Emergence of a Strategic Leader

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Supplemental reading for LD823 MS in Leadership Course at Granite State College, NH

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Overview of Strategic Planning

Strategic **planning** is an organization's process of defining its strategy, or direction, and making decisions about allocating its resources to pursue this strategy, including its capital and people. Various business analysis techniques can be used in strategic planning, including SWOT analysis (Strengths, Weaknesses, Opportunities, and Threats) and PEST analysis (Political, Economic, Social, and Technological analysis) or STEER analysis involving Socio-cultural, Technological, Economic, Ecological, and Regulatory factors and EPISTELS (Environment, Political, Informatic, Social, Technological, Economic, Legal and Spiritual)

Strategic planning is the formal consideration of an organization's future course. All strategic planning deals with at least one of three key questions:

1. "What do we do?"
2. "For whom do we do it?"
3. "How do we excel?"

In business strategic planning, the third question is better phrased "How can we beat or avoid competition?" (Bradford & Duncan, 2000, p. 1).

In many organizations, this is viewed as a process for determining where an organization is going over the next year or more -typically 3 to 5 years, although some extend their vision to 20 years.

In order to determine where it is going, the organization needs to know exactly where it stands, then determine where it wants to go and how it will get there. The resulting document is called the "strategic plan".

It is also true that strategic planning may be a tool for effectively plotting the direction of a company; however, strategic planning itself cannot foretell exactly how the market will evolve and what issues will surface in the coming days in order to plan your organizational strategy. Therefore, strategic innovation and tinkering with the ‘strategic plan’ have to be a cornerstone strategy for an organization to survive the turbulent business climate.

Vision, mission and values

- **Vision:** Defines the desired or intended future state of a specific organization or enterprise in terms of its fundamental objective and/or strategic direction.
- **Mission:** Defines the fundamental purpose of an organization or an enterprise, basically describing why it exists.
- **Values:** Beliefs that are shared among the stakeholders of an organization. Values drive an organization’s culture and priorities.

Methodologies

There are many approaches to strategic planning but typically a three-step process may be used:

- **Situation** – evaluate the current situation and how it came about.
- **Target** – define goals and/or objectives (sometimes called ideal state)
- **Path** – map a possible route to the goals/objectives

One alternative approach is called *Draw-See-Think*

- **Draw** – what is the ideal image or the desired end state?
- **See** – what is today’s situation? What is the gap from ideal and why?
- **Think** – what specific actions must be taken to close the gap between today’s situation and the ideal state?
- **Plan** – what resources are required to execute the activities?

An alternative to the *Draw-See-Think* approach is called *See-Think-Draw*

- **See** – what is today's situation?
- **Think** – define goals/objectives
- **Draw** – map a route to achieving the goals/objectives

In other terms strategic planning can be as follows:

- **Vision** – Define the vision and set a mission statement with hierarchy of goals
- **SWOT analysis|SWOT** – Analysis conducted according to the desired goals
- **Formulate** – Formulate actions and processes to be taken to attain these goals
- **Implement** – Implementation of the agreed upon processes
- **Control** – Monitor and get feedback from implemented processes to fully control the operation

Situational analysis

When developing strategies, analysis of the organization and its environment as it is at the moment and how it may develop in the future, is important. The analysis has to be executed at an internal level as well as an external level to identify all opportunities and threats of the external environment as well as the strengths and weaknesses of the organizations.

There are several factors to assess in the external situation analysis:

1. Markets (customers)
2. Competition
3. Technology
4. Supplier markets
5. Labor markets
6. The economy

7. The regulatory environment

It is rare to find all seven of these factors having critical importance. It is also uncommon to find that the first two – markets and competition – are not of critical importance. (Bradford "External Situation – What to Consider")

Analysis of the external environment normally focuses on the customer. Management should be visionary in formulating customer strategy, and should do so by thinking about market environment shifts, how these could impact customer sets, and whether those customer sets are the ones the company wishes to serve.

Analysis of the competitive environment is also performed, many times based on the framework suggested by Michael Porter.

Goals, objectives and targets

Strategic planning is a very important business activity. It is also important in the public sector areas such as education. It is practiced widely informally and formally. Strategic planning and decision processes should end with objectives and a roadmap of ways to achieve those objectives.

The following terms have been used in strategic planning: desired end states, plans, policies, goals, objectives, strategies, tactics and actions. Definitions vary, overlap and fail to achieve clarity. The most common of these concepts are specific, time bound statements of intended future results and general and continuing statements of intended future results, which most models refer to as either goals or objectives (sometimes interchangeably).

One model of organizing objectives uses hierarchies. The items listed above may be organized in a hierarchy of means and ends and **numbered** as follows: Top Rank Objective (TRO), Second Rank Objective, Third Rank Objective, etc. From any rank, the objective in a lower rank answers to the question "How?" and the objective in a higher rank answers to the question "Why?" The exception is the Top Rank Objective (TRO): there is no answer to the "Why?" question. That is how the TRO is defined.

People typically have several goals at the same time. "Goal congruency" refers to how well the goals combine with each other. Does goal A appear compatible with goal B? Do they fit together to form a unified strategy? "Goal hierarchy" consists of the nesting of one or more goals within other goal(s).

One approach recommends having short-term goals, medium-term goals, and long-term goals. In this model, one can expect to attain short-term goals fairly easily: they stand just slightly above one's reach. At the other extreme, long-term goals appear very difficult, almost impossible to attain. Strategic management jargon sometimes refers to "Big Hairy Audacious Goals" (BHAGs) in this context. Using one goal as a stepping-stone to the next involves **goal sequencing**. A person or group starts by attaining the easy short-term goals, then steps up to the medium-term, then to the long-term goals. Goal sequencing can create a "goal stairway". In an organizational setting, the organization may co-ordinate goals so that they do not conflict with each other. The goals of one part of the organization should mesh compatibly with those of other parts of the organization.

Mission statements and vision statements

Organizations sometimes summarize goals and objectives into a **mission statement** and/or a **vision statement**:

While the existence of a shared mission is extremely useful, many strategy specialists question the requirement for a written mission statement. However, there are many models of strategic planning that start with mission statements, so it is useful to examine them here.

- A ***Mission statement*** tells you the fundamental purpose of the organization. It concentrates on the present. It defines the customer and the critical processes. It informs you of the desired level of performance.

- A ***Vision statement*** outlines what the organization wants to be. It concentrates on the future. It is a source of inspiration. It provides clear decision-making criteria.

Many people mistake vision statement for mission statement. The Vision describes a future identity while the Mission serves as an ongoing and time-independent guide. The Mission describes why it is important to achieve the Vision. A Mission statement defines the purpose or broader goal for being in existence or in the business and can remain the same for decades if crafted well. A Vision statement is more specific in terms of both the future state and the time frame. Vision describes what will be achieved if the organization is successful.

A mission statement can resemble a vision statement in a few companies, but that can be a grave mistake. It can confuse people. The vision statement can galvanize the people to achieve defined objectives, even if they are stretch objectives, provided it can be elucidated in SMART (project management)|SMART (Specific, Measurable, Achievable, Relevant and Time-bound) terms. A mission statement provides a path to realize the vision in line with its values. These statements have a direct bearing on the bottom line and success of the organization.

Which comes first? The mission statement or the vision statement? That depends. If you have a new start up business, new program or plan to re engineer your current services, then the vision will guide the mission statement and the rest of the strategic plan. If you have an established business where the mission is established, then many times, the mission guides the vision statement and the rest of the strategic plan. Either way, you need to know your fundamental purpose – the mission, your current situation in terms of internal resources and capabilities (strengths and/or weaknesses) and external conditions (opportunities and/or threats), and where you want to go – the vision for the future. It's important that you keep the end or desired result in sight from the start.

Features of an effective vision statement include:

- Clarity and lack of ambiguity
- Vivid and clear picture
- Description of a bright future
- Memorable and engaging wording
- Realistic aspirations
- Alignment with organizational values and culture

To become really effective, an organizational vision statement must (the theory states) become assimilated into the organization's culture. Leaders have the responsibility of communicating the vision regularly, creating narratives that illustrate the vision, acting as role-models by embodying the vision, creating short-term objectives compatible with the vision, and encouraging others to craft their own personal vision compatible with the organization's overall vision. In addition, mission statements need to conduct an internal assessment and an external assessment. The internal assessment should focus on how members inside the organization interpret their mission statement. The external assessment – which includes all of the businesses stakeholders – is valuable since it offers a different perspective. These discrepancies between these two assessments can give insight on the organization's mission statement effectiveness.

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Overview of Inputs to Strategic Planning

Strategic plans can take the form of business or marketing plans, and consultants and industry experts are used in their development.

Strategy Hierarchy

In most corporations, there are several levels of management. Strategic management is the highest of these levels in the sense that it is the broadest—it applies to all parts of the firm and incorporates the longest time horizon. It gives direction to corporate values, corporate culture, corporate goals, and corporate missions. Under the broad corporate strategy are business-level competitive strategies and functional unit strategies.

- **Corporate strategy** refers to the overarching strategy of the diversified firm.
- **Business strategy** refers to the aggregated strategies of a single business firm or a strategic business unit (SBU) in a diversified corporation.
- **Functional strategies** include marketing strategies, new-product development strategies, human resource strategies, financial strategies, legal strategies, supply-chain strategies, and information-technology management strategies. The emphasis is on short-term and medium-term plans and is limited to the domain of each department's functional responsibility. Each functional department attempts to do its part to meet overall corporate objectives, so to some extent their strategies are derived from broader corporate strategies.

Many companies feel that a functional organizational structure is not an efficient way to organize activities, so they often re-engineer according to processes or SBUs. A strategic business unit is a semi-autonomous unit that is usually responsible for its own budgeting, new product decisions, hiring decisions, and price setting. An SBU is treated as an internal profit center by corporate headquarters.

Business Plans

A business plan is a formal statement of a set of business goals, the reasons they are attainable, and the plan for reaching them. It may also contain background information about the organization or team attempting to reach those goals.

For example, a business plan for a nonprofit might discuss the fit between the business plan and the organization's mission. Banks are quite concerned about defaults, so a business plan for a bank loan will build a convincing case for the organization's ability to repay the loan. Venture capitalists are primarily concerned about initial investment, feasibility, and exit valuation. A business plan for a project requiring equity financing will need to explain why current resources, upcoming growth opportunities, and sustainable competitive advantage will lead to a high exit valuation.

Preparing a business plan draws on a wide range of knowledge from many different business disciplines: finance, human resource management, intellectual-property management, supply-chain management, operations management, and marketing. It can be helpful to view the business plan as a collection of subplans, one for each of the main business disciplines.

Marketing Plans

A marketing plan is a written document that details the actions necessary to achieve one or more marketing objectives. It can be for a product, a service, a brand, or a product line. Marketing plans span between one and five years.

A marketing plan may be part of an overall business plan. Solid strategy is the foundation of a well-written marketing plan, and one way to achieve this is by using a method known as the seven Ps (product, place, price, promotion, physical environment, people, and process). A product-oriented company may use the seven Ps to develop a plan for each of its products. A market-oriented company will concentrate on each market. Each will base its plans on the detailed needs of its customers and on the strategies chosen to satisfy those needs.

The seven Ps

In marketing, the general process of identifying and approaching a target market is captured through the seven Ps: Place, Price, Promotion, People, Process, Physical Evidence, and Product.

Tools for Planning

Often discussed in tools for planning are models that measure the internal and external environments (e.g. Porter's Five Forces, SWOT, Value Chain, etc.). These models create forward-looking projections based on past and present data; therefore, they are useful only once enough data have been collected. Because of this, tools for planning largely focus on generating enough data to construct valid recommendations. These tools can include:

- **Industry experts:** Whether internal employees or external consultants, a few individuals with extensive experience in a given industry are valuable resources in the planning process. These industry experts can move beyond the PESTEL and Porter's Five Forces frameworks, making intuitive leaps as to the trajectory of the industry.
- **Consultants**: Consultants are commonly brought in during strategy formulation and for a variety of other reasons. Most important of these would be providing an objective lens for internal affairs. It is difficult to see the whole house from inside the house, and upper management can utilize an external opinion to ensure they are seeing operations clearly and objectively.
- **Inclusion of stakeholders:** Upper management will want as much information as possible from everyone involved. Some examples include consumer surveys on satisfaction, supplier projections for costs over a given time frame, consumer inputs on needs still unfilled, and shareholder views. The inclusion of stakeholders offers a variety of tools, each of which may or may not be a useful input depending on the context of the plan.

Benefits of Strategic Planning: Focus, Action, Control, Coordination, and Time Management

The Planning Process

The planning process is concerned with defining a company's goals and determining the resources necessary to achieve those goals. Achieving a vision requires coordinated efforts that adhere to a broader organizational plan. This is enabled through consistent strategies that are supported by staff at all levels. To meet business goals, managers develop business plans not only to reach targets but also to strengthen and change public perception of the company's brand.

Area	**Traditional S& OP**	Intergrated **Business Planning**
Business Objective	Supply demand balancing	Not simply about matching demand and meeting customer needs. Considers several plan alternatives and chooses one that best represents the business drivers.
Process	Rigid and prescriptive	Process is ore rules and exception based.
Technology	Weak and non-intergrated	Technology enables the processes through workflows
Frequency	Monthly or quaterly	Still monthly in a lot of cases but with the ability to rapidly handle exception situations
Focus	Inward focused	Collaborative and outward focused

Integrated business plan

This business plan takes aspects of a business and identifies clear goals for each: e.g., for the technology to move from being weak and non-integrated to enabling workflows, and for the business's focus to transition from being inwardly to outwardly focused.

Since they have achieved defined goals through the planning process, managers and employees can focus and control their efforts and their resources, follow determined plans of action, coordinate activities between divisions, and use time management to meet specific goals. Planning helps to achieve these goals or targets by efficiently and effectively using available time and resources. In short, planning, if executed properly, should lead to the following benefits:

Focus

There are a wide variety of activities an organization (or the individuals within the organization) might viably pursue. While there is value in the pursuit of many activities, understanding which ones the organization should focus on to leverage organizational competencies and align with market research requires careful planning and delegation. This is how planning achieves focus.

Coordinated Action

If department A is reliant on inputs from department B, department A cannot utilize department B's work without coordination. If department B has too much work and department A too little, there is poor interdepartmental coordination. This is alleviated through detail-oriented planning processes.

Control

The control process is based on benchmarks, which is to say that controlling requires a standard of comparison when viewing the actual operational results. Control relies on the planning process to set viable objectives, which can then be worked towards through controlling operations.

Time Management

Time management underlines the importance of maximizing the use of time to minimize the cost of production. If a full-time employee can accomplish their work within 32 hours, the planning process can find meaningful use for their remaining time. Costs can be lowered and productivity increased by ensuring that each element in the operational process functions according to ideal time constraints.

The Process Itself

Perhaps the most important benefit of developing business and marketing plans is the nature of the planning process itself. This typically offers a unique opportunity, a forum, for information-rich and productively focused discussions between the various managers involved. The plan and the discussions that arise from it provide an agreed context for subsequent management activities, even those not described in the plan itself.

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Entrepreneurial Orientation

The Value of Thinking and Acting Entrepreneurially

When asked to think of an entrepreneur, people typically offer examples such as Howard Schultz, Estée Lauder, and Michael Dell—individuals who have started their own successful businesses from the bottom up that generated a lasting impact on society. But entrepreneurial thinking and doing are not limited to those who begin in their garage with a new idea, financed by family members or personal savings. Some people in large organizations are filled with passion for a new idea, spend their time championing a new product or service, work with key players in the organization to build a constituency, and then find ways to acquire the needed resources to bring the idea to fruition. Thinking and behaving entrepreneurially can help a person's career too. Some enterprising individuals successfully navigate through the environments of their respective organizations and maximize their own career prospects by identifying and seizing new opportunities (Certo, et. al., 2009).

