluates a target firm for acquisition. In an effective due-diligence process, hundreds of items are examined in areas as diverse as the financing for the intended transaction, differences in cultures between the acquiring and target firm, tax consequences of the transaction, and actions that would be necessary to successfully meld the two workforces. Due diligence is commonly performed by investment bankers such as Deutsche Bank, Goldman Sachs, and Morgan Stanley, as well as accountants, lawyers, and management consultants specializing in that activity, although firms actively pursuing acquisitions may form their own internal due-diligence team. Although due diligence often focuses on evaluating the accuracy of the financial position and accounting standards used (a financial audit), due diligence also needs to examine the quality of the strategic fit and the ability of the acquiring firm to effectively integrate the target to realize the potential gains from the deal.

The failure to complete an effective due-diligence process may easily result in the acquiring firm paying an excessive premium for the target company. Interestingly, research shows that in times of high or increasing stock prices due diligence is relaxed; firms often overpay during these periods and long-run performance of the newly formed firm suffers. Research also shows that without due diligence, “the purchase price is
driven by the pricing of other ‘comparable’ acquisitions rather than by a rigorous assessment of where, when, and how management can drive real performance gains. [In these cases], the price paid may have little to do with achievable value.”

In addition, firms sometimes allow themselves to enter a “bidding war” for a target, even though they realize that their current bids exceed the parameters identified through due diligence. Earlier, we mentioned Valeant Pharmaceutical’s bid for Cephalon at 24 percent versus the winning bid by Teva at a 30 percent premium. We cannot be sure that Teva overpaid, but the point is that rather than enter a bidding war, firms should only extend bids that are consistent with the results of their due-diligence process. It could be that Cephalon will provide Teva with a new platform for growth and over time this deal will look cheap, but the key is doing a strategic analysis along with rational due diligence so that both the strategic fit and financials make sense.

Large or Extraordinary Debt

To finance a number of acquisitions completed during the 1980s and 1990s, some companies significantly increased their levels of debt. A financial innovation called junk bonds helped make this possible. Junk bonds are a financing option through which risky acquisitions are financed with money (debt) that provides a large potential return to lenders (bondholders). Because junk bonds are unsecured obligations that are not tied to specific assets for collateral, interest rates for these high-risk debt instruments sometimes reached between 18 and 20 percent during the 1980s. Some prominent financial economists viewed debt as a means to discipline managers, causing them to act in the shareholders’ best interests. Managers holding this view are less concerned about the amount of debt their firm assumes when acquiring other companies.

Junk bonds are now used less frequently to finance acquisitions, and the conviction that debt disciplines managers is less strong. Nonetheless, firms sometimes still take on what turns out to be too much debt when acquiring companies. Caterpillar, Inc., betting on a long-term boom and global demand for mining equipment, purchased Bucyrus International, Inc., a maker of mining equipment, for $7.6 billion in 2011. Rapid growth in emerging economies such as China, India, Brazil, and other developing economies over the next decade will push demand for coal, copper, iron ore, and “everything that comes out of the ground.” Caterpillar paid a 32 percent premium for Bucyrus. Furthermore, Bucyrus bought Terex Corp. for $1.3 billion in February 2010. Bucyrus’s debt, because of previous acquisitions, is significant and will force Caterpillar not only to issue new stock but absorb this additional debt. As noted earlier, firms often pay rich premiums and possibly “overpay,” partly because they have to take on additional debt. This has happened before—Bucyrus went through a leveraged buyout and had to file for bankruptcy in the mid-1990s because it took on more debt than it could handle at the time. Because of the assumption of debt for this deal, the price tag increased from $7.6 to $8.6 billion. As such, this is a significant increase in the premium noted earlier because of the assumption of debt. Thus, firms using an acquisition strategy must be certain that their purchases do not create a debt load that overpowers the company’s ability to remain solvent.
Inability to Achieve Synergy

Derived from *synergos*, a Greek word that means “working together,” *synergy* exists when the value created by units working together exceeds the value those units could create working independently (see Chapter 6). That is, synergy exists when assets are worth more when used in conjunction with each other than when they are used separately. For shareholders, synergy generates gains in their wealth that they could not duplicate or exceed through their own portfolio diversification decisions.71 Synergy is created by the efficiencies derived from economies of scale and economies of scope and by sharing resources (e.g., human capital and knowledge) across the businesses in the merged firm.

A firm develops a competitive advantage through an acquisition strategy only when a transaction generates private synergy. *Private synergy* is created when combining and integrating the acquiring and acquired firms’ assets, yield capabilities, and core competencies that could not be developed by combining and integrating either firm’s assets with another company. Private synergy is possible when firms’ assets are complementary in unique ways; that is, the unique type of asset complementarity is not possible by combining either company’s assets with another firm’s assets.72 Because of its uniqueness, private synergy is difficult for competitors to understand and imitate. However, private synergy is difficult to create.

A firm’s ability to account for costs that are necessary to create anticipated revenue- and cost-based synergies affects its efforts to create private synergy. Firms experience several expenses when trying to create private synergy through acquisitions. Called transaction costs, these expenses are incurred when firms use acquisition strategies to create synergy.74 Transaction costs may be direct or indirect. Direct costs include legal fees and charges from investment bankers who complete due diligence for the acquiring firm. Indirect costs include managerial time to evaluate target firms and then to complete negotiations, as well as the loss of key managers and employees following an acquisition.75 Firms tend to underestimate the sum of indirect costs when the value of the synergy that may be created by combining and integrating the acquired firm’s assets with the acquiring firm’s assets is calculated.

Too Much Diversification

As explained in Chapter 6, diversification strategies can lead to strategic competitiveness and above-average returns. In general, firms using related diversification strategies outperform those employing unrelated diversification strategies. However, conglomerates formed by using an unrelated diversification strategy also can be successful, as demonstrated by United Technologies Corp.

At some point, however, firms can become overdiversified. The level at which overdiversification occurs varies across companies because each firm has different capabilities to manage diversification. Recall from Chapter 6 that related diversification requires more information processing than does unrelated diversification. Because of this additional information processing, related diversified firms become overdiversified with a smaller number of business units than do firms using an unrelated diversification strategy.76 Regardless of the type of diversification strategy implemented, however, overdiversification leads to a decline in performance, after which business units are often divested.77 Commonly, such divestments, which tend to reshape a firm’s competitive scope, are part of a firm’s restructuring strategy. (We discuss the strategy in greater detail later in the chapter.)

Even when a firm is not overdiversified, a high level of diversification can have a negative effect on its long-term performance. For example, the scope created by additional amounts of diversification often causes managers to rely on financial rather than strategic controls to evaluate business units’ performance (we define and explain financial and strategic controls in Chapters 11 and 12). Top-level executives often rely on financial controls to assess the performance of business units when they do not have a
rich understanding of business units’ objectives and strategies. Using financial controls, such as return on investment (ROI), causes individual business-unit managers to focus on short-term outcomes at the expense of long-term investments. When long-term investments are reduced to increase short-term profits, a firm’s overall strategic competitiveness may be harmed.  

Another problem resulting from too much diversification is the tendency for acquisitions to become substitutes for innovation. As we noted earlier, pharmaceutical firms such as Teva Pharmaceutical must be aware of this tendency as they acquire other firms to gain access to their products and capabilities. Typically, managers have no interest in acquisitions substituting for internal R&D efforts and the innovative outcomes that they can produce. However, a reinforcing cycle evolves. Costs associated with acquisitions may result in fewer allocations to activities, such as R&D, that are linked to innovation. Without adequate support, a firm’s innovation skills begin to atrophy. Without internal innovation skills, the only option available to a firm to gain access to innovation is to complete still more acquisitions. Evidence suggests that a firm using acquisitions as a substitute for internal innovations eventually encounters performance problems.  

**Managers Overly Focused on Acquisitions**

Typically, a considerable amount of managerial time and energy is required for acquisition strategies to be used successfully. Activities with which managers become involved include (1) searching for viable acquisition candidates, (2) completing effective due-diligence processes, (3) preparing for negotiations, and (4) managing the integration process after completing the acquisition.

Top-level managers do not personally gather all of the data and information required to make acquisitions. However, these executives do make critical decisions on the firms to be targeted, the nature of the negotiations, and so forth. Company experiences show that participating in and overseeing the activities required for making acquisitions can divert managerial attention from other matters that are necessary for long-term competitive success, such as identifying and taking advantage of other opportunities and interacting with important external stakeholders.

Both theory and research suggest that managers can become overly involved in the process of making acquisitions. One observer suggested, “Some executives can become preoccupied with making deals—and the thrill of selecting, chasing and seizing a target.” The overinvolvement can be surmounted by learning from mistakes and by not having too much agreement in the boardroom. Dissent is helpful to make sure that all sides of a question are considered (see Chapter 10). When failure does occur, leaders may be tempted to blame the failure on others and on unforeseen circumstances rather than on their excessive involvement in the acquisition process.

The acquisitions strategy of Citigroup is a case in point. In 1998, Citigroup’s CEO John Reed in a merger between Citicorp and Travelers Group (CEO Sanford I. Weill) set out to cross-sell financial services to the same customer and thereby reduce sales costs. Weill ultimately became the CEO. To accomplish this goal, the merged firm focused on a set of acquisitions including insurance and private equity investing beyond traditional banking services. However, as noted by one commentator, “More than once, ambitious executives, such as San ford Weill of Citigroup fame, have assembled ‘financial super-markets,’ and thinking that customers’ needs for credit cards, checking accounts, wealth management services, insurance, and stock brokerage could be furnished most efficiently and effectively by the same company. Those efforts have failed, over and over again. Each function fulfills a different job that arises at a different point in a customer’s life, so a single source for all of them holds no advantage.” As outlined in the Strategic Focus, Vikram Pandit, the CEO who took over after Charles Prince at Citigroup, was forced to sell off a lot of those peripheral financial service businesses.
Citigroup was formed through a $76 billion merger between Travelers Group and Citicorp in 1998. Sanford I. Weill (Travelers) and John S. Reed (Citicorp), the two CEOs at the time, expected that Congress would soon pass legislation overturning the Glass-Steagall Act, which kept banking and insurance businesses separate. They foresaw developing “the financial supermarket,” serving every financial need of consumers and businesses. In 2002, with a significant downturn in Citigroup’s stock price, Weill retired. Through a search process, Charles Prince became the CEO of Citigroup in 2003. Vikram Pandit became the CEO of Citigroup just before the 2008 recession. In the midst of the recession, there was severe criticism of the “financial supermarket” concept, and many businesses were scheduled for sale as Citigroup restructured its operations to focus on more traditional consumer banking and investment banking focused on institutional and business clients. In fact, a part of Travelers Group had already been spun off in 2002 because it was harming Citigroup’s earnings. As part of this more recent restructuring program, Pandit orchestrated a division of Citigroup’s assets into two large camps, one focused on the traditional businesses as noted and another, called Citi Holdings, consisting of businesses that were up for sale as part of the restructuring effort.

On December 31, 2010, Citigroup announced that it had sold both its Discover Financial Services and its student loan corporation, which capped $31 billion in the last quarter of 2010. Citi Holdings’ CEO Michael Corbat, a former Salomon Brothers executive, said Citigroup wanted to “get these assets out the door” but that it “is not a distress seller.” Besides the $31 billion in the final quarter, $168 billion of combined assets had already been sold in 2009. This included the 51 percent stake that Citigroup held in the Smith Barney brokerage in a joint venture with Morgan Stanley. Another business that has not totally been sold is CitiFinancial, which focuses on providing commercial credit to subprime borrowers. Another approach it used was to do a spin-off of Primerica, the company with most of Citigroup’s insurance holdings, through an IPO in combination with Warburg Pincus LLC (a private equity partnership), although Citigroup maintained $7 billion in insurance assets because they generate steady cash flows.

Citigroup has also sold some of its private equity assets, even though these assets are part of its investment bank group. The Citigroup private equity operation manages many other businesses that are not in financial services. Some of these assets are in partnership with other private equity firms such as CVC Capital Partners Ltd.

Although part of the divestiture activity can be accounted for because of the financial crisis, another part is due to the media attention that Citigroup received from taking $45 billion in bailout funds from the U.S. government at the peak of the crisis to stave off possible bankruptcy. With this receipt of additional capital came tighter regulations that ultimately required re-separation of consumer banking and investment banking. Furthermore, Citigroup’s every move was scrutinized by both the government and the media. Ultimately, Citigroup paid back the funds to the U.S. government but is still focused on restructuring its businesses in order to not only focus on “core areas” in banking but also to meet new, stricter regulatory requirements.
At the height of the crisis, bankers’ salaries, including that of CEO Pandit, received significant scrutiny. Given the significant media attention and government criticism, Pandit requested that the board reduce his salary to $1 a year until Citigroup’s performance improved; however, the board had already set his salary at $1.75 million. The board thought his work was done well but had to justify the $10 million in restricted stock that he received in 2011. To realize this incentive, he has to meet certain income targets as well as manage the ongoing organizational restructuring and staffing goals.

In summary, through the history of Citigroup one can see that pursuing a concept that creates a firm that is overly diversified relative to its core businesses, too large to manage effectively, and too diversified such that it lacks the synergy to cross-sell products leads to significant devaluation for stockholders, especially during a financial crisis when multiple problems are revealed simultaneously. This was certainly the case for Citigroup during the crisis, and as such, it had to restructure itself into a much smaller, though global, business financial service firm. Although Citigroup is still involved in many financial services sectors, those that will remain after the refocusing of Citi Holdings is complete will be much more solidly focused on its main businesses, consumer and investment banking. However, it may be that due to the increased financial regulation that its profits from trading will not be as great; because the opportunities for financial service firms will be scrutinized more intensely by the media and government officials, it is likely that less trading risk will be undertaken.


Too Large

Most acquisitions create a larger firm, which should help increase its economies of scale. These economies can then lead to more efficient operations—for example, two sales organizations can be integrated using fewer sales representatives because such sales personnel can sell the products of both firms (particularly if the products of the acquiring and target firms are highly related). As illustrated by the Strategic Focus on Citigroup, size can also increase the complexity of the management challenge and create diseconomies of scope; that is, not enough economic benefit to outweigh the costs of managing the more complex organization created through acquisitions. This was also the case of the failed merger between DaimlerChrysler and Mitsubishi; it became too costly to integrate the operations of Mitsubishi to derive the necessary benefits of economies of scale in the merged firm.

Many firms seek increases in size because of the potential economies of scale and enhanced market power (discussed earlier). At some level, the additional costs required to manage the larger firm will exceed the benefits of the economies of scale and additional market power. The complexities generated by the larger size often lead managers to implement more bureaucratic controls to manage the combined firm’s operations. Bureaucratic controls are formalized supervisory and behavioral rules and policies designed to ensure consistency of decisions and actions across different units of a firm. However, through time, formalized controls often lead to relatively rigid and standardized managerial behavior. Certainly, in the long run, the diminished flexibility that accompanies rigid and standardized managerial behavior may produce less innovation. Because of innovation’s importance to competitive success, the bureaucratic controls...
resulting from a large organization (i.e., built by acquisitions) can have a detrimental effect on performance. For this reason, Cisco announced an internal restructuring to reduce bureaucracy after its numerous acquisitions; "it will dispense with most of a network of internal councils and associated boards that have been criticized for adding layers of bureaucracy and wasting managers’ time." As one analyst noted, "Striving for size per se is not necessarily going to make a company more successful. In fact, a strategy in which acquisitions are undertaken as a substitute for organic growth has a bad track record in terms of adding value." 

Effective Acquisitions

Earlier in the chapter, we noted that acquisition strategies do not always lead to above-average returns for the acquiring firm’s shareholders. Nonetheless, some companies are able to create value when using an acquisition strategy. The probability of success increases when the firm’s actions are consistent with the “attributes of successful acquisitions” shown in Table 7.1.

Cisco Systems appears to pay close attention to Table 7.1’s attributes when using its acquisition strategy. In fact, Cisco is admired for its ability to complete successful acquisitions and integrate them quickly, although as noted this has created a larger firm. A number of other network companies pursued acquisitions to build up their ability to sell into the network equipment binge, but only Cisco retained much of its value in the post-bubble era. Many firms, such as Lucent, Nortel, and Ericsson, teetered on the edge of bankruptcy after the dot-com bubble burst. When it makes an acquisition, “Cisco has gone much further in its thinking about integration. Not only is retention important, but Cisco also works to minimize the distractions caused by an acquisition. This is important, because the speed of change is so great that if the target firm’s product development teams are distracted, they will be slowed, contributing to

<table>
<thead>
<tr>
<th>Attributes</th>
<th>Results</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Acquired firm has assets or resources that are complementary to the acquiring firm’s core business</td>
<td>1. High probability of synergy and competitive advantage by maintaining strengths</td>
</tr>
<tr>
<td>2. Acquisition is friendly</td>
<td>2. Faster and more effective integration and possibly lower premiums</td>
</tr>
<tr>
<td>3. Acquiring firm conducts effective due diligence to select target firms and evaluate the target firm’s health (financial, cultural, and human resources)</td>
<td>3. Firms with strongest complementarities are acquired and overpayment is avoided</td>
</tr>
<tr>
<td>4. Acquiring firm has financial slack (cash or a favorable debt position)</td>
<td>4. Financing (debt or equity) is easier and less costly to obtain</td>
</tr>
<tr>
<td>5. Merged firm maintains low to moderate debt position</td>
<td>5. Lower financing cost, lower risk (e.g., of bankruptcy), and avoidance of trade-offs that are associated with high debt</td>
</tr>
<tr>
<td>6. Acquiring firm has sustained and consistent emphasis on R&amp;D and innovation</td>
<td>6. Maintain long-term competitive advantage in markets</td>
</tr>
<tr>
<td>7. Acquiring firm manages change well and is flexible and adaptable</td>
<td>7. Faster and more effective integration facilitates achievement of synergy</td>
</tr>
</tbody>
</table>
acquisition failure. So, integration must be rapid and reassuring. For example, Cisco facilitates acquired employees’ transitions to their new organization through a link on its Web site called “Cisco Acquisition Connection.” This Web site has been specifically designed for newly acquired employees and provides up-to-date materials tailored to their new jobs.

Results from a research study shed light on the differences between unsuccessful and successful acquisition strategies and suggest that a pattern of actions improves the probability of acquisition success. The study shows that when the target firm’s assets are complementary to the acquired firm’s assets, an acquisition is more successful. With complementary assets, the integration of two firms’ operations has a higher probability of creating synergy. In fact, integrating two firms with complementary assets frequently produces unique capabilities and core competencies. With complementary assets, the acquiring firm can maintain its focus on core businesses and leverage the complementary assets and capabilities from the acquired firm. In effective acquisitions, targets are often selected and “groomed” by establishing a working relationship prior to the acquisition. As discussed in Chapter 9, strategic alliances are sometimes used to test the feasibility of a future merger or acquisition between the involved firms.

The study’s results also show that friendly acquisitions facilitate integration of the firms involved in an acquisition. Through friendly acquisitions, firms work together to find ways to integrate their operations to create synergy. In hostile takeovers, animosity often results between the two top-management teams, a condition that in turn affects working relationships in the newly created firm. As a result, more key personnel in the acquired firm may be lost, and those who remain may resist the changes necessary to integrate the two firms. With effort, cultural clashes can be overcome, and fewer key managers and employees will become discouraged and leave.

Additionally, effective due-diligence processes involving the deliberate and careful selection of target firms and an evaluation of the relative health of those firms (financial health, cultural fit, and the value of human resources) contribute to successful acquisitions. Financial slack in the form of debt equity or cash, in both the acquiring and acquired firms, also frequently contributes to acquisition success. Even though financial slack provides access to financing for the acquisition, it is still important to maintain a low or moderate level of debt after the acquisition to keep debt costs low. When substantial debt was used to finance the acquisition, companies with successful acquisitions reduced the debt quickly, partly by selling off assets from the acquired firm, especially noncomplementary or poorly performing assets. For these firms, debt costs do not prevent long-term investments such as R&D, and managerial discretion in the use of cash flow is relatively flexible.

Another attribute of successful acquisition strategies is an emphasis on innovation, as demonstrated by continuing investments in R&D activities. Significant R&D investments show a strong managerial commitment to innovation, a characteristic that is increasingly important to overall competitiveness in the global economy as well as to acquisition success.

Flexibility and adaptability are the final two attributes of successful acquisitions. When executives of both the acquiring and the target firms have experience in managing change and learning from acquisitions, they will be more skilled at adapting their capabilities to new environments. As a result, they will be more adept at integrating the two organizations, which is particularly important when firms have different organizational cultures.

As we have learned, firms use an acquisition strategy to grow and achieve strategic competitiveness. Sometimes, though, the actual results of an acquisition strategy fall short of the projected results. When this happens, firms consider using restructuring strategies.
Restructuring

Restructuring is a strategy through which a firm changes its set of businesses or its financial structure. According to the text, it is a global phenomenon. From the 1970s into the 2000s, divesting businesses from company portfolios and downsizing accounted for a large percentage of firms’ restructuring strategies. Commonly, firms focus on a fewer number of products and markets following restructuring. The words of an executive describe this typical outcome: “Focus on your core business, but don’t be distracted, let other people buy assets that aren’t right for you.”

Although restructuring strategies are generally used to deal with acquisitions that are not reaching expectations, firms sometimes use these strategies because of changes they have detected in their external environment. For example, opportunities sometimes surface in a firm’s external environment that a diversified firm can pursue because of the capabilities it has formed by integrating firms’ operations. In such cases, restructuring may be appropriate to position the firm to create more value for stakeholders, given the environmental changes. This seems to be the case with the restructuring of Citigroup noted in the Strategic Focus.

As discussed next, firms use three types of restructuring strategies: downsizing, downscoping, and leveraged buyouts.

Downsizing

Downsizing is a reduction in the number of a firm’s employees and, sometimes, in the number of its operating units, but it may or may not change the composition of businesses in the company’s portfolio. Thus, downsizing is an intentional proactive management strategy whereas “decline is an environmental or organizational phenomenon that occurs involuntarily and results in erosion of an organization’s resource base.” Downsizing is often a part of acquisitions that fail to create the value anticipated when the transaction was completed. Downsizing is often used when the acquiring firm paid too high of a premium to acquire the target firm. Once thought to be an indicator of organizational decline, downsizing is now recognized as a legitimate restructuring strategy.

Reducing the number of employees and/or the firm’s scope in terms of products produced and markets served occurs in firms to enhance the value being created as a result of completing an acquisition. When integrating the operations of the acquired firm and the acquiring firm, managers may not at first appropriately downsize. This is understandable in that “no one likes to lay people off or close facilities.” However, downsizing may be necessary because acquisitions often create a situation in which the newly formed firm has duplicate organizational functions such as sales, manufacturing, distribution, human resource management, and so forth. Failing to downsize appropriately may lead to too many employees doing the same work and prevent the new firm from realizing the cost synergies it anticipated. Managers should remember that as a strategy, downsizing will be far more effective when they consistently use human resource practices that ensure procedural justice and fairness in downsizing decisions.

Downscoping

Downscoping refers to divestiture, spin-off, or some other means of eliminating businesses that are unrelated to a firm’s core businesses. Downscoping has a more positive effect on firm performance than does downsizing because firms commonly find that downscoping causes them to refocus on their core business. Managerial effectiveness increases because the firm has become less diversified, allowing the top management team to better understand and manage the remaining businesses. Interestingly, sometimes the divested unit can also take advantage of unforeseen opportunities not recognized while under the leadership of the parent firm.
Firms often use the downscoping and the downsizing strategies simultaneously. In Citigroup’s restructuring (see the Strategic Focus) it has used both downscoping and downsizing, as have many large financial institutions in the recession. However, when doing this, firms need to avoid layoffs of key employees, as such layoffs might lead to a loss of one or more core competencies. Instead, a firm that is simultaneously downscoping and downsizing becomes smaller by reducing the diversity of businesses in its portfolio.

In general, U.S. firms use downscoping as a restructuring strategy more frequently than do European companies—in fact, the trend in Europe, Latin America, and Asia has been to build conglomerates. In Latin America, these conglomerates are called grupos. Many Asian and Latin American conglomerates have begun to adopt Western corporate strategies in recent years and have been refocusing on their core businesses. This downscoping has occurred simultaneously with increasing globalization and with more open markets that have greatly enhanced competition. By downscoping, these firms have been able to focus on their core businesses and improve their competitiveness.

Leveraged Buyouts

A leveraged buyout (LBO) is a restructuring strategy whereby a party (typically a private equity firm) buys all of a firm’s assets in order to take the firm private. Once the transaction is completed, the company’s stock is no longer traded publicly. Traditionally, leveraged buyouts were used as a restructuring strategy to correct for managerial mistakes or because the firm’s managers were making decisions that primarily served their own interests rather than those of shareholders. However, some firms use buyouts to build firm resources and expand rather than simply restructure distressed assets.

After a firm is taken over by a private equity firm, such acquired firms are free to do “add-on” or “role-up” acquisitions to build the businesses from the base platform of a single acquisition. For example, Roark Capital Partners, a private equity firm, launched Focus Brands in 2004 through acquiring Cinnabon and Seattle’s Best Coffee International, niche franchise food service concepts, from AFC Enterprises. “Carvel, an existing portfolio company, was rolled into the platform and subsequent acquisitions included Schlotzky’s, Moe’s Southwest Grill and most recently, Auntie Anne’s.”

However, significant amounts of debt are commonly incurred to finance a buyout; hence the term leveraged buyout. To support debt payments and to downscope the company to concentrate on the firm’s core businesses, the new owners may immediately sell a number of assets. It is not uncommon for those buying a firm through an LBO to restructure the firm to the point that it can be sold at a profit within a five- to eight-year period.

Management buyouts (MBOs), employee buyouts (EBOs), and whole-firm buyouts, in which one company or partnership purchases an entire company instead of a part of it, are the three types of LBOs. In part because of managerial incentives, MBOs, more so than EBOs and whole-firm buyouts, have been found to lead to downscoping, increased strategic focus, and improved performance. Research shows that management buyouts can lead to greater entrepreneurial activity and growth. As such, buyouts can represent a form of firm rebirth to facilitate entrepreneurial efforts and stimulate strategic growth and productivity.

Restructuring Outcomes

The short- and long-term outcomes associated with the three restructuring strategies are shown in Figure 7.2. As indicated, downsizing typically does not lead to higher firm performance. In fact, some research results show that downsizing contributes to lower returns for both U.S. and Japanese firms. The stock markets in the firms’ respective nations evaluated downsizing negatively, believing that it would have long-term negative effects on the firms’ efforts to achieve strategic competitiveness. Investors also seem to
conclude that downsizing occurs as a consequence of other problems in a company. This assumption may be caused by a firm’s diminished corporate reputation when a major downsizing is announced.\textsuperscript{129}

The loss of human capital is another potential problem of downsizing (see Figure 7.2). Losing employees with many years of experience with the firm represents a major loss of knowledge. As noted in Chapter 3, knowledge is vital to competitive success in the global economy. Research also suggests that such loss of human capital can also spill over into dissatisfaction of customers.\textsuperscript{130} Thus, in general, research evidence and corporate experience suggest that downsizing may be of more tactical (or short-term) value than strategic (or long-term) value,\textsuperscript{131} meaning that firms should exercise caution when restructuring through downsizing.

Downscoping generally leads to more positive outcomes in both the short and long term than does downsizing or a leveraged buyout. Downscoping’s desirable long-term outcome of higher performance is a product of reduced debt costs and the emphasis on strategic controls derived from concentrating on the firm’s core businesses. In so doing, the refocused firm should be able to increase its ability to compete.\textsuperscript{132}

Although whole-firm LBOs have been hailed as a significant innovation in the financial restructuring of firms, they can involve negative trade-offs.\textsuperscript{133} First, the resulting large debt increases the firm’s financial risk, as is evidenced by the number of companies that filed for bankruptcy in the 1990s after executing a whole-firm LBO. Sometimes, the intent of the owners to increase the efficiency of the bought-out firm and then sell it within five to eight years creates a short-term and risk-averse managerial focus.\textsuperscript{134} As a result, these firms may fail to invest adequately in R&D or take other major actions designed to maintain or improve the company’s core competence.\textsuperscript{135} Research also suggests that in firms with an entrepreneurial mind-set, buyouts can lead to greater innovation, especially if the debt load is not too great.\textsuperscript{136} However, because buyouts more often result in significant debt, most LBOs have been completed in mature industries where stable cash flows are possible.

<table>
<thead>
<tr>
<th>Alternatives</th>
<th>Short-Term Outcomes</th>
<th>Long-Term Outcomes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Downsizing</td>
<td>Reduced labor costs</td>
<td>Loss of human capital</td>
</tr>
<tr>
<td>Downscoping</td>
<td>Reduced debt costs</td>
<td>Lower performance</td>
</tr>
<tr>
<td>Leveraged buyout</td>
<td>Emphasis on strategic controls</td>
<td>Higher performance</td>
</tr>
<tr>
<td></td>
<td>High debt costs</td>
<td>Higher risk</td>
</tr>
</tbody>
</table>

Figure 7.2 Restructuring and Outcomes
Although the number of mergers and acquisitions completed declined in 2008 and 2009, largely because of the global financial crisis, merger and acquisition strategies became more frequent in 2010 and 2011, as a path to firm growth and earning strategic competitiveness. Globalization and deregulation of multiple industries in many economies are two of the factors making mergers and acquisitions attractive to large corporations and small firms.

Firms use acquisition strategies to (1) increase market power, (2) overcome entry barriers to new markets or regions, (3) avoid the costs of developing new products and increase the speed of new market entries, (4) reduce the risk of entering a new business, (5) become more diversified, (6) reshape their competitive scope by developing a different portfolio of businesses, and (7) enhance their learning as the foundation for developing new capabilities.

Among the problems associated with using an acquisition strategy are (1) the difficulty of effectively integrating the firms involved, (2) incorrectly evaluating the target firm’s value, (3) creating debt loads that preclude adequate long-term investments (e.g., R&D), (4) overestimating the potential for synergy, (5) creating a firm that is too diversified, (6) creating an internal environment in which managers devote increasing amounts of their time and energy to analyzing and completing the acquisition, and (7) developing a combined firm that is too large, necessitating extensive use of bureaucratic, rather than strategic, controls.

Effective acquisitions have the following characteristics: (1) the acquiring and target firms have complementary resources that are the foundation for developing new capabilities; (2) the acquisition is friendly, thereby facilitating integration of the firms’ resources; (3) the target firm is selected and purchased based on thorough due diligence; (4) the acquiring and target firms have considerable slack in the form of cash or debt capacity; (5) the newly formed firm maintains a low or moderate level of debt by selling off portions of the acquired firm or some of the acquiring firm’s poorly performing units; (6) the acquiring and acquired firms have experience in terms of adapting to change; and (7) R&D and innovation are emphasized in the new firm.

Restructuring is used to improve a firm’s performance by correcting for problems created by ineffective management. Restructuring by downsizing involves reducing the number of employees and hierarchical levels in the firm. Although it can lead to short-term cost reductions, they may be realized at the expense of long-term success, because of the loss of valuable human resources (and knowledge) and overall corporate reputation.

The goal of restructuring through downsizing is to reduce the firm’s level of diversification. Often, the firm divests unrelated businesses to achieve this goal. Eliminating unrelated businesses makes it easier for the firm and its top-level managers to refocus on the core businesses.

Through an LBO, a firm is purchased so that it can become a private entity. LBOs usually are financed largely through debt. Management buyouts (MBOs), employee buyouts (EBOs), and whole-firm LBOs are the three types of LBOs. Because they provide clear managerial incentives, MBOs have been the most successful of the three. Often, the intent of a buyout is to improve efficiency and performance to the point where the firm can be sold successfully within five to eight years.

Commonly, restructuring’s primary goal is gaining or reestablishing effective strategic control of the firm. Of the three restructuring strategies, downsizing is aligned most closely with establishing and using strategic controls and usually improves performance more on a comparative basis.

**REVIEW QUESTIONS**

1. Why are merger and acquisition strategies popular in many firms competing in the global economy?
2. What reasons account for firms’ decisions to use acquisition strategies as a means to achieving strategic competitiveness?
3. What are the seven primary problems that affect a firm’s efforts to successfully use an acquisition strategy?
4. What are the attributes associated with a successful acquisition strategy?
5. What is the restructuring strategy, and what are its common forms?
6. What are the short- and long-term outcomes associated with the different restructuring strategies?
EXPERIENTIAL EXERCISES

EXERCISE 1: HOW DID THE DEAL WORK OUT?:

The text argues that mergers and acquisitions are a popular strategy for businesses both in the United States and across borders. However, returns for acquiring firms do not always live up to expectations. This exercise seeks to address this notion by analyzing, pre- and post hoc, the results of actual acquisitions. By looking at the notifications of a deal beforehand, categorizing that deal, and then following it for a year, you will be able to learn about actual deals and their implications for strategists.

Working in teams, identify a merger or acquisition that was completed in the last few years. This may be a cross-border acquisition or a U.S.–centered one. A couple of possible sources for this information are Reuters’s online M&A section or Yahoo! Finance’s U.S. Mergers and Acquisitions Calendar. Each team must get their M&A choice approved in advance so as to avoid duplicates.

To complete this assignment, you should be prepared to answer the following questions:

1. Describe the environment for this arrangement at the time it was completed. Using concepts discussed in the text, focus on management’s representation to shareholders, the industry environment, and the overall rationale for the deal.

2. Did the acquirer pay a premium for the target firm? If so, how much? In addition, search for investor comments regarding the wisdom of this agreement. Attempt to identify how the market reacted at the announcement of the deal (LexisNexis typically provides an article that will address this issue).

3. Describe the merger or acquisition going forward. Use the concepts from the text such as, but not limited to:
   a. The reason for the merger or acquisition (i.e., market power, overcoming entry barriers, etc.)
   b. Were there problems in achieving acquisition success?
   c. Would you categorize this deal as successful as of the time of your research, and give the reasons why or why not.

Plan on presenting your findings to the class in a 10- to 15-minute presentation. Organize the presentation as if you were updating the shareholders of the newly combined firm.

EXERCISE 2: WHY RESTRUCTURE?

According to your text, “Restructuring is a strategy through which a firm changes its set of businesses or its financial structure.” One way in which to analyze a firm’s restructuring is to look at the spin-offs that have occurred over time. According to Investopedia.com, a spin-off occurs when an independent company is created through the sale or distribution of new shares from an existing firm. This is a divestiture. Firms often do this to streamline operations by selling noncore or nonproducing assets. Often after a period of acquisition activity firms find themselves with divisions that do not fit their corporate-level strategy.

A search of the Bloomberg database reveals that between 2006 and halfway through 2011 there were 32 spin-offs originated by firms in the S&P 500. A listing of those firms is below.

<table>
<thead>
<tr>
<th>Announce Date</th>
<th>Target Name</th>
<th>Seller Name</th>
<th>Announced Value (millions of dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/13/2006</td>
<td>Covidien PLC</td>
<td>Tyco International Ltd.</td>
<td>$21,360.97</td>
</tr>
<tr>
<td>1/13/2006</td>
<td>TE Connectivity Ltd.</td>
<td>Tyco International Ltd.</td>
<td>19,009.29</td>
</tr>
<tr>
<td>8/2/2006</td>
<td>Broadridge Financial Solutions Inc.</td>
<td>Automatic Data Processing Inc.</td>
<td>2,897.29</td>
</tr>
<tr>
<td>12/19/2006</td>
<td>Discover Financial Services</td>
<td>Morgan Stanley</td>
<td>15,785.78</td>
</tr>
<tr>
<td>1/8/2007</td>
<td>Teradata Corp.</td>
<td>NCR Corp.</td>
<td>4,638.43</td>
</tr>
<tr>
<td>1/31/2007</td>
<td>Kraft Foods Inc.</td>
<td>Altria Group Inc.</td>
<td>45,532.27</td>
</tr>
<tr>
<td>2/1/2007</td>
<td>WABCO Holdings Inc.</td>
<td>Trane Inc.</td>
<td>3,504.92</td>
</tr>
<tr>
<td>2/26/2007</td>
<td>Forestar Group Inc.</td>
<td>Temple-Inland Inc.</td>
<td>838.40</td>
</tr>
<tr>
<td>2/26/2007</td>
<td>Guaranty Financial Group Inc.</td>
<td>Temple-Inland Inc.</td>
<td>578.09</td>
</tr>
<tr>
<td>2/26/2007</td>
<td>KBR Inc.</td>
<td>Halliburton Co.</td>
<td>N/A</td>
</tr>
<tr>
<td>4/3/2007</td>
<td>Metavante Technologies Inc.</td>
<td>Marshall &amp; Isley Corp.</td>
<td>N/A</td>
</tr>
<tr>
<td>5/18/2007</td>
<td>Patriot Coal Corp.</td>
<td>Peabody Energy Corp.</td>
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<tr>
<td>7/12/2007</td>
<td>PharMerica Corp.</td>
<td>AmerisourceBergen Corp.</td>
<td>290.73</td>
</tr>
</tbody>
</table>

(continued)
Your team’s challenge is to find out why any one of these transactions occurred. You may choose any transaction above with the approval of the instructor.

You should be prepared to answer the following questions:

1. Categorize the spin-off as downscoping, downsizing, or a leveraged buyout.
2. Read the management and analyst reports. What was the rationale given for implementing the spin-off?
3. Describe the spin-off in terms of ownership. Did the parent retain equity post-spin-off and did this ownership change over time (look at a year or two after the completion date if possible)?
4. What happened to the stock price of the parent company at the time of the spin-off announcement? How did the stock price change when the transaction was completed? Why do you think these changes occurred?
5. What has happened to the spun-off company? Has it been successful since the transaction was completed?
6. Overall, summarize the spin-off in terms of the parent company. Compare your thoughts with the information presented in Figure 7.2 in the text (Restructuring and Outcomes), in terms of short- and long-term consequences.

Be prepared to defend your observations and conclusions in class.

**THE POWER OF A MERGER: SOUTHWEST**

Southwest, long recognized for its discount airfares and its targeting of the price-conscious consumer, has combined forces with another discount carrier—AirTran. AirTran asserts that with such a merger the potential exists for the expansion of discount airfares in the industry. In an industry where profit motive is high, consolidation is not uncommon even among major airlines, but the air traveler still sees fewer seats and higher prices. While major carriers reap billions, particularly in add-on fees, Southwest continues to press the competition by refraining from excessive fees.

Be prepared to discuss the following concepts and questions in class:

**Concepts**
- Mergers
- Acquisitions
- Restructuring
Questions
1. What would make the arrangement between Southwest and AirTran a merger and not an acquisition?
2. What were the reasons that Southwest and AirTran had for merging? What approach(es) did these companies use?
3. What would cause the Southwest/AirTran merger not to be successful?
4. What strategies would you recommend to Southwest should it need to restructure?

NOTES
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122. T. Cody & K. MacFadyen, 2011, Tuck-in deals were an easy answer to the credit shortfall; the challenge will be the ensuing integration efforts, Mergers & Acquisitions: The Dealmaker’s Journal, 46(2): 16–56.


Studying this chapter should provide you with the strategic management knowledge needed to:

1. Explain incentives that can influence firms to use an international strategy.
2. Identify three basic benefits firms achieve by successfully implementing an international strategy.
3. Explore the determinants of national advantage as the basis for international business-level strategies.
4. Describe the three international corporate-level strategies.
5. Discuss environmental trends affecting the choice of international strategies, particularly international corporate-level strategies.
6. Explain the five modes firms use to enter international markets.
7. Discuss the two major risks of using international strategies.
8. Discuss the strategic competitiveness outcomes associated with international strategies particularly with an international diversification strategy.
9. Explain two important issues firms should have knowledge about when using international strategies.
With a mission “to inspire and nurture the human spirit—one person, one cup and one neighborhood at a time,” Starbucks launched its operations in 1971; today, Starbucks is one of the world’s most recognized brand names. Saying that it offers “…the finest coffees in the world, grown, prepared and served by the finest people,” Starbucks has over 17,000 stores (about half of the stores are company owned with the other half being licensed) with locations in more than 50 countries. While its operations in the United States remain important, global growth is a key objective for Starbucks. Based on a belief that profitable growth will result from embracing the global marketplace, the firm wants to grow substantially outside of North America, especially in China and India, markets it believes have significant potential for the firm. In fact, Starbucks believes that China may one day be second only to the United States in terms of sales revenue generated. Embracing the global marketplace is also important to Starbucks because it currently commands less than 1 percent of the global coffee market, suggesting there are significant growth opportunities available.

Of course seeking growth in China is not isolated to Starbucks. The size of China’s consumer and commercial markets entices a number of companies from around the world to find ways to successfully use an international strategy as the foundation for competitive success there. In the words of Starbucks’ CEO Howard Schulz: “There is a gold-rush mentality by every western brand known to mankind rushing into China.” However, only firms that successfully implement an international strategy that is appropriate for China have the potential to succeed there.

As we noted in Chapter 4’s Opening Case, Starbucks now has over 400 locations on mainland China, with plans to increase this number to 1,500 by 2015. Starbucks uses an international differentiation business-level strategy and a transnational international corporate-level strategy in its efforts to succeed in China. (We discuss both of these strategies in this chapter.) There are several capabilities that are the foundation on which these strategies were selected and are being implemented. Brand strength, superior customer service, convenient locations, and product innovation are examples of capabilities (that are also core competencies for the firm) on which Starbucks relies to implement its international strategies. Starbucks’ international differentiation strategy finds the firm offering unique products and experiences to customers, for which they are willing to pay a premium price. The transnational strategy is one through which Starbucks uses its core competencies to standardize its operations to gain global efficiencies while decentralizing decision-making responsibilities to local units in China so that some products can be customized to meet local consumers’ unique needs. The firm captures the essence of its transnational strategy by saying that while competing in China it continues “to stay true to (its) brand while finding fresh ways to be locally relevant…” Efforts to consolidate control of its mainland China operations for the purpose of ensuring a consistent brand image throughout the country while simultaneously seeking to introduce localized products in South China also demonstrate the implementation of the transnational strategy.
In Chapter 4’s opening case, we described how Starbucks changed the nature of coffee drinking in the United States. We also discussed actions the firm is taking to recover from the downturn it experienced in 2008. Extending this earlier discussion, our description of Starbucks’ competitive actions in this chapter’s Opening Case highlights the increasing importance of international markets for this firm. However, being able to effectively compete in countries and regions outside a firm’s domestic market is increasingly important to firms of all types, not just Starbucks. One reason for this is that the effects of globalization continue reducing the number of industrial and consumer markets in which only domestic firms can compete successfully. In place of what historically were relatively stable and predictable domestic markets, firms across the globe find they are now competing in globally oriented industries—industries in which firms must compete in all world markets where a consumer or commercial good or service is sold in order to be competitive. Unlike domestic markets, global markets are relatively unstable and unpredictable.

The purpose of this chapter is to discuss how international strategies can be a source of strategic competitiveness for firms competing in global markets. To do this, we examine a number of topics (see Figure 8.1). After describing factors or incentives that influence firms to identify international opportunities, we discuss three basic benefits that can accrue to firms that successfully use international strategies. We then turn our attention to the international strategies available to firms. Specifically, we examine both

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Figure 8.1 Opportunities and Outcomes of International Strategy

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<th>Identify International Opportunities</th>
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Source: © Copyrighted 2011 by Michael A. Hitt, R. Duane Ireland, and Robert E. Hoskisson
international business-level strategies and international corporate-level strategies. The five modes of entry firms consider when deciding how to enter international markets as a foundation for implementing their chosen international strategies are then considered. Firms encounter economic and political risks when using international strategies. These risks must be effectively managed if the firm is to achieve the strategic competitiveness outcomes of improved performance and enhanced innovation. After discussing the outcomes firms seek when using international strategies, the chapter closes with mention of two cautions about international strategy that should be kept in mind.

Identifying International Opportunities

An international strategy is a strategy through which the firm sells its goods or services outside its domestic market. In some instances, firms using an international strategy become quite diversified geographically as they compete in numerous countries or regions outside their domestic market. This is the case for Starbucks in that it competes in over 50 countries. In other cases, firms experience less geographic or international diversification in that they only compete in a small number of markets outside their “home” market.

There are incentives for firms to use an international strategy and to diversify their operations geographically, and they can gain three basic benefits when they successfully do so. We show international strategy’s incentives and benefits in Figure 8.2.

**Figure 8.2 Incentives and Basic Benefits of International Strategy**

<table>
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<th>Incentives</th>
<th>Basic Benefits</th>
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<td>Extend a product’s life cycle</td>
<td>Increased market size</td>
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<td>Gain easier access to raw materials</td>
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<td>Opportunities to integrate operations on a global scale</td>
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<td>Opportunities to better use rapidly developing technologies</td>
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Incentives to Use International Strategy

Raymond Vernon expressed the classic rationale for an international strategy. He suggested that typically a firm discovers an innovation in its home-country market, especially in advanced economies such as those in Germany, France, Japan, Sweden, Canada, and the United States. Often demand for the product then develops in other countries, causing a firm to export products from its domestic operations to fulfill that demand. Continuing increases in demand can subsequently justify a firm’s decision to establish operations outside of its domestic base. As Vernon noted, taking these actions in the form of international strategy has the potential to help a firm extend the life cycle of its product(s).

Gaining access to needed and potentially scarce resources is another reason firms use an international strategy. Key supplies of raw material—especially minerals and energy—are critical to firms’ efforts in some industries to manufacture their products. Of course energy and mining companies have operations throughout the world to gain access to the raw materials they in turn sell to manufacturers requiring those resources. Rio Tinto is a leading international mining group. Operating as a global organization, the firm indicates that “most of (its) assets are in Australia and North America, but that (the firm) also operates in Europe, South America, Asia and Africa.” Rio Tinto extracts the raw materials it sells from various sources including “open pit and underground mines, mills, refineries and smelters.” In other industries where labor costs account for a significant portion of a company’s expenses, firms may choose to establish facilities in other countries to gain access to less expensive labor. Clothing and electronics manufacturers are examples of firms pursuing an international strategy for this reason.

Increased pressure to integrate operations on a global scale is another factor influencing firms to pursue an international strategy. As nations industrialize, the demand for some products and commodities appears to become more similar. This borderless demand for globally branded products such as those Starbucks provides may be due to similarities in lifestyle in developed nations.

Increases in global communications also facilitate the ability of people in different countries to visualize and model lifestyles in different cultures. With over 127,000 employees and stores in 41 countries, IKEA has become a global retail brand selling a wide variety of furniture and related products. Using operations (including marketing and advertising) that are integrated globally, IKEA sells all of its furniture in components that can be packaged in flat packs and assembled by consumers after purchase. This business model allows for easy shipping and handling, which in turn facilitates development of a global brand. Winning the Cannes Lions 2011 Advertiser of the Year Award for its “creative and effective global advertising efforts” is one indicator of IKEA’s effectiveness at integrating its operations on a global basis.

In an increasing number of industries, technology drives globalization because the economies of scale necessary to reduce costs to the lowest level often require an investment greater than that needed to meet domestic market demand. Moreover, in emerging markets the increasingly rapid adoption of technologies such as the Internet and mobile applications permits greater integration of trade, capital, culture, and labor. In this sense, technologies are the foundation for efforts to bind together disparate markets and operations across the world. International strategy makes it possible for firms to use technologies to organize their operations into a seamless whole.

