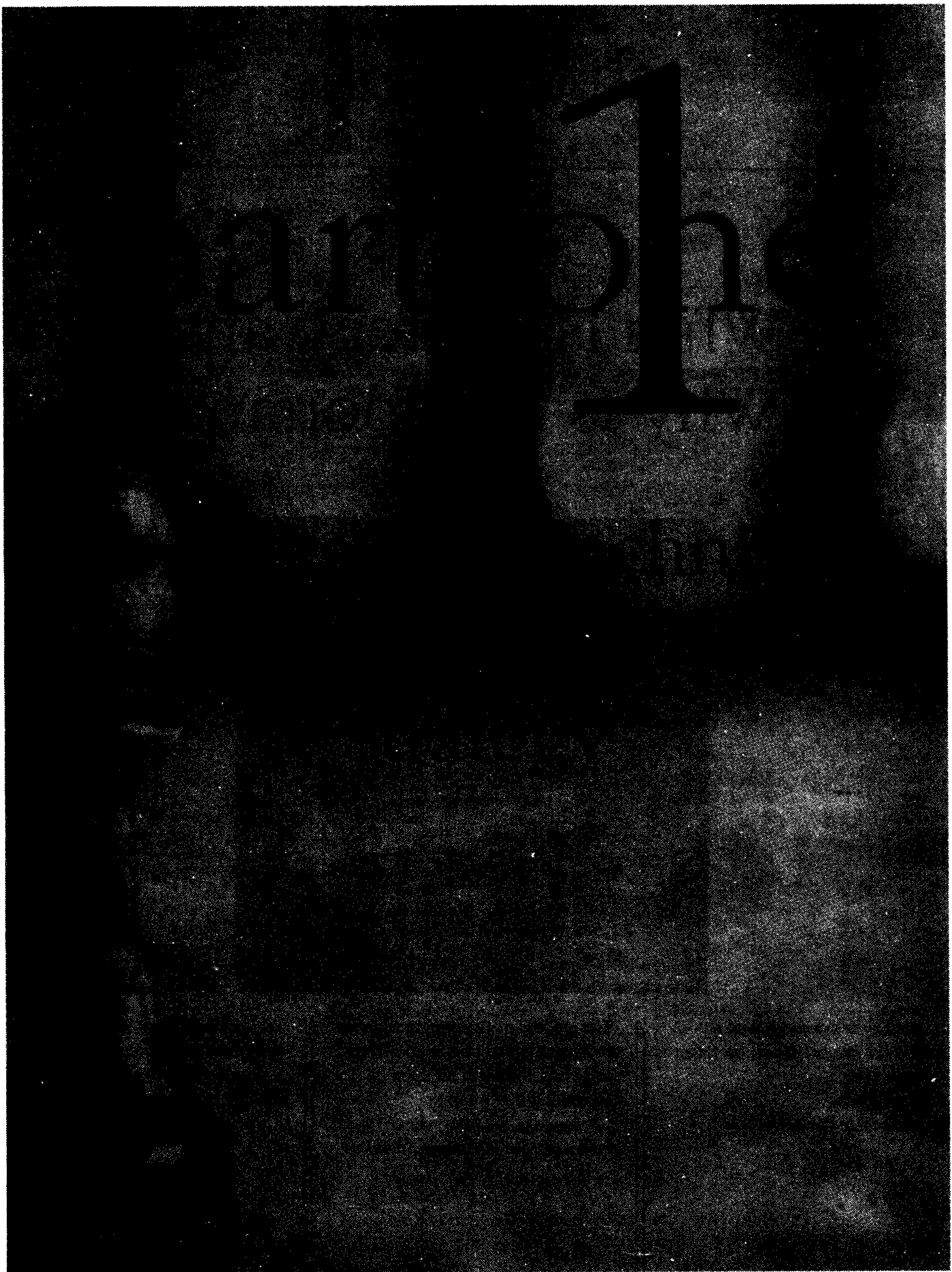


chapter | one 1

What Is Strategy and Why Is It Important?

(©Images.com/CORBIS)

A strategy is a commitment to undertake one set of actions rather than another.
—Sharon Oster
Professor, Yale University

The process of developing superior strategies is part planning, part trial and error, until you hit upon something that works.
—Costas Markides
Professor, London Business School

Without a strategy the organization is like a ship without a rudder.
—Joel Ross and Michael Kami
Business authors and consultants

Managers at all companies face three central questions in thinking strategically about their company's present circumstances and prospects: Where are we now? Where do we want to go? How will we get there? The question "Where are we now?" concerns the ins and outs of the company's present situation—its market standing, how appealing its products or services are to customers, the competitive pressures it confronts, its strengths and weaknesses, and its current performance. The question "Where do we want to go?" deals with the direction in which management believes the company should be headed in terms of growing the business and strengthening the company's market standing and financial performance in the years ahead. The question "How will we get there?" concerns crafting and executing a strategy to get the company from where it is to where it wants to go.

In this opening chapter, we define the concept of strategy and introduce its many elements and facets. We will explain how a strategy originates, the kinds of actions that determine what a company's strategy is, why strategies are partly proactive and partly reactive, and why company strategies tend to evolve over time. We will look at what sets a winning strategy apart from an ordinary strategy or one that is a sure loser and why the caliber of a company's strategy determines whether it will enjoy a competitive advantage or be burdened by competitive disadvantage. By the end of this chapter, you will have a pretty clear idea of why the tasks of crafting and executing strategy are core management functions and why excellent execution of an excellent strategy is the most reliable recipe for turning a company into a standout performer.

WHAT IS STRATEGY?

A company's **strategy** is management's game plan for growing the business, staking out a market position, attracting and pleasing customers, competing successfully, conducting operations, and achieving targeted objectives. In crafting a strategy, management is in effect saying, "Among all the paths we could have chosen, we have decided to focus on these markets and customer needs, compete in this fashion, allocate our resources and energies in these ways, and use these particular approaches to doing business." A company's strategy thus indicates the choices its managers have made about *how* to attract and please customers, *how* to respond to changing market conditions, *how* to compete successfully, *how* to grow the business, *how* to manage

core concept
A company's ***strategy*** consists of the competitive moves and business approaches that managers employ to attract and please customers, compete successfully, grow the business, conduct operations, and achieve targeted objectives.

each functional piece of the business and develop needed capabilities, and *how* to achieve performance targets. It puts the spotlight on the products/services, buyer segments, geographic areas, and business approaches management intends to emphasize.

Normally, markets are diverse enough to give companies a wide degree of strategic freedom in choosing the hows of strategy.[1] Some rivals have wide product lines while others have a narrow product focus, some target the high end of the market while others go after the middle or low end. Some strive for a competitive advantage based on low cost while others aim for a competitive edge based on product superiority or personalized customer service or added convenience. Some competitors position themselves in only one part of the industry's chain of production/distribution activities (preferring to be just in manufacturing or wholesale distribution or retailing), while others are partially or fully integrated, with operations ranging from components production to manufacturing and assembly to wholesale distribution or company-owned retail stores. Some rivals deliberately confine their operations to local or regional markets; others opt to compete nationally, internationally, or globally. Some companies decide to operate in only one industry, while others diversify broadly or narrowly, into related or unrelated industries, via acquisitions, joint ventures, strategic alliances, or internal start-ups.

At companies intent on gaining sales and market share at the expense of competitors, managers lean toward mostly offensive strategies, frequently launching fresh initiatives of one kind or another to make the company's product offering more distinctive and appealing to buyers. Conservative, risk-avoiding companies prefer a sound defense to an aggressive offense; their strategies emphasize gradual gains in the marketplace, fortifying the company's market position, and defending against the latest maneuvering of rivals and other developments that threaten the company's well-being.

There is no shortage of opportunity to fashion a strategy that tightly fits a company's own particular situation and that is discernibly different from the strategies of rivals. Carbon-copy strategies among companies in the same industry are the exception rather than the rule.

For a concrete example of the actions and approaches that comprise strategy, read the description of Southwest Airlines' strategy in Illustration Capsule 1.1.

Identifying a Company's Strategy

A company's strategy is reflected in its actions in the marketplace and the statements of senior managers about the company's current business approaches, future plans, and efforts to strengthen its competitiveness and performance. Figure 1.1 shows what to look for in identifying the substance of a company's overall strategy.

Once it is clear what to look for, the task of identifying a company's strategy is mainly one of researching information about the company's actions in the marketplace and business approaches. In the case of publicly owned enterprises, the strategy is often openly discussed by senior executives in the company's annual report and 10-K report, in press releases and company news (posted on the company's Web site), and in the information provided to investors at the company's Web site. To maintain the confidence of investors and Wall Street, most public companies have to be fairly open about their strategies. Company executives typically lay out key elements of their strategies in presentations to securities analysts (such presentations are usually posted in the investor relations section of the company's Web site). Hence, except for some about-to-be-launched moves and changes that remain under wraps and in the planning stage, there's usually nothing secret or undiscoverable about what a company's present strategy is.

Illustration capsule 1.1
The Chief Elements of Southwest Airlines' Strategy

Southwest Airlines pursues a low-cost/low-price/no-frills strategy that features offering passengers a single class of service at the lowest possible fares. Southwest's market focus is flying between pairs of cities ranging anywhere from 150 to 700 miles apart where there is high traffic potential, but recently Southwest has also begun offering longer-range flights, using its low-cost advantage to horn in on the most profitable routes of American, United, Northwest, Delta, and US Airways. The company's strategy in 2003 included the following elements:

- *Grow the business by gradually adding more flights on existing routes and by initiating service to new airports.* The objective was steady growth year after year, not rapid growth for a few years that was impossible to sustain.
- *Make friendly service a company trademark.* Company personnel worked hard at creating a positive, fun flying experience for passengers. Southwest's casually dressed gate personnel and flight attendants, all screened carefully for fun-loving and outgoing personalities, warmly greeted passengers, entertained those in the gate area with trivia questions or contests, directed boarding passengers to open seats and helped with luggage storage, and sometimes sang the announcements on takeoff and landing.
- *Maintain an aircraft fleet of only Boeing 737s.* A fleet with only one type of plane minimized spare parts inventories, made it easier to train maintenance and repair personnel, improved the proficiency and speed with which maintenance routines could be done, and simplified the task of scheduling planes for particular flights.
- *Encourage customers to make reservations and purchase tickets at the company's Web site.* Selling a ticket on its Web site cost Southwest a tenth as much as delivering a ticket through a travel agent and about half of the cost of processing a paper ticket through its own internal reservation system.
- *Avoid flying into congested airports, stressing instead routes between medium-sized cities and small airports close to major metropolitan areas.* This strategy element improved on-time performance and reduced the fuel costs associated with planes sitting in line on crowded taxiways or circling airports waiting for clearance to land, plus it allowed the company to avoid paying the higher landing fees and terminal gate costs at high-traffic airports.
- *Employ a point-to-point route system (as compared to hub-and-spoke systems of rival carriers).* The point-to-point system promoted higher utilization of aircraft and terminal facilities and reduced the number of both aircraft and terminal gates needed to support flight operations.
- *Economize on the amount of time it takes terminal personnel to check passengers in and on-load passengers.* Southwest did not assign each passenger a reserved seat; instead, passengers were given boarding passes preprinted with A, B, or C at check-in and then boarded in groups of 30 according to the letter on their card, sitting in whatever seat was open when they got on the plane. This method sped up the boarding process.
- *Economize on costs.* Southwest served no meals on flights, had no fancy clubs for its frequent flyers to relax in at terminals, and provided no baggage transfer services to other carriers. Whereas other carriers hired cleaning crews, Southwest required flight attendants to clean up trash left by deplaning passengers and get the plane presentable for passengers to board for the next flight. On occasion, pilots pitched in to help with facilitating turnarounds and keeping the ground time between flights to less than 20 minutes. Short turnaround times allowed Southwest planes to fly more flights per day.

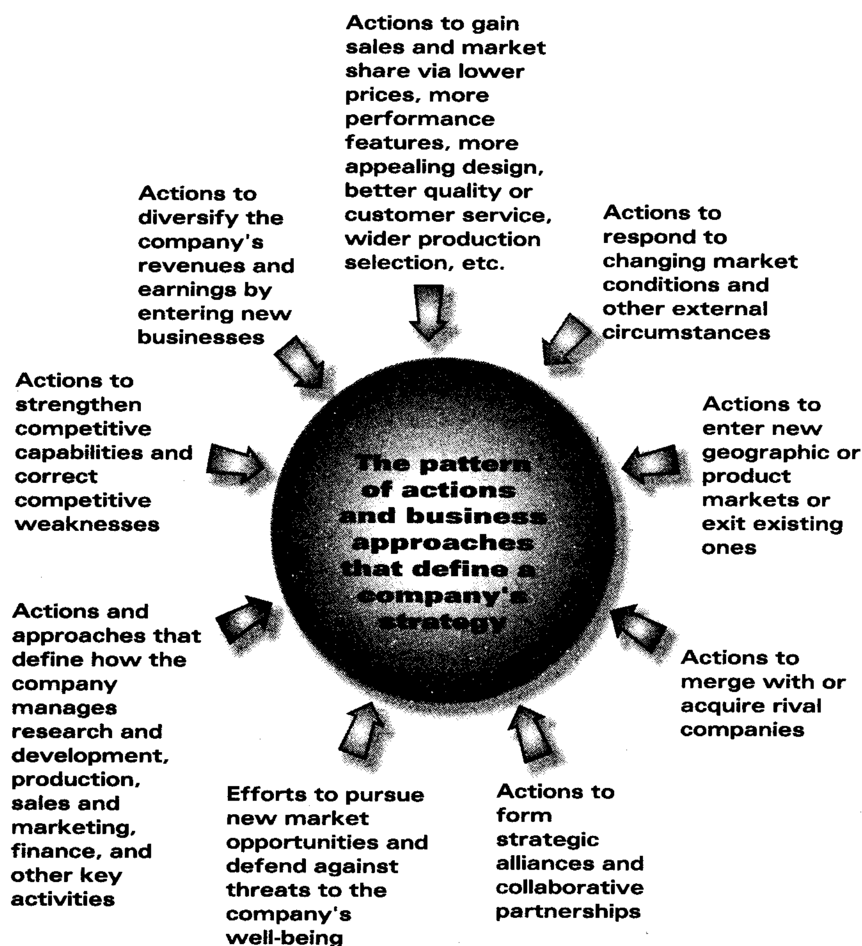
Southwest's strategy is a proven winner. Going into 2004, the company had earned a profit every quarter of every year since mid-1974—in an industry chronically riddled with money-losing companies.

Source: Company documents.

Strategy and the Quest for Competitive Advantage

Generally, a company's strategy should be aimed either at providing a product or service that is distinctive from what competitors are offering or at developing competitive capabilities that rivals can't quite

figure 1.1 **Identifying a Company's Strategy—What to Look For**



match. For instance, while such car rental companies as Hertz, Avis, National, and Dollar slug it out head-to-head trying to woo business and vacation travelers at airports, Enterprise Rent-A-Car has become the world's most profitable car rental company by focusing on people who need a car for ordinary use—for example, while their own is being repaired. Furthermore, instead of hiring low-paid service employees to staff its rental locations, Enterprise recruits recent college graduates and compensates them well for growing the volume of business at Enterprise's locations. Enterprise can also deliver a car to the renter's home and pick it up at the end of the rental. With its distinctive strategy and customer focus, Enterprise operates the biggest car rental fleet in the world and has more locations than any other car rental company.

What separates a powerful strategy from an ordinary or weak one is management's ability to forge a series of moves, both in the marketplace and internally, that makes the company *distinctive,* tilts the playing field in the company's favor by giving buyers reason to prefer its products or services, and pro-

duces a *sustainable competitive advantage* over rivals. With a durable competitive advantage, a company has good prospects for winning in the marketplace and realizing above-average profitability. Without competitive advantage, a company risks being beaten by stronger rivals and/or locked into mediocre financial performance.

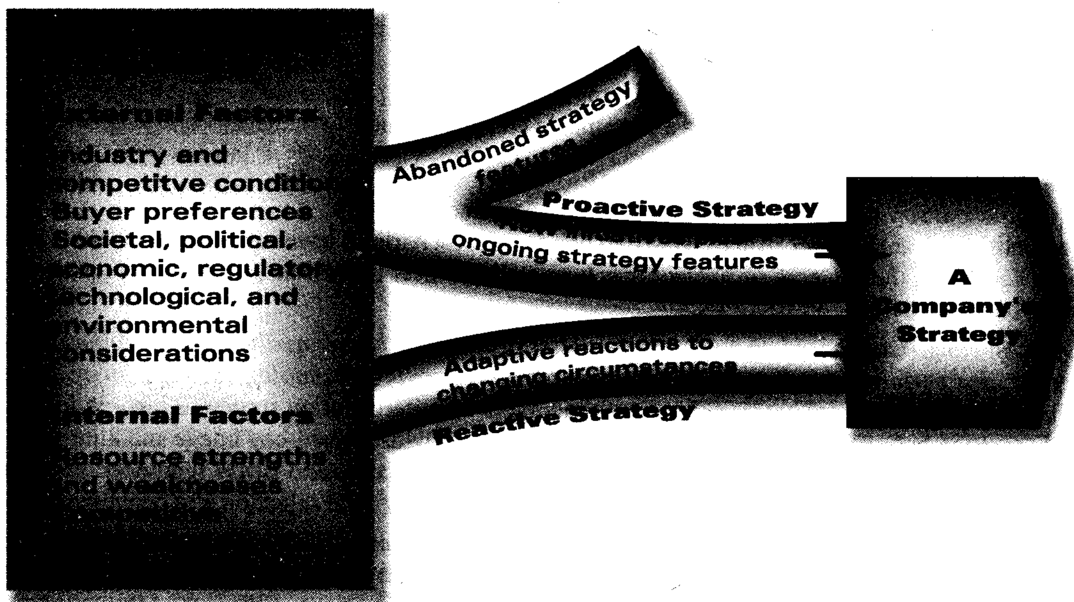
core concept
A company achieves sustainable competitive advantage when an attractive number of buyers prefer its products or services over the offerings of competitors and when the basis for this preference is durable.

Four of the most frequently used strategic approaches to setting a company apart from rivals and achieving a sustainable competitive advantage are:

1. *Being the industry's low-cost provider* (thereby gaining a cost-based competitive advantage over rivals). Wal-Mart and Southwest Airlines have earned strong market positions because of the low-cost advantages they have achieved over their rivals and their consequent ability to underprice their competitors.
2. *Outcompeting rivals based on such differentiating features as higher quality, wider product selection, added performance, better service, more attractive styling, technological superiority, or unusually good value for the money.* Successful adopters of differentiation strategies include Johnson & Johnson in baby products (product reliability), Harley-Davidson (bad-boy image and king-of-the-road styling), Chanel and Rolex (top-of-the-line prestige), Mercedes and BMW (engineering design and performance), L. L. Bean (good value), and Amazon.com (wide selection and convenience).
3. *Focusing on a narrow market niche* and winning a competitive edge by doing a better job than rivals of serving the special needs and tastes of niche buyers. Prominent companies that enjoy competitive success in a specialized market niche include eBay in online auctions, Jiffy Lube International in quick oil changes, McAfee in virus protection software, Starbucks in premium coffees and coffee drinks, Whole Foods Market in natural and organic foods, and Krispy Kreme in doughnuts.
4. *Developing expertise and resource strengths that give the company competitive capabilities that rivals can't easily imitate or trump with capabilities of their own.* FedEx has superior capabilities in next-day delivery of small packages, Walt Disney has hard-to-beat capabilities in theme park management and family entertainment, and IBM has wide-ranging capabilities in supporting the information systems and information technology needs of large corporations.

Most companies recognize that winning a durable competitive edge over rivals hinges more on building competitively valuable expertise and capabilities than it does on having a distinctive product. Rivals can nearly always copy the attributes of a popular or innovative product, but for rivals to match experience, know-how, and specialized competitive capabilities that a company has developed and perfected over a long period of time is substantially harder to duplicate and takes much longer—despite years of trying, Kmart, Sears, and other discount retailers and supermarket chains have struck out trying to match Wal-Mart's sophisticated distribution systems and its finely honed merchandising expertise. Company initiatives to build competencies and capabilities that rivals don't have and cannot readily match can relate to greater product innovation capabilities than rivals (3M Corporation), better mastery of a complex technological process (Michelin in making radial tires), expertise in defect-free manufacturing (Toyota and Honda), specialized marketing and merchandising know-how (Coca-Cola), global sales and distribution capability (Black & Decker in power tools), superior e-commerce capabilities (Dell Computer), unique ability to deliver personalized customer service (Ritz Carlton and Four Seasons hotels), or anything else that constitutes a competitively valuable strength in creating, producing, distributing, or marketing the company's product or service.

figure 1.2 **A Company's Actual Strategy Is Partly Proactive and Partly Reactive**



Strategy Is Partly Proactive and Partly Reactive

A company's strategy is typically a blend of (1) proactive actions on the part of managers to improve the company's market position and financial performance and (2) as-needed reactions to unanticipated developments and fresh market conditions—see Figure 1.2.[2] The biggest portion of a company's current strategy flows from previously initiated actions and business approaches that are working well enough to merit continuation and newly launched managerial initiatives to strengthen the company's overall position and performance. This part of management's game plan is deliberate and proactive, standing as the product of management's analysis and strategic thinking about the company's situation and its conclusions about how to position the company in the marketplace and tackle the task of competing for buyer patronage.

But not every strategic move is the result of proactive plotting and deliberate management design. Things happen that cannot be fully anticipated or planned for. When market and competitive conditions take an unexpected turn or some aspect of a company's strategy hits a stone wall, some kind of strategic reaction or adjustment is required. Hence, a portion of a company's strategy is always developed on the fly, coming as a reasoned response to unforeseen developments—fresh strategic maneuvers on the part of rival firms, shifting customer requirements and expectations, new technologies and market opportunities, a changing political or economic climate, or other unpredictable or unanticipated happenings in the surrounding environment. But apart from adapting strategy to changes in the market, there is also a need to adapt strategy as new learning emerges about which pieces of the strategy are working well and which aren't and as management hits upon new ideas for improving the strategy. Crafting a strategy thus involves stitching together a *proactive/intended strategy* and then adapting first one piece and then another as circumstances surrounding the company's situation change or better options emerge—a *reactive/adaptive strategy.*

A Company's Strategy Emerges Incrementally and Then Evolves over Time A company's strategy should always be viewed as a work in progress. Most of the time a company's strategy emerges in bits and pieces, the result of trial and error, experimentation, deliberate management design, and ongoing management actions to fine-tune this or that piece of the strategy and to adjust certain strategy elements in response to unfolding events. Nonetheless, on occasion, fine-tuning the existing strategy is not enough and major strategy shifts are called for, such as when a strategy is clearly failing and the company faces a financial crisis, when market conditions or buyer preferences change significantly and new opportunities arise, when competitors do something unexpected, or when important technological breakthroughs occur. Some industries are more volatile than others. Industry environments characterized by *high-velocity change* require companies to rapidly adapt their strategies.[3] For example, during the Internet gold rush and subsequent dot-com crash of 1997–2002, technology companies and e-commerce firms found it essential to revise demand forecasts, adjust key elements of their strategies, and update their financial projections at least quarterly and sometimes more frequently.

core concept
Changing circumstances and ongoing management efforts to improve the strategy cause a company's strategy to emerge and evolve over time—a condition that makes the task of crafting a strategy a work in progress, not a one-time event.

But regardless of whether a company's strategy changes gradually or swiftly, the important point is that a company's present strategy is temporary and on trial, pending new ideas for improvement from management, changing competitive conditions, and any other changes in the company's situation that managers believe warrant strategic adjustments. A company's strategy at any given point is fluid, representing the temporary outcome of an ongoing process that, on the one hand, involves reasoned and intuitive management efforts to design an effective strategy (a well-thought-out plan) and, on the other hand, involves responses to market change and constant experimentation and tinkering (adaptations to new conditions and learning about what has worked well enough to continue and what didn't work and has been abandoned).

A company's strategy is driven partly by management analysis and choice and partly by the necessity of adapting and learning by doing.

Crafting Strategy Calls for Good Entrepreneurship The constantly evolving nature of a company's situation puts a premium on management's ability to exhibit astute entrepreneurship. The faster a company's business environment is changing, the more critical it becomes for its managers to be adept in reading the winds of change and making timely strategic adjustments.[4] Managers are always under the gun to pick up on happenings in the external environment and steer company activities in directions that are aligned with unfolding market conditions. This means studying market trends and competitors' actions, listening to customers and anticipating their changing needs and expectations, scrutinizing the business possibilities that spring from new technological developments, building the firm's market position via acquisitions or new product introductions, and pursuing ways to strengthen the firm's competitive capabilities. It means paying attention to early warnings of future change and being willing to experiment with dare-to-be-different ways to establish a market position in that future. It means proactively searching out opportunities to do new things or to do existing things in new or better ways. When obstacles unexpectedly appear in a company's path, it means adapting rapidly and innovatively. *Masterful strategies come partly (maybe mostly) by doing things differently from competitors where it counts—outinnovating them, being more efficient, being more imaginative, adapting faster—rather than running with the herd.* Good strategy making is therefore inseparable from good business entrepreneurship. One cannot exist without the other.

Strategy and Ethics: Passing the Test of Moral Scrutiny

In choosing among strategic alternatives, company managers are well advised to embrace actions that are aboveboard and can pass the test of moral scrutiny. Crafting an ethical strategy means more than keeping a company's strategic actions within the bounds of what is legal. Ethical and moral standards go beyond the prohibitions of law and the language of "thou shalt not" to the issues of "right" versus "wrong" and *duty*—what one *should* do. A strategy is ethical only if: (1) it does not entail actions and behaviors that cross the line from "can do" to "should not do" and "unsavory" and (2) it allows management to fulfill its ethical duties to all stakeholders—owners/shareholders, employees, customers, suppliers, the communities in which it operates, and society at large.

Admittedly, it is not always easy to categorize a given strategic behavior as definitely ethical or definitely unethical; many strategic actions fall in a gray zone in between. Whether they are deemed ethical or unethical hinges on how high one sets the bar. For example, is it ethical for advertisers of alcoholic products to place ads in media having an audience of as much as 50 percent underage viewers? (In 2003, growing concerns about underage drinking prompted some beer and distilled spirits companies to agree to place ads in media with an audience at least 70 percent adult, up from a standard of 50 percent adult.) Is it ethical for an apparel retailer attempting to keep prices attractively low to source clothing from foreign manufacturers who pay substandard wages, employ child labor, or engage in unsavory sweatshop practices? Many people would say no, but some might argue that a company is not unethical simply because it does not police the business practices of its suppliers. Is it ethical for the manufacturers of firearms (in hopes of gaining a supply of resalable weapons) to encourage retired police officers to trade in or return automatic weapons whose manufacture has since been banned by Congress? Several firearms makers have been said to take advantage of a loophole in the law allowing them to traffic in such weapons. Is it ethical for a meatpacker to export meat products that do not meet safe standards in its home country to those countries where the safety and standards are low and inspection is lax? Several consumer groups have protested that certain meatpackers engage in this practice, but the meatpackers defend their actions by saying that none of the exported products constitute a danger to consumers (cross-country meat inspection standards and procedures vary considerably, such that products passing inspection in one country may not pass in another country).

Senior executives with strong character and ethical convictions are generally proactive in linking strategic action and ethics; they forbid the pursuit of ethically questionable business opportunities and insist that all aspects of company strategy reflect high ethical standards.[5] They make it clear that all company personnel are expected to act with integrity, and they put organizational checks and balances into place to monitor behavior, enforce ethical codes of conduct, and provide guidance to employees regarding any gray areas. Their commitment to conducting the company's business in an ethical manner is genuine, not hypocritical lip service.

Recent instances of corporate malfeasance, ethical lapses, and misleading or fraudulent accounting practices at Enron, WorldCom, Tyco, Adelphia, Dynegy, HealthSouth, and other companies leave no room to doubt the damage to a company's reputation and business that can result from ethical misconduct, corporate misdeeds, and even criminal behavior on the part of company personnel. Aside from just the embarrassment and black marks that accompany headline exposure of a company's unethical practices, the hard fact is that many customers and many suppliers are wary of doing business with a

company that engages in sleazy practices or that turns a blind eye to illegal or unethical behavior on the part of employees. They are turned off by unethical strategies or behavior and, rather than become victims or get burned themselves, wary customers will quickly take their business elsewhere and wary suppliers will tread carefully. Moreover, employees with character and integrity do not want to work for a company whose strategies are shady or whose executives lack character and integrity. There's little lasting benefit to unethical strategies and behavior, and the downside risks can be substantial. Besides, such actions are plain wrong.

THE RELATIONSHIP BETWEEN A COMPANY'S STRATEGY AND ITS BUSINESS MODEL

core concept
A company's ***business model*** relates to whether the revenue-cost-profit economics of its strategy demonstrate the viability of the business enterprise as a whole.

Closely related to the concept of strategy is the concept of a company's **business model.** While the word *model* conjures up images of ivory-tower ideas set apart from the real world, such images do not apply here. A company's business model sets forth the economic logic of how an enterprise's strategy can deliver value to customers at a price and cost that yields acceptable profitability.[6] A company's business model thus is management's storyline for how and why the company's product offerings and competitive approaches will generate a revenue stream and have an associated cost structure that produces attractive earnings and return on investment. The nitty-gritty issue surrounding a company's business model is whether the chosen strategy makes good business sense from a money-making perspective. The concept of a company's business model is, consequently, more narrowly focused than the concept of a company's business strategy. A company's strategy *relates broadly to its competitive initiatives and business approaches (irrespective of the financial outcomes it produces), while* a company's business model *deals with whether the revenues and costs flowing from the strategy demonstrate business viability.* Companies that have been in business for a while and are making acceptable profits have a "proven" business model—there is clear evidence that their strategy is capable of profitability and that they have a viable business enterprise. Companies that are in a start-up mode or that are losing money have "questionable" business models; their strategies have yet to produce good bottom-line results, putting their storyline about how they intend to make money and their viability as business enterprises in doubt. Illustration Capsule 1.2 discusses the contrasting business models of Microsoft and Red Hat Linux.

WHAT MAKES A STRATEGY A WINNER?

Three questions can be used to test the merits of one strategy versus another and distinguish a winning strategy from a losing or mediocre strategy:

1. *How well does the strategy fit the company's situation?* To qualify as a winner, a strategy has to be well matched to industry and competitive conditions, a company's best market opportunities, and other aspects of the enterprise's external environment. At the same time, it has to be tailored to the company's resource strengths and weaknesses, competencies, and competitive capabilities. Unless a strategy exhibits tight fit with both the external and internal aspects of a company's overall situation, it is likely to produce less than the best possible business results.

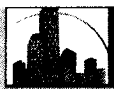


illustration capsule 1.2

Microsoft and Red Hat Linux: Two Contrasting Business Models

The strategies of rival companies are often predicated on strikingly different business models. Consider, for example, the business models for Microsoft and Red Hat Linux in operating system software for PCs.

Microsoft's business model for making money from its operating system products is based on the following revenue-cost-profit economics:

- Employ a cadre of highly skilled programmers to develop proprietary code; keep the source code hidden from users and lock them in to using Microsoft's proprietary software.
- Sell the resulting operating system and software package to personal computer (PC) makers and to PC users at relatively attractive prices (around $75 to PC makers and about $100 at retail to PC users) and achieve large unit sales.
- Most of Microsoft's costs arise on the front end in developing the software and are thus "fixed"; the variable costs of producing and packaging the CDs provided to users are only a couple of dollars per copy—once the break-even volume is reached, Microsoft's revenues from additional sales are almost pure profit.
- Provide technical support to users at no cost.

Red Hat Linux, a company formed to market its own version of the open-source Linux operating system, employs a business model based on sharply different revenue-cost-profit economics:

- Rely on the collaborative efforts of volunteer programmers from all over the world who contribute bits and pieces of code to improve and polish the Linux system. The global community of thousands of programmers who work on Linux in their spare time do what they do because they love it, because they are fervent believers that all software should be free (as in free speech), and, in some cases, because they are anti-Microsoft and want to have a part in undoing what they see as a Microsoft monopoly.
- Collect and test enhancements and new applications submitted by the open-source community of volunteer programmers. Linux's originator, Linus Torvalds, and a team of 300-plus Red Hat engineers and software developers evaluate which incoming submissions merit inclusion in new releases of Red Hat Linux—the evaluation and integration of new submissions are Red Hat's only up-front product development costs.
- Charge a modest fee to those who prefer to subscribe to the upgraded and tested family of Red Hat Linux products. Subscription fees include a limited number of days of service, support, patches, and updates.
- Release updated versions of Red Hat Linux every 4–6 months to small users and every 12–18 months to corporate users.
- Make the source code open and available to all users, allowing them to create a customized version of Linux.
- Capitalize on the specialized expertise required to use Linux in multiserver, multiprocessor applications by providing fees-based training, consulting, support, engineering, and content management services to Red Hat Linux users. Red Hat offers Linux certification training programs at all skill levels at more than 60 global locations—Red Hat certification in the use of Linux is considered the best in the world.

Microsoft's business model—sell proprietary code software and give service away free—is a proven money maker that generates billions in profits annually. On the other hand, the jury is still out on Red Hat's business model of marketing open-source software developed mainly by volunteers and depending heavily on sales of technical support services, training, and consulting to generate revenues sufficient to cover costs and yield a profit. Red Hat posted losses of $140 million on revenues of $79 million in fiscal year 2002 and losses of $6.6 million on revenues of $91 million in fiscal year 2003. But in the first 9 months of fiscal 2004, Red Hat earned a $9 million profit on revenues of $89 million. And the profits came from a shift in Red Hat's business model that involved putting more emphasis on selling subscriptions to the latest Red Hat Linux updates to corporate users.

Source: Company documents. Reprinted by permission from Microsoft Corporation, http://www.microsoft.com.