Autonomy – The tendency to bring forth ideas and see them through to completion.	Microsoft's values statement notes, "We take on big challenges, and pride ourselves on seeing them through." For example, Microsoft embraced a huge challenge when developing and launching its Xbox gaming system to compete with market leaders Nintendo and Sony.
Competitive Aggressiveness – The tendency to intensely and directly challenge rivals rather than trying to avoid competition.	One of Nike's past mission statements – "To experience the emotion of competition, winning, and crushing competitors" – highlights its aggressiveness.
Innovativeness – The tendency to pursue novel ideas, creative processes, and experimentation.	3M has built its business around its mission statement: to solve unsolved problems innovatively. 3M employs over 7,000 researchers and it was awarded nearly 600 patents in 2010. 3M's innovativeness has led it to develop thousands of products (such as Post-it notes and Scotch tape) that are sold in almost 200 countries.
Proactiveness – The tendency to anticipate and act on future opportunities rather than rely solely on existing products and services.	Proactive Communications Inc. lives up to its name by focusing on emerging and unusual opportunities. The firm embraces contracts in war zones and natural disaster areas that are often avoided by other telecommunications firms.
Risk Taking – The tendency to take bold actions rather than being cautious.	Richard Brandson's launching of Virgin Galactic – a company that plans to offer suborbital spaceflights to commercial passengers – reflects his love of high-risk, high-reward ventures.

Table 1 Understanding Entrepreneurial Orientation. A *famous Nike slogan encourages people to "just do it!" For people and organizations that have developed an entrepreneurial orientation, "just do it!" is a way of life. While often associated with starting new ventures, an entrepreneurial orientation can be very valuable to established organizations too. Below we describe each of the five characteristics associated with an entrepreneurial orientation: autonomy, competitive aggressiveness, innovativeness, proactiveness, and risk-taking.*

As a college student, Michael Dell demonstrated an entrepreneurial orientation by starting a computer-upgrading business in his dorm room. He later founded Dell Inc.

In the 1730s, Richard Cantillon used the French term *entrepreneur*, or literally "undertaker," to refer to those who undertake self-employment while also accepting an uncertain return. In subsequent years, entrepreneurs have also been referred to as innovators of new ideas (Thomas Edison), individuals who find and promote new combinations of factors of production (Bill Gates' bundling of Microsoft's products), and those who exploit opportunistic ideas to expand small enterprises (Mark Zuckerberg at Facebook). The common elements of these conceptions of entrepreneurs are that they do something new and that some individuals can make something out of opportunities that others cannot.

Entrepreneurial orientation (EO) is a key concept when executives are crafting strategies in the hopes of doing something new and exploiting opportunities that other organizations cannot exploit. EO refers to the processes, practices, and decision-making styles of organizations that act entrepreneurially (Lumpkin & Dess, 1996). Any organization's level of EO can be understood by examining how it stacks up relative to five dimensions: (1) autonomy, (2) competitive aggressiveness, (3) innovativeness, (4) proactiveness, (5) and risk taking. These dimensions are also relevant to individuals.

Autonomy

Autonomy refers to whether an individual or team of individuals within an organization has the freedom to develop an entrepreneurial idea and then see it through to completion. In an organization that offers high autonomy, people are offered the independence required to bring a new idea to fruition, unfettered by the shackles of corporate bureaucracy. When individuals and teams are unhindered by organizational traditions and norms, they are able to more effectively investigate and champion new ideas.

Some large organizations promote autonomy by empowering a division to make its own decisions, set its own objectives, and manage its own budgets. One example is Sony's PlayStation group, which was created by chief operating officer (COO) Ken Kutaragi, largely independent of the Sony bureaucracy. In time, the PlayStation business was responsible for nearly all Sony's net profit. Because of the success generated by the autonomous PlayStation group, Kutaragi later was tapped to transform Sony's core consumer electronics business into a PlayStation clone. In some cases, an autonomous unit eventually becomes completely distinct from the parent company, such as when Motorola spun off its successful semiconductor business to create Freescale.

Competitive Aggressiveness

Competitive aggressiveness is the tendency to intensely and directly challenge competitors rather than trying to avoid them. Aggressive moves can include price-cutting and increasing spending on marketing, quality, and production capacity. An example of competitive aggressiveness can be found in Ben & Jerry's marketing campaigns in the mid-1980s, when Pillsbury's Häagen-Dazs attempted to limit distribution of Ben & Jerry's products. In response, Ben & Jerry's launched their "What's the Doughboy Afraid

Of?" advertising campaign to challenge Pillsbury's actions. This marketing action was coupled with a series of lawsuits—Ben & Jerry's was competitively aggressive in both the marketplace and the courtroom.

Although aggressive moves helped Ben & Jerry's, too much aggressiveness can undermine an organization's success. A small firm that attacks larger rivals, for example, may find itself on the losing end of a price war. Establishing a reputation for competitive aggressiveness can damage a firm's chances of being invited to join collaborative efforts such as joint ventures and alliances. In some industries, such as the biotech industry, collaboration is vital because no single firm has the knowledge and resources needed to develop and deliver new products. Executives thus must be wary of taking competitive actions that destroy opportunities for future collaborating.

Innovativeness

Innovativeness is the tendency to pursue creativity and experimentation. Some innovations build on existing skills to create incremental improvements, while more radical innovations require brand-new skills and may make existing skills obsolete. Either way, innovativeness is aimed at developing new products, services, and processes. Those organizations that are successful in their innovation efforts tend to enjoy stronger performance than those that do not.

Known for efficient service, FedEx has introduced its Smart Package, which allows both shippers and recipients to monitor package location, temperature, and humidity. This type of innovation is a welcome addition to FedEx's lineup for those in the business of shipping delicate goods, such as human organs. How do firms generate these types of new ideas that meet customers' complex needs? Perennial innovators 3M and Google have found a few possible answers. 3M sends nine thousand of its technical personnel in thirty-four countries into customers' workplaces to experience firsthand the kinds of problems customers encounter each day. Google's two most popular features of its Gmail, thread sorting and unlimited e-mail archiving, were first suggested by an engineer who was fed up with his own e-mail woes. Both firms allow employees to use a portion of their work time on projects of their own choosing with the goal of creating new innovations for the company. This latter example illustrates how multiple EO dimensions—in this case, autonomy and innovativeness—can reinforce one another.

Ben & Jerry's displays innovativeness by developing a series of offbeat and creative flavors over time.

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Proactiveness

Proactiveness is the tendency to anticipate and act on future needs rather than reacting to events after they unfold. A proactive organization is one that adopts an opportunity-seeking perspective. Such organizations act in advance of shifting market demand and are often either the first to enter new markets or "fast followers" that improve on the initial efforts of first movers.

Consider Proactive Communications, an aptly named small firm in Killeen, Texas. From its beginnings in 2001, this firm has provided communications in hostile environments, such as Iraq and areas impacted by Hurricane Katrina. Being proactive in this case means being willing to don a military helmet or sleep outdoors—activities often avoided by other telecommunications firms. By embracing opportunities that others fear, Proactive's executives have carved out a lucrative niche in a world that is technologically, environmentally, and politically turbulent (Choi, 2008).

Risk Taking

Risk taking refers to the tendency to engage in bold rather than cautious actions. Starbucks, for example, made a risky move in 2009 when it introduced a new instant coffee called VIA Ready Brew. Instant coffee has long been viewed by many coffee drinkers as a bland drink, but Starbucks decided that the opportunity to distribute its product in a different format was worth the risk of associating its brand name with instant coffee.

Although a common belief about entrepreneurs is that they are chronic risk takers, research suggests that entrepreneurs do not perceive their actions as risky, and most take action only after using planning and forecasting to reduce uncertainty (Simon, et. al., 2000). But uncertainty seldom can be fully eliminated. A few years ago, Jeroen van der Veer, CEO of Royal Dutch Shell PLC, entered a risky energy deal in Russia's Far East. At the time, van der Veer conceded that it was too early to know whether the move would be successful (Certo, et. al., 2008). Just six months later, however, customers in Japan, Korea, and the United States had purchased all the natural gas expected to be produced there for the next twenty years. If political instabilities in Russia and challenges in pipeline construction do not dampen returns, Shell stands to post a hefty profit from its 27.5 percent stake in the venture.

Building an Entrepreneurial Orientation

Executives can steps to develop a stronger entrepreneurial orientation throughout an organization and by individuals to become more entrepreneurial themselves. For executives, it is important to design organizational systems and policies to reflect the five dimensions of EO. As an example, how an organization's compensation systems encourage or discourage these dimensions should be considered. Is taking sensible risks rewarded through raises and bonuses, regardless of whether the risks pay off, for example, or does the compensation system penalize risk taking? Other organizational characteristics such as corporate debt level may influence EO. Do corporate debt levels help or impede innovativeness? Is debt structured in such a way as to encourage risk taking? These are key questions for executives to consider.

Examination of some performance measures can assist executives in assessing EO within their organizations. To understand how the organization develops and reinforces autonomy, for example, top executives can administer employee satisfaction surveys and monitor employee turnover rates. Organizations that effectively develop autonomy should foster a work environment with high levels of employee satisfaction and low levels of turnover. Innovativeness can be gauged by considering how many new products or services the organization has developed in the last year and how many patents the firm has obtained.

Similarly, individuals should consider whether their attitudes and behaviors are consistent with the five dimensions of EO. Is an employee making decisions that focus on competitors? Does the employee provide executives with new ideas for products or processes that might create value for the organization? Is the employee making proactive as opposed to reactive decisions? Each of these questions will aid employees in understanding how they can help to support EO within their organizations.

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Planning Tools

Strategists have developed a large array of tools useful in the assessment of strategic planning, all of which provide unique insights into the feasibility and profitability of a given operational project. Identifying these tools, and selecting which are most appropriate for determining the effectiveness or efficiency of a project, is a central responsibility of a strategic-management team.

Listed below are the main tools available for consideration along with a brief description of how each tool is useful.

Forecasting

Forecasting is the the most common strategic tool and it should be considered whenever projects are being designed. Forecasting, simply put, is projecting the future of a project by leveraging all of the available knowledge to generate a likelihood of success. It is useful to construct pro forma financial statements, which illustrate expected costs and revenues.

Scenario Planning

Scenario planning is an interesting tool with which strategists construct various scenarios to test out the potential trajectories of specific operational plans. One popular scenario application is called the zero-sum game, where the costs and revenues are equated to see at what level of cost or what level of revenue a zero-sum bottom line can be achieved. By benchmarking this situation against reality, strategists can see in which situations value can be captured.

Benchmarking

Benchmarking can be done qualitatively or quantitatively, and it is a comparative approach to strategy. Benchmarking usually requires the identification of a close competitor with similar strategic prerogatives so that the strategist can compare and contrast the two companies' strengths and weaknesses, identifying strategies for improvements or competitive advantages.

Participatory and Contingency Planning

Contingency planning can be simply described as the back-up plan, while participatory planning is the primary plan. An excellent tool for strategists pursuing a particularly risky venture is to develop the primary objectives and strategy while simultaneously constructing a contingency plan that will limit the negative effects of failure. This offsets risk through finding various ways to achieve value regardless of the success of the overall venture. This requires creativity and a degree of adaptability.

Goal Setting

Goal setting, similar to MBO and SMART, is a simple method for strategists to establish and enforce specific goals within the organization or strategic business unit (SBU). Goal setting creates incentives for employees by identifying achievable end results, which drives the direction of the company towards commonly established goals. This theory was developed by Edwin A. Locke in the 1960s and is considered an "open" theory, which implies that new thoughts and developments may be layered on top of the original goal-setting framework.

Management by Objectives

MBO is the process of defining, disseminating, and implementing the objectives that an organization has identified as strategic. Objectives provide factual and achievable strategies that align with employee and manager goals in order to ensure that all participants are on the same page. It is also useful to set goals and a timeline to assess progress and ensure that each individual is achieving their segment of the plan.

SMART Goals

The SMART model aims to design goals that are specific, measurable, achievable, realistic, and time-targeted (SMART)

SMART *criteria*: *Each component of the SMART model describes an effective attribute of a performance objective. Objectives will ideally conform to these expectations.*

The SMART model identifies specific goals, measures inputs and outputs, ensures that the goals are attainable and relevant to the mission of the company, and constructs a timeline.

Though there are many other potential tools for strategists, these seven provide a strong framework for further development of strategic methodologies. Incorporating concepts such as forecasting and benchmarking in conjunction with larger corporate strategy frameworks such as SMART goals and MBO will equip strategists with a strong short-term and long-term approach.

Approaches to Strategic Management

General approaches

In general terms, there are two main approaches, which are opposite but complement each other in some ways, to strategic management:

- **The Industrial Organizational Approach**
  - based on economic theory – deals with issues like competitive rivalry, resource allocation, economies of scale
  - assumptions – rationality, self discipline behaviour, profit maximization
- **The Sociological Approach**
  - deals primarily with human interactions
  - assumptions – bounded rationality, satisfying behaviour, profit sub-optimality. An example of a company that currently operates this way is Google

Strategic management techniques can be viewed as bottom-up, top-down, or collaborative processes. In the bottom-up approach, employees submit proposals to their managers who, in turn, funnel the best ideas further up the organization. This is often accomplished by a capital budgeting process. Proposals are assessed using financial criteria such as return on investment or cost-benefit analysis. Cost underestimation and benefit overestimation are major sources of error. The proposals that are approved form the substance of a new strategy, all of which is done without a grand strategic design or a strategic architect. The top-down approach is the most common by far. In it, the CEO, possibly with the assistance of a strategic planning team, decides on the overall direction the company should take. Some organizations are starting to experiment with collaborative strategic planning techniques that recognize the emergent nature of strategic decisions.

The strategy hierarchy

In most corporations there are several levels of management. Strategic management is the highest of these levels in the sense that it is the broadest – applying to all parts of the firm – while also incorporating the longest time horizon. It gives direction to corporate values, corporate culture, corporate goals, and corporate missions. Under this broad corporate strategy there are typically business-level competitive strategies and functional unit strategies.

Corporate strategy refers to the overarching strategy of the diversified firm. Such a corporate strategy answers the questions of "in which businesses should we compete?" and "how does being in these businesses create synergy and/or add to the competitive advantage of the corporation as a whole?"

Business strategy refers to the aggregated strategies of a single business firm or a strategic business unit (SBU) in a diversified corporation. According to Michael Porter, a firm must formulate a business strategy that incorporates either cost leadership, differentiation or focus in order to achieve a sustainable competitive advantage and long-term success in its chosen arenas or industries.

Functional strategies include marketing strategies, new product development strategies, human resource strategies, financial strategies, legal strategies, supply-chain strategies, and information technology management strategies. The emphasis is on short and medium term plans and is limited to the domain of each department's functional responsibility. Each functional department attempts to do its part in meeting overall corporate objectives, and hence to some extent their strategies are derived from broader corporate strategies.

Many companies feel that a functional organizational structure is not an efficient way to organize activities so they are reengineering|reengineered according to processes or SBUs. A **strategic business unit** is a semi-autonomous unit that is usually responsible for its own budgeting, new product decisions, hiring decisions, and price setting. An SBU is treated as an internal profit centre by corporate headquarters.

An additional level of strategy called **operational strategy** was encouraged by Peter Drucker in his theory of management by objectives (MBO). It is very narrow in focus and deals with day-to-day operational activities such as scheduling criteria. It must operate within a budget but is not at liberty to adjust or create that budget. Operational level strategies are informed by business level strategies which, in turn, are informed by corporate level strategies.

Since the turn of the millennium, some firms have reverted to a simpler strategic structure driven by advances in information technology. It is felt that knowledge management systems should be used to share information and create common goals. Strategic divisions are thought to hamper this process. This notion of strategy has been captured under the rubric of **dynamic strategy**, popularized by Carpenter and Sanders's textbook [1]. This work builds on that of Brown and Eisenhart as well as Christensen and portrays firm strategy, both business and corporate, as necessarily embracing ongoing strategic change, and the seamless integration of strategy formulation and implementation. Such change and implementation are usually built into the strategy through the staging and pacing facets.

Vision, Mission, and Goals

The Importance of Vision

"Good business leaders create a vision, articulate the vision, passionately own the vision, and relentlessly drive it to completion."

–Jack Welch, former CEO of General Electric

Many skills and abilities separate effective strategic leaders like Howard Schultz from poor strategic leaders. One of them is the ability to inspire employees to work hard to improve their organization's performance. Effective strategic leaders are able to convince employees to embrace lofty ambitions and move the organization forward. In contrast, poor strategic leaders struggle to rally their people and channel their collective energy in a positive direction.