The potential of large demand for goods and services from people in emerging markets such as China and India is another strong incentive for firms to use an international strategy. This is the case for French-based Carrefour Group. This firm is the world’s second-largest retailer (behind only Walmart) and the largest in Europe. Carrefour operates four main grocery stores formats—hypermarkets, supermarkets, hard discount, and convenience stores. Recently, Carrefour acquired minority stakes in three mainland Chinese retailers to strengthen its presence there, as the firm sees this market as critical to its growth plans.
Even though India, another emerging market economy, differs from Western countries in many respects, including culture, politics, and the precepts of its economic system, it also offers a huge potential market and its government is becoming more supportive of foreign direct investment. However, differences among Chinese, Indian, and Western-style economies and cultures make the successful use of an international strategy challenging. In particular, firms seeking to meet customer demands in emerging markets must learn how to manage an array of political and economic risks, such as those we discuss later in the chapter.

We’ve now discussed incentives that influence firms to use international strategies. Firms derive three basic benefits by successfully using international strategies: (1) increased market size; (2) increased economies of scale and learning; and (3) development of a competitive advantage through location (e.g., access to low-cost labor, critical resources, or customers). These benefits will be examined here in terms of both their costs (such as higher coordination expenses and limited access to knowledge about host country political influences) and their challenges.

Three Basic Benefits of International Strategy

As noted, effectively using one or more international strategies can result in three basic benefits for the firm. These benefits facilitate the firm’s effort to achieve strategic competitiveness (see Figure 8.1) when using an international strategy.

Increased Market Size

Firms can expand the size of their potential market—sometimes dramatically—by using an international strategy to establish stronger positions in markets outside their domestic market. As noted, access to additional consumers is a key reason Carrefour sees China as a major source of growth.

Takeda, a large Japanese pharmaceutical company, recently acquired Swiss drug maker Nycomed for $13.7 billion. Buying Nycomed makes Takeda a major player in European markets. More significantly, the acquisition broadens Takeda’s distribution capability in emerging markets “at a time when pharmaceutical firms worldwide are wrestling with the impact on revenue from the expiration of patents.” In fact, the Nycomed deal will increase Takeda’s sales in China about fourfold. Along with Starbucks, Carrefour and Takeda are two additional companies relying on international strategy as the path to increased market size in China.

Firms such as Starbucks, Carrefour, and Takeda understand that effectively managing different consumer tastes and practices linked to cultural values or traditions in different markets is challenging. Nonetheless, they accept this challenge because of the potential to enhance the firm’s performance. Other firms accept the challenge of successfully implementing an international strategy largely because of limited growth opportunities in their domestic market. This appears to be at least partly the case for major competitors Coca-Cola and PepsiCo, firms that have not been able to generate significant growth in their U.S. domestic (and North America) markets for some time. Indeed, most of these firms’ growth is occurring in international markets. These two firms approach international growth somewhat differently. PepsiCo, the world’s largest snack-food maker as a result of its Frito-Lay division, relies “on chip sales overseas to make up for slower beverage sales volumes in North America.” Less diversified than PepsiCo in terms of products but not in terms of geography, Coca-Cola is the world’s largest producer of soft drink concentrates and syrups and the world’s largest producer of juice and juice-related products. Selling its products in more than 200 countries, Coca-Cola derives only approximately 32 percent of its revenue from sales in North America, suggesting that the firm’s international strategies are critical to its efforts to be competitively successful and that it does not rely on sales in North America as the cornerstone of its efforts to outperform PepsiCo, its chief rival.
An international market’s overall size also has the potential to affect the degree of benefit a firm can accrue as a result of using an international strategy. In general, larger international markets offer higher potential returns and thus pose less risk for the firm choosing to invest in those markets. Relatedly, the strength of the science base of the international markets in which a firm may compete is important in that scientific knowledge and the human capital needed to use that knowledge can facilitate efforts to more effectively sell and/or produce products that create value for customers.¹⁸

### Economies of Scale and Learning

By expanding the number of markets in which they compete, firms may be able to enjoy economies of scale, particularly in their manufacturing operations. More broadly, firms able to standardize the processes used to produce, sell, distribute, and service their products across country borders enhance their ability to learn how to continuously reduce costs while hopefully increasing the value their products create for customers. For example, rivals Airbus SAS and Boeing have multiple manufacturing facilities and outsource some activities to firms located throughout the world, partly for the purpose of developing economies of scale as a source of being able to create value for customers.

Economies of scale are critical in a number of settings in addition to the airline manufacturing industry. Automobile manufacturers certainly seek economies of scale as a benefit of their international strategies. Competing in markets throughout the world, Ford Motor Company “is counting on rapid growth in Asia to fuel a dramatic expansion of sales and boost profits over the next several years…”¹⁹ Overall, Ford seeks to increase the annual number of products it sells outside of North America to 8 million units by the end of 2015 (up from about 5.3 million sold internationally in 2010). Ford is using a global corporate-level international strategy to reach this objective (this strategy is discussed later in the chapter). Demonstrating the use of this international strategy is the fact that Ford is now run as a single global business developing cars and trucks that can be built and sold throughout the world. By 2015, the firm intends for about 75 percent of all the vehicles it sells globally to be variants of five basic sets of manufacturing platforms. “The company is counting on these platforms to cut costs by increasing economies of scale.”²⁰ Using these five platforms and the relatively small number of product variants they allow the firm to produce, Ford intends to increase the number of products it sells in China from 5 to 15 and in India to from 5 to 8.

Firms may also be able to exploit core competencies in international markets through resource and knowledge sharing between units and network partners across country borders.²¹ By sharing resources and knowledge in this manner, firms can learn how to create synergy, which in turn can help each firm learn how to produce higher-quality products at a lower cost. This may be the case for the members of the International Aero Engines (IAE) consortium: Pratt & Whitney, Rolls Royce, Japanese Aero Engines, and MTU Aero. Relying on their members’ joint capabilities and core competencies, IAE recently developed an innovative PurePower geared turbofan engine platform. One version of this engine is in some of Airbus’ new A320neo aircraft, which the consortium sees as a positive reaction to its innovation.²²

Working in multiple international markets also provides firms with new learning opportunities,²³ perhaps even in terms of research and development activities. Increasing the firm’s R&D ability can contribute to the efforts to enhance innovation, which is critical to both short- and long-term success. However, research
results suggest that to take advantage of international R&D investments, firms need to already have a strong R&D system in place to absorb knowledge resulting from effective R&D activities.24

Location Advantages
Locating facilities in markets outside their domestic market can sometimes help firms reduce costs. This benefit of an international strategy accrues to the firm when its facilities in international locations provide easier access to lower-cost labor, energy, and other natural resources. Other location advantages include access to critical supplies and to customers. Once positioned favorably with an attractive location, firms must manage their facilities effectively to gain the full benefit of a location advantage.25

A firm’s costs, particularly those dealing with manufacturing and distribution, as well as the nature of international customers’ needs, affect the degree of benefit it can capture through a location advantage.26 Cultural influences may also affect location advantages and disadvantages. International business transactions are less difficult for a firm to complete when there is a strong match among the cultures with which the firm is involved while implementing its international strategy.27 Finally, physical distances influence firms’ location choices as well as how to manage facilities in the chosen locations.28

International Strategies
Firms choose to use one or both basic types of international strategy: business-level international strategy and corporate-level international strategy. At the business level, firms select from among the generic strategies of cost leadership, differentiation, focused cost leadership, focused differentiation, and integrated cost leadership/differentiation. At the corporate level, multidomestic, global, and transnational international strategies (the transnational is a combination of the multidomestic and global strategies) are considered. To contribute to the firm’s efforts to achieve strategic competitiveness in the form of improved performance and enhanced innovation (see Figure 8.1), each international strategy the firm uses must be based on one or more core competencies.29

International Business-Level Strategy
Firms considering the use of any international strategy first develop domestic-market strategies (at the business level and at the corporate level if the firm has diversified at the product level). One reason this is important is that the firm may be able to use some of the capabilities and core competencies it has developed in its domestic market as the foundation for competitive success in international markets.30 However, research results indicate that the value created by relying on capabilities and core competencies developed in domestic markets as a source of success in international markets diminishes as a firm’s geographic diversity increases.31

As we know from our discussion of competitive dynamics in Chapter 5, firms do not select and then use strategies in isolation of market realities. In the case of international strategies, conditions in a firm’s domestic market affect the degree to which the firm can build on capabilities and core competencies it established in that market to create capabilities and core competencies in international markets. The reason for this is grounded in Michael Porter’s analysis of why some nations are more competitive than other nations and why and how some industries within nations are more competitive relative to those industries in other nations. Porter’s core argument is that conditions or factors in a firm’s home base—that is, in its domestic market—either hinder the firm’s efforts to use an international business-level strategy for the purpose of establishing a competitive advantage in international markets or support those efforts. Porter identifies four factors as determinants of a national advantage that some countries possess (see Figure 8.3).32 Interactions among these four factors influence a firm’s choice of international business-level strategy.
The first determinant of national advantage is factors of production. This determinant refers to the inputs necessary for a firm to compete in any industry. Labor, land, natural resources, capital, and infrastructure (such as transportation, postal, and communication systems) are examples of such inputs. There are basic factors (for example, natural and labor resources) and advanced factors (such as digital communication systems and a highly educated workforce). Other production factors are generalized (highway systems and the supply of debt capital) and specialized (skilled personnel in a specific industry, such as the workers in a port that specialize in handling bulk chemicals). If a country possesses advanced and specialized production factors, it is likely to serve an industry well by spawning strong home-country competitors that also can be successful global competitors.

Ironically, countries often develop advanced and specialized factors because they lack critical basic resources. For example, some Asian countries, such as South Korea, lack abundant natural resources but have a workforce with a strong work ethic, a large number of engineers, and systems of large firms to create an expertise in manufacturing. Similarly, Germany developed a strong chemical industry, partially because Hoechst and BASF spent years creating a synthetic indigo dye to reduce their dependence on imports, unlike Britain, whose colonies provided large supplies of natural indigo.

The second factor or determinant of national advantage, demand conditions, is characterized by the nature and size of customers’ needs in the home market for the products firms competing in an industry produce. Meeting the demand generated by a large number of customers creates conditions through which a firm can develop scale-efficient facilities and refine the capabilities, and perhaps core competencies, required to use those facilities. Once refined, the probability that the capabilities and core competencies will benefit the firm as it diversifies geographically increases.

This may be the case for some Chinese manufacturing companies that have spent years building their businesses in China and developing economies of scale and scale efficient facilities in the process of doing so. Today, many of these firms hope to be able
to rely on these facilities and the capabilities and core competencies they have developed to use those facilities to become “global players,” capable of using international business-level strategies to profitably sell their products in multiple international markets.  

The third factor in Porter’s model of the determinants of national advantage is related and supporting industries. Italy has become the leader in the shoe industry because of related and supporting industries. For example, a well-established leather-processing industry provides the leather needed to construct shoes and related products. Also, many people travel to Italy to purchase leather goods, providing support in distribution. Supporting industries in leather-working machinery and design services also contribute to the success of the shoe industry. In fact, the design services industry supports its own related industries, such as ski boots, fashion apparel, and furniture. In Japan, cameras and copiers are related industries. Similarly, it is argued that the creative resources associated with “popular cartoons such as Manga and the animation sector along with technological knowledge from the consumer electronics industry facilitated the emergence of a successful video game industry in Japan.” In a like manner, Germany is known for the quality of its machine tools, and Eastern Belgium is known for skilled manufacturing (supporting and related industries are important in these two settings too).

Firm strategy, structure, and rivalry make up the final determinant of national advantage and also foster the growth of certain industries. The types of strategy, structure, and rivalry among firms vary greatly from nation to nation. The excellent technical training system in Germany fosters a strong emphasis on continuous product and process improvements. In Japan, unusual cooperative and competitive systems facilitate the cross-functional management of complex assembly operations. In Italy, the national pride of the country’s designers spawns strong industries not only in shoes but also sports cars, fashion apparel, and furniture. In the United States, competition among computer manufacturers and software producers contributes to further development of these industries.

The four determinants of national advantage (see Figure 8.3) emphasize the structural characteristics of a specific economy that contribute to some degree to national advantage and that influence the firm’s selection of an international business-level strategy. Individual governments’ policies also affect the nature of the determinants as well as how firms compete within the boundaries governing bodies establish and enforce within a particular economy. While studying their external environment (see Chapter 2), firms considering the possibility of using an international strategy need to gather information and data that will allow them to understand the effects of governmental policies and their enforcement on their nation’s ability to establish advantage relative to other nations as well as the relative degree of competitiveness on a global basis of the industry in which firms might compete on a global scale.

Those leading companies should recognize that a firm based in a country with a national competitive advantage is not guaranteed success as it implements its chosen international business-level strategy. The actual strategic choices managers make may be the most compelling reasons for success or failure as firms diversify geographically. Accordingly, the factors illustrated in Figure 8.3 are likely to produce the foundation for a firm’s competitive advantages only when it develops and implements an appropriate international business-level strategy that takes advantage of distinct country factors. Thus, these distinct country factors should be thoroughly considered when making a decision about the international business-level strategy the firm will use. In a competitive rivalry sense, the firm will then make continuous adjustments to its international business-level strategy in light of the nature of competition it encounters in different international markets and in light of customers’ needs. Lexus, for example, does not have the share of the luxury car market in China that it desires. Accordingly, Toyota (Lexus’ manufacturer) is adjusting how it implements its international differentiation business-level strategy in China to better serve customers. The firm is doing this by “turning to the feature that cemented its early success in the United States: extreme customer service.
Showroom amenities such as cappuccino machines, Wi-Fi, Lego tables for the kids, and airport shuttles for busy executives dropping off their cars for servicing are examples of the services now being offered to customers in China. Time will tell if this adjustment to Lexus’ strategy in China will lead to the success the firm desires.

**International Corporate-Level Strategy**

A firm’s international business-level strategy is also based at least partially on its international corporate-level strategy. Some international corporate-level strategies give individual country units the authority to develop their own business-level strategies, while others dictate the business-level strategies in order to standardize the firm’s products and sharing of resources across countries.

International corporate-level strategy focuses on the scope of a firm’s operations through geographic diversification. International corporate-level strategy is required when the firm operates in multiple industries that are located in multiple countries or regions (e.g., Southeast Asia or the European Union) and in which they sell multiple products. The headquarters unit guides the strategy, although as noted, business- or country-level managers can have substantial strategic input depending on the type of international corporate-level strategy the firm uses. We show the three international corporate-level strategies in Figure 8.4. As shown, the international corporate-level strategies vary in terms of two dimensions—the need for global integration and the need for local responsiveness.

**Multidomestic Strategy**

A multidomestic strategy is an international strategy in which strategic and operating decisions are decentralized to the strategic business units in individual countries or regions for the purpose of allowing each unit the opportunity to tailor products to the local market.
local market. With this strategy, the firm’s need for local responsiveness is high while its need for global integration is low. Influencing these needs is the firm’s belief that consumer needs and desires, industry conditions (e.g., the number and type of competitors), political and legal structures, and social norms vary by country. Thus, a multidomestic strategy focuses on competition within each country in that market needs are thought to be segmented by country boundaries. To meet the specific needs and preferences of local customers, country or regional managers have the autonomy to customize the firm’s products. Therefore, these strategies should maximize a firm’s competitive response to the idiosyncratic requirements of each market. The multidomestic strategy is most appropriate for use when the differences between the markets a firm serves and the customers in them are significant.

The use of multidomestic strategies usually expands the firm’s local market share because the firm can pay attention to the local clientele’s needs. However, using a multidomestic strategy results in less knowledge sharing for the corporation as a whole because of the differences across markets, decentralization, and the different international business-level strategies employed by local units. Moreover, multidomestic strategies do not allow the development of economies of scale and thus can be more costly.

Unilever is a large European consumer products company selling products in over 180 countries. The firm has more than 400 global brands that are grouped into three business units—foods, home care, and personal care. Historically, Unilever has used a highly decentralized approach for the purpose of managing its global brands. This approach allows regional managers considerable autonomy to adapt the characteristics of specific products to satisfy the unique needs of customers in different markets. However, more recently, Unilever has sought to increase the coordination between its independent subsidiaries in order to establish an even stronger global brand presence. As such, Unilever may be transitioning from a multidomestic strategy to a transnational strategy.

**Global Strategy**

A global strategy is an international strategy in which a firm’s home office determines the strategies business units are to use in each country or region. This strategy indicates that the firm has a high need for global integration and a low need for local responsiveness. These needs indicate that compared to a multidomestic strategy, a global strategy seeks greater levels of standardization of products across country markets. The firm using a global strategy seeks to develop economies of scale as it produces the same or virtually the same products for distribution to customers throughout the world who are assumed to have similar needs. The global strategy offers greater opportunities to take innovations developed at the corporate level or in one market and apply them in other markets. Improvements in global accounting and financial reporting standards facilitate use of this strategy. A global strategy is most effective for us when the differences between markets and the customers the firm is serving are insignificant.

Efficient operations are required to successfully implement a global strategy. Increasing the efficiency of a firm’s international operations mandates resource sharing and greater coordination and cooperation across market boundaries. Centralized decision making as designed by headquarters details how resources are to be shared and coordinated across markets. Research results suggest that the outcomes a firm achieves by using a global strategy become more desirable when the strategy is used in areas where regional integration among countries is occurring.

CEMEX is a global building materials company that uses the international strategy. CEMEX is the world’s leading supplier of ready-mix concrete and one of the world’s largest producers of white Portland cement. CEMEX sells to customers in more than 50 countries in multiple regions, including the Americas, Europe, Africa, the Middle East, and Asia. With annual sales of more than $14 billion, the firm employs more than 47,000 people.

To implement its global strategy, CEMEX has centralized a number of its activities. The Shared Services Model is a recent example of how this firm centralizes operations in

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**A global strategy** is an international strategy in which a firm’s home office determines the strategies business units are to use in each country or region.
order to gain scale economies, among other benefits. According to company documents, this model “converges, centralizes, and streamlines back-office services—such as human resources and payroll, information technology, and transactional and financial services—for our operations across regions.” In essence, the Shared Services Model integrates and centralizes some support functions from the firm’s value chain (see Chapter 3). This integration and centralization brings about the types of benefits sought by firms when using a global strategy. Significant cost savings, increases in the productivity of the involved support functions, the fostering of economies of scale, and the freeing up of resources to enable an improved focus on core tasks are examples of the benefits CEMEX is accruing by using its Shared Services Model.

Because of increasing global competition and the need to simultaneously be cost efficient and produce differentiated products, the number of firms using a transnational international corporate-level strategy is increasing.

**Transnational Strategy**

A transnational strategy is an international strategy through which the firm seeks to achieve both global efficiency and local responsiveness. With this strategy, the firm has strong needs for both global integration and local responsiveness. As noted in the Opening Case, Starbucks is using the transnational strategy to pursue profitable growth in international markets. For example, in China Starbucks is trying to standardize its operations (global integration) while it simultaneously decentralizes some decision-making responsibility to local levels so products can be made to meet customers’ unique needs (local responsiveness). Chai tea lattes, green tea black sesame frappuccinos, and back bean muffins are examples of products Starbucks has adapted to meet local tastes in China.

Realizing the twin goals of global integration and local responsiveness is difficult in that global integration requires close global coordination while local responsiveness requires local flexibility. “Flexible coordination”—building a shared vision and individual commitment through an integrated network—is required to implement the transnational strategy. Such integrated networks allow a firm to manage its connections with customers, suppliers, partners, and other parties more efficiently rather than using arm’s-length transactions. The transnational strategy is difficult to use because of its conflicting goals (see Chapter 11 for more on the implementation of this and other corporate-level international strategies). On the positive side, effectively implementing a transnational strategy often produces higher performance than does implementing either the multidomestic or global strategies.

Transnational strategies are becoming increasingly necessary to successfully compete in international markets. Reasons for this include the fact that continuing increases in the number of viable global competitors challenge firms to reduce their costs. Simultaneously, the increasing sophistication of markets with greater information flows made possible largely by the diffusion of the Internet and the desire for specialized products to meet consumers’ unique needs pressures firms to differentiate their products in local markets. Differences in culture and institutional environments also require firms to adapt their products and approaches to local environments. However, some argue that transnational strategies are not required to successfully compete in international markets. Those holding this view suggest that most multinational firms try to compete at the regional level (e.g., the European Union) rather than at the country level. To the degree this is the case, the need for the firm to simultaneously offer relatively unique products that are adapted to local markets and to produce those products at lower costs permitted by developing scale economies is reduced.

Next we discuss trends in the global environment that are affecting the choices firms make when deciding which international corporate-level strategies to use and in which international markets to compete.
Environmental Trends

Although the transnational strategy is difficult to implement, an emphasis on global efficiency is increasing as more industries and the companies competing within them encounter intensified global competition. Magnifying the scope of this issue is the fact that, simultaneously, firms are experiencing demands for local adaptations of their products. These demands can be from customers (for products to satisfy their tastes and preferences) and from governing bodies (for products to satisfy a country’s regulations). In addition, most multinational firms desire coordination and sharing of resources across country markets to hold down costs, as illustrated by the CEMEX example.54

Because of these conditions, some large multinational firms with diverse products use a multidomestic strategy with certain product lines and a global strategy with others when diversifying geographically. Many multinational firms may require this type of flexibility if they are to be strategically competitive, in part due to trends that change over time.

Liability of foreignness and regionalization are two important trends influencing a firm’s choice and use of international strategies, particularly international corporate-level strategies. We discuss these trends next.

Liability of Foreignness

The dramatic success of Japanese firms such as Toyota and Sony in the United States and other international markets in the 1980s was a powerful jolt to U.S. managers and awakened them to the importance of international competition and the fact that many markets were rapidly becoming globalized. In the twenty-first century, Brazil, Russia, India, and China (BRIC) represent major international market opportunities for firms from many countries, including the United States, Japan, Korea, and members of the European Union.55 However, even if foreign markets seem attractive, as appears to be the case with the BRIC countries, there are legitimate concerns for firms considering entering these markets. This is the liability of foreignness,56 a set of costs associated with various issues firms face when entering foreign markets, including unfamiliar operating environments; economic, administrative, and cultural differences; and the challenges of coordination over distances.57 Four types of distances commonly associated with liability of foreignness are cultural, administrative, geographic, and economic.58

Walt Disney Company’s experience while opening theme parks in foreign countries demonstrates the liability of foreignness. For example, Disney suffered “lawsuits in France, at Disneyland Paris, because of the lack of fit between its transferred personnel policies and the French employees charged to enact them.”59 Disney executives learned from this experience in building the firm’s theme park in Hong Kong as the company “went out of its way to tailor the park to local tastes.”60 Thus, as with Walt Disney Company, firms thinking about using an international strategy to enter foreign markets must be aware of the four types of distances they’ll encounter when
Regionalization

Regionalization is a second global environmental trend influencing a firm’s choice and use of international strategies. This trend is becoming prominent largely because where a firm chooses to compete can affect its strategic competitiveness. As a result, the firm considering using international strategies must decide if it should enter individual country markets or if it would be better served by competing in one or more regional markets rather than in individual country markets.

Currently, the global international strategy is used less frequently. It remains difficult to successfully implement even when the firm uses Internet-based strategies. In addition, the amount of competition vying for a limited amount of resources and customers can limit firms’ focus to a specific region rather than on country-specific markets that are located in multiple parts of the world. A regional focus allows firms to marshal their resources to compete effectively rather than spreading their limited resources across multiple country-specific international markets.

However, a firm that competes in industries where the international markets differ greatly (in which it must employ a multidomestic strategy) may wish to narrow its focus to a particular region of the world. In so doing, it can better understand the cultures, legal and social norms, and other factors that are important for effective competition in those markets. For example, a firm may focus on Far East markets only rather than competing simultaneously in the Middle East, Europe, and the Far East. Or the firm may choose a region of the world where the markets are more similar and some coordination and sharing of resources would be possible. In this way, the firm may be able not only to better understand the markets in which it competes, but also to achieve some economies, even though it may have to employ a multidomestic strategy. For instance, research suggests that most large retailers are better at focusing on a particular region rather than being truly global. Firms commonly focus much of their international market entries on countries adjacent to their home country, which might be referred to as their home region.

Countries that develop trade agreements to increase the economic power of their regions may promote regional strategies. The European Union (EU) and South America’s Organization of American States (OAS) are country associations that developed trade agreements to promote the flow of trade across country boundaries within their respective regions. Many European firms acquire and integrate their businesses in Europe to better coordinate pan-European brands as the EU creates more unity in European markets. With this process likely to continue as new countries are added to the agreement, some international firms may prefer to focus on regions rather than multiple country markets when entering international markets.

The North American Free Trade Agreement (NAFTA), signed by the United States, Canada, and Mexico, facilitates free trade across country borders in North America. NAFTA loosens restrictions on international strategies within this region and provides greater opportunity for regional international strategies.

Most firms enter regional markets sequentially, beginning in markets with which they are more familiar. They also introduce their largest and strongest lines of business into these markets first, followed by other product lines once the initial efforts are deemed successful. The additional product lines typically are introduced in the original investment location. However, research also suggests that the size of the market and industry characteristics can influence this decision.

After selecting its business- and corporate-level international strategies, the firm determines how it will enter the international markets in which it has chosen to compete. We turn to this topic next.
Choice of International Entry Mode

Five modes of entry into international markets are available to firms. We show these entry modes and their characteristics in Figure 8.5. Each means of market entry has its advantages and disadvantages, suggesting that the choice of entry mode can affect the degree of success the firm achieves by implementing an international strategy. Large firms competing in multiple markets commonly use more than one and may use all five entry modes.

Exporting

For many firms, exporting is the initial mode of entry used. Exporting is an entry mode through which the firm sends products it produces in its domestic market to international markets. The characteristics of exporting are high cost, low control.

Figure 8.5 Modes of Entry and Their Characteristics

- Exporting
  - High cost, low control

- Licensing
  - Low cost, low risk, little control, low returns
  - Shared costs, shared resources, shared risks, problems of integration (e.g., two corporate cultures)
  - Quick access to new markets, high costs, complex negotiations, problems of merging with domestic operations

- Strategic alliances
  - Complex, often costly, time consuming, high risk, maximum control, potential above-average returns

- Acquisitions
  - New wholly owned subsidiary

Source: © Copyrighted 2011 by Michael A. Hitt, R. Duane Ireland, and Robert E. Hoskisson
markets. Western Forms Inc., a manufacturing firm based in Kansas City, Missouri, is successfully using exporting as an entry mode. Employing approximately 200 employees, Western Forms makes aluminum-forming systems for concrete buildings. In 2010, the U.S. International Trade Administration recognized Western Forms for its exporting achievement as demonstrated by millions of dollars of new sales in India. In recognizing this firm, an official said that “Western Forms is a great example of a firm that has and continues to diversify internationally to better weather the ups and downs of its industry and the global economy.” Western Forms’ selection of exporting as the way of entering international markets is not surprising in that exporting is a popular entry mode choice for small businesses.

The number of small U.S. firms using an international strategy is increasing, with some predicting that up to 50 percent of small U.S. firms will be involved in international trade by 2018, most of them through export. By exporting, firms avoid the expense of establishing operations in host countries (that is, in countries outside their home country) in which they have chosen to compete. However, firms must establish some means of marketing and distributing their products when exporting. Usually, contracts are formed with host-country firms to handle these activities. Potentially high transportation costs to export products to international markets and the expense of tariffs placed on the firm’s products as a result of host countries’ policies are examples of exporting costs. The loss of some control when the firm contracts with local companies located in host countries for marketing and distribution purposes is another disadvantage of exporting. Moreover, contracting with local companies can be expensive, making it harder for the exporting firm to earn profits.

Evidence suggests that, in general, using an international cost leadership strategy when exporting to developed countries has the most positive effect on firm performance while using an international differentiation strategy with larger scale when exporting to emerging economies leads to the greatest amount of success.

Firms export mostly to countries that are closest to their facilities because of the lower transportation costs and the usually greater similarity between geographic neighbors. For example, United States’ NAFTA partners Mexico and Canada account for more than half of the goods exported from Texas. The Internet has also made exporting easier. Firms of any size can use the Internet to access critical information about foreign markets, examine a target market, research the competition, and find lists of potential customers. Governments also use the Internet to support the efforts of those applying for export and import licenses, facilitating international trade among countries while doing so.

**Licensing**

Licensing is an entry mode in which an agreement is formed that allows a foreign company to purchase the right to manufacture and sell a firm’s products within a host country’s market or a set of host countries’ markets. The licensor is normally paid a royalty on each unit produced and sold. The licensee takes the risks and makes the monetary investments in facilities for manufacturing, marketing, and distributing products. As a result, licensing is possibly the least costly form of international diversification. As with exporting, licensing is an attractive entry mode option for smaller firms, and potentially for newer firms as well.

China, a country accounting for almost one-third of all cigarettes smoked worldwide, is obviously a huge market for this product. U.S. cigarette firms want to have a strong presence in China but have had trouble entering this market, largely because of successful lobbying by state-owned tobacco firms against such entry. Because of these conditions, cigarette manufacturer Philip Morris International (PMI) had an incentive to form a deal with these state-owned firms. Accordingly, PMI and the China National Tobacco Corporation (CNTC) completed a licensing agreement at the end of 2005. This agreement provides CNTC access to the most famous brand in the world, Marlboro. Because it is a licensing agreement rather than a foreign direct investment by PMI, China maintains control of distribution. However, the Chinese state-owned tobacco monopoly,
as part of the agreement, also gets to have PMI’s help in distributing its own brands in select foreign markets. The result of this distribution approach for Chinese cigarettes is uncertain though. An analyst made the following observation about this distribution arrangement: “The question is whether it can pluck three cigarette brands—RGD, Harmony and Dubliss—from relative obscurity and elevate them to an international, or at least regional, presence.”

Another potential benefit of licensing as an entry mode is the possibility of earning greater returns from product innovations by selling the firm’s innovations in international markets as well as in the domestic market. Edu-Science, a Hong-Kong manufacturer of educational toys that have a base in science, is doing this through its recent multiyear licensing agreement with Scientific American magazine. Scientific American, founded in 1845 and the oldest continuously published magazine in the United States, remains an important science publication. The agreement calls for Edu-Science to produce a Scientific American-branded toy line ranging from “Science Fair Projects” to “How Things Work Today.” Using some of its existing innovative products in addition to others the firm may develop, the Edu-Science toys that will be part of the Scientific American brand are to be “distributed internationally and to all retail channels.”

Licensing also has disadvantages. For example, once a firm licenses its product or brand to another party, it has little control over selling and distribution. Developing licensing agreements that protect the interests of both parties while supporting the relationship embedded within an agreement helps deal with this potential disadvantage. In addition, licensing provides the least potential returns because returns must be shared between the licensor and the licensee. A another disadvantage is that the international firm may learn the technology of the party with whom it formed an agreement and then produce and sell a similar competitive product after the licensing agreement expires. Komatsu, for example, first licensed much of its technology from International Harvester, Bucyrus-Erie, and Cummins Engine to compete against Caterpillar in the earthmoving equipment business. Komatsu then dropped these licenses and developed its own products using the technology it had gained from the U.S. companies. Because of potential disadvantages such as those we have discussed, the parties to a licensing arrangement should formally finalize an agreement only after they are convinced that both parties’ best interests are protected.

Strategic Alliances
Increasingly popular as an entry mode among firms using international strategies, a strategic alliance finds a firm collaborating with another company in a different setting in order to enter one or more international markets. Firms share the risks and the resources required to enter international markets when using strategic alliances. Moreover, because partners bring their unique resources together for the purpose of working collaboratively, strategic alliances can facilitate developing new capabilities and possibly core competencies that may contribute to the firm’s strategic competitiveness. Indeed, developing and learning how to use new capabilities and/or competencies (particularly those related to technology) is often a key purpose for which firms use strategic alliances as an entry mode. Firms should be aware that establishing trust between partners is critical for developing and managing technology-based capabilities while using strategic alliances.

French-based Limagrain is the fourth largest seed company in the world through its subsidiary Vilmorin & Cie. An international agricultural cooperative group specializing in field seeds, vegetable seeds, and cereal products, part of Limagrain’s strategy calls for it to enter additional international markets. Limagrain is using strategic alliances as an entry mode. Recently the firm formed a strategic alliance with the Brazilian seed company Sementes Guerra in Brazil. Corn is the focus of the alliance between these companies. Guerra is a family-owned company engaged in seed research, the production of corn, wheat, and soybeans, and the distribution of those products to farmers in Brazil.
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Commenting about the purpose of this alliance, a Limagrain official suggested that, "Our investment in research, combined with Guerra’s knowledge of the Brazilian market and its commercial network, will extend the range of varieties (of seeds and corn) proposed to farmers."  

Not all alliances formed for the purpose of entering international markets are successful. Incompatible partners and conflict between the partners are primary reasons for failure when firms use strategic alliances as an entry mode. Another issue here is that international strategic alliances are especially difficult to manage. Trust is an important aspect of alliances and must be carefully managed. The degree of trust between partners strongly influences alliance success. The probability of alliance success increases as the amount of trust between partners expands. Efforts to build trust are affected by at least four fundamental issues: the initial condition of the relationship, the negotiation process to arrive at an agreement, partner interactions, and external events. Trust is also influenced by the country cultures involved in the alliance. Firms should be aware of these issues when trying to appropriately manage trust.

Research has shown that equity-based alliances over which a firm has more control are more likely to produce positive returns. (We discuss equity-based and other types of strategic alliances in Chapter 9.) However, if trust is required to develop new capabilities through an alliance, equity positions can serve as a barrier to the necessary relationship building. If conflict in a strategic alliance formed as an entry mode is not manageable, using acquisitions to enter international markets may be a better option.

**Acquisitions**

When a firm acquires another company to enter an international market, it has completed a cross-border acquisition. Specifically, a cross-border acquisition is an entry mode through which a firm from one country acquires a stake in or purchases all of a firm located in another country.

As free trade expands in global markets, firms throughout the world are completing a larger number of cross-border acquisitions. The ability of cross-border acquisitions to provide rapid access to new markets is a key reason for their growth. In fact, of the five entry modes, acquisitions often are the quickest means for firms to enter international markets.

Today, there is a broad range of cross-border acquisitions being completed by a diverse set of companies. Increasingly, Chinese companies are acquiring firms in other nations as a means of entering international markets. LDK Solar Co., with headquarters in Hi-Tech Industrial Park, Xinyu City, Jiangxi Province in the People’s Republic of China, is a leading vertically integrated manufacturer of photovoltaic products as well as a leading manufacturer of solar wafers in terms of capacity. This firm recently acquired 70 percent of U.S.-based Solar Power Inc. (SPI), which too is a vertically integrated photovoltaic solar developer. In commenting about this transaction, LDK Solar’s CEO said, “This transaction expands our downstream vertical integration opportunities and provides LDK Solar and SPI the opportunity to jointly explore opening manufacturing operations in the U.S. to further enhance SPI’s competitive advantage in North America.” 

Thus, the expectation is that both firms will benefit from this transaction.

JA Solar is another Chinese company involved with solar power that is using cross-border acquisitions as an entry mode. One of the world’s largest manufacturers of high-performance solar cells and solar power products, JA Solar acquired 100 percent of Silver Age Holdings, “a British Virgin Islands company that owns 100 percent of Solar Silicon Valley Electronic Science and Technology Co., Ltd.” A JA Solar official commented about the expected benefits of this acquisition: “By boosting JA Solar’s internal wafer capacity through this acquisition, we expect to achieve greater economies of scale and improve the company’s profitability.”

Interestingly, firms use cross-border acquisitions less frequently to enter markets where corruption affects business transactions and, hence, the use of international...
strategies. Firms’ preference is to use joint ventures to enter markets in which corruption is an issue rather than using acquisitions. (Discussed fully in Chapter 9, a joint venture is a type of strategic alliance in which two or more firms create a legally independent company and share their resources and capabilities to operate it.) However, these ventures fail more often, although this is less frequently the case for firms experienced with entering “corrupt” markets. When acquisitions are made in such countries, acquirers commonly pay smaller premiums to buy firms in different markets.100

Although increasingly popular, acquisitions as an entry mode are not without costs, nor are they easy to successfully complete and operate. Cross-border acquisitions carry some of the disadvantages of domestic acquisitions (see Chapter 7). In addition, they often require debt financing to complete, which carries an extra cost. Another issue for firms to consider is that negotiations for cross-border acquisitions can be exceedingly complex and are generally more complicated than are the negotiations associated with domestic acquisitions. Dealing with the legal and regulatory requirements in the target firm’s country and obtaining appropriate information to negotiate an agreement are also frequent problems. Finally, the merging of the new firm into the acquiring firm is often more complex than is the case with domestic acquisitions. The firm completing the cross-border acquisition must deal not only with different corporate cultures, but also with potentially different social cultures and practices.101 These differences make integrating the two firms after the acquisition more challenging; it is difficult to capture the potential synergy when integration is slowed or stymied because of cultural differences.102 Therefore, while cross-border acquisitions are popular as an entry mode primarily because they provide rapid access to new markets, firms considering this option should be fully aware of the costs and risks associated with using it.

**New Wholly Owned Subsidiary**

A **greenfield venture** is an entry mode through which a firm invests directly in another country or market by establishing a new wholly owned subsidiary. The process of creating a greenfield venture is often complex and potentially costly, but this entry mode affords maximum control to the firm and has the greatest amount of potential to contribute to the firm’s strategic competitiveness as it implements international strategies. This potential is especially true for firms with strong intangible capabilities that might be leveraged through a greenfield venture.103 Moreover, having additional control over its operations in a foreign market is especially advantageous when the firm has proprietary technology.

Research also suggests that “wholly owned subsidiaries and expatriate staff are preferred” in service industries where “close contacts with end customers” and “high levels of professional skills, specialized know-how, and customization” are required.104 Other research suggests that as investment, greenfield ventures are used more prominently when the firm’s business relies significantly on the quality of its capital-intensive manufacturing facilities. In contrast, cross-border acquisitions are more likely to be used as an entry mode when a firm’s operations are human capital intensive—for example, if a strong local union and high cultural distance would cause difficulty in transferring knowledge to a host nation through a greenfield venture.105

The risks associated with greenfield ventures are significant in that the costs of establishing a new business operation in a new country or market can be substantial. To support the operations of a newly established operation in a foreign country, the firm may have to acquire knowledge and expertise about the new market by hiring either host-country nationals, possibly from competitors, or through consultants, which can be costly. This new knowledge and expertise often is necessary to facilitate the building of new facilities, establishing distribution networks, and learning how to implement marketing strategies that can lead to competitive success in the new market.106 Importantly, while taking these actions the firm maintains control over the technology, marketing, and distribution of its products. Research also suggests that when the country risk is high, firms prefer to enter with joint ventures instead of greenfield investments. However, if
firms have previous experience in a country, they prefer to use a wholly owned greenfield venture rather than a joint venture. 107

The globalization of the air cargo industry has implications for companies such as UPS and FedEx. The impact of this globalization is especially pertinent to China and the Asia Pacific region. China’s air cargo market is expected to grow 11 percent per year through 2023. Accordingly, UPS and FedEx opened new hub operations in Shanghai and Guangzhou, respectively. These hubs supported the firms’ distribution and logistics business during the Olympics in Beijing. These investments are wholly owned because these firms need to maintain the integrity of their IT and logistics systems in order to maximize efficiency. Greenfield ventures also help these two firms maintain the proprietary nature of their systems. 108

Dynamics of Mode of Entry

Several factors affect the firm’s choice about how to enter international markets. Market entry is often achieved initially through exporting, which requires no foreign manufacturing expertise and investment only in distribution. Licensing can facilitate the product improvements necessary to enter foreign markets, as in the Komatsu example. Strategic alliances are a popular entry mode because they allow a firm to connect with an experienced partner already in the market. Partly because of this, geographically diversifying firms often use alliances in uncertain situations, such as an emerging economy where there is significant risk (e.g., Venezuela and Columbia). 109 However, if intellectual property rights in the emerging economy are not well protected, the number of firms in the industry is growing fast, and the need for global integration is high, other entry modes such as a joint venture (see Chapter 9) or a wholly owned subsidiary are preferred. 110 In the final analysis though, all three modes—export, licensing, and strategic alliance—can be effective means of initially entering new markets and for developing a presence in those markets.

Acquisitions, greenfield ventures, and sometimes joint ventures are used when firms want to establish a strong presence in an international market. Aerospace firms Airbus and Boeing have used joint ventures, especially in large markets, to facilitate entry, while military equipment firms such as Thales SA have used acquisitions to build a global presence. Japanese auto manufacturer Toyota has established a presence in the United States through both greenfield ventures and joint ventures. Because of Toyota’s highly efficient manufacturing processes, the firm wants to maintain control over manufacturing when possible. To date, Toyota has established manufacturing facilities in over 20 countries. Demonstrating the importance of greenfield ventures and joint ventures to Toyota’s international diversification strategy is the fact that the firm opened its first new manufacturing plant in Japan in over 20 years in 2011. 111 Both acquisitions and greenfield ventures are likely to come at later stages in the development of a firm’s international strategies.

Thus, to enter a global market, a firm selects the entry mode that is best suited to the situation at hand. In some instances, the various options will be followed sequentially, beginning with exporting and ending with greenfield ventures. In other cases, the firm may use several, but not all, of the different entry modes, each in different markets. The decision regarding which entry mode to use is primarily a result of the industry’s competitive conditions, the country’s situation and government policies, and the firm’s unique set of resources, capabilities, and core competencies.

Walmart Stores Inc.’s operations are divided into three divisions—Walmart USA, Sam’s Club, and Walmart International. Through Walmart International, this firm is diversified geographically and uses several entry modes to enter the international markets it serves. We discuss Walmart International’s operations and its entry modes in the Strategic Focus. Of course, Walmart uses the international cost leadership business-level strategy and, historically at least, has used the global strategy as its international corporate-level strategy.

Explore Walmart’s international growth strategy.
www.cengagebrain.com
Walmart’s size and scope have become legendary since the firm was started in Rogers, Arkansas in 1962. The company now serves more than 200 million customers weekly through its roughly 9,300 retail units operating in 15 countries under a total of 60 banners (Asda [United Kingdom] and Seiyu [Japan] are two of Walmart’s banners). Walmart’s fiscal year 2010 sales exceeded $405 billion; the firm employs 2.1 million people on a worldwide basis.

In 1991, Walmart entered Mexico. This was the firm’s first foray into international markets. Today, Walmart International (WMI), one of three Walmart divisions that was formed in 1993, is important to the firm’s continuing growth. Commenting about this importance, the firm’s executive vice president and chief financial officer recently stated that “We’re stepping up growth in our international operations to take advantage of growing economies and opportunities in emerging markets such as China and Brazil.”

Generating sales in excess of $115 billion in 2010, WMI accounts for more than 25 percent of Walmart’s total sales; importantly, WMI’s sales revenue is increasing approximately 20 percent per year. Typically, Walmart relies on its distribution, warehousing, logistics, and data management core competencies that were developed in its domestic (U.S.) market as the foundation for entering international markets.

Walmart uses several entry modes to enter international markets. A joint venture with Mexico-based Cifra for the purpose of establishing a Sam’s Club in Mexico City was its first international entry. Thus, Walmart did not use exporting as its first entry mode, demonstrating the fact that firms do not necessarily use the five entry modes sequentially. Walmart acquired a majority interest in Cifra in 1997 and officially changed the Cifra name to Walmart de Mexico in 2000. Today, Walmart operates close to 1,800 retail units in Mexico. In many ways, Mexico remains Walmart’s most successful entry into international markets.

Walmart’s most common entry modes are acquisitions and joint ventures. For example, Walmart Canada was founded in 1994 when Walmart acquired the Canadian Woolco chain of 122 stores from Woolworth Canada. To enter Honduras, Walmart bought a 33 percent interest in Central American Retail Holding Company in 2005. Initially, Walmart entered Argentina by establishing a Sam’s Club as a new wholly owned subsidiary in 1995. In 2007, Walmart enhanced its position in Argentina when it acquired three Auchan stores. Also in 2007, Walmart entered India through a joint venture with Bharti Enterprises. Operating as a joint venture, Bharti Walmart Pvt. Ltd. intends to open 20 additional cash-and-carry stores in India by the end of 2012. Recently, Walmart acquired a minority stake in the holding company of Yihaodian, a fast-growing e-commerce company in China. Yihaodian has achieved a strong position in online grocery sales. This firm provides next-day delivery of purchased items to customers at what it believes are competitive prices.

As our discussion shows, over time, Walmart has used joint ventures, acquisitions, and new wholly owned subsidiaries to enter international markets. In each instance, Walmart selects the entry mode that is most appropriate to the international market it wishes to enter based on the conditions (e.g., governmental policies and regulations) characterizing each market. But as is true for all firms, successfully implementing international strategies once it has entered an international market can be a challenge. Recently, China accused Walmart
(as well as Carrefour) of “price gouging and misleading consumers by advertising false discounts on goods sold in their stores.” More broadly, New York City pension funds asked Walmart to do more than require its vendors “to publish annual reports detailing working conditions in their factories.” Walmart indicated that it intends to positively respond to these matters as well as others that might surface as it implements its international strategies.


Risks in an International Environment

International strategies are risky, particularly those that would cause a firm to become substantially more diversified in terms of geographic markets served. Political and economic risks cannot be ignored by firms using international strategies (see specific examples of political and economic risks in Figure 8.6).

Political Risks

Political risks “denote the probability of disruption of the operations of multinational enterprises by political forces or events whether they occur in host countries, home country, or result from changes in the international environment.” Possible disruptions to a firm’s operations when seeking to implement its international strategy create numerous problems, including uncertainty created by government regulation, the existence of many, possibly conflicting, legal authorities or corruption, and the
potential nationalization of private assets. Firms investing in other countries when implementing their international strategy may have concerns about the stability of the national government and the effects of unrest and government instability on their investments or assets. To deal with these concerns, firms should conduct a political risk analysis of the countries or regions they may enter using one of the five entry modes. Through political risk analysis, the firm examines potential sources and factors of noncommercial disruptions of their foreign investments and the operations flowing from them.

Russia has experienced a relatively high level of institutional instability in the years following its revolutionary transition to a more democratic government. Decentralized political control and frequent changes in policies created chaos for many, but especially for those in the business landscape. In an effort to regain more central control and reduce the chaos, Russian leaders took actions such as prosecuting powerful private firm executives, seeking to gain state control of firm assets, and not approving some foreign acquisitions of Russian businesses. The initial institutional instability, followed by the actions of the central government, caused some firms to delay or avoid significant foreign direct investment in Russia. Although leaders in Russia have tried to reassure potential investors about their property rights, prior actions, the fact that other laws (e.g., environmental and employee laws) are weak, and commonplace government corruption make firms leery of investing in Russia.

**Economic Risks**

Economic risks include fundamental weaknesses in a country or region’s economy with the potential to cause adverse effects on firms’ efforts to successfully implement their international strategies. As illustrated in the example of Russian institutional instability and property rights, political risks and economic risks are interdependent. If firms cannot protect their intellectual property, they are highly unlikely to use a means of entering a foreign market that involves significant and direct investments. Therefore, countries need to create, sustain, and enforce strong intellectual property rights in order to attract foreign direct investment.