2. *Is the strategy helping the company achieve a sustainable competitive advantage?* Winning strategies enable a company to achieve a competitive advantage that is durable. The bigger and more durable the competitive edge that a strategy helps build, the more powerful and appealing it is.

3. *Is the strategy resulting in better company performance?* A good strategy boosts company performance. Two kinds of performance improvements tell the most about the caliber of a company's strategy: (1) gains in profitability and financial strength and (2) gains in the company's competitive strength and market standing.

Once a company commits to a particular strategy and enough time elapses to assess how well it fits the situation and whether it is actually delivering competitive advantage and better performance, then one can determine what grade to assign its strategy. Strategies that come up short on one or more of the above questions are plainly less appealing than strategies passing all three test questions with flying colors.

Managers can also use the same questions to pick and choose among alternative strategic actions. A company evaluating which of several strategic options to employ can size up how well each option measures up against each of the three questions. The strategic option with the highest prospective passing scores on all three questions can be regarded as the best or most attractive strategic alternative.

core concept
A winning strategy must fit the enterprise's external and internal situation, build sustainable competitive advantage, and improve company performance.

Other criteria for judging the merits of a particular strategy include internal consistency and unity among all the pieces of strategy, the degree of risk the strategy poses as compared to alternative strategies, and the degree to which it is flexible and adaptable to changing circumstances. These criteria are relevant and merit consideration, but they seldom override the importance of the three test questions posed above.

WHY ARE CRAFTING AND EXECUTING STRATEGY IMPORTANT?

Crafting and executing strategy are top-priority managerial tasks for two very big reasons. First, there is a compelling need for managers to *proactively shape,* or *craft,* how the company's business will be conducted. A clear and reasoned strategy is management's prescription for doing business, its road map to competitive advantage, its game plan for pleasing customers and achieving performance targets. Winning in the marketplace requires a well-conceived, opportunistic strategy, usually one characterized by strategic offensives to outinnovate and outmaneuver rivals and secure sustainable competitive advantage, then using this market edge to achieve superior financial performance. A powerful strategy that delivers a home run in the marketplace can propel a firm from a trailing position into a leading one, clearing the way for its products/services to become the industry standard. High-achieving enterprises are nearly always the product of astute, proactive strategy making—companies don't get to the top of the industry rankings or stay there with strategies built around timid actions to try to do better. And only a handful of companies can boast of strategies that hit home runs in the marketplace due to lucky breaks or the good fortune of having stumbled into the right market at the right time with the right product. So there can be little argument that a company's strategy matters—and matters a lot.

Second, a *strategy-focused organization* is more likely to be a strong bottom-line performer. There's no escaping the fact that the quality of managerial strategy making and strategy execution has a positive impact on revenue growth, earnings, and return on investment. A company that lacks clear-cut direction, has vague or undemanding performance targets, has a muddled or flawed strategy, or can't seem to execute its strategy competently is a company whose financial performance is probably suffering, whose

business is at long-term risk, and whose management is sorely lacking. In contrast, when crafting and executing a winning strategy drive management's whole approach to operating the company, the odds are much greater that the initiatives and activities of different divisions, departments, managers, and work groups will be unified into a *coordinated, cohesive effort.* Mobilizing the full complement of company resources in a total team effort behind good execution of the chosen strategy and achievement of the targeted performance allows a company to operate at full power. The chief executive officer of one successful company put it well when he said:

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

Good Strategy + Good Strategy Execution = Good Management

Crafting and executing strategy are thus core management functions. Among all the things managers do, nothing affects a company's ultimate success or failure more fundamentally than how well its management team charts the company's direction, develops competitively effective strategic moves and business approaches, and pursues what needs to be done internally to produce good day-in, day-out strategy execution and operating excellence. Indeed, *good strategy and good strategy execution are the most trustworthy signs of good management.* Managers don't deserve a gold star for designing a potentially brilliant strategy but failing to put the organizational means in place to carry it out in high-caliber fashion—weak implementation and execution—undermine the strategy's potential and pave the way for shortfalls in customer satisfaction and company performance. Competent execution of a mediocre strategy scarcely merits enthusiastic applause for management's efforts either. The rationale for using the twin standards of good strategy making and good strategy execution to determine whether a company is well managed is therefore compelling: *The better conceived a company's strategy and the more competently it is executed, the more likely it is that the company will be a standout performer in the marketplace.*

core concept
Excellent execution of an excellent strategy is the best test of managerial excellence—and the most reliable recipe for turning companies into standout performers.

Throughout the text chapters to come and the accompanying case collection, the spotlight is trained on the foremost question in running a business enterprise: What must managers do, and do well, to make a company a winner in the marketplace? The answer that emerges, and that becomes the message of this book, is that doing a good job of managing inherently requires good strategic thinking and good management of the strategy-making, strategy-executing process.

The mission of this book is to explore what good strategic thinking entails; to present the core concepts and tools of strategic analysis; to describe the ins and outs of crafting and executing strategy; and, via the cases that have been included, to build your skills both in diagnosing how well the strategy-making, strategy-executing task is being performed in actual companies and in prescribing actions for how the companies in question can improve their approaches to crafting and executing their strategies.

As you tackle the following pages, ponder the following observation by the essayist and poet Ralph Waldo Emerson: "Commerce is a game of skill which many people play, but which few play well." The overriding objective of this book is to help you become a more savvy player and equip you to succeed in business.

key|points

The tasks of crafting and executing company strategies are the heart and soul of managing a business enterprise and winning in the marketplace. A company's **strategy** is the game plan management is using to stake out a market position, conduct its operations, attract and please customers, compete successfully, and achieve organizational objectives. The central thrust of a company's strategy is undertaking moves to build and strengthen the company's long-term competitive position and financial performance and, ideally, gain a competitive advantage over rivals that then becomes a company's ticket to above-average profitability. A company's strategy typically evolves and reforms over time, emerging from a blend of (1) proactive and purposeful actions on the part of company managers and (2) as-needed reactions to unanticipated developments and fresh market conditions.

Closely related to the concept of strategy is the concept of a company's **business model.** A company's business model is management's storyline for how and why the company's product offerings and competitive approaches will generate a revenue stream and have an associated cost structure that produces attractive earnings and return on investment—in effect, a company's business model sets forth the economic logic for making money in a particular business, given the company's current strategy.

A winning strategy fits the circumstances of a company's external situation and its internal resource strengths and competitive capabilities, builds competitive advantage, and boosts company performance.

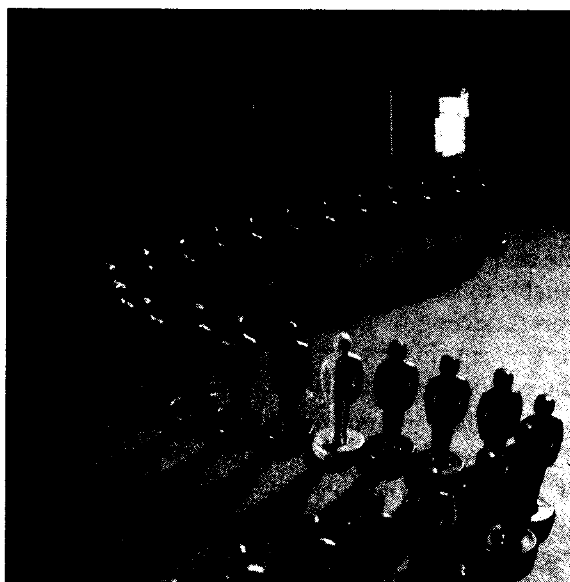
Crafting and executing strategy are core management functions. Whether a company wins or loses in the marketplace is directly attributable to the caliber of a company's strategy and the proficiency with which the strategy is executed.

| exercises

1. Go to www.redhat.com and check whether the company's business model is working. Is the company sufficiently profitable to validate its business model and strategy? Is its revenue stream from selling technical support services growing or declining as a percentage of total revenues? Does your review of the company's recent financial performance suggest that its business model and strategy are changing? Read the company's latest statement about its business model.
2. Go to www.levistrauss.com/about/vision and read what the company says about how its corporate values of originality, empathy, integrity, and courage are connected to its vision of clothing the world by marketing the most appealing and widely worn casual clothing in the world. Do you believe what the company says, or are its statements just a bunch of nice pontifications that represent the chief executive officer's personal values (and also good public relations)?

chapter | two 2

The Managerial Process of Crafting and Executing Strategy



(©Dale O'Dell/CORBIS)

Unless we change our direction we are likely to end up where we are headed.
—**Ancient Chinese proverb**

If we can know where we are and something about how we got there, we might see where we are trending—and if the outcomes which lie naturally in our course are unacceptable, to make timely change.
—**Abraham Lincoln**

If you don't know where you are going, any road will take you there.
—**The Koran**

Management's job is not to see the company as it is . . . but as it can become.
—**John W. Teets**
Former CEO

Crafting and executing strategy are the heart and soul of managing a business enterprise. But exactly what is involved in developing a strategy and executing it proficiently? And who besides top management has strategy-making, strategy-executing responsibility? In this chapter we present an overview of the managerial ins and outs of crafting and executing company strategies. Special attention will be given to management's direction-setting responsibilities—charting a strategic course, setting performance targets, and choosing a strategy capable of producing the desired outcomes. We will also examine which kinds of strategic decisions are made at which levels of management and the roles and responsibilities of the company's board of directors in the strategy-making, strategy-executing process.

WHAT DOES THE PROCESS OF CRAFTING AND EXECUTING STRATEGY ENTAIL?

Crafting and executing a company's strategy is a five-phase managerial process:

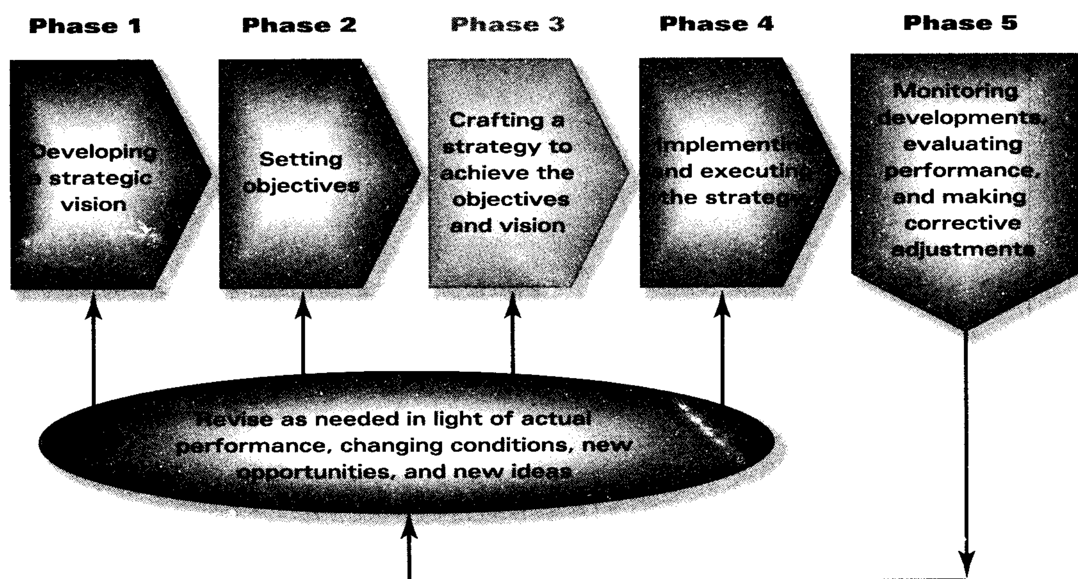
1. Developing a strategic vision of where the company needs to head and what its future product-customer-market-technology focus should be.
2. Setting objectives and using them as yardsticks for measuring the company's performance and progress.
3. Crafting a strategy to achieve the desired outcomes and move the company along the strategic course that management has charted.
4. Implementing and executing the chosen strategy efficiently and effectively.
5. Monitoring developments and initiating corrective adjustments in the company's long-term direction, objectives, strategy, or execution in light of the company's actual performance, changing conditions, new ideas, and new opportunities.

Figure 2.1 displays this process. Let's examine this five-phase strategy-making, strategy-executing framework in enough detail to set the stage for the forthcoming chapters and to give you a bird's-eye view of what the rest of this book is about.

DEVELOPING A STRATEGIC VISION: PHASE 1 OF THE STRATEGY-MAKING, STRATEGY-EXECUTING PROCESS

Very early in the strategy-making process, a company's senior managers must wrestle with the issue of what directional path the company should take and what changes in the company's product-market-customer-technology focus would improve its current market position and future prospects. Deciding to commit the company to one path versus another pushes managers to draw some carefully reasoned

figure 2.1 **The Strategy-Making, Strategy-Executing Process**



conclusions about how to try to modify the company's business makeup and the market position it should stake out. A number of direction-shaping factors need to be considered in deciding where to head and why such a direction makes good business sense—see Table 2.1.

core concept
A ***strategic vision*** is a road map showing the route a company intends to take in developing and strengthening its business. It paints a picture of a company's destination and provides a rationale for going there.

Top management's views and conclusions about the company's direction and the product-customer-market-technology focus constitute a **strategic vision** for the company. A strategic vision delineates management's aspirations for the business, providing a panoramic view of "where we are going" and a convincing rationale for why this makes good business sense for the company. A strategic vision thus points an organization in a particular direction, charts a strategic path for it to follow in preparing for the future, and molds organizational identity. A clearly articulated strategic vision communicates management's aspirations to stakeholders and helps steer the energies of company personnel in a common direction. For instance, Henry Ford's vision of a car in every garage had power because it captured the imagination of others, aided internal efforts to mobilize the Ford Motor Company's resources, and served as a reference point for gauging the merits of the company's strategic actions.

Well-conceived visions are distinctive and specific to a particular organization; they avoid generic, feel-good statements like "We will become a global leader and the first choice of customers in every market we choose to serve"—which could apply to any of hundreds of organizations.[1] And they are not the product of a committee charged with coming up with an innocuous but well-meaning one sentence vision that wins consensus approval from various stakeholders. Nicely worded vision statements with no specifics about the company's product-market-customer-technology focus are suspect. A strategic vision proclaiming management's quest "to be the market leader" or "to be the first choice of customers" or "to

table 2.1 **Factors to Consider in Deciding to Commit the Company to One Directional Path versus Another**

External Considerations	Internal Considerations
• Is the outlook for the company promising if it simply maintains its present product/market/customer/technology focus? Does sticking with the company's present strategic course present attractive growth opportunities? • Are changes under way in the market and competitive landscape enhancing or weakening the outlook for the company's present business? • What, if any, new customer groups and/or geographic markets should the company get in position to serve? • Which emerging market opportunities should the company pursue and which ones should it avoid? • Should the company plan to abandon any of the markets, market segments, or customer groups we are currently serving?	• What are our ambitions for the company? What industry standing does management want the company to have? • Will the company's present business generate sufficient growth and profitability in the years ahead to please shareholders? • What organizational strengths ought the company be trying to leverage in terms of adding new products or services and/or getting into new businesses? • Is the company stretching its resources too thin by trying to compete in too many markets or segments? Are some pieces of the company's business unprofitable? • Is the company's technological focus too broad or too narrow? Are any changes needed?

be the most innovative" or "to be recognized as the best company in the industry" offer scant guidance about a company's directions and what management intends to do to get there.

For a strategic vision to function as a valuable managerial tool, it must provide understanding of what management wants its business to look like and provide managers with a reference point in making strategic decisions and preparing the company for the future. It must say something definitive about how the company's leaders intend to position the company beyond where it is today. A good vision always needs to be a bit beyond a company's reach, but progress toward the vision is what unifies the efforts of company personnel. Table 2.2 lists some characteristics of an effective vision statement.

A sampling of vision statements currently in use shows a range from strong and clear to bland and ill-conceived. A surprising number of the vision statements found on company Web sites and in annual reports are dull, blurry, and uninspiring—they come across as having been written by a committee to attract consensus from a variety of organizational stakeholders and having been developed only because it is fashionable for companies to have an official vision statement.[2] Few corporate executives want to risk the embarrassment of being without a vision statement. The one- or two-sentence vision statement a company makes available to the public, of course, provides only a glimpse of what company executives are really thinking and where the company is headed and why. Having a vision is not a panacea but rather a useful management tool for giving an organization a sense of direction. Like any tool, it can be used properly or improperly, either strongly conveying a company's strategic course or not. Table 2.3 provides a list of the most common shortcomings in company vision statements.

Illustration Capsule 2.1 contains the strategic vision for Exelon, one of the leading and best-managed electric and gas utility companies in the United States. Illustration Capsule 2.2 provides examples of strategic visions of several prominent companies and nonprofit organizations. See if you can tell which ones are mostly meaningless or nice-sounding and which ones are managerially useful in communicating "where we are headed and the kind of company we are trying to become".

table 2.2 **Characteristics of an Effectively Worded Vision Statement**

Graphic	A well-stated vision paints a picture of the kind of company that management is trying to create and the market position the company is striving to stake out.
Directional	A well-stated vision says something about the company's journey or destination and signals the kinds of business and strategic changes that will be forthcoming.
Focused	A well-stated vision is specific enough to provide managers with guidance in making decisions and allocating resources.
Flexible	A well-stated vision is not a once-and-for-all-time pronouncement—visions about a company's future path may need to change as events unfold and circumstances change.
Feasible	A well-stated vision is within the realm of what the company can reasonably expect to achieve in due time.
Desirable	A well-stated vision appeals to the long-term interests of stakeholders—particularly shareowners, employees, and customers.
Easy to communicate	A well-stated vision is explainable in less than 10 minutes and ideally can be reduced to a simple, memorable slogan (like Henry Ford's famous vision of "a car in every garage").

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A Strategic Vision Is Different from a Mission Statement Whereas the chief concern of a strategic vision is with "where we are going and why," a company mission statement usually deals with a company's *present* business scope and purpose—"who we are, what we do, and why we are here." *A company's mission is defined by the buyer needs it seeks to satisfy, the customer groups and market segments it is endeavoring to serve, and the resources and technologies that it is deploying in trying to please its customers.* (Many companies prefer the term business purpose to mission statement, but the two phrases are essentially conceptually identical and are used interchangeably.) A typical example is the mission statement of Trader Joe's (a unique grocery chain):

> The mission of Trader Joe's is to give our customers the best food and beverage values that they can find anywhere and to provide them with the information required for informed buying decisions. We provide these with a dedication to the highest quality of customer satisfaction delivered with a sense of warmth, friendliness, fun, individual pride, and company spirit.

The distinction between a strategic vision and a mission statement is fairly clear-cut: A strategic vision portrays a company's future business scope ("where we are going") whereas a company's mission typically describes its present business scope and purpose ("who we are, what we do, and why we are here").

The mission statements that one finds in company annual reports or posted on company Web sites typically provide a brief overview of the company's present business purpose and raison d'être and sometimes its geographic coverage or standing as a market leader. They may or may not single out the company's present products/services, the buyer needs it is seeking to satisfy, the customer groups it serves, or its technological and business capabilities. But company mission statements almost never say anything about where the company is headed, the anticipated changes in its business, or its aspirations.

Occasionally, companies couch their mission in terms of making a profit. The notion that a company's mission or business purpose is to make a profit is misguided—profit is more correctly an *objective* and a *result* of what a company does. Making a profit is the obvious intent

table 2.3 **Common Shortcomings in Company Vision Statements**

1. Incomplete—short on specifics about where the company is headed or what kind of company management is trying to create.
2. Vague—doesn't provide much indication of whether or how management intends to alter the company's current product/market/customer/technology focus.
3. Bland—lacking in motivational power.
4. Not distinctive—could apply to most any company (or at least several others in the same industry).
5. Too reliant on such superlatives as *best, most successful, recognized leader, global or worldwide leader,* or *first choice of customers.*
6. Too generic—fails to identify the business or industry to which it is supposed to apply. The statement could apply to companies in any of several industries.
7. So broad that it really doesn't rule out most any opportunity that management might opt to pursue.

of every commercial enterprise. It is management's answer to "make a profit doing what and for whom?" that reveals the substance of a company's mission and gives it an identity apart from any other profit-seeking company. Such companies as Charles Schwab, Caterpillar, Toyota, Wal-Mart, and Nokia are each striving to earn a profit for shareholders; but plainly the fundamentals of their business are substantially different when it comes to "who we are and what we do." If a company's mission statement is to have any managerial value or reveal anything useful about its business, it must direct attention to the particular market arena in which it operates—the buyer needs it seeks to satisfy, the customer groups and market segments it is endeavoring to serve, and the types of resources and technologies that it is deploying in trying to please its customers.

Linking the Vision with Company Values

In the course of deciding "who we are and where we are going," many companies also come up with a statement of values to guide the company's pursuit of its vision. By **values,** we means the beliefs, business principles, and practices that are incorporated into the way the company operates and the behavior of company personnel. Values relate to such things as treatment of employees and customers, integrity, ethics, innovativeness, emphasis on quality or service, social responsibility, and community citizenship. Company values statements tend to contain between four and eight values, which, ideally, are tightly connected to and reinforce the company's vision, strategy, and operating practices. Home Depot has embraced eight values (entrepreneurial spirit, excellent customer service, giving back to the community, respect for all people, doing the right thing, taking care of people, building strong relationships, and creating shareholder value) in its quest to become the world's largest home improvement retailer by operating warehouse stores filled with a wide assortment of products at the lowest prices with trained associates giving absolutely the best customer service in the industry. Intel's corporate values of discipline, risk taking, quality, customer orientation, a results-oriented atmosphere, and being a great place to work guide the company's business behavior and pursuit of its "core mission" of "being the building block supplier to the Internet economy." At Intel, all employee badges are emblazoned with the company's values and employees are trained in over 40 behaviors exemplifying those values. DuPont, which calls itself "a science company" and makes a wide array of products, stresses four values—safety, ethics,

core concept
A company's ***values*** are the beliefs, business principles, and practices that guide the conduct of its business, the pursuit of its strategic vision, and the behavior of company personnel.

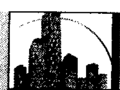

illustration capsule 2.1
Exelon's Strategic Vision

Exelon, an electric and gas utility company recently created by the merger of Philadelphia Electric Company and Commonwealth Edison, has the following vision statement:

EXELON—ONE COMPANY, ONE VISION

Exelon strives to build exceptional value—by becoming the best and most consistently profitable electricity and gas company in the United States. To succeed, we must . . .

Live up to our commitments	• Keep the lights on. • Perform safely—especially nuclear operations. • Constantly improve our environmental performance. • Act honorably and treat everyone with respect, decency, and integrity. • Continue building a high performance culture that reflects the diversity of our communities. • Report our results, opportunities, and problems honestly and reliably.
Perform at world-class levels	• Relentlessly pursue greater productivity, quality, and innovation. • Understand the relationships among our businesses and optimize the whole. • Promote and implement policies that build effective markets. • Adapt rapidly to changing markets, politics, economics and technology to meet our customers' needs. • Maximize the earnings and cash flow from our assets and businesses and sell those that do not meet our goals.
Invest in our consolidating industry	• Develop strategies based on learning from past successes and failures. • Implement systems and best practices that can be applied to future acquisitions. • Prioritize acquisition opportunities based on synergies from scale, scope, generation and delivery integration, and our ability to profitably satisfy . . . regulatory obligations. • Make acquisitions that will best employ our limited investment resources to produce the most consistent cash flow and earnings accretion. • Return earnings to shareholders when higher returns are not available from acquisition opportunities.

COMMENTARY ON EXELON'S VISION

While the one-sentence vision is definitely overly general and void of direction, what rescues it (and makes the overall vision statement managerially useful) are the specifics that follow. The three things that management says the company must do to succeed and the accompanying bullet points convey a reasonably clear sense of where management intends to take the company and what the company is endeavoring to do in order to deliver exceptional value to stakeholders. But Exelon's vision statement is still somewhat vague on where management is trying to take the company in terms of its future product/market/customer/ technology focus.

Source: Company documents.

respect for people, and environmental stewardship; the first three have been in place since the company was founded over 200 years ago by E. I. du Pont. Loblaw, a major grocery chain in Canada, focuses on just two main values in operating its stores—competence and honesty; it expects employees to display both, and top management strives to promote only those employees who are smart and honest.

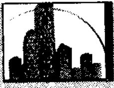

illustration capsule 2.2

Examples of Strategic Visions—How Well Do They Measure Up?

Using the information in Tables 2.2 and 2.3, critique the adequacy and merit of the following eight vision statements, ranking them from 1 (best) to 8 (in need of substantial improvement).

RED HAT LINUX

To extend our position as the most trusted Linux and open source provider to the enterprise. We intend to grow the market for Linux through a complete range of enterprise Red Hat Linux software, a powerful Internet management platform, and associated support and services.

WELLS FARGO

We want to satisfy all of our customers' financial needs, help them succeed financially, be the premier provider of financial services in every one of our markets, and be known as one of America's great companies.

WYETH

Our vision is to lead the way to a healthier world. By carrying out this vision at every level of our organization, we will be recognized by our employees, customers, and shareholders as the best pharmaceutical company in the world, resulting in value for all. We will achieve this by:

- Leading the world in innovation by linking pharmaceutical, biotech, and vaccines technologies
- Making quality, integrity, and excellence hallmarks of the way we do business
- Attracting, developing, and motivating the best people
- Continually growing and improving our business

GENERAL ELECTRIC

We will become number one or number two in every market we serve, and revolutionize this company to have the speed and agility of a small enterprise.

THE DENTAL PRODUCTS DIVISION OF 3M CORPORATION

Become THE supplier of choice to the global dental professional markets, providing world-class quality and innovative products. [All employees of the division wear badges bearing these words, and whenever a new product or business procedure is being considered, management asks "Is this representative of THE leading dental company?"]

NIKE

To bring innovation and inspiration to every athlete in the world.

HEINZ

Our vision, quite simply, is to be the world's premier food company, offering nutritious, superior tasting foods to people everywhere. Being the premier food company does not mean being the biggest but it does mean being the best in terms of consumer value, customer service, employee talent, and consistent and predictable growth.

INTEL

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

Sources: Company documents and Web sites.

Company managers connect values to the strategic vision in one of two ways. In companies with long-standing and deeply entrenched values, managers go to great lengths to explain how the vision is compatible with the company's value set, occasionally reinterpreting the meaning of existing values to indicate their relevance in pursuing the strategic vision. In new companies or companies with weak or incomplete sets of values, top management considers what values, beliefs, and operating principles will help drive the vision forward. Then new values that fit the vision are drafted and circulated among managers and employees for discussion and possible modification. A final values statement that connects to

the vision and that reflects the beliefs and principles the company wants to uphold is then officially adopted. A number of companies combine their vision and values into a single statement or document that is provided to all company personnel and often posted on the company's Web site.

Of course, sometimes there is a wide gap between a company's stated values and its actual conduct. Enron, for example, touted four corporate values—respect, integrity, communication, and excellence—but flagrant disregard for these values by some top officials in their management of the company's financial and accounting practices and energy-trading activities triggered the company's implosion. Once one of the world's Big Five public accounting firms, Arthur Andersen was renowned for its commitment to the highest standards of audit integrity, but its high-profile audit failures and partner approval of shady accounting at Enron, WorldCom, and other companies led to Andersen's demise.

Communicating the Strategic Vision

Developing a well-conceived vision is necessary but not sufficient. Effectively communicating the strategic vision down the line to lower-level managers and employees is as important as the strategic soundness of the journey and destination for which top management has opted. If company personnel don't know what management's vision is and don't buy into the rationale for the direction management wants the company to head, they are unlikely to wholeheartedly commit themselves to making the vision a reality. Furthermore, company personnel need to believe that top management has a sound basis for where it is trying to take the company, and they need to understand why the strategic course that management has charted is both reasonable and beneficial.

Winning the support of organization members for the vision nearly always means putting "where we are going and why" in writing, distributing the statement organizationwide, and having executives personally explain the vision and its rationale to as many people as feasible. Ideally, executives should present their vision for the company in a manner that reaches out and grabs people. An engaging and convincing vision can have enormous motivational value—for the same reason that a stonemason finds building a magnificent cathedral more inspiring than laying stones. When top management articulates a vivid and compelling picture of what the company needs to do and why, organizational members begin to say, "This has a lot of merit. I want to be involved and contribute to making it happen." The more that a vision evokes positive support and excitement, the greater its impact in terms of arousing a committed organizational effort and getting people to move in a common direction.[3]

core concept
An effectively communicated vision is management's most valuable tool for enlisting the commitment of company personnel to actions that will make the vision a reality.

Most organization members will rise to the challenge of pursuing a path that may significantly enhance the company's competitiveness and market prominence, win big applause from buyers and turn them into loyal customers, or produce important benefits for society as a whole. Presenting the vision as an endeavor that could make the company the world leader or greatly improve the well-being of customers and/or society is far more motivating than stressing the payoff for shareholders—it goes without saying that the company intends to profit shareholders. Unless most managers and employees are also shareholders (because the company incentivizes employees via a stock ownership plan), they are unlikely to be energized by a vision that does little more than enrich shareholders.

Executive ability to paint a convincing and inspiring picture of a company's journey and destination is an important element of effective strategic leadership.

Expressing the Essence of the Vision in a Slogan The task of effectively conveying the vision to company personnel is made easier when management's vision of where to head is captured in

a catchy slogan. A number of organizations have summed up their visions in a brief phrase:

- Levi Strauss & Company: "We will clothe the world by marketing the most appealing and widely worn casual clothing in the world."
- Microsoft Corporation: "Empower people through great software—any time, any place, and on any device."
- Mayo Clinic: "The best care to every patient every day."
- Scotland Yard: "To make London the safest major city in the world."
- Greenpeace: "To halt environmental abuse and promote environmental solutions."
- Charles Schwab: "To provide customers with the most useful and ethical financial services in the world."

Creating a short slogan to illuminate an organization's direction and purpose and then using it repeatedly as a reminder of the "where we are headed and why" helps keep organization members on the chosen path. But it is important to bear in mind that developing a strategic vision is not a wordsmithing exercise to come up with a snappy slogan. Rather, it is an exercise in thinking carefully about where a company needs to head to be successful. It involves selecting the market arenas in which to participate, putting the company on a clearly defined strategic course, and making a commitment to follow that course.

Breaking Down Resistance to a New Strategic Vision It is particularly important for executives to provide a compelling rationale for a dramatically *new* strategic vision and company direction. When company personnel don't understand or accept the need for redirecting organizational efforts, they are prone to resist change. Hence, reiterating the basis for the new direction, addressing employee concerns head-on, calming fears, lifting spirits, and providing updates and progress reports as events unfold all become part of the task in mobilizing support for the vision and winning commitment to needed actions. Just stating the case for a new direction once is not enough. Executives must repeat the reasons for the new direction often and convincingly at company gatherings and in company publications, and they must reinforce their pronouncements with updates about how the latest information confirms the choice of direction and the validity of the vision. Unless and until more and more people are persuaded of the merits of management's new vision and the vision gains wide acceptance, it will be a struggle to move the organization down the newly chosen path.

Recognizing Strategic Inflection Points Sometimes there's an order-of-magnitude change in a company's environment that dramatically alters its prospects and mandates radical revision of its strategic course. Intel's chairman Andrew Grove calls such occasions *strategic inflection points*—Illustration Capsule 2.3 relates Intel's two encounters with strategic inflection points and the resulting alterations in its strategic vision. As the Intel example forcefully demonstrates, when a company reaches a strategic inflection point, management has some tough decisions to make about the company's course. Often it is a question of what to do to sustain company success, not just how to avoid possible disaster. Responding to unfolding changes in the marketplace in timely fashion lessens a company's chances of becoming trapped in a stagnant or declining business or letting attractive new growth opportunities slip away.

The Payoffs of a Clear Vision Statement In sum, a well-conceived, forcefully communicated strategic vision pays off in several respects: (1) it crystallizes senior executives' own views about the firm's long-term direction; (2) it reduces the risk of rudderless decision making; (3) it is a tool for

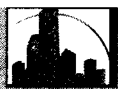

illustration capsule 2.3

Intel's Two Strategic Inflection Points

Intel Corporation has encountered two strategic inflection points within the past 20 years. The first came in the mid-1980s, when memory chips were Intel's principal business and Japanese manufacturers, intent on dominating the memory chip business, began cutting their prices 10 percent below the prices charged by Intel and other U.S. memory chip manufacturers. Each time U.S. companies matched the Japanese price cuts, the Japanese manufacturers responded with another 10 percent price cut. Intel's management explored a number of strategic options to cope with the aggressive pricing of its Japanese rivals—building a giant memory chip factory to overcome the cost advantage of Japanese producers, investing in research and development (R&D) to come up with a more advanced memory chip, and retreating to niche markets for memory chips that were not of interest to the Japanese.

At the time, Gordon Moore, Intel's chairman and cofounder, and Andrew Grove, Intel's chief executive officer (CEO), jointly concluded that none of these options offered much promise and that the best long-term solution was to abandon the memory chip business even though it accounted for 70 percent of Intel's revenue. Grove, with the concurrence of both Moore and the board of directors, then proceeded to commit Intel's full energies to the business of developing ever more powerful microprocessors for personal computers. (Intel had invented microprocessors in the early 1970s but had recently been concentrating on memory chips because of strong competition and excess capacity in the market for microprocessors.)

Grove's bold decision to withdraw from memory chips, absorb a $173 million write-off in 1986, and go all out in microprocessors produced a new strategic vision for Intel—becoming the preeminent supplier of microprocessors to the personal computing industry, making the personal computer (PC) the central appliance in the workplace and the home, and being the undisputed leader in driving PC technology forward. Grove's new vision for Intel and the strategic course he charted in 1985 produced spectacular results. Since 1996, over 80 percent of the world's PCs have been made with Intel microprocessors and Intel has become the world's most profitable chip maker.