As the quote from Jack Welch suggests, a vision is one key tool available to executives to inspire the people in an organization. An organization's vision describes what the organization hopes to become in the future. Well-constructed visions clearly articulate an organization's aspirations. Avon's vision is "to be the company that best understands and satisfies the product, service, and self-fulfillment needs of women–globally." This brief but powerful statement emphasizes several aims that are important to Avon, including excellence in customer service, empowering women, and the intent to be a worldwide player. Like all good visions, Avon sets a high standard for employees to work collectively toward. Perhaps no vision captures high standards better than that of aluminum maker Alcoa. This firm's very ambitious vision is "to be the best company in the world–in the eyes of our customers, shareholders, communities and people." By making clear their aspirations, Alcoa's executives hope to inspire employees to act in ways that help the firm become the best in the world.

The results of a survey of one thousand five hundred executives illustrate how the need to create an inspiring vision creates a tremendous challenge for executives. When asked to identify the most important characteristics of effective strategic leaders, 98 percent of the executives listed "a strong sense of vision" first. Meanwhile, 90 percent of the executives expressed serious doubts about their own ability to create a vision (Quigley, 1994). Not surprisingly, many organizations do not have formal visions. Many organizations that do have visions find that employees do not embrace and pursue the visions. Having a well-formulated vision employees embrace can therefore give an organization an edge over its rivals.

Company	Vision
Alcoa	To be the best company in the world–in the eyes of our customers, shareholders, communities and people.
Avon	To be the company that best understands and satisfies the product, service and self-fulfillment needs women–globally.
Chevron	To be the global energy company most admired for its people, partnership and performance.
Google	To develop a perfect search engine.
Kraft Foods	Helping people around the world eat and live better.
Proctor and Gamble	Be, and be recognized as, the best consumer products and services company in the world.

Table 1 The Big Picture: Organizational Vision. A*n organization's vision describes what the organization hopes to become in the future. Visions highlight the values and aspirations that lay at the heart of the organization. Although visions statements have the potential to inspire employees, customers, and other stakeholders, vision statements are relatively rare and good visions are even rarer. Some of the visions pursued by businesses today are in the table above.*

Mission Statements

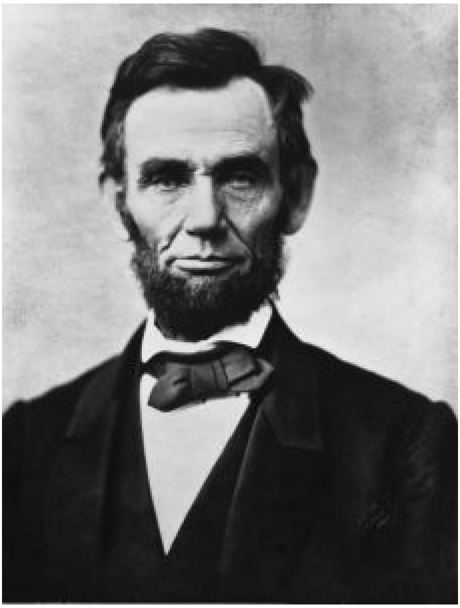
In working to turnaround Starbucks, Howard Schultz sought to renew Starbucks's commitment to its mission statement: "to inspire and nurture the human spirit–one person, one cup and one neighborhood at a time." A mission such as Starbucks's states the reasons for an organization's existence. Well-written mission statements effectively capture an organization's identity and provide answers to the fundamental question "Who are we?" While a vision looks to the future, a mission captures the key elements of the organization's past and present.

Company	Mission Statement
Harley Davidson	We ride with our customers and apply this deep connection in every market we serve to create superior value for all of our stakeholders.
Internal Revenue Service	Provide America's taxpayers top-quality srevice by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all.
Starbucks	To inspire and nurture the human spirit – one person, one cup and one neighborhood at a time.
The Estée Lauder Company	Bringing the best to everyone we touch and being the best in everything we do.
Limited Brands	Limited Brands is committed to building a family of the world's best fashion brands offering captivating customer experiences that drive long-term loyalty and deliver sustained growth for our shareholders.
Fender Musical Instruments	We will exceed the expectations of music enthusiasts worldwide and create a community for individual expression by focusing on our people, products, and business excellence.

Table 2 Missions. *While a vision describes what an organization desires to become in the future, an organization's mission is grounded in the past and present. A mission outlines the reasons for the organization's existence and explains what role it plays in society. A well-written mission statement captures the organization's identity and helps to answer the fundamental question of "Who are we?" As a practical matter, a mission statement explains to key stakeholders why they should support the organization.*

The following examples illustrate the connections between organizations and the needs of their key stakeholders.

In order to prosper, organizations need support from their key stakeholders, such as employees, owners, suppliers, and customers. A mission statement should explain to stakeholders why they should support the organization by making clear what important role or purpose the organization plays in society. Google's mission, for example, is "to organize the world's information and make it universally accessible and useful." Google pursued this mission in its early days by developing a very popular Internet search engine. The firm continues to serve its mission through various strategic actions, including offering its Internet browser Google Chrome to the online community, providing free e-mail via its Gmail service, and making books available online for browsing.



Many consider Abraham Lincoln to have been one of the greatest strategic leaders in modern history.

Wikimedia Commons – public domain.

One of Abraham Lincoln's best-known statements is that "a house divided against itself cannot stand." This provides a helpful way of thinking about the relationship between vision and mission. Executives ask for trouble if their organization's vision and mission are divided by emphasizing different domains. Some universities have fallen into this trap. Many large public universities were established in the late 1800s with missions that centered on educating citizens. As the twentieth century unfolded, however, creating scientific knowledge through research became increasingly important to these universities. Many university presidents responded by creating visions centered on building the scientific prestige of their schools. This created a dilemma for professors: should they devote most of their time and energy to teaching students (as the mission required) or on their research studies (as ambitious presidents demanded via their visions)? Some universities continue to struggle with this trade-off today and remain houses divided against themselves. In sum, an organization is more effective to the extent that its vision and its mission target employees' effort in the same direction.

Pursuing the Vision and Mission through SMART Goals

An organization's vision and mission offer a broad, overall sense of the organization's direction. To work toward achieving these overall aspirations, organizations also need to create goals—narrower aims that should provide clear and tangible guidance to employees as they perform their work on a daily basis. The most effective goals are those that are specific, measurable, aggressive, realistic, and time-bound. An easy way to remember these dimensions is to combine the first letter of each into one word: SMART. Employees are put in a good position to succeed to the extent that an organization's goals are SMART.

Specific	Coca-Cola is seeking to improve its water efficiency by a specific amount–20%. In contrast, goals such as "do your best" are vague, making it difficult to decide if a goal is actually reached.
Measurable	Water efficiency can be calculated, so Coca-Cola is able to track its progress relative to its 20% target. If progress is slow, more resources can be devoted to achieving the goal.
Aggressive	A series of research studies have established that performance is strongest when goals are challenging but attainable. Reaching a 20% improvement will requires aggressive work by Coke, but the goal can be reached.
Realistic	If Coca Cola's water efficiency goal was 95% improvement, Coca Cola's employees would probably react with surprise. Reaching a goal must be feasible in order for employees to embrace it. Unrealistic goals make most people give up. And basing goals on impossible clichés, such as "give 110%" creates confusion.
Time-bound	Coca Cola is seeking to achieve its 20% improvement by 2012. Some universities, such as Texas Tech University, provide incentives, including preferred scheduling for students who sign contracts agreeing to graduate on a four-year schedule. Deadlines such as these are motivating and they create accountability.

Table 3 Creating SMART Goals. *While missions and visions provide an overall sense of the organization's direction, goals are narrower aims that should provide clear and tangible guidance to employees. The most effective goals are those that are* SMART *(specific, measurable, aggressive, realistic, and time-bound).* SMART *goals help provide clarity, transparency, and accountability. One* SMART *goal is Coca-Cola's aim to "by 2012, improve our water efficiency by 20%, compared with a 2004 baseline."*

A goal is **specific** if it is explicit rather than vague. In May 1961, President John F. Kennedy proposed a specific goal in a speech to the US Congress: "I believe that this nation should commit itself to achieving the goal, before this decade is out, of landing a man on the moon and returning him safely to the earth (National Aeronautics and Space Administration)." Explicitness such as was offered in this goal is helpful because it targets people's energy. A few moments later, Kennedy made it clear that such targeting would be needed if this goal was to be reached. Going to the moon, he noted, would require "a major national commitment of scientific and technical manpower, materiel and facilities, and the possibility of their diversion from other important activities where they are already thinly spread." While specific goals make it clear how efforts should be directed, vague goals such as "do your best" leave individuals unsure of how to proceed.

A goal is **measurable** to the extent that whether the goal is achieved can be quantified. President Kennedy's goal of reaching the moon by the end of the 1960s offered very simple and clear measurability: Either Americans would step on the moon by the end of 1969 or they would not. One of Coca-Cola's current goals is a 20 percent improvement to its water efficiency by 2012 relative to 2004 water usage. Because water efficiency is easily calculated, the company can chart its progress relative to the 20 percent target and devote more resources to reaching the goal if progress is slower than planned.

A goal is **aggressive** if achieving it presents a significant challenge to the organization. A series of research studies have demonstrated that performance is strongest when goals are challenging but attainable. Such goals force people to test and extend the limits of their abilities. This can result in reaching surprising heights. President Kennedy captured this theme in a speech in September 1962: "We choose to go to the moon. We choose to go to the moon in this decade…not because [it is] easy, but because [it is] hard, because that goal will serve to organize and measure the best of our energies and skills."

In the case of Coca-Cola, reaching a 20% improvement will require a concerted effort, but the goal can be achieved. Meanwhile, easily achievable goals tend to undermine motivation and effort. Consider a situation in which you have done so well in a course that you only need a score of 60 percent on the final exam to earn an A for the course. Understandably, few students would study hard enough to score 90 percent or 100 percent on the final exam under these circumstances. Similarly, setting organizational goals that are easy to reach encourages employees to work just hard enough to reach the goals.

It is tempting to extend this thinking to conclude that setting nearly impossible goals would encourage even stronger effort and performance than does setting aggressive goals. People tend to get discouraged and give up, however, when faced with goals that have little chance of being reached. If, for example, President Kennedy had set a time frame of one year to reach the moon, his goal would have attracted scorn. The country simply did not have the technology in place to reach such a goal. Indeed, Americans did not even orbit the moon until seven years after Kennedy's 1961 speech. Similarly, if Coca-Cola's water efficiency goal was 95 percent improvement, Coca-Cola's employees would probably not embrace it. Thus goals must also be **realistic**, meaning that their achievement is feasible.

You have probably found that deadlines are motivating and that they help you structure your work time. The same is true for organizations, leading to the conclusion that goals should be **time-bound** through the creation of deadlines. Coca-Cola has set a deadline of 2012 for its water efficiency goal, for example. The deadline for President Kennedy's goal was the end of 1969. The goal was actually reached a few months early. On July 20, 1969, Neil Armstrong became the first human to step foot on the moon. Incredibly, the pursuit of a well-constructed goal had helped people reach the moon in just eight years.

The period after an important goal is reached is often overlooked but is critical. Will an organization rest on its laurels or will it take on new challenges? The US space program again provides an illustrative example. At the time of the first moon landing, *Time* magazine asked the leader of the team that built the moon rockets about the future of space exploration. "Given the same energy and dedication that took them to the moon," said Wernher von Braun, "Americans could land on Mars as early as 1982 (Time, 1969)." No new goal involving human visits to Mars was embraced, however, and human exploration of space was deemphasized in favor of robotic adventurers. Nearly three decades after von Braun's proposed timeline for reaching Mars expired, President Barack Obama set in 2010 a goal of creating by 2025 a new space vehicle capable of taking humans beyond the moon and into deep space. This would be followed in the mid-2030s by a flight to orbit Mars as a prelude to landing on Mars (Amos, 2010). Time will tell whether these goals inspire the scientific community and the country in general.

Vision	Young children often have grandiose visions, such as "I want to be the president of the United States." Now that you are in college, what do you aspire to become? Is your education setting the stage for you to reach this vision?
Mission	Is your mission in life simply to accumulate as much wealth as you can? Or do you also place value on your role in a family and as a member of society?
Specific	Do you create explicit rather than vague goals for yourself? This can help you to target your energy toward what is important.
Measurable	Quantifying your goals allows you to track your accomplishments over time and can help reduce stress. For example, meeting a goal of "write a page every day" might prevent panic the night before an important project is due.
Aggressive	Creating aggressive educational goals (e.g. maintain a 3.5 GPA) is likely to lead to higher performance than minimal goals (e.g., pass all my classes).
Realistic	To better understand your prospects in the job market, consider researching what kinds of jobs are common for your major and experience level.
Time-Bound	Time management is a challenge in today's world. If you tend to procrastinate, setting interim deadlines for yourself might help you to stay on schedule.

Table 4 Be SMART: Vision, Mission, Goals, and You. *Many of the principles for effective organizational vision, missions, and goals apply to individuals too. Here are some ideas that might help you think differently about your own aspirations and how you are working to reach them.*

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SWOT Analysis

SWOT Analysis

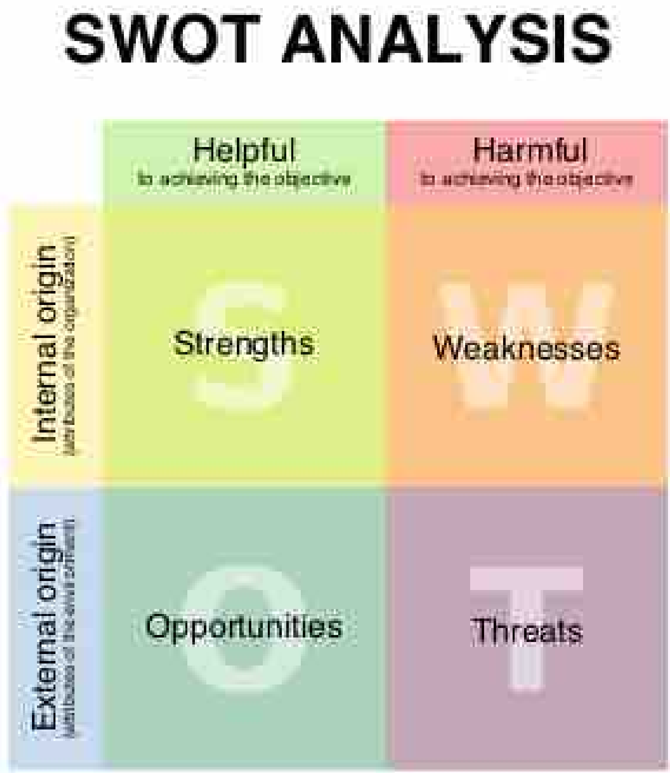
A method of analyzing the environment in which businesses operate is referred to as a context analysis. One of the most recognized of these is the SWOT (strengths, weaknesses, opportunities, and threats) analysis. Performing a SWOT analysis allows a business to gain insights into its internal strengths and weaknesses and to relate these insights to the external opportunities and threats posed by the marketplace in which the business operates. The main goal of a context analysis, SWOT or otherwise, is to analyze the business environment in order to develop a strategic plan.

SWOT and Strategy

A SWOT analysis is a strategic planning method used to evaluate the strengths, weaknesses, opportunities, and threats related to a project or business venture. A SWOT assessment involves specifying the business's objective and then identifying the internal and external factors that are favorable and unfavorable toward the business's ability to achieve its objective. Setting the objective, in terms of moving from strategy planning to strategy implementation, should be done after the SWOT analysis has been performed. Doing so allows the organization to set achievable goals and objectives.