Another economic risk is the perceived security risk of a foreign firm acquiring firms that have key natural resources or firms that may be considered strategic in regard to intellectual property. For instance, many Chinese firms have been buying natural resource firms in Australia and Latin America as well as manufacturing assets in the United States. This has made the governments of the key resource firms nervous about such strategic assets falling under the control of state-owned Chinese firms. Terrorism has also been of concern. Indonesia has difficulty competing for investment against China and India, countries that are viewed as having fewer security risks.

As noted earlier, the differences and fluctuations in the value of currencies is among the foremost economic risks of using an international strategy. This is especially true as the level of the firm’s geographic diversification increases to the point where the firm is trading in a large number of currencies. The value of the dollar relative to other currencies determines the value of the international assets and earnings of U.S. firms; for example, an increase in the value of the U.S. dollar can reduce the value of U.S. multinational firms’ international assets and earnings in other countries. Furthermore, the value of different currencies can dramatically affect a firm’s competitiveness in global markets because of its effect on the prices of goods manufactured in different countries. An increase in the value of the dollar can harm U.S. firms’ exports to international markets because of the price differential of the products. Thus, government oversight and control of economic and financial capital in a country affect not only local economic activity, but also foreign investments in the country. Certainly, the significant political and policy changes in Eastern Europe since the early 1990s have stimulated much more FDI there.
An international diversification strategy is a strategy through which a firm expands the sales of its goods or services across the borders of global regions and countries into a potentially large number of geographic locations or markets.

**Strategic Competitiveness Outcomes**

As previously discussed, international strategies can result in three basic benefits (increased market size, economies of scale and learning, and location advantages) for firms. These basic benefits are gained when the firm successfully manages political and economic risks while implementing its international strategies; in turn, these benefits are critical to the firm’s efforts to achieve strategic competitiveness (as measured by improved performance and enhanced innovation—see Figure 8.1).

Overall, the degree to which firms achieve strategic competitiveness through international strategies is expanded or increased when they successfully implement an international diversification strategy. As an extension or elaboration of international strategy, an international diversification strategy is a strategy through which a firm expands the sales of its goods or services across the borders of global regions and countries into a potentially large number of geographic locations or markets. Instead of entering one or just a few markets, the international diversification strategy finds firms using international business-level and international corporate-level strategies for the purpose of entering multiple regions and markets in order to sell their products.

**International Diversification and Returns**

Evidence suggests numerous reasons for firms to use an international diversification strategy, meaning that international diversification should be related positively to firms’ performance as measured by the returns it earns on its investments. Research has shown that as international diversification increases, a firm’s returns decrease initially but then increase quickly as it learns how to manage the increased geographic diversification it has created. In fact, the stock market is particularly sensitive to investments in international markets. Firms that are broadly diversified into multiple international markets usually achieve the most positive stock returns, especially when they diversify geographically into core business areas.

Many factors contribute to the positive effects of international diversification, such as private versus government ownership, potential economies of scale and experience, location advantages, increased market size, and the opportunity to stabilize returns. The stabilization of returns helps reduce a firm’s overall risk. Large, well-established firms and entrepreneurial ventures can both achieve these positive outcomes by successfully implementing an international diversification strategy.

Based in Japan, Asahi Group Holdings Ltd. seeks to become one of the world’s top 10 food and beverage companies. It touts alcoholic beverages, soft drinks, infant formula, dietary supplements, freeze dried soups, and candy in its portfolio. Using the acquisition mode of entry, Asahi is currently implementing an international diversification strategy as it acquires a number of companies in foreign markets. Recently, Asahi acquired all or part of companies in Australia, New Zealand, and China and plans to acquire companies in other markets in the years to come for the purpose of expanding its geographic scope, strengthening its product portfolio, and gaining economies of scale, particularly in supply chain management.
Enhanced Innovation

In Chapter 1, we indicated that developing new technology is at the heart of strategic competitiveness. As noted in our discussion of the determinants of national advantage (see Figure 8.3), a nation’s competitiveness depends, in part, on the capacity of its industries to innovate. Eventually and inevitably, competitors outperform firms that fail to innovate. Therefore, the only way for individual nations and individual firms to sustain a competitive advantage is to upgrade it continually through innovation.126

An international diversification strategy and the geographic diversification it brings about create the potential for firms to achieve greater returns on their innovations (through larger or more numerous markets) while reducing the often substantial risks of R&D investments. Additionally, international diversification may be necessary to generate the resources required to sustain a large-scale R&D operation. An environment of rapid technological obsolescence makes it difficult to invest in new technology and the capital-intensive operations necessary to compete in such an environment. Firms operating solely in domestic markets may find such investments difficult because of the length of time required to recoup the original investment. However, diversifying into a number of international markets improves a firm’s ability to appropriate additional returns from innovation before competitors can overcome the initial competitive advantage created by the innovation. In addition, firms moving into international markets are exposed to new products and processes. If they learn about those products and processes and integrate this knowledge into their operations, further innovation can be developed. To incorporate the learning into their own R&D processes, firms must manage those processes effectively in order to absorb and use the new knowledge to create further innovations.127 For a number of reasons then, international strategies and certainly an international diversification strategy provide incentives for firms to innovate.128

The relationship among international geographic diversification, innovation, and returns is complex. Some level of performance is necessary to provide the resources the firm needs to diversify geographically; in turn, geographic diversification provides incentives and resources to invest in R&D. Effective R&D should enhance the firm’s returns, which then provide more resources for continued geographic diversification and investment in R&D. Of course, the returns generated from these relationships increase through effective managerial practices. Evidence suggests that more culturally diverse management teams often have a greater knowledge of international markets and their idiosyncrasies, but their orientation to expand internationally can be affected by the nature of their compensation.129 Moreover, managing the business units of a geographically diverse multinational firm requires skill, not only in managing a decentralized set of businesses, but also coordinating diverse points of view emerging from businesses located in different countries and regions. Firms able to do this increase the likelihood of outperforming their rivals.130

The Challenge of International Strategies

Effectively using international strategies creates basic benefits and contributes to the firm’s strategic competitiveness. However, for several reasons, attaining these positive outcomes is difficult.

Complexity of Managing International Strategies

Pursuing international strategies, particularly an international diversification strategy, typically leads to growth in a firm’s size and the complexity of its operations. In turn, larger size and greater operational complexity make a firm more difficult to manage. At some point, size and complexity either cause firms to become virtually unmanageable or increase the cost of their management beyond the value using international strategies
creates. Different cultures and institutional practices (such as those associated with governmental agencies) that are part of the countries in which a firm competes when using an international strategy also can create difficulties.  

Toyota’s experiences over the past few years appear to demonstrate the relationship between firm size and managerial complexity. Toyota became the world’s largest car manufacturer at the end of 2008, surpassing General Motors (GM had been the largest auto manufacturer for 77 years). As always is the case though, larger size makes a firm harder to manage successfully. In spite of its legendary focus on and reputation for quality, Toyota experienced product quality problems, particularly in the all-important U.S. market, over the past few years and after becoming the world’s largest manufacturer. Perhaps the increased difficulty of managing a larger firm contributed to Toyota’s product quality problems. However, Toyota seems to be recovering from these difficulties and continues seeking additional growth through its international strategy. Saying that “India is an integral part of (the firm’s) global growth strategy,” Toyota recently introduced the Etios Liva as a competitor in India’s small car market.  

Interestingly, Volkswagen-Porsche has replaced Toyota as the world’s largest car and truck manufacturer. Highly diversified, this company’s portfolio of passenger cars includes Audi, Bentley, Bugatti, Lamborghini, SEAT, and Skoda in addition to Porsche and VW. Time will tell if this firm is now of a size and complexity level that will make it difficult to successfully manage its international strategies.

**Limits to International Expansion**

Learning how to effectively manage an international strategy improves the likelihood of achieving positive outcomes such as enhanced performance. However, at some point the degree of geographic and (possibly) product diversification the firm’s international strategies bring about causes the returns from using the strategies to level off and eventually become negative.  

There are several reasons that explain the limits to the positive effects of the diversification associated with international strategies. First, greater geographic dispersion across country borders increases the costs of coordination between units and the distribution of products. Second, trade barriers, logistical costs, cultural diversity, and other differences by country (e.g., access to raw materials and different employee skill levels) greatly complicate the implementation of an international strategy.

Institutional and cultural factors can be strong barriers to the transfer of a firm’s core competencies from one market to another. Marketing programs often have to be redesigned and new distribution networks established when firms expand into new markets. In addition, firms may encounter different labor costs and capital expenses. In general, it becomes increasingly difficult to effectively implement, manage, and control a firm’s international operations with increases in geographic diversity.

The amount of diversification in a firm’s international operations that can be managed varies from company to company and is affected by managers’ abilities to deal with ambiguity and complexity. The problems of central coordination and integration are mitigated if the firm’s international operations find it competing in friendly countries that are geographically close and have cultures similar to its own country’s culture. In that case, the firm is likely to encounter fewer trade barriers, the laws and customs are better understood, and the product is easier to adapt to local markets. For example, U.S. firms may find it less difficult to expand their operations into Mexico, Canada, and Western European countries than into Asian countries.

Relationships between the firm using an international strategy and the governments in the countries in which the firm is competing can also be constraining. The reason for this is that the differences in host countries’ governmental policies and practices can be substantial, creating a need for the focal firm to learn how to manage what can be a large set of different enforcement policies and practices. At some point, the differences create too many problems for the firm to be successful. Using strategic alliances is
another way firms can deal with this limiting factor. Partnering with companies in different countries allows the focal firm to rely on its partner to help deal with local laws, rules, regulations, and customs. But these partnerships are not risk free and managing them tends to be difficult.  

Known initially as the Qingdao Refrigerator Company, Haier Group is a Chinese company that started selling products in 1999 under the Haier name in international markets. Prior to doing so, the firm became a dominant competitor in its domestic Chinese markets and is using some of its domestic capabilities and core competencies to support its objective of establishing Haier as a global brand. We discuss these efforts in the Strategic Focus.

**STRATEGIC FOCUS**

**HAIER GROUP: A STORY OF PRODUCT AND GEOGRAPHIC DIVERSIFICATION**

Based in Qingdao, China, Haier Group is a company with a significant amount of product and geographic diversification. In terms of product diversification, the firm’s portfolio includes a broad array of products such as white goods home appliances (refrigerators, washing machines, freezers, televisions, DVD players, and so forth) and communication and information products (mobile phones and computers), among many others. Serving customers in Europe, South Asia, Asia-Pacific, the Middle East, and North America and in individual countries such as China demonstrates the company’s extensive geographic diversification. Haier America, which is the North American division of Haier Group, was established in 1999 as a wholly owned subsidiary. Today, Haier Group holds the largest share of the world’s market for major appliances.

Relying initially on techniques such as total quality management, Haier established a strong brand name for its refrigerators in China, its domestic market. Reliability and product quality were core competencies that allowed the firm to become China’s leading manufacturer of refrigerators. The firm then diversified into related appliances such as dishwashers, freezers, and microwaves and was able to expand its reputation for producing reliable, high-quality products. As is true for many firms, Haier concluded that geographic diversification in addition to the product diversification it had already experienced were critical to the firm’s continuing growth efforts. Today, product quality, reliability, and a strong customer focus are the core competencies developed in its domestic market on which Haier relies as the foundation for its international strategies.

When still known as the Qingdao Refrigerator Co., the firm exported refrigerators to Germany, its first international market. A more significant exporting effort was launched in 1992 when the firm exported larger numbers of refrigerators to Indonesia. To further diversify geographically, Haier has also used joint ventures and greenfield ventures. Over time, the firm has produced and sold its products through joint ventures in countries such as Indonesia, Malaysia, Yugoslavia, and Bangladesh and by establishing wholly owned subsidiaries in regions including North America. Thus, this firm has used several entry modes to enter international markets.

Using the multidomestic international corporate-level strategy, Haier wants to build a global brand name for its products. To some observers, reaching this objective could be
The use of international strategies is increasing. Multiple factors and conditions are influencing the increasing use of these strategies, including opportunities to (1) extend a product’s life cycle, (2) gain access to critical raw materials, sometimes including relatively inexpensive labor, (3) integrate a firm’s operations on a global scale to better serve customers in different countries, (4) better serve customers whose needs appear to be more alike today as a result of global communications’ media and the Internet’s capabilities to inform, and (5) meet increasing demand for goods and services that is surfacing in emerging markets.

When used effectively, international strategies yield three basic benefits: increased market size, economies of scale and learning, and location advantages. Firms use international business-level and international corporate-level strategies to geographically diversify their operations.

International business-level strategies are usually grounded in one or more home-country advantages. Research suggests that there are four determinants of national advantage: factors of production; demand conditions; related and supporting industries; and patterns of firm strategy, structure, and rivalry.

There are three types of international corporate-level strategies. A multidomestic strategy focuses on competition within each country in which the firm competes. Firms using a multidomestic strategy decentralize strategic and operating decisions to the business units operating in each country, so that each unit can tailor its products to local conditions. A global strategy assumes more standardization of products across country boundaries; therefore, a competitive strategy is centralized and controlled by the home office. Commonly, large multinational firms, particularly those with multiple diverse products being sold in many different markets, use a multidomestic strategy with some product lines and a global strategy with others.

A transnational strategy seeks to integrate characteristics of both multidomestic and global strategies for the purpose of being able to simultaneously emphasize local responsiveness and global integration.

Two global environmental trends—liability of foreignness and regionalization—are influencing firms’ choices of international strategies as well as their implementation. Liability of foreignness challenges firms to recognize that four types of distance between their domestic market and international markets affect how they compete. Some firms choose to concentrate their international strategies on regions (e.g., the EU and NAFTA) rather than on individual country markets.

Firms can use one or more of five entry modes to enter international markets. Exporting, licensing, strategic alliances, acquisitions, and new wholly owned subsidiaries, often referred to as greenfield ventures, are the five entry modes.
modes. Most firms begin with exporting or licensing, because of their lower costs and risks, but later they might use strategic alliances and acquisitions as well. The most expensive and risky means of entering a new international market is establishing a new wholly owned subsidiary. On the other hand, such subsidiaries provide the advantages of maximum control by the firm and, if successful, the greatest returns. Large, geographically diversified firms such as Walmart use most or all five entry modes when implementing international strategies.

Firms encounter a number of risks when implementing international strategies. The two major categories of risks firms need to understand and address when diversifying geographically through international strategies are political risks (risks concerned with the probability a firm’s operations will be disrupted by political forces or events, whether they occur in the firm’s domestic market or in the markets the firm has entered to implement its international strategies) and economic risks (risks resulting from fundamental weaknesses in a country’s or a region’s economy with the potential to adversely affect a firm’s ability to implement its international strategies).

**Review Questions**

1. What incentives influence firms to use international strategies?
2. What are the three basic benefits firms can achieve by successfully using an international strategy?
3. What four factors are determinants of national advantage and serve as a basis for international business-level strategies?
4. What are the three international corporate-level strategies? What are the advantages and disadvantages associated with these individual strategies?
5. What are some global environmental trends affecting the choice of international strategies, particularly international corporate-level strategies?
6. What five entry modes do firms consider as paths to use to enter international markets? What is the typical sequence in which firms use these entry modes?
7. What are political risks and what are economic risks? How should firms approach dealing with these risks?
8. What are the strategic competitiveness outcomes firms can reach through international strategies, and particularly through an international diversification strategy?
9. What are two important issues that can potentially affect a firm’s ability to successfully use international strategies?

**Experiential Exercises**

**Exercise 1: McDonald’s: Global, Multidomestic, or Transnational Strategy?**

McDonald’s is one of the world’s best-known brands. The company has approximately 32,000 restaurants located in more than 117 countries, and serves 58 million customers every day. McDonald’s opened its first international restaurant in Japan in 1971. Its “golden arches” are featured prominently in two former bastions of communism: Pushkin Square in Moscow and Tiananmen Square in Beijing, China.

What strategy has McDonald’s used to achieve such visibility? For this exercise, each group will be asked to conduct some background research on the firm and then make a brief presentation to identify the international strategy (i.e., global, multidomestic, or transnational) that McDonald’s is implementing.

**Individual**

Search the Internet to find examples of menu variations in different countries. How much do menu items for a McDonald’s restaurant in the United States differ from those in McDonald’s located outside the United States?

**Groups**

Review the characteristics of global, multidomestic, and transnational strategies. Conduct additional research to assess the
strategy that best describes the one McDonald’s is using. Prepare a flip chart with a single page of bullet points to explain your reasoning.

Whole Class
Each group should have five to seven minutes to explain its reasoning. Following a Q&A for each group, each class member should vote for his or her respective strategy choice.

EXERCISE 2: WHERE NEXT?
In this exercise, you are to consider your team to be a consultant to a multinational fast food restaurant company that is trying to increase its international exposure in the coming years. As you recall from the chapter, an international strategy is one in which “the firm sells its goods or services outside its domestic market.” The choices to do so are varied and include exporting, licensing, alliance, acquisition, or creating a new wholly owned subsidiary. The reasons are just as varied as the entry modes.

To identify a suitable candidate for analysis, consult research databases such as Datamonitor or Business Source Complete. For example, Jack in the Box operates over 2,700 units but they are all in the United States, which provides advantages as well as disadvantages. Compare this with McDonald’s, the world’s largest food-service retailing chain, with 32,737 restaurants operating in 117 countries as of 2011. You will also find SWOT (strengths, weaknesses, opportunities, threats) analysis on companies through databases such as those mentioned above.

Your consulting firm has been retained by the fast food retailer to investigate the feasibility of expanding internationally. You should be prepared to address the following questions:

1. Which international location(s) seem to fit best based on your research?
2. Which entry mode seems the most reasonable for the firms to use?
3. What macro environmental and industry trends support your recommendations? Economic characteristics include gross national product, wages, unemployment, and inflation. Trend analysis of these data (e.g., are wages rising or falling, rate of change in wages, etc.) is preferable to single point-in-time snapshots.
4. What country risks seem most problematic?

The following additional Internet resources may be useful in your research:
- The Library of Congress has a collection of country studies.
- BBC News offers country profiles.
- The Economist Intelligence Unit (http://www.eiu.com) offers country profiles.
- Both the United Nations and International Monetary Fund provide statistics and research reports.
- The CIA World Factbook has profiles of different regions.
- The Global Entrepreneurship Monitor provides reports with detailed information about economic conditions and social aspects for a number of countries.
- Links can be found at http://www.countryrisk.com to a number of resources that assess both political and economic risk for individual countries.
- For U.S. data, see http://www.census.gov.

Be prepared to discuss and defend your recommendations in class.

THE LURE OF AN INTERNATIONAL STRATEGY: INDIA/MOHANDAS PAI/CEO/INFOSYS
India, home to low-cost living and resources, has become a technology mecca that maintains the second-largest software industry in the world. The country has managed to amass the presence of big-name international companies and create a few of its own, such as InfoSys. Mohandas Pai, CEO of InfoSys, has stated that the key to luring foreign investors and workers is to create companies on par with any in the West. InfoSys, which is similar to a resort spa, continues to offer more experience and opportunity for many young Americans from U.S. colleges and has grown from 500 employees to 50,000 in 12 years.

Be prepared to discuss the following concepts and questions in class:

**Concepts**
- International strategy
- Business-level strategy
- Corporate-level strategy
- National advantage

**Questions**
1. What international strategy incentives does India offer to a foreign investor? What limitations exist in India for companies desiring international expansion?
2. What benefits does InfoSys receive from its international strategy?
3. How does India’s national advantage(s) influence its business-level strategy?
4. What corporate-level strategy is used by InfoSys and why?
NOTES


33. Ibid., 84.


99. Ibid.
115. Giersch, Political risk and political due diligence.
122. L. Li, 2007, Multinationality and performance: A synthetic review and


Studying this chapter should provide you with the strategic management knowledge needed to:

1. Define cooperative strategies and explain why firms use them.
2. Define and discuss the three major types of strategic alliances.
3. Name the business-level cooperative strategies and describe their use.
4. Discuss the use of corporate-level cooperative strategies in diversified firms.
5. Understand the importance of cross-border strategic alliances as an international cooperative strategy.
7. Describe two approaches used to manage cooperative strategies.
March 27, 1999—this is the day the alliance between French-based Renault and Japan-based Nissan was formally launched. At the time the alliance was formed, each of these firms lacked the size necessary to develop economies of scale and economies of scope that were critical to efforts to succeed in the 1990s and beyond in the global automobile market. The alliance the two companies formed finds them holding ownership stakes in each other; the larger of the two companies, Renault has a 44.3 percent stake in Nissan while Nissan has a 15 percent stake in Renault. Brazilian-born Carlos Ghosn serves as CEO for both companies. Three values guide this corporate-level synergistic alliance (we discuss this type of alliance later in the chapter): (1) Trust (work fairly, impartially and professionally), (2) Respect (honor commitments, liabilities, and responsibilities), and (3) Transparency (be open, frank, and clear).

The Renault-Nissan alliance is recognized for its success. The firms’ decision to establish Renault-Nissan B.V., which is a strategic management company that is responsible for creating common strategies for the companies and for facilitating and managing synergies resulting from combining some of the firms’ respective resources, capabilities, and core competencies, is a key reason for the alliance’s success. Also supporting the management of this alliance is a number of committees with members from each company. These individuals are expected to do everything possible to integrate the firms’ resource portfolios for the purpose of creating products customers will value and that will contribute to the firms’ profitability.

Cooperative strategies such as the one formed at the corporate level between Renault and Nissan are increasingly important to firms, but firms form many types of cooperative relationships in addition to corporat e-level ones. Moreover, an individual firm’s set of cooperative relationships can be complicated, as the Nissan and Renault alliance demonstrates. In addition to their corporate-level alliance, Renault and Nissan have each formed horizontal complementary strategic alliances at the business-unit level with other companies. (We discuss several types of business-unit level alliances in the chapter.) For example, Nissan and Mitsubishi Motors Corporation formed a joint venture (called NMKV Co., Ltd.) to produce minicars for the Japanese market. The cars are to be introduced in 2012 and are being manufactured in a facility the venture built in Thailand. This venture was formed for the purpose of uniting “the strengths of Nissan and Mitsubishi in the areas of vehicle engineering, development and parts sourcing, as part of an overall strategy to bring new minicar products to market.” Additionally, the firms are discussing the possibility of using this relationship for the purposes of collaborating to develop electric vehicles as well. Ghosn sees electric vehicles as a pillar to future strategies for both companies.
Renault has a cooperative relationship with Bajaj Auto Ltd. of India that is intended to produce a minicar that will compete against Tata Motors’ (headquartered in India) Nano, currently the world’s cheapest car at $US 3,158 for the base model. This partnership has yet to reach the level of success the partners seek. Additionally, Renault recently terminated a partnership with India’s Mahindra & Mahindra Ltd. because the sales in India resulting from this joint venture’s operations were disappointing.

As these examples demonstrate, the cooperative relationship between Renault and Nissan is complicated. Indeed, CEO Ghosn has noted that he is challenged to lead these firms in ways that allow each company to maintain its separate identity while benefitting from their collaboration.

As explained in the Opening Case, Renault and Nissan have formed a corporate-level cooperative strategy as a means of improving each firm’s performance. Additionally, each company is independently using a number of cooperative strategies at the business-unit level with the same objective in mind—to improve the performance of the individual firms. In all of these instances, Renault and Nissan, as is the case for all companies, are trying to use their resources and capabilities in ways that will create the greatest amount of value for stakeholders.

Forming a cooperative strategy like the one between Renault and Nissan, or between other global automobile companies (for example, Fiat SpA and Chrysler Group), has the potential to be a viable engine of firm growth. Specifically, a cooperative strategy is a means by which firms collaborate for the purpose of working together to achieve a shared objective. Cooperating with other firms is a strategy firms use to create value for a customer that it likely could not create by itself. For example, in describing a Fiat-designed and developed compact car that Chrysler will build and sell in the United States under its own name, an auto industry analyst said that a product such as this is “why the two auto makers . . . have a relationship.”

Firms also try to create competitive advantages when using a cooperative strategy. A competitive advantage developed through a cooperative strategy often is called a collaborative or relational advantage, denoting that the relationship that develops among collaborating partners is commonly the basis on which a competitive advantage is built. Importantly, successful use of cooperative strategies finds a firm outperforming its rivals in terms of strategic competitiveness and above-average returns, often because they’ve been able to form a competitive advantage.

We examine several topics in this chapter. First, we define and offer examples of different strategic alliances as primary types of cooperative strategies. We focus on strategic alliances because firms use them more frequently than other types of cooperative relationships. Next, we discuss the extensive use of cooperative strategies in the global economy and reasons for that use. In succession, we describe business-level, corporate-level, international, and network cooperative strategies. The chapter closes with a discussion of the risks of using cooperative strategies as well as how effectively managing the strategies can reduce those risks.
Strategic Alliances as a Primary Type of Cooperative Strategy

A strategic alliance is a cooperative strategy in which firms combine some of their resources and capabilities for the purpose of creating a competitive advantage. Strategic alliances involve firms with some degree of exchange and sharing of resources and capabilities to co-develop, sell, and service goods or services. In addition, firms use strategic alliances to leverage their existing resources and capabilities while working with partners to develop additional resources and capabilities as the foundation for new competitive advantages. To be certain, the reality today is that "strategic alliances have become a cornerstone of many firms’ competitive strategy." This means that for many firms, and particularly for large global competitors, strategic alliances are potentially many in number but are always important to efforts to outperform competitors.

Consider the case of BMW Group. Focusing exclusively on premium products, this firm uses an international focused differentiation business-level strategy (see Chapter 8) to sell its cars, trucks, and motorcycles in multiple geographic regions. According to the company’s CEO, this firm relies in part on a host of strategic alliances "to further shape (BMW’s) future, which involves topics such as technology leadership." Among BMW Group’s current alliances are (1) a purchasing cooperation with Daimler AG, (2) a joint venture with the SGL Group to produce carbon fibers (SGL Group is one of the world’s leading producers of carbon-based products), and (3) a joint venture with PSA Peugeot Citroen (BMW Peugeot Citroen Electrification) to produce four-cylinder engines and hybrid components.

Before describing three types of major strategic alliances and reasons for their use, we need to note that for all cooperative strategies, success is more likely when partners behave cooperatively. Actively solving problems, being trustworthy, and consistently pursuing ways to combine partners’ resources and capabilities to create value are examples of cooperative behavior known to contribute to alliance success. Recall that trust, respect, and transparency are three core values on which the Renault-Nissan corporate-level cooperative strategy is based. Perhaps these values are instrumental to the success that is credited to this cooperative relationship.

Types of Major Strategic Alliances

Joint ventures, equity strategic alliances, and nonequity strategic alliances are the three major types of strategic alliances firms use. The ownership arrangement is a key difference among these alliances.

A joint venture is a strategic alliance in which two or more firms create a legally independent company to share some of their resources and capabilities for the purpose of developing a competitive advantage. Some evidence suggests that recent economic difficulties have increased the attractiveness of this type of strategic alliance: "Joint ventures have become a more prevalent way for companies to gain access to new capabilities, products, and geographies since the start of the most recent economic downturn." Often formed to improve a firm’s ability to compete in uncertain competitive environments, such as those associated with economic downturns, joint ventures are effective in establishing long-term relationships and in transferring tacit knowledge. Because it can’t be codified, tacit knowledge, which is increasingly critical to firms’ efforts to develop core competencies, is learned through experiences such as those taking place when people from partner firms work together in a joint venture. Overall, a joint venture may be the optimal type of cooperative arrangement when firms need to combine their resources and capabilities to create a competitive advantage that is substantially different from any they possess individually and when the partners intend to enter highly uncertain, hypercompetitive markets.
Part 2: Strategic Actions: Strategy Formulation

The personal computer (PC) market has long been dynamic and challenging. In 1999, Fujitsu and Siemens formed a joint venture as a means of successfully dealing with the challenges associated with the PC market. This venture, Fujitsu Siemens Computers (FSC), was a legally independent company that the two partners owned equally (50 percent each). This company was formed by combining Fujitsu Computers Limited (at the time, the European computer business of Fujitsu Limited) and the Computer Systems business in Europe, the Middle East, and Africa of Siemens AG. Immediately then, FSC had a strong presence in key markets across the EMEA region (Europe, the Middle East, and Africa). Producing and selling a wide variety of products such as desktops, laptops, high-end servers and mainframes, storage devices, and peripherals in over 170 countries, FSC also focused on “green” computers and was recognized as an innovator in terms of its green manufacturing processes.

When forming the collaboration, the partners concluded that integrating their technological capabilities was critical to the venture’s success. In addition to integrating actual technologies, the partners agreed to find ways to transfer tacit knowledge and skills through which the technologies could be used for the purpose of creating value for customers. FSC achieved a reasonable degree of success, although as can be the case for firms competing in hyper-competitive markets, there were times when the venture’s performance trailed what its partners expected. Overall though the partners were pleased with FSC’s performance, as suggested by the following comments from a Fujitsu spokesperson: “In just a decade, the company has established a leading position in the EMEA market for IT infrastructure, earning a reputation for quality and innovation in the server, PC, and data storage fields.” The fact that the joint venture lasted for approximately 10 years is another indicator of its success.

Formally, FSC was dissolved when Fujitsu acquired Siemens’ 50 percent of the joint venture as of April 1, 2009. Siemens indicated that it agreed to sell its FSC stake so the company could focus on “the strategic sectors Energy, Industry and Healthcare.” For Siemens, exiting its partnership with Fujitsu was a product of the decision to restructure (see Chapter 7) its portfolio of businesses. After buying out its partner, Fujitsu formed Fujitsu Technology Solutions (FTS) as one
of its strategic business units. According to company documents, FTS is “the leading European IT infrastructure provider with a presence in all key markets in Europe, the Middle East and Africa, plus India, serving large-, medium- and small-sized companies as well as consumers.” For Fujitsu, owning all of its former joint venture with Siemens supported the firm’s global growth strategy. In the words of a Fujitsu official: “Fully integrating Fujitsu Siemens Computers into the Fujitsu Group fits perfectly into our global growth strategy. We’re inheriting a strong customer base in EMEA and an R&D capability that can support our global products development . . .”

Although the joint venture known as FSC was dissolved, Fujitsu and Siemens announced at that time that the companies would continue collaborating “in various fields of technology” in the years to come. Thus, as a joint venture, FSC helped the partnering firms reach objectives for a period of time; but the venture was dissolved when the partners made independent decisions about their business portfolios.


An equity strategic alliance is an alliance in which two or more firms own different percentages of the company they have formed by combining some of their resources and capabilities for the purpose of creating a competitive advantage. Many foreign direct investments, such as those companies from multiple countries are making in China, are completed through equity strategic alliances.

Recently, Japanese telecom operator NTT DoCoMo Inc. and Chinese Internet search operator Baidu Inc. established an equity strategic alliance in China to distribute games and other mobile-phone content. Baidu will own 80 percent of this collaboration with DoCoMo holding the remaining 20 percent. Content such as Japanese games, animation, and comic books are to be distributed in China, where “demand for mobile phone content is expected to surge in the coming years.” This collaborative arrangement contributes to DoCoMo’s efforts to increase its presence in international markets and to Baidu’s desire to generate additional revenues outside its core online search advertising business.

A nonequity strategic alliance is an alliance in which two or more firms develop a contractual relationship to share some of their resources and capabilities for the purpose of creating a competitive advantage. In this type of alliance, firms do not establish a separate independent company and therefore do not take equity positions. For this reason, nonequity strategic alliances are less formal, demand fewer partner commitments than do joint ventures and equity strategic alliances, and generally do not foster an intimate relationship between partners; nonetheless, research evidence indicates that they can create value for the involved firms. The relative informality and lower commitment levels characterizing nonequity strategic alliances make them unsuitable for complex projects where success requires effective transfers of tacit knowledge between partners. Licensing agreements, distribution agreements, and supply contracts are examples of nonequity strategic alliances.

A number of technology-based firms form nonequity strategic alliances. Hewlett-Packard (HP) actively uses this type of cooperative strategy to license some of its intellectual property. Xerox formed a six-year relationship with HCL Technologies. This nonequity alliance will find HCL handling disaster recovery, data center hosting and migration, virtualization, and consolidation tasks across Xerox’s data centers in North America and Europe. Describing the reason for this alliance, Xerox’s chief information officer said that “Data center environments are the heart of our business operations and we look to partner with companies that can manage our centers and take them to the next level.”

Commonly, outsourcing commitments are specified in the form of a nonequity strategic alliance. (Discussed in Chapter 3, outsourcing is the purchase of a value-chain
activity, or a support function activity from another firm.) Dell Inc. and most other computer firms outsource most or all of their production of laptop computers and often form nonequity strategic alliances to detail the nature of the relationship with firms to whom they outsource. Interestingly, many of these firms that outsource introduce modularity that prevents the contracting partner or outsourcee from gaining too much knowledge or from sharing certain aspects of the business the outsourcing firm does not want revealed.23

Reasons Firms Develop Strategic Alliances

Cooperative strategies are an integral part of the competitive landscape and are quite important to many companies and even to educational institutions. In fact, many firms are cooperating with educational institutions to help commercialize ideas flowing from basic research projects completed at universities.24 In for-profit organizations, many executives believe that strategic alliances are central to their firm’s growth and success.25 The fact that alliances can account for up to 25 percent or more of a firm’s sales revenue demonstrates their importance. Also highlighting alliances’ importance is the fact that in some settings, such as the global airline industry, competition is increasingly between large alliances rather than between large companies.26

Among other benefits, strategic alliances allow partners to create value that they couldn’t develop by acting independently and to enter markets more quickly and with greater market penetration possibilities.27 For example, Japanese trading house Itochu Corp. recently acquired a 20 percent stake in a Colombian coal-mining operation owned by Drummond Company Inc. As comments from the company indicate, Itochu formed this joint venture for the purpose of quickly expanding its market size. “Itochu said the investment in the operations, with production of about 25 million tons per year, is a ‘key step’ in plans to more than double its equity share in global mining operations. Itochu is targeting access to more than 20 million metric tons of coal per year by 2015, compared with 8 million metric tons currently.”28

Another reason to form strategic alliances is that most (if not all) firms lack the full set of resources and capabilities needed to reach their objectives, which indicates that partnering with others will increase the probability of reaching firm-specific performance objectives. This may be especially true for small businesses—ones in which capital is scarce. Given constrained resources, small firms can collaborate for a number of purposes, including those of reaching new customers and broadening the distribution of their products without adding significantly to their cost structures.29

Unique competitive conditions characterize slow-cycle, fast-cycle, and standard-cycle markets.30 We discussed these three market types in Chapter 5 while examining competitive rivalry and competitive dynamics. These unique conditions find firms using strategic alliances to reach objectives that differ slightly by market type (see Figure 9.1).

Slow-cycle markets are markets where the firm’s competitive advantages are shielded from imitation for relatively long periods of time and where imitation is costly. These markets are close to monopolistic conditions. Railroads and, historically, telecommunication, utilities, and financial services are industries characterized as slow-cycle markets. In fast-cycle markets, the firm’s competitive advantages are not shielded from imitation, preventing their long-term sustainability. Competitive advantages are moderately shielded from imitation in standard-cycle markets, typically allowing them to be sustained for a longer period of time than in fast-cycle market situations, but for a shorter period of time than in slow-cycle markets.

Slow-Cycle Markets

Firms in slow-cycle markets often use strategic alliances to enter restricted markets or to establish franchises in new markets. For example, because of consolidating acquisitions, the American steel industry has two remaining major players: U.S. Steel and Nucor. To improve their ability to compete successfully in the global steel market, these companies are forming cooperative relationships. They have formed strategic alliances in Europe and Asia and are invested in ventures in South America and Australia.
One of Nucor’s alliances with a firm outside its U.S. domestic market is its joint venture with Italian-based Duf erco Group’s subsidiary Duferdofin. Each firm has a 50 percent ownership of the venture, called Duferdofin–Nucor S.r.l. Through this collaboration, the firms are producing steel joists and beams in Italy and then selling them in Europe and North Africa. The resources and capabilities contributed by each partner are suggested by the following comment from Nucor’s CEO: “(This venture) combines Nucor’s world-recognized know-how in the efficient production of structural shapes with Duferdofin’s strong management team and strategic locations in Italy.”31 On the domestic front, Nucor recently formed a long-term strategic alliance with Truswal Systems Corporation, “a leading supplier of engineered products and state of the art software for the building components industry.” The purpose of this collaboration is the development of proprietary design, engineering, and layout software.32

The expectation is that the Truswal alliance will facilitate Nucor’s efforts to successfully compete in the global light gauge steel framing market.

Slow-cycle markets are becoming rare in the twenty-first century competitive landscape for several reasons, including the privatization of industries and economies, the rapid expansion of the Internet’s capabilities for quick dissemination of information, and the speed with which advancing technologies make quickly imitating even complex products possible.33 Firms competing in slow-cycle markets, including steel manufacturers, should recognize the future likelihood that they’ll encounter situations in which their competitive advantages become partially sustainable (in the instance of a standard-cycle market) or unsustainable (in the case of a fast-cycle market). Cooperative strategies can help firms transition from relatively sheltered markets to more competitive ones.34
Fast-Cycle Markets

Fast-cycle markets are unstable, unpredictable, and complex; in a word, hypercompetitive. Combined, these conditions virtually preclude establishing long-lasting competitive advantages, forcing firms to constantly seek sources of new competitive advantages while creating value by using current ones. Alliances between firms with current excess resources and capabilities and those with promising capabilities help companies compete in fast-cycle markets to effectively transition from the present to the future and to gain rapid entry into new markets. As such a “collaboration mindset” is paramount.

The entertainment business is fast becoming a new digital marketplace as television content is now available on the Web. This has led the entertainment business into a fast-cycle market where collaboration is important not only to succeed but to survive. Many of the firms that have digital video content have also sought to make a profit through digital music and have had difficulties in profiting from their earlier ventures. To address issues such as these, GE’s NBC Universal and News Corporation formed Hulu.com in 2007. Walt Disney Company joined this equity strategic alliance in 2009 (private equity investor Providence Equity Partners also has a stake in this alliance.) This Web-based cooperative relationship is an alliance between firms that are direct competitors. To support Hulu, ABC (owned by Disney) makes much of its content available on the Hulu site as do the other content providers including NBC Universal. As digital video content moves onto the Web, it will be interesting to see the evolution of competition and cooperation between these firms.

Telecommunications and software firms also compete in fast-cycle markets and use strategic alliances as a means of doing so. Microsoft and Nokia recently formed a comprehensive collaboration. The firms’ CEOs issued the following statement describing the agreed-upon arrangement: “Our two companies (have) plans for a broad strategic

Today, the battle is moving from one of mobile devices to one of mobile ecosystems, and our strengths here are complementary. Ecosystems thrive when they reach scale, when they are fueled by energy and innovation, and when they provide benefits and value to each person or company who participates. This is what we are creating; this is our vision; this is the work we are driving from this day forward.” Articulated jointly by Stephen Elop, CEO of Nokia, and Steve Ballmer, Microsoft’s CEO, these statements describe the comprehensive strategic alliance these firms announced in February 2011. The fact that several hundred pages were developed to specify the scope of the alliance and to detail each party’s responsibilities demonstrates this collaboration’s comprehensiveness and potentially its complexity.

Essentially, the strategic alliance between these firms calls for Nokia to transition its smartphone portfolio to Microsoft’s Windows phone platform. Additionally, there is a wide range of ways these firms will collaborate to complete this transition and to form a mobile ecosystem. For example, Microsoft’s Bing will power Nokia’s search services across all of its devices and services, Microsoft’s development tools are to be used to create applications that will run on Nokia Windows Phones, and the firms will collaborate to design and execute joint marketing activities. The market’s immediate reaction to this collaboration was negative, as Nokia’s
market value declined 5.7 billion euros ($7.7 billion) in the first two days following announcement of the alliance. A reason for this immediate reaction could be the risk some analysts believe Nokia is accepting by adopting the Windows Phone platform as its primary smartphone strategy.

Firms competing in fast-cycle markets experience a great deal of uncertainty, change, and dynamism. Being able to set a new industry standard in a fast-cycle market has the potential to be the foundation for a firm’s ability to deal successfully with these industry conditions and to outperform its rivals while doing so. In the instance of this alliance, the firms seek to use their complementary resources to build and sustain an ecosystem in the mobile communications space. In essence, “a business ecosystem’s scope is the set of positive sum relationships (symbiosis) between actors who work together around a core technology platform” such as Microsoft Windows “that induces a synergy between MS Windows compatible companies delivering hardware, software, services, etc.” Customers, markets, products, processes, organizations, stakeholders, and governments are an ecosystem’s actors. The idea of an ecosystem is that actors will share a key technology platform as the primary source of how they can flourish in this intertwined, networked environment. Using their strategic alliance to form a mobile ecosystem, Microsoft and Nokia believe they will be able “to deliver ground-breaking enterprise solutions for mobile productivity” while competing in and possibly disrupting the competitive patterns in what is a fast-cycle market.

As is true for all cooperative strategies, the success of the comprehensive alliance between Microsoft and Nokia is not assured. Some analysts believe that going forward Nokia’s R&D activities need to create more value than now seems to be the case, customers’ uncertainty about the viability and appropriateness of adopting a Windows-based smartphone strategy must be overcome, and the degree to which this alliance may help the partners (particularly Nokia) develop a product for the fast-growing tablet-based computer market must be monitored. Additionally, the firms’ ability to collaborate as the basis for developing a viable mobile ecosystem is an open question.


partnership that combines the respective strengths of our companies and builds a new global mobile ecosystem. The partnership increases our scale, which will result in significant benefits for consumers, developers, mobile operators and businesses around the world. We both are incredibly excited about the journey we are on together.”

As we discuss in the Strategic Focus, the alliance Microsoft and Nokia have formed demonstrates use of a collaborative mind-set as the foundation for the firms’ efforts to develop new products and perhaps form an industry technology standard as well (see Table 9.1).

Standard-Cycle Markets
In standard-cycle markets, alliances are more likely to be made by partners that have complementary resources and capabilities. The alliances formed by airline companies are an example of standard-cycle market alliances.

When initially established decades ago, these alliances were intended to allow firms to share their complementary resources and capabilities to make it easier for passengers to fly between secondary cities in the United States and Europe. Today, airline alliances are mostly global in nature and are formed primarily so members can gain marketing clout, have opportunities to reduce costs, and have access to additional international routes. Of these reasons, international expansion by having access to more international routes
is the most important in that these routes are the path to increased revenues and potential profits. To support efforts to control costs, alliance members jointly purchase some items and share facilities when possible, such as passenger gates, customer service centers, and airport passenger lounges. For passengers, airline alliances “offer simpler ticketing and smoother connections on intercontinental trips as well as the chance to earn and redeem frequent-flier miles on other member carriers.”

There are three major airline alliances operating today. Star Alliance is the largest with 27 members. With 12 members, OneWorld Alliance is the smallest while the 13-member SkyTeam Alliance has one more member. Given the geographic areas where markets are growing, these global alliances are adding partners from Asia. For example, in recent years, China Southern Airlines joined the SkyTeam alliance and Air China was added to the Star Alliance.

In addition to the three major alliances, a host of other alliances exist among airline carriers. For example, ANA (All Nippon Airways) and Deutsche Lufthansa AG are both members of the Star Alliance. However, these firms decided to launch a joint venture at the end of 2011 for the purpose of combining their resources to serve routes between Japan and Europe. Sharing revenue, coordinating flight schedules, and working together on joint product sales are examples of how the firms’ resources and capabilities are to be shared through the joint venture. Similarly, Singapore Airlines, a member of Star Alliance, and Virgin Australia announced plans for a wide-ranging alliance. Under the alliance, Singapore Airlines would have access to Virgin Australia’s routes to New Zealand and the U.S. West Coast. At the same time, Virgin Australia was planning to complete alliances with Air New Zealand and Etihad Airways PJSC, based in Abu Dhabi. In general, most airline alliances such as the ones we’ve described are formed to help firms gain economies of scale and meet competitive challenges (see Figure 9.1).

**Business-Level Cooperative Strategy**

A business-level cooperative strategy is a strategy through which firms combine some of their resources and capabilities for the purpose of creating a competitive advantage by competing in one or more product markets. As discussed in Chapter 4, business-level strategy details what the firm intends to do to gain a competitive advantage in specific product markets. Thus, the firm forms a business-level cooperative strategy when it believes that combining some of its resources and capabilities with those of one or more partners will create competitive advantages that it can’t create by itself and will lead to success in a specific product market. We list the four business-level cooperative strategies in Figure 9.2.

**Complementary Strategic Alliances**

Complementary strategic alliances are business-level alliances in which firms share some of their resources and capabilities in complementary ways for the purpose of creating a competitive advantage. Vertical and horizontal are the two types of complementary strategic alliances (see Figure 9.2).

**Vertical Complementary Strategic Alliance**

In a vertical complementary strategic alliance, firms share some of their resources and capabilities from different stages of the value chain for the purpose of creating a competitive advantage (see Figure 9.3). Oftentimes, vertical complementary alliances are formed to adapt to environmental changes; sometimes the changes represent an opportunity for partnering firms to innovate while adapting.

Operating with four segments (EA Games, EA Sports, The Sims, and EA Casual Entertainment), Electronic Arts (EA) develops, markets, publishes, and distributes video game software, mobile games, and online interactive games in over 35 countries, meaning that the firm is geographically diversified as well as diversified with its product lines.
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Figure 9.2 Business-Level Cooperative Strategies

Complementary strategic alliances
- Vertical
- Horizontal

Competition response strategy

Uncertainty-reducing strategy

Competition-reducing strategy


Figure 9.3 Vertical and Horizontal Complementary Strategic Alliances

Horizontal Alliance between Buyers (Each buyer is also a potential competitor)

Vertical Alliance - Supplier

Customer Value

Support Functions

Value Chain Activities

Vertical strategic alliances are a key part of how EA competes, including the ones the firm has formed with Nintendo and Hasbro. EA produces software and games for Nintendo’s Wii game console through the alliance it has with that firm. Through the alliance with Hasbro, EA offers MONOPOLY Millionaires on Facebook. An EA executive describes the firm’s alliance with Hasbro in this manner: “We strive to continually re-imagine Hasbro brands digitally in creative ways and MONOPOLY Millionaires is no exception. We’re bringing the world’s favorite game brand into the new era of social gaming, offering an accessible and enjoyable experience for Facebook users worldwide.”

Sometimes, private–public sector vertical collaborations are formed, such as the alliance Novartis AG and the World Health Organization (WHO) developed in 2001. The purpose of the 10-year alliance was to battle malaria in developing countries. The agreement called for Novartis to provide one of its drugs, Coartem, at an average price of USD $1.57 per treatment for adults and at a substantially discounted price for children, who are most vulnerable to malaria. Using the distribution part of the value chain, the WHO evaluated requests for Coartem and then distributed the drug through government agencies of malaria-endemic countries.

The terms of the original alliance between Novartis and the WHO expired in May 2011. At that time though, Novartis announced that because of its long-term commitment to battling malaria, it would “continue to provide Coartem to public health systems in developing countries on the same terms as before.”