The company encountered a second inflection point in 1998, opting to refocus on becoming the preeminent building block supplier to the Internet economy (see Illustration Capsule 2.2) and spurring efforts to make the Internet more useful. Starting in early 1998 and responding to the mushrooming importance of the Internet, Intel's senior management launched major new initiatives to direct attention and resources to expanding the capabilities of both the PC platform and the Internet. It was this strategic inflection point that led to Intel's latest strategic vision of playing a major role in getting a billion computers connected to the Internet worldwide, installing millions of servers, and building an Internet infrastructure that would support trillions of dollars of e-commerce and serve as a worldwide communication medium.

Source: Andrew S. Grove, *Only the Paranoid Survive,* (New York: Doubleday-Currency, 1996) and information posted at www.intel.com.

winning the support of organizational members for internal changes that will help make the vision a reality; (4) it provides a beacon for lower-level managers in forming departmental missions, setting departmental objectives, and crafting functional and departmental strategies that are in sync with the company's overall strategy; and (5) it helps an organization prepare for the future. When management is able to demonstrate significant progress in achieving these five benefits, the first step in organizational direction setting has been successfully completed.

SETTING OBJECTIVES: PHASE 2 OF THE STRATEGY-MAKING, STRATEGY-EXECUTING PROCESS

The managerial purpose of setting **objectives** is to convert the strategic vision into specific performance targets—results and outcomes the company's management wants to achieve—and then use these

objectives as yardsticks for tracking the company's progress and performance. Well-stated objectives are *quantifiable,* or *measurable,* and contain a *deadline for achievement.* As Bill Hewlett, cofounder of Hewlett-Packard, shrewdly observed, "You cannot manage what you cannot measure . . . And what gets measured gets done."[4] The experiences of countless companies and managers teach that precisely spelling out *how much* of *what kind* of performance *by when* and then pressing forward with actions and incentives calculated to help achieve the targeted outcomes will boost a company's actual performance. It definitely beats setting vague targets like "increase profits," "reduce costs," "become more efficient," or "boost sales," which specify neither how much nor by when, and then living with whatever results company personnel deliver.

core concept
Objectives **are an organization's performance targets—the results and outcomes it wants to achieve. They function as yardsticks for tracking an organization's performance and progress.**

Ideally, managers ought to use the objective-setting exercise as a tool for truly *stretching an organization to reach its full potential.* Challenging company personnel to go all out and deliver big gains in performance pushes an enterprise to be more inventive, to exhibit some urgency in improving both its financial performance and its business position, and to be more intentional and focused in its actions. *Stretch objectives* help build a firewall against contentment with slow, incremental improvements in organizational performance. As Mitchell Leibovitz, CEO of the auto parts and service retailer Pep Boys, once said, "If you want to have ho-hum results, have ho-hum objectives."

What Kinds of Objectives to Set: The Need for a Balanced Scorecard

Two very distinct types of performance yardsticks are required: those relating to *financial performance* and those relating to *strategic performance*—outcomes that indicate a company is strengthening its marketing standing, competitive vitality, and future business prospects. The following are examples of commonly used financial and strategic objectives:

Financial Objectives	Strategic Objectives
• An *x* percent increase in annual revenues • Annual increases in after-tax profits of *x* percent • Annual increases in earnings per share of *x* percent • Annual dividend increases of *x* percent • Profit margins of *x* percent • An *x* percent return on capital employed (ROCE) or shareholders' equity (ROE) • Increased shareholder value—in the form of an upward-trending stock price and annual dividend increases • Strong bond and credit ratings • Sufficient internal cash flows to fund new capital investment • Stable earnings during periods of recession	• Winning an *x* percent market share • Achieving lower overall costs than rivals • Overtaking key competitors on product performance or quality or customer service • Deriving *x* percent of revenues from the sale of new products introduced within the past five years • Achieving technological leadership • Having better product selection than rivals • Strengthening the company's brand-name appeal • Having stronger national or global sales and distribution capabilities than rivals • Consistently getting new or improved products to market ahead of rivals

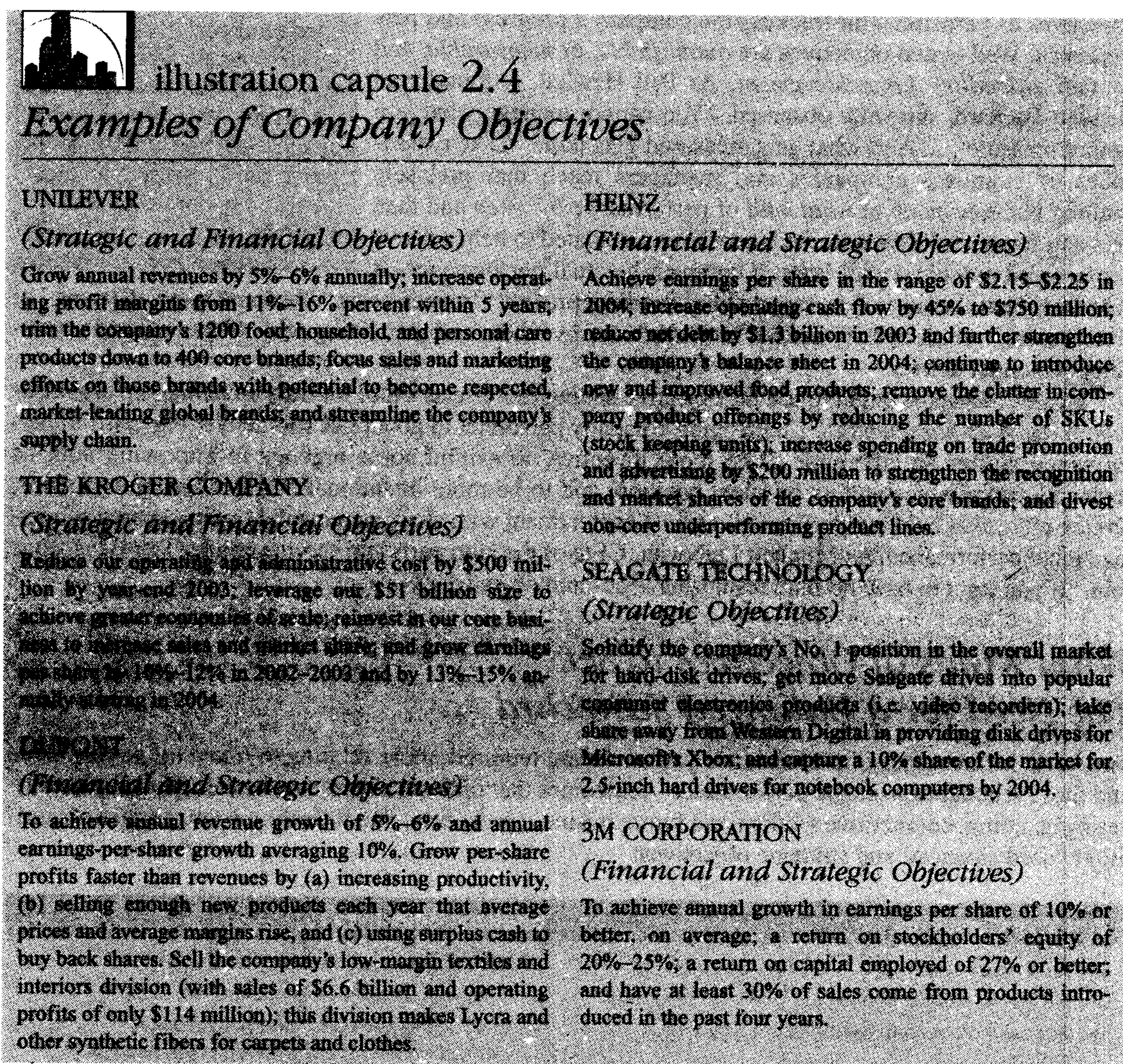

illustration capsule 2.4
Examples of Company Objectives

UNILEVER

(Strategic and Financial Objectives)

Grow annual revenues by 5%–6% annually; increase operating profit margins from 11%–16% percent within 5 years; trim the company's 1200 food, household, and personal care products down to 400 core brands; focus sales and marketing efforts on those brands with potential to become respected, market-leading global brands; and streamline the company's supply chain.

THE KROGER COMPANY

(Strategic and Financial Objectives)

Reduce our operating and administrative cost by $500 million by year-end 2003; leverage our $51 billion size to achieve greater economies of scale; reinvest in our core business to increase sales and market share; and grow earnings per share by 10%–12% in 2002–2003 and by 13%–15% annually starting in 2004.

DUPONT

(Financial and Strategic Objectives)

To achieve annual revenue growth of 5%–6% and annual earnings-per-share growth averaging 10%. Grow per-share profits faster than revenues by (a) increasing productivity, (b) selling enough new products each year that average prices and average margins rise, and (c) using surplus cash to buy back shares. Sell the company's low-margin textiles and interiors division (with sales of $6.6 billion and operating profits of only $114 million); this division makes Lycra and other synthetic fibers for carpets and clothes.

HEINZ

(Financial and Strategic Objectives)

Achieve earnings per share in the range of $2.15–$2.25 in 2004; increase operating cash flow by 45% to $750 million; reduce net debt by $1.3 billion in 2003 and further strengthen the company's balance sheet in 2004; continue to introduce new and improved food products; remove the clutter in company product offerings by reducing the number of SKUs (stock keeping units); increase spending on trade promotion and advertising by $200 million to strengthen the recognition and market shares of the company's core brands; and divest non-core underperforming product lines.

SEAGATE TECHNOLOGY

(Strategic Objectives)

Solidify the company's No. 1 position in the overall market for hard-disk drives; get more Seagate drives into popular consumer electronics products (i.e. video recorders); take share away from Western Digital in providing disk drives for Microsoft's Xbox; and capture a 10% share of the market for 2.5-inch hard drives for notebook computers by 2004.

3M CORPORATION

(Financial and Strategic Objectives)

To achieve annual growth in earnings per share of 10% or better, on average; a return on stockholders' equity of 20%–25%; a return on capital employed of 27% or better; and have at least 30% of sales come from products introduced in the past four years.

Sources: Company documents; *Business Week* (July 28, 2003), p. 106; *Business Week* (September 8, 2003), p. 108.

Achieving acceptable financial results is a must. Without adequate profitability and financial strength, a company's pursuit of its strategic vision, as well as its long-term health and ultimate survival, is jeopardized. Further subpar earnings and a weak balance sheet alarm shareholders and creditors and put the jobs of senior executives at risk.

But good financial performance, by itself, is not enough. Of equal or greater importance is a company's strategic performance—outcomes that indicate whether a company's market position and competitiveness are deteriorating, holding steady, or improving. Illustration Capsule 2.4 shows selected objectives of several prominent companies.

Improved Strategic Performance Fosters Better Financial Performance A company's financial performance measures are really *lagging indicators* that reflect the results of past

decisions and organizational activities. But a company's past or current financial performance is not a reliable indicator of its future prospects—poor financial performers often turn things around and do better, while good financial performers can fall on hard times. The best and most reliable *leading indicators* of a company's future financial performance and business prospects are strategic outcomes that indicate whether the company's competitiveness and market position are stronger or weaker. For instance, if a company has set aggressive strategic objectives and is achieving them—such that its competitive strength and market position are on the rise—then there's reason to expect that its future financial performance will be better than its current or past performance. If a company is losing ground to competitors and its market position is slipping—outcomes that reflect weak strategic performance (and, very likely, failure to achieve its strategic objectives)—then its ability to maintain its present profitability is highly suspect. Hence, the degree to which a company's managers set, pursue, and achieve stretch strategic objectives tends to be a reliable leading indicator of its ability to generate higher profits from business operations.

The Balanced Scorecard Approach: A Combination of Strategic and Financial Objectives The balanced scorecard approach for measuring company performance requires setting both financial and strategic objectives and tracking their achievement. Unless a company is in deep financial difficulty, such that its very survival is threatened, company managers are well advised to put more emphasis on achieving strategic objectives than on achieving financial objectives whenever a trade-off has to be made. *The surest path to sustained future profitability quarter after quarter and year after year is to relentlessly pursue strategic outcomes that strengthen a company's business position and, ideally, give it a growing competitive advantage over rivals.* What ultimately enables a company to deliver better financial results from operations is the achievement of strategic objectives that improve its competitiveness and market strength.

Illustration Capsule 2.5 describes why a growing number of companies are utilizing both financial and strategic objectives to create a "balanced scorecard" approach to measuring company performance.

A Need for Both Short-Term and Long-Term Objectives As a rule, a company's set of financial and strategic objectives ought to include both short-term and long-term performance targets. Having quarterly or annual objectives focuses attention on delivering immediate performance improvements. Targets to be achieved within three to five years prompt considerations of what to do *now* to put the company in position to perform better down the road. A company that has an objective of doubling its sales within five years can't wait until the third or fourth year to begin growing its sales and customer base. By spelling out annual (or perhaps quarterly) performance targets, management indicates the *speed* at which longer-range targets are to be approached.

Short-range objectives can be identical to long-range objectives if an organization is already performing at the targeted long-term level. For instance, if a company has an ongoing objective of 15 percent profit growth every year and is currently achieving this objective, then the company's long-range and short-range objectives for increasing profits coincide. The most important situation in which short-range objectives differ from long-range objectives occurs when managers are trying to elevate organizational performance and cannot reach the long-range target in just one year. Short-range objectives then serve as stairsteps or milestones.

The Concept of Strategic Intent A company's objectives sometimes play another role—that of signaling unmistakable **strategic intent** to make quantum gains in competing against key rivals and

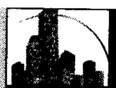

illustration capsule 2.5

Organizations That Use a Balanced Scorecard Approach to Objective Setting

In recent years organizations like Exxon Mobil, CIGNA, United Parcel Service, Sears, Nova Scotia Power, Duke Children's Hospital, and the City of Charlotte, North Carolina—among numerous others—have used the "Balanced Scorecard" approach to objective setting in all or parts of their operations. This approach, developed and fine-tuned by two Harvard professors, stems from the recognition that exclusive reliance on financial performance measures, which really are lag indicators (i.e., they report the consequences of past actions), induced company managers to take actions that make the company's near-term financial performance look good and to neglect the lead indicators (i.e., the drivers of future financial performance). The solution: measure the performance of a company's strategy and make strategic objectives an integral part of a company's set of performance targets. The balanced scorecard approach to objective setting advocates using a company's strategic vision and strategy as the basis for determining what specific strategic and financial outcomes are appropriate measures of the progress a company is making. The intent is to use the balanced scorecard (containing a carefully chosen combination of strategic and financial performance indicators tailored to the company's particular business) as a tool for managing strategy and measuring its effectiveness.

Four of the initial users of the balanced scorecard approach were money-losing operations that were trailing the industry. Each had new management teams that were implementing strategies that required market repositioning and becoming more customer-driven. All four needed to adopt a new set of cultural values and priorities as well as cost reduction measures. At these four companies, use of a balanced scorecard, consisting of both financial targets (the lag indicators) and strategic targets (the lead indicators of future financial performance), not only served as a vehicle for helping communicate the strategy to organization personnel but also caused the organization to become more strategy-focused.

During the past decade, growing numbers of companies have adopted a balanced scorecard approach, believing that a mix of financial and strategic performance targets is superior to a purely financial set of performance measures and that winning in the marketplace requires paying close attention to whether the company's present strategy is boosting its competitiveness and promoting the development of a sustainable competitive advantage.

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core concept
A company exhibits ***strategic intent*** when it relentlessly pursues an ambitious strategic objective and concentrates its full resources and competitive actions on achieving that objective.

establish itself as a clear-cut winner in the marketplace, often against long odds.[5] A company's strategic intent can entail becoming the dominant company in the industry, unseating the existing industry leader, delivering the best customer service of any company in the industry (or the world), or turning a new technology into products capable of changing the way people work and live. Ambitious companies almost invariably begin with strategic intents that are out of proportion to their immediate capabilities and market positions. But they are undeterred by a grandiose objective that may take a sustained effort of 10 years or more to achieve. So intent are they on reaching the target that they set aggressive stretch objectives and pursue them relentlessly, sometimes even obsessively. Capably managed, up-and-coming enterprises with strategic intents exceeding their present reach and resources often prove to be more formidable competitors over time than larger cash-rich rivals with modest market ambitions. Nike's strategic intent during the 1960s was to overtake Adidas, which connected nicely with Nike's core purpose "to experience the emotion of competition, winning, and crushing competitors." Throughout the 1980s,

Wal-Mart's strategic intent was to "overtake Sears" as the largest U.S. retailer (a feat accomplished in 1991). For some years, Toyota has been driving to overtake General Motors as the world's largest motor vehicle producer (and it surpassed Ford Motor Company in total vehicles sold in 2003, to rank in second place).

Sometimes a company's strategic intent serves as a rallying cry for managers and employees. When Yamaha overtook Honda in the motorcycle market, Honda responded with "*Yamaha wo tsubusu*" ("We will crush, squash, slaughter Yamaha"). Canon's strategic intent in copying equipment was to "beat Xerox." In the 1960s, Komatsu, Japan's leading earth-moving equipment company, had little market presence outside Japan, depended on its small bulldozers for most of its revenue, and was less than one-third the size of its U.S. rival Caterpillar. But Komatsu's strategic intent was to eventually "encircle Caterpillar" with a broader product line and then compete globally against Caterpillar—its motivating battle cry among managers and employees was "beat Caterpillar." By the late 1980s, Komatsu was the industry's second-ranking company, with a strong sales presence in North America, Europe, and Asia plus a product line that included industrial robots and semiconductors as well as a broad selection of earth-moving equipment.

The Need for Objectives at All Organizational Levels Objective setting should not stop with top management's establishing of companywide performance targets. Company objectives need to be broken down into performance targets for each separate business, product line, functional department, and individual work unit. Company performance can't reach full potential unless each area of the organization does its part and contributes directly to the desired companywide outcomes and results. This means setting performance targets for each organization unit that support—rather than conflict with or negate—the achievement of companywide strategic and financial objectives.

The ideal situation is a team effort in which each organizational unit strives to produce results in its area of responsibility that contribute to the achievement of the company's performance targets and strategic vision. Such consistency signals that organizational units know their strategic role and are on board in helping the company move down the chosen strategic path and produce the desired results.

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

personnel, breaks the sales objective of 1 million units into unit sales targets for each sales territory, each item in the product line, and each salesperson. It is logical for organizationwide objectives and strategy to be established first so that they can guide objective setting and strategy making at lower levels.

A top-down process of setting objectives ensures that the financial and strategic performance targets established for business units, divisions, functional departments, and operating units are directly connected to the achievement of companywide objectives. This integration of objectives has two powerful advantages: (1) it helps produce *cohesion* among the objectives and strategies of different parts of the organization, and (2) it helps *unify internal efforts* to move the company along the chosen strategic path. Bottom-up objective setting, with little or no guidance from above, nearly always signals an absence of strategic leadership on the part of senior executives.

CRAFTING A STRATEGY: PHASE 3 OF THE STRATEGY-MAKING, STRATEGY-EXECUTING PROCESS

A company's senior executives obviously have important strategy-making roles. An enterprise's chief executive officer (CEO), as captain of the ship, carries the mantles of chief direction setter, chief objective setter, chief strategy maker, and chief strategy implementer for the total enterprise. Ultimate responsibility for *leading* the strategy-making, strategy-executing process rests with the CEO. In some enterprises the CEO or owner functions as strategic visionary and chief architect of strategy, personally deciding which of several strategic options to pursue, although senior managers and key employees may well assist with gathering and analyzing background data and advising the CEO on which way to go. Such an approach to strategy development is characteristic of small owner-managed companies and sometimes large corporations that have been founded by the present CEO—Michael Dell at Dell Computer, Bill Gates at Microsoft, and Howard Schultz at Starbucks are prominent examples of corporate CEOs who exert a heavy hand in shaping their company's strategy.

In most companies, however, the heads of business divisions and major product lines; the chief financial officer; and vice presidents (VPs) for production, marketing, human resources, and other functional departments have influential strategy-making roles. Normally, a company's chief financial officer is in charge of devising and implementing an appropriate financial strategy; the production VP takes the lead in developing and executing the company's production strategy; the marketing VP orchestrates sales and marketing strategy; a brand manager is in charge of the strategy for a particular brand in the company's product lineup, and so on.

But it is a mistake to view strategy-making as exclusively a top management function, the province of owner-entrepreneurs, CEOs, and other senior executives. The more wide-ranging a company's operations are, the more that strategy making is a collaborative team effort involving managers (and sometimes key employees) down through the whole organizational hierarchy. Take a company like Toshiba—a $43 billion corporation with 300 subsidiaries, thousands of products, and operations extending across the world. It would be a far-fetched error to assume that a few senior executives in Toshiba headquarters have either the expertise or a sufficiently detailed understanding of all the relevant factors to wisely craft all the strategic initiatives taken in Toshiba's numerous and diverse organizational units. Rather, it takes

core concept
Every company manager has a strategy-making, strategy-executing role—it is flawed thinking to look on the tasks of managing strategy as something only high-level managers do.

involvement on the part of Toshiba's whole management team to craft and execute the thousands of strategic initiatives that constitute the whole of Toshiba's strategy.

Major organizational units in a company—business divisions, product groups, functional departments, plants, geographic offices, distribution centers—normally have a leading or supporting role in the company's strategic game plan. Because senior executives in the corporate office seldom know enough about the situation in every geographic area and operating unit to direct every strategic move made in the field, it is common practice for top-level managers to delegate strategy-making authority to middle- and lower-echelon managers who head the organizational subunits where specific strategic results must be achieved. The more that a company's operations cut across different products, industries, and geographical areas, the more that headquarters executives are prone to delegate considerable strategy-making authority to on-the-scene personnel who have firsthand knowledge of customer requirements, can better evaluate market opportunities, and are better able to keep the strategy responsive to changing market and competitive conditions. While managers farther down in the managerial hierarchy obviously have a narrower, more specific strategy-making, strategy-executing role than managers closer to the top, the important understanding here is that in most of today's companies *every company manager typically has a strategy-making, strategy-executing role—ranging from minor to major—for the area he or she heads.* Hence, the notion that an organization's strategists are at the top of the management hierarchy and that midlevel and frontline managers and employees merely carry out their directives is misguided.

With decentralized decision making becoming common at companies of all stripes, it is now typical for key pieces of a company's strategy to originate in a company's middle and lower ranks.[6] For example, in a recent year, Electronic Data Systems conducted a yearlong strategy review involving 2,500 of its 55,000 employees and coordinated by a core of 150 managers and staffers from all over the world.[7] J. M. Smucker Company, well known for its jams and jellies, formed a team of 140 employees (7 percent of its 2,000-person workforce) who spent 25 percent of their time over a six-month period looking for ways to rejuvenate the company's growth. Involving teams of people to dissect complex situations and come up with strategic solutions is becoming increasingly necessary in many businesses. Not only are many strategic issues too far-reaching or too involved for a single manager to handle, but they often cut across functional areas and departments, thus requiring the contributions of many disciplinary experts and the collaboration of managers from different parts of the organization. A valuable strength of collaborative strategy making is that the group of people charged with crafting the strategy can easily include the very people who will also be charged with implementing and executing it. Giving people an influential stake in crafting the strategy they must later help implement and execute not only builds motivation and commitment but also allows them to be held accountable for putting the strategy into place and making it work—the oft-used excuse of "It wasn't my idea to do this" won't fly.

In some companies, top management makes a regular practice of encouraging individuals and teams to develop and champion proposals for new product lines and new business ventures. The idea is to unleash the talents and energies of promising "corporate intrapreneurs," letting them try out untested business ideas and giving them the room to pursue new strategic initiatives. Executives serve as judges of which proposals merit support, give company intrapreneurs the needed organizational and budgetary support, and let them run with the ball. Thus, important pieces of company strategy originate with those intrapreneuring individuals and teams who succeed in championing a proposal through the approval stage

and then end up being charged with the lead role in launching new products, overseeing the company's entry into new geographic markets, or heading up new business ventures. W. L. Gore and Associates, a privately owned company famous for its Gore-Tex waterproofing film, is an avid and highly successful practitioner of the corporate intrapreneur approach to strategy making. Gore expects all employees to initiate improvements and to display innovativeness. Each employee's intrapreneuring contributions are prime considerations in determining raises, stock option bonuses, and promotions. W. L. Gore's commitment to intrapreneuring has produced a stream of product innovations and new strategic initiatives that has kept the company vibrant and growing for nearly two decades.

The Strategy-Making Pyramid

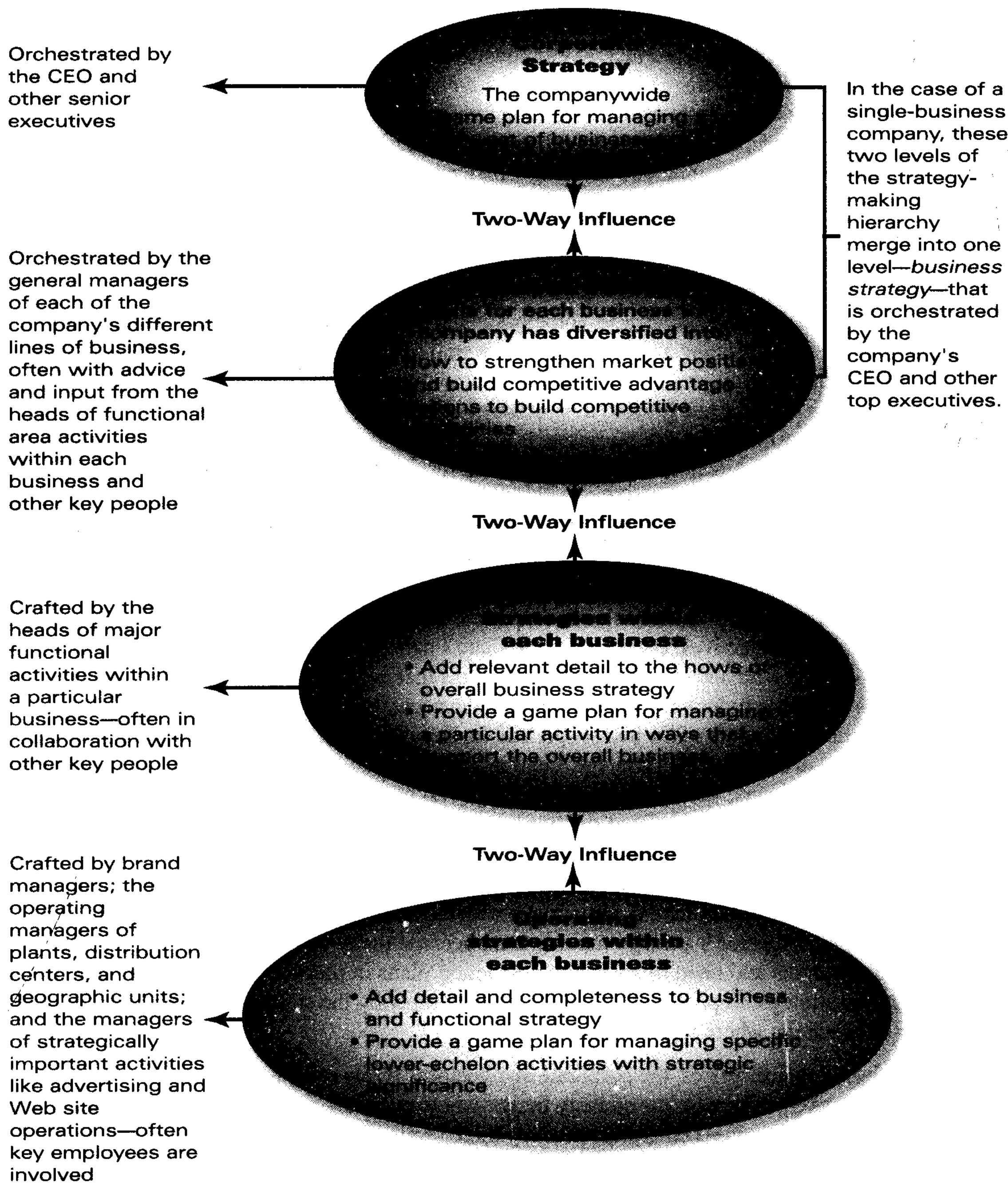
It thus follows that *a company's overall strategy is really a collection of strategic initiatives and actions* devised by managers and key employees up and down the whole organizational hierarchy. The larger and more diverse the operations of an enterprise, the more points of strategic initiative it has and the more managers and employees at more levels of management that have a relevant strategy-making role. Figure 2.2 shows who is generally responsible for devising what pieces of a company's overall strategy.

In diversified, multibusiness companies where the strategies of several different businesses have to be managed, the strategy-making task involves four distinct types or levels of strategy, each of which involves different facets of the company's overall strategy:

1. *Corporate strategy* consists of the kinds of initiatives the company uses to establish business positions in different industries, the approaches corporate executives pursue to boost the combined performance of the set of businesses the company has diversified into, and the means of capturing cross-business synergies and turning them into competitive advantage. Senior corporate executives normally have lead responsibility for devising corporate strategy and for choosing among whatever recommended actions bubble up from the organization below. Key business-unit heads may also be influential, especially in strategic decisions affecting the businesses they head. Major strategic decisions are usually reviewed and approved by the company's board of directors. We will look deeper into the strategy-making process at diversified companies when we get to Chapter 9.

2. *Business strategy* concerns the actions and the approaches crafted to produce successful performance in one specific line of business. The key focus here is crafting responses to changing market circumstances and initiating actions to strengthen market position, build competitive advantage, and develop strong competitive capabilities. Orchestrating the development of business-level strategy is the responsibility of the manager in charge of the business. The business head has at least two other strategy-related roles: (1) seeing that lower-level strategies are well conceived, consistent with each other, and adequately matched to the overall business strategy, and (2) getting major business-level strategic moves approved by corporate-level officers (and sometimes the board of directors) and keeping them informed of market developments and emerging strategic issues. In diversified companies, business-unit heads may have the additional obligation of making sure business-level objectives and strategy conform to corporate-level objectives and strategy themes.

figure 2.2 **A Company's Strategy-Making Hierarchy**



3. *Functional-area strategies* concern the actions, approaches, and practices to be employed in managing particular functions or business processes or key activities within a business. A company's marketing strategy, for example, represents the managerial game plan for running the sales and marketing part of the business. A company's new product development strategy represents the managerial game plan for keeping the company's product lineup fresh and in tune with what buyers are looking for. Functional-area strategies add specifics to the hows of business-level strategy. Plus, they aim at establishing or strengthening a business unit's competencies and capabilities in performing strategy-critical activities so as to enhance the business's market position and standing with customers. The primary role of a functional-area strategy is to *support* the company's overall business strategy and competitive approach.

Lead responsibility for functional-area strategies within a business is normally delegated to the heads of the respective functions, with the general manager of the business having final approval and perhaps even exerting a strong influence over the content of particular pieces of functional-area strategies. To some extent, functional managers have to collaborate and coordinate their strategy-making efforts to avoid uncoordinated or conflicting strategies. For the overall business strategy to have maximum impact, a business's marketing strategy, production strategy, finance strategy, customer service strategy, new product development strategy, and human resources strategy should be compatible and mutually reinforcing rather than serving their own narrower purposes. If inconsistent functional-area strategies are sent up the line for final approval, the business head is responsible for spotting the conflicts and getting them resolved.

4. *Operating strategies* concern the relatively narrow strategic initiatives and approaches for managing key operating units (plants, distribution centers, geographic units) and specific operating activities with strategic significance (advertising campaigns, the management of specific brands, supply chain–related activities, and Web site sales and operations). A plant manager needs a strategy for accomplishing the plant's objectives, carrying out the plant's part of the company's overall manufacturing game plan, and dealing with any strategy-related problems that exist at the plant. A company's advertising manager needs a strategy for getting maximum audience exposure and sales impact from the ad budget. Operating strategies, while of limited scope, add further detail and completeness to functional-area strategies and to the overall business strategy. Lead responsibility for operating strategies is usually delegated to frontline managers, subject to review and approval by higher-ranking managers.

Even though operating strategy is at the bottom of the strategy-making hierarchy, its importance should not be downplayed. A major plant that fails in its strategy to achieve production volume, unit cost, and quality targets can undercut the achievement of company sales and profit objectives and wreak havoc with strategic efforts to build a quality image with customers. Frontline managers are thus an important part of an organization's strategy-making team because many operating units have strategy-critical performance targets and need to have strategic action plans in place to achieve them. One cannot reliably judge the strategic importance of a given action simply by the strategy level or location within the managerial hierarchy where it is initiated.

In single-business enterprises, the corporate and business levels of strategy making merge into one level—business strategy—because the strategy for the whole company involves only one distinct line of business. Thus, a single-business enterprise has only three levels of strategy: (1) business strategy for the company as a whole, (2) functional-area strategies for each main area within the business, and (3) operating strategies undertaken by lower-echelon managers to flesh out strategically significant aspects for the

company's business and functional area strategies. Proprietorships, partnerships, and owner-managed enterprises may have only one or two strategy-making levels since in small-scale enterprises the whole strategy-making, strategy-executing function can be handled by just a few key people.

Uniting the Strategy-Making Effort

core concept
A company's strategy is at full power only when its many pieces are united.

Ideally, the pieces and layers of a company's strategy should fit together like a jigsaw puzzle. To achieve this unity, the strategizing process generally has proceeded from the corporate level to the business level and then from the business level to the functional and operating levels. *Midlevel and frontline managers cannot do good strategy making without understanding the company's long-term direction and higher-level strategies.* The strategic disarray that occurs in an organization when senior managers don't set forth a clearly articulated companywide strategy is akin to what would happen to a football team's offensive performance if the quarterback decided not to call a play for the team but instead let each player pick whatever play he thought would work best at his respective position. In business, as in sports, all the strategy makers in a company are on the same team and the many different pieces of the overall strategy crafted at various organizational levels need to be in sync and united. Anything less than a unified collection of strategies weakens company performance.