Components of SWOT

- **Strengths:** internal characteristics of the business that give it an advantage over competitors
- **Weaknesses:** internal characteristics that place the business at a disadvantage against competitors
- **Opportunities:** external chances to improve performance in the overall business environment
- **Threats:** external elements in the environment that could cause trouble for the business



SWOT analysis

The SWOT analysis matrix illustrates where the company's strengths and weaknesses lie relative to factors in the market. Strengths and opportunities (the S and O of SWOT) are both helpful toward achieving company objectives, but strengths originate internally while opportunities originate externally. Similarly, weaknesses and threats (the W and T of SWOT) are harmful toward achieving objectives, but weaknesses originate internally and threats originate externally. Assessing all four points of the SWOT acronym ensures a thorough evaluation.

Identifying SWOTs is essential, as subsequent stages of planning can be derived from the analysis. Decision makers first determine whether an objective is attainable, given the SWOTs. If the objective is not attainable, a different objective must be selected, and then the process can be repeated. Users of SWOT analysis must ask and answer questions that generate meaningful information for each category to maximize the benefits of the evaluation and identify the organization's competitive advantages.

Assessing Organizational Performance

Organizational Performance: A Complex Concept

Organizational performance refers to how well an organization is doing to reach its vision, mission, and goals. Assessing organizational performance is a vital aspect of strategic management. Executives must know how well their organizations are performing to figure out what strategic changes, if any, to make. Performance is a very complex concept, however, and a lot of attention needs to be paid to how it is assessed.

Two important considerations are (1) performance measures and (2) performance referents (Table 1 "How Organizations and Individuals Can Use Financial Performance Measures and Referents"). A performance measure is a metric along which organizations can be gauged. Most executives examine measures such as profits, stock price, and sales in an attempt to better understand how well their organizations are competing in the market. But these measures provide just a glimpse of organizational performance. Performance referents are also needed to assess whether an organization is doing well. A performance referent is a benchmark used to make sense of an organization's standing along a performance measure. Suppose, for example, that a firm has a profit margin of 20 percent in 2011. This sounds great on the surface. But suppose that the firm's profit margin in 2010 was 35 percent and that the average profit margin across all firms in the industry for 2011 was 40 percent. Viewed relative to these two referents, the firm's 2011 performance is cause for concern.

Using a variety of performance measures and referents is valuable because different measures and referents provide different information about an organization's functioning. The parable of the blind men and the elephant—popularized in Western cultures through a poem by John Godfrey Saxe in the nineteenth century—is useful for understanding the complexity associated with measuring organizational performance. As the story goes, six blind men set out to "see" what an elephant was like. The first man touched the elephant's side and believed the beast to be like a great wall. The second felt the tusks and thought elephants must be like spears. Feeling the trunk, the third man thought it was a type of snake. Feeling a limb, the fourth man thought it was like a tree trunk. The fifth, examining an ear, thought it was like a fan. The sixth, touching the tail, thought it was like a rope. If the men failed to communicate their different impressions they would have all been partially right but wrong about what ultimately mattered.

insert table here

Table 1 How Organizations and Individuals Can Use Financial Performance Measures and Referents

This story parallels the challenge involved in understanding the multidimensional nature of organization performance because different measures and referents may tell a different story about the organization's performance. For example, the *Fortune* 500 lists the largest US firms in terms of sales. These firms are generally not the strongest performers in terms of growth in stock price, however, in part because they are so big that making major improvements is difficult. During the late 1990s, a number of Internet-centered businesses enjoyed exceptional growth in sales and stock price but reported losses rather than profits. Many investors in these firms who simply fixated on a single performance measure—sales growth—absorbed heavy losses when the stock market's attention turned to profits and the stock prices of these firms plummeted.

Figure 1: The story of the blind men and the elephant provides a metaphor for understanding the complexities of measuring organizational performance.

The number of performance measures and referents that are relevant for understanding an organization's performance can be overwhelming, however. For example, a study of what performance metrics were used within restaurant organizations' annual reports found that 788 different combinations of measures and referents were used within this one industry in a single year (Short & Palmer, 2003). Thus executives need to choose a rich yet limited set of performance measures and referents to focus on.

The Balanced Scorecard

To organize an organization's performance measures, Professor Robert Kaplan and Professor David Norton of Harvard University developed a tool called the balanced scorecard. Using the scorecard helps managers resist the temptation to fixate on financial measures and instead monitor a diverse set of important measures. Indeed, the idea behind the framework is to provide a "balance" between financial measures and other measures that are important for understanding organizational activities that lead to sustained, long-term performance. The balanced scorecard recommends that managers gain an overview of the organization's performance by tracking a small number of key measures that collectively reflect four dimensions: (1) financial, (2) customer, (3) internal business process, and (4) learning and growth (Kaplan & Norton, 1992).

Scorecard Point	Definition	You could ask yourself…
Financial measures	such as *return on assets* and *stock price*–relate to effectiveness and profits.	How can I improve my personal wealth? Measures might include cash, savings account, and retirement.
Customer measures	such as *number of new or repeat customers* and *percentage of repeat customers*–relate to customer attraction and satisfaction.	How strong is my social network? The number of new contacts you make over time might reflect this dimension.
Internal business process measures	such *as speed at serving a customer* and *time it takes to create a new product and get it to market*–relate to organizational efficiency.	Am I getting better at my current job? Tracking improvements in personal efficiency such as the time needed to complete a task can be helpful.
Learning and growth measures	such as the *average number of new skills learned by each employee every year*–relate to the future and emphasize that employee learning is often more important than formal training.	What skills should I develop now for the future? Although the acquisition of new skills is hard to measure, the attainment of specialized licenses or earning of a graduate degree are tangible benchmarks.

Table 2 Beyond Profits: Measuring Performance Using the Balanced Scorecard. *Because the concept of organizational performance is multidimensional, wise managers realize that understanding organizational performance is like flying a plane pilots must be on track in terms of altitude, air speed, and oil pressure and make sure*

they have enough gas to finish their flight plan. For tracking organizational performance, assessing how the organization is doing financially is just a starting point. The "balanced scorecard" encourages managers to also monitor how well the organization is serving customers, managing internal activities, and setting the stage for future improvements. This provides a fast but comprehensive view of the organization. As shown below, monitoring these four dimensions also can help individuals assess themselves.

Financial Measures

Financial measures of performance relate to organizational effectiveness and profits. Examples include financial ratios such as return on assets, return on equity, and return on investment. Other common financial measures include profits and stock price. Such measures help answer the key question "How do we look to shareholders?"

Financial performance measures are commonly articulated and emphasized within an organization's annual report to shareholders. To provide context, such measures should be objective and be coupled with meaningful referents, such as the firm's past performance. For example, Starbucks's 2009 annual report highlights the firm's performance in terms of net revenue, operating income, and cash flow over a five-year period.

Customer Measures

Customer measures of performance relate to customer attraction, satisfaction, and retention. These measures provide insight to the key question "How do customers see us?" Examples might include the number of new customers and the percentage of repeat customers.

Starbucks realizes the importance of repeat customers and has taken a number of steps to satisfy and to attract regular visitors to their stores. For example, Starbucks rewards regular customers with free drinks and offers all customers free Wi-Fi access (Miller, 2010). Starbucks also encourages repeat visits by providing cards with codes for free iTunes downloads. The featured songs change regularly, encouraging frequent repeat visits.

Internal Business Process Measures

Internal business process measures of performance relate to organizational efficiency. These measures help answer the key question "What must we excel at?" Examples include the time it takes to manufacture the organization's good or deliver a service. The time it takes to create a new product and bring it to market is another example of this type of measure.

Organizations such as Starbucks realize the importance of such efficiency measures for the long-term success of its organization, and Starbucks carefully examines its processes with the goal of decreasing order fulfillment time. In one recent example, Starbucks efficiency experts challenged their employees to assemble a Mr. Potato Head to understand how work could be done more quickly (Jargon, 2009). The aim of this exercise was to help Starbucks employees in general match the speed of the firm's high performers, who boast an average time per order of twenty-five seconds.

Learning and Growth Measures

Learning and growth measures of performance relate to the future. Such measures provide insight to tell the organization, "Can we continue to improve and create value?" Learning and growth measures focus on innovation and proceed with an understanding that strategies change over time. Consequently, developing new ways to add value will be needed as the organization continues to adapt to an evolving environment. An example of a learning and growth measure is the number of new skills learned by employees every year.

One way Starbucks encourages its employees to learn skills that may benefit both the firm and individuals in the future is through its tuition reimbursement program. Employees who have worked with Starbucks for more than a year are eligible. Starbucks hopes that the knowledge acquired while earning a college degree might provide employees with the skills needed to develop innovations that will benefit the company in the future. Another benefit of this program is that it helps Starbucks reward and retain high-achieving employees.

Measuring Performance Using the Triple Bottom Line

Ralph Waldo Emerson once noted, “Doing well is the result of doing good. That’s what capitalism is all about.” While the balanced scorecard provides a popular framework to help executives understand an organization’s performance, other frameworks highlight areas such as social responsibility. One such framework, the triple bottom line, emphasizes the three Ps of *people* (making sure that the actions of the organization are socially responsible), the *planet* (making sure organizations act in a way that promotes environmental sustainability), and traditional organization *profits*. This notion was introduced in the early 1980s but did not attract much attention until the late 1990s.

Figure 2: The triple bottom line emphasizes the three Ps of people (social concerns), planet (environmental concerns), and profits (economic concerns).

In the case of Starbucks, the firm has made clear the importance it attaches to the planet by creating an environmental mission statement (“Starbucks is committed to a role of environmental leadership in all facets of our business”) in addition to its overall mission (Starbucks, 2011). In terms of the “people” dimension of the triple bottom line, Starbucks strives to purchase coffee beans harvested by farmers who work under humane conditions and are paid reasonable wages. The firm works to be profitable as well, of course.

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PESTEL Analysis: An Organization and Its Environment

What Is the Environment?

For any organization, the environment consists of the set of external conditions and forces that have the potential to influence the organization. In the case of Subway, for example, the environment contains its customers, its rivals such as McDonald's and Kentucky Fried Chicken, social trends such as the shift in society toward healthier eating, political entities such as the US Congress, and many additional conditions and forces.

It is useful to break the concept of the environment down into two components. The general environment (or macroenvironment) includes overall trends and events in society such as social trends, technological trends, demographics, and economic conditions. The industry (or competitive environment) consists of multiple organizations that collectively compete with one another by providing similar goods, services, or both.

Every action that an organization takes, such as raising its prices or launching an advertising campaign, creates some degree of changes in the world around it. Most organizations are limited to influencing their industry. Subway's move to cut salt in its sandwiches, for example, may lead other fast-food firms to revisit the amount of salt contained in their products. A few organizations wield such power and influence that they can shape some elements of the general environment. While most organizations simply react to major technological trends, for example, the actions of firms such as Intel, Microsoft, and Apple help create these trends. Some aspects of the general environment, such as demographics, simply must be taken as a given by all organizations. Overall, the environment has a far greater influence on most organizations than most organizations have on the environment.

Why Does the Environment Matter?

Understanding the environment that surrounds an organization is important to the executives in charge of the organizations. There are several reasons for this. First, the environment provides resources that an organization needs in order to create goods and services. In the seventeenth century, British poet John Donne famously noted that "no man is an island." Similarly, it is accurate to say that no organization is self-sufficient. As the human body must consume oxygen, food, and water, an organization needs to take in resources such as labor, money, and raw materials from outside its boundaries. Subway, for example, simply would cease to exist without the contributions of the franchisees that operate its stores, the suppliers that provide food and other necessary inputs, and the customers who provide Subway with money through purchasing its products. An organization cannot survive without the support of its environment.

Second, the environment is a source of opportunities and threats for an organization. Opportunities are events and trends that create chances to improve an organization's performance level. In the late 1990s, for example, Jared Fogle's growing fame created an opportunity for Subway to position itself as a healthy alternative to traditional fast-food restaurants. Threats are events and trends that may undermine an organization's performance. Subway faces a threat from some upstart restaurant chains. Saladworks, for example, offers a variety of salads that contain fewer than five hundred calories. Noodles and Company offers a variety of sandwiches, pasta dishes, and salads that contain fewer than four hundred calories. These two firms are much smaller than Subway, but they could grow to become substantial threats to Subway's positioning as a healthy eatery.

Executives must also realize that virtually any environmental trend or event is likely to create opportunities for some organizations and threats for others. This is true even in extreme cases. In addition to horrible human death and suffering, the March 2011 earthquake and tsunami in Japan devastated many organizations, ranging from small businesses to corporate giants such as Toyota, whose manufacturing capabilities were undermined. As odd as it may seem, however, these tragic events also opened up significant opportunities for other organizations. The rebuilding of infrastructure and dwellings requires concrete, steel, and other materials. Japanese concrete manufacturers, steelmakers, and construction companies are likely to be very busy in the years ahead.

Third, the environment shapes the various strategic decisions that executives make as they attempt to lead their organizations to success. The environment often places important constraints on an organization's goals, for example. A firm that sets a goal of increasing annual sales by 50 percent might struggle to achieve this goal during an economic recession or if several new competitors enter its business. Environmental conditions also need to be taken into account when examining whether to start doing business in a new country, whether to acquire another company, and whether to launch an innovative product, to name just a few.

The Elements of the General Environment: PESTEL Analysis

An organization's environment includes factors that it can readily affect as well as factors that largely lay beyond its influence. The latter set of factors are said to exist within the general environment. Because the general environment often has a substantial influence on an organization's level of success, executives must track trends and events as they evolve and try to anticipate the implications of these trends and events.

PESTEL analysis is one important tool that executives can rely on to organize factors within the general environment and to identify how these factors influence industries and the firms within them. PESTEL is an anagram, meaning it is a word that created by using parts of other words. In particular, PESTEL reflects the names of the six segments of the general environment: (1) political, (2) economic, (3) social, (4) technological, (5) environmental, and (6) legal. Wise executives carefully examine each of these six segments to identify major opportunities and threats and then adjust their firms' strategies accordingly.

P	Political factors include elements such as tax policies, changes in trade restrictions and tariffs, and the stability of governments.
E	Economic factors include elements such as interest rates, inflation rates, gross domestic product, unemployment rates, levels of disposable income, and the general growth or decline of the economy.
S	Social factors include trends in demographics such as population size, age, and ethnic mix, as well as cultural trends such as attitudes toward obesity and consumer activism.
T	Technological factors include, for example, changes in the rate of new product development, increases in automation, and advancements in service industry delivery.
E	Environmental factors include, for example, natural disasters and weather patterns.
L	Legal factors include laws involving issues such as employment, health and safety, discrimination, and antitrust.

Table 1 PESTEL *Examining the general enviornment involves gaining an understanding of key factors and trends in broader society.* PESTEL *analysis is a popular framework for organizing these factors and trends and isolating how they influence industries and the firms within them. Below we describe each of the six dimensions associated with* PESTEL *analysis: political*, *economic*, *social*, *technological*, *environmental*, *and legal.*

P Is for "Political"

The political segment centers on the role of governments in shaping business. This segment includes elements such as tax policies, changes in trade restrictions and tariffs, and the stability of governments (Table 2 "Political Factors"). Immigration policy is an aspect of the political segment of the general environment that offers important implications for many different organizations. What approach to take to illegal immigration into the United States from Mexico has been a hotly debated dilemma. Some hospital executives have noted that illegal immigrants put a strain on the health care system because immigrants seldom can pay for medical services and hospitals cannot by law turn them away from emergency rooms.

The extent to which companies developing clean energy sources should be subsidized by the government versus being left on their own to compete with providers of traditional energy sources is currently a hotly contested political issue.
The use of child labor was once commonplace in the United States now firms face political scrutiny when using overseas suppliers that employ child labor.
The word *tariff* derived from an Arabic word meaning "fees to be paid." By levying tariffs and implementing other trade restrictions, governments can – to some extent – protect domestic firms from international competition.
The stability of the US government provides a source of confidence for foreign firms who want to do business in the United States. Countries that face frequent regime change and political turmoil have a harder time attracting foreign investments.
One of the most important duties of elected officials in the United States is to debate and set new tax policies.

Table 2 Political Factors *Examples of several key trends representing political factors in the general environment are illustrated above.* Proposals to provide support to businesses are often featured within political campaigns.