**Horizontal Complementary Strategic Alliance**

A horizontal complementary strategic alliance is an alliance in which firms share some of their resources and capabilities from the same stage (or stages) of the value chain for the purpose of creating a competitive advantage. Commonly, firms use complementary strategic alliances to focus on joint long-term product development and distribution opportunities. As noted previously, Hulu (http://www.hulu.com) is a joint Web site that GE’s NBC Universal, News Corporation, and Walt Disney Company formed for the purpose of distributing video content. Through this equity strategic alliance, the alliance’s partners provide content (one stage of the value chain) to Hulu for distribution (another part of the value chain).

Pharmaceutical companies form a number of horizontal alliances. For example, as health care reform takes place in the United States, large pharmaceutical firms are seeking relationships with generic drug producers. Pfizer recently formed an alliance with Santaris Pharma A/S to develop and commercialize RNA-targeted medicines using Santaris Pharma A/S’s locked nucleic acid (LNA) drug platform. (Santaris is a clinical-stage biopharmaceutical company.)

Novartis AG’s orientation to collaborations reflects the perspective of many pharmaceutical manufacturers. Supporting Novartis’ collaborations is the belief that “the path for scientific breakthrough to successful pharmaceutical brand depends on mobilizing the best global resources, expertise and experience.” Thus as noted earlier in the chapter, cooperative strategies are used largely so firms (such as pharmaceutical manufacturers) can combine the “world’s best” resources, capabilities, and core competencies in the pursuit of competitive success.

Many horizontal complementary strategic alliances are formed in the automobile manufacturing industry. As discussed in the Opening Case, Renault and Nissan formed a corporate-level synergistic strategic alliance. A number of horizontal complementary strategic alliances the two firms have developed support implementation of their corporate-level alliance. The Renault alliance with Bajaj Auto Ltd. of India is an example of the horizontal relationships the firm is forming. Even more broadly, cooperative strategies of all types are instrumental to automobile manufacturers’ efforts to successfully compete globally.

**Competition Response Strategy**

As discussed in Chapter 5, competitors initiate competitive actions to attack rivals and launch competitive responses to their competitors’ actions. Strategic alliances can be
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used at the business level to respond to competitors’ attacks. Because they can be difficult to reverse and expensive to operate, strategic alliances are primarily formed to take strategic rather than tactical actions and to respond to competitors’ actions in a like manner.

Even during the downtown the U.S. housing market has experienced over the past few years, the Washington D.C. area remains fairly strong. As a result, this area is attractive to builders and land and community developers. In fact, investors are buying land parcels to develop and homebuilders are building houses throughout the area. In response to this increased level of activity, homebuilder NVR Inc. has formed a joint venture with an affiliate of investment bank Morgan Stanley to purchase a large land portfolio in the suburbs of the U.S. capital. Specifically, the partners intend to buy 5,600 home sites in nine master-planned communities in the Virginia suburbs. Analysts feel that this partnership demonstrates that the two parties are confident that the D.C. market will remain attractive and that their collaboration is one through which they will be able to compete successfully against strong competitors in the D.C. market. 52

**Uncertainty-Reducing Strategy**

Firms sometimes use business-level strategic alliances to hedge against risk and uncertainty, especially in fast-cycle markets. 53 These strategies are also used where uncertainty exists, such as in entering new product markets and especially those of emerging economies.

As large global auto firms manufacture more hybrid vehicles, there is insufficient industry capacity to meet the demand for the type of batteries used in these vehicles. In turn, the lack of a sufficient supply of electric batteries creates uncertainty for automobile manufacturers. To reduce this uncertainty, auto firms are forming alliances. For example, Volkswagen has formed an agreement with Samuel Electric and Toshiba Corp. of Japan to manufacture lithium-ion batteries used in hybrid vehicles. 54 Renault-Nissan established a joint venture with the French government in 2009 to make batteries. However, this venture was dissolved in mid-2011 because the “French government will no longer help finance the battery plant as had originally been planned.” 55

**Competition-Reducing Strategy**

Used to reduce competition, collusive strategies differ from strategic alliances in that collusive strategies are often an illegal type of cooperative strategy. Explicit collusion and tacit collusion are the two types of collusive strategies.

*Explicit collusion* exists when two or more firms negotiate directly to jointly agree about the amount to produce as well as the prices for what is produced. 56 Explicit collusion strategies are illegal in the United States and most developed economies (except in regulated industries). Accordingly, companies choosing to use explicit collusion as a strategy should recognize that competitors and regulatory bodies might challenge the acceptability of their competitive actions.

*Tacit collusion* exists when several firms in an industry indirectly coordinate their production and pricing decisions by observing each other’s competitive actions and responses. 57 Tacit collusion results in production output that is below fully competitive levels and above fully competitive prices. Unlike explicit collusion, firms engaging in tacit collusion do not directly negotiate output and pricing decisions. However, research suggests that joint ventures or cooperation between two firms can lead to less competition in other markets in which both firms operate. 58

Tacit collusion tends to be used as a competition-reducing business-level strategy in industries with a high degree of concentration, such as the airline and breakfast cereal industries. Research in the airline industry suggests that tacit collusion reduces service quality and on-time performance. 59 Firms in these industries recognize their interdependence, which means that their competitive actions and responses significantly affect competitors’ behavior toward them. Understanding this interdependence and carefully observing competitors can lead to tacit collusion.
Over time, four firms—Kellogg Company (producers of Kellogg’s Corn Flakes, Fruit Loops, etc.), General Mills Inc. (Cheerios, Charms, etc.), Ralcorp Holdings Inc. (Shredded Wheat, Post Raisin, etc.), and Quaker Foods North America, a part of PepsiCo (Quaker Oatmeal, Cap’n Crunch, etc.)—have accounted for as much as 80 percent of sales volume in the ready-to-eat segment of the U.S. cereal market. Some believe that this high degree of concentration results in prices to consumers that substantially exceed the costs companies incur to produce and sell their products. If prices are above the competitive level in this industry, it may be a possibility that the dominant firms use a tacit collusion cooperative strategy.

Discussed in Chapter 6, mutual forbearance is a form of tacit collusion in which firms do not take competitive actions against rivals they meet in multiple markets. Rivals learn a great deal about each other when engaging in multmarket competition, including how to deter the effects of their rivals’ competitive attacks and responses. Given what they know about each other as competitors, firms choose not to engage in what could be destructive competition in multiple product markets.

In general, governments in free-market economies seek to determine how rivals can form cooperative strategies for the purpose of increasing their competitiveness without violating established regulations about competition. However, this task is challenging when evaluating collusive strategies, particularly tacit ones. For example, the regulation of pharmaceutical and biotech firms who collaborate to meet global competition might lead to too much price fixing, meaning that regulation is required to make sure that the balance is “right” (though sometimes the regulation gets in the way of efficient markets). In turn, individual companies must analyze the effect of a competition-reducing strategy on their performance and competitiveness and decide if pursuing such a strategy is an overall facilitator of their competitive success.

Assessing Business-Level Cooperative Strategies

Firms use business-level cooperative strategies to develop competitive advantages that can contribute to successful positions in individual product markets. Evidence suggests that complementary business-level strategic alliances, especially vertical ones, have the greatest probability of creating a competitive advantage and possibly even a sustainable one. Horizontal complementary alliances are sometimes difficult to maintain because often they are formed between firms that compete against each other at the same time they are cooperating. Renault and Nissan still compete against each other with some of their products while collaborating to produce and sell other products. In a case such as this, partnering firms may feel a “push” toward and a “pull” from alliances. Airline firms, for example, want to compete aggressively against others serving their markets and target customers. However, the need to develop scale economies and to share resources and capabilities (such as scheduling systems) dictates that alliances be formed so the firms can compete by using cooperative actions.
and responses while they simultaneously compete against one another through competitive actions and responses. The challenge in these instances is for each firm to find ways to create the greatest amount of value from both their competitive and cooperative actions. It seems that Nissan and Renault may have learned how to achieve this balance.

Although strategic alliances designed to respond to competition and to reduce uncertainty can also create competitive advantages, these advantages often are more temporary than those developed through complementary (both vertical and horizontal) alliances. The primary reason for this is that complementary alliances have a stronger focus on creating value than do competition-reducing and uncertainty-reducing alliances, which are formed to respond to competitors’ actions or reduce uncertainty rather than to attack competitors.

Of the four business-level cooperative strategies, the competition-reducing strategy has the lowest probability of creating a competitive advantage. For example, research suggests that firms following a foreign direct investment strategy using alliances as a follow-the-leader imitation approach may not have strong strategic or learning goals. Thus, such investment could be attributable to tacit collusion among the participating firms rather than trying to develop a competitive advantage (which should be the core objective).

Corporate-Level Cooperative Strategy

A corporate-level cooperative strategy is a strategy through which a firm collaborates with one or more companies for the purpose of expanding its operations. The alliance between Itochu Corp. and Drummond Company mentioned earlier will “allow Itochu to diversify its coal assets to a new geographic region and grow its trading activities.”65 As such this is a corporate-level cooperative strategy between these two firms. Diversifying alliances, synergistic alliances, and franchising are the most commonly used corporate-level cooperative strategies (see Figure 9.4).

Firms use diversifying and synergistic alliances to improve their performance by diversifying their operations through a means other than or in addition to internal organic growth or a merger or acquisition.66 When a firm seeks to diversify into markets in which the host nation’s government prevents mergers and acquisitions, alliances become an especially appropriate option. Corporate-level strategic alliances are also attractive compared with mergers and particularly acquisitions, because they require fewer resource commitments67 and permit greater flexibility in terms of efforts to diversify partners’ operations.68 An alliance can be used as a way to determine whether the partners might benefit from a future merger or acquisition between them. This “testing” process often characterizes alliances formed to combine firms’ unique technological resources and capabilities.69

Figure 9.4 Corporate-Level Cooperative Strategies

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Diversifying Strategic Alliance

A *diversifying strategic alliance* is a strategy in which firms share some of their resources and capabilities to engage in product and/or geographic diversification. The agreement between Itochu and Drummond is a diversifying strategic alliance.

The spread of high-speed wireless networks and devices with global positioning chips and the popularity of Web site applications running on various companies‘ smartphones indicate that consumers are more frequently and intensely accessing mobile information. Equipped with this knowledge, Alcatel-Lucent entered the market through mobile advertising, which will allow a cell phone carrier to alert customers about the location of a favored store or the closest ATM. The partners are pursuing this alliance with 1020 Placecast, a California-based developer of cell phone online ads associated with user locations. Hyatt, FedEx, and Avis are especially interested in using the service. The ads will also include a link to coupons or other promotions. Recently, Alcatel-Lucent and Millicom Ghana Ltd. “under the brand of Tigo, one of Ghana’s leading mobile network operators, (formed) a partnership to introduce the first permission- and preference-based mobile advertising service in Ghana.” Through this partnership, Tigo’s customers are able to receive targeted promotions on their phones. Overall, these networks are trying to gain a share of the profits that would normally be out of their reach through revenue-sharing models with companies that are advertising as well as the ad-producing service companies.

Synergistic Strategic Alliance

A *synergistic strategic alliance* is a strategy in which firms share some of their resources and capabilities to create economies of scope. Similar to the business-level horizontal complementary strategic alliance, synergistic strategic alliances create synergy across multiple functions or multiple businesses between partner firms. The Renault-Nissan collaboration we discussed in the Opening Case is a synergistic strategic alliance in that among other outcomes, the firms seek to create economies of scope by sharing their resources and capabilities to develop manufacturing platforms that can be used to produce cars that will be either a Renault or a Nissan. The cooperative arrangement between Fiat and Chrysler is also a synergistic alliance. As noted earlier, Chrysler will produce a Fiat-designed and developed compact car in its Belvidere, Illinois facility. Reflecting the complexity of synergistic alliances and their “twin” horizontal complementary alliances at the business-unit level is the fact that Fiat used the same underpinnings for what will be a car carrying the Dodge brand that it uses to produce the Alfa Romeo Giulietta. (Alfa Romeo is a part of Fiat SpA.) Without economies of scope such as those Fiat seeks by using the same underpinnings for a car carrying the Dodge brand and the Alfa Romeo brand, the probability of success with a synergistic alliance is substantially reduced.

Franchising

Franchising is a strategy in which a firm (the franchisor) uses a franchise as a contractual relationship to describe and control the sharing of its resources and capabilities with its partners (the franchisees). A *franchise* is a “contractual agreement between two legally independent companies whereby the franchisor grants the right to the franchisee to sell the franchisor’s product or do business under its trademarks in a given location for a specified period of time.” Often, success is determined in these strategic alliances by how well the franchisor can replicate its success across multiple partners in a cost-effective way.

Franchising is a popular strategy. Recent estimates are that in the United States alone, the gross domestic product of all franchised businesses is approximately $1.2 trillion (this is about one-third of all sales generated in the United States) and that there are more than 828,000 individual franchise stores locations employing a total of 18 million people. Already frequently used in developed nations, franchising is also expected to account for significant portions of growth in emerging economies in the twenty-first century. As with diversifying and synergistic strategic alliances, franchising is an...
alternative to pursuing growth through mergers and acquisitions. McDonald’s, Hilton International, Marriott International, Mrs. Fields Cookies, Subway, and Ace Hardware are well-known examples of firms using the franchising corporate-level cooperative strategy.

Franchising is a particularly attractive strategy to use in fragmented industries, such as retailing, hotels and motels, and commercial printing. In fragmented industries, a large number of small and medium-sized firms compete as rivals; however, no firm or small set of firms has a dominant share, making it possible for a company to gain a large market share by consolidating independent companies through the contractual relationships that are a part of a franchise agreement.

In the most successful franchising strategy, the partners (the franchisor and the franchisees) work closely together. A primary responsibility of the franchisor is to develop programs to transfer to the franchisees the knowledge and skills that are needed to successfully compete at the local level. In return, franchisees should provide feedback to the franchisor regarding how their units could become more effective and efficient. Working cooperatively, the franchisor and its franchisees find ways to strengthen the core company’s brand name, which is often the most important competitive advantage for franchisees operating in their local markets.

Assessing Corporate-Level Cooperative Strategies

Costs are incurred to implement each type of cooperative strategy. Compared with their business-level counterparts, corporate-level cooperative strategies commonly are broader in scope and more complex, making them relatively more challenging and costly to use.

In spite of these costs, firms can create competitive advantages and value for customers by effectively using corporate-level cooperative strategies. Internalizing successful alliance experiences makes it more likely that the strategy will attain the desired advantages. In other words, those involved with forming and using corporate-level cooperative strategies can also use them to develop useful knowledge about how to succeed in the future. To gain maximum value from this knowledge, firms should organize it and verify that it is always properly distributed to those involved with forming and using alliances.

We explain in Chapter 6 that firms answer two questions when dealing with corporate-level strategy—in which businesses and product markets will the firm choose to compete and how will those businesses be managed? These questions are also answered as firms form corporate-level cooperative strategies. Thus, firms able to develop corporate-level cooperative strategies and manage them in ways that are valuable, rare, imperfectly imitable, and nonsubstitutable (see Chapter 3) develop a competitive advantage that is in addition to advantages gained through the activities completed to implement individual cooperative strategies. (Later in the chapter, we further describe alliance management as another potential competitive advantage.)

International Cooperative Strategy

The new competitive landscape finds firms using cross-border transactions for several purposes. In Chapter 7, we discussed cross-border acquisitions, actions through which a company located in one country acquires a firm located in a different country. In
Chapter 8, we described how firms use cross-border acquisitions as a way of entering international markets. Here in Chapter 9, we examine cross-border strategic alliances as a type of international cooperative strategy. Thus, firms engage in cross-border activities to achieve several related objectives.

A cross-border strategic alliance is a strategy in which firms with headquarters in different countries decide to combine some of their resources and capabilities for the purpose of creating a competitive advantage. Taking place in virtually all industries, the number of cross-border alliances firms are completing continues to increase. These alliances too are sometimes formed instead of mergers and acquisitions, which can be riskier. Even though cross-border alliances can themselves be complex and hard to manage, they have the potential to help firms use some of their resources and capabilities to create value in locations outside their home market.

Limited domestic growth opportunities and foreign government economic policies are key reasons firms use cross-border alliances. As discussed in Chapter 8, local ownership is an important national policy objective in some nations. In India and China, for example, governmental policies reflect a strong preference to license local companies. Thus, in some countries, the full range of entry mode choices we described in Chapter 8 may not be available to firms seeking to geographically diversify into a number of international markets. Indeed, investment by foreign firms in these instances may be allowed only through a partnership with a local firm, such as in a cross-border alliance. Important too is the fact that strategic alliances with local partners can help firms overcome certain liabilities of moving into a foreign country, including those related to a lack of knowledge of the local culture or institutional norms. A cross-border strategic alliance can also help foreign partners from an operational perspective, because the local partner has significantly more information about factors contributing to competitive success such as local markets, sources of capital, legal procedures, and politics.

As a result of two major global trends—increasing fuel costs and tougher environmental regulations—airlines are deeply interested in flying planes that are powered by more fuel-efficient engines. Manufacturers of airplane engines are responding to this strong customer interest and are pushing “the frontiers of technology by building lighter plans and borrowing essential engine-design advances from the auto industry, like automatic transmissions.” To build these engines, manufacturers are forming strategic alliances, many of which are cross-border alliances. For example, Volvo Aero, which is a wholly owned subsidiary of Sweden’s AB Volvo, and U.S.-based Pratt & Whitney (which is one of United Technology’s strategic business units) formed a cross-border strategic alliance to collaborate on the new PW1100G engine, an engine that “is a part of Pratt & Whitney’s Next Generation Product Family of engines which contain geared turbofan technology.” Through this collaboration—which is not the first between these two firms—Volvo Aero will design and manufacture two components that are critical to Pratt & Whitney’s new engine. As we noted in Chapter 8 this engine initially is being designed for use in the A320neo family, which is an updated version of the Airbus A320. “The engine is expected to reduce fuel consumption, carbon dioxide and nitric oxide emissions, and noise, as well as lowering running and operating costs significantly.”

In general then, cross-border strategic alliances are more complex and risky than are domestic strategic alliances, especially when used in emerging economies. However, the fact that firms competing internationally tend to outperform domestic-only competitors suggests the importance of learning how to geographically diversify into international markets. Compared with mergers and acquisitions, cross-border alliances may be a better way to learn this process, especially in the early stages of a firm’s geographic diversification efforts.
Network Cooperative Strategy

In addition to forming their own alliances with individual companies, an increasing number of firms are collaborating in multiple networks. A network cooperative strategy is a strategy wherein several firms agree to form multiple partnerships for the purpose of achieving shared objectives.

Through its Global Partner Network, Cisco has formed alliances with a host of individual companies including IBM, Microsoft, Accenture, Emerson, Fujitsu, Intel, and Nokia. According to Cisco, partnering allows a firm to “drive growth and differentiate its business by extending its capabilities to meet customer requirements.” Demonstrating the complexity of network cooperative strategies is the fact that Cisco also competes against a number of the firms with whom it has formed cooperative agreements. For example, Cisco is competing against IBM as it now sells and services servers. Although a new business line for Cisco, sales revenue for Cisco’s servers exceeded $900 million in 2010. At the same time, Cisco and IBM’s alliance is very active as the firms seek to help customers “maximize (their) business results by unifying IBM’s vast industry, business process and implementation expertise with Cisco’s world-class unified communications and networking technologies.” Overall, in spite of their complexity as the IBM/Cisco example shows, firms are using network cooperative strategies more extensively as a way of creating value for customers by offering many goods and services in many geographic (domestic and international) markets.

A network cooperative strategy is particularly effective when it is formed by geographically clustered firms, as in California’s Silicon Valley (where “the culture of Silicon Valley encourages collaborative webs”) and Singapore’s Biopolis (in the biomedical sciences) and the new fusionopolis (collaborations in “physical sciences and engineering to tackle global science and technology challenges”). Effective social relationships and interactions among partners while sharing their resources and capabilities make it more likely that a network cooperative strategy will be successful, as having a productive strategic center firm (we discuss strategic center firms in detail in Chapter 11). Firms involved in networks gain information and knowledge from multiple sources. They can use these heterogeneous knowledge sets to produce more and better innovation. As a result, firms involved in networks of alliances tend to be more innovative. However, there are disadvantages to participating in networks as a firm can be locked into its partnerships, precluding the development of alliances with others. In certain network configurations, such as Japanese keiretsus, firms in a network are expected to help other firms in that network whenever support is required. Such expectations can become a burden and negatively affect the focal firm’s performance over time.

Alliance Network Types

An important advantage of a network cooperative strategy is that firms gain access to their partners’ other partners. Having access to multiple collaborations increases the likelihood that additional competitive advantages will be for med as the set of shared resources and capabilities expands. In turn, being able to develop new capabilities further stimulates product innovations that are critical to strategic competitiveness in the global economy.
The set of strategic alliance partnerships firms develop when using a network cooperative strategy is called an **alliance network**. Companies’ alliance networks vary by industry characteristics. A **stable alliance network** is formed in mature industries where demand is relatively constant and predictable. Through a stable alliance network, firms try to extend their competitive advantages to other settings while continuing to profit from operations in their core, relatively mature industry. Thus, stable networks are built primarily to **exploit** the economies (scale and/or scope) that exist between the partners such as in the airline industry.103

**Dynamic alliance networks** are used in industries characterized by frequent product innovations and short product life cycles.104 For instance, the pace of innovation in the information technology (IT) industry (as well as other fast-cycle market industries) is too fast for any one company to be successful across time if it only competes independently. Another example is the movie industry, an industry in which firms participate in a number of networks for the purpose of producing and distributing movies.105 In dynamic alliance networks, partners typically **explore** new ideas and possibilities with the potential to lead to product innovations, entries to new markets, and the development of new markets.106 Often large firms in industries such as software and pharmaceuticals create networks of relationships with smaller entrepreneurial startup firms in their search for innovation-based outcomes.107 An important outcome for small firms successfully partnering with larger firms in an alliance network is the credibility they build by being associated with their larger collaborators.108

**Competitive Risks with Cooperative Strategies**

Stated simply, many cooperative strategies fail. In fact, evidence shows that two-thirds of cooperative strategies have serious problems in their first two years and that as many as 50 percent of them fail. This failure rate suggests that even when the partnership has potential complementarities and synergies, alliance success is elusive.109 Although failure is undesirable, it can be a valuable learning experience, meaning that firms should carefully study a cooperative strategy’s failure to gain insights with respect to how to form and manage future cooperative arrangements.110 We show prominent cooperative strategy risks in Figure 9.5.

![Figure 9.5 Managing Competitive Risks in Cooperative Strategies](image-url)
One cooperative strategy risk is that a firm may act in a way that its partner thinks is opportunistic. Amylin Pharmaceuticals seems to believe that this is the case with Eli Lilly & Co., its partner in an alliance formed in 2002. Developing and commercializing the type 2 diabetes drug exenatide, which is sold as a twice-daily injection under the brand Byetta, is a major outcome of this alliance. However, Lilly’s recently signed agreement with another firm for the purpose of jointly developing and commercializing several diabetes drugs—including Tradjenta, a drug the U.S. Food and Drug Administration has approved—is creating a situation in which Amylin seems to have concluded that Lilly is acting opportunistically. Because of this, Amylin has filed a lawsuit against Lilly, “alleging (that) Lilly’s recent diabetes venture with Boehringer Ingelheim GmbH breaches the terms of Lilly’s older partnership with Amylin to market other drugs for the disease.”

In general, opportunistic behaviors surface either when formal contracts fail to prevent them or when an alliance is based on a false perception of partner trustworthiness. Not infrequently, the opportunistic firm wants to acquire as much of its partner’s tacit knowledge as it can. Full awareness of what a partner wants in a cooperative strategy reduces the likelihood that a firm will suffer from another’s opportunistic actions.

Some cooperative strategies fail when it is discovered that a firm has misrepresented the competencies it can bring to the partnership. This risk is more common when the partner’s contribution is grounded in some of its intangible assets. Superior knowledge of local conditions is an example of an intangible asset that partners often fail to deliver. An effective way to deal with this risk may be to ask the partner to provide evidence that it does possess the resources and capabilities (even when they are largely intangible) it will share in the cooperative strategy.

A firm’s failure to make available to its partners the resources and capabilities (such as the most sophisticated technologies) that it committed to the cooperative strategy is a third risk. For example, the effectiveness of a recently-formed collaboration between BP Plc and OAO Rosneft is dependent on each firm contributing some of its seismic and drilling-related resources and capabilities as the foundation for efforts to develop three blocks in Russia’s Arctic Ocean. A failure by either partner to contribute needed resources and capabilities to this alliance has the potential to diminish the likelihood of success. This particular risk surfaces most commonly when firms form an international cooperative strategy, especially in emerging economies. In these instances, different cultures and languages can cause misinterpretations of contractual terms or trust-based expectations.

A final risk is that one firm may make investments that are specific to the alliance while its partner does not. For example, the firm might commit resources and capabilities to develop manufacturing equipment that can be used only to produce items coming from the alliance. If the partner isn’t also making alliance-specific investments, the firm is at a relative disadvantage in terms of returns earned from the alliance compared with investments made to earn the returns.

Managing Cooperative Strategies

Cooperative strategies are an important means of firm growth and enhanced performance, but these strategies are difficult to effectively manage. Because the ability to effectively manage cooperative strategies is unevenly distributed across organizations in general, assigning managerial responsibility for a firm’s cooperative strategies to a high-level executive or to a team improves the likelihood that the strategies will be well managed. In turn, being able to successfully manage cooperative strategies can itself be a competitive advantage.

Those responsible for managing the firm’s cooperative strategies should take the actions necessary to coordinate activities, categorize knowledge learned from previous
experiences, and make certain that what the firm knows about how to effectively form and use cooperative strategies is in the hands of the right people at the right time. Firms must also learn how to manage both the tangible and intangible assets (such as knowledge) that are involved with a cooperative arrangement. Too often, partners concentrate on managing tangible assets at the expense of taking action to also manage a cooperative relationship’s intangible assets.117

Cost minimization and opportunity maximization are the two primary approaches firms use to manage cooperative strategies118 (see Figure 9.5). In the cost-minimization approach, the firm develops formal contracts with its partners. These contracts specify how the cooperative strategy is to be monitored and how partner behavior is to be controlled. The alliance between BP Plc and OAO Rosneft, through which the firms will develop three blocks in Russia’s Arctic Ocean to search for oil, is managed largely through contracts. Remember from the discussion of the Microsoft/Nokia alliance in the Strategic Focus that hundreds of pages were developed to specify each party’s responsibilities and commitments to the collaboration. Thus it appears that at least at the outset, the cost-minimization approach is being used to manage this alliance. The goal of the cost-minimization approach is to minimize the cooperative strategy’s cost and to prevent opportunistic behavior by a partner.

Maximizing a partnership’s value-creating opportunities is the focus of the opportunity-maximization approach. In this case, partners are prepared to take advantage of unexpected opportunities to learn from each other and to explore additional marketplace possibilities. Less formal contracts, with fewer constraints on partners’ behaviors, make it possible for partners to explore how their resources and capabilities can be shared in multiple value-creating ways. This is the approach Renault and Nissan use to manage their collaborative relationship. The values of trust, respect, and transparency on which this alliance is based facilitate use of the opportunity-maximization management approach.

Firms can successfully use both approaches to manage cooperative strategies. However, the costs to monitor the cooperative strategy are greater with cost minimization, in that writing detailed contracts and using extensive monitoring mechanisms is expensive, even though the approach is intended to reduce alliance costs. Although monitoring systems may prevent partners from acting in their own best interests, they also often preclude positive responses to new opportunities that surface to productively use alliance partners’ resources and capabilities. Thus, formal contracts and extensive monitoring systems tend to stifle partners’ efforts to gain maximum value from their participation in a cooperative strategy and require significant resources to be put into place and used.120

The relative lack of detail and formality that is a part of the contract developed when using the opportunity-maximization approach means that firms need to trust that each party will act in the partnership’s best interests. The psychological state of trust in the context of cooperative arrangements is the belief that a firm will not do anything to exploit its partner’s vulnerabilities even if it has an opportunity to do so. When partners trust each other, there is less need to write detailed formal contracts to specify each firm’s alliance behaviors121 and the cooperative relationship tends to be more stable.122

On a relative basis, trust tends to be more difficult to establish in international cooperative strategies compared with domestic ones. Differences in trade policies, cultures, laws, and politics that are part of cross-border alliances account for the increased difficulty. When trust exists, monitoring costs are reduced and opportunities to create value are maximized. Essentially, in these cases, the firms have built social capital. Renault and Nissan have built social capital through their alliance by building their relationship on the mutual trust between the partners as well as their adherence to operating within the framework of agreed-upon confidentiality rules.124

Research showing that trust between partners increases the likelihood of success when using alliances highlights the benefits of the opportunity-maximization approach to managing cooperative strategies. Trust may also be the most efficient way to influence
Firms use corporate-level cooperative strategies to engage alliance partners’ behaviors. Research indicates that trust can be a capability that is valuable, rare, imperfectly imitable, and often nonsubstitutable. Thus, firms known to be trustworthy can have a competitive advantage in terms of how they develop and use cooperative strategies. Increasing the importance of trust in alliances is the fact that it is not possible to specify all operational details of a cooperative strategy in a formal contract. As such, being confident that its partner can be trusted reduces the firm’s concern about the inability to contractually control all alliance details.

**SUMMARY**

- A cooperative strategy is one through which firms work together to achieve a shared objective. Strategic alliances, where firms combine some of their resources and capabilities for the purpose of creating a competitive advantage, are the primary form of cooperative strategies. Joint ventures (where firms create and own equal shares of a new venture), equity strategic alliances (where firms own different shares of a newly created venture), and nonequity strategic alliances (where firms cooperate through a contractual relationship) are the three major types of strategic alliances. Outsourcing, discussed in Chapter 3, commonly occurs as firms form nonequity strategic alliances.

- Collusive strategies are the second type of cooperative strategies (with strategic alliances being the other). In many economies, explicit collusive strategies are illegal unless sanctioned by government policies. Increasing globalization has led to fewer government-sanctioned situations of explicit collusion. Tacit collusion, also called mutual forbearance, is a cooperative strategy through which firms tacitly cooperate to reduce industry output below the potential competitive output level, thereby raising prices above the competitive level.

- The reasons firms use cooperative strategies vary by slow-cycle, fast-cycle, and standard-cycle market conditions. To enter restricted markets (slow cycle), to move quickly from one competitive advantage to another (fast cycle), and to gain market power (standard cycle) are among the reasons firms choose to use cooperative strategies.

- Four business-level cooperative strategies are used to help the firm improve its performance in individual product markets: (1) Through vertical and horizontal complementary alliances, companies combine some of their resources and capabilities to create value in different parts (vertical) or the same parts (horizontal) of the value chain. (2) Competition response strategies are formed to respond to competitors’ actions, especially strategic actions. (3) Uncertainty-reducing strategies are used to hedge against the risks created by the conditions of uncertain competitive environments (such as new product markets). (4) Competition-reducing strategies are used to avoid excessive competition while the firm marshals its resources and capabilities to improve its strategic competitiveness. Complementary alliances have the highest probability of helping a firm form a competitive advantage; competition-reducing alliances have the lowest probability.

- Firms use corporate-level cooperative strategies to engage in product and/or geographic diversification. Through diversifying strategic alliances, firms agree to share some of their resources and capabilities to enter new markets or produce new products. Synergistic alliances are ones where firms share some of their resources and capabilities to develop economies of scope. Synergistic alliances are similar to business-level horizontal complementary alliances where firms try to develop operational synergy, except that synergistic alliances are used to develop synergy at the corporate level. Franchising is a corporate-level cooperative strategy where the franchisor uses a franchise as a contractual relationship to specify how resources and capabilities will be shared with franchisees.

- As an international cooperative strategy, a cross-border strategic alliance is used for several reasons, including the performance superiority of firms competing in markets outside their domestic market and governmental restrictions on a firm’s efforts to grow through mergers and acquisitions. Commonly, cross-border strategic alliances are riskier than their domestic counterparts, particularly when partners aren’t fully aware of each other’s purpose for participating in the partnership.

- In a network cooperative strategy, several firms agree to form multiple partnerships to achieve shared objectives. A firm’s opportunity to gain access “to its partner’s other partnerships” is a primary benefit of a network cooperative strategy. Network cooperative strategies are used to form either a stable alliance network or a dynamic alliance network. Used in mature industries, stable networks are used to extend competitive advantages into new areas. In rapidly changing environments where frequent product innovations occur, dynamic networks are used primarily as a tool of innovation.

- Cooperative strategies aren’t risk free. If a contract is not developed appropriately, or if a partner misrepresents its competencies or fails to make them available, failure is likely. Furthermore, a firm may be held hostage through asset-specific investments made in conjunction with a partner, which may be exploited.

- Trust is an increasingly important aspect of successful cooperative strategies. Firms place high value on opportunities to partner with companies known for their trustworthiness. When trust exists, a cooperative strategy is managed to maximize the pursuit of opportunities between partners. Without trust, formal contracts and extensive monitoring systems are used to manage cooperative strategies. In this case, the interest is “cost minimization” rather than “opportunity maximization.”
REVIEW QUESTIONS

1. What is the definition of cooperative strategy, and why is this strategy important to firms competing in the twenty-first century competitive landscape?

2. What is a strategic alliance? What are the three major types of strategic alliances firms form for the purpose of developing a competitive advantage?

3. What are the four business-level cooperative strategies? What are the key differences among them?

4. What are the three corporate-level cooperative strategies? How do firms use each of these strategies for the purpose of creating a competitive advantage?

5. Why do firms use cross-border strategic alliances?

6. What risks are firms likely to experience as they use cooperative strategies?

7. What are the differences between the cost-minimization approach and the opportunity-maximization approach to managing cooperative strategies?

EXPERIENTIAL EXERCISES

EXERCISE 1: WHAT IS IT—TV, INTERNET, OR BOTH?
Hulu (http://www.hulu.com) is a Web site and cooperative alliance that offers commercially supported content of TV (video on demand) shows through the Internet. The name is derived from a Chinese word that means “holder of precious things.” The alliance has many different partners that are related in interesting ways and that are from very different market types.

Working in groups, answer the following questions:

1. Describe the alliance partners. Characterize the market type as slow, fast, or standard cycle.

2. Characterize the type of strategic alliance Hulu has become.

3. In what type of market is Hulu competing?

4. Why did this alliance form? List some competitive pressures that made this alliance a necessity for its partners.

5. What does the future hold for this alliance?

EXERCISE 2: AIRLINES AND ALLIANCES
According to your text, a strategic alliance “is a partnership between firms whereby their resources and capabilities are combined to create a competitive advantage.” So what is in an alliance for an airline company such as United, American, or British Airways? In this exercise, your instructor will assign one of the three main alliances (OneWorld, Star, or SkyTeam) and your teams will be requested to investigate the alliance and be prepared to discuss the following issues:

1. In general, why do airlines form an alliance with one another (particularly internationally) rather than expanding by acquisition?

2. What is the history of the alliance to which you were assigned?

3. Describe the main benefits that airlines hope to gain through membership. What is the competitive advantage of your particular alliance, if you find there is one?

4. Categorize the alliance in terms of the three types of strategic alliance. Also describe the cooperative strategy of a member firm in relation to its business-level and corporate-level strategy.

5. Think through issues of the future of airline alliances. If you were the CEO of a major U.S. airline, what might worry you about in your particular alliance, if anything?

VIDEO CASE

A PARTNERSHIP WITH A COOPERATIVE TWIST: MICROSOFT AND YAHOO!
In its infancy, the Microsoft/Yahoo! partnership brought a cloud of layoff and market concerns, but the priority was to compete against Google for control of the Internet search market. Media and analysts predicted benefits to partners and consumers over the long term. Yahoo! remains an independent company with control of its user interface, while Microsoft added strength to its browser and gained a greater share of Internet advertising, which all provide an alternative to the Internet search market. Statistics show that Google has 65 percent of the Internet search market, with Yahoo! at 20 percent and Microsoft at 10 percent.
Questions
1. What kind of competitive advantage is created through the Microsoft/Yahoo! cooperative strategy?
2. What kind of strategic alliance has occurred between Microsoft and Yahoo!? Explain your answer. For what reasons do you think they developed such an alliance?
3. Now that Microsoft and Yahoo! have partnered, what business-level cooperative strategies do you think we can expect? Why?
4. What corporate-level cooperative strategies do you think we can expect? Why?

NOTES

5. Bennett, Dodge will test Fiat alliance.

22. 2009, Xerox signs six-year deal with India’s HCL, BusinessWeek, April 6.


65. Maxwell, Itochu buys stake in Colombian coal operation.
81. Ibid.


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PART 3
Strategic Actions: Strategy Implementation

10. Corporate Governance, 292
11. Organizational Structure and Controls, 324
12. Strategic Leadership, 360
13. Strategic Entrepreneurship, 390
Studying this chapter should provide you with the strategic management knowledge needed to:

1. Define corporate governance and explain why it is used to monitor and control top-level managers’ decisions.

2. Explain why ownership is largely separated from managerial control in organizations.

3. Define an agency relationship and managerial opportunism and describe their strategic implications.

4. Explain the use of three internal governance mechanisms to monitor and control managers’ decisions.

5. Discuss the types of compensation top-level managers receive and their effects on managerial decisions.

6. Describe how the external corporate governance mechanism—the market for corporate control—restrains top-level managers’ decisions.

7. Discuss the nature and use of corporate governance in international settings, especially in Germany, Japan, and China.

8. Describe how corporate governance fosters the making of ethical decisions by a firm’s top-level managers.
Corporate Governance: What Is All the Fuss About?

Appearing in business publications, these statements deal with slightly different but related issues. What the statements have in common is that each deals with corporate governance. Defined formally in the first part of this chapter, corporate governance is concerned with various activities, including those intended to (1) strengthen the effectiveness of a company’s board of directors, (2) verify the transparency of a firm’s operations, (3) enhance accountability to shareholders, (4) effectively incentivize executives, and in an overall sense, (5) maximize the firm’s ability to create value for stakeholders and especially for shareholders. Thus, at a core level, corporate governance deals with the actions a firm should take as a result of top-level managers’ decisions and verifying that the intended actions do take place.

In this chapter, we explore the set of issues and subsequent actions that are central to corporate governance. One of these issues is the set of responsibilities assigned to a firm’s board of directors. For example, a board is expected to verify that the firm has a viable CEO succession plan in place at all times. Apple Inc.’s board recently used that firm’s succession plan to appoint Tim Cook as CEO following Steve Jobs’ resignation. Cook had been serving as Apple’s Chief Operating Officer and had been with the firm for a total of 13 years at the time of his appointment as CEO. Selecting the CEO and working with that individual and her/his top-management team to form a firm’s strategy are other important board of directors’ responsibilities.

Given recent criticisms, boards’ actions in nations throughout the world are being more carefully scrutinized and regulated. In the United Kingdom, directors are now required to stand for re-election annually. Additionally, a new principle in the United Kingdom “is that members of the board should be selected on merit, against objective criteria, and with due regard for the benefits of diversity including gender diversity.” In the United States, the fact that after being fired by their firm, a number of CEOs still remain as members of other firms’ boards of directors is drawing close attention.

Corporate governance is also important to nations. Accordingly, “India plans to soon seek parliament’s approval for a new companies’ bill that would replace some of the archaic laws and help boost investors’ confidence as the South Asian nation stresses on sprucing its corporate governance image.” The Chinese government apparently is assessing actions to take to deal with conclusions drawn by ratings agencies such as Moody’s Investors Services and Fitch Ratings. This suggests that corporate governance is weak in many Chinese firms and that there is concern about the validity and reliability of some auditors’ work and the quality of companies’ financial statements.

As these examples suggest, the reason there is a “fuss” about corporate governance is that these activities are critical to a nation’s efforts to signal to the global community that its business-related infrastructure is consistent with global standards for transparency and to the ability of individual firms in countries throughout the world to achieve strategic
As the Opening Case suggests, corporate governance involves a number of activities dealing with how firms operate and, at a broader level, the type of infrastructure individual nations develop as the framework within which companies compete. Given that we are concerned with the strategic management process firms use, our focus in this chapter is on corporate governance in companies rather than on governance-related issues affecting individual nations (although we do also address governance at the level of nations as well).

Corporate governance is the set of mechanisms used to manage the relationship among stakeholders and to determine and control the strategic direction and performance of organizations. At its core, corporate governance is concerned with identifying ways to ensure that decisions (especially strategic decisions) are made effectively and that they facilitate a firm’s efforts to achieve strategic competitiveness.1 For example, if the board makes the wrong decisions in selecting, governing, and compensating the firm’s CEO as its key strategic leader, the shareholders and the firm suffer. When CEOs are motivated to act in the best interests of the firm—in particular, the shareholders—the company’s value should increase. Additionally, effective succession plans and appropriate monitoring and direction-setting efforts by the board of directors contribute positively to a firm’s performance.

Corporate governance is the set of mechanisms used to manage the relationship among stakeholders and to determine and control the strategic direction and performance of organizations.2 At its core, corporate governance is concerned with identifying ways to ensure that decisions (especially strategic decisions) are made effectively and that they facilitate a firm’s efforts to achieve strategic competitiveness.3 Governance can also be thought of as a means to establish and maintain harmony between parties (the firm’s owners and its top-level managers) whose interests may conflict.

In modern corporations—especially those in nations with “Westernized” infrastructures and business practices such as the United States and the United Kingdom—ensuring that top-level managers’ interests are aligned with other stakeholders’ interests, particularly those of shareholders, is a primary objective of corporate governance. Thus, corporate governance involves oversight in areas where owners, managers, and members of boards of directors may have conflicts of interest. Processes used to elect members of the board’s controller, the general supervision of CEO pay and more focused supervision of director pay, and the corporation’s overall strategic direction are examples of areas in which oversight is sought.4 Because corporate governance is an ongoing process concerned with how a firm is to be managed, its nature evolves in light of types of never-ending changes in a firm’s external environment that we discussed in Chapter 2.

Chapter 10: Corporate Governance

The recent emphasis on corporate governance that is occurring across the globe stems mainly from the apparent failure of corporate governance mechanisms to adequately monitor and control top-level managers’ decisions during recent times. In turn, undesired or unacceptable consequences resulting from using corporate governance mechanisms cause changes to these mechanisms, especially to the board of directors as a means of governance. A second and more positive reason for this interest comes from evidence that a well-functioning corporate governance system can create a competitive advantage for an individual firm.

As noted earlier, corporate governance is of concern to nations as well as to individual firms. Although corporate governance reflects company standards, it also collectively reflects the societal standards of nations. Commenting about governance-related changes being made in Singapore, an official noted that, “Good corporate governance plays an important role in ensuring the effective functioning of Singapore’s capital markets.” Ensuring the independence of board members and practices a board should follow to exercise effective oversight of a firm’s internal control efforts are examples of recent changes to governance standards being applied in Singapore. Efforts such as these are important in that research shows that how nations choose to govern their corporations does affect firms’ investment decisions. In other words, firms seek to invest in nations with national governance standards that are acceptable to them. This is particularly the case when firms consider the possibility of geographically expanding into emerging markets.

In the chapter’s first section, we describe the relationship on which the modern corporation is built—namely, the relationship between owners and managers. We use the majority of the chapter to explain various mechanisms owners use to govern managers and to ensure that they comply with their responsibility to satisfy stakeholders’ needs, especially those of shareholders.

Three internal governance mechanisms and a single external one are used in the modern corporation. The three internal governance mechanisms we describe in this chapter are (1) ownership concentration, represented by types of shareholders and their different incentives to monitor managers; (2) the board of directors; and (3) executive compensation. We then consider the market for corporate control, an external corporate governance mechanism. Essentially, this market is a set of potential owners seeking to acquire undervalued firms and earn above-average returns on their investments by replacing ineffective top-level management teams. The chapter’s focus then shifts to the issue of international corporate governance. We briefly describe governance approaches used in German, Japanese, and Chinese firms. In part, this discussion suggests that the structures used to govern global companies competing in both developed and emerging economies are becoming more, rather than less, similar. Closing our analysis of corporate governance is a consideration of the need for these control mechanisms to encourage and support ethical behavior in organizations.

Separation of Ownership and Managerial Control

Historically, U.S. firms were managed by founder-owners and their descendants. In these cases, corporate ownership and control resided in the same persons. As firms grew larger, “the managerial revolution led to a separation of ownership and control in most large corporations, where control of the firm shifted from entrepreneurs to professional managers while ownership became dispersed among thousands of unorganized stockholders who were removed from the day-to-day management of the firm.” These changes created the modern public corporation, which is based on the efficient separation of ownership and managerial control. Supporting the separation is a basic legal premise
suggesting that the primary objective of a firm’s activities is to increase the corporation’s profit and, thereby, the owners’ (shareholders’) financial gains.12

The separation of ownership and managerial control allows shareholders to purchase stock, which entitles them to income (residual returns) from the firm’s operations after paying expenses. This right, however, requires that shareholders take a risk that the firm’s expenses may exceed its revenues. To manage this investment risk, shareholders maintain a diversified portfolio by investing in several companies to reduce their overall risk.13 The poor performance or failure of any one firm in which they invest has less overall effect on the value of the entire portfolio of investments. Thus, shareholders specialize in managing their investment risk.

Commonly, those managing small firms also own a significant percentage of the firm. In such instances, there is less separation between ownership and managerial control. Moreover, in a large number of family-owned firms, ownership and managerial control are not separated at all. Research shows that family-owned firms perform better when a member of the family is the CEO than when the CEO is an outsider.14

In many regions outside the United States, such as in Latin America, Asia, and some European countries, family-owned firms dominate the competitive landscape.15 The primary purpose of most of these firms is to increase the family’s wealth, which explains why a family CEO often is better than an outside CEO. Family ownership is also significant in U.S. companies in that at least one-third of the S&P 500 firms have substantial family ownership, holding on average about 18 percent of a firm’s equity.16

Family-controlled firms face at least two critical issues related to corporate governance. First, as they grow, they may not have access to all of the skills needed to effectively manage the firm and maximize returns for the family. Thus, outsiders may be required to facilitate growth. Also, as they grow, they may need to seek outside capital and thus give up some of the ownership. In these cases, protecting the minority owners’ rights becomes important.17 To avoid these potential problems, when family firms grow and become more complex, their owner-managers may contract with managerial specialists. These managers make major decisions in the owners’ firm and are compensated on the basis of their decision-making skills. Research suggests that firms in which families own enough equity to have influence without major control tend to make the best strategic decisions.18

Without owner (shareholder) specialization in risk bearing and management specialization in decision making, a firm may be limited by its owners’ abilities to simultaneously manage it and make effective strategic decisions relative to risk. Thus, the separation and specialization of ownership (risk bearing) and managerial control (decision making) should produce the highest returns for the firm’s owners.

**Agency Relationships**

The separation between owners and managers creates an agency relationship. An agency relationship exists when one or more persons (the principal or principals) hire another person or persons (the agent or agents) as decision-making specialists to perform a service.19 Thus, an agency relationship exists when one party delegates decision-making responsibility to a second party for compensation (see Figure 10.1).