Achieving unity in strategy making is partly a function of communicating the company's basic strategy themes effectively across the whole organization and establishing clear strategic principles and guidelines for lower-level strategy making. Cohesive strategy making down through the hierarchy becomes easier to achieve when company strategy is distilled into pithy, easy-to-grasp terminology that can be used to drive consistent strategic action throughout the company.[8] The greater the numbers of company personnel who know, understand, and buy in to the company's basic direction and strategy, the smaller the risk that people and organization units will go off in conflicting strategic directions when decision making is pushed down to frontline levels and many people are given a strategy-making role. Good communication of strategic themes and guiding principles thus serves a valuable strategy-unifying purpose.

Merging the Strategic Vision, Objectives, and Strategy into a Strategic Plan

core concept
A company's *strategic plan* lays out its future direction, performance targets, and strategy.

Developing a strategic vision, setting objectives, and crafting a strategy are basic direction-setting tasks. They map out the company's direction, its short-range and long-range performance targets, and the competitive moves and internal action approaches to be used in achieving the targeted business results. Together, they constitute a **strategic plan** for coping with industry and competitive conditions, the expected actions of the industry's key players, and the challenges and issues that stand as obstacles to the company's success.[9]

In companies committed to regular strategy reviews and the development of explicit strategic plans, the strategic plan may take the form of a written document that is circulated to managers (and perhaps to selected employees). In small privately owned companies, strategic plans exist mostly in the form of oral understandings and commitments among managers and key employees about where to head, what to accomplish, and how to proceed. Short-term performance targets are the part of the strategic plan

most often spelled out explicitly and communicated to managers and employees. A number of companies summarize key elements of their strategic plans in the company's annual report to shareholders, in postings on their Web site, in press releases, or in statements provided to the business media. Other companies, perhaps for reasons of competitive sensitivity, make only vague, general statements about their strategic plans that could apply to most any company.

IMPLEMENTING AND EXECUTING THE STRATEGY: PHASE 4 OF THE STRATEGY-MAKING, STRATEGY-EXECUTING PROCESS

Managing strategy implementation and execution is an operations-oriented, make-things-happen activity aimed at shaping the performance of core business activities in a strategy-supportive manner. It is easily the most demanding and time-consuming part of the strategy-management process. To convert strategic plans into actions and results, a manager must be able to direct organizational change, motivate people, build and strengthen company competencies and competitive capabilities, create a strategy-supportive work climate, and meet or beat performance targets.

Management's action agenda for implementing and executing the chosen strategy emerges from assessing what the company, given its particular operating practices and organizational circumstances, will have to do differently or better to execute the strategy proficiently and achieve the targeted performance. Each company manager has to think through the answer to "What has to be done in my area to execute my piece of the strategic plan, and what actions should I take to get the process under way?" How much internal change is needed depends on how much of the strategy is new, how far internal practices and competencies deviate from what the strategy requires, and how well the present work climate/culture supports good strategy execution. Depending on the amount of internal change involved, full implementation and proficient execution of company strategy (or important new pieces thereof) can take several months to several years.

In most situations, managing the strategy-execution process includes the following principal aspects:

- Staffing the organization with the needed skills and expertise, consciously building and strengthening strategy-supportive competencies and competitive capabilities, and organizing the work effort.
- Developing budgets that steer ample resources into those activities critical to strategic success.
- Ensuring that policies and operating procedures facilitate rather than impede effective execution.
- Using the best-known practices to perform core business activities and pushing for continuous improvement. Organizational units have to periodically reassess how things are being done and diligently pursue useful changes and improvements in how the strategy is being executed.
- Installing information and operating systems that enable company personnel to better carry out their strategic roles day in and day out.

- Motivating people to pursue the target objectives energetically and, if need be, modifying their duties and job behavior to better fit the requirements of successful strategy execution.
- Tying rewards and incentives directly to the achievement of performance objectives and good strategy execution.
- Creating a company culture and work climate conducive to successful strategy implementation and execution.
- Exerting the internal leadership needed to drive implementation forward and keep improving strategy execution. When the organization encounters stumbling blocks or weaknesses, management has to see that they are addressed and rectified quickly.

Good strategy execution involves creating strong "fits" between strategy and organizational capabilities, between strategy and the reward structure, between strategy and internal operating systems, and between strategy and the organization's work climate and culture. The stronger these fits—that is, the more that the company's capabilities, reward structure, internal operating systems, and culture facilitate and promote proficient strategy execution—the better the execution and the higher the company's odds of achieving its performance targets. Furthermore, deliberately shaping the performance of core business activities around the strategy helps unite the organization.

INITIATING CORRECTIVE ADJUSTMENTS: PHASE 5 OF THE STRATEGY-MAKING, STRATEGY-EXECUTING PROCESS

The fifth phase of the strategy-management process—evaluating the company's progress, assessing the impact of new external developments, and making corrective adjustments—is the trigger point for deciding whether to continue or change the company's vision, objectives, strategy, and/or strategy-execution methods. So long as the company's direction and strategy seem well matched to industry and competitive conditions and performance targets are being met, company executives may decide to stay the course. Simply fine-tuning the strategic plan and continuing with ongoing efforts to improve strategy execution are sufficient.

But whenever a company encounters disruptive changes in its external environment, questions need to be raised about the appropriateness of its direction and strategy. If a company experiences a downturn in its market position or shortfalls in performance, then company managers are obligated to ferret out whether the causes relate to poor strategy, poor execution, or both and then to take timely corrective action. A company's direction, objectives, and strategy have to be revisited anytime external or internal conditions warrant. It is to be expected that a company will modify its strategic vision, direction, objectives, and strategy over time.

core concept
A company's vision, objectives, strategy, and approach to strategy execution are never final; managing strategy is an ongoing process, not an every now and then task.

Likewise, it is not unusual for a company to find that one or more aspects of implementing and executing the strategy are not going as well as intended. Proficient strategy execution is always the product of much organizational learning. It is achieved unevenly—coming quickly in some areas and proving nettlesome and problematic in others. Periodically assessing what aspects of strategy execution are

working well and what needs improving is normal and desirable. Successful strategy execution entails vigilantly searching for ways *to continuously improve* and then making corrective adjustments whenever and wherever it is useful to do so.

CORPORATE GOVERNANCE: THE ROLE OF THE BOARD OF DIRECTORS IN THE STRATEGY-MAKING, STRATEGY-EXECUTING PROCESS

Although senior managers have *lead responsibility* for crafting and executing a company's strategy, it is the duty of the board of directors to exercise strong oversight and see that the five tasks of strategic management are done in a manner that benefits shareholders (in the case of investor-owned enterprises) or stakeholders (in the case of not-for-profit organizations). In watching over management's strategy-making, strategy-executing actions and making sure that executive actions are not only proper but also aligned with the interests of stakeholders, a company's board of directors have three obligations to fulfill:

1. *Be inquiring critics and overseers.* Board members must ask probing questions and draw on their business acumen to make independent judgments about whether strategy proposals have been adequately analyzed and whether proposed strategic actions appear to have greater promise than alternatives. If executive management is bringing well-supported and reasoned strategy proposals to the board, there's little reason for board members to aggressively challenge and try to pick apart everything put before them. Asking incisive questions is usually sufficient to test whether the case for management's proposals is compelling and to exercise vigilant oversight. However, when the company's strategy is failing or is plagued with faulty execution, and certainly when there is a precipitous collapse in profitability, board members have a duty to be proactive, expressing their concerns about the validity of the strategy and/or operating methods, initiating debate about the company's strategic path, having one-on-one discussions with key executives and other board members, and perhaps directly intervening as a group to alter the company's executive leadership and, ultimately, its strategy and business approaches.
2. *Evaluate the caliber of senior executives' strategy-making and strategy-executing skills.* The board is always responsible for determining whether the current CEO is doing a good job of strategic leadership (as a basis for awarding salary increases and bonuses and deciding on retention or removal). Boards must also exercise due diligence in evaluating the strategic leadership skills of other senior executives in line to succeed the CEO. When the incumbent CEO steps down or leaves for a position elsewhere, the board must elect a successor, either going with an insider or deciding that an outsider is needed to perhaps radically change the company's strategic course.
3. *Institute a compensation plan for top executives that rewards them for actions and results that serve stakeholder interests, and most especially those of shareholders.* A basic principle of corporate governance is that the owners of a corporation delegate operating authority and managerial control to top management in return for compensation. In their role as an agent of shareholders, top executives have a clear and unequivocal *duty* to make decisions and operate the company in accord with shareholder interests (but this does not mean disregarding the interests of other stakeholders, particularly

those of employees, with whom they also have an agency relationship). Most boards of directors have a compensation committee, composed entirely of outside directors, to develop a salary and incentive compensation plan that makes it in the self-interest of executives to operate the business in a manner that benefits the owners; the compensation committee's recommendations are presented to the full board for approval. But in addition to creating compensation plans intended to align executive actions with owner interests, it is incumbent on the board of directors to put a halt to self-serving executive perks and privileges that simply enrich the personal welfare of executives. Numerous media reports have recounted instances in which boards of directors have gone along with opportunistic executive efforts to secure excessive, if not downright obscene, compensation of one kind or another (multimillion-dollar interest-free loans, personal use of corporate aircraft, lucrative severance and retirement packages, outsized stock incentive awards, and so on).

The number of prominent companies that have fallen on hard times because of the actions of scurrilous or out-of-control CEOs, the growing propensity of disgruntled stockholders to file lawsuits alleging director negligence, and the escalating costs of liability insurance for directors all underscore the responsibility that a board of directors has for overseeing a company's strategy-making, strategy-executing process and ensuring that management actions are proper and responsible. Moreover, holders of large blocks of shares (mutual funds and pension funds), regulatory authorities, and the financial press consistently urge that board members, especially outside directors, be active and diligent in their oversight of company strategy and maintain a tight rein on executive actions.

Every corporation should have a strong, independent board of directors that has the courage to curb management actions they believe are inappropriate or unduly risky.[10] Boards of directors that lack the backbone to challenge a strong-willed or "imperial" CEO or that rubber-stamp most anything the CEO recommends without probing inquiry and debate (perhaps because the board is stacked with the CEO's cronies) abdicate their duty to represent shareholder interests. The whole fabric of effective corporate governance is undermined when boards of directors shirk their responsibility to maintain ultimate control over the company's strategic direction, the major elements of its strategy, and the business approaches management is using to implement and execute the strategy. Boards of directors thus have a very important oversight role in the strategy-making, strategy-executing process.

key | points

The managerial process of crafting and executing a company's strategy consists of five interrelated and integrated tasks:

1. *Developing a strategic vision of where the company needs to head and what its product-market-customer-technology focus should be.* The vision must provide long-term direction, infuse the organization with a sense of purposeful action, and communicate to stakeholders what management's aspirations for the company are.
2. *Setting objectives.* The role of objectives is to convert the strategic vision into specific performance outcomes for the company to achieve. Objectives need to spell out *how much* of *what kind* of performance *by when,* and they need to require a significant amount of organizational stretch. A balanced scorecard approach to measuring company performance entails setting both *financial*

objectives and *strategic objectives*. Judging how well a company is doing by its financial performance is not enough—financial outcomes are "lagging indicators" that reflect the impacts of past decisions and organizational activities. But the "lead indicators" of a company's future financial performance are its current achievement of strategic targets that indicate a company is strengthening its marketing standing, competitive vitality, and business prospects.

3. *Crafting a strategy to achieve the desired outcomes and move the company toward where it wants to go*. Crafting strategy is concerned principally with forming responses to changes under way in the external environment, devising competitive moves and market approaches aimed at producing sustainable competitive advantage, building competitively valuable competencies and capabilities, and uniting the strategic actions initiated in various parts of the company. The more wide-ranging a company's operations, the more that strategy making is a team effort. The overall strategy that emerges in such companies is really a collection of strategic actions and business approaches initiated partly by senior company executives, partly by the heads of major business divisions, partly by functional-area managers, and partly by operating managers on the frontlines. The larger and more diverse the operations of an enterprise, the more points of strategic initiative it has and the more managers and employees at more levels of management that have a relevant strategy-making role. A single business enterprise has three levels of strategy—business strategy for the company as a whole, functional-area strategies for each main area within the business, and operating strategies undertaken by lower-echelon managers to flesh out strategically significant aspects for the company's business and functional area strategies. In diversified, multibusiness companies, the strategy-making task involves four distinct types or levels of strategy: corporate strategy for the company as a whole, business strategy (one for each business the company has diversified into), functional-area strategies within each business, and operating strategies. Typically, the strategy-making task is more top-down than bottom-up, with higher-level strategies serving as the guide for developing lower-level strategies.
4. *Implementing and executing the chosen strategy efficiently and effectively*. Managing the implementation and execution of strategy is an operations-oriented, make-things-happen activity aimed at shaping the performance of core business activities in a strategy-supportive manner. Converting a company's strategy into actions and results tests a manager's ability to direct organizational change, motivate people with a reward and incentive compensation system tied to good strategy execution and the achievement of target outcomes, build and strengthen company competencies and competitive capabilities, create a strategy-supportive work climate, and deliver the desired results. The quality of a company's operational excellence in executing the chosen strategy is a major driver of how well the company ultimately performs.
5. *Evaluating performance and initiating corrective adjustments in vision, long-term direction, objectives, strategy, or execution in light of actual experience, changing conditions, new ideas, and new opportunities*. This phase of the strategy management process is the trigger point for deciding whether to continue or change the company's vision, objectives, strategy, and/or strategy execution methods. Sometimes it suffices to simply fine-tune the strategic plan and continue with efforts to improve strategy execution. At other times, major overhauls are required.

Developing a strategic vision and mission, setting objectives, and crafting a strategy are basic direction-setting tasks; together, they constitute a *strategic plan* for coping with industry and competitive conditions, the actions of rivals, and the challenges and issues that stand as obstacles to the company's success.

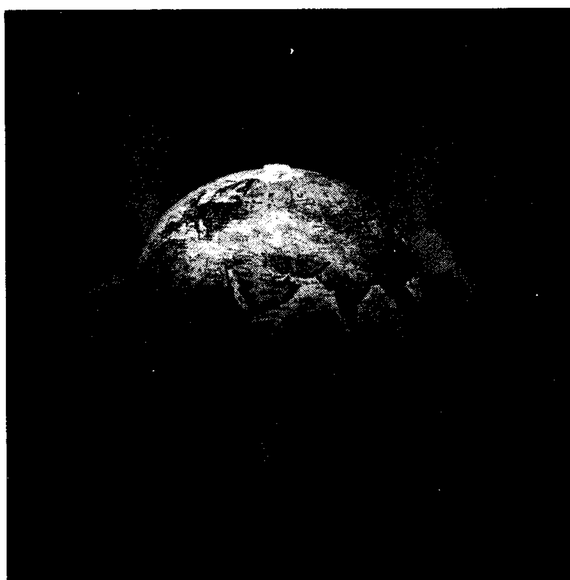
Boards of directors have a duty to shareholders to play a vigilant supervisory role in a company's strategy-making, strategy-executing process. They are obligated to (1) critically appraise and ultimately approve strategic action plans, (2) evaluate the strategic leadership skills of the CEO and others in line to succeed the incumbent CEO, and (3) institute a compensation plan for top executives that rewards them for actions and results that serve stakeholder interests, and most especially those of shareholders. Boards of directors that are not aggressive and forceful in fulfilling these responsibilities undermine the fabric of effective corporate governance.

exercise

1. Go to the investors section of www.heinz.com and read the letter to the shareholders in the company's fiscal 2003 annual report. Is the vision for Heinz articulated by Chairman and CEO William R. Johnson sufficiently clear and well defined? Why or why not? Are the company's objectives well stated and seemingly appropriate? What about the strategy that Johnson outlines for the company? If you were a shareholder, would you be satisfied with what Johnson has told you about the company's direction, performance targets, and strategy?

chapter | three

Analyzing a Company's External Environment



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Analysis is the critical starting point of strategic thinking.
—Kenichi Ohmae
consultant and author

Things are always different—the art is figuring out which differences matter.
—**Laszlo Birinyi**
investments manager

Competitive battles should be seen not as one-shot skirmishes but as a dynamic multiround game of moves and countermoves.
—**Anil K. Gupta**
professor

Managers are not prepared to act wisely in steering a company in a new direction or altering its strategy until they have a deep understanding of the company's situation. This understanding requires thinking strategically about two facets of the company's situation: (1) the industry and competitive environment in which the company operates and the forces acting to reshape this environment, and (2) the company's own market position and competitiveness—its resources and capabilities, its strengths and weaknesses vis-à-vis rivals, and its windows of opportunity.

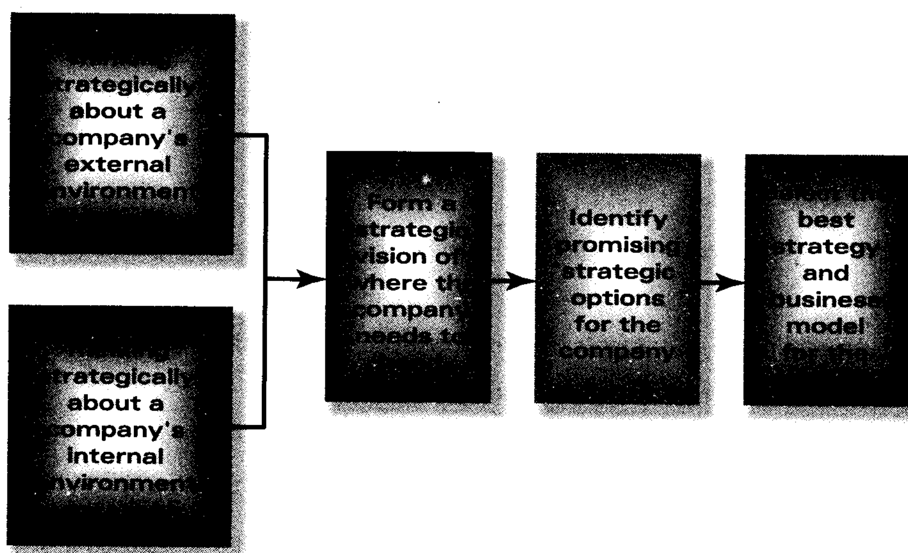
Managers must be able to perceptively diagnose a company's external and internal environments to succeed in crafting a strategy that is an excellent fit with the company's situation, is capable of building competitive advantage, and promises to boost company performance—the three criteria of a winning strategy. Developing a strategy begins with an appraisal of the company's external and internal situations (to form a strategic vision of where the company needs to head), then moves toward an evaluation of the most promising strategy options, and finally culminates in a choice of a strategy and business model (see Figure 3.1).

This chapter presents the concepts and analytical tools for assessing a single-business company's external environment. Attention centers on the competitive arena in which a company operates, together with the technological, societal, regulatory, or demographic influences in the macroenvironment that are acting to reshape the company's future market arena. In Chapter 4 we explore the methods of evaluating a company's internal circumstances and competitiveness.

THE STRATEGICALLY RELEVANT COMPONENTS OF A COMPANY'S EXTERNAL ENVIRONMENT

All companies operate in a "macroenvironment" shaped by influences emanating from the economy at large, population demographics, societal values and lifestyles, governmental legislation and regulation, technological factors, and, closer to home, the industry and competitive arena in which the company operates (see Figure 3.2). Strictly speaking, a company's macroenvironment includes *all relevant factors and influences* outside the company's boundaries; by *relevant*, we mean important enough to have a bearing on the decisions the company ultimately makes about its direction, objectives, strategy, and business model. For the most part, influences coming from the outer ring of the macroenvironment

figure 3.1 **From Thinking Strategically about the Company's Situation to Choosing a Strategy**



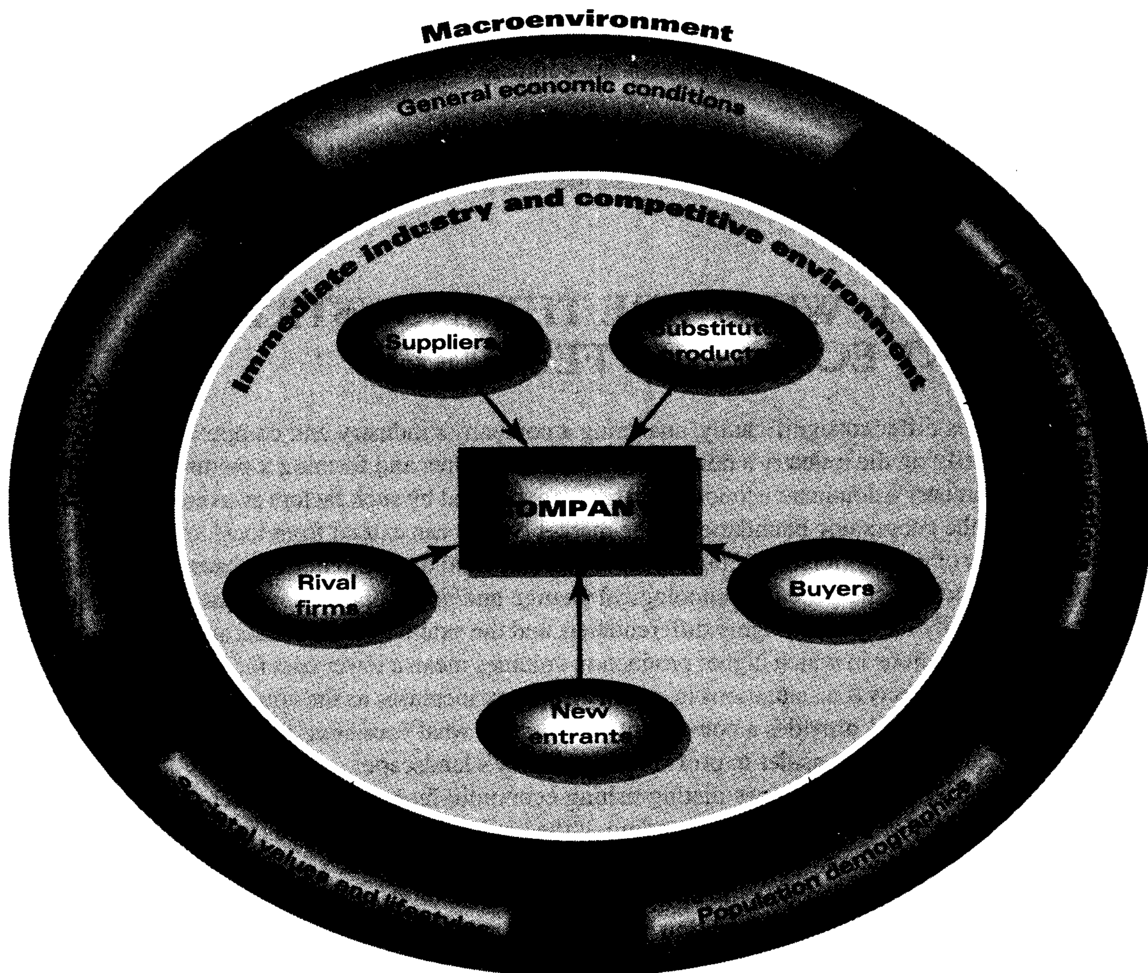
have a low impact on a company's business situation and shape only the edges of the company's direction and strategy. (There are notable exceptions, though. Cigarette producers have found their strategic opportunities to be greatly reduced by antismoking ordinances and the growing cultural stigma attached to smoking; the market growth potential for health care and prescription drug companies is quite favorably affected by the demographics of an aging population and longer life expectancies; and companies in most all industries, seeking to capitalize on the benefits of Internet technology applications, are rushing to incorporate e-commerce elements into their strategies.) But while the strategy-shaping impact of outer-ring influences is normally low, there are enough strategically relevant trends and developments in the outer ring of the macroenvironment to justify a watchful eye. As company managers scan the external environment, they must watch for potentially important outer-ring forces, assess their impact and influence, and adapt the company's direction and strategy as needed.

However, the factors and forces in a company's macroenvironment having the biggest strategy-shaping impact almost always pertain to the company's immediate industry and competitive environment. Consequently, it is on these factors that we concentrate our attention in this chapter.

THINKING STRATEGICALLY ABOUT A COMPANY'S INDUSTRY AND COMPETITIVE ENVIRONMENT

Industries differ widely in their economic features, competitive character, and profit outlook. The economic features and competitive character of the trucking industry bear little resemblance to those of discount retailing. The fast-food business has little in common with the business of developing software for Internet applications. The cable TV business is shaped by industry and competitive considerations

figure 3.2 **The Components of a Company's Macroenvironment**



radically different from those that dominate the soft-drink business. An industry's economic traits and competitive conditions—and how they are expected to change—determine whether its future profit prospects will be poor, average, or excellent.

To gain a deep understanding of a company's industry and competitive environment, managers do not need to gather all the information they can find and spend lots of time digesting it. Rather, the task is much more focused. Thinking strategically about a company's competitive environment entails using some well-defined concepts and analytical tools to get clear answers to seven questions:

1. What are the dominant economic features of the industry in which the company operates?
2. What kinds of competitive forces are industry members facing, and how strong is each force?
3. What forces are driving changes in the industry, and what impact will these changes have on competitive intensity and industry profitability?

4. What market positions do industry rivals occupy—who is strongly positioned and who is not?
5. What strategic moves are rivals likely to make next?
6. What are the key factors for future competitive success?
7. Does the outlook for the industry present the company with sufficiently attractive prospects for profitability?

The answers to these questions provide managers with a solid diagnosis of the industry and competitive environment. The remainder of this chapter describes the methods of analyzing a company's industry and competitive environment.

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

Because industries differ so significantly, analyzing a company's industry and competitive environment begins with identifying the industry's dominant economic features and forming a picture of the industry landscape. An industry's dominant economic features are defined by such factors as overall size and market growth rate, the geographic boundaries of the market (which can extend from local to worldwide), the number and sizes of competitors, what buyers are looking for and the attributes that cause them to choose one seller over another, the pace of technological change and/or product innovations, whether sellers' products are virtually identical or highly differentiated, and the extent to which costs are affected by *scale economies* (i.e., situations in which higher production volumes mean a lower cost for each item produced) and *learning curve* effects (i.e., situations in which efficiency increases as the company gains knowledge and experience). Table 3.1 provides a convenient summary of what economic features to look at and the corresponding questions to consider in profiling an industry's landscape.

Getting a handle on an industry's distinguishing economic features not only sets the stage for the analysis to come but also promotes understanding of the kinds of strategic moves that industry members are likely to employ. For example, in industries characterized by one product advance after another, companies must invest in R&D and develop strong product innovation capabilities—a strategy of continuous product innovation becomes a condition of survival in such industries as video games, computers, and pharmaceuticals. An industry that has recently passed through the rapid-growth stage and is looking at only single-digit percentage increases in buyer demand is likely to be experiencing a competitive shake-out and much stronger strategic emphasis on cost reduction and improved customer service.

In industries like semiconductors, strong learning/experience effects in manufacturing cause unit costs to decline about 20 percent each time *cumulative* production volume doubles. With a 20 percent experience curve effect, if the first 1 million chips cost $100 each, by a production volume of 2 million the unit cost would be $80 (80 percent of $100), by a production volume of 4 million the unit cost would be $64 (80 percent of $80), and so on.[1] The bigger the learning or experience curve effect, the bigger the cost advantage of the company with the largest *cumulative* production volume. Thus, when an industry is characterized by important learning-experience curve effects, industry members are driven to pursue increased sales volumes and capture the resulting cost-saving economies; moreover, low-volume firms come under considerable pressure to grow sales in order to gain the experience needed to become more

table 3.1 **What to Consider in Identifying an Industry's Dominant Economic Features**

Economic Feature	Questions to Answer
Market size and growth rate	• How big is the industry and how fast is it growing? • What does the industry's position in the business life cycle (early development, rapid growth and takeoff, early maturity, maturity, saturation and stagnation, decline) reveal about the industry's growth prospects?
Scope of competitive rivalry	• Is the geographic area over which most companies compete local, regional, national, multinational, or global? • Is having a presence in foreign markets becoming more important to a company's long-term competitive success?
Number of rivals	• Is the industry fragmented into many small companies or dominated by a few large companies? • Is the industry going through a period of consolidation to a smaller number of competitors?
Buyer needs and requirements	• What are buyers looking for—what attributes prompt buyers to choose one brand over another? • Are buyer needs or requirements changing? If so, what is driving such changes?
Production capacity	• Is a surplus of capacity pushing prices and profit margins down? • Is the industry overcrowded with too many competitors?
Pace of technological change	• What role does advancing technology play in this industry? • Are ongoing upgrades of facilities/equipment essential because of rapidly advancing production process technologies? • Do most industry members have or need strong technological capabilities? Why?
Vertical integration	• Are some competitors in this industry partially or fully integrated? • Are there important cost differences among fully versus partially versus nonintegrated firms? • Is there any competitive advantage or disadvantage associated with being fully or partially integrated?
Product innovation	• Is the industry characterized by rapid product innovation and short product life cycles? • How important is R&D and product innovation? • Are there opportunities to overtake key rivals by being first-to-market with next-generation products?
Degree of product differentiation	• Are the products of rivals becoming more differentiated or less differentiated? • Are increasingly look-alike products of rivals causing heightened price competition?
Economies of scale	• Is the industry characterized by economies of scale in purchasing, manufacturing, advertising, shipping, or other activities? • Do companies with large-scale operations have an important cost advantage over small-scale firms?
Learning and experience curve effects	• Are certain industry activities characterized by strong learning and experience effects ("learning by doing") such that unit costs decline as a company's experience in performing the activity builds? • Do any companies have significant cost advantages because of their experience in performing particular activities?

cost-competitive with large-volume rivals. Competitors are also forced to race to build unit volume when larger-scale operations are more economical than smaller-scale operations. The bigger the learning curve effects and/or scale economies in an industry, the more imperative it becomes for competing sellers to pursue strategies to win additional sales and market share—the company with the biggest sales volume gains sustainable competitive advantage as the low-cost producer.

QUESTION 2: WHAT KINDS OF COMPETITIVE FORCES ARE INDUSTRY MEMBERS FACING?

The character, mix, and subtleties of competitive forces are never the same from one industry to another. Far and away the most powerful and widely used tool for systematically diagnosing the principal competitive pressures in a market and assessing the strength and importance of each is the *five-forces model of competition.*[2] This model, depicted in Figure 3.3, holds that the state of competition in an industry is a composite of competitive pressures operating in five areas of the overall market:

1. Competitive pressures associated with the market maneuvering and jockeying for buyer patronage that goes on among *rival sellers* in the industry.
2. Competitive pressures associated with the threat of *new entrants* into the market.
3. Competitive pressures coming from the attempts of companies in other industries to win buyers over to their own *substitute products.*
4. Competitive pressures stemming from *supplier* bargaining power and supplier–seller collaboration.
5. Competitive pressures stemming from *buyer* bargaining power and seller–buyer collaboration.

The way one uses the five-forces model to determine what competition is like in a given industry is to build the picture of competition in three steps:

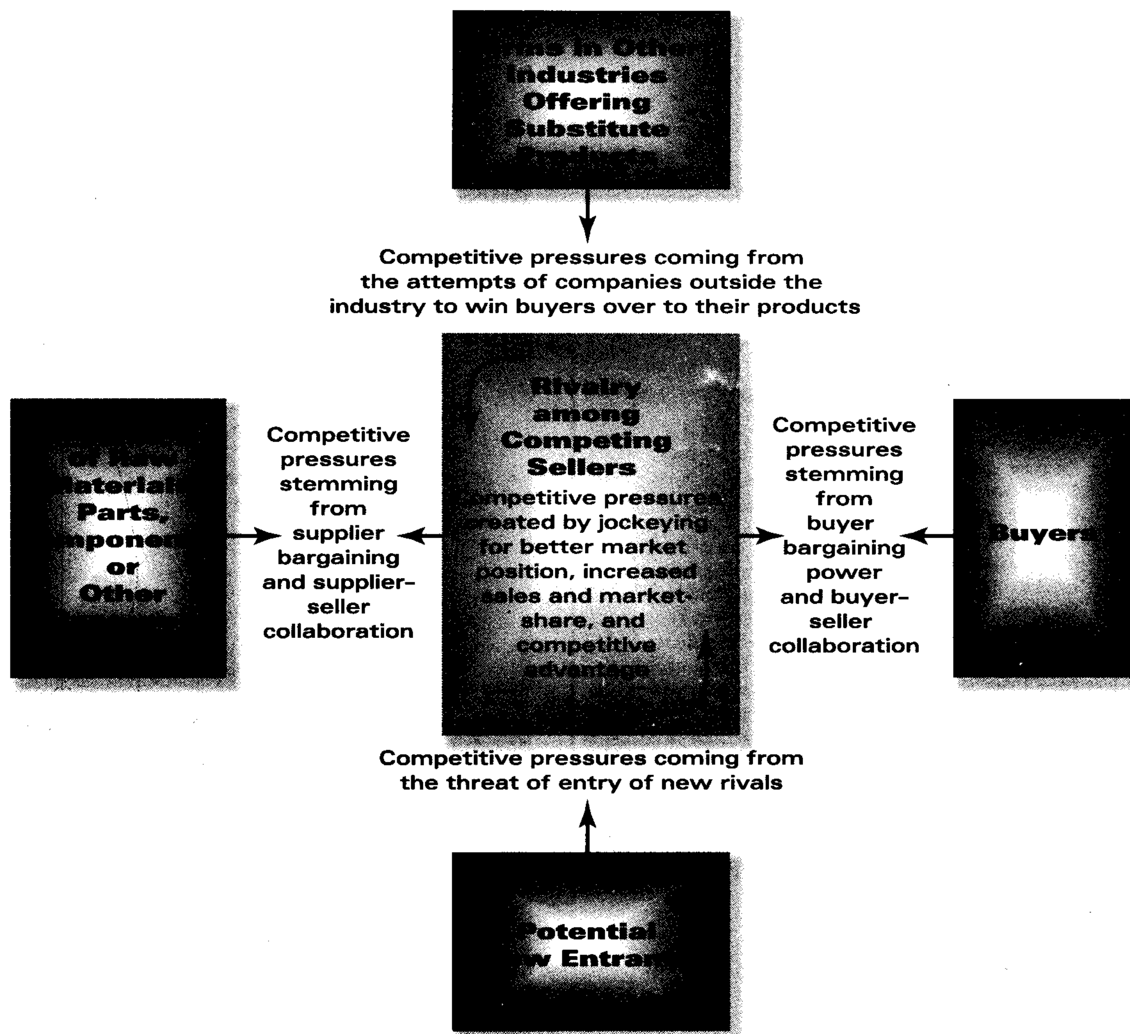
- *Step 1*: Identify the specific competitive pressures associated with each of the five forces.
- *Step 2*: Evaluate how strong the pressures comprising each of the five forces are (fierce, strong, moderate to normal, or weak).
- *Step 3*: Determine whether the collective strength of the five competitive forces is conducive to earning attractive profits.