Meanwhile, farmers argue that a tightening of immigration policy would be harmful because farmers rely heavily on cheap labor provided by illegal immigrants. In particular, if farmers were forced to employ only legal workers, this would substantially increase the cost of vegetables. Restaurant chains such as Subway would then pay higher prices for lettuce, tomatoes, and other perishables. Subway would then have to decide whether to absorb these costs or pass them along to customers by charging more for subs. Overall, any changes in immigration policy will have implications for hospitals, farmers, restaurants, and many other organizations.

E Is for "Economic"

The economic segment centers on the economic conditions within which organizations operate. It includes elements such as interest rates, inflation rates, gross domestic product, unemployment rates, levels of disposable income, and the general growth or decline of the economy. The economic crisis of the late 2000s has had a tremendous negative effect on a vast array of organizations. Rising unemployment discouraged consumers from purchasing expensive, nonessential goods such as automobiles and television sets. Bank failures during the economic crisis led to a dramatic tightening of credit markets. This dealt a huge blow to home builders, for example, who saw demand for new houses plummet because mortgages were extremely difficult to obtain.

Housing starts in an economic indicator that measures the number of houses, apartments, and condos on which new construction has been started. Because construction involves a wide array of industries–concrete, steel, wood, drywall, plumbing, banks, and many others–housing starts are a carefully watched measure of economic conditions.
Gross domestic product (GDP) refers to the market value of goods and services within a country produced in a given time period and serves as a rough indicator of a country's standard of living. The United States has a much larger GDP than China, but China has enjoyed a much higher rate of GDP growth in recent years.
The Federal Reserve System (commonly referred to as "The Fed") is the United States' central banking system. The Fed attempts to strengthen the economy through its decisions, such as setting short-term interest rates.
Discretionary income refers to the amount of money individuals have to spend after all necessary bills are paid. As discretionary income increases, firms such as boutique clothing retailers that sell nonessential goods and services are more likely to prosper.

Table 3 Economic Factors. *Examples of several key trends representing economic factors in the general environment are illustrated below.*

The unemployment rate is the percentage of the labor force actively lookin for employment within the last four weeks. During the Great Depression of the 1930s, the United States suffered through an unemployment rate of approximately 25%.

Some businesses, however, actually prospered during the crisis. Retailers that offer deep discounts, such as Dollar General and Walmart, enjoyed an increase in their customer base as consumers sought to find ways to economize. Similarly, restaurants such as Subway that charge relatively low prices gained customers, while high-end restaurants such as Ruth's Chris Steak House worked hard to retain their clientele.

Decisions about interest rates made by the Federal Reserve create opportunities for some organizations and threats for others.

S Is for "Social"

A generation ago, ketchup was an essential element of every American pantry and salsa was a relatively unknown product. Today, however, food manufacturers sell more salsa than ketchup in the United States. This change reflects the social segment of the general environment. Social factors include trends in demographics such as population size, age, and ethnic mix, as well as cultural trends such as attitudes toward obesity and consumer activism. The exploding popularity of salsa reflects the increasing number of Latinos in the United States over time, as well as the growing acceptance of Latino food by other ethnic groups.

The rise of upscale cupcake outlets reflects a current trend in American eateries: pricey specialty stores are very popular among some consumers.
Hunters remain a powerful force in American society, but their ranks shrunk by 10% between 1996 and 2006. Wildlife agencies worry about the loss of license-fee revenue will affect their ability to manage land and water resources, and lower levels of demand for their products threaten the success of gun makers.
In the 1800s, most American couples raised many children. Farmers, for example, took this approach because it supplied labor that small farms needed in order to operate. Today, most families are smaller.
One in three Americans is obese, due in part to the increasing prevalence of fast-good restaurants and the popularity of sedentary activities such as playing video games.
Hemline theory contends that women's skirt lengths predict stock market increases and declines. The idea was born in the 1920s when economist George Taylor noticed that many women raised their skirts to reveal their silk stockings when times were good, but lowered their skirts to hide the fact that they weren't wearing stockings when times were tough.
The tendency to collect material items while being reluctant to throw them away has led to a rise in self-storage outlets as well as awareness of a hoarding epidemic.

Table 3.4 Social Factors. *Examples of several key trends representing social factors in the general environment are illustrated above.*

Sometimes changes in the social segment arise from unexpected sources. Before World War II, the American workforce was overwhelmingly male. When millions of men were sent to Europe and Asia to fight in the war, however, organizations had no choice but to rely heavily on female employees. At the time, the attitudes of many executives toward women were appalling. Consider, for example, some of the advice provided to male supervisors of female workers in the July 1943 issue of *Transportation Magazine*:1

- Older women who have never contacted the public have a hard time adapting themselves and are inclined to be cantankerous and fussy. It's always well to impress upon older women the importance of friendliness and courtesy.
- General experience indicates that "husky" girls—those who are

just a little on the heavy side—are more even tempered and efficient than their underweight sisters.

- Give every girl an adequate number of rest periods during the day. You have to make some allowances for feminine psychology. A girl has more confidence and is more efficient if she can keep her hair tidied, apply fresh lipstick and wash her hands several times a day.

The tremendous contributions of female workers during the war contradicted these awful stereotypes. The main role of women who assembled airplanes, ships, and other war materials was to support the military, of course, but their efforts also changed a lot of male executives' minds about what females could accomplish within organizations if provided with opportunities. Inequities in the workplace still exist today, but modern attitudes among men toward women in the workplace are much more enlightened than they were in 1943.

Women's immense contributions to the war effort during World War II helped create positive social changes in the ensuing decades.

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Beyond being a positive social change, the widespread acceptance of women into the workforce has created important opportunities for certain organizations. Retailers such as Talbot's and Dillard's sell business attire to women. Subway and other restaurants benefit when the scarceness of time lead dual income families to purchase take-out meals rather than cook at home.

A surprising demographic trend is that both China and India have more than twice as many English-speaking college graduates each year than does the United States.

T Is for "Technological"

The technological segment centers on improvements in products and services that are provided by science. Relevant factors include, for example, changes in the rate of new product development, increases in automation, and advancements in service industry delivery. One key feature of the modern era is the ever-increasing pace of technological innovation. In 1965, Intel cofounder Gordon E. Moore offered an idea that has come to be known as Moore's law. Moore's law suggests that the performance of microcircuit technology roughly doubles every two years. This law has been very accurate in the decades since it was offered.

Unsuccessful technological innovations such a Smell-O-Vision (a system that would release different odors that matched the events shown on screen) highlight the risk associated with the technology sector. Image watching a show on horse stables!
The adoption rate of new technology is closely monitored by market research firms. The Internet reached 50 million users in 4 years. To reach the same number of users took 13 years for TV and 38 years for radio.
The dramatic changes in the video game industry over the past 25 years highlight the need to constantly adapt to technological factors to maintain market leadership. Once-mighty Atari has given way to current leaders Sony, Nintendo, and Microsoft.
Moore's law suggests that the performance of microcircuit technology roughly doubles every two years.
The amount of government spending for research and development affects numerous industries. The government's decision to dramatically scale back moon-based space programs may reduce the pace of scientific breakthroughs.

Table 5 Technological Factors. *Examples of several key trends representing technological factors in the general environment are illustrated above.*

One implication of Moore's law is that over time electronic devices can become smaller but also more powerful. This creates important opportunities and threats in a variety of settings. Consider, for example, photography. Just a decade ago, digital cameras were relatively large and they produced mediocre images. With each passing year, however, digital cameras have become smaller, lighter, and better. Meanwhile, film photography icon Kodak has been forced to abandon products that had been successful for decades. In 2005, the firm announced that it would stop producing black-and-white photographic paper. Four years later, Kodachrome color film was phased out.

Successful technologies are embraced at a much faster rate than in earlier generations. The Internet reached fifty million users in only four years. In contrast, television reached the same number of users in thirteen years and radio thirty-eight years. This trend creates great opportunities for organizations that depend on emerging technologies. Writers of applications for Apple's iPad and other tablet devices, for example, are able to target a fast-growing population of users. At the same time, organizations that depend on technologies that are being displaced must be aware that consumers could abandon them at a very rapid pace. As more and more Internet users rely on Wi-Fi service, the demand for cable modems may plummet.

Moore's law explains how today's iPhone can be one hundred times faster, one hundred times lighter, and ten times less expensive than a "portable" computer built in the 1980s.

Although the influence of the technological segment on technology-based companies such as Panasonic and Apple is readily apparent, technological trends and events help to shape low-tech businesses too. In 2009, Subway started a service called Subway Now. This service allows customers to place their orders in advance using text. By offering customers this service, Subway is also responding to a trend in the general environment's social segment: the need to save time in today's fast-paced society.

E Is for "Environmental"

The environmental segment involves the physical conditions within which organizations operate. It includes factors such as natural disasters, pollution levels, and weather patterns. The threat of pollution, for example, has forced municipalities to treat water supplies with chemicals. These chemicals increase the safety of the water but detract from its taste. This has created opportunities for businesses that provide better-tasting water. Rather than consume cheap but bad-tasting tap water, many consumers purchase bottled water. Indeed, according to the Beverage Marketing Corporation, the amount of bottled water consumed by the average American increased from 1.6 gallons in 1976 to 28.3 gallons in 2006 (Earth911). At present, roughly one-third of Americans drink bottled water regularly.

The Subaru automotive plant in Lafayette, Indiana, was the first auto manufacturing facility to achieve zero landfill status.
Debate has raged over climate change in recent years. To the extend that more policy markers and consumers believe that human activity is increasing temperatures on the Earth, opportunities could increase for solar energy companies.
Individuals embracing the three Rs of green living–reduce, reuse, recycle–has fueled new business concepts such as Recycle Match, a firm that brings together waste products with businesses that need those materials.
Concern about the environmental effects of burning fossil fuels has contributed to the growing popularity of scooters.
The increase in the number of food cooperatives reflects growing interest in sustainable, natural foods that are produced with a high degree of social responsibility.

Table 6 Environmental Factors

Examples of several key trends representing enviornmental factors in the general environment are illustrated above.

As is the case for many companies, bottled water producers not only have benefited from the general environment but also have been threatened by it. Some estimates are that 80 percent of plastic bottles end up in landfills. This has led some socially conscious consumers to become hostile to bottled water. Meanwhile, water filtration systems offered by Brita and other companies are a cheaper way to obtain clean and tasty water. Such systems also hold considerable appeal for individuals who feel the need to cut personal expenses due to economic conditions.

A key trend within the environmental segment is an increasing emphasis on conserving fossil fuels.

L Is for "Legal"

The legal segment centers on how the courts influence business activity. Examples of important legal factors include employment laws, health and safety regulations, discrimination laws, and antitrust laws.

Intellectual property rights are a particularly daunting aspect of the legal segment for many organizations. When a studio such as Pixar produces a movie, a software firm such as Adobe revises a program, or a video game company such as Activision devises a new game, these firms are creating intellectual property. Such firms attempt to make profits by selling copies of their movies, programs, and games to individuals. Piracy of intellectual property—a process wherein illegal copies are made and sold by others—poses a serious threat to such profits. Law enforcement agencies and courts in many countries, including the United States, provide organizations with the necessary legal mechanisms to protect their intellectual property from piracy.

Electronic recycling laws are creating opportunities for "green collar jobs." A recent Missouri law, for example, requires computer electronic equipment manufacturers to develop and implement recycling plans.
The Sherman Antitrust Act of 1890 limits cartels and monopolies in the United States. Senator John Sherman was the principal author of this legislation.
In the United States, it is illegal to discriminate against anyone based on age, race, religion, gender or disability.
The role of the Occupational Safety and Health Administration (OSHA) is to prevent work-related injuries, diseases, and fatalities by enforcing standards for workplace safety and health.
Laws requiring that nutrition information must appear on the packaging of most food products are intended to protect consumers and help them make informed choices.

Table 7 Legal Factors. *Examples of several key trends representing legal factors in the general environment are illustrated below*

In other countries, such as China, piracy of intellectual property is quite common. Three other general environment segments play a role in making piracy a major concern. First, in terms of the social segment, China is the most populous country in the world. Second, in terms of the economic segment, China's affluence is growing rapidly. Third, in terms of the technological segment, rapid advances in computers and communication have made piracy easier over time. Taken together, these various general environment trends lead piracy to be a major source of angst for firms that rely on intellectual property to deliver profits.

A key legal trend in recent years is forcing executives to have greater accountability for corporate misdeeds via laws such as the 2002 Sarbanes-Oxley Act.

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Add morter and pestle image.

Just as a mortar and pestle are used to crush food, PESTEL can crush an organization.

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Evaluating Industry

Evaluating the Industry

POTENTIAL ENTRANTS are firms that are not currently considered viable competitors in the industry but that may become viable competitors in the future. For example, Tesla Motors' production of electric vehicles poses a threat to displace the traditional powers in the auto industry, and Chinese auto makers are rumored to be eyeing the US market.
SUPPLIERS to the auto industry include firms such as Lear Corporation who produces auto interior systems.
INDUSTRY COMPETITORS in the auto industry include firms such as Ford, Chrysler, and GM.
BUYERS are those firms that buy directly from the industry such as automobile dealerships. Automakers also have to pay careful attention to end users, of course, such as individual drivers and rental car agencies.
SUBSTITUTES for the auto industry's products include bicycles and mass transit. Luckily for automakers competing in the US market, Americans are notoriously reluctant to embrace these substitutes.

Table 1 Industry Analysis. *Understanding the dynamics that shape how much profit potential exists within an industry is key to knowing how likely a particular firm is to succeed within the industry. There are five key forces that determine the profitability of a particular industry.*

The Purpose of Five Forces Analysis

Visit the executive suite of any company and the chances are very high that the chief executive officer and her vice presidents are relying on five forces analysis to understand their industry. Introduced more than thirty years ago by Professor Michael Porter of the Harvard Business School, five forces analysis has long been and remains perhaps the most popular analytical tool in the business world.

Porter's Five Forces

The purpose of five forces analysis is to identify how much profit potential exists in an industry. To do so, five forces analysis considers the interactions among the competitors in an industry, potential new entrants to the industry, substitutes for the industry's offerings, suppliers to the industry, and the industry's buyers (Porter, 1979). If none of these five forces works to undermine profits in the industry, then the profit potential is very strong. If all the forces work to undermine profits, then the profit potential is very weak. Most industries lie somewhere in between these extremes. This could involve, for example, all five forces providing firms with modest help or two forces encouraging profits while the other three undermine profits. Once executives determine how much profit potential exists in an industry, they can then decide what strategic moves to make to be successful. If the situation looks bleak, for example, one possible move is to exit the industry.

The Rivalry among Competitors in an Industry

The competitors in an industry are firms that produce similar products or services. Competitors use a variety of moves such as advertising, new offerings, and price cuts to try to outmaneuver one another to retain existing buyers and to attract new ones. Because competitors seek to serve the same general set of buyers, rivalry can become intense. Subway faces fierce competition within the restaurant business, for example. This is illustrated by a quote from the man who built McDonald's into a worldwide icon. Former CEO Ray Kroc allegedly once claimed that "if any of my competitors were drowning, I'd stick a hose in their mouth." While this sentiment was (hopefully) just a figure of speech, the announcement in March 2011 that Subway had surpassed McDonald's in terms of numbers of stores might lead the hostility of McDonald's toward its rival to rise.

Rivalry among existing competitors tends to be high to the extent that…

Competitors are numerous or are roughly equal in size and power.	No one firm rules the industry, and cutthroat moves are likely as firms jockey for position.
The growth rate of the industry is slow.	A shortage of new customers leads firms to steal each other's customers.
Competitors are not differentiated from each other.	This forces firms to compete based on price rather than based on the uniqueness of their offerings.
Fixed costs in the industry are high.	These costs must be covered, even if it means slashing prices in order to do so.
Exit barriers are high.	Firms must stay and fight rather than leaving the industry gracefully.
Excess capacity exists in the industry.	When too much of a product is available, firms must work hard to earn sales.
Capacity must be expanded in large increments to be efficient.	The high costs of adding these increments needs to be covered.
The product is perishable	Firms need to sell their wares before they spoil and become worthless.