In addition to shareholders and top-level managers, other examples of agency relationships are consultants and clients and insured and insurer. Moreover, within organizations, an agency relationship exists between managers and their employees, as well as between top-level managers and the firm’s owners.20 However, in this chapter we focus on the agency relationship between the firm’s owners (the principals) and top-level managers (the principals’ agents) because these managers are responsible for formulating and implementing the firm’s strategies, which have major effects on firm performance.21

The separation between ownership and managerial control can be problematic. Research evidence documents a variety of agency problems in the modern corporation.22 Problems can surface because the principal and the agent have different interests.
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and goals or because shareholders lack direct control of large publicly traded corporations. Problems also surface when an agent makes decisions that result in pursuing goals that conflict with those of the principals. Thus, the separation of ownership and control potentially allows divergent interests (between principals and agents) to occur, which can lead to managerial opportunism.

Managerial opportunism is the seeking of self-interest with guile (i.e., cunning or deceit).\textsuperscript{23} Opportunism is both an attitude (e.g., an inclination) and a set of behaviors (i.e., specific acts of self-interest).\textsuperscript{24} Principals do not know beforehand which agents will or will not act opportunistically. A top-level manager’s reputation is an imperfect predictor; moreover, opportunistic behavior cannot be observed until it has occurred. Thus, principals establish governance and control mechanisms to prevent agents from acting opportunistically, even though only a few are likely to do so. Interestingly, research suggests that when CEOs feel constrained by governance mechanisms, they are more likely to seek external advice that in turn helps them make better strategic decisions.\textsuperscript{25}

The agency relationship suggests that any time principals delegate decision-making responsibilities to agents, the opportunity for conflicts of interest exists. Top-level managers, for example, may make strategic decisions that maximize their personal welfare and minimize their personal risk.\textsuperscript{26} Decisions such as these prevent maximizing shareholder wealth. Decisions regarding product diversification demonstrate this situation.

Product Diversification as an Example of an Agency Problem

As explained in Chapter 6, a corporate-level strategy to diversify the firm’s product lines can enhance a firm’s strategic competitiveness and increase its returns, both of which serve the interests of all stakeholders and certainly shareholders and top-level managers. However, product diversification can create two benefits for top-level managers that
shareholders do not enjoy, meaning that they may prefer product diversification more than shareholders do.²⁷

The fact that product diversification usually increases the size of a firm and that size is positively related to executive compensation is the first of the two benefits of additional diversification that may accrue to top-level managers. Diversification also increases the complexity of managing a firm and its network of businesses, possibly requiring additional managerial pay because of this complexity.²⁸ Thus, increased product diversification provides an opportunity for top-level managers to increase their compensation.²⁹

The second potential benefit is that product diversification and the resulting diversification of the firm’s portfolio of businesses can reduce top-level managers’ employment risk. Managerial employment risk is the risk of job loss, loss of compensation, and loss of managerial reputation.³⁰ These risks are reduced with increased diversification, because a firm and its upper-level managers are less vulnerable to the reduction in demand associated with a single or limited number of product lines or businesses. Events occurring at Kellogg Co. demonstrate these issues.

In 2001, Kellogg was almost entirely focused on breakfast cereal when it suffered its first-ever market share leadership loss to General Mills, Inc. Shortly thereafter, long-time Kellogg employee Carlos Gutierrez became Kellogg’s CEO. Under his leadership, the firm embarked on a new strategy to overcome its poor performance. A business writer described some of the details of Gutierrez’s strategy as follows: "To drive sales, Gutierrez unveiled such novel products as Special K snack bars, bought cookie maker Keebler Co., and ramped up Kellogg’s healthy foods presence by snapping up Worthington Foods Inc., a maker of soy and vegetarian products, and cereal maker Kashi. He pushed net earnings up 77 percent, to $890.6 million, from 1998 to 2004, as sales rose 42 percent, to $9.6 billion."³¹

Today, as it pursues its vision “to be the food company of choice,” Kellogg operates manufacturing facilities in 18 countries and sells its diversified product lines in more than 180 countries. Kellogg indicates that it “is the world’s leading producer of cereal and a leading producer of convenience foods, including cookies, crackers, toaster pastries, cereal bars, fruit-flavored snacks, frozen waffles and veggie foods.”³² As this set of products suggests and as indicated by the number of countries in which the firm sells what it produces, Kellogg’s diversification continues increasing in terms of products and geography. However, the increased diversification involves highly related businesses through which Kellogg creates synergy as a foundation for competitive success. As Kellogg became more diversified in terms of products and geography, the risk of job loss for former CEO Gutierrez and his successors David Mackay and current CEO John Bryant was also reduced. Importantly, research results suggest that related diversification such as Kellogg pursued can enhance a firm’s profitability.³³

Free cash flow is the source of another potential agency problem. Calculated as operating cash flow minus capital expenditures, free cash flow represents the cash remaining after the firm has invested in all projects that have positive net present value within its current businesses.³⁴ Top-level managers may decide to invest free cash flow in product lines that are not associated with the firm’s current lines of business to increase the firm’s degree of diversification. However, when managers use free cash flow to diversify the firm in ways that do not have a strong possibility of creating additional value for stakeholders and certainly for shareholders, the firm is overdiversified. Overdiversification is an example of self-serving and opportunistic managerial behavior. In contrast to managers, shareholders may prefer that free cash flow be distributed to them as dividends, so they can control how the cash is invested.³⁵

In Figure 10.2, Curve S shows shareholders’ optimal level of diversification. As the firm’s owners, shareholders seek the level of diversification that reduces the risk of the firm’s total failure while simultaneously increasing its value by developing economies of scale and scope (see Chapter 6). Of the four corporate-level diversification strategies shown in Figure 10.2, shareholders likely prefer the diversified position noted by point A on Curve S—a position that is located between the dominant business and
related-constrained diversification strategies. Of course, the optimum level of diversification owners seek varies from firm to firm. Factors that affect shareholders’ preferences include the firm’s primary industry, the intensity of rivalry among competitors in that industry, and the top management team’s experience with implementing diversification strategies and its effects on other firm strategies, such as its entry into international markets.

As is the case for principals, top-level managers—as agents—also seek an optimal level of diversification. Declining performance resulting from too much diversification increases the probability that external investors (representing the market for corporate control) will purchase a substantial percentage of the entire firm for the purpose of controlling it. If a firm is acquired, the employment risk for its top-level managers increases significantly. Furthermore, these managers’ employment opportunities in the external managerial labor market (discussed in Chapter 12) are affected negatively by a firm’s poor performance. Therefore, top-level managers prefer that the firms they lead be diversified. However, their preference is that the firm’s diversification falls short of the point at which it increases their employment risk and reduces their employment opportunities. Curve \( M \) in Figure 10.2 shows that top-level managers prefer higher levels of product diversification than do shareholders. Top-level managers might find the optimal level of diversification as shown by point \( B \) on Curve \( M \).

In general, shareholders prefer riskier strategies and more focused diversification. Shareholders reduce their risk by holding a diversified portfolio of investments. Alternatively, managers cannot balance their employment risk by working for a diverse portfolio of firms; therefore, managers may prefer a level of diversification that maximizes firm size and their compensation while also reducing their employment risk. Product diversification, therefore, is a potential agency problem that could result in principals incurring costs to control their agents’ behaviors.

**Agency Costs and Governance Mechanisms**

The potential conflict between shareholders and top-level managers shown in Figure 10.2, coupled with the fact that principals cannot easily predict which managers might
PART 3: Strategic Actions: Strategy Implementation

act opportunistically, demonstrates why principals establish governance mechanisms. However, the firm incurs costs when it uses one or more governance mechanisms. **Agency costs** are the sum of incentive costs, monitoring costs, enforcement costs, and individual financial losses incurred by principals because governance mechanisms cannot guarantee total compliance by the agent. Because monitoring activities taking place within a firm is difficult, the principals’ agency costs are larger in diversified firms given the additional complexity of diversification. 39

In general, managerial interests may prevail when governance mechanisms are weak and as such, ineffective; this is exemplified in situations where managers have a significant amount of autonomy to make strategic decisions. If, however, the board of directors controls managerial autonomy, or if other strong governance mechanisms are used, the firm’s strategies should better reflect stakeholders and certainly shareholders’ interests.

More recently, observers of firms’ governance practices have been concerned about more egregious behavior beyond mere ineffective corporate strategies, such as that discovered at Enron and WorldCom. Partly in response to these behaviors, the U.S. Congress enacted the Sarbanes-Oxley (SOX) Act in 2002 and passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) in mid-2010.

Because of these two acts, corporate governance mechanisms should receive greater scrutiny. 40 While the implementation of SOX has been controversial to some, most believe that its use has led to generally positive outcomes in terms of protecting stakeholders and certainly shareholders’ interests. For example, Section 404 of SOX, which prescribes significant transparency improvement on internal controls associated with accounting and auditing, has arguably improved the internal auditing scrutiny (and thereby trust) in firms’ financial reporting. Moreover, research suggests that internal controls associated with Section 404 increase shareholder value. 41 Nonetheless, some argue that the Act, especially Section 404, creates excessive costs for firms. In addition, a decrease in foreign firms listing on U.S. stock exchanges occurred at the same time as listing on foreign exchanges increased. In part, this shift may be because of the costs SOX generates for firms seeking to list on U.S. exchanges.

Although the details of its implementation remain incomplete, Dodd-Frank is recognized as the most sweeping set of financial regulatory reforms in the United States since the Great Depression. The Act is intended to align financial institutions’ actions with society’s interests. Dodd-Frank includes provisions related to the categories of consumer protection, systemic risk oversight, executive compensation, and capital requirements for banks. Some legal analysts offer the following description of the Act’s provisions: “(Dodd-Frank) creates a Financial Stability Oversight Council headed by the Treasury Secretary, establishes a new system for liquidation of certain financial companies, provides for a new framework to regulate derivatives, establishes new corporate governance requirements, and regulates credit rating agencies and securitizations. The Act also establishes a new consumer protection bureau and provides for extensive consumer protection in financial services.” 42

More intensive application of governance mechanisms as mandated by legislation such as Sarbanes-Oxley and Dodd-Frank affects firms’ choice of strategies. For example, more intense governance might find firms choosing to pursue fewer risky projects, possibly decreasing shareholder wealth as a result. In considering how some provisions associated with Dodd-Frank that deal with banks might be put into practice, a U.S. federal regulator said, “To put it plainly, my view is that we are in danger of trying to squeeze too much risk and complexity out of banking.” 43 As this comment suggests, determining governance practices that strike an appropriate balance between protecting stakeholders’ interests and allowing firms to implement strategies with some degree of risk is difficult.

Next, we explain the effects of the three internal governance mechanisms on managerial decisions regarding the firm’s strategies.

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**Agency costs** are the sum of incentive costs, monitoring costs, enforcement costs, and individual financial losses incurred by principals because governance mechanisms cannot guarantee total compliance by the agent.
Ownership Concentration

Ownership concentration is defined by the number of large-block shareholders and the total percentage of the firm’s shares they own. Large-block shareholders typically own at least 5 percent of a company's issued shares. Ownership concentration as a governance mechanism has received considerable interest because large-block shareholders are increasingly active in their demands that firms adopt effective governance mechanisms to control managerial decisions so that they will best represent owners’ interests.44 In recent years, the number of individuals who are large-block shareholders has declined. Institutional owners have replaced individuals as large-block shareholders.

In general, diffuse ownership (a large number of shareholders with small holdings and few, if any, large-block shareholders) produces weak monitoring of managers' decisions. One reason for this is that diffuse ownership makes it difficult for owners to effectively coordinate their actions. As noted earlier, diversification beyond the shareholders' optimum level can result from ineffective monitoring of managers’ decisions. Higher levels of monitoring could encourage managers to avoid strategic decisions that harm shareholder value, such as too much diversification. Research evidence suggests that ownership concentration is associated with lower levels of firm product diversification.45 Thus, with high degrees of ownership concentration, the probability is greater that managers’ decisions will be designed to maximize shareholder value.46

As noted, ownership concentration influences decisions made about the strategies a firm will use and the value created by their use. In general, but not in every case, ownership concentration’s influence on strategies and firm performance is positive. For example, when large-block shareholders have a high degree of wealth, they have power relative to minority shareholders to appropriate the firm’s wealth; this is particularly the case when they are in managerial positions. Excessive appropriation at the expense of minority shareholders is somewhat common in countries such as Korea where minority shareholder rights are not as protected as they are in the United States.47 The importance of boards of directors to mitigate excessive appropriation of minority shareholder value has been found in firms with strong family ownership wherein family members have incentives to appropriate shareholder wealth, especially in the second generation after the founder has departed.48

The Increasing Influence of Institutional Owners

A classic work published in the 1930s argued that a separation of ownership and control had come to characterize the “modern” corporation.49 This change occurred primarily because growth prevented founders-owners from maintaining their dual positions in what were increasingly complex companies. More recently, another shift has occurred: Ownership of many modern corporations is now concentrated in the hands of institutional investors rather than individual shareholders.50 Institutional owners are financial institutions such as mutual funds and pension funds that control large-block shareholder positions. Because of their prominent ownership positions, institutional owners, as large-block shareholders, have the potential to be a powerful governance mechanism. In 2009, estimates were that institutional owners held roughly 51 percent of all U.S. corporate equity and close to 73 percent of the equity among the 1,000 largest U.S. companies.51 Recent commentary suggests the importance of pension funds to an entire economy: “Pension funds are critical drivers of growth and economic activity in the United States because they are one of the only significant sources of long-term, patient capital.”52

These percentages suggest that as investors, institutional owners have both the size and the incentive to discipline ineffective top-level managers and that they can significantly influence a firm’s choice of strategies and strategic decisions.53 Research evidence indicates that institutional and other large-block shareholders are becoming...
more active in their efforts to influence a corporation’s strategic decisions, unless they have a business relationship with the firm. Initially, these shareholder activists and institutional investors concentrated on the performance and accountability of CEOs and contributed to the dismissal of a number of them. Activists often target the actions of boards more directly via proxy vote proposals that are intended to give shareholders more decision rights because they believe board processes have been ineffective.54 A rule approved by the U.S. Securities and Exchange Commission allowing large shareholders (owning 1 to 5 percent of a company’s stock) to nominate up to 25 percent of a company’s board of directors may enhance shareholders’ decision rights.55

Established in 1932, CalPERS is a large institutional owner providing retirement and health coverage to more than 1.6 million California public employees, retirees, and their families. In 2011, CalPERS was the largest public employee pension fund in the United States. The recent economic crisis resulted in the fund encountering a loss of 24 percent of its invested assets in 2009, though by mid-2011 much of that loss had been recovered.56

As a large institutional owner, CalPERS is thought to aggressively promote governance decisions and actions that it believes will enhance shareholder value in companies in which it invests. One action CalPERS takes is to annually develop its Shareowner/Corporate Engagement Program to engage “underperforming public stock companies through private contacts and proxy actions rather than by posting a public ‘name-and-shame’ List.”57 Previously, CalPERS published a Focus List of companies it felt demonstrated very poor governance practices. Commenting about the change to its new program, the president of the CalPERS board noted that “The Focus List has served us well by calling public attention to some of the worst market players, but the time has come for a more effective approach.”58 Regardless of the actions taken, CalPERS is recognized as an effective steward of shareholders’ best interests when interacting with companies in which it has invested.

To date, research suggests that institutional activism may not have a strong direct effect on firm performance but may indirectly influence a targeted firm’s strategic decisions, including those concerned with international diversification and innovation. Thus, to some degree at least, institutional activism has the potential to discipline managers and to enhance the likelihood of a firm taking future actions that are in shareholders’ best interests.59

Board of Directors

Shareholders elect the members of a firm’s board of directors. The board of directors is a group of elected individuals whose primary responsibility is to act in the owners’ best interests by formally monitoring and controlling the firm’s top-level managers.60 Those elected to a firm’s board of directors are expected to oversee managers and to ensure that the corporation operates in ways that will best serve stakeholders’ interests, and particularly the owners’ interests. Helping board members reach their expected objectives are their powers to direct the affairs of the organization and reward and discipline top-level managers.

Though important to all shareholders, a firm’s individual shareholders with small ownership percentages are very dependent on the board of directors to represent their
interests. Unfortunately, evidence suggests that boards have not been highly effective in monitoring and controlling top-level managers’ decisions and subsequent actions. Because of their relatively ineffective performance and in light of the recent financial crisis, boards are experiencing increasing pressure from shareholders, lawmakers, and regulators to become more forceful in their oversight role to prevent top-level managers from acting in their own best interests. Moreover, in addition to their monitoring role, board members increasingly are expected to provide resources to the firms they serve. These resources include their personal knowledge and expertise and their relationships with a wide variety of organizations.

Generally, board members (often called directors) are classified into one of three groups (see Table 10.1). **Insiders** are active top-level managers in the company who are elected to the board because they are a source of information about the firm’s day-to-day operations. **Related outsiders** have some relationship with the firm, contractual or otherwise, that may create questions about their independence; but, these individuals are not involved with the corporation’s day-to-day activities. **Outsiders** provide independent counsel to the firm and may hold top-level managerial positions in other companies or may have been elected to the board prior to the beginning of the current CEO’s tenure.

Historically, inside managers dominated a firm’s board of directors. A widely accepted view is that a board with a significant percentage of its membership from the firm’s top-level managers provides relatively weak monitoring and control of managerial decisions. With weak board monitoring, managers sometimes use their power to select and compensate directors and exploit their personal ties with them. In response to the SEC’s proposal to require audit committees to be composed of outside directors, in 1984 the New York Stock Exchange implemented a rule requiring outside directors to head the audit committee. Subsequently, other rules required that independent outsider directors lead important committees such as the compensation committee and the nomination committee. These other requirements were instituted after the Sarbanes-Oxley Act was passed, and policies of the New York Stock Exchange now require companies to maintain boards of directors that are composed of a majority of outside independent directors and to maintain full independent audit committees. Thus, additional scrutiny of corporate governance practices is resulting in a significant amount of attention being devoted to finding ways to encourage boards to take actions that fully represent shareholders’ best interests.

Critics advocate reforms to ensure that independent outside directors are a significant majority of a board’s total membership; research suggests this has been accomplished. However, others argue that having outside directors is not enough to resolve the problems in that CEO power can strongly influence a board’s decision. One proposal to reduce the power of the CEO is to separate the chair’s role and the CEO’s role on the board so that the same person does not hold both positions. A situation in which an individual holds both the CEO and chair of the board title is called **CEO duality**.

<table>
<thead>
<tr>
<th>Classification of Board of Directors’ Members</th>
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<tbody>
<tr>
<td><strong>Insiders</strong></td>
</tr>
<tr>
<td>• The firm’s CEO and other top-level managers</td>
</tr>
<tr>
<td><strong>Related outsiders</strong></td>
</tr>
<tr>
<td>• Individuals not involved with the firm’s day-to-day operations, but who have a relationship with the company</td>
</tr>
<tr>
<td><strong>Outsiders</strong></td>
</tr>
<tr>
<td>• Individuals who are independent of the firm in terms of day-to-day operations and other relationships</td>
</tr>
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having a board that actively monitors top-level managers’ decisions and actions does
not ensure high performance. The value that the directors bring to the company also
influences the outcomes. For example, boards with members having significant relevant
experience and knowledge are the most likely to help the firm formulate and implement
effective strategies.  

Alternatively, having a large number of outside board members can also create some
problems. For example, because outsiders typically do not have contact with the firm’s
day-to-day operations and do not have ready access to detailed information about
managers and their skills, they lack the insights required to fully and effectively evaluate their
decisions and initiatives. 70 Outsiders can, however, obtain valuable information through
frequent interactions with inside board members and during board meetings to enhance
their understanding of managers and their decisions.

Because they work with and lead the firm daily, insiders have access to information
that facilitates forming and implementing appropriate strategies. Accordingly, some evi-
dence suggests that boards with a critical mass of insiders typically are better informed
about intended strategic initiatives, the reasons for the initiatives, and the outcomes
expected from pursuing them. 71 Without this type of information, outsider-dominated
boards may emphasize financial, as opposed to strategic, controls to gather performance
information to evaluate managers’ and business units’ performances. A virtually exclu-
sive reliance on financial evaluations shifts risk to top-level managers who, in turn, may
make decisions to maximize their interests and reduce their employment risk. Reducing
investments in R&D, further diversifying the firm, and pursuing higher levels of com-
pen-sation are some of the results of managers’ actions to reach the financial goals set by
outsider-dominated boards. 72 Additionally, boards can make mistakes in CEO succes-
sion decisions because of the lack of important information about candidates as well as
the firm’s specific needs. Overall, knowledgeable and balanced boards are likely to be the
most effective over time. 73

Enhancing the Effectiveness of the Board of Directors

Because of the importance of boards of direc-
tors in corporate governance and as a result of
in increased scrutiny from shareholders—in par-
ticular, large institutional investors—the per-
formances of individual board members and
of entire boards are being evaluated more for-
mally and with greater intensity. 74 The demand
for greater accountability and improved per-
formance is stimulating many boards to volun-
tarily make changes. Among these changes are
(1) increases in the diversity of the backgrounds
of board members (e.g., a greater number of
directors from public service, academic, and
scientific settings; a greater percentage of eth-
nic minorities and women; and members from
different countries on boards of U.S. firms),
(2) the strengthening of internal management
and accounting control systems, (3) establishing
and consistently using formal processes to evalu-
ate the board’s performance, (4) modifying the
compensation of directors, especially reducing or
eliminating stock options as a part of their pack-
age, and (5) creating the “lead director” role

Executive Director of the United Nations World Food
Programme, Josette Sheeran, Co-Chair of the Bill &
Melinda Gates Foundation, Melinda Gates, World Health
Organization (WHO) General-Director Margaret Chan, U2
pop group lead singer Bono, Chairman of the Board and
Chief Executive Officer (CEO) of The Coca-Cola Company,
Muhtar A. Kent, and President and Chief Executive Officer
of Novo Nordisk, Lars Sorensen attend a session entitled
“Raising Healthy Children” at the World Economic Forum.
Often, individuals sit on multiple boards at a time.
that has strong powers with regard to the board agenda and oversight of nonmanagement board member activities.

An increase in the board’s involvement with a firm’s strategic decision-making processes creates the need for effective collaboration between board members and top-level managers. Some argue that improving the processes used by boards to make decisions and monitor managers and firm outcomes is important for board effectiveness. Moreover, because of the increased pressure from owners and the potential conflict among board members, procedures are necessary to help boards function effectively while seeking to discharge their responsibilities.

Increasingly, outside directors are being required to own significant equity stakes as a prerequisite to holding a board seat. In fact, some research suggests that firms perform better if outside directors have such a stake; the trend is toward higher pay for directors with more stock ownership, but with fewer stock options. However, other research suggests that too much ownership can lead to lower independence for board members. In addition, other research suggests that diverse boards help firms make more effective strategic decisions and perform better over time. Although questions remain about whether more independent and diverse boards enhance board effectiveness, the trends for greater independence and increasing diversity among board members are likely to continue.

**Executive Compensation**

The compensation of top-level managers, and especially of CEOs, generates a great deal of interest and strongly held opinions. Some believe that top-management team members and certainly CEOs have a great deal of responsibility for a firm’s performance and that they should be rewarded accordingly. Others conclude that these individuals (and again, especially CEOs) are greatly overpaid and that their compensation is not as strongly related to firm performance as should be the case. One of the three internal governance mechanisms seeks to deal with these issues. Specifically, executive compensation is a governance mechanism that seeks to align the interests of managers and owners through salaries, bonuses, and long-term incentives, such as stock awards and options.

Long-term incentive plans (typically involving stock options and stock awards) are an increasingly important part of compensation packages for top-level managers, especially those leading U.S. firms. Theoretically, using long-term incentives facilitates the firm’s efforts (through the board of directors’ pay-related decisions) to avoid potential agency problems by linking managerial compensation to the wealth of common shareholders. Effectively designed long-term incentive plans have the potential to prevent large-block stockholders (e.g., institutional investors) from pressing for changes in the composition of the board of directors and the top-management team in that they assume that when exercised, the plans will ensure that top-level managers will act in shareholders’ best interests. Additionally, shareholders typically assume that top-level managers’ pay and the firm’s performance are more properly aligned when outsiders are the dominant block of a board’s membership. Research results suggesting that fraudulent behavior can be associated with stock option incentives, such as earnings manipulation, demonstrate the importance of the firm’s board of directors (as a governance mechanism) actively monitoring the use of executive compensation as a governance mechanism.

Effectively using executive compensation as a governance mechanism is particularly challenging for firms implementing international strategies. For example, the interests of the owners of multinational corporations may be best served by less uniformity in the firm’s foreign subsidiaries’ compensation plans. Developing an array of unique compensation plans requires additional monitoring, potentially increasing the firm’s agency costs. Importantly, pay levels vary by regions of the world. For example, managerial pay is highest in the United States and much lower in Asia. Historically, compensation for top-level managers has been lower in India partly because many of the largest firms have
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strong family ownership and control.\textsuperscript{86} Also, acquiring firms in other countries increases the complexity associated with a board of directors’ efforts to use executive compensation as an effective internal corporate governance mechanism.\textsuperscript{87}

The Effectiveness of Executive Compensation

As an internal governance mechanism, executive compensation—especially long-term incentive compensation—is complicated, for several reasons. First, the strategic decisions top-level managers make are complex and nonroutine, meaning that direct supervision (even by the firm’s board of directors) is likely to be ineffective as a means of judging the quality of their decisions. The result is a tendency to link top-level managers’ compensation to outcomes the board can easily evaluate, such as the firm’s financial performance. This leads to a second issue in that, typically, the effects of top-level managers’ decisions are stronger on the firm’s long-term than its short-term performance. This reality makes it difficult to assess the effects of their decisions on a regular basis such as annually. Third, a number of other factors affect a firm’s performance besides top-level managerial decisions and behavior. Unpredictable changes in segments (economic, demographic, political/legal, etc.) in the firm’s general environment (see Chapter 2) make it difficult to separate out the effects of top-level managers’ decisions and the effects (both positive and negative) of changes in the firm’s external environment on the firm’s performance.

Properly designed and used incentive compensation plans for top-level managers may increase the value of a firm in line with shareholder expectations, but such plans are subject to managerial manipulation.\textsuperscript{88} Additionally, annual bonuses may provide incentives to pursue short-run objectives at the expense of the firm’s long-term interests. Although long-term, performance-based incentives may reduce the temptation to under-invest in the short run, they increase executive exposure to risks associated with uncontrollable events, such as market fluctuations and industry decline. The longer term the focus of incentive compensation, the greater are the long-term risks top-level managers bear. Also, because long-term incentives tie a manager’s overall wealth to the firm in a way that is inflexible, such incentives and ownership may not be valued as highly by a manager as by outside investors who have the opportunity to diversify their wealth in a number of other financial investments.\textsuperscript{89} Thus, firms may have to overcompensate for managers using long-term incentives.

Even though some stock option-based compensation plans are well designed with option strike prices substantially higher than current stock prices, some have been developed for the primary purpose of giving executives more compensation. Research of stock option repricing where the strike price value of the option has been lowered from its original position suggests that action is taken more frequently in high-risk situations.\textsuperscript{90} However, repricing also happens when firm performance is poor, to restore the incentive effect for the option. Evidence also suggests that politics are often involved, which has resulted in “option backdating.”\textsuperscript{91} While this evidence shows that no internal governance mechanism is perfect, some compensation plans accomplish their purpose. For example, recent research suggests that long-term pay designed to encourage managers to be environmentally friendly has been linked to higher success in preventing pollution.\textsuperscript{92}

The Strategic Focus summarizes some issues regarding executive compensation. As the discussion suggests, this internal governance mechanism is likely to continue receiving a great deal of scrutiny in the years to come. One of these issues is the degree to which executive compensation practices promote a long-term versus a short-term focus on the part of CEOs.

When designed properly and used effectively, each of the three internal governance mechanisms can contribute positively to the firm operating in ways that best serve stakeholders and especially shareholders’ interests. By the same token, because none of the three mechanisms are perfect in design or execution, the market for corporate control, an external governance mechanism, is sometimes needed.
EXECUTIVE COMPENSATION: WHAT ARE SOME OF THE ISSUES AND WHAT MIGHT THE FUTURE HOLD?

CEO pay remains a topic of interest to multiple parties including shareholders, boards of directors, government regulators, and citizens of many countries. Increasingly, this intense interest is spreading to other members of top-management teams seeing increases in pay, such as chief financial officers (CFOs). In 2010 in the United States, CFO pay varied widely from $600,000 to more than $60 million, with five CFOs receiving over $20 million in compensation. Governance observers suggest that additional responsibilities mandated to CFOs by legislation such as Sarbanes-Oxley contribute to enhancements of compensation plans for these individuals.

Average compensation for the CEOs of large corporations in the United States was noticeably higher in 2010 compared to 2009: “The median value of salaries, bonuses and long-term incentive awards for CEOs of 350 major companies surged 10.7 percent to $9.27 million” in 2010. Simultaneously, the stock market’s performance improved during the same year, as shown by the 13 percent increase in the value of the S&P 500 index.

Many believe that CEO pay is too high. A recent survey of a broad range of people (teachers, laborers, students, doctors, community leaders, and others) revealed that 77 percent believe that CEOs are paid too much. However, this must be placed in the context of the CEO’s job-related expectations. In other words, are CEOs overpaid relative to what is expected of them?

As we know, as an agent for the firm’s shareholders (the principals), the CEO is to lead the firm by making decisions that are in the owners’ best interests. The consensus from a corporate governance perspective is that agents need to serve shareholders’ long-term interests more so than their short-term interests. This is a potential issue—are CEOs rewarded primarily for short-term performance rather than for the firm’s long-term performance? Walt Disney Company CEO Robert Iger believes that this is indeed the case in that “there is too much emphasis in his and other CEOs’ pay packages on short-term stock results, and he urges compensation committees to rethink their approach.” Thus a governance issue is that boards of directors need to verify that the CEO and other top-management team members are receiving compensation plans framed around the shareholders’ long-term, not short-term, interests.

A potentially more significant governance issue relative to executive compensation is the possibility that CEO pay is not tied to the firm’s short- or long-term performance. Following extensive analyses of significant amounts of data, well-known compensation consultant Graf Crystal recently reported that “no matter how (you) parse the numbers, (there is) no relationship between shareholder returns and CEO compensation.” These findings caused Crystal to conclude that companies simply are not paying CEOs for the performance the firm delivers under their direction. If Crystal’s conclusion is shown by additional research to be valid and reliable, boards of directors are challenged to develop and then use executive compensation plans with a higher probability of aligning agents and principals’ long-term interests.

Ideas about how executive compensation could be more effectively structured for the purpose of aligning agents, and principals’ interests are being offered. For example, “Crystal recommends awarding stock options with a strike price that’s the average of the last 90 days
and can’t be exercised for five years to avoid ‘opportunistic’ pricing. He also suggests reducing bonuses if incentive targets aren’t met.” From a regulatory perspective, one of the provisions of Dodd-Frank, called “say for pay,” allows shareholders to approve the compensation upper-level executives are to receive. Supporters believe that this provision can “empower shareholders and curb (executive) pay.” Additional recommendations include large-block shareholders accepting full responsibility for evaluating CEO and company performance instead of relying on third parties to complete those evaluations and increasing the transparency of boards of directors’ decisions and actions. Given the interest in executive compensation, there is little doubt that many additional recommendations regarding how to best use this governance mechanism will be offered in the years to come.


Read more about Viacom Inc.’s CEO compensation plans. www.cengagebrain.com

### Market for Corporate Control

The **market for corporate control** is an external governance mechanism that is active when a firm’s internal governance mechanisms fail.\(^{93}\) The market for corporate control is composed of individuals and firms that buy ownership positions in or purchase all of potentially undervalued corporations typically for the purpose of forming new divisions in established companies or merging two previously separate firms. Because the top-level managers are assumed to be responsible for the undervalued firm’s poor performance, they are usually replaced. An effective market for corporate control ensures that ineffective and/or opportunistic top-level managers are disciplined.\(^ {94}\)

Commonly, target firm managers and board members are sensitive about takeover bids emanating from the market for corporate control in that being a target suggests that they have been ineffective with efforts to fulfill their responsibilities. For top-level managers, a board’s decision to accept an acquiring firm’s offer typically finds them losing their jobs in that the acquirer usually wants different people to lead the firm. At the same time, rejection of an offer also increases the risk of job loss for top-level managers because the pressure from the board and shareholders for them to improve the firm’s performance becomes substantial.\(^ {95}\)

A hedge fund is a fund that can pursue many different investment strategies such as taking long and short positions, using arbitrage, and buying and selling undervalued securities for the purpose of maximizing investors’ returns. Growing at roughly 20 percent annually, hedge funds are estimated to be a $1 trillion industry in the United States alone.\(^ {96}\) Given investors’ increasing desire to hold underperforming funds and their managers accountable, hedge funds are becoming increasingly active in the market for corporate control.\(^ {97}\)

In general, activist pension funds (as institutional investors and as an internal governance mechanism) are reactive in nature, taking actions when they conclude that a firm is underperforming. In contrast, activist hedge funds (as part of the market for corporate control) are proactive, “identifying a firm whose performance could be improved and then investing in it.” \(^{98}\) This means that “hedge funds are better at identifying under-valued companies, locating potential acquirers for them, and removing opposition to a takeover.”\(^ {99}\)

In mid-2011, investor Carl Icahn made a bid to purchase Clorox Co. In announcing his bid, Icahn criticized Clorox’s top-level managers for what he believed was the firm’s underperformance relative to its potential. In leveling this criticism he was essentially saying that the firm’s internal governance mechanisms had failed. Clorox’s board
rejected the initial bid of $76.50 per share as well as Icahn’s subsequent bid of $80 per share, indicating that both bids undervalued the firm’s true worth.\(^\text{100}\)

The situation between Icahn and Clorox demonstrates the possibility that the firm may have been underperforming and, as such, that the market for corporate control should be active to discipline managers and to represent shareholders’ best interests. The situation also demonstrates another possibility: that research results indicate can happen—namely, that as a governance mechanism, investors sometimes use the market for corporate control to take an ownership position in firms that are performing well.\(^\text{101}\) A study of active corporate raiders in the 1980s showed that takeover attempts often were focused on above-average performance firms in an industry,\(^\text{102}\) suggesting that the market for corporate control too is an imperfect governance mechanism.\(^\text{103}\)

In summary, the market for corporate control may appear to be a blunt instrument for corporate governance; nonetheless, this governance mechanism does have the potential to represent shareholders’ best interests. Accordingly, top-level managers want to lead their firms in ways that make disciplining by activists outside the company unnecessary and/or inappropriate.

There are a number of defense tactics top-level managers can choose to use to fend off a takeover attempt. Managers leading a target firm that is performing well are almost certain to use tactics to thwart the takeover attempt. Even in instances when the target firm is underperforming its peers, managers might use defense tactics to protect their own interests. In general, managers’ use of defense tactics is thought to be self-serving in nature.

**Managerial Defense Tactics**

In the majority of cases, hostile takeovers are the principal means by which the market for corporate control is activated. A **hostile takeover** is an acquisition of a target company by an acquiring firm that is accomplished “not by coming to an agreement with the target company’s management but by going directly to the company’s shareholders or fighting to replace management in order to get the acquisition approved.”\(^\text{104}\) Firms targeted for a hostile takeover may use multiple defense tactics to fend off the takeover attempt. The increased use of the market for corporate control has enhanced the sophistication and variety of managerial defense tactics that are used in takeovers.

Because the market for corporate control tends to increase risk for managers, managerial pay may be augmented indirectly through golden parachutes (wherein a CEO can receive up to three years’ salary if his or her firm is taken over). Golden parachutes, similar to most other defense tactics, are controversial. Another takeover defense strategy is traditionally known as a “poison pill.” This strategy usually allows shareholders (other than the acquirer) to convert “shareholders’ rights” into a large number of common shares if an individual or company acquires more than a set amount of the target firm’s stock (typically 10 to 20 percent). Increasing the total number of outstanding shares dilutes the potential acquirer’s existing stake, meaning that to maintain or expand its ownership position the potential acquirer must buy additional shares at premium prices. The additional purchases increase the potential acquirer’s costs. Some firms amend the corporate charter so board member elections are staggered, resulting in only one third of members being up for reelection each year. Research shows that this results in managerial entrenchment and reduced vulnerability to hostile takeovers.\(^\text{105}\) Additional takeover defense strategies beyond those discussed here are presented in Table 10.2.

Most institutional investors oppose the use of defense tactics. TIAA-CREF and CalPERS have taken actions to have several firms’ poison pills eliminated. Many institutional investors also oppose severance packages (golden parachutes), and the opposition is increasing significantly in Europe as well.\(^\text{106}\) However, an advantage to severance packages is that they may encourage top-level managers to accept takeover bids with the potential to best serve shareholders’ interest.\(^\text{107}\) Alternatively, research results show that using takeover defenses reduces the amount of pressure managers feel to seek short-term
**Table 10.2 Hostile Takeover Defense Strategies**

<table>
<thead>
<tr>
<th>Defense strategy</th>
<th>Success as a strategy</th>
<th>Effects on shareholder wealth</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Capital structure change</strong></td>
<td>Medium</td>
<td>Inconclusive</td>
</tr>
<tr>
<td>Dilution of the target firm’s stock, making it more costly for an acquiring firm to continue purchasing the target’s shares. Employee stock option plans (ESOPs), recapitalization, issuance of additional debt, and share buybacks are actions associated with this strategy.</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Corporate charter amendment</strong></td>
<td>Very low</td>
<td>Negative</td>
</tr>
<tr>
<td>An amendment to the target firm’s charter for the purpose of staggering the elections of members to its board of directors so that all are not elected during the same year. This change to the firm’s charter prevents a potential acquirer from installing a completely new board in a single year.</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Golden parachute</strong></td>
<td>Low</td>
<td>Negligible</td>
</tr>
<tr>
<td>A lump-sum payment of cash that is given to one or more top-level managers when the firm is acquired in a takeover bid.</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Greenmail</strong></td>
<td>Medium</td>
<td>Negative</td>
</tr>
<tr>
<td>The repurchase of the target firm’s shares of stock that were obtained by the acquiring firm at a premium in exchange for an agreement that the acquirer will no longer target the company for takeover.</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Litigation</strong></td>
<td>Low</td>
<td>Positive</td>
</tr>
<tr>
<td>Lawsuits that help the target firm stall hostile takeover attempts. Antitrust charges and inadequate disclosure are examples of the grounds on which the target firm could file.</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Poison pill</strong></td>
<td>High</td>
<td>Positive</td>
</tr>
<tr>
<td>An action the target firm takes to make its stock less attractive to a potential acquirer.</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Standstill agreement</strong></td>
<td>Low</td>
<td>Negative</td>
</tr>
<tr>
<td>A contract between the target firm and the potential acquirer specifying that the acquirer will not purchase additional shares of the target firm for a specified period of time in exchange for a fee paid by the target firm.</td>
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</tr>
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performance gains, resulting in them concentrating on developing strategies with a longer time horizon and a high probability of serving stakeholders’ interests. When they do this, the firm’s market value increases, rewarding shareholders as a result of doing so. 108

An awareness on the parts of top-level managers about the existence of external investors in the form of individuals (e.g., Carl Icahn) and groups (e.g., hedge funds) often positively influences them to align their interests with those of the firm’s stakeholders, especially the shareholders. Moreover, when active as an external governance mechanism, the market for corporate control has brought about significant changes in many firms’ strategies and, when used appropriately, has served shareholders’ interests. Next, we describe international governance practices to explain how they differ across regions and countries.

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**International Corporate Governance**

Corporate governance is an increasingly important issue in economies around the world, including emerging economies. Globalization in trade, investments, and equity markets increases the potential value of firms throughout the world using similar mechanisms to govern corporate activities. Moreover, because of globalization, major companies want to attract foreign investment. For this to happen, foreign investors must be confident that adequate corporate governance mechanisms are in place to protect their investments.
Although globalization is stimulating an increase in the intensity of efforts to improve corporate governance and potentially to reduce the variation in regions and nations’ governance systems, the reality remains that different nations do have different governance systems in place. Recognizing and understanding differences in various countries’ governance systems as well as changes taking place within those systems improves the likelihood a firm will be able to compete successfully in the international markets it chooses to enter. Next, to highlight the general issues of differences and changes taking place in governance systems, we discuss corporate governance practices in two developed economies—Germany and Japan—and in China, a developing economy.

**Corporate Governance in Germany and Japan**

In many private German firms, the owner and manager may be the same individual. In these instances, agency problems are not present. Even in publicly traded German corporations, a single shareholder is often dominant. Thus, the concentration of ownership is an important means of corporate governance in Germany, as it is in the United States.

Historically, banks occupied the center of the German corporate governance system. This is the case in other European countries as well, such as Italy and France. As lenders, banks become major shareholders when companies they financed seek funding on the stock market or default on loans. Although the stakes are usually less than 10 percent, banks can hold a single ownership position up to but not exceeding 15 percent of the bank’s capital. Although shareholders can tell banks how to vote their ownership position, they generally do not do so. The banks monitor and control managers, both as lenders and as shareholders, by electing representatives to supervisory boards.

German firms with more than 2,000 employees are required to have a two-tiered board structure that places the responsibility for monitoring and controlling managerial (or supervisory) decisions and actions in the hands of a separate group. All the functions of strategy and management are the responsibility of the management board (the Vorstand); however, appointment to the Vorstand is the responsibility of the supervisory tier (the Aufsichtsrat). Employees, union members, and shareholders appoint members to the Aufsichtsrat. Proponents of the German structure suggest that it helps prevent corporate wrongdoing and rash decisions by “dictatorial CEOs.” However, critics maintain that it slows decision making and often ties a CEO’s hands. The corporate governance practices in Germany make it difficult to restructure companies as quickly as can be done in the United States. Because of the role of local government (through the board structure) and the power of banks in Germany’s corporate governance structure, private shareholders rarely have major ownership positions in German firms. Large institutional investors, such as pension funds and insurance companies, are also relatively insignificant owners of corporate stock. Thus, at least historically, German executives generally have not been dedicated to maximizing shareholder wealth to the degree that is the case for top-level managers in the United Kingdom and the United States.

However, corporate governance practices used in Germany are changing. A manifestation of these changes is that a number of German firms are beginning to gravitate toward U.S. governance mechanisms. Recent research suggests that the traditional system in Germany produced some agency costs because of a lack of external ownership power. Interestingly, German firms with listings on U.S. stock exchanges have increasingly adopted executive stock option compensation as a long-term incentive pay policy.

The concepts of obligation, family, and consensus affect attitudes toward corporate governance in Japan. In Japan, an obligation “may be to return a service for one rendered or it may derive from a more general relationship, for example, to one’s family or old alumni, or one’s company (or Ministry), or the country. This sense of particular obligation is common elsewhere but it feels stronger in Japan.” As part of a company family, individuals are members of a unit that envelops their lives; families command
PART 3: Strategic Actions: Strategy Implementation

the attention and allegiance of parties through - out corporations. Moreover, a keiretsu (a group of firms tied together by cross-shareholdings) is more than an economic concept; it, too, is a family. Some believe, though, that extensive cross-shareholdings impede the type of structural change that is needed to improve the nation’s corporate governance practices.116 Consensus, another important influence in Japanese corporate governance, calls for the expenditure of significant amounts of energy to win the hearts and minds of people whenever possible, as opposed to top-level managers issuing edicts.117 Consensus is highly valued, even when it results in a slow and cumbersome decision-making process.

As in Germany, banks in Japan have an important role in financing and monitoring large public firms.118 Because it owns the largest share of stocks and holds the largest amount of debt, the main bank has the closest relationship with a firm’s top-level managers. The main bank provides financial advice to the firm and also closely monitors managers. Thus, Japan has a bank-based financial and corporate governance structure whereas the United States has a market-based financial and governance structure.119

Aside from lending money, a Japanese bank can hold up to 5 percent of a firm’s total stock; a group of related financial institutions can hold up to 40 percent. In many cases, main-bank relationships are part of a horizontal keiretsu. A keiretsu firm usually owns less than 2 percent of any other member firm; however, each company typically has a stake of that size in every firm in the keiretsu. As a result, somewhere between 30 and 90 percent of a firm is owned by other members of the keiretsu. Thus, a keiretsu is a system of relationship investments.

Japan’s corporate governance practices are changing. For example, because of Japanese banks’ continuing development as economic organizations, their role in the monitoring and control of managerial behavior and firm outcomes is less significant than in the past.120 Also, deregulation in the financial sector has reduced the cost of mounting hostile takeovers.121 As such, deregulation facilitated additional activity in Japan’s market for corporate control, which was nonexistent in past years. Interestingly, however, recent research shows that CEOs of both public and private companies in Japan receive similar levels of compensation and their compensation is tied closely to observable performance goals.122

Corporate Governance in China

“China has a unique and large, socialist, market-oriented economy. The government has done much to improve the corporate governance of listed companies.”123 These comments denote the fact that corporate governance practices in China are changing and that the country is experiencing increasing privatization of businesses and the development of equity markets. However, the stock markets in China remain young and underdeveloped. In their early years, these markets were weak because of significant insider trading, but with stronger governance these markets have improved.124

There has been a gradual decline in China in the equity held in state-owned enterprises and the number and percentage of private firms have grown, but the state still relies on direct and/or indirect controls to influence the strategies firms use. In terms of long-term success, these conditions may affect firms’ performances in that research shows that firms with higher state ownership tend to have lower market value and more volatility in that value across time. This is because of agency conflicts in the firms and because the executives do not seek to maximize shareholder returns given that they must...
Chapter 10: Corporate Governance

also seek to satisfy social goals placed on them by the government. This suggests a potential conflict between the principals, particularly the state owner and the private equity owners of the state-owned enterprises.

Some evidence suggests that corporate governance in China may be tilting toward the Western model. For example, China YCT International (a firm specializing in producing and selling Gingko nutraceutical health products) is strengthening its corporate governance. To this end, the firm has established an audit committee within its board of directors, appointed three new independent directors, and more openly speaks about serving investors’ needs. In addition, recent research shows that with increasing frequency, the compensation of top-level executives in Chinese companies is closely related to prior and current financial performance of their firm.

In spite of these changes and as suggested in the Opening Case, much work remains if the governance of Chinese companies is to meet international and Western standards. For example, after analyzing governance practices in multiple Chinese companies in mid-2011, Fitch Ratings concluded that, “Allegations of fraud and accounting irregularities at Chinese companies are likely to continue for at least the near term and the accusations may hamper the firms’ access to funds regardless of the claims’ merit.” This warning from Fitch highlights the fact that changing a nation’s governance systems is a complicated task that will encounter problems as well as successes while seeking progress. Thus, corporate governance in Chinese companies continues evolving and likely will for some time to come as parties (e.g., the Chinese government and those seeking further movement toward free-market economies) interact to form governance mechanisms that are best for their nation, business firms, and citizens.