The Rivalry among Competing Sellers

core concept
Competitive jockeying among industry rivals is ever changing, as fresh offensive and defensive moves are initiated and rivals emphasize first one mix of competitive weapons and tactics, then another.

The strongest of the five competitive forces is nearly always the market maneuvering and jockeying for buyer patronage that goes on among rival sellers of a product or service. In effect, *a market is a competitive battlefield* where it is customary and expected that rival sellers will employ whatever resources and weapons they have in their business arsenal to improve their market positions and performance. The strategy-making challenge of managers is to craft a competitive strategy that, at the very least, allows their company to hold its own against rivals and that, ideally, strengthens the company's standing with buyers, delivers good profitability, and *produces a competitive*

figure 3.3 **The Five Forces Model of Competition: A Key Tool for Diagnosing the Competitive Environment**



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edge over rivals. But when one firm makes a strategic move that produces good results, its rivals often respond with offensive or defensive countermoves, shifting their strategic emphasis from one combination of product attributes, marketing tactics, and competitive capabilities to another. This pattern of action and reaction, move and countermove, adjust and readjust, is what makes competitive rivalry a combative, ever-changing contest. The market battle for buyer patronage in an industry takes on a life of its own, with one or another rivals gaining or losing market momentum according to whether their latest strategic adjustments succeed or fail.

figure 3.4 **Weapons for Competing and Factors Affecting the Strength of Rivalry**

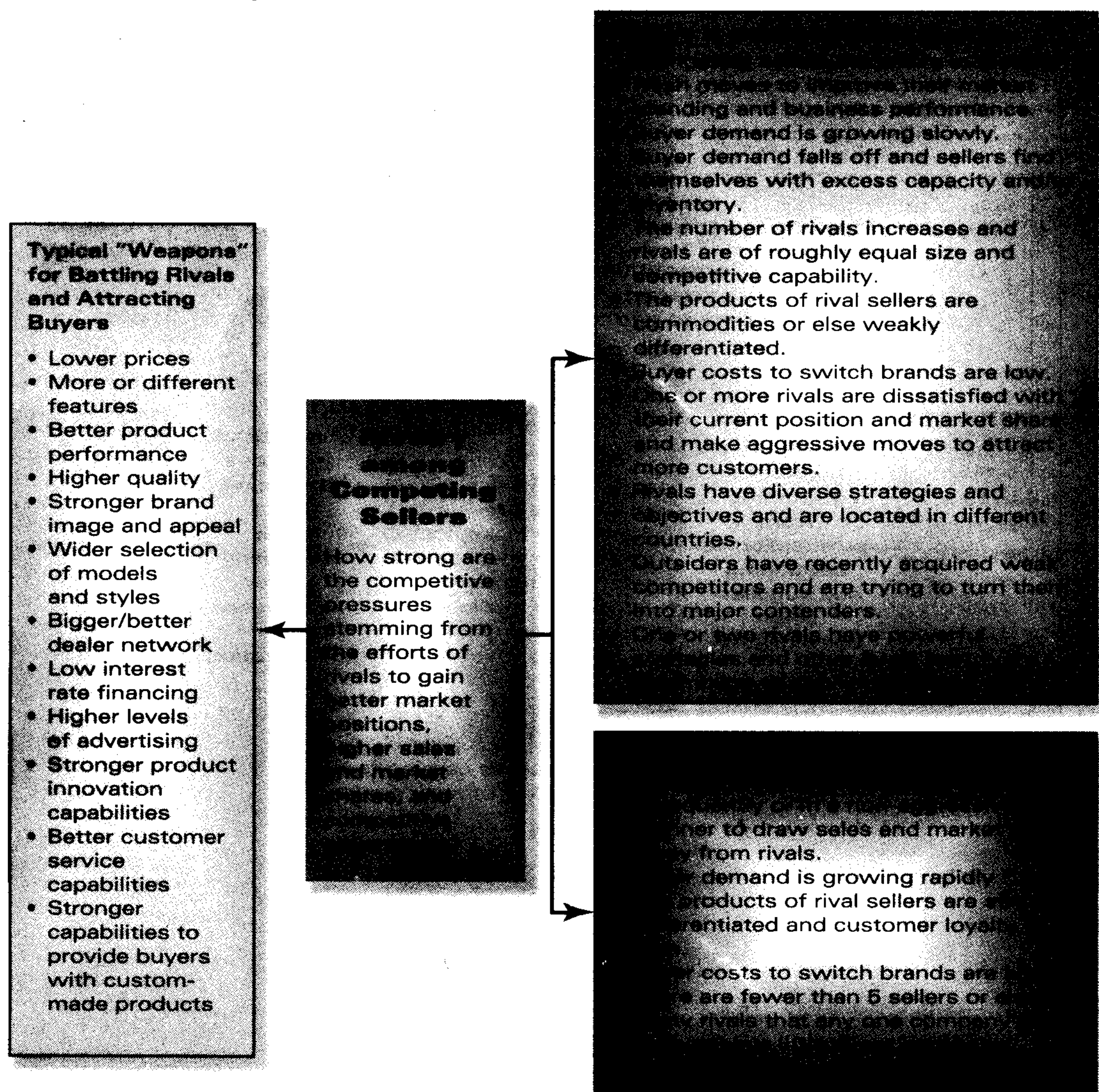


Figure 3.4 shows a sampling of competitive weapons that firms can deploy in battling rivals and indicates the factors that influence the intensity of their rivalry. A brief discussion of some of the factors that influence the tempo of rivalry among industry competitors is in order:[3]

- *Rivalry among competing sellers intensifies the more frequently and more aggressively that industry members undertake fresh actions to boost their market standing and performance—perhaps at the expense of rivals.* Rivalry tends to be fairly intense whenever sellers actively engage in vigorous

price competition. Lively price competition pressures rival companies to aggressively pursue ways to drive costs out of the business; high-cost companies are hard-pressed to survive. Other indicators of the intensity of rivalry among industry members include:

- Whether industry members are racing to offer better performance features, higher quality, improved customer service, or a wider product selection.
- How frequently rivals resort to such marketing tactics as sales promotions, new advertising campaigns, rebates, or low-interest-rate financing to drum up additional sales.
- How actively industry members are pursuing efforts to build stronger dealer networks or establish positions in foreign markets or otherwise expand their distribution capabilities and market presence.
- The frequency with which rivals introduce new and improved products (and thus are competing on the basis of their product innovation capabilities).
- How hard companies are striving to gain a market edge by developing valuable expertise and capabilities that rivals cannot match.

Normally, industry members are proactive in drawing on their arsenal of competitive weapons and deploying their organizational resources in a manner calculated to strengthen their market positions and performance.

- *Rivalry is usually stronger in slow-growing markets and weaker in fast-growing markets.* Rapidly expanding buyer demand produces enough new business for all industry members to grow. Indeed, in a fast-growing market, a company may find itself stretched just to keep abreast of incoming orders, let alone devote resources to stealing customers away from rivals. But in markets where growth is sluggish or where buyer demand drops off unexpectedly, expansion-minded firms and/or firms with excess capacity often are quick to cut prices and initiate other sales-increasing tactics, thereby igniting a battle for market share that can result in a shake-out of weak, inefficient firms.
- *Rivalry intensifies as the number of competitors increases and as competitors become more equal in size and capability.* The greater the number of competitors, the higher the probability that one or more companies will be busily engaged in a strategic offensive intended to enhance their marketing standing, thereby heating up competition and putting new pressures on rivals to respond with offensive or defensive moves of their own. In addition, when rivals are nearly equal in size and capability, they can usually compete on a fairly even footing, making it harder for one or two firms to emerge as victorious over the others. Consequently, markets tend to be more hotly contested as the number of resourceful and capable rivals increases.
- *Rivalry is usually weaker in industries comprised of so many rivals that the impact of any one company's actions is spread thinly across all industry members; likewise, it is often weak when there are fewer than five competitors.* A progressively larger number of competitors can actually begin to weaken head-to-head rivalry once an industry becomes populated with so many rivals that the impact of successful moves by any one company is spread thinly across many industry members. To the extent that a company's strategic moves ripple out to have little discernible impact on the businesses of its many rivals, then industry members quickly learn that it is not imperative to respond every time one or another rival does something to enhance its market position—an outcome that weakens the intensity of head-to-head battles for market share. Rivalry also tends to be weak if an industry consists of just two or three or four sellers. In a market with few rivals, each competitor

soon learns that aggressive moves to grow its sales and market share can have immediate adverse impact on rivals' businesses, almost certainly provoking vigorous retaliation and risking an all-out battle that is likely to lower the profits of all concerned. Thus, although occasional warfare can break out (the current fierce battle between Linux and Microsoft is a prime example), competition among the few normally produces a live-and-let-live approach to competing because rivals see the merits of *restrained* efforts to wrest sales and market share from competitors as opposed to undertaking hard-hitting offensives that escalate into a profit-eroding arms race or price war.

- *Rivalry increases as the products of rival sellers become more standardized.* When the offerings of rivals are identical or only weakly differentiated, buyers have less reason to be brand loyal—a condition that makes it easier for rivals to convince buyers to switch to their offering. And since the brands of different sellers have comparable attributes, buyers can shop the market for the best deal and switch brands at will. In contrast, rivalry typically weakens as the products of rival sellers become more strongly differentiated. Significantly different product attributes from seller to seller breed higher brand loyalty on the part of buyers. The attachment that buyers have to their present brand, coupled with convictions that certain attributes or brands better suit their needs than others, make it tougher for competing companies to steal one another's customers. Unless meaningful numbers of buyers are open to considering new or different product attributes being offered by rivals, strong product differentiation works against fierce rivalry among competing sellers.
- *Rivalry increases as it becomes less costly for buyers to switch brands.* The less expensive it is for buyers to switch their purchases from one seller to another, the easier it is for sellers to steal customers away from rivals. But the higher the costs buyers incur to switch brands, the less prone they are to brand switching. Even if buyers view one or more rival brands as more attractive, they may not believe that switching is worth the costs they will incur. Consequently, unless buyers are dissatisfied with the brand they are presently purchasing, high switching costs can significantly weaken the rivalry among competing sellers.
- *Rivalry is more intense when industry conditions tempt competitors to use price cuts or other competitive weapons to boost unit volume.* When a product is perishable, seasonal, or costly to hold in inventory, or when buyer demand slacks off, competitive pressures build quickly anytime one or more rivals decide to cut prices and dump excess supplies on the market. Likewise, whenever fixed costs account for a large fraction of total cost so that unit costs tend to be lowest at or near full capacity, then industry rivals come under significant pressure to cut prices or otherwise try to boost sales. Unused capacity imposes a significant cost-increasing penalty because there are fewer units over which to spread fixed costs. The pressure of high fixed costs can push rival firms into price concessions, special discounts, rebates, low-interest-rate financing, and other volume-boosting tactics.
- *Rivalry increases when one or more competitors become dissatisfied with their market position and launch moves to bolster their standing at the expense of rivals.* Firms that are losing ground or in financial trouble often react aggressively by acquiring smaller rivals, introducing new products, boosting advertising, discounting prices, and so on. Such actions heighten rivalry and can trigger a hotly contested battle for market share. The market maneuvering among rivals usually heats up when a competitor makes new offensive moves—because it sees an opportunity to better please customers or is under pressure to improve its market share or profitability.

- *Rivalry increases in proportion to the size of the payoff from a successful strategic move.* The greater the benefits of going after a new opportunity, the more likely that one or more rivals will initiate moves to capture it. Competitive pressures nearly always intensify when several rivals start pursuing the same opportunity. For example, competition in music CD e-tailing heated up with the entries of Amazon.com, Barnesandnoble.com, and Buy.com. Furthermore, the size of the strategic payoff can vary with the speed of retaliation. When competitors respond slowly (or not at all), the initiator of a fresh competitive strategy can reap benefits in the intervening period and perhaps gain a first-mover advantage that is not easily surmounted. The greater the benefits of moving first, the more likely some competitor will accept the risk and try it.
- *Rivalry becomes more volatile and unpredictable as the diversity of competitors increases in terms of visions, strategic intents, objectives, strategies, resources, and countries of origin.* A diverse group of sellers often contains one or more mavericks willing to try novel, high-risk, rule-breaking market approaches, thus generating a livelier and less predictable competitive environment. Globally competitive markets often contain rivals with different views about where the industry is headed and a willingness to employ perhaps radically different competitive approaches. Attempts by cross-border rivals to gain stronger footholds in each other's domestic markets usually boost the intensity of rivalry, especially when the aggressors have lower costs or products with more attractive features.
- *Rivalry increases when strong companies outside the industry acquire weak firms in the industry and launch aggressive, well-funded moves to transform their newly acquired competitors into major market contenders.* A concerted effort to turn a weak rival into a market leader nearly always entails launching well-financed strategic initiatives to dramatically improve the competitor's product offering, excite buyer interest, and win a much bigger market share—actions that, if successful, put added pressure on rivals to counter with fresh strategic moves of their own.
- *A powerful, successful competitive strategy employed by one company greatly intensifies the competitive pressures on its rivals to develop effective strategic responses or be relegated to also-ran status.*

Rivalry can be characterized as *cutthroat* or *brutal* when competitors engage in protracted price wars or habitually employ other aggressive tactics that are mutually destructive to profitability. Rivalry can be considered *fierce* to *strong* when the battle for market share is so vigorous that the profit margins of most industry members are squeezed to bare-bones levels. Rivalry can be characterized as *moderate* or *normal* when the maneuvering among industry members, while lively and healthy, still allows most industry members to earn acceptable profits. Rivalry is *weak* when most companies in the industry are relatively well satisfied with their sales growth and market shares, rarely undertake offensives to steal customers away from one another, and have comparatively attractive earnings and returns on investment.

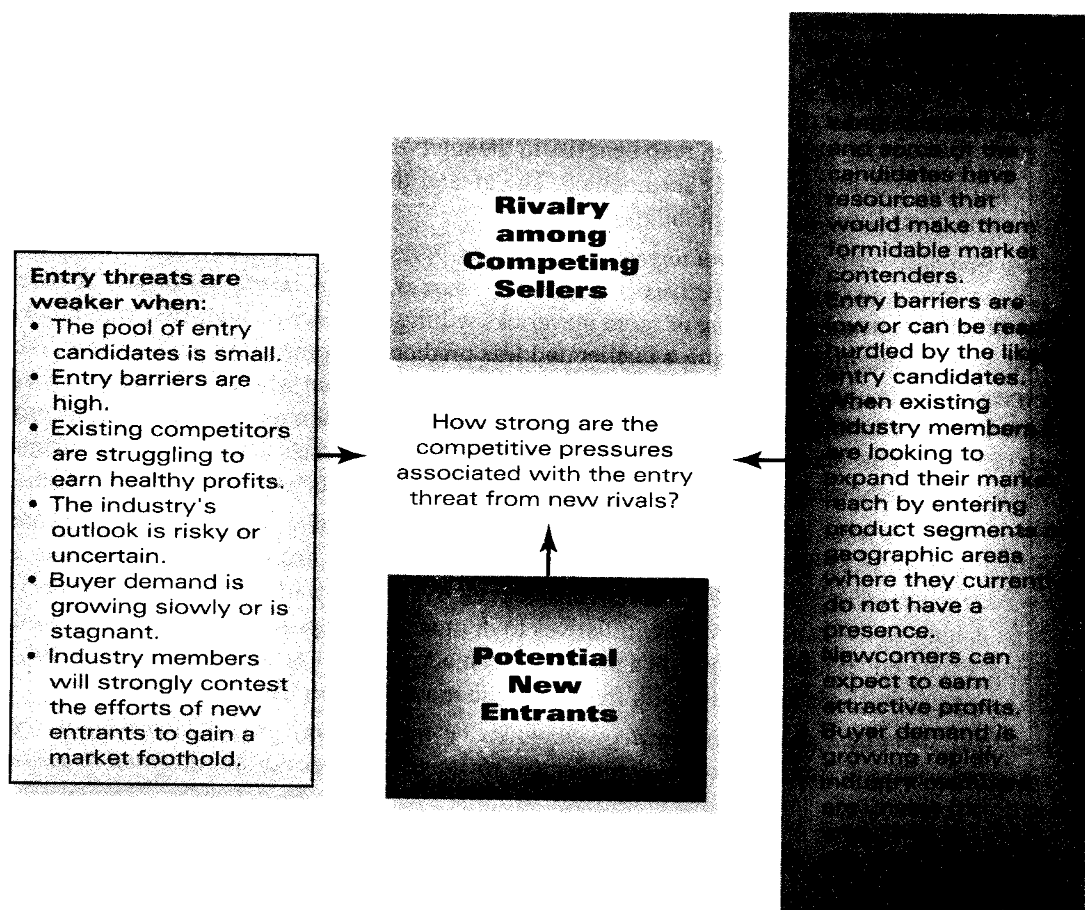
Srinivas Institute of Technology

The Potential Entry of New Competitors

Acc. No. 28 66

Several factors affect the strength of the competitive threat of potential entry in a particular industry (see Figure 3.5). One factor relates to the size of the pool of likely entry candidates and the resources at their command. As a rule, competitive pressures intensify as the pool of entry candidates increases in size. This is especially true when some of the likely entry candidates have ample resources and the potential to

figure 3.5 **Factors Affecting the Strength of Threat of Entry**



become formidable contenders for market leadership. Frequently, the strongest competitive pressures associated with potential entry come not from outsiders but from current industry participants looking for growth opportunities. *Existing industry members are often strong candidates to enter market segments or geographic areas where they currently do not have a market presence.* Companies already well established in certain product categories or geographic areas often possess the resources, competencies, and competitive capabilities to hurdle the barriers of entering a different market segment or new geographic area.

A second factor concerns whether the likely entry candidates face high or low entry barriers. The most common barriers that entry candidates must hurdle include:[4]

- *The presence of sizable economies of scale in production or other areas of operation*—When incumbent companies enjoy cost advantages associated with large-scale operation, outsiders must either enter on a large scale (a costly and perhaps risky move) or accept a cost disadvantage and consequently lower profitability. Trying to overcome the disadvantages of small size by entering on a large scale at the outset can result in long-term overcapacity problems for the new entrant (until

sales volume builds up), and it can so threaten the market shares of existing firms that they launch strong defensive maneuvers (price cuts, increased advertising and sales promotion, and similar blocking actions) to maintain their positions and make things hard on a newcomer.

- *Cost and resource disadvantages not related to size*—Existing firms may have low unit costs as a result of experience or learning-curve effects, key patents, partnerships with the best and cheapest suppliers of raw materials and components, proprietary technology know-how not readily available to newcomers, favorable locations, and low fixed costs (because they have older plants that have been mostly depreciated).
- *Brand preferences and customer loyalty*—In some industries, buyers are strongly attached to established brands. Japanese consumers, for example, are fiercely loyal to Japanese brands of motor vehicles, electronics products, cameras, and video games. European consumers have traditionally been loyal to European brands of major household appliances. High brand loyalty means that a potential entrant must commit to spending enough money on advertising and sales promotion to overcome customer loyalties and build its own clientele. Establishing brand recognition and building customer loyalty can be a slow and costly process. In addition, if it is costly or inconvenient for a customer to switch to a new brand, a new entrant must persuade buyers that its brand is worth the switching costs. To overcome switching-cost barriers, new entrants may have to offer buyers a discounted price or an extra margin of quality or service. All this can mean lower expected profit margins for new entrants, which increases the risk to start-up companies dependent on sizable early profits to support their new investments.
- *Capital requirements*—The larger the total dollar investment needed to enter the market successfully, the more limited the pool of potential entrants. The most typical capital requirements for new entrants are those associated with investing in the necessary manufacturing facilities and equipment, being able to finance the introductory advertising and sales promotion campaigns to build brand awareness and establish a clientele, securing the working capital to finance inventories and customer credit, and having sufficient cash reserves to cover start-up losses.
- *Access to distribution channels*—In consumer goods industries, a potential entrant may face the barrier of gaining adequate access to consumers. Wholesale distributors may be reluctant to take on a product that lacks buyer recognition. A network of retail dealers may have to be set up from scratch. Retailers have to be convinced to give a new brand ample display space and an adequate trial period. Entry is tough when existing producers have strong, well-functioning distributor–dealer networks and a newcomer must struggle to squeeze its way into existing distribution channels. To overcome the barrier of gaining adequate access to consumers, potential entrants may have to "buy" their way into wholesale or retail channels by cutting their prices to provide dealers and distributors with higher markups and profit margins or by giving them big advertising and promotional allowances. As a consequence, a potential entrant's own profits may be squeezed unless and until its product gains enough consumer acceptance that distributors and retailers want to carry it.
- *Regulatory policies*—Government agencies can limit or even bar entry by requiring licenses and permits. Regulated industries like cable TV, telecommunications, electric and gas utilities, radio and television broadcasting, liquor retailing, and railroads entail government-controlled entry. In international markets, host governments commonly limit foreign entry and must approve all foreign

investment applications. Stringent government-mandated safety regulations and environmental pollution standards are entry barriers because they raise entry costs.

- *Tariffs and international trade restrictions*—National governments commonly use tariffs and trade restrictions (antidumping rules, local content requirements, quotas, etc.) to raise entry barriers for foreign firms and protect domestic producers from outside competition.

Whether an industry's entry barriers ought to be considered high or low and how hard it is for new entrants to compete on a level playing field depend on the resources and competencies possessed by the pool of potential entrants. Entry barriers can be formidable for newly formed enterprises that have to find some way to gain a market foothold and then over time make inroads against well-established companies. But opportunity-seeking companies in other industries, if they have suitable resources, competencies, and brand-name recognition, may be able to hurdle an industry's entry barriers rather easily. In evaluating the potential threat of entry, company managers must look at (1) how formidable the entry barriers are for each type of potential entrant—start-up enterprises, specific candidate companies in other industries, and current industry participants looking to expand their market reach—and (2) how attractive the growth and profit prospects are for new entrants. *Rapidly growing market demand and high potential profits act as magnets, motivating potential entrants to commit the resources needed to hurdle entry barriers.*[5]

The threat of entry is stronger when entry barriers are low, when there's a sizable pool of entry candidates, when industry growth is rapid and profit potentials are high, and when incumbent firms are unable or unwilling to vigorously contest a newcomer's entry.

However, even if a potential entrant has or can acquire the needed competencies and resources to attempt entry, it still faces the issue of how existing firms will react.[6] Will incumbent firms offer only passive resistance, or will they aggressively defend their market positions using price cuts, increased advertising, product improvements, and whatever else they can think of to give a new entrant (as well as other rivals) a hard time? A potential entrant can have second thoughts when financially strong incumbent firms send clear signals that they will stoutly defend their market positions against newcomers. A potential entrant may also turn away when incumbent firms can leverage distributors and customers to retain their business.

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

One additional point: *The threat of entry changes as the industry's prospects grow brighter or dimmer and as entry barriers rise or fall.* For example, in the pharmaceutical industry the expiration of a key patent on a widely prescribed drug virtually guarantees that one or more drug makers will enter with generic offerings of their own. Use of the Internet for shopping is making it much easier for e-tailers to enter into competition against some of the best-known retail chains. In international markets, entry barriers for foreign-based firms fall as tariffs are lowered, as host governments open up their domestic markets to outsiders, as domestic wholesalers and dealers seek out lower-cost foreign-made goods, and as domestic buyers become more willing to purchase foreign brands.

Competitive Pressures from the Sellers of Substitute Products

Companies in one industry come under competitive pressure from the actions of companies in a closely adjoining industry whenever buyers view the products of the two industries as good substitutes. For instance, the producers of sugar experience competitive pressures from the sales and marketing efforts of the makers of artificial sweeteners. Similarly, the producers of eyeglasses and contact lenses are currently facing mounting competitive pressures from growing consumer interest in corrective laser surgery. Newspapers are feeling the competitive force of the general public turning to cable news channels for late-breaking news and using Internet sources to get information about sports results, stock quotes, and job opportunities.

Just how strong the competitive pressures are from the sellers of substitute products depends on three factors: (1) whether substitutes are readily available and attractively priced; (2) whether buyers view the substitutes as being comparable or better in terms of quality, performance, and other relevant attributes; and (3) how much it costs end users to switch to substitutes. Figure 3.6 lists factors affecting the strength of competitive pressures from substitute products and signs that indicate substitutes are a strong competitive force.

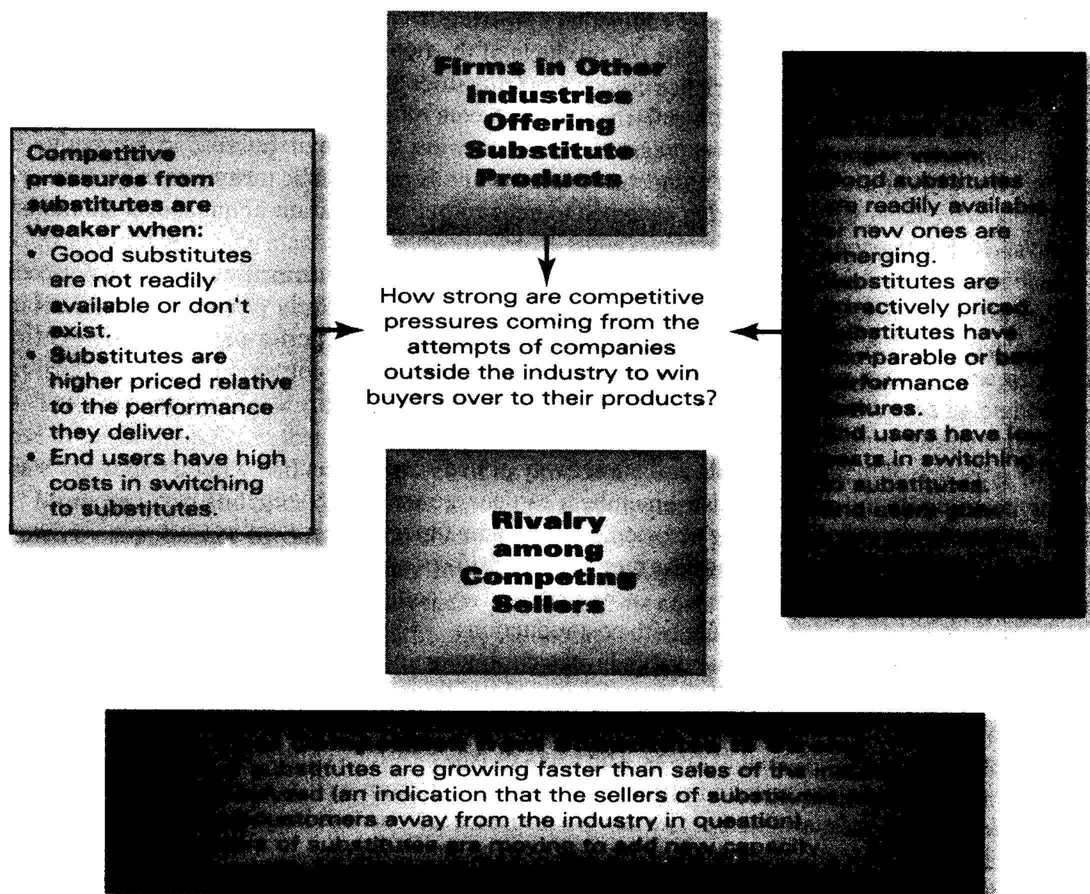
The presence of readily available and attractively priced substitutes creates competitive pressure by placing a ceiling on the prices industry members can charge without giving customers an incentive to switch to substitutes and risking sales erosion.[7] At the same time, this price ceiling puts a lid on the profits that industry members can earn unless they find ways to cut costs. When substitutes are cheaper than an industry's product, industry members come under heavy competitive pressure to reduce their prices and find ways to absorb the price cuts with cost reductions.

The availability of substitutes inevitably invites customers to compare performance, features, ease of use, and other attributes as well as price. For example, the makers of films and film-based cameras are experiencing strong competition from the makers of digital cameras because consumers like the convenience and low operating costs of digital cameras. The users of paper cartons constantly weigh the performance trade-offs with plastic containers and metal cans. Competition from well-performing substitute products pushes industry participants to incorporate new performance features and heighten efforts to convince customers their product has attributes that are superior to those of substitutes.

The strength of competition from substitutes is significantly influenced by how difficult or costly it is for the industry's customers to switch to a substitute.[8] Typical switching costs include the time and inconvenience that may be involved, the costs of additional equipment, the time and cost in testing the quality and reliability of the substitute, the psychological costs of severing old supplier relationships and establishing new ones, payments for technical help in making the changeover, and employee retraining costs. When buyers incur high costs in switching to substitutes, the competitive pressures that industry members experience from substitutes are usually lessened unless the sellers of substitutes begin offering price discounts or major performance benefits that entice the industry's customers away. When switching costs are low, it's much easier for sellers of substitutes to convince buyers to change to their products.

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

figure 3.6 **Factors Affecting Competition from Substitute Products**



Competitive Pressures Stemming from Supplier Bargaining Power and Supplier-Seller Collaboration

Whether supplier–seller relationships represent a weak or a strong competitive force depends on (1) whether major suppliers can exercise sufficient bargaining power to influence the terms and conditions of supply in their favor, and (2) the nature and extent of supplier–seller collaboration in the industry.

How Supplier Bargaining Power Can Create Competitive Pressures When the major suppliers to an industry have considerable leverage in determining the terms and conditions of the item they are supplying, they are in a position to exert competitive pressure on one or more rival sellers. For instance, Microsoft and Intel, both of which supply personal computer (PC) makers with products that most PC users consider essential, are known for using their dominant market status not only to charge PC makers premium prices but also to leverage PC makers in other ways. Microsoft pressures PC makers to load only Microsoft products on the PCs they ship and to position the icons for Microsoft software prominently on the screens of new computers that come with factory-loaded software. Intel pushes greater use

of Intel microprocessors in PCs by granting PC makers sizable advertising allowances on PC models equipped with "Intel Inside" stickers; it also tends to give PC makers that use the biggest percentages of Intel chips in their PC models top priority in filling orders for newly introduced Intel chips. Being on Intel's list of preferred customers helps a PC maker get an allocation of the first production runs of Intel's latest and greatest chips and thus get new PC models equipped with these chips to market ahead of rivals who are heavier users of chips made by Intel's rivals. The ability of Microsoft and Intel to pressure PC makers for preferential treatment of one kind or another in turn affects competition among rival PC makers.

Several other instances of supplier bargaining power are worth citing. Small-scale retailers must often contend with the power of manufacturers whose products enjoy prestigious and well-respected brand names; when a manufacturer knows that a retailer needs to stock the manufacturer's product because consumers expect to find the product on the shelves of retail stores where they shop, the manufacturer usually has some degree of pricing power and can also push hard for favorable shelf displays. Motor vehicle manufacturers typically exert considerable power over the terms and conditions with which they supply new vehicles to their independent automobile dealerships. The operators of franchised units of such chains as Krispy Kreme Doughnuts, Burger King, Pizza Hut, and Hampton Inns must frequently agree not only to source some of their supplies from the franchisor at prices and terms favorable to that franchisor but also to operate their facilities in a manner largely dictated by the franchisor. Strong supplier bargaining power is a competitive factor in industries where unions have been able to organize the workforces of some industry members but not others; those industry members that must negotiate wages, fringe benefits, and working conditions with powerful unions (which control the supply of labor) often find themselves with higher labor costs than their competitors with nonunion labor forces. The bigger the gap between union and nonunion labor costs in an industry, the more that unionized industry members must scramble to find ways to relieve the competitive pressure associated with their disadvantage on labor costs.