Table 2 Rivalry. *High levels of rivalry tend to reduce the profit potential of an industry.* A *number of characteristics that affect the intensity of the rivalry among competitors are illustrated above.*

Understanding the intensity of rivalry among an industry's competitors is important because the degree of intensity helps shape the industry's profit potential. Of particular concern is whether firms in an industry compete based on price. When competition is bitter and cutthroat, the prices competitors charge—and their profit margins—tend to go down. If, on the other hand, competitors avoid bitter rivalry, then price wars can be avoided and profit potential increases.

Every industry is unique to some degree, but there are some general characteristics that help to predict the likelihood that fierce rivalry will erupt. Rivalry tends to be fierce, for example, to the extent that the growth rate of demand for the industry's offerings is low (because a lack of new customers forces firms to compete more for existing customers), fixed costs in the industry are high (because firms will fight to have enough customers to cover these costs), competitors are not differentiated from one another (because this forces firms to compete based on price rather than based on the uniqueness of their offerings), and exit barriers in the industry are high (because firms do not have the option of leaving the industry gracefully). Exit barriers can include emotional barriers, such as the bad publicity associated with massive layoffs, or more objective reasons to stay in an industry, such as a desire to recoup considerable costs that might have been previously spent to enter and compete.

High-Concentration Industries
Circuses (89%) and Breakfast cereal manufacturing (85%)
Medium-Concentration Industries
Flight training (52%) and Sugar manufacturing (60%)
Low-Concentration (or "Fragmented") Industries
Full-service restaurants (9%), Legal services (3%), Truck driving schools (27%), and Telephone call centers (22%)

Table 3 Industry Concentration. *Industry concentration refers to the extent to which large firms dominate an industry. Buyers and suppliers generally have more bargaining power when they are from concentrated industries. This is because the firms that do business with them have fewer options when seeking buyers and suppliers. One popular way to measure industry concentration is via the percentage of total industry output that is produced by the four biggest competitors. Below are examples of industries that have high* (80%-100%), *medium* (50%-79%), *and low* (*below* 50%) *levels of concentration.*

Industry concentration is an important aspect of competition in many industries. Industry concentration is the extent to which a small number of firms dominate an industry. Among circuses, for example, the four largest companies collectively own 89 percent of the market. Meanwhile, these companies tend to keep their competition rather polite. Their advertising does not lampoon one another, and they do not put on shows in the same city at the same time. This does not guarantee that the circus industry will be profitable; there are four other forces to consider as well as the quality of each firm's strategy. But low levels of rivalry certainly help build the profit potential of the industry.

In contrast, the restaurant industry is fragmented, the largest rivals control just a small fraction of the business and a large number of firms are important participants. Rivalry in fragmented industries tends to become bitter and fierce. Quiznos, a chain of sub shops that is roughly 15 percent the size of Subway, has directed some of its advertising campaigns directly at Subway, including one depicting a fictional sub shop called "Wrong Way" that bore a strong resemblance to Subway.

Within fragmented industries, it is almost inevitable that over time some firms will try to steal customers from other firms, such as by lowering prices, and that any competitive move by one firm will be matched by others.

Economies of scale – As the number of customers a firm seves increases, the cost of serving each customer tends to decrease. This is because fixed costs–the expenses the firm must pay, such as the loan payments on an automobile factory–are allocated across a larger number of sales. When the firms in an industry enjoy significant economies of scale, new firms struggle to be able to sell their wares at competitive prices.

Capital requirements – The more expensive it is to enter a business, the less likely a new firm is to attempt to enter it. When these capital requirements are substantial (as in the automobile and many other manufacturing industries), existing competitors have less fear of new firms entering their market. It is simply very difficult to gather up enough cash to enter certain businesses.

Access to distribution channels – The ability to get goods and services to customers can pose a significant challenge to would-be newcomers. In the auto industry, for example, a new firm would struggle to match the network of dealerships enjoyed by Ford, GM, and other auto makers.

Government policy – Decisions made by governments can deter or encourage potential new entrants. In 2009, the U.S. government kept GM afloat via a massive infusion of cash. Had GM been left to die instead, this could have opened the door for a new company to enter the industry, perhaps by buying some of GM's factories.

Differentiation – Auto makers spend millions of dollars each year on advertising in order to highlight the unique features of their cars. A new entrant would struggle to match the differentiation that years of advertising have created for various brands.

Switching costs – Switching costs endured by consumers are one of the challenges facing the makers of alternative fuel vehicles. A massive number of gas stations and repair shops are in place to support gasoline-powered cars, but few facilities can recharge or fix electric cars. At present, few consumers are willing to live with the significant hassles and inconvenience that arise when purchasing an alternative fuel vehicle.

Expected retaliation – New firms must be concerned about whether current industry members will aggressively respond to them entering the market. If a firm succeeded in entering the automobile business, for example, existing companies might slash their prices in order to keep their market share intact.

Cost advantages independent of size – Proprietary technology, access to raw materials, and desirable geographic location are all examples of cost advantages not directly associated with size (and economies of scale). In the auto industry, the decades of engineering experience possessed by the major auto markers is an example of such an advantage. A new entrant would struggle to duplicate this know-how at any price.

Table 4 New Entrants. *The Great Wall of China effectively protected China against potential raiders for centuries. The metaphor of a high* *wall as a defense against potential entrants is a key element in Porter's five forces model. Industries with higher barriers to entry are in a safer defensive position that industries with lower barriers. Below we describe several factors that make it difficult for would-be invaders to enter an industry.*

The Threat of Potential New Entrants to an Industry

Competing within a highly profitable industry is desirable, but it can also attract unwanted attention from outside the industry. Potential new entrants to an industry are firms that do not currently compete in the industry but may in the future. New entrants tend to reduce the profit potential of an industry by increasing its competitiveness. If, for example, an industry consisting of five firms is entered by two new firms, this means that seven rather than five firms are now trying to attract the same general pool of customers. Thus executives would need to analyze how likely it is that one or more new entrants will enter their industry as part of their effort to understand the profit potential that their industry offers.

New entrants may join the fray within an industry in several different ways. Start-up companies created by entrepreneurs, foreign firms that decide to enter a new geographic area, supplier firmsmay choose to enter their customers' business, or buyer firms that choose to enter their suppliers' business. The likelihood of these four paths being taken varies across industries. Restaurant firms such as Subway, for example, do not need to worry about their buyers entering the industry because they sell directly to individuals, not to firms. It is also unlikely that Subway's suppliers, such as farmers, will make a big splash in the restaurant industry.

On the other hand, entrepreneurs launch new restaurant concepts every year, and one or more of these concepts may evolve into a fearsome competitor. Also, competitors based overseas sometimes enter Subway's core US market. In February 2011, Australia-based Oporto opened its first US store in California (Odell, 2011). Oporto operates more than 130 chicken burger restaurants in its home country. Time will tell whether this new entrant has a significant effect on Subway and other restaurant firms. Because a chicken burger closely resembles a hamburger, McDonald's and Burger King may have more to fear from Oporto than does Subway.

Every industry is unique to some degree, but some general characteristics help to predict the likelihood that new entrants will join an industry. New entry is less likely, for example, to the extent that existing competitors enjoy economies of scale (because new entrants struggle to match incumbents' prices), capital requirements to enter the industry are high (because new entrants struggle to gather enough cash to get started), access to distribution channels is limited (because new entrants struggle to get their offerings to customers), governmental policy discourages new entry, differentiation among existing competitors is high (because each incumbent has a group of loyal customers that enjoy its unique features), switching costs are high (because this discourages customers from buying a new entrant's offerings), expected retaliation from existing competitors is high, and cost advantages independent of size exist.

Cooking at home can be an effective substitute for eating at restaurants, especially in challenging economic times.
E-mails and faxes are less expensive substitutes for some of the US Postal Service's offerings. Meanwhile, text messages can serve as substitutes for many e-mails.
Typewriting classes were once common in schools. But once personal computers and printers became widely accepted, the typewriter industry declined dramatically.
Railroads once held almost a monopoly position on freight transportation. However, the rise of the trucking industry reduced demand for the railroad industry's services.
DIRECTV's commercials compare the firm's offerings not only to what its fellow satellite television provider DISH Network provides but also to the offerings of a close substitute–cable television companies.

Table 5 Substitutes. A *substitute teacher is a person who fills in for a teacher. Some substitute teachers are almost as good as the "real" teacher while others are woefully inadequate. In business, the competitors in an industry not only must watch each other, they must keep an eye on firms in other industries whose products or services*

can serve as effective substitutes for their offerings. In some cases, substitutes are so effective that they are said to "disrupt" the industry, meaning they kill most or all industry demand. Below we note a number of effective substitutes for particular industries.

The Threat of Substitutes for an Industry's Offerings

Executives need to take stock not only of their direct competition but also of players in other industries that can steal their customers. Substitutes are offerings that differ from the goods and services provided by the competitors in an industry but that fill similar needs to what the industry offers. How strong of a threat substitutes are depends on how effective substitutes are in serving an industry's customers.

At first glance, it could appear that the satellite television business is a tranquil one because there are only two significant competitors—DIRECTV and DISH Network. These two industry giants, however, face a daunting challenge from substitutes. The closest substitute for satellite television is provided by cable television firms, such as Comcast and Charter Communications. DIRECTV and DISH Network also need to be wary of streaming video services, such as Netflix, and video rental services, such as Redbox. The availability of viable substitutes places stringent limits on what DIRECTV and DISH Network can charge for their services. If the satellite television firms raise their prices, customers will be tempted to obtain video programs from alternative sources. This limits the profit potential of the satellite television business.

In other settings, viable substitutes are not available, and this helps an industry's competitors enjoy profits. Like lightbulbs, candles can provide lighting within a home. Few consumers, however, would be willing to use candles instead of lightbulbs. Candles simply do not provide as much light as lightbulbs. Also, the risk of starting a fire when using candles is far greater than the fire risk of using lightbulbs. Because candles are a poor substitute, lightbulb makers such as General Electric and Siemens do not need to fear candle makers stealing their customers and undermining their profits.

The dividing line between which firms are competitors and which firms offer substitutes is a challenging issue for executives. Most observers would agree that, from Subway's perspective, sandwich maker Quiznos should be considered a competitor and that grocery stores such as Kroger offer a substitute for Subway's offerings. But what about full-service restaurants, such as Ruth's Chris Steak House, and "fast causal" outlets, such as Panera Bread? Whether firms such as these are considered competitors or substitutes depends on how the industry is defined. Under a broad definition—Subway competes in the restaurant business—Ruth's Chris and Panera should be considered competitors. Under a narrower definition—Subway competes in the sandwich business—Panera is a competitor and Ruth's Chris is a substitute. Under a very narrow definition—Subway competes in the sub sandwich business—both Ruth's Chris and Panera provide substitute offerings. Thus clearly defining a firm's industry is an important step for executives who are performing a five forces analysis.

A supplier group is powerful if it is dominated by a few companies or is more concentrated than the industry that it supplies.	The DeBeers Company of South Africa owns the vast majority of diamond mines in the world. This gives the firm great leverage when negotiating with various jewelry produces.
A supplier group is powerful if there is no substitute for what the supplier group provides.	Although artificial diamonds are fine for industrial applications, real diamonds are necessary for jewelry. Any groom who thinks otherwise is playing a risky game indeed.
A supplier group is powerful if industry members rely heavily on suppliers to be profitable.	Computer, cellular phone, and digital appliance manufacturers all rely heavily on suppliers in the microchip manufacturing industry.
A supplier group is powerful if industry members face high costs when changing suppliers.	Most computers installed in university classrooms are PCs. A university that wants to switch to using Apple computers would endure enormous costs in money and labor. This strengthens the position of PC makers a bit when they deal with universities.
A supplier group is powerful if their products are differentiated.	Dolby Laboratories offers top-quality audio systems that are backed by a superb reputation. Firms that make home theater equipment and car stereos have little choice but to buy from Dolby because many consumers simply expect to enjoy Dolby's technology.
A supplier group is powerful if it can credibly threaten to compete (integrate forward) in the industry if motivated.	Before a rental car company drives too hard of a bargain when buying cars from an auto maker, it should remember that Ford used to own Hertz.

Table 6 Suppliers. A *number of characteristics that impact the power of suppliers to a given industry.*

The Power of Suppliers to an Industry

Suppliers provide inputs that the firms in an industry need to create the goods and services that they in turn sell to their buyers. A variety of supplies are important to companies, including raw materials, financial resources, and labor. For restaurant firms such as Subway, key suppliers include such firms as Sysco that bring various foods to their doors, restaurant supply stores that sell kitchen equipment, and employees that provide labor.

The relative bargaining power between an industry's competitors and its suppliers helps shape the profit potential of the industry. If suppliers have greater leverage over the competitors than the competitors have over the suppliers, then suppliers can increase their prices over time. This cuts into competitors' profit margins and makes them less likely to be prosperous. On the other hand, if suppliers have less leverage over the competitors than the competitors have over the suppliers, then suppliers may be forced to lower their prices over time. This strengthens competitors' profit margins and makes them more likely to be prosperous. Thus when analyzing the profit potential of their industry, executives must carefully consider whether suppliers have the ability to demand higher prices.

Every industry is unique to some degree, but some general characteristics help to predict the likelihood that suppliers will be powerful relative to the firms to which they sell their goods and services. Suppliers tend to be powerful, for example, to the extent that the suppliers' industry is dominated by a few companies, if it is more concentrated than the industry that it supplies and/or if there is no effective substitute for what the supplier group provides. These circumstances restrict industry competitors' ability to shop around for better prices and put suppliers in a position of strength.

Supplier power is also stronger to the extent that industry members rely heavily on suppliers to be profitable, industry members face high costs when changing suppliers, and suppliers' products are differentiated. Finally, suppliers possess power to the extent that they have the ability to become a new entrant to the industry if they wish. This is a strategy called forward vertical integration. Ford, for example, used a forward vertical integration strategy when it purchased rental car company (and Ford customer) Hertz. A difficult financial situation forced Ford to sell Hertz for $5.6 billion in 2005. But before rental car companies such as Avis and Thrifty drive too hard of a bargain when buying cars from an automaker, their executives should remember that automakers are much bigger firms than are rental car companies. The executives running the automaker might simply decide that they want to enjoy the rental car company's profits themselves and acquire the firm.

Strategy at the Movies

Flash of Genius

When dealing with a large company, a small supplier can get squashed like a bug on a windshield. That is what college professor and inventor Dr. Robert Kearns found out when he invented intermittent windshield wipers in the 1960s and attempted to supply them to Ford Motor Company. As depicted in the 2008 movie *Flash of Genius*, Kearns dreamed of manufacturing the wipers and selling them to Detroit automakers. Rather than buy the wipers from Kearns, Ford replicated the design. An angry Kearns then spent many years trying to hold the firm accountable for infringing on his patent. Kearns eventually won in court, but he paid a terrible personal price along the way, including a nervous breakdown and estrangement from his family. Kearns's lengthy battle with Ford illustrates the concept of bargaining power that is central to Porter's five forces model. Even though Kearns created an exceptional new product, he had little leverage when dealing with a massive, well-financed automobile manufacturer.

A buyer group is powerful when there are relatively few buyers compared to the number of firms supplying the industry.	Buyers that purchase a large percentage of the seller's goods and services are more powerful, as Walmart has demonstrated by aggressively negotiating with suppliers over the years.
A buyer group is powerful when the industry's goods or services are standardized or undifferentiated.	Subway can drive a hard bargain when purchasing commodities such as wheat and yeast is typically identical to another vendor's.
A buyer group is powerful when they face little or no switching costs in changing vendors.	Circuses can find elephants, clowns, and trapeze artists from any source possible. This allows circus managers to shop around for the best prices.
A buyer group is powerful when the good or service purchased by the buyers represents a high percentage of the buyer's costs, encouraging ongoing searches for lower-priced suppliers.	Most consumers pay little attention to prices when buying toothpaste, but may spend hours exhaustively searching the Internet for information on automobile prices.
A buyer group is powerful if it can credibly threaten to compete (integrate backward) in the industry if motivated.	For and General Motors are well known for threatening to self-manufacture auto parts if suppliers do not provide goods and services at acceptable prices.
A buyer group is powerful when the good or service purchased by buyer groups is of limited importance to the quality or price of the buyer's offerings.	While stereo systems and tires are components that car buyers may be sensitive to when making a purchase decision, auto manufacturers can purchase glass and spark plugs from any vendor as long as it meets quality standards. This gives automakers leverage when negotiating with glass and spark plugs companies.