Governance Mechanisms and Ethical Behavior

The three internal and one external governance mechanisms are designed to ensure that the agents of the firm’s owners—the corporation’s top-level managers—make strategic decisions that best serve the interests of all stakeholders. In the United States, shareholders are commonly recognized as the company’s most significant stakeholders. Increasingly though, top-level managers are expected to lead their firms in ways that will also serve the needs of product market stakeholders (e.g., customers, suppliers, and host communities) and organizational stakeholders (e.g., managerial and nonmanagerial employees). Therefore, the firm’s actions and the outcomes flowing from them should result in at least minimal satisfaction of the interests of all stakeholders. Without at least minimal satisfaction of its interests, a dissatisfied stakeholder will withdraw its support from the firm and provide it to another (e.g., customers will purchase products from a supplier offering an acceptable substitute).

Some believe that the internal corporate governance mechanisms designed and used by ethically responsible companies increase the likelihood the firm will be able to at least minimally satisfy all stakeholders’ interests. Scandals at companies such as Enron, WorldCom, HealthSouth, and Satyam (a large information technology company based in India), among others, illustrate the negative effects of poor ethical behavior on a firm’s efforts to satisfy stakeholders. The issue of ethical behavior by top-level managers as a foundation for best serving stakeholders’ interests is being taken seriously in countries throughout the world. In India, the former managing director of Mumbai-based DB Realty and officials from mobile-phone operators Unitech and Reliance ADA Group all face charges of unethical behavior while leading their companies.

The decisions and actions of the board of directors can be an effective deterrent to unethical behaviors by top-level managers. Indeed, evidence suggests that the most effective boards set boundaries for their firms’ business ethics and values.
THE MANY FACETS OF CORPORATE GOVERNANCE: RIO TINTO’S EXPERIENCES

“Integrity delivered through good governance. Successful operation of our business requires good governance, whether it be complying with legal requirements or engaging with our stakeholders to understand their expectations in relation to our business.” These comments from Rio Tinto suggest that the company is fully committed to designing and using governance practices that, among other outcomes, will align agents and principals’ interests. The values of accountability, respect, teamwork, and integrity facilitate effective implementation of the firm’s governance practices.

Perhaps the firm’s size and complexity increase the difficulty associated with achieving effective corporate governance. Rio Tinto is a leading international mining group that is widely diversified in terms of products (focusing on copper, diamonds, gold, industrial materials, titanium dioxide, borates, talc, and salt and iron ore) and geography (operating in over 40 countries). Being a dual listed company is a strong indicator of the firm’s complexity. Formally, the firm is known as Rio Tinto Group, which is a combination of Rio Tinto plc, a London-listed public company headquartered in the United Kingdom, and Rio Tinto Limited, which is listed on the Australian Stock Exchange.

Regardless of the reasons, Rio Tinto’s governance has been challenged. In 2000, large-block pension funds supported union-backed resolutions requesting the appointment of a single independent non-executive deputy chairman and the adoption of the International Labour Organisation’s conventions concerning human rights conditions and practices at worksites. Responding to other pressures, Rio Tinto’s CEO indicated in 2002 that the firm would resume reviewing its business and governance practices following a five-year absence of formally doing so.

More recently, concerns have been expressed about executive compensation practices. A business writer expressed these concerns as follows: “Rio Tinto is facing a fresh row over pay after one of its largest investors criticized the mining giant for handing bosses generous reward for hitting ‘unchallenging’ targets.” The statement captures large-block institutional owner Standard Life Investments’ (the firm’s fifth largest shareholder) position in that this investor concluded that Rio Tinto’s top-level managers could receive significant rewards by achieving goals that were not challenging and in the shareholders’ best interests. The fact that a regulation was passed in Australia (and might pass in New Zealand as well) giving shareholders the power to force the “re-election of an entire board if they think executives are being paid too much” suggests that actions will be forthcoming from Rio Tinto’s board to develop compensation plans that challenge executives as a foundation for driving superior growth and profitability for the firm’s owners.

On the other hand, Rio Tinto is being acknowledged for strengthening its governance practices for the purpose of better supporting “whistleblowers.” One reason to strengthen such practices is the belief that “Australian whistleblower-protection laws are among the worst in the English-speaking world.” Another reason is that four of Rio’s Shanghai-based employees were recently found guilty of accepting bribes. “Speak-Out” is Rio Tinto’s governance program, which it has enlarged and strengthened to...
ensure compliance by all managers and employees with the firm’s expectations regarding ethical behavior.

As these examples demonstrate, effective corporate governance can be challenging for multinational companies with significant amounts of product and geographic diversification. Rio Tinto is aware of this reality and seeks to establish and use strong corporate governance practices. As part of its corporate governance standards manual, the firm notes that “Rio Tinto is committed to high standards of corporate governance for which the directors are accountable to shareholders.” The manual also stipulates that “The role of the board is to provide Rio Tinto with good governance and strategic direction.” Thus, Rio Tinto formally supports and seeks governance practices that are consistent with generally accepted expectations regarding effective corporate governance mechanisms.


boundaries for ethical behavior are determined and likely formalized in a code of ethics, the board’s ethics-based expectations must be clearly communicated to the firm’s top-level managers and to other stakeholders (e.g., customers and suppliers) with whom interactions are necessary for the firm to produce and sell its products. Moreover, as agents of the firm’s owners, top-level managers must understand that the board, acting as an internal governance mechanism, will hold them fully accountable for developing and supporting an organizational culture in which only ethical behaviors are permitted. As explained in Chapter 12, CEOs can be positive role models for improved ethical behavior.

Through effective governance that results from well-designed internal mechanisms and the appropriate use of the market for corporate control as an external mechanism, top-level managers, working with others, are able to help their firm select and use strategies with a high probability of resulting in strategic competitiveness and earning above-average returns. While some firms’ governance mechanisms are ineffective, other companies are recognized for the quality of their governance activities.

World Finance evaluates the corporate governance practices of companies throughout the world. For 2011, some of this group’s “Best Corporate Governance Awards” by country were given to Royal Bank of Canada (Canada), Vestas Wind Systems A/S (Denmark), BSF AG (Germany), Empresas ICA (Mexico), and Cisco Systems (United States). These awards are determined by analyzing a number of issues concerned with corporate governance, such as board accountability and financial disclosure, executive compensation, shareholder rights, ownership base, takeover provisions, corporate behavior, and overall responsibility exhibited by the company.

As the discussion in this chapter suggests, corporate governance mechanisms are a vital, yet imperfect, part of firms’ efforts to select and successfully use strategies. And as we discuss in the Strategic Focus about Rio Tinto, firms are involved with a wide range of different kinds of issues when dealing with corporate governance. The effectiveness of this firm’s governance has been challenged from time to time, even though Rio Tinto seeks to establish and use effective governance mechanisms.
Corporate governance is a relationship among stakeholders that is used to determine a firm’s direction and control its performance. How firms monitor and control top-level managers’ decisions and actions affects the implementation of strategies. Effective governance that aligns managers’ decisions with shareholders’ interests can help produce a competitive advantage for the firm.

Three internal governance mechanisms are used in the modern corporation: (1) ownership concentration, (2) the board of directors, and (3) executive compensation. The market for corporate control is an external governance mechanism influencing managers’ decisions and the outcomes resulting from them.

Ownership is separated from control in the modern corporation. Owners (principals) hire managers (agents) to make decisions that maximize the firm’s value. As risk-bearing specialists, owners diversify their risk by investing in multiple corporations with different risk profiles. Owners expect their agents (the firm’s top-level managers, who are decision-making specialists) to make decisions that will help to maximize the value of their firm. Thus, modern corporations are characterized by an agency relationship that is created when one party (the firm’s owners) hires and pays another party (top-level managers) to use its decision-making skills.

Separation of ownership and control creates an agency problem when an agent pursues goals that conflict with the principals’ goals. Principals establish and use governance mechanisms to control this problem.

Ownership concentration is based on the number of large-block shareholders and the percentage of shares they own. With significant ownership percentages, such as those held by large mutual funds and pension funds, institutional investors often are able to influence top-level managers’ strategic decisions and actions. Thus, unlike diffuse ownership, which tends to result in relatively weak monitoring and control of managerial decisions, concentrated ownership produces more active and effective monitoring. Institutional investors are a powerful force in corporate America and actively use their positions of concentrated ownership to force managers and boards of directors to make decisions that best serve shareholders’ interests.

In the United States and the United Kingdom, a firm’s board of directors, composed of insiders, related outsiders, and outsiders, is a governance mechanism expected to represent shareholders’ interests. The percentage of outside directors on many boards now exceeds the percentage of inside directors. Through implementation of the SOX Act, outsiders are expected to be more independent of a firm’s top-level managers compared with directors selected from inside the firm. New rules imposed by the U.S. Securities and Exchange Commission to allow owners with large stakes to propose new directors are likely to change the balance even more in favor of outside and independent directors. Although their precise nature is unknown, additional governance-related regulations will flow from Dodd-Frank as well.

Executive compensation is a highly visible and often criticized governance mechanism. Salary, bonuses, and long-term incentives are used for the purpose of aligning managers’ and shareholders’ interests. A firm’s board of directors is responsible for determining the effectiveness of the firm’s executive compensation system. An effective system elicits managerial decisions that are in shareholders’ best interests.

In general, evidence suggests that shareholders and boards of directors have become more vigilant in controlling managerial decisions. Nonetheless, these mechanisms are imperfect and sometimes insufficient. When the internal mechanisms fail, the market for corporate control—as an external governance mechanism—becomes important. Although it too is imperfect, the market for corporate control has been effective in causing corporations to combat inefficient diversification and to implement more effective strategic decisions.

Corporate governance structures used in Germany, Japan, and China differ from each other and from the structure used in the United States. Historically, the U.S. governance structure focused on maximizing shareholder value. In Germany, employees, as a stakeholder group, take a more prominent role in governance. By contrast, until recently, Japanese shareholders played virtually no role in monitoring and controlling top-level managers. However, Japanese firms are now being challenged by “activist” shareholders. In China, the central government still plays a major role in corporate governance practices. Internationally, all these systems are becoming increasingly similar, as are many governance systems both in developed countries, such as France and Spain, and in transitional economies, such as Russia and India.

Effective governance mechanisms ensure that the interests of all stakeholders are served. Thus, strategic competitiveness results when firms are governed in ways that permit at least minimal satisfaction of capital market stakeholders (e.g., shareholders), product market stakeholders (e.g., customers and suppliers), and organizational stakeholders (managerial and nonmanagerial employees; see Chapter 2). Moreover, effective governance produces ethical behavior in the formulation and implementation of strategies.
REVIEW QUESTIONS

1. What is corporate governance? What factors account for the considerable amount of attention corporate governance receives from several parties, including shareholder activists, business press writers, and academic scholars? Why is governance necessary to control managers’ decisions?

2. What is meant by the statement that ownership is separated from managerial control in the corporation? Why does this separation exist?

3. What is an agency relationship? What is managerial opportunism? What assumptions do owners of corporations make about managers as agents?

4. How is each of the three internal governance mechanisms—ownership concentration, boards of directors, and executive compensation—used to align the interests of managerial agents with those of the firm’s owners?

5. What trends exist regarding executive compensation? What is the effect of the increased use of long-term incentives on top-level managers’ strategic decisions?

6. What is the market for corporate control? What conditions generally cause this external governance mechanism to become active? How does this mechanism constrain top-level managers’ decisions and actions?

7. What is the nature of corporate governance in Germany, Japan, and China?

8. How can corporate governance foster ethical decisions and behaviors on the part of managers as agents?

EXPERIENTIAL EXERCISES

EXERCISE 1: WHO PAYS BETTER AT THE TOP: THE MOST- OR LEAST-ADMIREDF COMPANY?

According to your text, “executive compensation is a governance mechanism that seeks to align the interests of managers and owners through salaries, bonuses, and long-term incentives such as stock awards and options.” The key to the compensation structure for a firm is to achieve a balance that both enhances short-term financial performance and also preserves the firm’s competitive advantage to allow it to achieve long-term competitive success.

Fortune magazine annually publishes its list of most admired companies in the United States. The magazine also publishes its least-admired list of companies. They are ranked in nine different categories, including social responsibility, financial soundness, and innovation.

So who pays better; most admired or least admired?

Part One

Each team should pick a pair of companies—one from Fortune’s most admired list and one from Fortune’s least admired. The teams should pick two companies that come from the same comparison list, such as one of the most admired and one of the least admired in innovation. There are nine comparison categories so choose the category your team finds most interesting (your instructor may pick these for you). You will note that some of the firms on the Fortune list are foreign-owned entities. While a foreign-owned firm will make for interesting comparison, make sure you are able to gather appropriate data for that firm.

Part Two

Present to the class a description of what you find. In particular, be able to discuss the following topics for each firm:

1. CEO compensation and that of the top 5 executives.
2. The governance structure and any relationships between directors that might hinder objectivity.
3. CEO tenure and that of the members of the firm’s top-management team.
4. Compensation plan structure—stock, fixed pay, other perks.
5. Conclusions you might draw from looking at the two firms side by side.
6. Each firm’s performance versus the general market it is in, such as the S&P 500. Look short term and long term.
7. The way in which Fortune creates its lists. What are the rules?

EXERCISE 2: GOVERNANCE: DOES IT MATTER COMPETITIVELY?

Governance mechanisms are effective when they meet the needs of all stakeholders. Governance mechanisms are also a key way in which to ensure that strategic decisions are made effectively. As a potential employee, how would you go about investigating a firm’s governance structure, and would that investigation weigh in your decision to become an employee? Identify a firm that you currently would like to join or one that you just find interesting. Working individually, research the following aspects of your target firm:

Find a copy of the firm’s most recent proxy statement and 10-K. Proxy statements are sent to shareholders prior to each year’s annual meeting and contain detailed information about the company’s governance and issues on which a shareholder vote might be held. Proxy statements are typically available.
from a firm’s Web site (look for an “Investors” submenu). You can also access proxy statements and other government filings such as the 10-K from the SEC’s EDGAR database (http://www.sec.gov/edgar.shtml). Alongside the proxy you should also be able to access the firm’s annual report. Here you will find information concerning performance, governance, and the firm’s outlook, among other matters.

Identify one of the firm’s main competitors for comparison. You can find one of the firm’s main competitors by using company analysis tools such as Datamonitor.

Some of the topics that you should examine include:

- Compensation plans (for both the CEO and board members; be sure to look for difference between fixed and incentive compensation)
- Board composition (e.g., board size, insiders and outsiders, interlocking directorates, functional experience, how many active CEOs, how many retired CEOs, what is the demographic makeup, and age diversity)
- Committees (e.g., how many, composition, compensation)
- Stock ownership by officers and directors—identify beneficial ownership from stock owned (you will need to look through the notes of the ownership tables to comprehend this)
- Ownership concentration—how much of the firm’s outstanding stock is owned by institutions, individuals, insiders? How many large-block shareholders are there (5 percent or more owners)?
- Does the firm utilize a duality structure for the CEO and chair of the board?
- Is there a lead director who is not an officer of the company?
- Activities by activist shareholders regarding corporate governance issues of concern
- Are there any managerial defense tactics employed by the firm? For example, what does it take for a shareholder proposal to come to a vote and be adopted?
- What is the firm’s code of conduct?

Prepare a report summarizing the results of your findings that compares your target firm and its competitor side by side. Your memo should include the following topics:

- Summarize the key aspects of the firm’s governance mechanisms.
- Create a single graph covering the last 10-year historical stock performance for both companies. If applicable, find a representative index to compare both with, such as S&P or NASDAQ.
- Highlight key differences between your target firm and its competitor.
- Based on your review of the firm’s governance, did you change your opinion of the firm’s desirability as an employer? Why or why not? How does the target firm compare to the main competitor you identified?

**VIDEO CASE**

**KNOWLEDGE BRINGS CORPORATE GOVERNANCE: WHISTLEBLOWING/STAFFORD GENERAL HOSPITAL**

Emphasizing targets rather than proper care, Stafford General Hospital created a culture that discouraged complaints and resulted in high mortality rates. The public campaigns of family members and relatives to vocalize their knowledge of Stafford’s failures in basic nursing care stimulated government investigations, which revealed doctor and nurse knowledge of the hospital’s poor care and how their concerns were ignored. While whistleblower provisions were already in place, this investigation and new leadership has made quality of care a primary concern along with monetary commitments to staff, facilities, and training, and a “no blame whistleblowing policy” to bring poor practices out in the open.

Be prepared to discuss the following concepts and questions in class:

**Concepts**
- Corporate governance
- Agency relationship

**Questions**
1. What corporate governance mechanisms failed at Stafford General Hospital?
2. Were there possibilities of agency problems within Stafford? Why or why not? Could managerial opportunism be an issue?
3. Can the Trust Foundation for Stafford be effective as a market for corporate control?
4. What role do you think the corporate governance structure of the United Kingdom played in the problems at Stafford?
5. How do you think the situation at Stafford will impact international corporate governance?
NOTES


58. www.ca.gov.


Studying this chapter should provide you with the strategic management knowledge needed to:

1. Define organizational structure and controls and discuss the difference between strategic and financial controls.
2. Describe the relationship between strategy and structure.
3. Discuss the functional structures used to implement business-level strategies.
4. Explain the use of three versions of the multidivisional (M-form) structure to implement different diversification strategies.
5. Discuss the organizational structures used to implement three international strategies.
6. Define strategic networks and discuss how strategic center firms implement such networks at the business, corporate, and international levels.
Continuing the saga from Chapter 1, Borders, one of the original superstore chains, declared bankruptcy in 2011 with debts of $1.293 billion and assets of $1.275 billion. Borders was founded in 1971 in Ann Arbor, Michigan.

It had an innovative inventory system, made certain that employees were knowledgeable about books, and offered espresso (before Starbucks became popular). Its inventory system was popular and the Borders brothers licensed it and simultaneously began to expand the Borders’ store locations. In 1991 they sold the relatively small bookstore chain and inventory system to Kmart. At the time, Borders was performing well but Kmart was just beginning its decline. This led to Borders being spun off with an initial public offering (IPO) in 1995. This change worked for a while as Borders started to expand and take market share from independent book retailers.

However, Borders began making mistakes. Partly in reaction to Amazon.com’s success in selling books in the Internet, Borders launched a major growth initiative into international markets. This diversification reduced Borders’ focus on the largest and most lucrative book retailing market in the United States. It seemed unable to structure its operations in ways that allowed it to manage the different businesses in each country and market effectively.

Eventually, the international strategy failed and its stores in the United States became vulnerable to competition because they no longer were operated as they were at one time. In fact, one analyst described Borders as changing “from a place that celebrated books to a place that warehoused them.”

It also seemed that Borders developed an insular management structure that was impervious to the changes in the market. For example, when competitors such as Barnes & Noble developed the capability to sell online, Borders signed an agreement with Amazon to handle its Internet sales. This was a boon to Amazon but a disaster for Borders because it sent customers and business to a major competitor. It was obviously a way to save money because of the required investment in technology and human capital with that specialized knowledge, but it was a very poor decision. The lack of technological expertise in Borders was astounding. Upon a visit to a Borders store in Madison, Wisconsin, one writer was surprised to learn that it had no Internet connection (and this was in 2007). All external communications had to be channeled through the company headquarters in Ann Arbor. This suggests that the firm was highly centralized, which largely disallows flexibility at the local level to respond to unique needs in the community. The lack of technology expertise was evident in Borders’ lack of adaptation to the market’s demand for e-books. It was the last major book retailer to enter this market segment and then sold e-book readers developed by others (e.g., Sony’s e-book reader).

Because of the centralized and insular structure leading to further poor strategic decisions, Borders ended up with a large number of unprofitable stores, perhaps as many as 275 out of a little more than 600 stores. It had already closed 264 stores in 2008–2010. It had significant debt still on the books from its failed foray into international markets. In an attempt to increase its stock price to help shareholders and encourage investors, top executives decided to borrow money and use it to buy back stock. However, this increased debt to exceptionally high levels. In 1998, Borders stock price reached its highest level at $41.75. In March 2011 after declaring bankruptcy, its stock price was 23 cents per share.
Borders had incredibly bad management, especially at the higher levels of the firm. In addition, it was unable to correct these problems because of an inadequate structure and a focus on financial engineering (financial controls), both of which crippled its ability to respond effectively to changes in the marketplace and to implement its strategies (e.g., international strategy) effectively.


As we explained in Chapter 4, all firms use one or more business-level strategies. In Chapters 6–9, we discuss other strategies firms may choose to use (corporate-level, international, and cooperative). After they are selected, strategies must be implemented effectively to make them work. Organizational structure and controls, this chapter’s topic, provide the framework within which strategies are implemented and used in both for-profit organizations and not-for-profit agencies. However, as we explain, separate structures and controls are required to successfully implement different strategies. In all organizations, top-level managers have the final responsibility for ensuring that the firm has matched each of its strategies with the appropriate organizational structure and that both change when necessary. Thus, the CEO of Borders (actually there were several during the years of its decline) is responsible for changing its organizational structure to effectively implement its business- or corporate-level strategy. The match or degree of fit between strategy and structure influences the firm’s attempts to earn above-average returns. Thus, the ability to select an appropriate strategy and match it with the appropriate structure is an important characteristic of effective strategic leadership. Borders employed some ineffective (i.e., wrong) strategies and also did a very poor job of implementing the strategies chosen. First, its decision to enter international markets likely failed because of poor implementation and management of the international operations. The wrong strategies were employed regarding the use of technologies in sales and type of material provided. Having a centralized structure in which Internet connections were disallowed for individual stores (as late as 2007), requiring instead that all communications flow through the central office, was an obvious manifestation of Borders’ problems. Strategic management scholar Richard Rumelt sums up the problems of Borders in his statement that “... weakly managed organizations tend to become less organized and focused.”

This chapter opens with an introduction to organizational structure and controls. We then provide more details about the need for the firm’s strategy and structure to be properly matched. Affecting firms’ efforts to match strategy and structure is their influence on each other. As we discuss, strategy has a more important influence on structure, although once in place, structure influences strategy. Next, we describe the relationship between growth and structural change successful firms experience. We then discuss the different organizational structures firms use to implement separate business-level, corporate-level, international, and cooperative strategies. A series of figures highlights the different structures firms match with strategies. Across time and based on their experiences, organizations, especially large and complex ones, customize these general structures to meet their unique needs. Typically, the firm tries to form a structure that is complex enough to facilitate use of its strategies but simple enough for all parties to understand and implement. When strategies become more diversified, a firm must adjust its structure to deal with the increased complexity.
Organizational Structure and Controls

Research shows that organizational structure and the controls that are a part of the structure affect firm performance. In particular, evidence suggests that performance declines when the firm’s strategy is not matched with the most appropriate structure and controls. Even though mismatches between strategy and structure do occur, research indicates that managers try to act rationally when forming or changing their firm’s structure. His record of success at General Electric (GE) suggests that CEO Jeffrey Immelt pays close attention to the need to make certain that strategy and structure remain matched, as evidenced by restructuring alignments in GE Capital, GE’s financial service group, during the economic downturn.

Organizational Structure

Organizational structure specifies the firm’s formal reporting relationships, procedures, controls, and authority and decision-making processes. Developing an organizational structure that effectively supports the firm’s strategy is difficult, especially because of the uncertainty (or unpredictable variation) about cause-effect relationships in the global economy’s rapidly changing and dynamic competitive environments. When a structure’s elements (e.g., reporting relationships, procedures, etc.) are properly aligned with one another, the structure facilitates effective use of the firm’s strategies. Thus, organizational structure is a critical component of effective strategy implementation processes.

A firm’s structure specifies the work to be done and how to do it, given the firm’s strategy or strategies. Thus, organizational structure influences how managers work and the decisions resulting from that work. Supporting the implementation of strategies, structure is concerned with processes used to complete organizational tasks. Having the right structure and process is important. For example, many product-oriented firms have been moving to develop service businesses associated with those products. As we learned in Chapter 6, this strategy has been used by GE. However, research suggests that developing a separate division for such services in product-oriented companies, rather than managing the service business within the product divisions, leads to additional growth and profitability in the service business. GE developed a separate division for its financial services businesses and this helped facilitate GE’s growth over the last two decades.

Effective structures provide the stability a firm needs to successfully implement its strategies and maintain its current competitive advantages while simultaneously providing the flexibility to develop advantages it will need in the future. Structural stability provides the capacity the firm requires to consistently and predictably manage its daily work routines while structural flexibility provides the opportunity to explore competitive possibilities and then allocate resources to activities that will shape the competitive advantages the firm will need to be successful in the future. An effectively flexible organizational structure allows the firm to exploit current competitive advantages while developing new ones that can potentially be used in the future. Alternatively, an ineffective structure that is inflexible may drive good employees away because of frustration and an inability to complete their work in the best way possible. As such it can lead to a loss of knowledge by the firm, sometimes referred to as a knowledge spillover, which benefits competitors.

Modifications to the firm’s current strategy or selection of a new strategy call for changes to its organizational structure. However, research shows that once in place, organizational inertia often inhibits efforts to change structure, even when the firm’s performance suggests that it is time to do so. In his pioneering work, Alfred Chandler found that organizations change their structures when inefficiencies force them to. Chandler’s contributions to our understanding of organizational structure and its
Part 3: Strategic Actions: Strategy Implementation

relationship to strategies and performance are quite significant. Indeed, some believe that Chandler’s emphasis on “organizational structure so transformed the field of business history that some call the period before Chandler’s work was published ‘B.C.,’ meaning ‘before Chandler.’”

Firms seem to prefer the structural status quo and its familiar working relationships until the firm’s performance declines to the point where change is absolutely necessary. For example, necessity is obviously the case for General Motors given that it went into bankruptcy to force the required restructuring. As noted in the Opening Case, after bankruptcy, Borders is now restructuring. However, there are concerns that it may not survive or perhaps another company will purchase the firm’s remaining assets and put them to more effective use.

Top-level managers often hesitate to conclude that the firm’s structure (or its strategy, for that matter) is the problem, because doing so suggests that their previous choices were not the best ones. Because of these inertial tendencies, structural change is often induced instead by actions from stakeholders (e.g., those from the capital market and customers—see Chapter 2) who are no longer willing to tolerate the firm’s performance. This happened at Borders, for example. Evidence shows that appropriate timing of structural change happens when top-level managers recognize that a current organizational structure no longer provides the coordination and direction needed for the firm to successfully implement its strategies. Interestingly, many organizational changes take place in an economic downturn, as was the case with the recent one, apparently because poor performance reveals organizational weaknesses. As we discuss next, effective organizational controls help managers recognize when it is time to adjust the firm’s structure.

Organizational Controls

Organizational controls are an important aspect of structure. Organizational controls guide the use of strategy, indicate how to compare actual results with expected results, and suggest corrective actions to take when the difference is unacceptable. When fewer differences separate actual from expected outcomes, the organization’s controls are more effective. It is difficult for the company to successfully exploit its competitive advantages without effective organizational controls. Properly designed organizational controls provide clear insights regarding behaviors that enhance firm performance. Firms use both strategic controls and financial controls to support the implementation and use of their strategies.

Strategic controls are largely subjective criteria intended to verify that the firm is using appropriate strategies for the conditions in the external environment and the company’s competitive advantages. Thus, strategic controls are concerned with examining the fit between what the firm might do (as suggested by opportunities in its external environment) and what it can do (as indicated by its competitive advantages). Effective strategic controls help the firm understand what it takes to be successful. Strategic controls demand rich communications between managers responsible for using them to judge the firm’s performance and those with primary responsibility for implementing the firm’s strategies (such as middle and first-level managers). These frequent exchanges are both formal and informal in nature.

Strategic controls are also used to evaluate the degree to which the firm focuses on the requirements to implement its strategies. For a business-level strategy, for example, the strategic controls are used to study primary and support activities (see Tables 3.6 and 3.7, on page 000) to verify that the critical activities are being emphasized and properly executed. In fact, Nokia failed to employ effective strategic controls and is now fighting for survival as a result. With related corporate-level strategies, strategic controls are used by corporate strategic leaders to verify the sharing of appropriate strategic factors such as knowledge, markets, and technologies across businesses. To effectively use strategic controls when evaluating related diversification strategies, headquarter executives must
have a deep understanding of each unit’s business-level strategy. As we described in the Opening Case, Borders’ significant strategic problems likely stemmed at least partly from the ineffective use of strategic controls.

Financial controls are largely objective criteria used to measure the firm’s performance against previously established quantitative standards. Accounting-based measures such as return on investment (ROI) and return on assets (ROA) as well as market-based measures such as economic value added are examples of financial controls. Partly because strategic controls are difficult to use with extensive diversification, financial controls are emphasized to evaluate the performance of the firm using the unrelated diversification strategy. The unrelated diversification strategy’s focus on financial outcomes (see Chapter 6) requires using standardized financial controls to compare performances between business units and associated managers.

When using financial controls, firms evaluate their current performance against previous outcomes as well as against competitors’ performance and industry averages. In the global economy, technological advances are being used to develop highly sophisticated financial controls, making it possible for firms to more thoroughly analyze their performance results, and to assure compliance with regulations. Companies such as Oracle and SAP sell software tools that automate processes firms use to meet the financial reporting requirements specified by the Sarbanes-Oxley Act. As noted in Chapter 10, this act requires a firm’s principal executive and financial officers to certify corporate financial and related information in quarterly and annual reports submitted to the Securities and Exchange Commission. These companies will likely develop software to help the financial services industry deal with the newest federal regulations on banking.

Both strategic and financial controls are important aspects of each organizational structure, and as we noted previously, any structure’s effectiveness is determined by using a combination of strategic and financial controls. However, the relative use of controls varies by type of strategy. For example, companies and business units of large diversified firms using the cost leadership strategy emphasize financial controls (such as quantitative cost goals), while companies and business units using the differentiation strategy emphasize strategic controls (such as subjective measures of the effectiveness of product development teams). As previously explained, a corporation-wide emphasis on sharing among business units (as called for by related diversification strategies) results in an emphasis on strategic controls, while financial controls are emphasized for strategies in which activities or capabilities are not shared (e.g., in an unrelated diversification strategy).

As firms consider controls, the important point is to properly balance the use of strategic and financial controls. Indeed, over-emphasizing one at the expense of the other can lead to performance declines. According to Michael Dell, an overemphasis on financial controls to produce attractive short-term results contributed to performance difficulties at Dell Inc. In addressing this issue, Dell said the following: “The company was too focused on the short term, and the balance of priorities was way too leaning toward things that deliver short-term results.” Executives at Dell have now achieved a more appropriate emphasis on the long term as well as the short term due to a reemphasis on strategic controls, continuing its focus on recapturing market share and leadership in the PC market.
Relationships between Strategy and Structure

Strategy and structure have a reciprocal relationship. This relationship highlights the interconnectedness between strategy formulation (Chapters 4, 6–9) and strategy implementation (Chapters 10–13). In general, this reciprocal relationship finds structure flowing from or following selection of the firm’s strategy. Once in place though, structure can influence current strategic actions as well as choices about future strategies. Consider, for example, the possible influences of Borders’ structure and control system in influencing its strategy as illustrated in the Opening Case. The financial engineering in which it engaged by buying its own stock led to higher debt. This suggests that Borders’ managers likely used strong financial controls to try to pay the heavy debt costs. The centralized structure did not provide information from local stores that might have been useful in changing its technology strategy much sooner than it did. The general nature of the strategy/structure relationship means that changes to the firm’s strategy create the need to change how the organization completes its work.

Alternatively because structure likely influences strategy by constraining the potential alternatives considered, firms must be vigilant in their efforts to verify how their structure not only affects implementation of chosen strategies, but also the limits the structure places on future strategies to be considered. Research shows, however, that “strategy has a much more important influence on structure than the reverse.”

Regardless of the strength of the reciprocal relationships between strategy and structure, those choosing the firm’s strategy and structure should be committed to matching each strategy with a structure that provides the stability needed to use current competitive advantages as well as the flexibility required to develop future advantages. Therefore, when changing strategies, the firm should simultaneously consider the structure that will be needed to support use of the new strategy; properly matching strategy and structure can create a competitive advantage.

Evolutionary Patterns of Strategy and Organizational Structure

Research suggests that most firms experience a certain pattern of relationships between strategy and structure. Chandler found that firms tend to grow in somewhat predictable patterns: “first by volume, then by geography, then integration (vertical, horizontal), and finally through product/business diversification” (see Figure 11.1). Chandler interpreted his findings as an indication that firms’ growth patterns determine their structural form.

As shown in Figure 11.1, sales growth creates coordination and control problems the existing organizational structure cannot efficiently handle. Organizational growth creates the opportunity for the firm to change its strategy to try to become even more successful. However, the existing structure’s formal reporting relationships, procedures, controls, and authority and decision-making processes lack the sophistication required to support using the new strategy. A new structure is needed to help decision makers gain access to the knowledge and understanding required to effectively integrate and coordinate actions to implement the new strategy.

Firms choose from among three major types of organizational structures—simple, functional, and multidivisional—to implement strategies. Across time, successful firms
move from the simple to the functional to the multidivisional structure to support changes in their growth strategies.

**Simple Structure**

The *simple structure* is a structure in which the owner-manager makes all major decisions and monitors all activities while the staff serves as an extension of the manager’s supervisory authority. Typically, the owner-manager actively works in the business on a daily basis. Informal relationships, few rules, limited task specialization, and unsophisticated information systems characterize this structure. Frequent and informal communications between the owner-manager and employees make coordinating the work to be done relatively easy. The simple structure is matched with focus strategies and business-level strategies, as firms implementing these strategies commonly compete by offering a single product line in a single geographic market. Local restaurants, repair businesses, and other specialized enterprises are examples of firms using the simple structure.
As the small firm grows larger and becomes more complex, managerial and structural challenges emerge. For example, the amount of competitively relevant information requiring analysis substantially increases, placing significant pressure on the owner-manager. Additional growth and success may cause the firm to change its strategy. Even if the strategy remains the same, the firm’s larger size dictates the need for more sophisticated workflows and integrating mechanisms. At this evolutionary point, firms tend to move from the simple structure to a functional organizational structure.

### Functional Structure

The functional structure consists of a chief executive officer and a limited corporate staff, with functional line managers in dominant organizational areas such as production, accounting, marketing, R&D, engineering, and human resources. This structure allows for functional specialization, thereby facilitating active sharing of knowledge within each functional area. Knowledge sharing facilitates career paths as well as professional development of functional specialists. However, a functional orientation can negatively affect communication and coordination among those representing different organizational functions. For this reason, the CEO must verify that the decisions and actions of individual business functions promote the entire firm rather than a single function. The functional structure supports implementing business-level strategies and some corporate-level strategies (e.g., single or dominant business) with low levels of diversification. When changing from a simple to a functional structure, firms want to avoid introducing value-destroying bureaucratic procedures such as failing to promote innovation and creativity.

### Multidivisional Structure

With continuing growth and success, firms often consider greater levels of diversification. Successfully using a diversification strategy requires analyzing substantially greater amounts of data and information when the firm offers the same products in different markets (market or geographic diversification) or offers different products in several markets (product diversification). In addition, trying to manage high levels of diversification through functional structures creates serious coordination and control problems, a fact that commonly leads to a new structural form.

The multidivisional (M-form) structure consists of a corporate office and operating divisions, each representing a separate business or profit center in which the top corporate officer delegates responsibilities for day-to-day operations and business-unit strategy to division managers. Each division represents a distinct, self-contained business with its own functional hierarchy. As initially designed, the M-form was thought to have three major benefits: (1) it enabled corporate officers to more accurately monitor the performance of each business, which simplified the problem of control; (2) it facilitated comparisons between divisions, which improved the resource allocation process; and (3) it stimulated managers of poorly performing divisions to look for ways of improving performance. Active monitoring of performance through the M-form increases the likelihood that decisions made by managers heading individual units will be in stakeholders’ best interests. Because diversification is a dominant corporate-level strategy used in the global economy, the M-form is a widely adopted organizational structure.

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**The functional structure consists of a chief executive officer and a limited corporate staff, with functional line managers in dominant organizational areas such as production, accounting, marketing, R&D, engineering, and human resources.**

**The multidivisional (M-form) structure consists of a corporate office and operating divisions, each representing a separate business or profit center in which the top corporate officer delegates responsibilities for day-to-day operations and business-unit strategy to division managers.**

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**This executive heads up a productive brainstorming meeting with a team of functional line managers.**

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**Boris Arapovic/Shutterstock.com**

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**Cengage Learning**

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Chapter 11: Organizational Structure and Controls

Used to support implementation of related and unrelated diversification strategies, the M-form helps firms successfully manage diversification’s many demands. Chandler viewed the M-form as an innovative response to coordination and control problems that surfaced during the 1920s in the functional structures then used by large firms such as DuPont and General Motors. Research shows that the M-form is appropriate when the firm grows through diversification. Partly because of its value to diversified corporations, some consider the multidivisional structure to be one of the twentieth century’s most significant organizational innovations.

No one organizational structure (simple, functional, or multidivisional) is inherently superior to the others. Peter Drucker says the following about this matter: “There is no one right organization. . . . Rather the task . . . is to select the organization for the particular task and mission at hand.” This statement suggests that the firm must select a structure that is “right” for successfully using the chosen strategy. Because no single structure is optimal in all instances, managers concentrate on developing proper matches between strategies and organizational structures rather than searching for an “optimal” structure. We now describe the strategy/structure matches that evidence shows positively contribute to firm performance.

**Matches between Business-Level Strategies and the Functional Structure**

Firms use different forms of the functional organizational structure to support implementing the cost leadership, differentiation, and integrated cost leadership/differentiation strategies. The differences in these forms are accounted for primarily by different uses of three important structural characteristics: specialization (concerned with the type and number of jobs required to complete work), centralization (the degree to which decision-making authority is retained at higher managerial levels), and formalization (the degree to which formal rules and procedures govern work).

**Using the Functional Structure to Implement the Cost Leadership Strategy**

Firms using the cost leadership strategy sell large quantities of standardized products to an industry’s typical customer. Firms using this strategy need a structure and capabilities that allow them to achieve efficiencies and produce their goods at costs lower than those of competitors. Simple reporting relationships, few layers in the decision-making and authority structure, a centralized corporate staff, and a strong focus on process improvements through manufacturing function rather than development of new products by emphasizing product R&D help to achieve the efficiencies and thus characterize the cost leadership form of the functional structure (see Figure 11.2). This structure contributes to the emergence of a low-cost culture—a culture in which employees constantly try to find ways to reduce the costs incurred to complete their work. They can do this through the development of a product architecture that is simple and easy to manufacture, as well as through the development of efficient processes to produce the goods.

In terms of centralization, decision-making authority is centralized in a staff function to maintain a cost-reducing emphasis within each organizational function (engineering, marketing, etc.). While encouraging continuous cost reductions, the centralized staff also verifies that further cuts in costs in one function won’t adversely affect the productivity levels in other functions.

Jobs are highly specialized in the cost leadership functional structure; work is divided into homogeneous subgroups. Organizational functions are the most common subgroup, although work is sometimes batched on the basis of products produced or clients served. Specializing in their work allows employees to increase their efficiency, resulting in reduced costs. Guiding individuals’ work in this structure are highly formalized rules and procedures, which often emanate from the centralized staff.
Walmart Stores Inc. uses the functional structure to implement cost leadership strategies in each of its three segments (Walmart Stores, Sam’s Clubs, and International Division). In the Walmart Stores segment (which generates the largest share of the firm’s total sales), the cost leadership strategy is used in the firm’s Supercenter, Discount, and Neighborhood Market retailing formats. The stated purpose of Walmart from the beginning has been “saving people money to help them live better.” Although the slogan is new, Walmart continues using the functional organizational structure in its divisions to drive costs lower. As discussed in Chapter 4, competitors’ efforts to duplicate the success of Walmart’s cost leadership strategies have generally failed, partly because of the effective strategy/structure matches in each of the firm’s segments.

**Using the Functional Structure to Implement the Differentiation Strategy**

Firms using the differentiation strategy produce products that customers hopefully perceive as being different in ways that create value for them. With this strategy, the firm wants to sell nonstandardized products to customers with unique needs. Relatively complex and flexible reporting relationships, frequent use of cross-functional product development teams, and a strong focus on marketing and product R&D rather than manufacturing and process R&D (as with the cost leadership form of the functional structure) characterize the differentiation form of the functional structure (see Figure 11.3). From this structure emerges a development-oriented culture in which employees try to find ways to further differentiate current products and to develop new, highly differentiated products.

Continuous product innovation demands that people throughout the firm interpret and take action based on information that is often ambiguous, incomplete, and
uncertain. Following a strong focus on the external environment to identify new opportunities, employees often gather this information from people outside the firm (e.g., customers and suppliers). Commonly, rapid responses to the possibilities indicated by the collected information are necessary, suggesting the need for decentralized decision-making responsibility and authority. It also requires building a strong technological capability and strategic flexibility, which allow the organization to take advantage of opportunities created by changes in the market.  

Under Armour has used a differentiation strategy and matching structure to create success in the sports apparel market. Under Armour’s objective is to create improved athletic performance through innovative design, testing, and marketing, especially to professional athletes and teams, and translate that perception to the broader market. With a strong match between strategy and structure, it has successfully created innovative sports performance products and challenged Nike and other sports apparel competitors.

**Using the Functional Structure to Implement the Integrated Cost Leadership/Differentiation Strategy**

Firms using the integrated cost leadership/differentiation strategy sell products that create value because of their relatively low cost and reasonable sources of differentiation. The cost of these products is low “relative” to the cost leader’s prices while their differentiation is “reasonable” when compared with the clearly unique features of the differentiator’s products.

Although challenging to implement, the integrated cost leadership/differentiation strategy is used frequently in the global economy. The challenge of using this strategy is
due largely to the fact that different primary and support activities (see Chapter 3) are emphasized when using the cost leadership and differentiation strategies. To achieve the cost leadership position, production and process engineering need to be emphasized, with infrequent product changes. To achieve a differentiated position, marketing and new product R&D need to be emphasized while production and process engineering are not. Thus, effective use of the integrated strategy depends on the firm’s successful combination of activities intended to reduce costs with activities intended to create additional differentiation features. As a result, the integrated form of the functional structure must have decision-making patterns that are partially centralized and partially decentralized. Additionally, jobs are semi-specialized, and rules and procedures call for some formal and some informal job behavior. All of this requires a measure of flexibility to emphasize one or the other set of functions at any given time.

**Matches between Corporate-Level Strategies and the Multidivisional Structure**

As explained earlier, Chandler’s research shows that the firm’s continuing success leads to product or market diversification or both. The firm’s level of diversification is a function of decisions about the number and type of businesses in which it will compete as well as how it will manage the businesses (see Chapter 6). Geared to managing individual organizational functions, increasing diversification eventually creates information processing, coordination, and control problems that the functional structure cannot handle. Thus, using a diversification strategy requires the firm to change from the functional structure to the multidivisional structure to develop an appropriate strategy/structure match.

As defined in Figure 6.1, corporate-level strategies have different degrees of product and market diversification. The demands created by different levels of diversification highlight the need for a unique organizational structure to effectively implement each strategy (see Figure 11.4).

Cisco must use a differentiation strategy in order to compete in its several high technology product market segments. However, given the presence of major competitors in those markets, such as Hewlett-Packard and Huawei, and its loss of market share in its core market of routers, Cisco must also be sensitive to costs. Thus, the horizontal structure can be useful to integrate the two disparate dimensions of structure needed to implement Cisco’s integrated cost leadership-differentiation strategy. In addition, Cisco needs to coordinate several related product units, and the horizontal structure should facilitate this cooperation. Therefore, Cisco’s approach is similar to the cooperative M-form structure, discussed next.

**Figure 11.4** Three Variations of the Multidivisional Structure
Chapter 11: Organizational Structure and Controls

A few years ago, Cisco’s CEO, John T. Chambers, announced major changes in the structure of the firm. The intent of the changes was to promote greater coordination, integration, and cooperation across the major units in the organization. Essentially, the new structure involved a large number of cross-functional councils responsible for making key decisions regarding the allocation of resources to units and projects. The hope was for this structure to facilitate Cisco’s move into a significant number of consumer product market segments, such as health care. Actually, the new structure entailed three levels of teams with the councils at the highest level. Below them were a larger number of management boards. In all, the company had 59 different teams. The hope for these interdisciplinary teams was to increase the speed and ability for execution of their assigned tasks.

Unfortunately, the teams did not create the outcomes desired. In fact, they harmed the focus in the organization and reduced the firm’s ability to move quickly and to execute. Some managers inside the organization suggest that it created chaos with managers often attending several meetings of different teams each day, spending hours trying to reach decisions. It not only slowed the decision-making and implementation processes but also made accountability for decisions less clear. Many managers were frustrated because they had to petition councils/boards for departmental budgets, and they felt they had less control of these units. Because this structure created a culture of frustration, Cisco lost a number of its top managers and other key professionals.

The new structure caused Cisco to “take its eye off” of its most critical and lucrative market for routers. As a result, it started to lose market share to major competitors such as Hewlett-Packard, Huawei Technologies, and Juniper Networks. In fact, Cisco’s market share in routers declined from 68 percent to 55 percent. The loss of market share and key human capital produced lower confidence among analysts and investors, resulting in a declining stock price. Chambers had to make changes and did so. In 2011, he announced a significant reduction in the number of councils and boards. Now, the firm will have three cross-functional councils, down from nine, and 15 management boards, down from 42. Thus, Cisco is still trying to achieve coordination and collaboration but in a more efficient manner, with a greater balance between the vertical and horizontal structures. In addition, Chambers also announced that the firm would focus anew on core routing, switching and services, collaboration, data center virtualization, architectures, and video. It will streamline its sales, services, and engineering operations and reorganize its worldwide field operations into three geographic regions: Americas (United States, Canada, and Latin America), EMEA (Europe, Middle East, and Africa), and Asia Pacific (including Japan and Greater China). In order to help the firm focus, it closed the Flip Camera business it had acquired only a few years earlier.

Thus, although the CEO tried to move away from the “silo” structure that often creates inertia and slow or little change, he too heavily emphasized the horizontal structure and thereby created chaos. Hopefully, the new structure will gain the benefits of both without the negative outcomes (inertia or chaos).

Cisco, maker of FlipCam, announced that it has decided to discontinue manufacturing and supporting this product. It made this decision so it can focus on its revised structure.
Using the Cooperative Form of the Multidivisional Structure to Implement the Related Constrained Strategy

The cooperative form is an M-form structure in which horizontal integration is used to bring about interdivisional cooperation. Divisions in a firm using the related constrained diversification strategy commonly are formed around products, markets, or both. In Figure 11.5, we use product divisions as part of the representation of the cooperative form of the multidivisional structure, although market divisions could be used instead of or in addition to product divisions to develop the figure.

Figure 11.5 Cooperative Form of the Multidivisional Structure for Implementing a Related Constrained Strategy

Notes:
- Structural integration devices create tight links among all divisions
- Corporate office emphasizes centralized strategic planning, human resources, and marketing to foster cooperation between divisions
- R&D is likely to be centralized
- Rewards are subjective and tend to emphasize overall corporate performance in addition to divisional performance
- Culture emphasizes cooperative sharing
Using this structure, Cisco has implemented the related constrained strategy as described in the Strategic Focus. Cisco tried to enter 30 consumer markets related to its core businesses. This required implementation of the cooperative M-form and Cisco tried to manage it with significant decentralization among the various business units to foster cooperation and synergy. However, there were too many markets, and the horizontal teams designed to foster collaboration and coordination across related businesses created significant challenges. In the end, there was not enough vertical structure to provide oversight and avoid the chaos created by the multiple cross-functional teams and management boards. Thus, Cisco has streamlined its set of businesses and balanced its vertical and horizontal structure to mirror the more common form of the cooperative structure. Interestingly, research suggests that informal ties may be even more important than formal coordination devices in achieving cooperation.