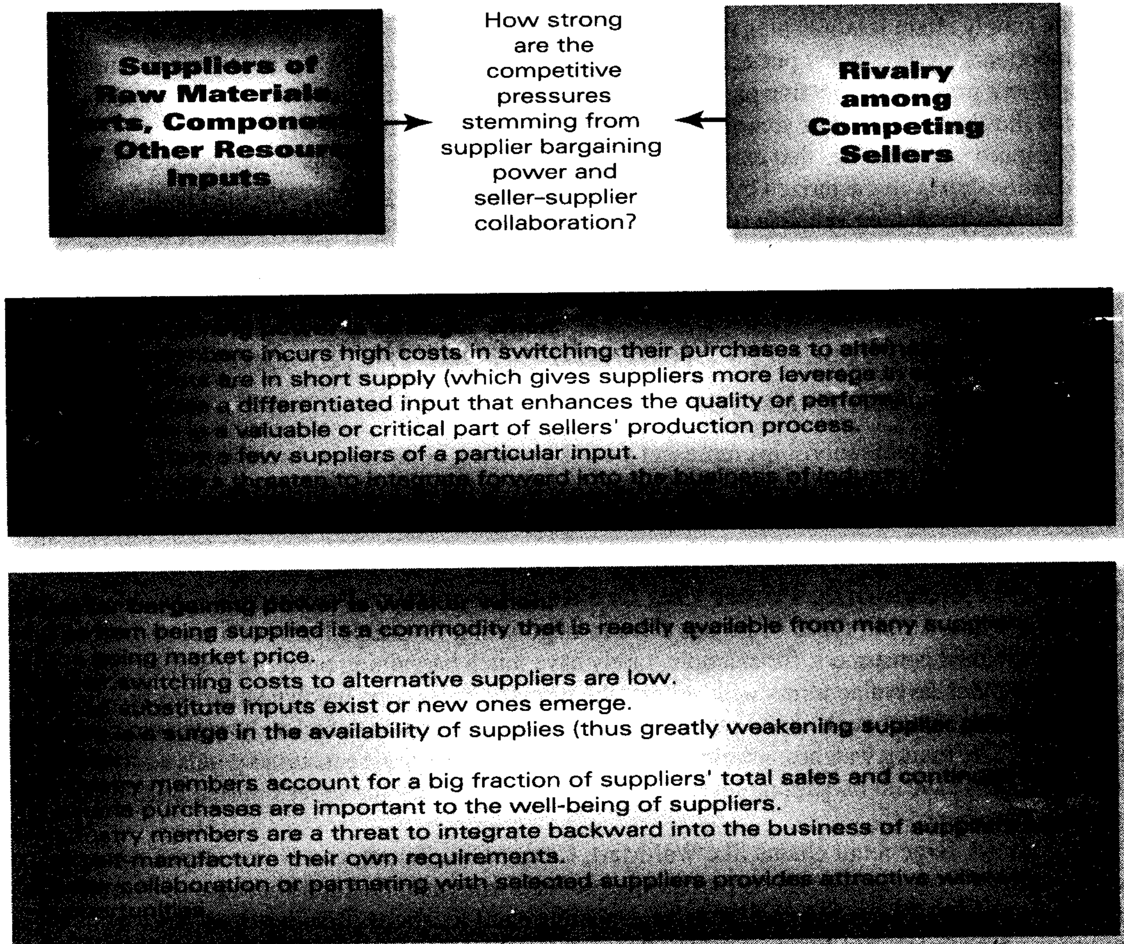
The factors that determine whether any of the suppliers to an industry are in a position to exert substantial bargaining power or leverage are fairly clear-cut:[9]

- *Whether the item being supplied is a commodity that is readily available from many suppliers at the going market price.* Suppliers have little or no bargaining power or leverage whenever industry members have the ability to source their requirements at competitive prices from any of several alternative and eager suppliers, perhaps dividing their purchases among two or more suppliers to promote lively competition for orders. The suppliers of commoditylike items have market power only when supplies become quite tight and industry members are so eager to secure what they need that they agree to terms more favorable to suppliers.
- *Whether a few large suppliers are the primary sources of a particular item.* The leading suppliers may well have pricing leverage unless they are plagued with excess capacity and are scrambling to secure additional orders for their products. Major suppliers with good reputations and strong demand for the items they supply are harder to wring concessions from than struggling suppliers striving to broaden their customer base or more fully utilize their production capacity.
- *Whether it is difficult or costly for industry members to switch their purchases from one supplier to another or to switch to attractive substitute inputs.* High switching costs signal strong bargaining power on the part of suppliers, whereas low switching costs and ready availability of good substitute inputs signal weak bargaining power. Soft-drink bottlers, for example, can counter the bargaining

power of aluminum-can suppliers by shifting or threatening to shift to greater use of plastic containers and introducing more attractive plastic container designs.

- *Whether certain needed inputs are in short supply.* Suppliers of items in short supply have some degree of pricing power, whereas a surge in the availability of particular items greatly weakens supplier pricing power and bargaining leverage.
- *Whether certain suppliers provide a differentiated input that enhances the performance or quality of the industry's product.* The more valuable a particular input is in terms of enhancing the performance or quality of the products of industry members or of improving the efficiency of their production processes, the more bargaining leverage its suppliers are likely to possess.
- *Whether certain suppliers provide equipment or services that deliver valuable cost-saving efficiencies to industry members in operating their production processes.* Suppliers who provide cost-saving equipment or other valuable or necessary production-related services are likely to possess bargaining leverage. Industry members that do not source from such suppliers may find themselves at a cost disadvantage and thus under competitive pressure to do so (on terms that are favorable to the suppliers).
- *Whether suppliers provide an item that accounts for a sizable fraction of the costs of the industry's product.* The bigger the cost of a particular part or component, the more opportunity for the pattern of competition in the marketplace to be affected by the actions of suppliers to raise or lower their prices.
- *Whether industry members are major customers of suppliers.* As a rule, suppliers have less bargaining leverage when their sales to members of this one industry constitute a big percentage of their total sales. In such cases, the well-being of suppliers is closely tied to the well-being of their major customers. Suppliers then have a big incentive to protect and enhance their customers' competitiveness via reasonable prices, exceptional quality, and ongoing advances in the technology of the items supplied.
- *Whether it makes good economic sense for industry members to integrate backward and self-manufacture items they have been buying from suppliers.* The make-or-buy issue generally boils down to whether suppliers who specialize in the production of a particular part or component and make them in volume for many different customers have the expertise and scale economies to supply as good or better component at a lower cost than industry members could achieve via self-manufacture. Frequently, it is difficult for industry members to self-manufacture parts and components more economically than they can obtain them from suppliers who specialize in making such items. For instance, most producers of outdoor power equipment (lawn mowers, rotary tillers, leaf blowers, etc.) find it cheaper to source the small engines they need from outside manufacturers who specialize in small-engine manufacture rather than make their own engines because the quantity of engines they need is too small to justify the investment in manufacturing facilities, master the production process, and capture scale economies. Specialists in small-engine manufacture, by supplying many kinds of engines to the whole power equipment industry, can obtain a big enough sales volume to fully realize scale economies, become proficient in all the manufacturing techniques, and keep costs low. As a rule, suppliers are safe from the threat of self-manufacture by their customers *until* the volume of parts a customer needs becomes large enough for the customer to justify backward integration into self-manufacture of the component. Suppliers also gain bargaining power when they have

figure 3.7 **Factors Affecting the Bargaining Power of Suppliers**



the resources and profit incentive to integrate forward into the business of the customers they are supplying and thus become a strong rival.

Figure 3.7 summarizes the conditions that tend to make supplier bargaining power strong or weak.

How Seller–Supplier Partnerships Can Create Competitive Pressures In more and more industries, sellers are forging strategic partnerships with select suppliers in efforts to (1) reduce inventory and logistics costs (e.g., through just-in-time deliveries); (2) speed the availability of next-generation components; (3) enhance the quality of the parts and components being supplied and reduce defect rates; and (4) squeeze out important cost savings for both themselves and their suppliers. Numerous Internet technology applications are now available that permit real-time data sharing, eliminate paperwork, and produce cost savings all along the supply chain. The many benefits of effective seller–supplier collaboration can translate into competitive advantage for industry members who do the best job of managing supply chain relationships.

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

The more opportunities that exist for win–win efforts between a company and its suppliers, the less their relationship is characterized by who has the upper hand in bargaining with the other. So long as the relationship is producing valuable benefits for both parties, it will last; only if a supply partner is falling behind alternative suppliers is a company likely to switch suppliers and incur the costs and trouble of building close working ties with a different supplier.

Competitive Pressures Stemming from Buyer Bargaining Power and Seller-Buyer Collaboration

Whether seller–buyer relationships represent a weak or strong competitive force depends on (1) whether some or many buyers have sufficient bargaining leverage to obtain price concessions and other favorable terms and conditions of sale, and (2) the extent and competitive importance of seller–buyer strategic partnerships in the industry.

How Buyer Bargaining Power Can Create Competitive Pressures As with suppliers, the leverage that certain types of buyers have in negotiating favorable terms can range from weak to strong. Individual consumers, for example, rarely have much bargaining power in negotiating price concessions or other favorable terms with sellers; the primary exceptions involve situations in which price haggling is customary, such as the purchase of new and used motor vehicles, homes, and certain big-ticket items like luxury watches, jewelry, and pleasure boats. For most consumer goods and services, individual buyers have no bargaining leverage—their option is to pay the seller's posted price or take their business elsewhere.

In contrast, large retail chains like Wal-Mart, Circuit City, Target, and Home Depot typically have considerable negotiating leverage in purchasing products from manufacturers because of manufacturers' need for broad retail exposure and the most appealing shelf locations. Retailers may stock two or three competing brands of a product but rarely all competing brands, so competition among rival manufacturers for visibility on the shelves of popular multistore retailers gives such retailers significant bargaining strength. Major supermarket chains like Kroger, Safeway, and Royal Ahold, which provide access to millions of grocery shoppers, have sufficient bargaining power to demand promotional allowances and lump-sum payments (called slotting fees) from food products manufacturers in return for stocking certain brands or putting them in the best shelf locations. Motor vehicle manufacturers have strong bargaining power in negotiating to buy original equipment tires from Goodyear, Michelin, Bridgestone/ Firestone, Continental, and Pirelli not only because they buy in large quantities but also because tire makers believe they gain an advantage in supplying replacement tires to vehicle owners if their tire brand is original equipment on the vehicle. "Prestige" buyers have a degree of clout in negotiating with sellers because a seller's reputation is enhanced by having prestige buyers on its customer list.

Even if buyers do not purchase in large quantities or offer a seller important market exposure or prestige, they gain a degree of bargaining leverage in the following circumstances:[10]

- *If buyers' costs of switching to competing brands or substitutes are relatively low*—Buyers who can readily switch brands or source from several sellers have more negotiating leverage than buyers who have high switching costs. When the products of rival sellers are virtually identical, it is relatively easy for buyers to switch from seller to seller at little or no cost and anxious sellers may be willing to make concessions to win or retain a buyer's business.
- *If the number of buyers is small or if a customer is particularly important to a seller*—The smaller the number of buyers, the less easy it is for sellers to find alternative buyers when a customer is lost to a competitor. The prospect of losing a customer not easily replaced often makes a seller more willing to grant concessions of one kind or another.
- *If buyer demand is weak and sellers are scrambling to secure additional sales of their products*—Weak or declining demand creates a "buyers' market" and shifts bargaining power to buyers; conversely, strong or rapidly growing demand creates a "sellers' market" and shifts bargaining power to sellers.
- *If buyers are well informed about sellers' products, prices, and costs*—The more information buyers have, the better bargaining position they are in. The mushrooming availability of product information on the Internet is giving added bargaining power to individuals. Buyers can easily use the Internet to compare prices and features of vacation packages, shop for the best interest rates on mortgages and loans, and find the best prices on big-ticket items such as digital cameras. Bargain-hunting individuals can shop around for the best deal on the Internet and use that information to negotiate a better deal from local retailers; this method is becoming commonplace in buying new and used motor vehicles. Further, the Internet has created opportunities for manufacturers, wholesalers, retailers, and sometimes individuals to join online buying groups to pool their purchasing power and approach vendors for better terms than could be gotten individually. A multinational manufacturer's geographically scattered purchasing groups can use Internet technology to pool their orders with parts and components suppliers and bargain for volume discounts. Purchasing agents at some companies are banding together at third-party Web sites to pool corporate purchases to get better deals or special treatment.
- *If buyers pose a credible threat of integrating backward into the business of sellers*—Companies like Anheuser-Busch, Coors, and Heinz have integrated backward into metal-can manufacturing to gain bargaining power in obtaining the balance of their can requirements from otherwise powerful metal-can manufacturers. Retailers gain bargaining power by stocking and promoting their own private-label brands alongside manufacturers' name brands. Wal-Mart, for example, has elected to compete against Procter & Gamble, its biggest supplier, with its own brand of laundry detergent, called Sam's American Choice, which is priced 25 to 30 percent lower than Procter & Gamble's Tide.
- *If buyers have discretion in whether and when they purchase the product*—If consumers are unhappy with the present deals offered on major appliances, hot tubs, home entertainment centers, or other goods for which time is not a critical purchase factor, they may be in a position to delay purchase until prices and financing terms improve. If business customers are not happy with the prices or security features of bill-payment software systems, they can either delay purchase until next-generation products become available or attempt to develop their own software in-house. If college students believe that the prices of new textbooks are too high, they can purchase used copies.

figure 3.8 **Factors Affecting the Bargaining Power of Buyers**

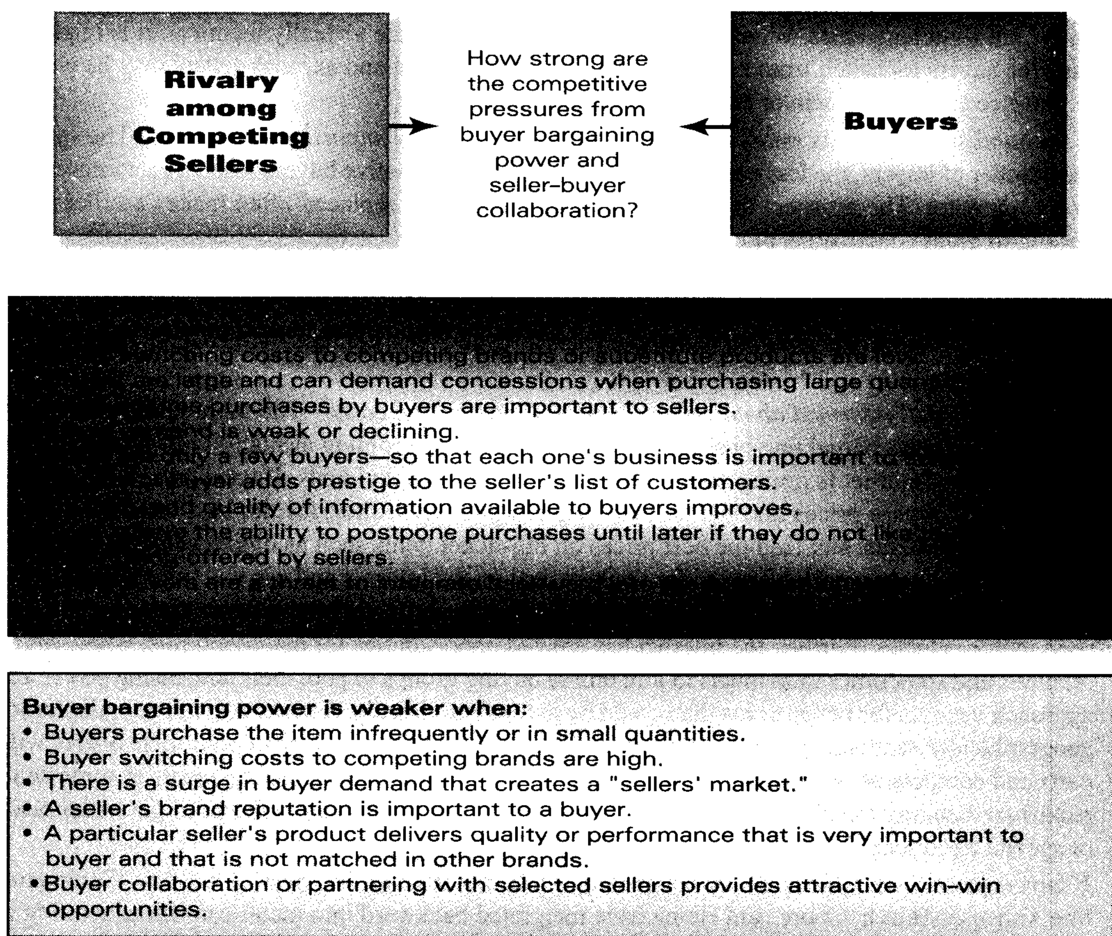


Figure 3.8 summarizes the circumstances that make for strong or weak bargaining power on the part of buyers.

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

How Seller–Buyer Partnerships Can Create Competitive Pressures Partnerships between sellers and buyers are an increasingly important element of the competitive picture in *business-to-business relationships* (as opposed to business-to-consumer relationships). Many sellers that provide items to business customers have found it in their mutual interest to collaborate closely on such matters as just-in-time deliveries, order processing, electronic invoice payments, and data sharing. Wal-Mart, for example, provides the manufacturers with whom it does business (like Procter & Gamble) with daily sales at each of its stores so that the manufacturers can maintain sufficient inventories at Wal-Mart's distribution centers to keep the shelves at each Wal-Mart store amply stocked. Dell Computer has partnered with its largest customers to create online systems for over 50,000 corporate customers, providing their employees with information on approved product configurations, global pricing, paperless purchase orders, real-time order tracking, invoicing, purchasing history, and other efficiency tools. Dell also loads a customer's software at the factory and installs asset tags so that customer setup time is minimal; it also helps customers upgrade their PC systems to next-generation hardware and software. Dell's partnerships with its corporate customers have put significant competitive pressure on other PC makers.

Determining Whether the Collective Strength of the Five Competitive Forces Promotes Profitability

Scrutinizing each of the five competitive forces one by one provides a powerful diagnosis of what competition is like in a given market. Once company managers understand the specific competitive pressures comprising each force and determine whether these pressures constitute a strong or weak competitive force, the next step is to evaluate the collective strength of the five forces and determine whether the state of competition promotes profitability. Is the collective impact of the five competitive forces stronger than normal? Are some of the competitive forces sufficiently strong to undermine industry profitability? Can companies in this industry reasonably expect to earn decent profits in light of the prevailing competitive forces?

Does the State of Competition Promote Profitability? *As a rule, the stronger the collective impact of the five competitive forces, the lower the combined profitability of industry participants.* The most extreme case of a competitively unattractive industry is when all five forces are producing strong competitive pressures: rivalry among sellers is vigorous, low entry barriers allow new rivals to gain a market foothold, competition from substitutes is intense, and both suppliers and customers are able to exercise considerable bargaining leverage. Fierce to strong competitive pressures coming from all five directions nearly always drive industry profitability to unacceptably low levels, frequently producing losses for many industry members and forcing some out of business. But an industry can be competitively unattractive without all five competitive forces being strong. Intense competitive pressures from just two or three of the five forces may suffice to destroy the conditions for good profitability and prompt some companies to exit the business. The manufacture of disk drives, for example, is brutally competitive; IBM recently announced the sale of its disk drive business to Hitachi, taking a loss of over $2 billion on its exit from the business. Especially intense competitive conditions seem to be the norm in tire manufacturing and apparel, two industries where profit margins have historically been thin.

> **The stronger the forces of competition, the harder it becomes for industry members to earn attractive profits.**

In contrast, when the collective impact of the five competitive forces is moderate to weak, an industry is competitively attractive in the sense that industry members can reasonably expect to earn good profits and a nice return on investment. The ideal competitive environment for earning superior profits is one in which both suppliers and customers are in weak bargaining positions, there are no good substitutes, high barriers block further entry, and rivalry among present sellers generates only moderate competitive pressures. Weak competition is the best of all possible worlds for also-ran companies because even they can usually eke out a decent profit—if a company can't make a decent profit when competition is weak, then its business outlook is indeed grim.

In most industries, the collective strength of the five competitive forces is somewhere near the middle of the two extremes of very intense and very weak, typically ranging from slightly stronger than normal to slightly weaker than normal and typically allowing well-managed companies with sound strategies to earn attractive profits.

A company's strategy is increasingly effective the more it provides some insulation from competitive pressures and shifts the competitive battle in the company's favor.

Does Company Strategy Match Competitive Conditions? Working through the five-forces model step by step not only aids strategy makers in assessing whether the intensity of competition allows good profitability but also promotes sound strategic thinking about how to better match company strategy to the specific competitive character of the marketplace. Effectively matching a company's strategy to the particular competitive pressures and competitive conditions that exist has two aspects:

1. Pursuing actions to shield the firm, as much as possible, from the prevailing competitive pressures.
2. Initiating actions calculated to produce sustainable competitive advantage, thereby shifting competition in the company's favor, putting added competitive pressure on rivals, and perhaps even defining the business model for the industry.

But making headway on these two fronts first requires identifying competitive pressures, gauging the relative strength of each, and gaining a deep enough understanding of the state of competition in the industry to know which strategy buttons to push.

QUESTION 3: WHAT FACTORS ARE DRIVING INDUSTRY CHANGE AND WHAT IMPACTS WILL THEY HAVE?

An industry's present conditions don't necessarily reveal much about the strategically relevant ways in which the industry environment is changing. All industries are characterized by trends and new developments that gradually or speedily produce changes important enough to require a strategic response from participating firms. The popular hypothesis that industries go through a life cycle of takeoff, rapid growth, early maturity, market saturation, and stagnation or decline helps explain industry change—but it is far from complete.[11] An industry's normal progression through the life cycle is by no means the only cause of industry change.

The Concept of Driving Forces

Although it is important to judge what growth stage an industry is in, there's more analytical value in identifying the specific factors causing fundamental industry and competitive adjustments. Industry and

competitive conditions change because certain forces are enticing or pressuring industry participants to alter their actions.[12] **Driving forces** are those that have the biggest influence on what kinds of changes will take place in the industry's structure and competitive environment. Some driving forces originate in the company's macroenvironment; some originate from within the company's more immediate industry and competitive environment. Driving-forces analysis has two steps: (1) identifying what the driving forces are, and (2) assessing the impact they will have on the industry.

core concept
Industry conditions change because important forces are *driving* industry participants (competitors, customers, or suppliers) to alter their actions; the ***driving forces*** in an industry are the *major underlying causes* of changing industry and competitive conditions—some driving forces originate in the macroenvironment and some originate from within a company's immediate industry and competitive environment.

Identifying an Industry's Driving Forces

Many events can affect an industry powerfully enough to qualify as driving forces. Some are unique and specific to a particular industry situation, but most drivers of change fall into one of the following categories:[13]

- *Growing use of the Internet and emerging new Internet technology applications*—The Internet and the adoption of Internet technology applications represent a driving force of historical and revolutionary proportions. The Internet is proving to be an important new distribution channel, allowing manufacturers to access customers directly rather than distribute exclusively through traditional wholesale and retail channels, and also making it easy for companies of all types to extend their geographic reach and vie for sales in areas where they formerly did not have a presence. Being able to reach consumers via the Internet can increase the number of rivals a company faces and escalate rivalry among sellers, sometimes pitting pure online sellers against combination brick-and-click sellers against pure brick-and-mortar sellers. The Web sites of rival sellers are only a few clicks apart and are open for business 24 hours a day every day of the year, giving buyers unprecedented ability to research the product offerings of competitors and shop the market for the best value. Companies can use the Internet to reach beyond their borders to find the best suppliers and, further, to collaborate closely with them to achieve efficiency gains and cost savings. Moreover, companies across the world are using a host of Internet technology applications to revamp internal operations and squeeze out cost savings. Internet technology has so many business applications that companies across the world are pursuing its operational benefits and making online systems a normal part of everyday operations. But the impacts vary from industry to industry and company to company, and the industry and competitive implications are continuously evolving. The challenges here are to assess precisely how the Internet and Internet technology applications are altering a particular industry's landscape and to factor these impacts in to the strategy-making equation.
- *Increasing globalization*—Competition begins to shift from primarily a regional or national focus to an international or global focus when industry members begin seeking out customers in foreign markets or when production activities begin to migrate to countries where costs are lowest. Globalization of competition really starts to take hold when one or more ambitious companies precipitate a race for worldwide market leadership by launching initiatives to expand into more and more country markets. Globalization can also be precipitated by the blossoming of consumer demand in more and more countries and by the actions of government officials in many countries to reduce trade barriers or open up once-closed markets to foreign competitors, as is occurring in many parts of Europe, Latin America, and Asia. Significant differences in labor costs among countries give manufacturers a strong incentive

to locate plants for labor-intensive products in low-wage countries and use these plants to supply market demand across the world. Wages in China, India, Singapore, Mexico, and Brazil, for example, are about one-fourth those in the United States, Germany, and Japan. The forces of globalization are sometimes such a strong driver that companies find it highly advantageous, if not necessary, to spread their operating reach into more and more country markets. Globalization is very much a driver of industry change in such industries as credit cards, mobile phones, motor vehicles, steel, refined petroleum products, public accounting, and textbook publishing.

- *Changes in the long-term industry growth rate*—Shifts in industry growth up or down are a driving force for industry change, affecting the balance between industry supply and buyer demand, entry and exit, and the character and strength of competition. An upsurge in buyer demand triggers a race among established firms and newcomers to capture the new sales opportunities; ambitious companies with trailing market shares may see the upturn in demand as a golden opportunity to broaden their customer base and move up several notches in the industry standings to secure a place among the market leaders. A slowdown in the rate at which demand is growing nearly always portends mounting rivalry and increased efforts by some firms to maintain their high rates of growth by taking sales and market share away from rivals. If industry sales suddenly turn flat or begin to shrink after years of rising steadily, competition is certain to intensify as industry members scramble for the available business and as mergers and acquisitions result in industry consolidation to a smaller number of competitively stronger participants. Dimming sales prospects usually prompt both competitively weak and growth-oriented companies to sell their business operations to those industry members who elect to stick it out; as demand for the industry's product continues to shrink, the remaining industry members may be forced to close inefficient plants and retrench to a smaller production base—all of which results in a much-changed competitive landscape.
- *Changes in who buys the product and how they use it*—Shifts in buyer demographics and new ways of using the product can alter the state of competition by opening the way to market an industry's product through a different mix of dealers and retail outlets; prompting producers to broaden or narrow their product lines; bringing different sales and promotion approaches into play; and forcing adjustments in customer service offerings (credit, technical assistance, maintenance and repair). The mushrooming popularity of downloading music from the Internet, storing music files on PC hard drives, and burning custom discs has forced recording companies to reexamine their distribution strategies and raised questions about the future of traditional retail music stores; at the same time, it has stimulated sales of disc burners and blank discs. Longer life expectancies and growing percentages of relatively well-to-do retirees are driving changes in such industries as health care, prescription drugs, recreational living, and vacation travel. The growing percentage of households with PCs and Internet access is opening opportunities for banks to expand their electronic bill-payment services and for retailers to move more of their customer services online.
- *Product innovation*—Competition in an industry is always affected by rivals racing to be first to introduce one new product or product enhancement after another. An ongoing stream of product innovations tends to alter the pattern of competition in an industry by attracting more first-time buyers, rejuvenating industry growth, and/or creating wider or narrower product differentiation among rival sellers. Successful new product introductions strengthen the market positions of the

innovating companies, usually at the expense of companies that stick with their old products or are slow to follow with their own versions of the new product. Product innovation has been a key driving force in such industries as digital cameras, golf clubs, video games, toys, and prescription drugs.

- *Technological change and manufacturing process innovation*—Advances in technology can dramatically alter an industry's landscape, making it possible to produce new and better products at lower cost and opening up whole new industry frontiers. Technological developments can also produce competitively significant changes in capital requirements, minimum efficient plant sizes, distribution channels and logistics, and experience or learning-curve effects. In the steel industry, ongoing advances in electric arc minimill technology (which involve recycling scrap steel to make new products) have allowed steelmakers with state-of-the-art minimills to gradually expand into the production of more and more steel products, steadily taking sales and market share from higher-cost integrated producers (which make steel from scratch using iron ore, coke, and traditional blast furnace technology). Nucor, the leader of the minimill technology revolution in the United States, came from nowhere in 1970 to emerge as the nation's biggest and the lowest-cost steel producer as of 2002, having overtaken U.S. Steel and Bethlehem Steel, both integrated producers and the longtime market leaders. In a space of 30 years, advances in minimill technology have changed the face of the steel industry worldwide.
- *Marketing innovation*—When firms are successful in introducing new ways to market their products, they can spark a burst of buyer interest, widen industry demand, increase product differentiation, and lower unit costs—any or all of which can alter the competitive positions of rival firms and force strategy revisions. In today's world, Internet marketing is shaking up competition in such industries as electronics retailing, stock brokerage (where online brokers have taken significant business away from traditional brokers), and office supplies (where Office Depot, Staples, and Office Max are using their Web sites to market office supplies to corporations, small businesses, schools and universities, and government agencies).
- *Entry or exit of major firms*—The entry of one or more foreign companies into a geographic market once dominated by domestic firms nearly always shakes up competitive conditions. Likewise, when an established domestic firm from another industry attempts entry either by acquisition or by launching its own start-up venture, it usually applies its skills and resources in some innovative fashion that pushes competition in new directions. Entry by a major firm thus often produces a new ball game, not only with new key players but also with new rules for competing. Similarly, exit of a major firm changes the competitive structure by reducing the number of market leaders (perhaps increasing the dominance of the leaders who remain) and causing a rush to capture the exiting firm's customers.
- *Diffusion of technical know-how across more companies and more countries*—As knowledge about how to perform a particular activity or execute a particular manufacturing technology spreads, the competitive advantage held by firms originally possessing this know-how erodes. Knowledge diffusion can occur through scientific journals, trade publications, on-site plant tours, word of mouth among suppliers and customers, employee migration, and Internet sources. It can also occur when those possessing technological know-how license others to use it for a royalty fee or team up with a company interested in turning the technology into a new business venture. Quite often, technologi-

cal know-how can be acquired by simply buying a company that has the wanted skills, patents, or manufacturing capabilities. In recent years, *rapid technology transfer across national boundaries has been a prime factor in causing industries to become more globally competitive.* As companies worldwide gain access to valuable technical know-how, they upgrade their manufacturing capabilities in a long-term effort to compete head-on with established companies. Cross-border technology transfer has made the once domestic industries of automobiles, tires, consumer electronics, telecommunications, computers, and others increasingly global.

- *Changes in cost and efficiency*—Widening or shrinking differences in the costs among key competitors tend to dramatically alter the state of competition. The low cost of e-mail and fax transmission has put mounting competitive pressure on the relatively inefficient and high-cost operations of the U.S. Postal Service—sending a one-page fax is cheaper and far quicker than sending a first-class letter; sending e-mail is faster and cheaper still. In the electric power industry, sharply lower costs to generate electricity at newly constructed combined-cycle generating plants during 1998–2001 forced older coal-fired and gas-fired plants to lower their production costs to remain competitive. Shrinking cost differences in producing multifeatured mobile phones is turning the mobile phone market into a commodity business and causing more buyers to base their purchase decisions on price.
- *Growing buyer preferences for differentiated products instead of a commodity product (or for a more standardized product instead of strongly differentiated products)*—When buyer tastes and preferences start to diverge, sellers can win a loyal following with product offerings that stand apart from those of rival sellers. In recent years, beer drinkers have grown less loyal to a single brand and have begun to drink a variety of domestic and foreign beers; as a consequence, beer manufacturers have introduced a host of new brands and malt beverages with different tastes and flavors. Buyer preferences for motor vehicles are becoming increasingly diverse, with few models generating sales of more than 250,000 units annually. When a shift from standardized to differentiated products occurs, the driver of change is the contest among rivals to cleverly outdifferentiate one another.

  However, buyers sometimes decide that a standardized, budget-priced product suits their requirements as well as or better than a premium-priced product with lots of snappy features and personalized services. Online brokers, for example, have used the lure of cheap commissions to attract many investors willing to place their own buy–sell orders via the Internet; growing acceptance of online trading has put significant competitive pressures on full-service brokers whose business model has always revolved around convincing clients of the value of asking for personalized advice from professional brokers and paying their high commission fees to make trades. Pronounced shifts toward greater product standardization usually spawn lively price competition and force rival sellers to drive down their costs to maintain profitability. The lesson here is that competition is driven partly by whether the market forces in motion are acting to increase or decrease product differentiation.
- *Reductions in uncertainty and business risk*—An emerging industry is typically characterized by much uncertainty over potential market size, how much time and money will be needed to surmount technological problems, and what distribution channels and buyer segments to emphasize. Emerging industries tend to attract only risk-taking entrepreneurial companies. Over time, however, if the business model of industry pioneers proves profitable and market demand for the product appears

durable, more conservative firms are usually enticed to enter the market. Often, these later entrants are large, financially strong firms looking to invest in attractive growth industries.

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

- *Regulatory influences and government policy changes*—Government regulatory actions can often force significant changes in industry practices and strategic approaches. Deregulation has proved to be a potent pro-competitive force in the airline, banking, natural gas, telecommunications, and electric utility industries. Government efforts to reform Medicare and health insurance have become potent driving forces in the health care industry. In international markets, host governments can drive competitive changes by opening their domestic markets to foreign participation or closing them to protect domestic companies. Note that this driving force is spawned by forces in a company's macroenvironment.
- *Changing societal concerns, attitudes, and lifestyles*—Emerging social issues and changing attitudes and lifestyles can be powerful instigators of industry change. Growing antismoking sentiment has emerged as a major driver of change in the tobacco industry; concerns about terrorism are having a big impact on the travel industry. Consumer concerns about salt, sugar, chemical additives, saturated fat, cholesterol, and nutritional value have forced food producers to revamp food-processing techniques, redirect R&D efforts into the use of healthier ingredients, and compete in developing nutritious, good-tasting products. Safety concerns have transformed the automobile, toy, and outdoor power equipment industries, to mention a few. Increased interest in physical fitness has spawned new industries in exercise equipment, mountain biking, outdoor apparel, sports gyms and recreation centers, vitamin and nutrition supplements, and medically supervised diet programs. Social concerns about air and water pollution have forced industries to incorporate expenditures for controlling pollution into their cost structures. Shifting societal concerns, attitudes, and lifestyles alter the pattern of competition, usually favoring those players that respond quickly and creatively with products targeted to the new trends and conditions. As with the preceding driving force, this driving force springs from factors at work in a company's macroenvironment.

These most common driving forces are summarized in Table 3.2.