Table 7 Buyers. A *number of characteristics that impact the power of buyers to a given industry are illustrated below.*

The Power of an Industry's Buyers

Buyers purchase the goods and services that the firms in an industry produce. For Subway and other restaurants, buyers are individual people. In contrast, the buyers for some firms are other firms rather than end users. For Procter & Gamble, for example, buyers are retailers such as Walmart and Target who stock Procter & Gamble's pharmaceuticals, hair care products, pet supplies, cleaning products, and other household goods on their shelves.

The relative bargaining power between an industry's competitors and its buyers helps shape the profit potential of the industry. If buyers have greater leverage over the competitors than the competitors have over the buyers, then the competitors may be forced to lower their prices over time. This weakens competitors' profit margins and makes them less likely to be prosperous. Walmart furnishes a good example. The mammoth retailer is notorious among manufacturers of goods for demanding lower and lower prices over time (Bianco & Zellner, 2003). In 2008, for example, the firm threatened to stop selling compact discs if record companies did not lower their prices. Walmart has the power to insist on price concessions because its sales volume is huge. Compact discs make up a small portion of Walmart's overall sales, so exiting the market would not hurt Walmart. From the perspective of record companies, however, Walmart is their biggest buyer. If the record companies were to refuse to do business with Walmart, they would miss out on access to a large portion of consumers.

On the other hand, if buyers have less leverage over the competitors than the competitors have over the buyers, then competitors can raise their prices and enjoy greater profits. This description fits the textbook industry quite well. College students are often dismayed to learn that an assigned textbook costs $150 or more. Historically, textbook publishers have been able to charge high prices because buyers had no leverage. A student enrolled in a class must purchase the specific book that the professor has selected. Used copies are sometimes a lower-cost option, but textbook publishers have cleverly worked to undermine the used textbook market by releasing new editions after very short periods of time.

Of course, the presence of a very high profit industry is attractive to potential new entrants. Firms such as, the publisher of this book, have entered the textbook market with lower-priced offerings. Time will tell whether such offerings bring down textbook prices. Like any new entrant, upstarts in the textbook business must prove that they can execute their strategies before they can gain widespread acceptance. Overall, when analyzing the profit potential of their industry, executives must carefully consider whether buyers have the ability to demand lower prices. In the textbook market, buyers do not.

Every industry is unique to some degree, but some general characteristics help to predict the likelihood that buyers will be powerful relative to the firms from which they purchases goods and services. Buyers tend to be powerful, for example, to the extent that there are relatively few buyers compared with the number of firms that supply the industry, the industry's goods or services are standardized or undifferentiated, buyers face little or no switching costs in changing vendors, the good or service purchased by the buyers represents a high percentage of the buyer's costs, and the good or service is of limited importance to the quality or price of the buyer's offerings.

Finally, buyers possess power to the extent that they have the ability to become a new entrant to the industry if they wish. This strategy is called backward vertical integration. DIRECTV used to be an important customer of TiVo, the pioneer of digital video recorders. This situation changed, however, when executives at DIRECTV grew weary of their relationship with TiVo. DIRECTV then used a backward vertical integration strategy and started offering DIRECTV-branded digital video recorders. Profits that used to be enjoyed by TiVo were transferred at that point to DIRECTV.

The Limitations of Five Forces Analysis

Five forces analysis is useful, but it has some limitations too. The description of five forces analysis provided by its creator, Michael Porter, seems to assume that competition is a zero-sum game, meaning that the amount of profit potential in an industry is fixed. One implication is that, if a firm is to make more profit, it must take that profit from a rival, a supplier, or a buyer. In some settings, however, collaboration can create a larger pool of profit that benefits everyone involved in the collaboration. In general, collaboration is a possibility that five forces analysis tends to downplay. The relationships among the rivals in an industry, for example, are depicted as adversarial. In reality, these relationships are sometimes adversarial and sometimes collaborative. General Motors and Toyota compete fiercely all around the world, for example, but they also have worked together in joint ventures. Similarly, five forces analysis tends to portray a firm's relationships with its suppliers and buyers as adversarial, but many firms find ways to collaborate with these parties for mutual benefit. Indeed, concepts such as just-in-time inventory systems depend heavily on a firm working as a partner with its suppliers and buyers.

INSERT GRAPHIC HERE....

Table 8 Strategic Groups

Strategic groups are sets of firms that follow similar strategies. Understanding the nature of strategic groups within an industry is important in part because the members of a firm's group are usually that firm's closest rivals. Below we illustrate several strategic groups in the restaurant industry.

The analysis of the strategic groups in an industry can offer important insights to executives. Strategic groups are sets of firms that follow similar strategies to one another (Hunt, 1972; Short, et. al., 2007). More specifically, a strategic group consists of a set of industry competitors that have similar characteristics to one another but differ in important ways from the members of other groups.

Understanding the nature of strategic groups within an industry is important for at least three reasons. First, emphasizing the members of a firm's group is helpful because these firms are usually its closest rivals. When assessing their firm's performance and considering strategic moves, the other members of a group are often the best referents for executives to consider. In some cases, one or more strategic groups in the industry are irrelevant. Subway, for example, does not need to worry about competing for customers with the likes of Ruth's Chris Steak House and P. F. Chang's. This is partly because firms confront mobility barriers that make it difficult or illogical for a particular firm to change groups over time. Because Subway is unlikely to offer a gourmet steak as well as the experience offered by fine-dining outlets, they can largely ignore the actions taken by firms in that restaurant industry strategic group.

Second, the strategies pursued by firms within other strategic groups highlight alternative paths to success. A firm may be able to borrow an idea from another strategic group and use this idea to improve its situation. During the recession of the late 2000s, midquality restaurant chains such as Applebee's and Chili's used a variety of promotions such as coupons and meal combinations to try to attract budget-conscious consumers. Firms such as Subway and Quiznos that already offered low-priced meals still had an inherent price advantage over Applebee's and Chili's, however: There is no tipping expected at the former restaurants, but there is at the latter. It must have been tempting to executives at Applebee's and Chili's to try to expand their appeal to budget-conscious consumers by experimenting with operating formats that do not involve tipping.

Third, the analysis of strategic groups can reveal gaps in the industry that represent untapped opportunities. Within the restaurant business, for example, it appears that no national chain offers both very high-quality meals and a very diverse menu. Perhaps the firm that comes the closest to filling this niche is the Cheesecake Factory, a chain of approximately 150 outlets whose menu includes more than 200 lunch, dinner, and dessert items. Ruth's Chris Steak House already offers very high quality food; its executives could consider moving the firm toward offering a very diverse menu as well. This would involve considerable risk, however. Perhaps no national chain offers both very high quality meals and a very diverse menu because doing so is extremely difficult. Nevertheless, examining the strategic groups in an industry with an eye toward untapped opportunities offers executives a chance to consider novel ideas.

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Managing Organizational Resources

Strategic Resources	Expansion
VALUABLE resources aid in improving the organization's effectiveness and efficiency while neutralizing the opportunities and threats of competitors.	Although the airline industry is extremely competitive, Southwest Airlines' turns a profit virtually every year. One key reason why is a legendary organizational culture that inspires employees to do their very best.
RARE resources are those held by few or no other competitors.	Southwest Airlines' culture provides the firm with uniquely strong employee relations in an industry where strikes, layoffs, and poor morale are common.
DIFFICULT-TO-IMITATE resources often involve legally protected intellectual property such as trademarks, patents, or copyrights. Other difficult-to-imitate resources, such as brand names, usually need time to develop fully.	Southwest's culture arose from its very humble beginnings and has evolved across hour decades. Because of this unusual history, other airlines could not replicate Southwest's culture, regardless of how hard they might try.
NONSUBSTITUTABLE resources exist when the resource combinations of other firms cannot duplicate the strategy provided by the resource bundle of a particular firm.	The influence of Southwest's organizational culture extends to how customers are treated by employees. Executives at other airlines would love to attract the customer loyalty that Southwest enjoys, but they have yet to find ways to inspire the kind of customer service that the Southwest culture encourages.

Table 1 Resource-Based Theory: The Basics. *According to resource-based theory, organizations that own "strategic resources" have important competitive advantages over organizations that do not. Some resources, such as cash and trucks, are not considered to be strategic resources because an organization's competitors can readily acquire them. Instead, a resource is strategic to the extent that it is valuable, rare, difficult to imitate, and nonsubstitutable.*

Important Points to Remember:

1. Resources such as Southwest's culture reflect four qualities of competitive advantage–valuable, rare, difficult to imitate, and nonsubstitutable–are ideal because they can create sustained competitive advantages. A resource that has three or less of the qualities can provide an edge in the short term, but competitors can overcome such an advantage eventually.
2. Firms often bundle together multiple resources and strategies (that may not be unique in and of themselves) to create uniquely powerful combinations. Southwest's culture is complemented by approaches that individually could be copied–the airline's emphasis on direct flights, its reliance on one type of plane, and its unique system for passenger boarding–in order to create a unique business model in which effectiveness and efficiency is the envy of competitors.
3. Satisfying only one or two of the valuable, rare, difficult to imitate, nonsubstitutable criteria will likely only lead to competitive parity or a temporary advantage.

Four Characteristics of Strategic Resources

Southwest Airlines provides an illustration of resource-based theory in action. Resource-based theory contends that the possession of strategic resources provides an organization with a golden opportunity to develop competitive advantages over its rivals. These competitive advantages in turn can help the organization enjoy strong profits (Barney, 1991; Wernerfelt, 1981).

A strategic resource is an asset that is valuable, rare, difficult to imitate, and nonsubstitutable (Barney, 1991; Chi, 1994). A resource is valuable to the extent that it helps a firm create strategies that capitalize on opportunities and ward off threats. Southwest Airlines' culture fits this standard well. Most airlines struggle to be profitable, but Southwest makes money virtually every year. One key reason is a legendary organizational culture that inspires employees to do their very best. This culture is also rare in that strikes, layoffs, and poor morale are common within the airline industry.

Competitors have a hard time duplicating resources that are difficult to imitate. Some difficult to imitate resources are protected by various legal means, including trademarks, patents, and copyrights. Other resources are hard to copy because they evolve over time and they reflect unique aspects of the firm. Southwest's culture arose from its very humble beginnings. The airline had so little money that at times it had to temporarily "borrow" luggage carts from other airlines and put magnets with the Southwest logo on top of the rivals' logo. Southwest is a "rags to riches" story that has evolved across several decades. Other airlines could not replicate Southwest's culture, regardless of how hard they might try, because of Southwest's unusual history.

A resource is nonsubstitutable when competitors cannot find alternative ways to gain the benefits that a resource provides. A key benefit of Southwest's culture is that it leads employees to treat customers well, which in turn creates loyalty to Southwest among passengers. Executives at other airlines would love to attract the customer loyalty that Southwest enjoys, but they have yet to find ways to inspire the kind of customer service that the Southwest culture encourages.

Ideally, a firm will have a culture, like Southwests firm will own resources like Southwest's cultures, that embraces the four qualities shown in Table 1 "Resource-Based Theory: The Basics". that have all four of these qualities. If so, these resources can provide not only a competitive advantage but also a sustained competitive advantage—one that will endure over time and help the firm stay successful far into the future. Resources that do not have all four qualities can still be very useful, but they are unlikely to provide long-term advantages. A resource that is valuable and rare but that can be imitated, for example, might provide an edge in the short term, but competitors can overcome such an advantage eventually.

Resource-based theory also stresses the merit of an old saying: the whole is greater than the sum of its parts. Specifically, it is also important to recognize that strategic resources can be created by taking several strategies and resources that each could be copied and bundling them together in a way that cannot be copied. For example, Southwest's culture is complemented by approaches that individually could be copied—the airline's emphasis on direct flights, its reliance on one type of plane, and its unique system for passenger boarding—to create a unique business model whose performance is without peer in the industry.

Resource-based theory can be confusing because the term *resources* is used in many different ways within everyday common language. It is important to distinguish strategic resources from other resources. To most individuals, cash is an important resource. Tangible goods such as one's car and home are also vital resources. When analyzing organizations, however, common resources such as cash and vehicles are not considered to be strategic resources. Resources such as cash and vehicles are valuable, of course, but an organization's competitors can readily acquire them. Thus an organization cannot hope to create an enduring competitive advantage around common resources.

On occasion, events in the environment can turn a common resource into a strategic resource. Consider, for example, a very generic commodity: water. Humans simply cannot live without water, so water has inherent value. Also, water cannot be imitated (at least not on a large scale), and no other substance can substitute for the life-sustaining properties of water. Despite having three of the four properties of strategic resources, water in the United States has remained cheap. Yet this may be changing. Major cities in hot climates such as Las Vegas, Los Angeles, and Atlanta are confronted by dramatically shrinking water supplies. As water becomes more and more rare, landowners in Maine stand to benefit. Maine has been described as "the Saudi Arabia of water" because its borders contain so much drinkable water. It is not hard to imagine a day when companies in Maine make huge profits by sending giant trucks filled with water south and west or even by building water pipelines to service arid regions.

Tangible resources are resources than can be readily seen, touched, and quantified. Physical assets such as a firm's property, plant, and equipment are considered to be tangible resources, as is cash.
Intangible resources are quite difficult to see, touch, or quantify. Intangible resources include, for example, the knowledge and skills of employees, a firm's reputation, and a firm's culture. In a nod to Southwest Airlines' outstanding reputation, the firm ranks fourth in *Fortune* magazine's 2011 list of the "World's Most Admired Companies." Only Apple, Google, and Berkshire Hathaway enjoy a stronger reputation.
A *dynamic capability* exists when a firm is skilled at continually updating its array of capabilities to keep pace with changes in its environment. General Electric, for example, buys and sells firms to maintain its market leadership over time while Coca-Cola has an uncanny knack for building new brands and products as the soft-drink market evolves. Not surprisingly, both of these firms rank among the top thirteen among the "World's Most Admired Companies" for 2011.

Table 2 Resources and Capabilities. *Resources and capabilities are the basic building blocks that organizations use to create strategies. These two building blocks are tightly linked–capabilities from using resources over time.*

From Resources to Capabilities

The tangibility of a firm's resources is an important consideration within resource-based theory. Tangible resources are resources that can be readily seen, touched, and quantified. Physical assets such as a firm's property, plant, and equipment, as well as cash, are considered to be tangible resources. In contrast, intangible resources are quite difficult to see, to touch, or to quantify. Intangible resources include, for example, the knowledge and skills of employees, a firm's reputation, and a firm's culture. In comparing the two types of resources, intangible resources are more likely to meet the criteria for strategic resources (i.e., valuable, rare, difficult to imitate, and nonsubstitutable) than are tangible resources. Executives who wish to achieve long-term competitive advantages should therefore place a premium on trying to nurture and develop their firms' intangible resources.

Capabilities are another key concept within resource-based theory. A good and easy-to-remember way to distinguish resources and capabilities is this: resources refer to what an organization *owns*, capabilities refer to what the organization can *do*. Capabilities tend to arise over time as a firm takes actions that build on its strategic resources. Southwest Airlines, for example, has developed the capability of providing excellent customer service by building on its strong organizational culture. Capabilities are important in part because they are how organizations capture the potential value that resources offer. Customers do not simply send money to an organization because it owns strategic resources. Instead, capabilities are needed to bundle, to manage, and otherwise to exploit resources in a manner that provides value added to customers and creates advantages over competitors.

Some firms develop a dynamic capability. This means that a firm has a unique capability of creating new capabilities. Said differently, a firm that enjoys a dynamic capability is skilled at continually updating its array of capabilities to keep pace with changes in its environment. General Electric, for example, buys and sells firms to maintain its market leadership over time, while Coca-Cola has an uncanny knack for building new brands and products as the soft-drink market evolves. Not surprisingly, both of these firms rank among the top thirteen among the "World's Most Admired Companies" for 2011.