Sharing divisional competencies facilitates the corporation’s efforts to develop economies of scope. As explained in Chapter 6, economies of scope (cost savings resulting from the sharing of competencies developed in one division with another division) are linked with successful use of the related constrained strategy. Interdivisional sharing of competencies depends on cooperation, suggesting the use of the cooperative form of the multidivisional structure. Cisco’s new structure and processes hopefully will accomplish this.

The cooperative structure uses different characteristics of structure (centralization, standardization, and formalization) as integrating mechanisms to facilitate interdivisional cooperation. Frequent, direct contact between division managers, another integrating mechanism, encourages and supports cooperation and the sharing of knowledge, capabilities, or other resources that could be used to create new advantages. Sometimes, liaison roles are established in each division to reduce the time division managers spend integrating and coordinating their unit’s work with the work occurring in other divisions. Temporary teams and task forces may be formed around projects whose success depends on sharing competencies that are embedded within several divisions. Cisco uses these devices for gaining collaboration and coordination between units, as described in the Strategic Focus. Formal integration departments might be established in firms frequently using temporary teams or task forces.

Ultimately, a matrix organization may evolve in firms implementing the related constrained strategy. A matrix organization is an organizational structure in which there is a dual structure combining both functional specialization and business product or project specialization. Although complicated, an effective matrix structure can lead to improved coordination among a firm’s divisions.

The success of the cooperative multidivisional structure is significantly affected by how well divisions process information. However, because cooperation among divisions implies a loss of managerial autonomy, division managers may not readily commit themselves to the type of integrative information-processing activities that this structure demands. Moreover, coordination among divisions sometimes results in an unequal flow of positive outcomes to divisional managers. In other words, when managerial rewards are based at least in part on the performance of individual divisions, the manager of the division that is able to benefit the most by the sharing of corporate competencies might be viewed as receiving relative gains at others’ expense. Strategic controls are important in these instances, as divisional managers’ performance can be evaluated at least partly on the basis of how well they have facilitated interdivisional cooperative efforts. In addition, using reward systems that emphasize overall company performance, besides outcomes achieved by individual divisions, helps overcome problems associated with the cooperative form. Still, the costs of coordination and inertia in organizations limit the amount of related diversification attempted (i.e., they constrain the economies of scope that can be created).
**Using the Strategic Business Unit Form of the Multidivisional Structure to Implement the Related Linked Strategy**

Firms with fewer links or less constrained links among their divisions use the related linked diversification strategy. The strategic business unit form of the multidivisional structure supports implementation of this strategy. The **strategic business unit (SBU) form** is an M-form structure consisting of three levels: corporate headquarters, strategic business units (SBUs), and SBU divisions (see Figure 11.6). The SBU structure is used by large firms and can be complex, given associated organization size and product and market diversity.

The divisions within each SBU are related in terms of shared products or markets or both, but the divisions of one SBU have little in common with the divisions of the other SBUs. Divisions within each SBU share product or market competencies to develop economies of scope and possibly economies of scale. The integrating mechanisms used by the divisions in this structure can be equally well used by the divisions within the individual strategic business units that are part of the SBU form of the multidivisional structure. In this structure, each SBU is a profit center that is controlled and evaluated by the headquarters office. Although both financial and strategic controls are important, on a relative basis financial controls are vital to headquarters’ evaluation of each SBU; strategic controls are critical when the heads of SBUs evaluate their divisions’ performances. Strategic controls are also critical to the headquarters’ efforts to determine whether the company has formed an effective

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**Figure 11.6 SBU Form of the Multidivisional Structure for Implementing a Related Linked Strategy**

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Notes:
- Structural integration among divisions within SBUs, but independence across SBUs
- Strategic planning may be the most prominent function in headquarters for managing the strategic planning approval process of SBUs for the president
- Each SBU may have its own budget for staff to foster integration
- Corporate headquarters staff members serve as consultants to SBUs and divisions, rather than having direct input to product strategy, as in the cooperative form
portfolio of businesses and whether those businesses are being successfully managed. Therefore, there is need for strategic structures that promote exploration to identify new products and markets, but also for actions that exploit the current product lines and markets.88

Sears Holdings changed to the SBU form in 2008 by dividing into five strategic business units (with multiple divisions as parts of each SBU): brands, real estate, support, online, and store operations.89 This allowed for related businesses to work together (such as Sears and K-Mart, which merged in 2005) to focus on their distinct customer sets, but also provided for better control for headquarters in order to evaluate performance of each strategic business unit and division within the SBU. The annual sales revenues for Sears declined for five straight years starting in 2006. In 2007, Sears’ stock price reached its highest level in recent years ($143.78/share) but declined to $61.76 early in 2010. At the time, this price was well below the average S&P price of $110.53 and the retail industry average price of $115.96.90 Therefore, change in structure was likely designed to improve the firm’s overall performance but thus far it has not done so. The SBU structure is difficult to implement.

Sharing competencies among units within an SBU is an important characteristic of the SBU form of the multidivisional structure (see the notes to Figure 11.6). A drawback to the SBU structure is that multifaceted businesses often have difficulties in communicating this complex business model to stockholders.91 Furthermore, if coordination between SBUs is needed, problems can arise because the SBU structure, similar to the competitive form discussed next, does not readily foster cooperation across SBUs.

Using the Competitive Form of the Multidivisional Structure to Implement the Unrelated Diversification Strategy

Firms using the unrelated diversification strategy want to create value through efficient internal capital allocations or by restructuring, buying, and selling businesses.92 The competitive form of the multidivisional structure supports implementation of this strategy.

The competitive form is an M-form structure characterized by complete independence among the firm’s divisions which compete for corporate resources (see Figure 11.7). Unlike the divisions included in the cooperative structure, divisions that are part of the competitive structure do not share common corporate strengths. Because strengths are not shared, integrating devices are not developed for use by the divisions included in the competitive structure.

The efficient internal capital market that is the foundation for using the unrelated diversification strategy requires organizational arrangements emphasizing divisional competition rather than cooperation.93 Three benefits are expected from the internal competition. First, internal competition creates flexibility (e.g., corporate headquarters can have divisions working on different technologies and projects to identify those with the greatest potential). Resources can then be allocated to the division appearing to have the most potential to fuel the entire firm’s success. Second, internal competition challenges the status quo and inertia, because division heads know that future resource allocations are a product of excellent current performance as well as superior positioning in terms of future performance. Last, internal competition motivates effort in that the challenge...
Figure 11.7 Competitive Form of the Multidivisional Structure for Implementing an Unrelated Strategy

- **Corporate headquarters has a small staff.**
- Finance and auditing are the most prominent functions in the headquarters office to manage cash flow and assure the accuracy of performance data coming from divisions.
- The legal affairs function becomes important when the firm acquires or divests assets.
- Divisions are independent and separate for financial evaluation purposes.
- Divisions retain strategic control, but cash is managed by the corporate office.
- Divisions compete for corporate resources.

Table 11.1 Characteristics of the Structures Necessary to Implement the Related Constrained, Related Linked, and Unrelated Diversification Strategies

<table>
<thead>
<tr>
<th>Structural Characteristics</th>
<th>Cooperative M-Form (Related Constrained Strategy)*</th>
<th>SBU M-Form (Related Linked Strategy)*</th>
<th>Competitive M-Form (Unrelated Diversification Strategy)*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Centralization of operations</td>
<td>Centralized at corporate office</td>
<td>Partially centralized (in SBUs)</td>
<td>Decentralized to divisions</td>
</tr>
<tr>
<td>Use of integration mechanisms</td>
<td>Extensive</td>
<td>Moderate</td>
<td>Nonexistent</td>
</tr>
<tr>
<td>Divisional performance evaluation</td>
<td>Emphasizes subjective (strategic) criteria</td>
<td>Uses a mixture of subjective (strategic) and objective (financial) criteria</td>
<td>Emphasizes objective (financial) criteria</td>
</tr>
<tr>
<td>Divisional incentive compensation</td>
<td>Linked to overall corporate performance</td>
<td>Mixed linkage to corporate, SBU, and divisional performance</td>
<td>Linked to divisional performance</td>
</tr>
</tbody>
</table>

*Strategy implemented with structural form.

of competing against internal peers can be as great as the challenge of competing against external rivals. In this structure, organizational controls (primarily financial controls) are used to emphasize and support internal competition among separate divisions and as the basis for allocating corporate capital based on divisions' performances.
Textron Inc., a large “multi-industry” company, seeks “to identify, research, select, acquire and integrate companies, and has developed a set of rigorous criteria to guide decision making.” Textron continuously looks “to enhance and reshape its portfolio by divesting non-core assets and acquiring branded businesses in attractive industries with substantial long-term growth potential.” Textron operates four independent businesses—Bell Helicopter (31 percent of revenue), Cessna Aircraft (24 percent), Textron Systems (19 percent), Finance (2 percent), and Industrial (24 percent). The firm uses return on invested capital (ROIC) as a way to evaluate the contribution of its diversified set of businesses as they compete internally for resources.95

To emphasize competitiveness among divisions, the headquarters office maintains an arm’s-length relationship with them, intervening in divisional affairs only to audit operations and discipline managers whose divisions perform poorly. In emphasizing competition between divisions, the headquarters office relies on strategic controls to set rate-of-return targets and financial controls to monitor divisional performance relative to those targets. The headquarters office then allocates cash flow on a competitive basis, rather than automatically returning cash to the division that produced it. Thus, the focus of the headquarters’ work is on performance appraisal, resource allocation, and long-range planning to verify that the firm’s portfolio of businesses will lead to financial success.96

The three major forms of the multidivisional structure should each be paired with a particular corporate-level strategy. Table 11.1 shows these structures’ characteristics. Differences exist in the degree of centralization, the focus of the performance evaluation, the horizontal structures (integrating mechanisms), and the incentive compensation schemes. The most centralized and most costly structural form is the cooperative structure. The least centralized, with the lowest bureaucratic costs, is the competitive structure. The SBU structure requires partial centralization and involves some of the mechanisms necessary to implement the relatedness between divisions. Also, the divisional incentive compensation awards are allocated according to both SBUs and corporate performance.

The Strategic Focus on the LG Company suggests that it is operating like a holding company and appears to be using a competitive multidivisional structure. The different units are operating in significantly different industries. LG Electronics, one of the companies in the LG Company portfolio, has several businesses operating in different consumer products businesses. LG Company issued financial controls to govern and evaluate the different corporations in its portfolio. The replacing of the CEO of LG Electronics after only two quarters of losses suggests a heavy emphasis on financial criteria in performance evaluations.

Matches between International Strategies and Worldwide Structure

As explained in Chapter 8, international strategies are becoming increasingly important for long-term competitive success97 in what continues to become an increasingly borderless global economy.98 Among other benefits, international strategies allow the firm to search for new markets, resources, core competencies, and technologies as part of its efforts to outperform competitors.99

As with business-level and corporate-level strategies, unique organizational structures are necessary to successfully implement the different international strategies.100 Forming proper matches between international strategies and organizational structures facilitates the firm’s efforts to effectively coordinate and control its global operations. More importantly, research findings confirm the validity of the international strategy/structure matches we discuss here.101
EVALUATING PERFORMANCE IN A LARGE CONGLomerate: LG COMPANY

The LG Company is a large conglomerate headquartered in Korea that has manufacturing corporations operating in such industries as electronics, chemicals, household goods and health care, life sciences, and oil. The two largest corporations in the group are LG Chemicals and LG Electronics. LG Electronics received a lot of coverage in the media in 2010 and 2011 because its CEO was replaced and a competitor filed a major complaint with the U.S. Commerce Department accusing LG of selling its refrigerators in the U.S. market at a price that was lower than it cost to produce them. How did the electronics business reach this state of affairs?

LG Electronics performed reasonably well in 2009 despite the global economic problems. It had good increases in sales revenue in each of its five major divisions and was profitable. However, in the fourth quarter of 2010 and the first quarter of 2011, LG Electronics suffered losses and the CEO was replaced. This shows that the LG Company was strongly emphasizing financial criteria to evaluate the performance of its business portfolio. The problems, however, ran deeper than two unprofitable quarters. The Mobile Communications Division had projected an increase in sales for 2010 but it did not materialize. In fact, its third quarter share of the global mobile phone market declined from 10.3 percent in 2009 to 6.6 percent in 2010. Its 2010 sales were almost 17 percent below what the firm projected. The firm also experienced slow demand for flat-screen televisions. Thus, it experienced declines in its revenues and profits even though some divisions performed well (e.g., LG’s Home Appliance Division).

Perhaps because of pressure to enhance the financial picture for the overall electronics business, it sold refrigerators at an exceptionally low price in the U.S. market. Whirlpool filed a complaint suggesting that the Korean government had provided subsidies to both LG and Samsung allowing them to sell products at below the cost of production. Of course, Whirlpool argued that this represented unfair competition. The U.S. International Trade Commission ruled in favor of Whirlpool. As demonstrated, use of strong financial controls even in a competitive multidivisional structure, such as used by LG Company, can produce some unintended consequences. Executives may try to take short-term actions to shore up the overall financial picture that are not in the long-term best interests of the company.

Using the Worldwide Geographic Area Structure to Implement the Multidomestic Strategy

The multidomestic strategy decentralizes the firm’s strategic and operating decisions to business units in each country so that product characteristics can be tailored to local preferences. Firms using this strategy try to isolate themselves from global competitive forces by establishing protected market positions or by competing in industry segments that are most affected by differences among local countries. The worldwide geographic area structure is used to implement this strategy. The worldwide geographic area structure emphasizes national interests and facilitates the firm’s efforts to satisfy local differences (see Figure 11.8).

Although the U.S. automobile industry is doing poorly in global markets, on a relative basis Ford of Europe is doing better than other auto firms in Europe within the same middle market segment strategy. This is due to the fact that Ford implemented the worldwide geographic area structure more than a decade ago to give local European managers more autonomy to manage their operations. One analysis called Ford “the most efficient volume carmaker in Europe.” Furthermore, Ford has an efficient set of designs matched responsively to the European market. Ford has kept costs down by partnering with European automakers such as Fiat and France’s PSA Peugeot Citroen on chassis and engine production. Using the multidomestic strategy requires little coordination between different country markets, meaning that integrating mechanisms among divisions around the world are not needed. Coordination among units in a firm’s worldwide geographic area structure is often informal. As mentioned earlier, this may be the most effective form of cooperation.

The multidomestic strategy/worldwide geographic area structure match evolved as a natural outgrowth of the multicultural European marketplace. Friends and family...
members of the main business who were sent as expatriates into foreign countries to develop the independent country subsidiary often used this structure for the main business. The relationship to corporate headquarters by divisions took place through informal communication among “family members.”

A key disadvantage of the multidomestic strategy/worldwide geographic area structure is the inability to create strong global efficiency. With an increasing emphasis on lower-cost products in international markets, the need to pursue worldwide economies of scale has also increased. These changes foster use of the global strategy and its structural match, the worldwide product divisional structure.

**Using the Worldwide Product Divisional Structure to Implement the Global Strategy**

With the corporation’s home office dictating competitive strategy, the global strategy is one through which the firm offers standardized products across country markets. The firm’s success depends on its ability to develop economies of scope and economies of scale on a global level. Decisions to outsource or maintain integrated subsidiaries may in part depend on the country risk and institutional environment in which the firm is entering.

The worldwide product divisional structure supports use of the global strategy. In the worldwide product divisional structure, decision-making authority is centralized in the worldwide division headquarters to coordinate and integrate decisions and actions among divisional business units (see Figure 11.9). This structure is often used in rapidly growing firms seeking to manage their diversified product lines effectively. Avon Products, Inc. is an example of a firm using the worldwide product divisional structure.

**Figure 11.9 Worldwide Product Divisional Structure for Implementing a Global Strategy**

Notes:
- The “headquarters” circle indicates centralization to coordinate information flow among worldwide products
- Corporate headquarters uses many intercoordination devices to facilitate global economies of scale and scope
- Corporate headquarters also allocates financial resources in a cooperative way
- The organization is like a centralized federation
Avon is a global brand leader in products for women such as lipsticks, fragrances, and anti-aging skin care. Committed to “empowering women all over the world since 1886,” Avon relies on product innovation to be a first-mover in its markets. For years, Avon used the multidomestic strategy. However, the firm’s growth came to a screeching halt in 2006. Contributing to this decline were simultaneous stumbles in sales revenues in emerging markets (e.g., Russia and Central Europe), the United States, and Mexico. To cope with its problems, the firm changed to a global strategy and to the worldwide product divisional structure to support its use. Commenting on this change, CEO Andrea Jung noted that, “Previously, Avon managers from Poland to Mexico ran their own plants, developed new products, and created their own ads, often relying as much on gut as numbers.”

Today, Avon is organized around product divisions including Avon Color, the firm’s “flagship global color cosmetics brand, which offers a variety of color cosmetics products, including foundations, powders, lip, eye, and nail products,” Skincare, Bath & Body, Hair Care, Wellness, and Fragrance. The analysis of these product divisions’ performances is conducted by individuals in the firm’s New York headquarters. One of the purposes of changing strategy and structure is for Avon to control its costs and gain additional scale economies as paths to performance improvements. Avon announced the success of this restructuring program and vowed to cut costs even further; the original program was “expected to result in annual savings of about $430 million by 2011–12,” while the additional changes were expected to achieve “another $450 million expected to be saved beginning in 2010.” The results are starting to pay off as Avon’s financial performance in 2011 is much better than 2010. In the first quarter of 2011 net operating profit is 29 percent higher than in the previous year, and earnings per share were more than three times those achieved in the first quarter of 2010.

Integrating mechanisms are important in the effective use of the worldwide product divisional structure. Direct contact between managers, liaison roles between departments, and both temporary task forces and permanent teams are examples of these mechanisms. One researcher describes the use of these mechanisms in the worldwide structure: “There is extensive and formal use of task forces and operating committees to supplement communication and coordination of worldwide operations.” The disadvantages of the global strategy/worldwide structure combination are the difficulty involved with coordinating decisions and actions across country borders and the inability to quickly respond to local needs and preferences.

To deal with these types of disadvantages, Avon has approximately 6.5 million local salespeople in 100 countries who are committed to the organization and who help the company to become locally responsive. Another solution is to develop a regional approach in addition to the product focus, which might be similar to the combination structure discussed next.

**Using the Combination Structure to Implement the Transnational Strategy**

The transnational strategy calls for the firm to combine the multidomestic strategy’s local responsiveness with the global strategy’s efficiency. Firms using this strategy are trying to gain the advantages of both local responsiveness and global efficiency. The combination structure is used to implement the transnational strategy. The combination structure is a structure drawing characteristics and mechanisms from both the worldwide geographic area structure and the worldwide product divisional structure. The transnational strategy is often implemented through two possible combination structures: a global matrix structure and a hybrid global design.

The global matrix design brings together both local market and product expertise into teams that develop and respond to the global marketplace. The global matrix design (the basic matrix structure was defined earlier) promotes flexibility in designing products and responding to customer needs. However, it has severe limitations in that it places employees in a position of being accountable to more than one manager. At any
given time, an employee may be a member of several functional or product group teams. Relationships that evolve from multiple memberships can make it difficult for employees to be simultaneously loyal to all of them. Although the matrix places authority in the hands of managers who are most able to use it, it creates problems in regard to corporate reporting relationships that are so complex and vague that it is difficult and time-consuming to receive approval for major decisions.

We illustrate the hybrid structure in Figure 11.10. In this design, some divisions are oriented toward products while others are oriented toward market areas. Thus, in cases when the geographic area is more important, the division managers are area-oriented. In other divisions where worldwide product coordination and efficiencies are more important, the division manager is more product-oriented.

The fit between the multidomestic strategy and the worldwide geographic area structure and between the global strategy and the worldwide product divisional structure is apparent. However, when a firm wants to implement the multidomestic and global strategies simultaneously through a combination structure, the appropriate integrating mechanisms are less obvious. The structure used to implement the transnational strategy must be simultaneously centralized and decentralized; integrated and nonintegrated; formalized and nonformalized.

IKEA has done a good job of balancing these organization aspects in implementing the transnational strategy. IKEA is a global furniture retailer with more than 300 outlets in 39 countries and regions. IKEA focuses on lowering its costs and understanding its customers’ needs, especially younger customers. It has been able to manage these seemingly opposite characteristics through its structure and management process. It has also been able to encourage its employees to understand the effects of cultural and geographic diversity on firm operations. The positive results from this are evident in the more than 600 million visitors to IKEA stores. IKEA’s system also has internal network attributes, which are discussed next in regard to external interorganizational networks.

**Matches between Cooperative Strategies and Network Structures**

As discussed in Chapter 9, a network strategy exists when partners form several alliances in order to improve the performance of the alliance network itself through cooperative endeavors. The greater levels of environmental complexity and uncertainty facing
companies in today’s competitive environment are causing more firms to use cooperative strategies such as strategic alliances and joint ventures.\textsuperscript{115}

The breadth and scope of firms’ operations in the global economy create many opportunities for firms to cooperate.\textsuperscript{116} In fact, a firm can develop cooperative relationships with many of its stakeholders, including customers, suppliers, and competitors. When a firm becomes involved with combinations of cooperative relationships, it is part of a strategic network, or what others call an alliance constellation or portfolio.\textsuperscript{117}

A \textit{strategic network} is a group of firms that has been formed to create value by participating in multiple cooperative arrangements. An effective strategic network facilitates discovering opportunities beyond those identified by individual network participants. A strategic network can be a source of competitive advantage for its members when its operations create value that is difficult for competitors to duplicate and that network members can’t create by themselves.\textsuperscript{118} Strategic networks are used to implement business-level, corporate-level, and international cooperative strategies.

Commonly, a strategic network is a loose federation of partners participating in the network’s operations on a flexible basis. At the core or center of the strategic network, the \textit{strategic center firm} is the one around which the network’s cooperative relationships revolve (see Figure 11.11).

Because of its central position, the strategic center firm is the foundation for the strategic network’s structure. Concerned with various aspects of organizational structure, such as formal reporting relationships and procedures, the strategic center firm manages what are often complex, cooperative interactions among network partners. To perform the tasks discussed next, the strategic center firm must make sure that incentives for participating in the network are aligned so that network firms continue to have a reason to remain connected.\textsuperscript{119} The strategic center firm is engaged in four primary tasks as it manages the strategic network and controls its operations: \textsuperscript{120}

\textit{Strategic outsourcing}. The strategic center firm outsources and partners with more firms than other network members. At the same time, the strategic center firm requires
network partners to be more than contractors. Members are expected to find opportunities for the network to create value through its cooperative work.

**Competencies.** To increase network effectiveness, the strategic center firm seeks ways to support each member’s efforts to develop core competencies with the potential of benefiting the network.

**Technology.** The strategic center firm is responsible for managing the development and sharing of technology-based ideas among network members. The structural requirement that members submit formal reports detailing the technology-oriented outcomes of their efforts to the strategic center firm facilitates this activity.121

**Race to learn.** The strategic center firm emphasizes that the principal dimensions of competition are between value chains and between networks of value chains. Because of this interconnection, the strategic network is only as strong as its weakest value-chain link. With its centralized decision-making authority and responsibility, the strategic center firm guides participants in efforts to form network-specific competitive advantages. The need for each participant to have capabilities that can be the foundation for the network’s competitive advantages encourages friendly rivalry among participants seeking to develop the skills needed to quickly form new capabilities that create value for the network.122

Interestingly, strategic networks are being used more frequently, partly because of the ability of a strategic center firm to execute a strategy that effectively and efficiently links partner firms. Improved information systems and communication capabilities (e.g., the Internet) make such networks possible.

### Implementing Business-Level Cooperative Strategies

As noted in Chapter 9, the two types of business-level complementary alliances are vertical and horizontal. Firms with competencies in different stages of the value chain form a vertical alliance to cooperatively integrate their different, but complementary, skills. Firms combining their competencies to create value in the same stage of the value chain are using a horizontal alliance. Vertical complementary strategic alliances such as those developed by Toyota Motor Company are formed more frequently than horizontal alliances.123

A strategic network of vertical relationships such as the network in Japan between Toyota and its suppliers often involves a number of implementation issues.124 First, the strategic center firm encourages subcontractors to modernize their facilities and provides them with technical and financial assistance to do so, if necessary. Second, the strategic center firm reduces its transaction costs by promoting longer-term contracts with subcontractors, so that supplier-partners increase their long-term productivity. This approach is diametrically opposed to that of continually negotiating short-term contracts based on unit pricing. Third, the strategic center firm enables engineers in upstream companies (suppliers) to have better communication with those companies with whom it has contracts for services. As a result, suppliers and the strategic center firm become more interdependent and less independent.

The lean production system (a vertical complementary strategic alliance) pioneered by Toyota and others has been diffused throughout the global auto industry.125 In vertical complementary strategic alliances, such as the one between Toyota and its suppliers, the strategic center firm is obvious, as is the structure that firm establishes. However, the same is not always true with horizontal complementary strategic alliances where firms try to create value in the same part of the value chain. For example, airline alliances are commonly formed to create value in the marketing and sales primary activity segment...
of the value chain (see Table 3.6). Because air carriers commonly participate in multiple horizontal complementary alliances such as the Star Alliance between Lufthansa, United (and originally Continental before its merger with United), US Airways, Thai, Air Canada, SAS, and others, it is difficult to determine the strategic center firm. Moreover, participating in several alliances can cause firms to question partners’ true loyalties and intentions. Also, if rivals band together in too many collaborative activities, one or more governments may suspect the possibility of illegal collusive activities. For these reasons, horizontal complementary alliances are used less often and less successfully than their vertical counterpart, although there are examples of success, for instance, among auto and aircraft manufacturers.

Implementing Corporate-Level Cooperative Strategies

Corporate-level cooperative strategies (such as franchising) are used to facilitate product and market diversification. As a cooperative strategy, franchising allows the firm to use its competencies to extend or diversify its product or market reach, but without completing a merger or an acquisition. Research suggests that knowledge embedded in corporate-level cooperative strategies facilitates synergy. For example, McDonald’s Corporation pursues a franchising strategy, emphasizing a limited value-priced menu in more than 100 countries. The McDonald’s franchising system is a strategic network. McDonald’s headquarters serves as the strategic center firm for the network’s franchisees. The headquarters office uses strategic and financial controls to verify that the franchisees’ operations create the greatest value for the entire network.

An important strategic control issue for McDonald’s is the location of its franchisee units. Because it believes that its greatest expansion opportunities are outside the United States, the firm has decided to continue expanding in countries such as China and India, where it often needs to adjust its menu according to the local culture. For example, “McDonald’s adapts its restaurants in India to local tastes; in a nation that is predominantly Hindu and reveres the cow, beef isn’t on the menu, for instance, replaced by chicken burgers and vegetable patties.” As the strategic center firm around the globe for its restaurants, McDonald’s is devoting the majority of its capital expenditures to develop units in non-U.S. markets.

Implementing International Cooperative Strategies

Strategic networks formed to implement international cooperative strategies result in firms competing in several countries. Differences among countries’ regulatory environments increase the challenge of managing international networks and verifying that at a minimum, the network’s operations comply with all legal requirements.

Distributed strategic networks are the organizational structure used to manage international cooperative strategies. As shown in Figure 11.12, several regional strategic center firms are included in the distributed network to manage partner firms’ multiple cooperative arrangements. The structure used to implement the international cooperative strategy is complex and demands careful attention to be used successfully.
Organizational structure specifies the firm’s formal reporting relationships, procedures, controls, and authority and decision-making processes. Essentially, organizational structure details the work to be done in a firm and how that work is to be accomplished. Organizational controls guide the use of strategy, indicate how to compare actual and expected results, and suggest actions to take to improve performance when it falls below expectations. A proper match between strategy and structure can lead to a competitive advantage.

Strategic controls (largely subjective criteria) and financial controls (largely objective criteria) are the two types of organizational controls used to implement a strategy. Both controls are critical, although their degree of emphasis varies based on individual matches between strategy and structure.

Strategy and structure influence each other; overall though, strategy has a stronger influence on structure. Research indicates that firms tend to change structure when declining performance forces them to do so. Effective managers anticipate the need for structural change and quickly modify structure to better accommodate the firm’s strategy when evidence calls for that action.

The functional structure is used to implement business-level strategies. The cost leadership strategy requires a centralized functional structure—one in which manufacturing efficiency and process engineering are emphasized. The differentiation strategy’s functional structure decentralizes implementation-related decisions, especially those concerned with marketing, to those involved with individual organizational functions. Focus strategies, often used in small firms, require a simple structure until such time that the firm diversifies in terms of products and/or markets.

Unique combinations of different forms of the multidivisional structure are matched with different corporate-level diversification strategies to properly implement these strategies. The cooperative M-form, used to implement the related constrained corporate-level strategy, has a centralized corporate office and extensive integrating mechanisms. Divisional incentives are linked to overall corporate performance to foster cooperation among divisions. The related linked SBU M-form structure establishes separate profit centers within the diversified firm. Each profit center or SBU may have divisions offering similar products, but the SBUs are often
unrelated to each other. The competitive M-form structure, used to implement the unrelated diversification strategy, is highly decentralized, lacks integrating mechanisms, and utilizes objective financial criteria to evaluate each unit’s performance.

The multidomestic strategy, implemented through the worldwide geographic area structure, emphasizes decentralization and locates all functional activities in the host country or geographic area. The worldwide product divisional structure is used to implement the global strategy. This structure is centralized in order to coordinate and integrate different functions’ activities so as to gain global economies of scope and economies of scale. Decision-making authority is centralized in the firm’s worldwide division headquarters.

The transnational strategy—a strategy through which the firm seeks the local responsiveness of the multidomestic strategy and the global efficiency of the global strategy—is implemented through the combination structure. Because it must be simultaneously centralized and decentralized, integrated and nonintegrated, and formalized and informalized, the combination structure is difficult to organize and successfully manage. However, two structural designs are suggested: the matrix and the hybrid structure with both geographic and product-oriented divisions.

Increasingly important to competitive success, cooperative strategies are implemented through organizational structures framed around strategic networks. Strategic center firms play a critical role in managing strategic networks. Business-level strategies are often employed in vertical and horizontal alliance networks. Corporate-level cooperative strategies are used to pursue product and market diversification. Franchising is one type of corporate strategy that uses a strategic network to implement this strategy. This is also true for international cooperative strategies, where distributed networks are often used.

**Review Questions**

1. What is organizational structure and what are organizational controls? What are the differences between strategic controls and financial controls? What is the importance of these differences?

2. What does it mean to say that strategy and structure have a reciprocal relationship?

3. What are the characteristics of the functional structures used to implement the cost leadership, differentiation, integrated cost leadership/differentiation, and focused business-level strategies?

4. What are the differences among the three versions of the multidivisional (M-form) organizational structures that are used to implement the related constrained, the related linked, and the unrelated corporate-level diversification strategies?

5. What organizational structures are used to implement the multidomestic, global, and transnational international strategies?

6. What is a strategic network? What is a strategic center firm? How is a strategic center used in business-level, corporate-level, and international cooperative strategies?

**Experiential Exercises**

**EXERCISE 1: ORGANIZATIONAL STRUCTURE AND BUSINESS-LEVEL STRATEGY**

The purpose of this exercise is to apply the concepts introduced in this chapter to live examples of business-level strategies and to examples of how various firms actually structure their organizations to compete. Your instructor will assign teams of students a business-level strategy, such as differentiation or cost leadership. After you have your category assigned, identify a firm that exemplifies this strategy and pictorially draw out its corporate structure. You will need to present the results of your investigation by comparing your firm’s organizational chart with that in your text identified for your particular business-level strategy (see Figure 11.3 labeled “Functional Structure for Implementing a Differentiation [or Cost Leadership] Strategy). Be prepared to address the following issues:

1. Describe your firm’s business-level strategy. Why do you consider it to be a cost leader or a differentiator?

2. What is the mission statement and/or vision statement of this firm? Are there specific goals that you can identify that this firm is targeting?

3. Using the text examples for a functional structure, how does your firm differ, if it does?
4. Summarize your conclusions. Does your team believe that this firm is structured appropriately, considering its goals for the future?

EXERCISE 2: IS STRUCTURE CONTAGIOUS?
Form two teams to analyze and recommend changes (if any) regarding pairs of competitors. Are these competitors, such as Walgreen and CVS, structured similarly or differently? How do their strategies and board structure compare?

Part One
Select a pair of competitors. You have wide latitude in this choice, such as large publicly held companies (i.e., Walgreens/CVS; Whole Foods/Kroger; American Airlines/Delta Airlines; Cooper Industries/Danaher; Loews/Home Depot; to name a few). Another option is to select two competitors that reside in your town that may be small to medium-sized firms. The important thing is that the firms should be competitors and roughly comparable in size.

Part Two
Research the firms and be prepared to address the following issues:
- Describe the strategies of the two firms—differences and similarities.
- Present the two firms’ organizational structures and note differences and similarities.
- Does structure follow strategy as Chandler argues?
- Are the boards of directors structured similarly between the pair as far as committees, meetings, and titles?
- Which one of these companies would you most likely desire to work for, all else being equal?

Be prepared to discuss your findings in a PowerPoint presentation to the class.

A MATCH FOR ORGANIZATIONAL STRUCTURE AND CONTROL—GM BANKRUPTCY
Emerging from bankruptcy, GM’s commitment to smaller more fuel-efficient cars has resulted in a move from a GM corporation to a smaller GM company. Selling-off and phasing-out brands along with changing logos are steps toward a new GM. With the Obama administration’s desire for a complete overhaul of GM’s structure, the U.S. Treasury became the company’s biggest stockholder while American taxpayers had greater than 60 percent ownership in the new company. New management teams representing stability and design appear to set the stage for a match point.

BE PREPARED TO DISCUSS THE FOLLOWING CONCEPTS AND QUESTIONS IN CLASS:

Concepts
- Organizational structure
- Organizational controls

Questions
1. Is GM’s organizational structure aligned with its strategies? If so, why? If not, what is needed?
2. What organizational controls do you think were lacking in the old GM? What organizational controls are needed in the new GM?
3. What specific strategic controls do you believe are key to GM’s future success? Should GM’s value chain change?
4. Recognizing GM’s current state, how do you see the new GM strategy and structure relationship? How do you see it evolving?

NOTES


44. Keats & O’Neill, Organizational structure, 531.


47. Keats & O’Neill, Organizational structure, 524.


63. Hoskisson, Hill, & Kim, The multidivisional structure: Organizational fossil or source of value?

69. Hall, Organizations, 64–75.
71. Barney, Gaining and Sustaining Competitive Advantage, 467.
77. Simon, Hitt, Ireland, & Gilbert, Resource orchestration to create competitive advantage; Olson, Slater, Tomas, & Hult, The performance implications of fit.
80. Simon, Hitt, Ireland, & Gilbert, Resource orchestration to create competitive advantage.
93. Hill, Hitt, & Hoskisson, Cooperative versus competitive structures, 512.


108. Midgley, Emerging structural patterns, 197

109. Rugman & Verbeke, A regional solution to the strategy and structure of multinationals.


Studying this chapter should provide you with the strategic management knowledge needed to:

1. Define strategic leadership and describe top-level managers’ importance.
2. Explain what top management teams are and how they affect firm performance.
3. Describe the managerial succession process using internal and external managerial labor markets.
4. Discuss the value of strategic leadership in determining the firm’s strategic direction.
5. Describe the importance of strategic leaders in managing the firm’s resources.
6. Define organizational culture and explain what must be done to sustain an effective culture.
7. Explain what strategic leaders can do to establish and emphasize ethical practices.
8. Discuss the importance and use of organizational controls.
SUCCESSION AT HP: CAN THE NEW CEO SAVE THE COMPANY’S SOUL?

Mark Hurd, the former CEO at HP, left under a controversial cloud. Hurd was efficiency oriented and had made the company money by tightly controlling costs, but HP’s culture of innovation suffered under his leadership. Thus, when he departed because of allegations of misusing his position, the new CEO had the opportunity to “reboot” the company and its culture. Former SAP CEO Leo Apotheker was named as HP’s CEO to succeed Hurd. He was described by one HP board member as a strategic thinker with a passion for technology. It was also suggested that he had a record of promoting technological innovation, just what many believed HP needed. However, some also questioned his selection because he lost his position as CEO of SAP after only seven months on the job (although he was co-CEO for almost two years prior to holding the position alone).

Apotheker began his work by talking to employees, customers, and analysts to understand the company and its strategic position. He made a decision popular with employees to restore several of the pay cuts made by Hurd in the previous year. Over the next several months, he made several other moves, including replacing a number of top managers and changing the reporting structure of some positions. The changes were in line with the new strategy he developed to focus HP on the development of new software in line with cloud computing. Given that HP has been a major hardware company (e.g., the largest manufacturer of personal computers), this represents a significant change in direction for the company. Apotheker claims that his strategy will be evolutionary and will feed HP’s core businesses but many question this outcome. In addition, he intends to employ a disciplined acquisition strategy that will allow the firm to purchase new capabilities. In fact, this may be required to make the moves into software and cloud computing successful, given that HP has lost its culture of innovation. It is very difficult to rebuild an innovation culture and capability.

Apotheker was hired as CEO in the fall of 2010, but by the summer of 2011 he was on the hot seat because HP announced a reduction in its profit target (the second time the target was reduced during Apotheker’s short tenure) and the price of the firm’s shares of stock declined. Thus, he was facing criticism for his new strategy in the face of declining company performance. Some investors were questioning Apotheker’s leadership. Unfortunately, the market is merciless and expects strong performance. This expectation exists even though a major strategic change along with a new structure and key management personnel in new jobs take time to produce fruitful results. Thus, a major requirement for Apotheker and all strategic leaders is to convince constituents of the efficacy of their strategy and changes so that he or she will be given enough time to bring them to fruition. Information leaked that Apotheker was considering layoffs to reduce costs and increase profits. Unfortunately such actions have a short-term focus and are unlikely to help the firm reclaim an innovation culture. And, because of these problems, Apotheker was replaced by the board with Meg Whitman in September 2011.
As the Opening Case implies, strategic leaders’ work is demanding, challenging, and requires balancing short-term performance with long-term goals. Regardless of how long (or short) they remain in their positions, strategic leaders (and most prominently CEOs) can make a major difference in how a firm performs. If a strategic leader can create a strategic vision for the firm using forward thinking, she may be able to energize the firm’s human capital and achieve positive outcomes. However, the challenge of strategic leadership is significant. For example, replacing Mark Hurd as CEO of HP was difficult, even though HP likely needed new leadership at the time. Although Apotheker’s strategy to refocus on HP’s innovation culture appeared to have value, making these changes while simultaneously maintaining short-term performance proved to be highly challenging. Thus HP’s Board named Meg Whitman to replace Apotheker as the CEO.

A major message in this chapter is that effective strategic leadership is the foundation for successfully using the strategic management process. As is implied in Figure 1.1 (on page 5), strategic leaders guide the firm in ways that result in forming a vision and mission (see Chapter 1). Often, this guidance finds leaders thinking of ways to create goals that stretch everyone in the organization to improve performance. Moreover, strategic leaders facilitate the development of appropriate strategic actions and determine how to implement them. As we show in Figure 12.1, these actions are the path to strategic competitiveness and above-average returns.

We begin this chapter with a definition of strategic leadership; we then discuss its importance as a potential source of competitive advantage as well as effective strategic leadership styles. Next, we examine top management teams and their effects on innovation, strategic change, and firm performance. Following this discussion, we analyze the internal and external managerial labor markets from which strategic leaders are selected. Closing the chapter are descriptions of the five key components of effective strategic leadership: determining a strategic direction, effectively managing the firm’s resource portfolio (which includes exploiting and maintaining core competencies along with developing human capital and social capital), sustaining an effective organizational culture, emphasizing ethical practices, and establishing balanced organizational controls.

**Strategic Leadership and Style**

Strategic leadership is the ability to anticipate, envision, maintain flexibility, and empower others to create strategic change as necessary. Multifunctional in nature, strategic leadership involves managing through others, managing an entire enterprise rather than a functional subunit, and coping with change that continues to increase in the global economy. Because of the global economy’s complexity, strategic leaders must learn how to effectively influence human behavior, often in uncertain environments. By word or by personal example, and through their ability to envision the future, effective strategic leaders meaningfully influence the behaviors, thoughts, and feelings of those with whom they work.

The ability to attract and then manage human capital may be the most critical of the strategic leader’s skills, especially because the lack of talented human capital constrains...
firm growth. Increasingly, leaders throughout the global economy possess or are developing this skill. Some believe, for example, that leaders now surfacing in Chinese companies understand the rules of competition in market-based economies and are leading in ways that will develop their firm’s human capital.  

In the twenty-first century, intellectual capital that the firm’s human capital possesses, including the ability to manage knowledge and create and commercialize innovation, affects a strategic leader’s success. Effective strategic leaders also establish the context through which stakeholders (such as employees, customers, and suppliers) can perform at peak efficiency. Being able to demonstrate these skills is important, given that the crux of strategic leadership is the ability to manage the firm’s operations effectively and sustain high performance over time.

A firm’s ability to achieve a competitive advantage and earn above-average returns is compromised when strategic leaders fail to respond appropriately and quickly to changes in the complex global competitive environment. The inability to respond or to identify
the need for change in the competitive environment is one of the reasons some CEOs fail. Although Mark Hurd was replaced as CEO of HP for questionable practices, his replacement felt that HP’s former innovation culture needed to be revived in order to respond effectively to the rapidly changing technology environment (described in the Opening Case). The new HP CEO implied that HP had not kept pace with technology development or its competitors. Therefore, strategic leaders must learn how to deal with diverse and complex environmental situations. Individual judgment is an important part of learning about and analyzing the firm’s competitive environment. In particular, effective strategic leaders build strong ties with external stakeholders to gain access to information and advice on the events in the external environment.

The primary responsibility for effective strategic leadership rests at the top, in particular with the CEO. Other commonly recognized strategic leaders include members of the board of directors, the top management team, and divisional general managers. In truth, any individual with responsibility for the performance of human capital and/or a part of the firm (e.g., a production unit) is a strategic leader. Regardless of their title and organizational function, strategic leaders have substantial decision-making responsibilities that cannot be delegated. Strategic leadership is a complex but critical form of leadership. Strategies cannot be formulated and implemented for the purpose of achieving above-average returns without effective strategic leaders.

The styles used to provide leadership often affect the productivity of those being led. Transformational leadership is the most effective strategic leadership style. This style entails motivating followers to exceed the expectations others have of them, to continuously enrich their capabilities, and to place the interests of the organization above their own. Transformational leaders develop and communicate a vision for the organization and formulate a strategy to achieve the vision. They make followers aware of the need to achieve valued organizational outcomes and encourage them to continuously strive for higher levels of achievement. These types of leaders have a high degree of integrity (Ray Kroc, founder of McDonald’s, was a strategic leader valued for his high degree of integrity) and character. Speaking about character, one CEO said the following: “Leaders are shaped and defined by character. Leaders inspire and enable others to do excellent work and realize their potential. As a result, they build successful, enduring organizations.” Additionally, transformational leaders have emotional intelligence. Emotionally intelligent leaders understand themselves well, have strong motivation, are empathetic with others, and have effective interpersonal skills. As a result of these characteristics, transformational leaders are especially effective in promoting and nurturing innovation in firms.

The Role of Top-Level Managers

Top-level managers play a critical role in that they are charged to make certain their firm is able to effectively formulate and implement strategies. Top-level managers’ strategic decisions influence how the firm is designed and goals will be achieved. Thus, a critical element of organizational success is having a top management team with superior managerial skills.

Managers often use their discretion (or latitude for action) when making strategic decisions, including those concerned with effectively implementing strategies. Managerial discretion differs significantly across industries. The primary factors that determine the amount of decision-making discretion held by a manager (especially a top-level manager) are (1) external environmental sources such as the industry structure, the rate of market growth in the firm’s primary industry, and the degree to which products can be differentiated; (2) characteristics of the organization, including its size, age, resources, and culture; and (3) characteristics of the manager, including commitment to the firm and its strategic outcomes, tolerance for ambiguity, skills in working
with different people, and aspiration levels (see Figure 12.2). Because strategic leaders’
decisions are intended to help the firm gain a competitive advantage, how managers
exercise discretion when determining appropriate strategic actions is critical to the firm’s
success.22

In addition to determining new strategic initiatives, top-level managers develop a
firm’s organizational structure and reward systems. Top executives also have a major
effect on a firm’s culture. Evidence suggests that managers’ values are critical in shaping
a firm’s cultural values.23 Accordingly, top-level managers have an important effect on
organizational activities and performance.24 Because of the challenges top executives face,
they often are more effective when they operate as top management teams.

**Top Management Teams**

In most firms, the complexity of challenges and the need for substantial amounts of
information and knowledge require strategic leadership by a team of executives. Using
a team to make strategic decisions also helps to avoid another potential problem when
these decisions are made by the CEO alone: managerial hubris. Research evidence shows
that when CEOs begin to believe glowing press accounts and to feel that they are unlikely
to make errors, they are more likely to make poor strategic decisions.25 Top executives

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**Figure 12.2** Factors Affecting Managerial Discretion

*Managerial Discretion*

**External Environment**
- Industry structure
- Rate of market growth
- Number and type of competitors
- Nature and degree of political/legal constraints
- Degree to which products can be differentiated

**Characteristics of the Organization**
- Size
- Age
- Culture
- Availability of resources
- Patterns of interaction among employees

**Characteristics of the Manager**
- Tolerance for ambiguity
- Commitment to the firm and its desired strategic outcomes
- Interpersonal skills
- Aspiration level
- Degree of self-confidence

need to have self-confidence but must guard against allowing it to become arrogance and a false belief in their own invincibility. To guard against CEO overconfidence and poor strategic decisions, firms often use the top management team to consider strategic opportunities and problems and to make strategic decisions. The top management team is composed of the key individuals who are responsible for selecting and implementing the firm’s strategies. Typically, the top management team includes the officers of the corporation, defined by the title of vice president and above or by service as a member of the board of directors. The quality of the strategic decisions made by a top management team affects the firm’s ability to innovate and engage in effective strategic change.

Top Management Team, Firm Performance, and Strategic Change

The job of top-level executives is complex and requires a broad knowledge of the firm’s operations, as well as the three key parts of the firm’s external environment—the general, industry, and competitor environments, as discussed in Chapter 2. Therefore, firms try to form a top management team with knowledge and expertise needed to operate the internal organization, yet that also can deal with all the firm’s stakeholders as well as its competitors. To have these characteristics normally requires a heterogeneous top management team. A heterogeneous top management team is composed of individuals with different functional backgrounds, experience, and education.

Members of a heterogeneous top management team benefit from discussing the different perspectives advanced by team members. In many cases, these discussions increase the quality of the team’s decisions, especially when a synthesis emerges within the team after evaluating the diverse perspectives. The net benefit of such actions by heterogeneous teams has been positive in terms of market share and above-average returns. Research shows that more heterogeneity among top management team members promotes debate, which often leads to better strategic decisions. In turn, better strategic decisions produce higher firm performance.