That there are so many different *potential driving forces* explains why it is too simplistic to view industry change only in terms of the life-cycle model and why a full understanding of the *causes* underlying the emergence of new competitive conditions is a fundamental part of industry analysis. However, while many forces of change may be at work in a given industry, no more than three or four are likely to be true driving forces powerful enough to qualify as the *major determinants* of why and how the industry is changing. Thus company strategists must resist the temptation to label every change they see as a driving force; the analytical task is to evaluate the forces of industry and competitive change carefully enough to separate major factors from minor ones.

table 3.2 **The Most Common Driving Forces**

1. Growing use of the Internet and emerging new Internet technology applications.
2. Increasing globalization of the industry.
3. Changes in the long-term industry growth rate.
4. Changes in who buys the product and how they use it.
5. Product innovation.
6. Technological change and manufacturing process innovation.
7. Marketing innovation.
8. Entry or exit of major firms.
9. Diffusion of technical know-how across more companies and more countries.
10. Changes in cost and efficiency.
11. Growing buyer preferences for differentiated products instead of standardized commodity products (or for a more standardized product instead of strongly differentiated products).
12. Reductions in uncertainty and business risk.
13. Regulatory influences and government policy changes.
14. Changing societal concerns, attitudes, and lifestyles.

Assessing the Impact of the Driving Forces

The second phase of driving-forces analysis is to determine whether the driving forces are, on the whole, acting to make the industry environment more or less attractive. Answers to three questions are needed here:

1. Are the driving forces causing demand for the industry's product to increase or decrease?
2. Are the driving forces acting to make competition more or less intense?
3. Will the driving forces lead to higher or lower industry profitability?

Getting a handle on the collective impact of the driving forces usually requires looking at the likely effects of each force separately, since the driving forces may not all be pushing change in the same direction. For example, two driving forces may be acting to spur demand for the industry's product while one driving force may be working to curtail demand. Whether the net effect on industry demand is up or down hinges on which driving forces are the more powerful. The analyst's objective here is to get a good grip on what external factors are shaping industry change and what difference these factors will make.

The Link between Driving Forces and Strategy

Sound analysis of an industry's driving forces is a prerequisite to sound strategy making. Without understanding the forces driving industry change and the impacts these forces will have on the character of the industry environment and on the company's business over the next one to three years, managers are ill-prepared to craft a strategy tightly matched to emerging conditions. Similarly, if managers are uncertain about the implications of each driving force, or if their views are incomplete or off base, it's difficult for them to craft a strategy that is responsive to the driving forces and their consequences for the industry. So driving-forces analysis is not something to take lightly; it has practical value and is basic to the task of thinking strategically about where the industry is headed and how to prepare for the changes.

QUESTION 4: WHAT MARKET POSITIONS DO RIVALS OCCUPY—WHO IS STRONGLY POSITIONED AND WHO IS NOT?

Since competing companies commonly sell in different price/quality ranges, emphasize different distribution channels, incorporate product features that appeal to different types of buyers, have different geographic coverage, and so on, it stands to reason that some companies enjoy stronger or more attractive market positions than other companies. Understanding which companies are strongly positioned and which are weakly positioned is an integral part of analyzing an industry's competitive structure. The best technique for revealing the market positions of industry competitors is **strategic group mapping.**[14] This analytical tool is useful for comparing the market positions of each firm separately or for grouping them into like positions when an industry has so many competitors that it is not practical to examine each one in depth.

core concept
Strategic group mapping is a technique for displaying the different market or competitive positions that rival firms occupy in the industry.

Using Strategic Group Maps to Assess the Market Positions of Key Competitors

A **strategic group** consists of those industry members with similar competitive approaches and positions in the market.[15] Companies in the same strategic group can resemble one another in any of several ways: they may have comparable product-line breadth, sell in the same price/quality range, emphasize the same distribution channels, use essentially the same product attributes to appeal to similar types of buyers, depend on identical technological approaches, or offer buyers similar services and technical assistance.[16] An industry contains only one strategic group when all sellers pursue very similar strategies and have comparable market positions. At the other extreme, an industry may contain as many strategic groups as there are competitors when each rival pursues a distinctively different competitive approach and occupies a substantially different market position.

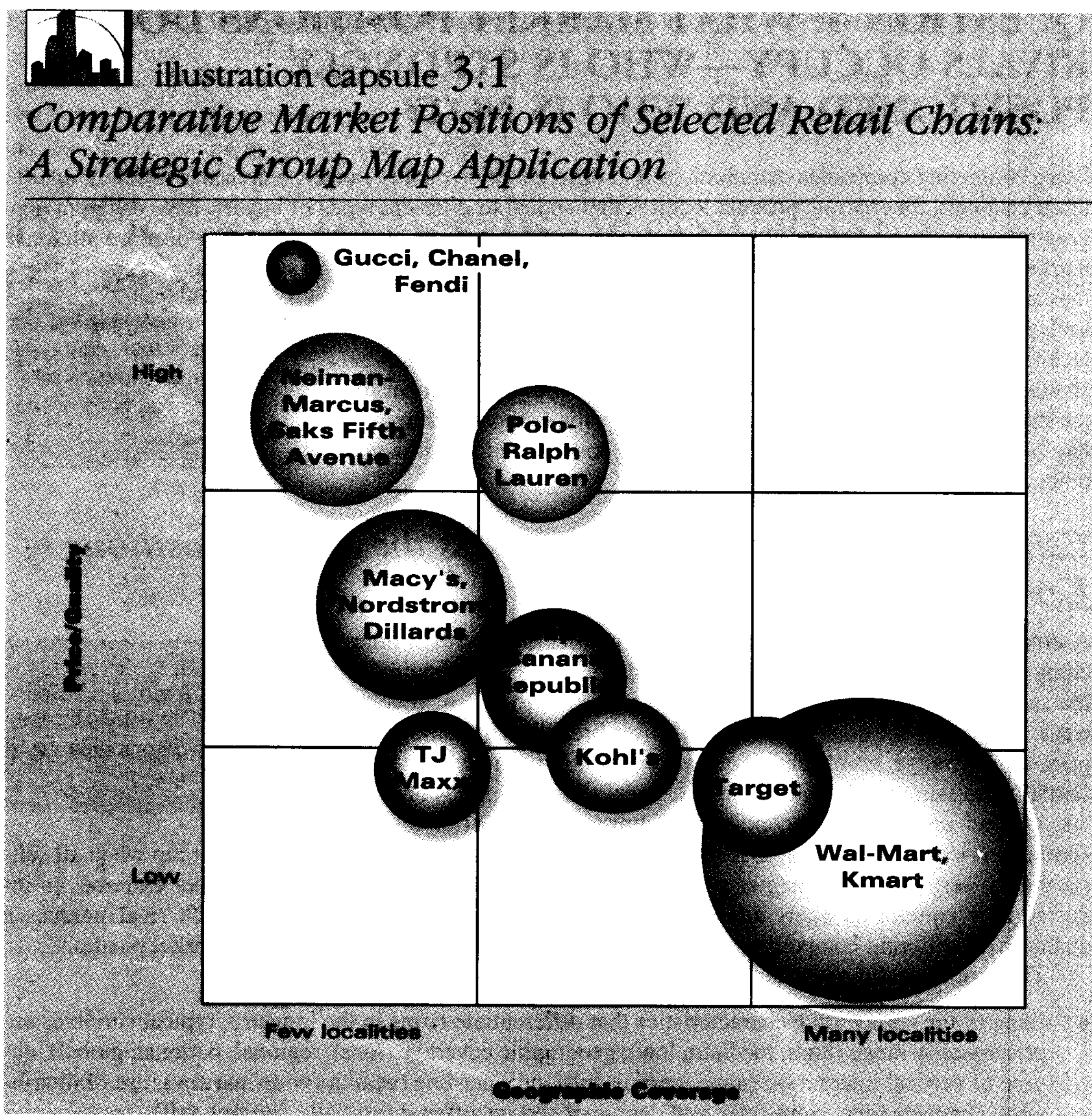
core concept
A ***strategic group*** is a cluster of firms in an industry with similar competitive approaches and market positions.

The procedure for constructing a *strategic group map* is straightforward:

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

This produces a two-dimensional diagram like the one for the retailing industry in Illustration Capsule 3.1.

Several guidelines need to be observed in mapping the positions of strategic groups in the industry's overall strategy space.[17] First, the two variables selected as axes for the map should *not* be highly correlated; if they are, the circles on the map will fall along a diagonal and strategy makers will learn noth-



Note: Circles are drawn roughly proportional to the sizes of the chains, based on revenues.

ing more about the relative positions of competitors than they would by considering just one of the variables. For instance, if companies with broad product lines use multiple distribution channels while companies with narrow lines use a single distribution channel, then looking at broad versus narrow product lines reveals just as much about who is positioned where as looking at single versus multiple distribution channels; that is, one of the variables is redundant. Second, the variables chosen as axes for the map should expose big differences in how rivals position themselves to compete in the marketplace. This, of course, means that analysts must identify the characteristics that differentiate rival firms and use these

differences as variables for the axes and as the basis for deciding which firm belongs in which strategic group. Third, the variables used as axes don't have to be either quantitative or continuous; rather, they can be discrete variables or defined in terms of distinct classes and combinations. Fourth, drawing the sizes of the circles on the map proportional to the combined sales of the firms in each strategic group allows the map to reflect the relative sizes of each strategic group. Fifth, if more than two good competitive variables can be used as axes for the map, several maps can be drawn to give different exposures to the competitive positioning relationships present in the industry's structure. Because there is not necessarily one best map for portraying how competing firms are positioned in the market, it is advisable to experiment with different pairs of competitive variables.

What Can Be Learned from Strategic Group Maps

One thing to look for in assessing rivals' market positions is to what extent *industry driving forces and competitive pressures favor some strategic groups and hurt others.*[18] Firms in adversely affected strategic groups may try to shift to a more favorably situated group; how hard such a move proves to be depends on whether entry barriers for the target strategic group are high or low. Attempts by rival firms to enter a new strategic group nearly always increase competitive pressures. If certain firms are known to be trying to change their competitive positions on the map, then attaching arrows to the circles showing the targeted direction helps clarify the picture of competitive maneuvering among rivals.

Driving forces and competitive pressures do not affect all strategic groups evenly. Profit prospects vary from group to group according to the relative attractiveness of their market positions.

Another consideration is to what extent *the profit potential of different strategic groups varies due to the strengths and weaknesses in each group's market position.* Differences in profitability can occur because of differing degrees of bargaining leverage or collaboration with suppliers and/or customers, differing degrees of exposure to competition from substitute products outside the industry, differing degrees of competitive rivalry within strategic groups, and differing growth rates for the principal buyer segments served by each group.

Generally speaking, *the closer strategic groups are to each other on the map, the stronger the cross-group competitive rivalry tends to be.* Although firms in the same strategic group are the closest rivals, the next closest rivals are in the immediately adjacent groups.[19] Often, firms in strategic groups that are far apart on the map hardly compete at all. For instance, Tiffany & Co. and Wal-Mart both sell gold and silver jewelry, but their clientele and the prices and quality of their products are much too different to justify calling them competitors. For the same reason, Timex is not a meaningful competitive rival of Rolex, and Subaru is not a close competitor of Lincoln or Mercedes-Benz.

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

Unless a company pays attention to what competitors are doing and knows their strengths and weaknesses, it ends up flying blind into competitive battle. As in sports, scouting the opposition is essential. *Competitive intelligence* about rivals' strategies, their latest actions and announcements, their resource strengths and weaknesses, the efforts being made to improve their situation, and the thinking and leadership styles of their executives is valuable for predicting or anticipating the strategic moves

Good scouting reports on rivals provide a valuable assist in anticipating what moves rivals are likely to make next and outmaneuvering them in the marketplace.

competitors are likely to make next in the marketplace. Having good information to predict the strategic direction and likely moves of key competitors allows a company to prepare defensive countermoves, to craft its own strategic moves with some confidence about what market maneuvers to expect from rivals, and to exploit any openings that arise from competitors' missteps or strategy flaws.

Identifying Competitors' Strategies and Resource Strengths and Weaknesses

Keeping close tabs on a competitor's strategy entails monitoring what the rival is doing in the marketplace, what its management is saying in company press releases, information posted on the company's Web site (especially press releases and the presentations management has recently made to securities analysts), and such public documents as annual reports and 10-K filings, articles in the business media, and the reports of securities analysts. (Figure 1.1 in Chapter 1 indicates what to look for in identifying a company's strategy.) Company personnel may be able to pick up useful information from a rival's exhibits at trade shows and from conversations with a rival's customers, suppliers, and former employees.[20] Many companies have a competitive intelligence unit that sifts through the available information to construct up-to-date strategic profiles of rivals—their current strategies, their resource strengths and competitive capabilities, their competitive shortcomings, and the latest pronouncements and leadership styles of their executives. Such profiles are typically updated regularly and made available to managers and other key personnel.

Those who gather competitive intelligence on rivals, however, can sometimes cross the fine line between honest inquiry and unethical or even illegal behavior. For example, calling rivals to get information about prices, the dates of new product introductions, or wage and salary levels is legal, but misrepresenting one's company affiliation during such calls is unethical. Pumping rivals' representatives at trade shows is ethical only if one wears a name tag with accurate company affiliation indicated. Avon Products at one point secured information about its biggest rival, Mary Kay Cosmetics (MKC), by having its personnel search through the garbage bins outside MKC's headquarters.[21] When MKC officials learned of the action and sued, Avon claimed it did nothing illegal, since a 1988 Supreme Court case had ruled that trash left on public property (in this case, a sidewalk) was anyone's for the taking. Avon even produced a videotape of its removal of the trash at the MKC site. Avon won the lawsuit—but Avon's action, while legal, scarcely qualifies as ethical.

In sizing up the strategies and the competitive strengths and weaknesses of competitors, it makes sense for company strategists to make three assessments:

1. Which competitor has the best strategy? Which competitors appear to have flawed or weak strategies?
2. Which competitors are poised to gain market share, and which ones seem destined to lose ground?
3. Which competitors are likely to rank among the industry leaders five years from now? Do one or more up-and-coming competitors have powerful strategies and sufficient resource capabilities to overtake the current industry leader?

The industry's *current* major players are generally easy to identify, but some of the leaders may be plagued with weaknesses that are causing them to lose ground; others may lack the resources and

capabilities to remain strong contenders given the superior strategies and capabilities of up-and-coming companies. In evaluating which competitors are favorably or unfavorably positioned to gain market ground, company strategists need to focus on why there is potential for some rivals to do better or worse than other rivals. Usually, a competitor's prospects are a function of its vulnerability to driving forces and competitive pressures, whether its strategy has resulted in competitive advantage or disadvantage, and whether its resources and capabilities are well suited for competing on the road ahead.

Today's market leaders don't automatically become tomorrow's.

Predicting Competitors' Next Moves

Predicting the next strategic moves of competitors is the hardest yet most useful part of competitor analysis. Good clues about what actions a specific company is likely to undertake can often be gleaned from how well it is faring in the marketplace, the problems or weaknesses it needs to address, and how much pressure it is under to improve its financial performance. Content rivals are likely to continue their present strategy with only minor fine-tuning. Ailing rivals can be performing so poorly that fresh strategic moves are virtually certain. Ambitious rivals looking to move up in the industry ranks are strong candidates for launching new strategic offensives to pursue emerging market opportunities and exploit the vulnerabilities of weaker rivals.

Since the moves a competitor is likely to make are generally predicated on the views their executives have about the industry's future and their beliefs about their firm's situation, it makes sense to closely scrutinize the public pronouncements of rival company executives about where the industry is headed and what it will take to be successful, what they are saying about their firm's situation, information from the grapevine about what they are doing, and their past actions and leadership styles. Other considerations in trying to predict what strategic moves rivals are likely to make next include the following:

- Which rivals badly need to increase their unit sales and market share? What strategic options are they most likely to pursue: lowering prices, adding new models and styles, expanding their dealer networks, entering additional geographic markets, boosting advertising to build better brand-name awareness, acquiring a weaker competitor, or placing more emphasis on direct sales via their Web site?
- Which rivals have a strong incentive, along with the resources, to make major strategic changes, perhaps moving to a different position on the strategic group map? Which rivals are probably locked in to pursuing the same basic strategy with only minor adjustments?
- Which rivals are good candidates to be acquired? Which rivals may be looking to make an acquisition and are financially able to do so?
- Which rivals are likely to enter new geographic markets?
- Which rivals are strong candidates to expand their product offerings and enter new product segments where they do not currently have a presence?

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

Managers who fail to study competitors closely risk being caught napping by the new strategic moves of rivals.

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

core concept
Key success factors (KSFs) **are the product attributes, competencies, competitive capabilities, and market achievements with the greatest impact on future competitive success in the marketplace.**

An industry's **key success factors (KSFs)** are those competitive factors that most affect industry members' ability to prosper in the marketplace—the particular strategy elements, product attributes, resources, competencies, competitive capabilities, and market achievements that spell the difference between being a strong competitor and a weak competitor. KSFs by their very nature are so important to future competitive success that *all firms* in the industry must be competent at performing or achieving them or risk becoming an industry also-ran. How well a company's product offering, resources, and capabilities measure up against an industry's KSFs determines just how financially and competitively successful that company will be. Identifying KSFs, in light of the prevailing and anticipated industry and competitive conditions, is therefore always a top priority analytical and strategy-making consideration. Company strategists need to understand the industry landscape well enough to separate the factors most important to competitive success from those that are less important.

In the beer industry, the KSFs are full utilization of brewing capacity (to keep manufacturing costs low), a strong network of wholesale distributors (to get the company's brand stocked and favorably displayed in retail outlets where beer is sold), and clever advertising (to induce beer drinkers to buy the company's brand and thereby pull beer sales through the established wholesale/retail channels). In apparel manufacturing, the KSFs are appealing designs and color combinations (to create buyer interest) and low-cost manufacturing efficiency (to permit attractive retail pricing and ample profit margins). In tin and aluminum cans, because the cost of shipping empty cans is substantial, one of the keys is having can-manufacturing facilities located close to end-use customers. KSFs thus vary from industry to industry, and even from time to time within the same industry, as driving forces and competitive conditions change. Table 3.3 lists the most common types of KSFs.

An industry's KSFs can usually be deduced from what was learned from the previously described analysis of the industry and competitive environment. Which factors are most important to future competitive success flow directly from the industry's dominant characteristics, what competition is like, the impacts of the driving forces, the comparative market positions of industry members, and the likely next moves of key rivals. In addition, the answers to three questions help identify an industry's key success factors:

1. On what basis do buyers of the industry's product choose between the competing brands of sellers? That is, what attributes of competitors' product offerings are crucial?
2. Given the nature of competitive rivalry and the competitive forces prevailing in the marketplace, what resources and competitive capabilities does a company need to have to be competitively successful?
3. What shortcomings are almost certain to put a company at a significant competitive disadvantage?

Only rarely are there more than five or six key factors for future competitive success. And even among these, two or three usually outrank the others in importance. Managers should therefore bear in mind that identifying KSFs requires judgments about which factors are *most important* to future competitive success—temptations to designate each minor factor as a KSF must be resisted. To compile a list of every factor that matters even a little bit defeats the purpose of concentrating management attention on the factors truly critical to long-term competitive success.

table 3.3 Common Types of Industry Key Success Factors (KSFs)

Technology-related KSFs	• Expertise in a particular technology or in scientific research (important in pharmaceuticals, Internet applications, mobile communications, and most high-tech industries) • Proven ability to improve production processes (important in industries where advancing technology opens the way for higher manufacturing efficiency and lower production costs)
Manufacturing-related KSFs	• Ability to achieve scale economies and/or capture learning-curve effects (important to achieving low production costs) • Quality control know-how (important in industries where customers insist on product reliability) • High utilization of fixed assets (important in capital-intensive/high-fixed-cost industries) • Access to attractive supplies of skilled labor • High labor productivity (important for items with high labor content) • Low-cost product design and engineering (reduces manufacturing costs) • Ability to manufacture or assemble products that are customized to buyer specifications
Distribution-related KSFs	• A strong network of wholesale distributors/dealers • Strong direct sales capabilities via the Internet and/or having company-owned retail outlets • Ability to secure favorable display space on retailer shelves
Marketing-related KSFs	• Breadth of product line and product selection • A well-known and well-respected brand name • Fast, accurate technical assistance • Courteous, personalized customer service • Accurate filling of buyer orders (few back orders or mistakes) • Customer guarantees and warranties (important in mail-order and online retailing, big-ticket purchases, new product introductions) • Clever advertising
Skills and capability-related KSFs	• A talented workforce (superior talent is important in professional services like accounting and investment banking) • National or global distribution capabilities • Product innovation capabilities (important in industries where rivals are racing to be first to market with new product attributes or performance features) • Design expertise (important in fashion and apparel industries) • Short-delivery-time capability • Supply chain management capabilities • Strong e-commerce capabilities—a user-friendly Web site and/or skills in using Internet technology applications to streamline internal operations
Other types of KSFs	• Overall low costs (not just in manufacturing) so as to be able to meet low-price expectations of customers • Convenient locations (important in many retailing businesses) • Ability to provide fast, convenient after-the-sale repairs and service • A strong balance sheet and access to financial capital (important in newly emerging industries with high degrees of business risk and in capital-intensive industries) • Patent protection

Correctly diagnosing an industry's KSFs raises a company's chances of crafting a sound strategy. The goal of company strategists should be to design a strategy aimed at stacking up well on all of the industry's future KSFs and trying to be *distinctively better* than rivals on one (or possibly two) of the

core concept
A sound strategy incorporates the intent to stack up well on all of the industry's KSFs and to excel on one (or two) in particular.

KSFs. Indeed, companies that stand out or excel on a particular KSF are likely to enjoy a stronger market position—*being distinctively better than rivals on one or two key success factors tends to translate into competitive advantage*. Hence, using the industry's KSFs as *cornerstones* for the company's strategy and trying to gain sustainable competitive advantage by excelling at one particular KSF is a fruitful competitive strategy approach.[22]

QUESTION 7: DOES THE OUTLOOK FOR THE INDUSTRY PRESENT AN ATTRACTIVE OPPORTUNITY?

The final step in evaluating the industry and competitive environment is to use the preceding analysis to decide whether the outlook for the industry presents the company with sufficiently attractive prospects for profitability and growth. The important factors on which to base such a conclusion include:

- The industry's growth potential.
- Whether powerful competitive forces are squeezing industry profitability to subpar levels and whether competition appears destined to grow stronger or weaker.
- Whether industry profitability will be favorably or unfavorably affected by the prevailing driving forces.
- The degrees of risk and uncertainty in the industry's future.
- Whether the industry as a whole confronts severe problems—regulatory or environmental issues, stagnating buyer demand, industry overcapacity, mounting competition, and so on.
- The company's competitive position in the industry vis-à-vis rivals. (Being an entrenched leader or strongly positioned contender in a lackluster industry may present adequate opportunity for good profitability; however, having to fight a steep uphill battle against much stronger rivals may hold little promise of eventual market success or good return on shareholder investment, even though the industry environment is attractive.)
- The company's potential to capitalize on the vulnerabilities of weaker rivals (perhaps converting a relatively unattractive *industry* situation into a potentially rewarding *company* opportunity).
- Whether the company has sufficient competitive strength to defend against or counteract the factors that make the industry unattractive.
- Whether continued participation in this industry adds importantly to the firm's ability to be successful in other industries in which it may have business interests.

As a general proposition, *if an industry's overall profit prospects are above average, the industry environment is basically attractive; if industry profit prospects are below average, conditions are unattractive.* However, it is a mistake to think of a particular industry as being equally attractive or unattractive to all industry participants and all potential entrants. Attractiveness is relative, not absolute, and conclusions one way or the other have to be drawn from the perspective of a particular company. Industries attractive to insiders may be unattractive to outsiders. Companies on the outside may look at an industry's environment and conclude that it is an unattractive business for them to get into, given the prevailing entry barriers, the difficulty of challenging current market leaders with their particular resources and competencies,

and the opportunities they have elsewhere. Industry environments unattractive to weak competitors may be attractive to strong competitors. A favorably positioned company may survey a business environment and see a host of opportunities that weak competitors cannot capture.

When a company decides an industry is fundamentally attractive and presents good opportunities, a strong case can be made that it should invest aggressively to capture the opportunities it sees and to improve its long-term competitive position in the business. When a strong competitor concludes an industry is relatively unattractive and lacking in opportunity, it may elect to simply protect its present position, investing cautiously if at all and looking for opportunities in other industries. A competitively weak company in an unattractive industry may see its best option as finding a buyer, perhaps a rival, to acquire its business.

core concept
The degree to which an industry is attractive or unattractive is not the same for all industry participants and all potential entrants; the opportunities an industry presents depends partly on a company's ability to capture them.

key | points

Thinking strategically about a company's external situation involves probing for answers to the following seven questions:

1. *What are the industry's dominant economic features?* Industries differ significantly on such factors as market size and growth rate, the geographic scope of competitive rivalry, the number and relative sizes of both buyers and sellers, ease of entry and exit, the extent of vertical integration, how fast basic technology is changing, the extent of scale economies and learning-curve effects, the degree of product standardization or differentiation, and overall profitability. While setting the stage for the analysis to come, identifying an industry's economic features also promotes understanding of the kinds of strategic moves that industry members are likely to employ.
2. *What kinds of competitive forces are industry members facing, and how strong is each force?* The strength of competition is a composite of five forces: the rivalry among competing sellers, the presence of attractive substitutes, the potential for new entry, the competitive pressures stemming from supplier bargaining power and supplier–seller collaboration, and the competitive pressures stemming from buyer bargaining power and seller–buyer collaboration. These five forces have to be examined one by one to identify the specific competitive pressures they each comprise and to decide whether these pressures constitute a strong or weak competitive force. The next step in competition analysis is to evaluate the collective strength of the five forces and determine whether the state of competition is conducive to good profitability. Working through the five-forces model step by step not only aids strategy makers in assessing whether the intensity of competition allows good profitability but also promotes sound strategic thinking about how to better match company strategy to the specific competitive character of the marketplace. Effectively matching a company's strategy to the particular competitive pressures and competitive conditions that exist has two aspects: (1) pursuing avenues that shield the firm from as many of the prevailing competitive pressures as possible, and (2) initiating actions calculated to produce sustainable competitive advantage, thereby shifting competition in the company's favor, putting added competitive pressure on rivals, and perhaps even defining the business model for the industry.

3. *What forces are driving changes in the industry, and what impact will these changes have on competitive intensity and industry profitability?* Industry and competitive conditions change because forces are in motion that create incentives or pressures for change. The first phase is to identify the forces that are driving change in the industry; the most common **driving forces** include the Internet and Internet technology applications, globalization of competition in the industry, changes in the long-term industry growth rate, changes in buyer composition, product innovation, entry or exit of major firms, changes in cost and efficiency, changing buyer preferences for standardized versus differentiated products or services, regulatory influences and government policy changes, changing societal and lifestyle factors, and reductions in uncertainty and business risk. The second phase of driving-forces analysis is to determine whether the driving forces, taken together, are acting to make the industry environment more or less attractive. Are the driving forces causing demand for the industry's product to increase or decrease? Are the driving forces acting to make competition more or less intense? Will the driving forces lead to higher or lower industry profitability?
4. *What market positions do industry rivals occupy—who is strongly positioned and who is not?* **Strategic group mapping** is a valuable tool for understanding the similarities, differences, strengths, and weaknesses inherent in the market positions of rival companies. Rivals in the same or nearby **strategic groups** are close competitors, whereas companies in distant strategic groups usually pose little or no immediate threat. The lesson of strategic group mapping is that some positions on the map are more favorable than others. The profit potential of different strategic groups varies due to strengths and weaknesses in each group's market position. Often, industry driving forces and competitive pressures favor some strategic groups and hurt others.
5. *What strategic moves are rivals likely to make next?* This analytical step involves identifying competitors' strategies, deciding which rivals are likely to be strong contenders and which are likely to be weak, evaluating rivals' competitive options, and predicting their next moves. Scouting competitors well enough to anticipate their actions can help a company prepare effective countermoves (perhaps even beating a rival to the punch) and allows managers to take rivals' probable actions into account in designing their own company's best course of action. Managers who fail to study competitors risk being caught unprepared by the strategic moves of rivals.
6. *What are the key factors for competitive success?* An industry's **key success factors (KSFs)** are the particular strategy elements, product attributes, competitive capabilities, and business outcomes that spell the difference between being a strong competitor and a weak competitor—and sometimes between profit and loss. KSFs by their very nature are so important to competitive success that *all firms* in the industry must pay close attention to them or risk becoming an industry also-ran. Correctly diagnosing an industry's KSFs raises a company's chances of crafting a sound strategy. The goal of company strategists should be to design a strategy aimed at stacking up well on all of the industry KSFs and trying to be *distinctively better* than rivals on one (or possibly two) of the KSFs. Indeed, using the industry's KSFs as *cornerstones* for the company's strategy and trying to gain sustainable competitive advantage by excelling at one particular KSF is a fruitful competitive strategy approach.
7. *Does the outlook for the industry present the company with sufficiently attractive prospects for profitability?* The answer to this question is a major driver of company strategy. An assessment that the industry and competitive environment is fundamentally attractive typically suggests employing a

strategy calculated to build a stronger competitive position in the business, expanding sales efforts, and investing in additional facilities and equipment as needed. If the industry is relatively unattractive, outsiders considering entry may decide against it and look elsewhere for opportunities, weak companies in the industry may merge with or be acquired by a rival, and strong companies may restrict further investments and employ cost-reduction strategies or product innovation strategies to boost long-term competitiveness and protect their profitability. On occasion, an industry that is unattractive overall is still very attractive to a favorably situated company with the skills and resources to take business away from weaker rivals.

A competently conducted industry and competitive analysis generally tells a clear, easily understood story about the company's external environment. But different analysts can still have different judgments about competitive intensity, the impacts of driving forces, how industry conditions will evolve, how good the outlook is for industry profitability, and the degree to which the industry environment offers the company an attractive business opportunity. However, while no method can guarantee a single conclusive diagnosis about the state of industry and competitive conditions and an industry's future outlook, this doesn't justify shortcutting hardnosed strategic analysis and relying instead on opinion and casual observation. Managers become better strategists when they know what questions to pose and what tools to use. This is why this chapter has concentrated on suggesting the right questions to ask, explaining concepts and analytical approaches, and indicating the kinds of things to look for. There's no substitute for staying on the cutting edge of what's happening in the industry—anything less weakens managers' ability to craft strategies that are well matched to the industry and competitive situation.

exercises

1. As the owner of a new fast-food enterprise seeking a loan from a bank to finance the construction and operation of three new store locations, you have been asked to provide the loan officer with a brief analysis of the competitive environment in fast food. Draw a five-forces diagram for the fast-food industry, and briefly discuss the nature and strength of each of the five competitive forces in fast food.
2. Use the strategic group map in Illustration Capsule 3.1 to answer the following: Who are Wal-Mart's two closest competitors? Between which two strategic groups is competition the weakest? Which strategic group faces the weakest competition from the members of other strategic groups?
3. Based on your knowledge of the ice cream industry, which of the following factors might qualify as possible driving forces capable of causing fundamental change in the industry's structure and competitive environment:
   a. Increasing sales of frozen yogurt and frozen sorbets.
   b. The potential for additional makers of ice cream to enter the market.
   c. Growing consumer interest in low-calorie/low-fat dessert alternatives.
   d. A slowdown in the rate of consumer demand for ice cream products.
   e. An increase in the prices of milk and sugar.
   f. A decision by Häagen-Dazs to increase its prices by 10 percent.
   g. A decision by Ben & Jerry's to add five new flavors to its product line.
   h. A trend among ice cream manufacturers to promote their brands on the Internet.

chapter | four

Analyzing a Company's Resources and Competitive Position

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Before executives can chart a new strategy, they must reach common understanding of the company's current position.
—**W. Chan Kim and Rene Mauborgne**

The real question isn't how well you're doing today against your own history, but how you're doing against your competitors.
—**Donald Kress**

Organizations succeed in a competitive marketplace over the long run because they can do certain things their customers value better than can their competitors.
—**Robert Hayes, Gary Pisano, and David Upton**

Only firms who are able to continually build new strategic assets faster and cheaper than their competitors will earn superior returns over the long term.
—**C. C. Markides and P. J. Williamson**

In Chapter 3 we described how to use the tools of industry and competitive analysis to assess a company's external environment and lay the groundwork for matching a company's strategy to its external situation. In this chapter we discuss the techniques of evaluating a company's internal circumstances—its resource capabilities, relative cost position, and competitive strength versus rivals. The analytical spotlight will be trained on five questions:

1. How well is the company's present strategy working?
2. What are the company's resource strengths and weaknesses, and its external opportunities and threats?
3. Are the company's prices and costs competitive?
4. Is the company competitively stronger or weaker than key rivals?
5. What strategic issues and problems merit front-burner managerial attention?

In probing for answers to these questions, four analytical tools—SWOT analysis, value chain analysis, benchmarking, and competitive strength assessment—will be used. All four are valuable techniques for revealing a company's competitiveness and for helping company managers match their strategy to the company's own particular circumstances.

QUESTION 1: HOW WELL IS THE COMPANY'S PRESENT STRATEGY WORKING?

In evaluating how well a company's present strategy is working, a manager has to start with what the strategy is. Figure 4.1 shows the key components of a single-business company's strategy. The first thing to pin down is the company's competitive approach. Is the company striving to be a low-cost leader *or* stressing ways to differentiate its product offering from rivals? Is it concentrating its efforts on serving a broad spectrum of customers *or* a narrow market niche? Another strategy-defining consideration is the firm's competitive scope within the industry—what its geographic market coverage is and whether it operates in just a single stage of the industry's production/distribution chain or is vertically integrated across several stages. Another good indication of the company's strategy is whether the company has made moves recently to improve its competitive position and performance—for instance, by cutting prices, improving design, stepping up advertising, entering a new geographic market (domestic or foreign), or merging with a competitor. The company's functional strategies in R&D, production, marketing, finance, human resources, information technology, and so on further characterize company strategy.

figure 4.1 **Identifying the Components of a Single-Business Company's Strategy**

While there's merit in evaluating the strategy from a *qualitative* standpoint (its completeness, internal consistency, rationale, and relevance), the best *quantitative* evidence of how well a company's strategy is working comes from its results. The two best empirical indicators are (1) whether the company is achieving its stated financial and strategic objectives, and (2) whether the company is an above-average industry performer. Persistent shortfalls in meeting company performance targets and weak performance relative to rivals are reliable warning signs that the company suffers from poor strategy making, less-than-competent strategy execution, or both. Other indicators of how well a company's strategy is working include:

- Whether the firm's sales are growing faster, slower, or about the same pace as the market as a whole, thus resulting in a rising, eroding, or stable market share.
- Whether the company is acquiring new customers at an attractive rate as well as retaining existing customers.
- Whether the firm's profit margins are increasing or decreasing and how well its margins compare to rival firms' margins.

- Trends in the firm's net profits and return on investment and how these compare to the same trends for other companies in the industry.
- Whether the company's overall financial strength and credit rating are improving or on the decline.
- Whether the company can demonstrate continuous improvement in such internal performance measures as days of inventory, employee productivity, unit cost, defect rate, scrap rate, misfilled orders, delivery times, warranty costs, and so on.
- How shareholders view the company based on trends in the company's stock price and shareholder value (relative to the stock price trends at other companies in the industry).
- The firm's image and reputation with its customers.
- How well the company stacks up against rivals on technology, product innovation, customer service, product quality, delivery time, price, getting newly developed products to market quickly, and other relevant factors on which buyers base their choice of brands.

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

The stronger a company's financial performance and market position, the more likely it has a well-conceived, well-executed strategy.

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

Appraising a company's resource strengths and weaknesses and its external opportunities and threats, commonly known as **SWOT analysis,** provides a good overview of whether its overall situation is fundamentally healthy or unhealthy. Just as important, a first-rate SWOT analysis provides the basis for crafting a strategy that capitalizes on the company's resources, aims squarely at capturing the company's best opportunities, and defends against the threats to its well-being.

core concept
SWOT analysis **is a simple but powerful tool for sizing up a company's resource capabilities and deficiencies, its market opportunities, and the external threats to its future well-being.**

Identifying Company Resource Strengths and Competitive Capabilities

A *strength* is something a company is good at doing or an attribute that enhances its competitiveness. A strength can take any of several forms:

- *A skill or important expertise*—low-cost manufacturing capabilities, strong e-commerce expertise, technological know-how, skills in improving production processes, a proven track record in defect-free manufacture, expertise in providing consistently good customer service, excellent mass merchandising skills, or unique advertising and promotional talents.
- *Valuable physical assets*—state-of-the-art plants and equipment, attractive real estate locations, worldwide distribution facilities, or ownership of valuable natural resource deposits.

- *Valuable human assets*—an experienced and capable workforce, talented employees in key areas, cutting-edge knowledge and intellectual capital, collective learning embedded in the organization and built up over time, or proven managerial know-how.[1]
- *Valuable organizational assets*—proven quality control systems, proprietary technology, key patents, mineral rights, a cadre of highly trained customer service representatives, sizable amounts of cash and marketable securities, a strong balance sheet and credit rating (thus giving the company access to additional financial capital), or a comprehensive list of customers' e-mail addresses.
- *Valuable intangible assets*—a powerful or well-known brand name, a reputation for technological leadership, or strong buyer loyalty and goodwill.
- *Competitive capabilities*—product innovation capabilities, short development times in bringing new products to market, a strong dealer network, cutting-edge supply chain management capabilities, quickness in responding to shifting market conditions and emerging opportunities, or state-of-the-art systems for doing business via the Internet.
- *An achievement or attribute that puts the company in a position of market advantage*—low overall costs relative to competitors, market share leadership, a superior product, a wider product line than rivals, wide geographic coverage, a well-known brand name, superior e-commerce capabilities, or exceptional customer service.
- *Competitively valuable alliances or cooperative ventures*—fruitful partnerships with suppliers that reduce costs and/or enhance product quality and performance; alliances or joint ventures that provide access to valuable technologies, competencies, or geographic markets.

core concept
A company is better positioned to succeed if it has a competitively valuable complement of resources at its command.

Taken together, a company's strengths determine the complement of competitively valuable *resources* with which it competes—a company's resource strengths represent *competitive assets*. The caliber of a firm's resource strengths and competitive capabilities, along with its ability to mobilize them in the pursuit of competitive advantage, are big determinants of how well a company will perform in the marketplace.[2]

Company Competencies and Competitive Capabilities Sometimes a company's resource strengths relate to fairly specific skills and expertise (like just-in-time inventory control) and sometimes they flow from pooling the knowledge and expertise of different organizational groups to create a company competence or competitive capability. Competence or capability in continuous product innovation, for example, comes from teaming the efforts of people and groups with expertise in market research, new product R&D, design and engineering, cost-effective manufacturing, and market testing.[3] Company competencies can range from merely a competence in performing an activity to a core competence to a distinctive competence:

core concept
A ***competence*** is something an organization is good at doing; it is nearly always the product of learning and experience.

1. A **competence** is something an organization is good at doing. It is nearly always the product of experience, representing an accumulation of learning and the buildup of proficiency in performing an internal activity. Usually a company competence originates with deliberate efforts to develop the organizational ability to do something, however imperfectly or inefficiently. Such efforts involve selecting people with the requisite knowledge and skills, upgrading or expanding individual abilities as needed, and then molding the efforts and work products of individuals into a cooperative group effort to create organizational ability. Then, as experience builds, such that the company gains proficiency in performing the activity consistently well and at an acceptable cost, the ability

evolves into a true competence and company capability. Examples of competencies include proficiency in merchandising and product display, the capability to create attractive and easy-to-use Web sites, expertise in a specific technology, proven capabilities in selecting good locations for retail outlets, and a proficiency in working with customers on new applications and uses of the product.

2. A **core competence** is a proficiently performed internal activity that is *central* to a company's strategy and competitiveness. A core competence is a more valuable resource strength than a competence because of the well-performed activity's core role in the company's strategy and the contribution it makes to the company's success in the marketplace. A core competence can relate to any of several aspects of a company's business: expertise in integrating multiple technologies to create families of new products, know-how in creating and operating a cost-efficient supply chain, the capability to speed new or next-generation products to market, good after-sale service capabilities, skills in manufacturing a high-quality product at a low cost, or the capability to fill customer orders accurately and swiftly. A company may have more than one core competence in its resource portfolio, but rare is the company that can legitimately claim more than two or three core competencies. Most often, *a core competence is knowledge-based, residing in people and in a company's intellectual capital and not in its assets on the balance sheet.* Moreover, a core competence is more likely to be grounded in cross-department combinations of knowledge and expertise rather than being the product of a single department or work group.

core concept
A ***core competence*** is a competitively important activity that a company performs better than other internal activities.

3. A **distinctive competence** is a competitively valuable activity that a company *performs better than its rivals.* A distinctive competence thus represents a *competitively superior resource strength.* A company may perform some competitively important activity well enough to claim that activity as a core competence. But what a company does best internally doesn't translate into a distinctive competence unless the company enjoys *competitive superiority in performing that activity.* For instance, most retailers believe they have core competencies in product selection and in-store merchandising, but many retailers run into trouble in the marketplace because they encounter rivals whose core competencies in product selection and in-store merchandising are better than theirs. Consequently, *a core competence becomes a basis for competitive advantage only when it rises to the level of a distinctive competence.* Sharp Corporation's distinctive competence in flat-panel display technology has enabled it to dominate the worldwide market for liquid crystal displays (LCDs). The distinctive competencies of Toyota and Honda in low-cost, high-quality manufacturing and in short design-to-market cycles for new models have proved to be considerable competitive advantages in the global market for motor vehicles. Intel's distinctive competence in rapidly developing new generations of ever-more-powerful semiconductor chips for PCs and network servers has helped give the company a dominating presence in the semiconductor industry. Starbucks' distinctive competence in store ambience and innovative coffee drinks has propelled it to the forefront among coffee retailers.

core concept
A ***distinctive competence*** is a competitively valuable activity that a company performs better than its rivals.

The conceptual differences between a competence, a core competence, and a distinctive competence draw attention to the fact that competitive capabilities are not all equal. Some competencies and competitive capabilities merely enable market survival because most rivals have them—indeed, not having a competence or capability that rivals have can result in competitive disadvantage. Core competencies are *competitively* more important than simple competencies because they add power to the company's strategy and have a bigger positive impact on its market position and profitability. On occasion, a company

may have a uniquely strong competitive capability that holds the potential for creating competitive advantage if it meets the criterion for a distinctive competence and delivers value to buyers.[4] *The importance of a distinctive competence to strategy-making rests with (1) the competitively valuable capability it gives a company, (2) its potential for being the cornerstone of strategy, and (3) the competitive edge it can produce in the marketplace.* It is always easier to build competitive advantage when a firm has a distinctive competence in performing an activity important to market success, when rival companies do not have offsetting competencies, and when it is costly and time-consuming for rivals to imitate the competence. A distinctive competence is thus potentially the mainspring of a company's success—unless it is trumped by more powerful resources of rivals.

What Is the Competitive Power of a Resource Strength? It is not enough to simply compile a list of a company's resource strengths and competitive capabilities. What is most telling about a company's strengths, individually and collectively, is how powerful they are in the marketplace. The competitive power of a company strength is measured by how many of the following four tests it can pass:[5]

1. *Is the resource strength hard to copy?* The more difficult and more expensive it is to imitate a company's resource strength, the greater its potential competitive value. Resources tend to be difficult to copy when they are unique (a fantastic real estate location, patent protection); when they must be built over time in ways that are difficult to imitate (a brand name, mastery of a technology); and when they carry big capital requirements (a cost-effective plant to manufacture cutting-edge microprocessors). Wal-Mart's competitors have failed miserably in their attempts over the past two decades to match Wal-Mart's superefficient state-of-the-art distribution and store operations capabilities. Hard-to-copy strengths and capabilities are valuable competitive assets, adding to a company's market prowess and contributing to sustained profitability.
2. *Is the resource strength durable—does it have staying power?* The longer the competitive value of a resource lasts, the greater its value. Some resources lose their clout in the marketplace quickly because of the rapid speeds at which technologies or industry conditions are moving. The value of Eastman Kodak's resources in film and film processing is rapidly being undercut by the growing popularity of digital cameras. The investments that commercial banks have made in branch offices is a rapidly depreciating asset because of growing use of direct deposits, automated teller machines, and telephone and Internet banking options.
3. *Is the resource really competitively superior?* Companies have to guard against pridefully believing that their core competencies are distinctive competencies or that their brand name is more powerful than the brand names of rivals. Who can really say whether Coca-Cola's consumer marketing know-how is better than Pepsi-Cola's or whether the Mercedes-Benz brand name is more powerful than that of BMW or Lexus?
4. *Can the resource strength be trumped by the different resource strengths and competitive capabilities of rivals?* Many commercial airlines (American Airlines, Delta Airlines, Continental Airlines, Singapore Airlines) have attracted large numbers of passengers because of their resources and capabilities in offering safe, convenient, reliable air transportation services and in providing an array of amenities to passengers. However, Southwest Airlines has consistently been a more profitable air carrier because it provides safe, reliable, basic services at radically lower fares. The prestigious brand names of Cadillac and Lincoln have faded in the market for luxury cars because Mercedes, BMW, Audi, Lexus, Acura, and Infiniti have introduced the most appealing luxury vehicles in

recent years. Amazon.com is putting a big dent in the business prospects of brick-and-mortar bookstores; likewise, Wal-Mart (with its lower prices) is putting major competitive pressure on Toys "R" Us, at one time the leading toy retailer in the United States, and on traditional supermarket chains like Kroger, Albertson's, and Safeway, which have struggled to hold their own against Wal-Mart's march into supermarket retailing (where it now is the market leader).

The vast majority of companies are not well endowed with competitively valuable resources, much less with competitively superior resources capable of passing all four tests with high marks. Most firms have a mixed bag of resources—one or two quite valuable, some good, many satisfactory to mediocre. Only a few companies, usually the strongest industry leaders or up-and-coming challengers, possess a distinctive competence or competitively superior resource.

But even if a company doesn't possess a competitively superior resource, it can still marshal potential for winning in the marketplace. Sometimes a company derives significant competitive vitality, maybe even competitive advantage, from a collection of good-to-adequate resources that collectively have competitive power in the marketplace. Toshiba's laptop computers were the global market leader throughout most of the 1990s—an indicator that Toshiba had competitively valuable resource strengths. Yet Toshiba's laptops were not demonstrably faster than rivals' laptops; nor did they have bigger screens, more memory, longer battery power, a better pointing device, or other superior performance features; nor did Toshiba provide clearly superior technical support services to buyers of its laptops. Further, Toshiba laptops were definitely not cheaper, model for model, than the comparable models of its rivals, and they seldom ranked first in the overall performance ratings done by various organizations. Rather, Toshiba's market share leadership stemmed from a *combination* of *good* resource strengths and capabilities—its strategic partnerships with suppliers of laptop components, efficient assembly capability, design expertise, skills in choosing quality components, a wide selection of models, the attractive mix of built-in performance features found in each model when balanced against price, the better-than-average reliability of its models (based on buyer ratings), and good technical support services (based on buyer ratings). The verdict from the marketplace was that PC buyers considered Toshiba laptops to be better, all things considered, than competing brands. (More recently, however, Toshiba has been overtaken by Dell Computer, the present global leader in laptop PCs.)

A company's success in the marketplace becomes more likely when it has appropriate and ample resources with which to compete, and especially when it has strengths and capabilities with competitive advantage potential.

Identifying Company Resource Weaknesses and Competitive Deficiencies

A *weakness,* or *competitive deficiency,* is something a company lacks or does poorly (in comparison to others) or a condition that puts it at a disadvantage in the marketplace. A company's weaknesses can relate to (1) inferior or unproven skills, expertise, or intellectual capital in competitively important areas of the business; (2) deficiencies in competitively important physical, organizational, or intangible assets; or (3) missing or competitively inferior capabilities in key areas. *Internal weaknesses are thus shortcomings in a company's complement of resources and represent competitive liabilities.* Nearly all companies have competitive liabilities of one kind or another. Whether a company's resource weaknesses make it competitively vulnerable depends on how much they matter in the marketplace and whether they are offset by the company's resource strengths.

core concept
A company's resource strengths represent *competitive assets;* its resource weaknesses represent *competitive liabilities.*

Table 4.1 lists the kinds of factors to consider in compiling a company's resource strengths and weaknesses. Sizing up a company's complement of resource capabilities and deficiencies is akin to constructing a *strategic balance sheet,* on which resource strengths represent *competitive assets* and resource weaknesses represent *competitive liabilities.* Obviously, the ideal condition is for the company's competitive assets to outweigh its competitive liabilities by an ample margin—a 50–50 balance is definitely not the desired condition!

Identifying a Company's Market Opportunities

Market opportunity is a big factor in shaping a company's strategy. Indeed, managers can't properly tailor strategy to the company's situation without first identifying its opportunities and appraising the growth and profit potential each one holds. Depending on the prevailing circumstances, a company's opportunities can be plentiful or scarce and can range from wildly attractive (an absolute "must" to pursue) to marginally interesting (because the growth and profit potential are questionable) to unsuitable (because there's not a good match with the company's strengths and capabilities). A checklist of potential market opportunities is included in Table 4.1.

In evaluating a company's market opportunities and ranking their attractiveness, managers have to guard against viewing every *industry* opportunity as a *company* opportunity. Not every company is equipped with the resources to successfully pursue each opportunity that exists in its industry. Some companies are more capable of going after particular opportunities than others, and a few companies may be hopelessly outclassed. Occasionally managers may have to deliberately adapt a company's resources to position it to contend for attractive growth opportunities. *But the market opportunities most relevant to a company are those that match up well with the company's financial and organizational resource capabilities, offer the best growth and profitability, and present the most potential for competitive advantage.*

A company is well advised to pass on a particular market opportunity unless it has or can acquire the resources to capture it.

Identifying Threats to a Company's Future Profitability

Often, certain factors in a company's external environment pose *threats* to its profitability and competitive well-being. Examples of threats include the emergence of cheaper or better technologies, rivals' introduction of new or improved products, lower-cost foreign competitors' entry into a company's market stronghold, new regulations that may be more burdensome to a company than to its competitors, vulnerability to a rise in interest rates, the potential of a hostile takeover, unfavorable demographic shifts, adverse changes in foreign exchange rates, political upheaval in a foreign country where the company has facilities, and so on (Table 4.1). External threats may pose no more than a moderate degree of adversity (all companies confront some threatening elements in the course of doing business), or they may be so imposing as to make a company's situation and outlook quite tenuous. It is management's job to identify the threats to the company's future profitability and to evaluate what strategic actions can be taken to neutralize or lessen their impact.

Simply making lists of a company's strengths, weaknesses, opportunities, and threats is not enough; the payoff from SWOT analysis comes from the conclusions about a company's situation and the implications for strategy improvement that flow from the four lists.

What Do the SWOT Listings Reveal?

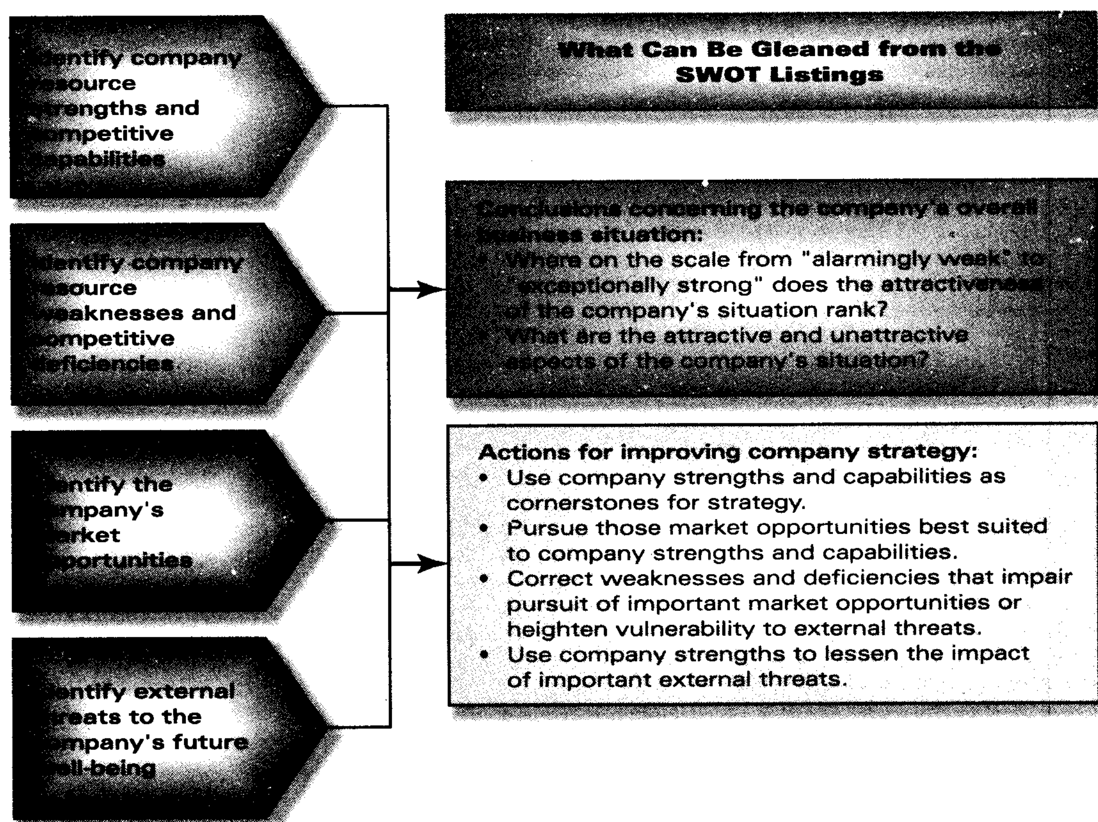
SWOT analysis involves more than making four lists. The two most important parts of SWOT analysis are *drawing conclusions* from the

table 4.1 **What to Look for in Identifying a Company's Strengths, Weaknesses, Opportunities, and Threats**

Potential Resource Strengths and Competitive Capabilities	Potential Resource Weaknesses and Competitive Deficiencies
• A powerful strategy • Core competencies in ______ • A distinctive competence in ______ • A product that is strongly differentiated from those of rivals • Competencies and capabilities that are well matched to industry key success factors • A strong financial condition; ample financial resources to grow the business • Strong brand-name image/company reputation • An attractive customer base • Economy of scale and/or learning and experience curve advantages over rivals • Proprietary technology/superior technological skills/important patents • Superior intellectual capital relative to key rivals • Cost advantages over rivals • Strong advertising and promotion • Product innovation capabilities • Proven capabilities in improving production processes • Good supply chain management capabilities • Good customer service capabilities • Better product quality relative to rivals • Wide geographic coverage and/or strong global distribution capability • Alliances/joint ventures with other firms that provide access to valuable technology, competencies, and/or attractive geographic markets	• No clear strategic direction • Resources that are not well matched to industry key success factors • No well-developed or proven core competencies • A weak balance sheet; too much debt • Higher overall unit costs relative to key competitors • Weak or unproven product innovation capabilities • A product/service with ho-hum attributes or features inferior to those of rivals • Too narrow a product line relative to rivals • Weak brand image or reputation • Weaker dealer network than key rivals and/or lack of adequate global distribution capability • Behind on product quality, R&D, and/or technological know-how • In the wrong strategic group • Losing market share because ______ • Lack of management depth • Inferior intellectual capital relative to leading rivals • Subpar profitability because ______ • Plagued with internal operating problems or obsolete facilities • Behind rivals in e-commerce capabilities • Short on financial resources to grow the business and pursue promising initiatives • Too much underutilized plant capacity

Potential Market Opportunities	Potential External Threats to a Company's Well-Being
• Openings to win market share from rivals • Sharply rising buyer demand for the industry's product • Serving additional customer groups or market segments • Expanding into new geographic markets • Expanding the company's product line to meet a broader range of customer needs • Utilizing existing company skills or technological know-how to enter new product lines or new businesses • Online sales • Integrating forward or backward • Falling trade barriers in attractive foreign markets • Acquiring rival firms or companies with attractive technological expertise or capabilities • Entering into alliances or joint ventures that can expand the firm's market coverage or boost its competitive capability • Openings to exploit emerging new technologies	• Increasing intensity of competition among industry rivals—may squeeze profit margins • Slowdowns in market growth • Likely entry of potent new competitors • Loss of sales to substitute products • Growing bargaining power of customers or suppliers • A shift in buyer needs and tastes away from the industry's product • Adverse demographic changes that threaten to curtail demand for the industry's product • Vulnerability to industry driving forces • Restrictive trade policies on the part of foreign governments • Costly new regulatory requirements

figure 4.2 **The Three Steps of SWOT Analysis: Identify, Draw Conclusions, Translate into Strategic Action**



SWOT listings about the company's overall situation, and *acting on those conclusions* to better match the company's strategy to its resource strengths and market opportunities, to correct the important weaknesses, and to defend against external threats. Figure 4.2 shows the three steps of SWOT analysis.

Just what story the SWOT analysis tells about the company's overall situation is often revealed in the answers to the following sets of questions.

- Does the company have an attractive set of resource strengths? Does it have any strong core competencies or a distinctive competence? Are the company's strengths and capabilities well matched to the industry key success factors? Do they add adequate power to the company's strategy, or are more or different strengths needed? Will the company's current strengths and capabilities matter in the future?
- How serious are the company's weaknesses and competitive deficiencies? Are they mostly inconsequential and readily correctable, or could one or more prove fatal if not remedied soon? Are some of the company's weaknesses in areas that relate to the industry's key success factors? Are there any weaknesses that if uncorrected, would keep the company from pursuing an otherwise attractive opportunity? Does the company have important resource gaps that need to be filled for it to move up in the industry rankings and/or boost its profitability?

- Do the company's resource strengths and competitive capabilities (its competitive assets) outweigh its resource weaknesses and competitive deficiencies (its competitive liabilities) by an attractive margin?
- Does the company have attractive market opportunities that are well suited to its resource strengths and competitive capabilities? Does the company lack the resources and capabilities to pursue any of the most attractive opportunities?
- Are the threats alarming, or are they something the company appears able to deal with and defend against?
- All things considered, how strong is the company's overall situation? Where on a scale of 1 to 10 (where 1 is alarmingly weak and 10 is exceptionally strong) should the firm's position and overall situation be ranked? What aspects of the company's situation are particularly attractive? What aspects are of the most concern?

The final piece of SWOT analysis is to translate the diagnosis of the company's situations into actions for improving the company's strategy and business prospects. The following questions point to implications the SWOT listings have for strategic action:

- Which competitive capabilities need to be strengthened immediately (so as to add greater power to the company's strategy and boost sales and profitability)? Do new types of competitive capabilities need to be put in place to help the company better respond to emerging industry and competitive conditions? Which resources and capabilities need to be given greater emphasis, and which merit less emphasis? Should the company emphasize leveraging its existing resource strengths and capabilities, or does it need to create new resource strengths and capabilities?
- What actions should be taken to reduce the company's competitive liabilities? Which weaknesses or competitive deficiencies are in urgent need of correction?
- Which market opportunities should be top priority in future strategic initiatives (because they are good fits with the company's resource strengths and competitive capabilities, present attractive growth and profit prospects, and/or offer the best potential for securing competitive advantage)? Which opportunities should be ignored, at least for the time being (because they offer less growth potential or are not suited to the company's resources and capabilities)?
- What should the company be doing to guard against the threats to its well-being?

A company's resource strengths should generally form the cornerstones of strategy because they represent the company's best chance for market success.[6] As a rule, strategies that place heavy demands on areas where the company is weakest or has unproven ability are suspect and should be avoided. If a company doesn't have the resources and competitive capabilities around which to craft an attractive strategy, managers need to take decisive remedial action either to upgrade existing organizational resources and capabilities and add others as needed or to acquire them through partnerships or strategic alliances with firms possessing the needed expertise. Plainly, managers have to look toward correcting competitive weaknesses that make the company vulnerable, hold down profitability, or disqualify it from pursuing an attractive opportunity.

At the same time, sound strategy making requires sifting through the available market opportunities and aiming strategy at capturing those that are most attractive and suited to the company's circumstances. Rarely does a company have the resource depth to pursue all available market opportunities simultaneously without spreading itself too thin. In deciding how much attention to devote to defending against external threats to the company's market position and future performance, managers must

determine how vulnerable the company is, whether there are attractive defensive moves that can be taken to lessen their impact, and whether the costs of undertaking such moves represent the best use of company resources.

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

Managers are often stunned when a competitor cuts its price to "unbelievably low" levels or when a new market entrant comes on strong with a very low price. The competitor may not, however, be "dumping" (an economic term for selling large amounts of goods below market price), buying market share, or waging a desperate move to gain sales; it may simply have substantially lower costs. One of the most telling signs of whether a company's business position is strong or precarious is whether its prices and costs are competitive with industry rivals. Price–cost comparisons are especially critical in a commodity-product industry where the value provided to buyers is the same from seller to seller, price competition is typically the ruling market force, and lower-cost companies have the upper hand.

The higher a company's costs are above those of close rivals, [illegible]

But even in industries where products are differentiated and competition centers on the different attributes of competing brands as much as on price, rival companies have to keep their costs *in line* and make sure that any added costs they incur, and any price premiums they charge, create ample buyer value. While some cost disparity is justified so long as the products or services of closely competing companies are sufficiently differentiated, a high-cost firm's market position becomes increasingly vulnerable the more its costs exceed those of close rivals.

Two analytical tools are particularly useful in determining whether a company's prices and costs are competitive and thus conducive to winning in the marketplace: value chain analysis and benchmarking.

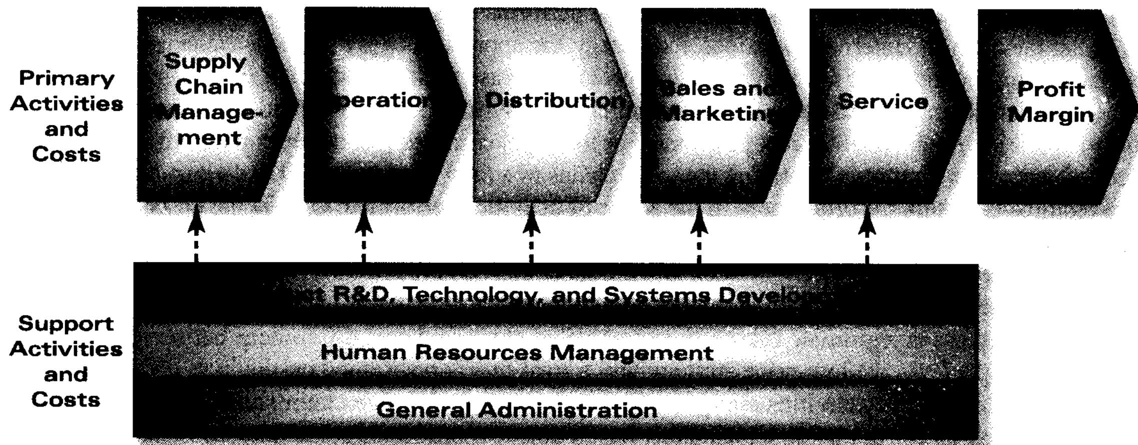
The Concept of a Company Value Chain

core concept
A company's ***value chain*** identifies the primary activities that create customer value and the related support activities.

Every company's business consists of a collection of activities undertaken in the course of designing, producing, marketing, delivering, and supporting its product or service. A company's **value chain** consists of the linked set of value-creating activities the company performs internally. As shown in Figure 4.3, the value chain consists of two broad categories of activities: the *primary activities* that are foremost in creating value for customers and the requisite *support activities* that facilitate and enhance the performance of the primary activities.[7] The value chain includes a profit margin because a markup over the cost of performing the firm's value-creating activities is customarily part of the price (or total cost) borne by buyers—a fundamental objective of every enterprise is to create and deliver a value to buyers whose margin over cost yields an attractive profit.

Disaggregating a company's operations into primary and secondary activities exposes the major elements of the company's cost structure. Each activity in the value chain gives rise to costs and ties up assets; assigning the company's operating costs and assets to each individual activity in the chain provides cost estimates and capital requirements. Quite often, there are links between activities such that the manner in which one activity is done can affect the costs of performing other activities. For instance, Japan-

figure 4.3 **A Representative Company Value Chain**



PRIMARY ACTIVITIES

- **Supply Chain Management**—activities, costs, and assets associated with purchasing fuel, energy, raw materials, parts and components, merchandise, and consumable items from vendors; receiving, storing, and disseminating inputs from suppliers; inspection; and inventory management.
- **Operations**—activities, costs, and assets associated with converting inputs into final products.

SUPPORT ACTIVITIES

- **Product R&D, Technology, and Systems Development**—activities, costs, and assets relating to product R&D, process R&D, process design improvement, equipment design, computer software development, telecommunications systems, computer-assisted design and engineering, database capabilities, and development of computerized support systems.
- **Human Resources Management**—activities, costs, and assets associated with the recruitment, hiring, training, development, and compensation of all types of personnel; labor relations activities; and development of knowledge-based skills and core competencies.
- **General Administration**—activities, costs, and assets relating to general management, accounting and finance, legal and regulatory affairs, safety and security, management information systems, forming strategic alliances and collaborating with strategic partners, and other "overhead" functions.

Source: Adapted from Michael E. Porter, *Ccmpetitive Advantage* (New York: Free Press, 1985), pp. 37–43.

ese producers of videocassette recorders (VCRs) were able to reduce prices from around $1,300 in 1977 to under $300 in 1984 by spotting the impact of an early step in the value chain (product design) on a later step (production) and deciding to change the product design to drastically reduce the number of parts in each VCR.[8]

The combined costs of all the various activities in a company's value chain define the company's internal cost structure. Further, the cost of each activity contributes to whether the company's overall cost position relative to rivals is favorable or unfavorable. The tasks of value chain analysis and benchmarking are to develop the data for comparing a company's costs activity by activity against the costs of key rivals and to learn which internal activities are a source of cost advantage or disadvantage. A company's relative cost position is a function of how the overall costs of the activities it performs in conducting business compare to the overall costs of the activities performed by rivals.

Why the Value Chains of Rival Companies Often Differ

A company's value chain and the manner in which it performs each activity reflect the evolution of its own particular business and internal operations, its strategy, the approaches it is using to execute its strategy, and the underlying economics of the activities themselves.[9] Because these factors differ from company to company, the value chains of rival companies sometimes differ substantially—a condition that complicates the task of assessing rivals' relative cost positions. For instance, competing companies may differ in their degrees of vertical integration. Comparing the value chains of a fully integrated rival and a partially integrated rival requires adjusting for differences in the scope of activities performed. Clearly the costs of internally performed activities for a manufacturer that *makes* all of its own parts and components will be greater than the costs of internally performed activities of a producer that *buys* the needed parts and components from outside suppliers and only performs assembly operations.

Likewise, there is legitimate reason to expect value chain and cost differences between a company that is pursuing a low-cost/low-price strategy and a rival that is positioned on the high end of the market. The costs of certain activities along the low-cost company's value chain should indeed be below those of the high-end firm that understandably has to devote more resources to performing activities that create the added quality and extra features of its products.

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

The Value Chain System for an Entire Industry

As the tire industry example makes clear, a company's value chain is embedded in a larger system of activities that includes the value chains of its suppliers and its distribution channel allies engaged in getting its product or service to end users.[10] *Accurately assessing a company's competitiveness in end-use markets requires that company managers understand the entire value chain system for delivering a product or service to end users, not just the company's own value chain.* At the very least, this means considering the value chains of suppliers and forward channel allies (if any), as shown in Figure 4.4.

Suppliers' value chains are relevant because suppliers perform activities and incur costs in creating and delivering the purchased inputs used in a company's own value chain. The costs, performance features, and