It is also important for top management team members to function cohesively. In general, the more heterogeneous and larger the top management team is, the more difficult it is for the team to effectively implement strategies. Comprehensive and long-term strategic plans can be inhibited by communication difficulties among top executives who have different backgrounds and different cognitive skills. Alternatively, communication among diverse top management team members can be facilitated through electronic communications, sometimes reducing the barriers before face-to-face meetings. However, a group of top executives with diverse backgrounds may inhibit the process of decision making if it is not effectively managed. In these cases, top management teams may fail to comprehensively examine threats and opportunities, leading to a suboptimal strategic decision. Thus, the CEO must attempt to achieve behavioral integration among the team members.

Having members with substantive expertise in the firm’s core functions and businesses is also important to a top management team’s effectiveness. In a high-technology industry, it may be critical for a firm’s top management team members to have R&D expertise, particularly when growth strategies are being implemented. Yet their eventual effect on strategic decisions depends not only on their expertise and the way the team is managed but also on the context in which they make the decisions (the governance structure, incentive compensation, etc.).

The characteristics of top management teams and even the personalities of the CEO and other team members are related to innovation and strategic change. For example, more heterogeneous top management teams are positively associated with innovation and strategic change. The heterogeneity may force the team or some of its members to "think outside of the box" and thus be more creative in making decisions.

Therefore, firms that need to change their strategies are more likely to do so if they have top management teams with diverse backgrounds and expertise. When a new CEO is hired from outside the industry, the probability of strategic change is greater than...
if the new CEO is from inside the firm or inside the industry. 41 Also, there can sometimes be significant change if the new CEO is from outside the firm but from within the industry. The Opening Case suggests that HP’s new CEO, who had experience at SAP, is making major changes in the direction of HP. Although hiring a new CEO from outside the industry adds diversity to the team, the top management team must be managed effectively to use the diversity in a positive way. Thus, to successfully create strategic change, the CEO should exercise transformational leadership to shape the new capabilities needed for implementation of the change. 42 A top management team with various areas of expertise is more likely to identify environmental changes (opportunities and threats) or changes within the firm, suggesting the need for a different strategic direction.

In the current competitive environment, an understanding of international markets is vital. However, recent research suggests that only about 15 percent of the top executives in Fortune 500 firms have global leadership expertise. 43 Executives generally gain this knowledge by working in one of the firm’s international subsidiaries but can also gain some knowledge by working with international alliance partners. 44

**The CEO and Top Management Team Power**

As noted in Chapter 10, the board of directors is an important governance mechanism for monitoring a firm’s strategic direction and for representing stakeholders’ interests, especially those of shareholders. 45 In fact, higher performance normally is achieved when the board of directors is more directly involved in shaping a firm’s strategic direction. 46

Boards of directors, however, may find it difficult to direct the strategic actions of powerful CEOs and top management teams. 47 Often, a powerful CEO appoints a number of sympathetic outside members to the board or may have inside board members who are also on the top management team and report to her or him. 48 In either case, the CEO may significantly influence the board’s actions. Thus, the amount of discretion a CEO has in making strategic decisions is related to the board of directors and how it chooses to oversee the actions of the CEO and the top management team. 49

CEOs and top management team members can achieve power in other ways. A CEO who also holds the position of chairperson of the board usually has more power than the CEO who does not. 50 Some analysts and corporate "watchdogs" criticize the practice of CEO duality (when the CEO and the chairperson of the board are the same) because it can lead to poor performance and slow response to change, partly because the board engages in less monitoring of the CEO’s decisions and actions. 51

Although it varies across industries, CEO duality occurs most commonly in larger firms. Increased shareholder activism, however, has brought CEO duality under scrutiny and attack in both U.S. and European firms. As reported in Chapter 10, an independent board leadership structure in which the same person did not hold the positions of CEO and chair is commonly believed to enhance a board’s ability to monitor top-level managers’ decisions and actions, particularly with respect to financial performance. 52 On the other hand, if a CEO acts as a steward, holding the dual roles facilitates effective decisions and actions. In these instances, the increased effectiveness gained through CEO duality accrues from the individual who wants to perform effectively and desires to be the best possible steward of the firm’s assets. Because of this person’s positive orientation and actions, extra governance and the coordination costs resulting from an independent board leadership structure would be unnecessary. 53

Top management team members and CEOs who have long tenure—on the team and in the organization—have a greater influence on board decisions. CEOs with greater influence may take actions in their own best interests, the outcomes of which increase their compensation from the company. 54 As reported in Chapter 10, many people are angry about excessive top executive compensation, especially during poor economic times when others are losing their jobs because of ineffective strategic decisions made by the same managers.
In general, long tenure is thought to constrain the breadth of an executive’s knowledge base. Some evidence suggests that with the limited perspectives associated with a restricted knowledge base, long-tenured top executives typically develop fewer alternatives to evaluate in making strategic decisions. However, long-tenured managers also may be able to exercise more effective strategic control, thereby obviating the need for board members’ involvement because effective strategic control generally produces higher performance. Intriguingly, recent findings suggest that “the liabilities of short tenure … appear to exceed the advantages, while the advantages of long tenure—firm-specific human and social capital, knowledge, and power—seem to outweigh the disadvantages of rigidity and maintaining the status quo.” Overall then the relationship between CEO tenure and firm performance is complex, indicating that to strengthen the firm, boards of directors should develop an effective relationship with the top management team.

In summary, the relative degrees of power held by the board and top management team members should be examined in light of an individual firm’s situation. For example, the abundance of resources in a firm’s external environment and the volatility of that environment may affect the ideal balance of power between the board and the top management teams. Moreover, a volatile and uncertain environment may create a situation where a powerful CEO is needed to move quickly, but a diverse top management team may create less cohesion among team members and prevent or stall necessary strategic actions. With effective working relationships, boards, CEOs, and other top management team members have the foundation required to select arrangements with the highest probability of best serving stakeholders’ interests.

Managerial Succession

The choice of top executives—especially CEOs—is a critical decision with important implications for the firm’s performance. Many companies use leadership screening systems to identify individuals with managerial and strategic leadership potential as well as to determine the criteria individuals should satisfy to be candidates for the CEO position.

The most effective of these systems assesses people within the firm and gains valuable information about the capabilities of other companies’ managers, particularly their strategic leaders. Based on the results of these assessments, training and development programs are provided for current individuals in an attempt to preselect and shape the skills of people who may become tomorrow’s leaders. Because of the quality of its programs, General Electric “is famous for developing leaders who are dedicated to turning imaginative ideas into leading products and services.” However, there are many companies that do not have succession plans for their top executives. For example, a recent survey found that 43 percent of the largest public companies in the United States had no formal succession plan for their CEOs. Of those companies with plans, only about 20 percent were satisfied with their succession processes.

Organizations select managers and strategic leaders from two types of managerial labor markets—internal and external. An "internal managerial labor market" consists of a firm’s opportunities for managerial positions and the qualified employees within that firm. An "external managerial labor market" is the collection of managerial career opportunities and the qualified people who are external to the organization in which the opportunities exist.
managerial career opportunities and the qualified people who are external to the organization in which the opportunities exist.

Several benefits are thought to accrue to a firm when the internal labor market is used to select an insider as the new CEO. Because of their experience with the firm and the industry environment in which it competes, insiders are familiar with company products, markets, technologies, and operating procedures. Also, internal hiring produces lower turnover among existing personnel, many of whom possess valuable firm-specific knowledge. When the firm is performing well, internal succession is favored to sustain high performance. It is assumed that hiring from inside keeps the important knowledge necessary to sustain performance.

Results of work completed by management consultant Jim Collins support the value of using the internal labor market when selecting a CEO. Collins found that high-performing firms almost always appoint an insider to be the new CEO. He argues that bringing in a well-known outsider, whom he refers to as a “white knight,” is a recipe for mediocrity.65 For example, given the phenomenal success of General Electric (GE) during Jack Welch’s tenure as CEO and the firm’s highly effective management and leadership development programs, insider Jeffrey Immelt was chosen to succeed Welch. However, shareholders have become disgruntled because GE’s stock values have decreased in recent years; GE has suffered along with many other firms in the global economic crisis. Thus, GE under Immelt’s leadership is not experiencing the returns achieved by his predecessor.

Employees commonly prefer the internal managerial labor market when selecting top management team members and a new CEO. In the past, companies have also had a preference for insiders to fill top-level management positions because of a desire for continuity and a continuing commitment to the firm’s current vision, mission, and chosen strategies.66 For example, Campbell Soup Company has had relatively stable leadership with only 12 CEOs since it was founded in 1869. This represents a CEO succession about every 12 years on average. And, the firm implemented a CEO succession in 2011 with the naming of insider Denise Morrison. Unfortunately, analysts are concerned about the lack of growth in the company and the firm’s stock price declined by approximately 8 percent when Morrison was announced as the new CEO. Analysts believed that major changes are required and that an insider is unlikely to make those changes.67

Because of a changing competitive landscape and varying levels of performance, an increasing number of boards of directors are turning to outsiders to succeed CEOs. A firm often has valid reasons to select an outsider as its new CEO. In some situations, long tenure with a firm may reduce strategic leaders’ level of commitment to pursue innovation. Given innovation’s importance to firm success (see Chapter 13), this hesitation could be a liability for a strategic leader. In Figure 12.3, we show how the composition of the top management team and the CEO succession (managerial labor market) interact to affect strategy. For example, when the top management team is homogeneous (its members have similar functional experiences and educational backgrounds) and a new CEO is selected from inside the firm, the firm’s current strategy is unlikely to change. Alternatively, when a new CEO is selected from outside the firm and the top management team is heterogeneous, the probability is high that strategy will change. When the new CEO is from inside the firm and a heterogeneous top management team is in place, the strategy may not change, but innovation is likely to continue. An external CEO succession with a homogeneous team creates a more ambiguous situation. Furthermore, outside CEOs who lead moderate change often achieve increases in performance, but high strategic change by outsiders frequently leads to declines in performance.68

When firms do not have a formal managerial succession plan, they sometimes will appoint an interim CEO until a new CEO is identified and in place.69 The advantage of using an interim CEO is that it allows adequate time to do a thorough search to find the best candidate. Most interim CEOs perform the basic functions and keep the organization operating; however, they rarely will make major strategic decisions. Therefore, interim CEOs are generally only used when the CEO departs unexpectedly and abruptly.
Succession plans are very important to maintain the desired course for the firm when there is a change in the CEO. Yet, the Strategic Focus suggests that only slightly more than one-third of the companies are prepared for a succession of the CEO. Because of the importance of the CEO position and the influence CEOs have on the firm’s stock price (e.g., Steve Jobs at Apple), investors have been placing increasing pressure on boards to develop formal succession plans for the top management positions. As noted in the Strategic Focus, formal succession plans often call for the use of external executive search firms (sometimes referred to as headhunters). Research suggests that executive search firms primarily target executives in large, reputable, and high-performing firms but these firms also identify the executives to target, largely based on their job title instead of known capabilities or individual performance. The executives who agree to be candidates in the search frequently have less tenure and experience and hold positions in less successful firms. Therefore, executive search firms may not always provide the best pool of candidates.

Including talent from all parts of both the internal and external labor markets increases the likelihood that the firm will be able to form an effective top-management team. Evidence suggests that women are a qualified source of talent as strategic leaders that have been somewhat overlooked. In light of the success of a growing number of female executives, the foundation for change may be established. Trailblazers such as Catherine Elizabeth Hughes (the first African-American woman to head a firm that was publicly traded on a U.S. stock exchange), Muriel Siebert (the first woman to purchase a seat on the New York Stock Exchange), and publisher Judith Regan have made important contributions as strategic leaders. Recent years have produced several prominent female CEOs, such as Anne Mulcahy (Xerox Corporation), Meg Whitman (eBay and HP), and Andrea Jung (Avon Products). As noted in the following Strategic Focus, perhaps the next CEO of IBM will be a woman (Virginia Rometty).

Managerial talent is critical to a firm’s success, and one area in which managerial talent is crucial is in the integration of an acquired firm into the acquiring business. In fact, the top management team of an acquired firm is vital to a successful integration process because they play a critical role in helping the change be implemented and accepted by the acquired firm’s employees. However, it is common for there to be major turnover among the top management team of acquired firms. Sometimes it occurs because the acquiring firm unwisely replaces them. In other cases, the managers depart voluntarily...
Can the replacement for Steve Jobs, the highly successful former CEO of Apple, Tim Cook, be equally successful? It will be very difficult to do so. In fact, the stock market does not seem to think so. When Steve Jobs announced his retirement and the new CEO, the price of Apple’s stock declined. Likewise, can IBM’s successful CEO, Sam Palmisano, be replaced successfully. Because IBM’s CEOs have a tradition of retiring when they are 60, Palmisano is expected to retire in 2012. There are several potential successors but the most likely is Virginia Rometty, who heads IBM’s sales unit.

Investor groups pressured Apple’s board to develop a formal succession plan for Steve Jobs because in 2011 he was on his third medical leave. This caused considerable angst among investors. The board did not want to name formal successors because the members wanted Jobs back and also believed that he was very important to Apple’s success. Jobs turned 56 in 2011 but his age was not the concern; it was his illnesses that created worry. Despite his third leave of absence, Jobs proclaimed that he would participate in all major strategic decisions. Even the laborers’ union pushed Apple for a succession plan. The delay in communicating a succession plan coupled with Jobs eventual resignation as CEO did not inspire confidence among the various groups concerned about the loss of Jobs.

Alternatively, IBM seems to be in much better position for a smooth transition of CEOs. There are at least three candidates for the CEO position when vacated by Palmisano. They are Rometty, mentioned earlier; Michael Daniels, head of the Global Services unit; and Rodney Adkins, senior vice president of hardware. All three have demonstrated their capabilities with strong performances in their respective units. In addition, Palmisano has established a strong plan of action through 2015. For example, the plan calls for generating 30 percent of IBM’s total annual revenue from emerging markets by 2015. The plan also calls for $7 billion in annual cloud revenue and $16 billion in annual business analytics revenue within the same time period. As such, the next CEO only needs to continue efforts already launched.

Interestingly, CEO turnover among the 2,500 largest public companies in the world declined in 2010. However, this is clouded by the fact that more emerging market firms (including many from China) have been added to the list and they have low turnover among their CEOs. Therefore, there is still considerable CEO turnover in North American and European firms. As such, they have a greater need for succession planning. Selecting successors for the CEO and other officer positions is the responsibility of the board of directors. Boards have come under increasing pressure to develop formal succession plans, especially for the CEO position. However, recent surveys suggest that only about 35 percent of them are prepared for a departure of their CEO. Most formal plans begin with the purposeful development of internal candidates. The better plans also have preparations to replace the CEO in emergency situations (e.g., the CEO dies unexpectedly). Many formal plans call for the use of executive search firms, assuming that external searches are implemented.

Baker Hughes has a formal succession plan. In accordance with the plan, it announced in 2011 that its current CEO and chairman, Chad Deaton, would undertake the new role of executive chairman.
and that Martin Craighead would become president and chief executive officer. Likewise, Howard Stringer, CEO of Sony, has been grooming four potential successors. In 2011, he promoted one of them, Kazuo Hirai, to be his top manager reporting directly to him. Thus, it appears that Sony has also chosen its CEO successor.


Key Strategic Leadership Actions

Certain actions characterize effective strategic leadership; we present the most important ones in Figure 12.4. Many of the actions interact with each other. For example, managing the firm’s resources effectively includes developing human capital and contributes to establishing a strategic direction, fostering an effective culture, exploiting core competencies, using effective organizational control systems, and establishing ethical practices. The most effective strategic leaders create viable options in making decisions regarding each of the key strategic leadership actions.74

Determining Strategic Direction

Determining strategic direction involves specifying the vision and the strategy to achieve this vision over time.75 The strategic direction is framed within the context of the conditions (i.e., opportunities and threats) strategic leaders expect their firm to face in roughly the next three to five years.

The ideal long-term strategic direction has two parts: a core ideology and an envisioned future. The core ideology motivates employees through the company’s heritage, but the envisioned future encourages employees to stretch beyond their expectations of accomplishment and requires significant change and progress to be realized.76 The envisioned future serves as a guide to many aspects of a firm’s strategy implementation process, including motivation, leadership, employee empowerment, and organizational design. The strategic direction could include such actions as entering new international markets and developing a set of new suppliers to add to the firm’s value chain.77

Most changes in strategic direction are difficult to design and implement; however, CEO Jeffrey Immelt had an even greater challenge at GE. GE performed exceptionally well under Jack Welch’s leadership. Although change was necessary because the competitive landscape had shifted significantly, stakeholders accustomed to Jack Welch and high performance had problems accepting Immelt’s changes (e.g., changes to the firm’s corporate-level strategy and structure). As explained in the Strategic Focus, it is difficult following successful leaders such as Jack Welch, Steve Jobs (Apple), and Sam Palmisano (IBM). Additionally, information regarding the firm’s strategic direction must be consistently and clearly communicated to all affected parties.78
Some strategic leaders, however, may not choose the best strategy for the firm to follow given its competitive environment. For example, some executives are committed to the status quo. This risk-averse stance is common in firms that have performed well in the past and for CEOs who have been in their jobs for extended periods of time. Research also suggests that some CEOs are erratic or even ambivalent in their choices of strategic direction, especially when their competitive environment is turbulent and it is difficult to identify the best strategy. Of course, these behaviors are unlikely to produce high performance and may then lead to CEO turnover. Interestingly, research has found that incentive compensation in the form of stock options encourages talented executives to select the best strategies and thus achieve the highest performance. However, the same incentives used with less talented executives produce lower performance.

A charismatic CEO may foster stakeholders’ commitment to a new vision and strategic direction. Nonetheless, it is important not to lose sight of the organization’s strengths and weaknesses when making changes required by a new strategic direction. The firm must take advantage of resource strengths and overcome or avoid actions requiring capabilities in areas where the firm is weak. To do this requires that top managers develop the capability to analyze complex conditions and understand the interrelationships that exist in order to design the most effective strategy. In the current global competitive landscape, top managers also need to be ambicultural. In other words, they need to be able to identify the best managerial and strategic practices regardless of their cultural origin and meld them to create the best strategic approach for their firm wherever they operate across the globe. The goal is to pursue the firm’s short-term need to adjust to a new vision and strategic direction while maintaining its long-term survivability by effectively managing its portfolio of resources.

**Effectively Managing the Firm’s Resource Portfolio**

Effectively managing the firm’s portfolio of resources may be the most important strategic leadership task. The firm’s resources are categorized as financial capital, human capital, social capital, and organizational capital (including organizational culture).

Clearly, financial capital is critical to organizational success; strategic leaders understand this reality. However, the most effective strategic leaders recognize the equivalent importance of managing each remaining type of resource as well as managing the...
integration of resources (e.g., using financial capital to provide training opportunities to enhance the capabilities embedded in human capital). Most importantly, effective strategic leaders manage the firm’s resource portfolio by organizing the resources into capabilities, structuring the firm to facilitate using those capabilities, and choosing strategies through which the capabilities are successfully leveraged to create value for customers. Exploiting and maintaining core competencies and developing and retaining the firm’s human and social capital are actions taken to reach these important objectives.

Exploiting and Maintaining Core Competencies
Examined in Chapters 1 and 3, core competencies are capabilities that serve as a source of competitive advantage for a firm over its rivals. Typically, core competencies relate to an organization’s functional skills, such as manufacturing, finance, marketing, and research and development. Strategic leaders must verify that the firm’s competencies are emphasized when implementing strategies. Intel, for example, has core competencies of competitive agility (an ability to act in a variety of competitively relevant ways) and competitive speed (an ability to act quickly when facing environmental and competitive pressures). Capabilities are developed over time as firms learn from their actions and enhance their knowledge about specific actions needed. For example, through repeated interactions, some firms have formed a capability allowing them to fully understand customers’ needs as they change. Firms with capabilities in R&D that develop into core competencies are rewarded by the market because of the critical nature of innovation in many industries. To continuously develop current competencies and build new ones, firms create a dynamic capability.

Given the need for transformation, GM’s newest CEO, Dan Akerson, is investing to build new capabilities in technology development and in marketing, especially in customer service. His intent is to develop these into the new core competencies of GM. Using the dynamic capability described earlier, firms must continuously develop and, when appropriate, change their core competencies to outperform rivals. If they have a competence that provides an advantage, competitors will eventually imitate that competence and reduce or eliminate the firm’s competitive advantage. Additionally, firms must guard against the competence becoming a liability, thereby preventing change.

As we discuss next, human capital is critical to a firm’s success. One reason it’s so critical is that human capital is the resource through which core competencies are developed and used.

Developing Human Capital and Social Capital
Human capital refers to the knowledge and skills of a firm’s entire workforce. From the perspective of human capital, employees are viewed as a capital resource requiring continuous investment. Investments made to acquire and develop high-quality human capital are productive, in that much of the development of U.S. industry can be attributed to the effectiveness of its human resources. This fact suggests that “as the dynamics of competition accelerate, people are perhaps the only truly sustainable source of competitive advantage.” In all types of organizations—large and small, new and established, and so forth—human capital’s increasing importance suggests a significant role for the firm’s human resource management activities. As a support activity (see Chapter 3), human resource
management practices facilitate people’s efforts to successfully select and especially to use the firm’s strategies.96

Effective training and development programs increase the probability of individuals becoming successful strategic leaders.97 These programs are increasingly linked to firm success as knowledge becomes more integral to gaining and sustaining a competitive advantage.98 Additionally, such programs build knowledge and skills, inculcate a common set of core values, and offer a systematic view of the organization, thus promoting the firm’s vision and organizational cohesion.

Effective training and development programs also contribute positively to the firm’s efforts to form core competencies.99 Furthermore, they help strategic leaders improve skills that are critical to completing other tasks associated with effective strategic leadership, such as determining the firm’s strategic direction, exploiting and maintaining the firm’s core competencies, and developing an organizational culture that supports ethical practices. Thus, building human capital is vital to the effective execution of strategic leadership. Indeed, some argue that the world’s “best companies are realizing that no matter what business they’re in, their real business is building leaders.”100

When human capital investments are successful, the result is a workforce capable of learning continuously. Continuous learning and leveraging the firm’s expanding knowledge base are linked with strategic success.101

Learning also can preclude making errors. Strategic leaders tend to learn more from their failures than their successes because they sometimes make the wrong attributions for the successes.102 For example, the effectiveness of certain approaches and knowledge can be context specific. Thus, some “best practices” may not work well in all situations. We know that using teams to make decisions can be effective, but sometimes it is better for leaders to make decisions alone, especially when the decisions must be made and implemented quickly (e.g., in crisis situations).103 As such, effective strategic leaders recognize the importance of learning from success and from failure.

Learning and building knowledge are important for creating innovation in firms. Innovation leads to competitive advantage. Overall, firms that create and maintain greater knowledge usually achieve and maintain competitive advantages. However, as noted with core competencies, strategic leaders must guard against allowing high levels of knowledge in one area to lead to myopia and overlooking knowledge development opportunities in other important areas of the business.

When facing challenging conditions, firms sometimes decide to lay off some of their human capital. Strategic leaders must recognize though that layoffs can result in a significant loss of the knowledge possessed by the firm’s human capital. Research shows that moderate-sized layoffs may improve firm performance, but large layoffs produce stronger performance downturns in firms because of the loss of human capital.104 Although it is also not uncommon for restructuring firms to reduce their expenditures on or investments in training and development programs, restructuring may actually be an important time to increase investments in these programs. The reason for increased focus on training and development is that restructuring firms have less slack and cannot absorb as many errors; moreover, the employees who remain after layoffs may find themselves in positions without all the skills or knowledge they need to perform the required tasks effectively.

Viewing employees as a resource to be maximized rather than as a cost to be minimized facilitates successful implementation of a firm’s strategies, as does the strategic leader’s ability to approach layoffs in a manner that employees believe is fair and equitable. A critical issue for employees is the fairness in the layoffs and how they are treated in their jobs, especially relative to their peers.105
Social capital involves relationships inside and outside the firm that help the firm accomplish tasks and create value for customers and shareholders. Social capital is a critical asset for a firm. Inside the firm, employees and units must cooperate to get the work done. In multinational organizations, employees often must cooperate across country boundaries on activities such as R&D to achieve performance objectives (e.g., developing new products).

External social capital is increasingly critical to firm success. The reason for this is that few if any companies have all of the resources they need to successfully compete against their rivals. Firms can use cooperative strategies such as strategic alliances (see Chapter 9) to develop social capital. Social capital can be built in strategic alliances as firms share complementary resources. Resource sharing must be effectively managed, though, to ensure that the partner trusts the firm and is willing to share the desired resources. This social capital has many benefits. For example, firms with strong social capital are able to be more ambidextrous; that is, they can develop or have access to multiple capabilities providing them with the flexibility to take advantage of opportunities identified and to respond to significant challenges encountered.

Research evidence suggests that the success of many types of firms may partially depend on social capital. Large multinational firms often must establish alliances in order to enter new foreign markets. Likewise, entrepreneurial firms often must establish alliances to gain access to resources, venture capital, or other types of resources (e.g., special expertise that the entrepreneurial firm cannot afford to maintain in-house). Retaining quality human capital and maintaining strong internal social capital can be affected strongly by the firm’s culture.

Sustaining an Effective Organizational Culture

In Chapter 1, we defined organizational culture as a complex set of ideologies, symbols, and core values that are shared throughout the firm and influence the way business is conducted. Evidence suggests that a firm can develop core competencies in terms of both the capabilities it possesses and the way the capabilities are leveraged when implementing strategies to produce desired outcomes. In other words, because the organizational culture influences how the firm conducts its business and helps regulate and control employees’ behavior, it can be a source of competitive advantage. Given its importance, it may be that a vibrant organizational culture is the most valuable competitive differentiator for business organizations. Thus, shaping the context within which the firm formulates and implements its strategies—that is, shaping the organizational culture—is an essential strategic leadership action.

Entrepreneurial Mind-Set

Especially in large organizations, an organizational culture often encourages (or discourages) strategic leaders from pursuing (or not pursuing) entrepreneurial opportunities. This issue is important because entrepreneurial opportunities are a vital source of growth and innovation. Therefore, a key role of strategic leaders is to encourage and promote innovation by pursuing entrepreneurial opportunities.

One way to encourage innovation is to invest in opportunities as real options—that is, invest in an opportunity in order to provide the potential option of taking advantage of the opportunity at some point in the future. For example, a firm might buy a piece of land to have the option to build on it at some time in the future should the company need more space and should that location increase in value to the company. Firms might enter strategic alliances for similar reasons. In this instance, a firm might form an alliance to have the option of acquiring the partner later or of building a stronger relationship with it (e.g., developing a joint new venture).

In Chapter 13, we describe how large firms use strategic entrepreneurship to pursue entrepreneurial opportunities and to gain first-mover advantages. Small and medium-sized firms also rely on strategic entrepreneurship when trying to develop innovations as
the foundation for profitable growth. In firms of all sizes, strategic entrepreneurship is more likely to be successful when employees have an entrepreneurial mind-set.119

Five dimensions characterize a firm’s entrepreneurial mind-set: autonomy, innovativeness, risk taking, proactiveness, and competitive aggressiveness.120 In combination, these dimensions influence the actions a firm takes to be innovative and launch new ventures.

Autonomy, the first of an entrepreneurial orientation’s five dimensions, allows employees to take actions that are free of organizational constraints and permits individuals and groups to be self-directed. The second dimension, innovativeness, “reflects a firm’s tendency to engage in and support new ideas, novelty, experimentation, and creative processes that may result in new products, services, or technological processes.”121 Cultures with a tendency toward innovativeness encourage employees to think beyond existing knowledge, technologies, and parameters to find creative ways to add value. Risk taking reflects a willingness by employees and their firm to accept risks when pursuing entrepreneurial opportunities. Assuming significant levels of debt and allocating large amounts of other resources (e.g., people) to projects that may not be completed are examples of these risks. The fourth dimension of an entrepreneurial orientation, proactiveness, describes a firm’s ability to be a market leader rather than a follower. Proactive organizational cultures constantly use processes to anticipate future market needs and to satisfy them before competitors learn how to do so. Finally, competitive aggressiveness is a firm’s propensity to take actions that allow it to consistently and substantially outperform its rivals.122

Changing the Organizational Culture and Restructuring
Changing a firm’s organizational culture is more difficult than maintaining it; however, effective strategic leaders recognize when change is needed. Incremental changes to the firm’s culture typically are used to implement strategies.123 More significant and sometimes even radical changes to organizational culture support selecting strategies that differ from those the firm has implemented historically. Regardless of the reasons for change, shaping and reinforcing a new culture requires effective communication and problem solving, along with selecting the right people (those who have the values desired for the organization), engaging in effective performance appraisals (establishing goals and measuring individual performance toward goals that fit in with the new core values), and using appropriate reward systems (rewarding the desired behaviors that reflect the new core values).124 As noted in the Opening Case, the new CEO at HP is trying to recapture the firm’s soul.

Evidence suggests that cultural changes succeed only when the firm’s CEO, other key top management team members, and middle-level managers actively support them.125 To effect change, middle-level managers in particular need to be highly disciplined to energize the culture and foster alignment with the strategic vision.126 In addition, managers must be sensitive to the effects of other major strategic changes on organizational culture. For example, major downsizings can have negative effects on an organization’s culture, especially if they are not implemented in accordance with the dominant organizational values.127

Emphasizing Ethical Practices
The effectiveness of processes used to implement the firm’s strategies increases when they are based on ethical practices. Ethical companies encourage and enable people at all organizational levels to act ethically when doing what is necessary to implement strategies. In turn, ethical practices and the judgment on which they are based create “social capital” in the organization, increasing the “goodwill available to individuals and groups” in the organization.128 Alternatively, when unethical practices evolve in an organization, they may become acceptable to many managers and employees.129 One study found that in these circumstances, managers were particularly likely to engage in unethical practices to meet their goals when current efforts to meet them were insufficient.130
To properly influence employees’ judgment and behavior, ethical practices must shape the firm’s decision-making process and must be an integral part of organizational culture. In fact, research evidence suggests that a value-based culture is the most effective means of ensuring that employees comply with the firm’s ethical requirements. As we explained in Chapter 10, managers may act opportunistically, making decisions that are in their own best interests but not in the firm’s best interests when facing lax expectations regarding ethical behavior. In other words, managers acting opportunistically take advantage of their positions, making decisions that benefit themselves to the detriment of the firm’s stakeholders. But strategic leaders are most likely to integrate ethical values into their decisions when the company has explicit ethics codes, the code is integrated into the business through extensive ethics training, and shareholders expect ethical behavior.

Firms should employ ethical strategic leaders—leaders who include ethical practices as part of their strategic direction for the firm, who desire to do the right thing, and for whom honesty, trust, and integrity are important. Strategic leaders who consistently display these qualities inspire employees as they work with others to develop and support an organizational culture in which ethical practices are the expected behavioral norms.

Strategic leaders can take several actions to develop an ethical organizational culture. Examples of these actions include (1) establishing and communicating specific goals to describe the firm’s ethical standards (e.g., developing and disseminating a code of conduct); (2) continuously revising and updating the code of conduct, based on inputs from people throughout the firm and from other stakeholders (e.g., customers and suppliers); (3) disseminating the code of conduct to all stakeholders to inform them of the firm’s ethical standards and practices; (4) developing and implementing methods and procedures to use in achieving the firm’s ethical standards (e.g., using internal auditing practices that are consistent with the standards); (5) creating and using explicit reward systems that recognize acts of courage (e.g., rewarding those who use proper channels and procedures to report observed wrongdoings); and (6) creating a work environment in which all people are treated with dignity. The effectiveness of these actions increases when they are taken simultaneously and thereby are mutually supportive. When strategic leaders and others throughout the firm fail to take actions such as these—perhaps because an ethical culture has not been created—problems are likely to occur.

As explained in the Strategic Focus, Alibaba experienced a significant problem with the fraud it discovered. The problem was made more serious because it was purposefully facilitated by some of its own employees, suggesting that the company was unable to prevent the unethical practices. Alibaba dealt with this perception by taking forceful actions in the resignations of its CEO and COO. Furthermore, it repaid those customers who lost money due to the fraud. And, it instituted new practices trying to ensure these problems do not reoccur. Hopefully, the firm’s actions will restore the trust in Alibaba’s practices so important to all firms but especially to e-commerce firms. As we discuss next, formal organizational controls can help prevent further problems and reinforce better ethical practices.

**Establishing Balanced Organizational Controls**

Organizational controls are basic to a capitalistic system and have long been viewed as an important part of strategy implementation processes. Controls are necessary to help ensure that firms achieve their desired outcomes. Defined as the “formal, information-based ... procedures used by managers to maintain or alter patterns in organizational activities,” controls help strategic leaders build credibility, demonstrate the value of strategies to the firm’s stakeholders, and promote and support strategic change. Most critically, controls provide the parameters for implementing strategies as well as the corrective actions to be taken when implementation-related adjustments are required. For example, Alibaba exercised control to identify and eliminate the fraud. Furthermore, it developed additional controls to prevent such actions from occurring again.
THE KEY TO E-COMMERCE IS TRUST: FRAUD AT ALIBABA

Jack Ma, founder of Alibaba, once said that the key to the success of e-commerce in China is trust. He was likely correct, and his firm garnered a fair amount of trust as it became the largest Internet company in China. In fact, Alibaba.com’s IPO on the Hong Kong stock exchange produced $1.7 billion—the second largest Internet IPO behind only Google. Alibaba accounts for 80 percent of all e-commerce in China, with gross sales volume of almost $60 billion in 2010. Alibaba has 57 million registered users globally and about 14 million of them are registered on its English language network.

Despite its success and Ma’s emphasis on trust and values, he announced in February that an internal investigation found fraudulent practices within the company. Essentially, approximately 2,300 sellers who pay Alibaba to sell their goods and services on its site defrauded customers (e.g., obtaining payments but never providing the goods to the buyers). These sellers received assistance from about 100 of the more than 5,000 sales associates employed by Alibaba. Overall, the sales amounted to approximately $6 million, only a small amount of Alibaba’s total business. However, all of the buyers defrauded were from outside of China, the primary set of customers targeted by Alibaba for China’s companies. Ma and Alibaba acted swiftly and forcefully when the investigation conclusively showed fraud. Alibaba’s CEO, David Wei, and COO, Elvis Lee, both resigned accepting blame for the unethical practices, even though they were not directly involved in the activities. In addition, Deng Kangming, chief of human resources, was demoted. These actions suggest the seriousness with which the firm judges these problems. Jonathan Lu, CEO of Taobao, another major company in the Alibaba group, was named CEO of Alibaba.com. Eventually, Chinese police arrested 36 individuals for the Alibaba.com fraudulent activity.

Now, Alibaba must work hard to reestablish the trust that Ma feels is so important for an e-commerce company. It is establishing practices to guard against further fraudulent activities. Furthermore, it is identifying the customers defrauded and repaying them the money that they lost in the transactions. The fraud is likely to slow Alibaba’s growth but most analysts suggest that the problems will be experienced only in the short term if the company takes the proper actions. Hopefully the firm can avoid such problems in the future.


In early 2011, Alibaba discovered that nearly 2,300 of its sales personnel had defrauded customers. The company is now working double time to regain the trust of its e-commerce customers.

In this chapter, we focus on two organizational controls—strategic and financial—that were introduced in Chapter 11. Strategic and financial controls are important because strategic leaders, especially those at the top of the organization, are responsible for their development and effective use.

As we explained in Chapter 11, financial control focuses on short-term financial outcomes. In contrast, strategic control focuses on the content of strategic actions rather
than their outcomes. Some strategic actions can be correct but still result in poor financial outcomes because of external conditions such as an economic recession, unexpected domestic or foreign government actions, or natural disasters. Therefore, emphasizing financial controls often produces more short-term and risk-averse managerial decisions, because financial outcomes may be caused by events beyond managers’ direct control. Alternatively, strategic control encourages lower-level managers to make decisions that incorporate moderate and acceptable levels of risk because outcomes are shared among the business-level executives making strategic proposals and the corporate-level executives evaluating them.

The challenge for strategic leaders is to achieve an appropriate balance of financial and strategic controls so that firm performance improves. The Balanced Scorecard is a tool that helps strategic leaders to evaluate the effectiveness of the controls used.

The Balanced Scorecard

The balanced scorecard is a framework firms can use to verify that they have established both strategic and financial controls to assess their performance. This technique is most appropriate for use in evaluating business-level strategies; however, it can also be used with the other strategies firms implement (e.g., corporate level, international, and cooperative).

The underlying premise of the balanced scorecard is that firms jeopardize their future performance when financial controls are emphasized at the expense of strategic controls. This occurs because financial controls provide feedback about outcomes achieved from past actions, but do not communicate the drivers of future performance. Thus, an overemphasis on financial controls may promote managerial behavior that sacrifices the firm’s long-term, value-creating potential for short-term performance gains. An appropriate balance of strategic controls and financial controls, rather than an overemphasis on either, allows firms to achieve higher levels of performance.

Four perspectives are integrated to form the balanced scorecard framework: financial (concerned with growth, profitability, and risk from the shareholders’ perspective), customer (concerned with the amount of value customers perceive was created by the firm’s products), internal business processes (with a focus on the priorities for various business processes that create customer and shareholder satisfaction), and learning and growth (concerned with the firm’s effort to create a climate that supports change, innovation, and growth). Thus, using the balanced scorecard framework allows the firm to understand how it responds to shareholders (financial perspective), how customers view it (customer perspective), the processes it must emphasize to successfully use its competitive advantage (internal perspective), and what it can do to improve its performance in order to grow (learning and growth perspective). Generally speaking, strategic controls tend to be emphasized when the firm assesses its performance relative to the learning and growth perspective, whereas financial controls are emphasized when assessing performance in terms of the financial perspective.

Firms use different criteria to measure their standing relative to the scorecard’s four perspectives. We show sample criteria in Figure 12.5. The firm should select the number of criteria that will allow it to have both a strategic understanding and a financial understanding of its performance without becoming immersed in too many details. For example, we know from research that a firm’s innovation, quality of its goods and services, growth of its sales, and its profitability are all interrelated.

Strategic leaders play an important role in determining a proper balance between strategic controls and financial controls, whether they are in single-business firms or large diversified firms. A proper balance between controls is important, in that “wealth creation for organizations where strategic leadership is exercised is possible because these leaders make appropriate investments for future viability [through strategic control], while maintaining an appropriate level of financial stability in the present [through financial control].” In fact, most corporate restructuring is designed to refocus the firm
on its core businesses, thereby allowing top executives to reestablish strategic control of their separate business units.148

Successfully using strategic control frequently is integrated with appropriate autonomy for the various subunits so that they can gain a competitive advantage in their respective markets.149 Strategic control can be used to promote the sharing of both tangible and intangible resources among interdependent businesses within a firm’s portfolio. In addition, the autonomy provided allows the flexibility necessary to take advantage of specific marketplace opportunities. As a result, strategic leadership promotes simultaneous use of strategic control and autonomy.150

The balanced scorecard is being used by car manufacturer Porsche. After this manufacturer of sought-after sports cars regained its market-leading position, it implemented a balanced scorecard approach in an effort to maintain this position. In particular, Porsche used the balanced scorecard to promote learning and continuously improve the business. For example, knowledge was collected from all Porsche dealerships throughout the world. The instrument used to collect the information was referred to as “Porsche Key Performance Indicators.” The fact that Porsche is now the world’s most profitable automaker suggests the value the firm gained and is gaining by using the balanced scorecard as a foundation for simultaneously emphasizing strategic and financial controls.151

As we have explained, strategic leaders are critical to a firm’s ability to successfully use all parts of the strategic management process. As described in the Strategic Focus, Jack Ma and his new CEO of Alibaba, Jonathan Lu, are acting as strategic leaders to achieve the appropriate balance of strategic and financial controls to create positive outcomes for all of a firm’s stakeholders.
Effective strategic leadership is a prerequisite to successfully using the strategic management process. Strategic leadership entails the ability to anticipate events, envision possibilities, maintain flexibility, and empower others to create strategic change.

Top-level managers are an important resource for firms to develop and exploit competitive advantages. In addition, when they and their work are valuable, rare, imperfectly imitable, and nonsubstitutable, strategic leaders are also a source of competitive advantage.

The top management team is composed of key managers who play a critical role in selecting and implementing the firm’s strategies. Generally, they are officers of the corporation and/or members of the board of directors.

The top management team’s characteristics, a firm’s strategies, and its performance are all interrelated. For example, a top management team with significant marketing and R&D knowledge positively contributes to the firm’s use of a growth strategy. Overall, having diverse skills increases most top management teams’ effectiveness.

Typically, performance improves when the board of directors is involved in shaping a firm’s strategic direction. However, when the CEO has a great deal of power, the board may be less involved in decisions about strategy formulation and implementation. By appointing people to the board and simultaneously serving as CEO and chair of the board, CEOs increase their power.

In managerial succession, strategic leaders are selected from either the internal or the external managerial labor market. Because of their effect on firm performance, selection of strategic leaders has implications for a firm’s effectiveness. There are a variety of reasons that companies select the firm’s strategic leaders from either internal or external sources. In most instances, the internal market is used to select the CEO; but the number of outsiders chosen is increasing. Outsiders often are selected to initiate major changes in strategy.

Effective strategic leadership has five major components: determining the firm’s strategic direction, effectively managing the firm’s resource portfolio (including exploiting and maintaining core competencies and managing human capital and social capital), sustaining an effective organizational culture, emphasizing ethical practices, and establishing balanced organizational controls.

Strategic leaders must develop the firm’s strategic direction. The strategic direction specifies the image and character the firm wants to develop over time. To form the strategic direction, strategic leaders evaluate the conditions (e.g., opportunities and threats in the external environment) they expect their firm to face over the next three to five years.

Strategic leaders must ensure that their firm exploits its core competencies, which are used to produce and deliver products that create value for customers, when implementing its strategies. In related diversified and large firms in particular, core competencies are exploited by sharing them across units and products.

The ability to manage the firm’s resource portfolio and manage the processes used to effectively implement the firm’s strategy are critical elements of strategic leadership. Managing the resource portfolio includes integrating resources to create capabilities and leveraging those capabilities through strategies to build competitive advantages. Human capital and social capital are perhaps the most important resources.

As a part of managing the firm’s resources, strategic leaders must develop a firm’s human capital. Effective strategic leaders view human capital as a resource to be maximized—not as a cost to be minimized. Such leaders develop and use programs designed to train current and future strategic leaders to build the skills needed to nurture the rest of the firm’s human capital.

Effective strategic leaders build and maintain internal and external social capital. Internal social capital promotes cooperation and coordination within and across units in the firm. External social capital provides access to resources the firm needs to compete effectively.

Shaping the firm’s culture is a central task of effective strategic leadership. An appropriate organizational culture encourages the development of an entrepreneurial orientation among employees and an ability to change the culture as necessary.

In ethical organizations, employees are encouraged to exercise ethical judgment and to always act ethically. Improved ethical practices foster social capital. Setting specific goals to meet the firm’s ethical standards, using a code of conduct, rewarding ethical behaviors, and creating a work environment where all people are treated with dignity are actions that facilitate and support ethical behavior.

Developing and using balanced organizational controls are the final components of effective strategic leadership. The balanced scorecard is a tool that measures the effectiveness of the firm’s strategic and financial controls. An effective balance between strategic and financial controls allows for flexible use of core competencies, but within the parameters of the firm’s financial position.
REVIEW QUESTIONS

1. What is strategic leadership? In what ways are top executives considered important resources for an organization?
2. What is a top management team, and how does it affect a firm’s performance and its abilities to innovate and design and implement effective strategic changes?
3. How important are the internal and external managerial labor markets for the managerial succession process?
4. What is the effect of strategic leadership on determining the firm’s strategic direction?
5. How do strategic leaders effectively manage their firm’s resource portfolio to exploit its core competencies and leverage the human capital and social capital to achieve a competitive advantage?
6. What is organizational culture? What must strategic leaders do to develop and sustain an effective organizational culture?
7. As a strategic leader, what actions could you take to establish and emphasize ethical practices in your firm?
8. What are organizational controls? Why are strategic controls and financial controls important aspects of the strategic management process?

EXPERIENTIAL EXERCISES

EXERCISE 1: THE CEO AND TOP MANAGEMENT TEAM
Chapter 10 discussed corporate governance and the fiduciary role that the board plays in overseeing the affairs of the company. The composition of the top management team is critical in assessing the strategic direction of a firm. It is not uncommon for a powerful CEO and top management team to thwart the desires of the board. There are various ways in which a CEO may become powerful; it may be the result of equity ownership, tenure, expertise, or by appointing sympathetic board members, etc. This exercise will allow you to assess the power of a CEO and his or her team and develop your thoughts regarding their relationship to the board.

Part One
Identify with your team the firm you would like to analyze. Pick a company that is publicly traded so that you have adequate information about the executives.

Part Two
Explore the power relationship between the CEO and his top management team (TMT) and the board. You should at a minimum be able to address the following points:
1. CEO tenure
2. TMT tenure
3. TMT relationships to the CEO (i.e., were they hired by the CEO or his predecessor?)
4. Board member tenure and structure (i.e., does the board structure possess a lead independent director, is CEO duality present?)
5. Describe the CEO and his TMT in terms of experience and networks. For example, do they sit on other firms’ boards of directors, are there any overlaps with their employer’s board?
6. What conclusions do you reach regarding the power relationship between the CEO and the board?

Be prepared to discuss this utilizing a PowerPoint presentation of your findings and conclusions.

EXERCISE 2: STRATEGIC LEADERSHIP IS TOUGH!
Your text defines strategic leadership as “the ability to anticipate, envision, maintain flexibility, and empower others...” Accordingly, this exercise combines the practical elements of leadership in an experiential exercise. You are asked to replicate leaders and followers in the attainment of a defined goal.

Divide the class into teams of 3 to 5 individuals. Each team should choose a leader (and by that decision, who will be the followers). It is important to choose wisely. The classroom instructor will then assign the task to be completed.

Students should be prepared to debrief the rest of the class when the assignment is completed. Your instructor will guide this discussion.
AN EXAMPLE OF STRATEGIC LEADERSHIP:
MEG WHITMAN/CEO/EBAY

Meg Whitman, head of eBay, is considered a pioneer at creating a global marketplace and at inciting an e-commerce revolution. Whitman attributes her female characteristics as being effective in the eBay environment. Despite the real and difficult sacrifices and the guilt of not spending as much time with her children, she attributes her drive to keep going to her love and satisfaction in the eBay environment. Despite the real and difficult sacrifices she would do it all over again. Today, eBay has more than 10 million registered users, produces $224 million in annual revenue, and has an actual income of $10.8 million.

Be prepared to discuss the following concepts and questions in class:

**Concepts**
- Strategic leadership
- Top management team
- Human capital
- Social capital
- Organizational culture

**Questions**
1. In what ways did Meg Whitman's characteristics provided strategic leadership at eBay?
2. How is Meg Whitman appropriate for a top management team?
3. What do you think would be Whitman's approach to human capital?
4. How important is social capital to the success of eBay?
5. With Meg Whitman at the helm, describe eBay's organizational culture. Is there evidence of an entrepreneurial mind-set?

**Notes**


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