Strategy at the Movies

<u>That Thing You Do!</u>

How can the members of an organization reach success "doing that thing they do"? According to resource-based theory, one possible road to riches is creating—on purpose or by accident—a unique combination of resources. In the 1996 movie *That Thing You Do!*, unwittingly assembling a unique bundle of resources leads a 1960s band called The Wonders to rise from small-town obscurity to the top of the music charts. One resource is lead singer Jimmy Mattingly, who possesses immense musical talent. Another is guitarist Lenny Haise, whose fun attitude reigns in the enigmatic Mattingly. Although not a formal band member, Mattingly's girlfriend Faye provides emotional support to the group and even suggests the group's name. When the band's usual drummer has to miss a gig due to injury, the door is opened for charismatic drummer Guy Patterson, whose energy proves to be the final piece of the puzzle for The Wonders.

Despite Mattingly's objections, Guy spontaneously adds an up-tempo beat to a sleepy ballad called "That Thing You Do!" during a local talent contest. When the talent show audience goes crazy in response, it marks the beginning of a meteoric rise for both the song and the band. Before long, The Wonders perform on television and "That Thing You Do!" is a top-ten hit record. The band's magic vanishes as quickly as it appeared, however. After their bass player joins the Marines, Lenny elopes on a whim, and Jimmy's diva attitude runs amok, the band is finished and Guy is left to "wonder" what might have been. *That Thing You Do!* illustrates that while bundling resources in a unique way can create immense success, preserving and managing these resources over time can be very difficult.

Is Resource-Based Theory Old News?

Resource-based theory has evolved in recent years to provide a way to understand how strategic resources and capabilities allow firms to enjoy excellent performance. But more than one wry observer has wondered aloud, "Is resource-based theory just old wine in a new bottle?" This is a question worth considering because the role of resources in shaping success and failure has been discussed for many centuries.

Aesop was a Greek storyteller who lived approximately 2,500 years ago. Aesop is known in particular for having created a series of fables—stories that appear on the surface to be simply children's tales but that offer deep lessons for everyone. One of Aesop's fables focuses on an ass (donkey) and some grasshoppers. When the ass tries to duplicate the sweet singing of the grasshoppers by copying their diet, he soon dies of starvation. Attempting to replicate the grasshoppers' unique singing capability proved to be a fatal mistake. The fable illustrates a central point of resource-based theory: it is an array of resources and capabilities that fuels enduring success, not any one resource alone.

A distinctive competence is a set of activities that an organization performs especially well. Southwest Airlines, for example, appears to have a distinctive competency in operations, as evidenced by how quickly it moves its flights in and out of airports. Further, Selznick suggested that possessing a distinctive competency creates a competitive advantage for a firm. Certainly, there is plenty of overlap between the concept of distinctive competency, on the one hand, and capabilities, on the other.

So is resource-based theory in fact old wine in a new bottle? Not really. Resource-based theory builds on past ideas about resources, but it represents a big improvement on past ideas in at least two ways. First, resource-based theory offers a complete framework for analyzing organizations, not just snippets of valuable wisdom like Aesop and Selznick provided. Second, the ideas offered by resource-based theory have been developed and refined through scores of research studies involving thousands of organizations. In other words, there is solid evidence backing it up.

The Marketing Mix

A firm's *product* is what it sells to customers. The unique cakes offered by Duff have included replicas of Radio City Music Hall and the Hubble space telescope.
The *price* of a good or service should provide a good match with the value offered. While a grocery store's cake might sell for $30 or less, the uniqueness of Duff's cakes allows him to charge upwards of $1,000 per cake.
Place can refer to a physical purchase point as well as a distribution channel. The location of Charm City Cakes is itself unique–a converted church. This adds to the hip image Duff tries to project.
Promotion consists of the communications used to market a product, including advertising, public relations, and other forms of direct and indirect selling. Duff's popular show on The Food Network, *Ace of Cakes*, spread Duff's fame and extended the reach of his cake shop dramatically.

Table 3 The Marketing Mix. *Much like a baker mixes together ingredients to create a delicious cake, executives need to blend*

together various ways to appeal to customers. As one of the most famous business "recipes," the marketing mix suggests four factors that need to work together in order for a firm to achieve superior performance. The four Ps of the marketing mix are illustrated below using Duff Goldman's custom cake shop, Charm City Cakes.

Leveraging resources and capabilities to create desirable products and services is important, but customers must still be convinced to purchase these goods and services. The marketing mix—also known as the four Ps of marketing—provides important insights into how to make this happen. A master of the marketing mix was circus impresario P. T. Barnum, who is famous in part for his claim that "there's a sucker born every minute." The real purpose of the marketing mix is not to trick customers but rather to provide a strong alignment among the four Ps (product, price, place, and promotion) to offer customers a coherent and persuasive message.

A firm's product is what it sells to customers. Southwest Airlines sells, of course, airplane flights. The airline tries to set its flights apart from those of airlines by making flying fun. This can include, for example, flight attendants offering preflight instructions as a rap. The price of a good or service should provide a good match with the value offered. Throughout its history, Southwest has usually charged lower airfares than its rivals. Place can refer to a physical purchase point as well as a distribution channel. Southwest has generally operated in cities that are not served by many airlines and in secondary airports in major cities. This has allowed the firm to get favorable lease rates at airports and has helped it create customer loyalty among passengers who are thankful to have access to good air travel.

Finally, promotion consists of the communications used to market a product, including advertising, public relations, and other forms of direct and indirect selling. Southwest is known for its clever advertising. In a recent television advertising campaign, for example, Southwest lampooned the baggage fees charged by most other airlines while highlighting its more customer-friendly approach to checked luggage. Given the consistent theme of providing a good value plus an element of fun to passengers that is developed across the elements of the marketing mix, it is no surprise that Southwest has been so successful within a very challenging industry.

Defining Intellectual Property

The inability of competitors to imitate a strategic resource is a key to leveraging the resource to achieve long-term competitive advantages. Companies are clever, and effective imitation is often very possible. But resources that involve intellectual property reduce or even eliminate this risk. As a result, developing intellectual property is important to many organizations.

Intellectual property refers to creations of the mind, such as inventions, artistic products, and symbols. The four main types of intellectual property are patents, trademarks, copyrights, and trade secrets. If a piece of intellectual property is also valuable, rare, and nonsubstitutable, it constitutes a strategic resource. Even if a piece of intellectual property does not meet all four criteria for serving as a strategic resource, it can be bundled with other resources and activities to create a resource.

A variety of formal and informal methods are available to protect a firm's intellectual property from imitation by rivals. Some forms of intellectual property are best protected by legal means, while defending others depends on surrounding them in secrecy. This can be contrasted with Southwest Airlines' well-known culture, which rivals are free to attempt to copy if they wish. Southwest's culture thus is not intellectual property, although some of its complements such as Southwest's logo and unique color schemes are.

Patents protect inventions from direct imitation for a limited period of time. Within the pharmaceutical industry, patents protect the new drugs created by firms such as Merck and Pfizer for up to twenty years. If a new drug gains acceptance in the market, its patent creates a window of opportunity for the patent holder to enjoy excellent profits.
Trademarks are phrases, pictures, names, or symbols used to identify a particular organization. McDonald's golden arches, the phrase "Intel Inside," and the brand name Old Navy are examples of trademarks.
Copyrights provide exclusive rights to the creators of original artistic works such as books, movies, songs, and screenplays. Sometimes copyrights are sold and licensed. The late pop star Michael Jackson bought the rights to The Beatle's music catalog and later licensed songs to Target and other companies for use in television advertisements.
Trade secrets refer to formulas, practices, and designs that are central to a firm's business and that remain unknown to competitors. One famous example is the blend of eleven herbs and spices used in Kentucky Fried Chicken's original recipe chicken. KFC protects this secret by having multiple suppliers each produce a portion of the herb and spice blend; no one supplier knows the full recipe.

Table 4 Types of Intellectual Property. *The term* ***intellectual property*** *refers to creations of the mind, such as inventions, artistic products, and symbols. Some forms of intellectual property by law while others can best be defended by surrounding them in secrecy.*

Patents

To earn a patent from the U.S. Patent and Trademark Office, an inventor must demonstrate than an invention is new, non obvious, and useful.	As several different inventors raced to create a workable system for voice transmission over wires, Alexander Graham Bell was awarded a patent for the telephone in 1876.
Perhaps the greatest inventor in history was Thomas Edison, who was awarded over one thousand patents.	In a 2011 lawsuit, EBSCO alleged that Bass Pro Shops sold a product that violated EBSCO's patent on a deer-hunting stand that helps prevent hunters from falling out of trees. EBSCO's complaint was settled out of court.

Table 5 Patents. *Patents protect inventions from direct imitation for a limited period of time. Some examples and key issues surrounding patents are illustrated below.*

Patents are legal decrees that protect inventions from direct imitation for a limited period of time. Obtaining a patent involves navigating a challenging process. To earn a patent from the US Patent and Trademark Office, an inventor must demonstrate than an invention is new, nonobvious, and useful. If the owner of a patent believes that a company or person has infringed on the patent, the owner can sue for damages. In 2011, for example, a private company named EBSCO alleged that retailer Bass Pro Shops sold a product that violated EBSCO's patent on a deer-hunting stand that helps prevent hunters from falling out of trees. Rather than endure a costly legal fight, the two sides agreed to settle EBSCO's complaint out of court.

Patenting an invention is important because patents can fuel enormous profits. Imagine, for example, the potential for lost profits if the Slinky had not been patented. Shipyard engineer Richard James came up with the idea for the Slinky by accident in 1943 while he was trying to create springs for use in ship instruments. When James accidentally tipped over one of his springs, he noticed that it moved downhill in a captivating way. James spent his free time perfecting the Slinky and then applied for a patent in 1946. To date, more than three hundred million Slinkys have been sold by the company that Richard James and his wife Betty created.

Trademarks

Trademarks are phrases, pictures, names, or symbols used to identify a particular organization. Trademarks are important because they help an organization stand out and build an identity in the marketplace. Some trademarks are so iconic that almost all consumers recognize them, including McDonald's golden arches, the Nike swoosh, and Apple's outline of an apple.

Other trademarks help rising companies carve out a unique niche for themselves. For example, French shoe designer Christian Louboutin has trademarked the signature red sole of his designer shoes. Because these shoes sell for many hundreds of dollars via upscale retailers such as Neiman Marcus and Saks Fifth Avenue, competitors would love to copy their look. Thus legally protecting the distinctive red sole from imitation helps preserve Louboutin's profits.

Trademarks are important to colleges and universities. Schools earn tremendous sums of money through royalties on T-shirts, sweatshirts, hats, backpacks, and other consumer goods sporting their names and logos. On any given day, there are probably several students in your class wearing one or more pieces of clothing featuring your school's insignia; your school benefits every time items like this are sold.

Schools' trademarks are easy to counterfeit, however, and the sales of counterfeit goods take money away from colleges and universities. Not surprisingly, many schools fight to protect their trademarks. In October 2009, for example, the University of Oklahoma announced that it was teaming with law enforcement officials to combat the sale of counterfeit goods around its campus (Ward, 2009). This initiative and similar ones at other colleges and universities are designed to ensure that schools receive their fair share of the sales that their names and logos generate.

To be fully protected in the United States, a trademark must be registered with the United States Patent and Trademark Office. A capital R with a circle around it denotes a registered trademark.	Many small companies use their founders' name as the basis for a trademarked company name.
As part of the punishment for German aggression during World War I, German drug maker Bayer lost its trademark on "Aspirin" in France, Russia, the United Kingdom, and the United States. Today, Bayer still retains its trademark in Germany, Canada, Mexico and dozens of other countries.	The distinctive pattern of Burberry Ltd. is an example of a trademark that does not involve words or symbols.

Table 6 Trademarks. *An organization's trademarks consist of phrases, pictures, names, or symbols that are closely associated with the organization. Some examples and key issues surrounding trademarks are illustrated above.*

Copyrights

In China, millions of pirated DVDs are sold each year, and music piracy is estimated to account for at least 95 percent of music sales. In response, the U.S. government has pressed its Chinese counterpart to better enforce copyrights.	The presence of the copyright symbol tells consumers that they are not allowed to duplicate the product that carriers the copyright.	When it became apparent that The Verve's 1997 hit single "Bittersweet Symphony" duplicated a Rolling Stones song, The Verve was forced to give up the copyright for the song.
Television ads aimed at inventors follow a long traditional of companies offering to help individuals copyright their ideas–for a small fee, of course.	A painting such as Johannes Vermeer's "Girl with a Pearl Earring" enters the public domain (i.e., is not subject to copyright) one hundred years after its creator's death.	

Table 7 Copywrites. *The rights of creators of original artistic works such as books, movies, songs, and screenplays are protected by copyrights. Some examples and key issues surrounding copyrights are illustrated below.*

Copyrights provide exclusive rights to the creators of original artistic works such as books, movies, songs, and screenplays. Sometimes copyrights are sold and licensed. In the late 1960s, Buick thought it had an agreement in place to license the number one hit "Light My Fire" for a television advertisement from The Doors until the band's volatile lead singer Jim Morrison loudly protested what he saw as mistreating a work of art. In recent years, classic rock by The Beatles has been used in television ads. After the late pop star Michael Jackson bought the rights to The Beatles' music catalog, he licensed songs to Target and other companies. Some devoted music fans consider such ads to be abominations, perhaps proving the merit of Morrison's protest decades ago.

Over time, piracy has become a huge issue for the owners of copyrighted works. In China, millions of pirated DVDs are sold each year, and music piracy is estimated to account for at least 95 percent of music sales. This piracy deprives movie studios, record labels, and artists of millions of dollars in royalties. In response to the damage piracy has caused, the US government has pressed its Chinese counterpart and other national governments to better enforce copyrights.

Trade Secrets

Trade secrets refer to formulas, practices, and designs that are central to a firm's business and that remain unknown to competitors. Trade secrets are protected by laws on theft, but once a secret is revealed, it cannot be a secret any longer. This leads firms to rely mainly on silence and privacy rather than the legal system to protect trade secrets.

WD-40 was developed to repel water and prevent corrosion, but it was later found to hav thousand uses. Creating WD-40 took a lot of work: the product's unusual name stands for Displacement, 40th attempt." Despite being created in 1953, the formula for making WD-4 unknown outside the company that sells it.

FarmVille creator Zynga alleged in a lawsuit that Disney had lured away Zynga employees for Disney and then urged the employees to turn over a secret "playbook" that described strategy. The case was settled out of court in late 2010.

Table 8 Trade Secrets. *Trade secrets are formulas, practices, and designs that are central to a firm's business and that remain unknown to competitors. Everyone loves a good mystery, so it is no surprise that legends have arisen around some trade secrets. Some examples and key issues surrounding trade secrets are illustrated.*

Some trade secrets have become legendary, perhaps because a mystique arises around the unknown. One famous example is the blend of eleven herbs and spices used in Kentucky Fried Chicken's original recipe chicken. KFC protects this secret by having multiple suppliers each produce a portion of the herb and spice blend; no one supplier knows the full recipe. The formulation of Coca-Cola is also shrouded in mystery. In 2006, Pepsi was approached by shady individuals who were offering a chance to buy a stolen copy of Coca-Cola's secret recipe. Pepsi wisely refused. An FBI sting was used to bring the thieves to justice. The soft-drink industry has other secrets too. Dr Pepper's recipe remains unknown outside the company. Although Coke's formula has been the subject of greater speculation, Dr Pepper is actually the original secret soft drink; it was created a year before Coca-Cola.

Elements of the Value Chain

When executives choose strategies, an organization's resources and capabilities should be examined alongside consideration of its value chain. A value chain charts the path by which products and services are created and eventually sold to customers (Porter, 1985). The term *value chain* reflects the fact that, as each step of this path is completed, the product becomes more valuable than it was at the previous step. Within the lumber business, for example, value is added when a tree is transformed into usable wooden boards; the boards created from a tree can be sold for more money than the price of the tree.

The Value Chain

Value chains include both primary and secondary activities. Primary activities are actions that are directly involved in creating and distributing goods and services. Consider a simple illustrative example: doughnut shops. Doughnut shops transform basic commodity products such as flour, sugar, butter, and grease into delectable treats. Value is added through this process because consumers are willing to pay much more for doughnuts than they would be willing to pay for the underlying ingredients.

There are five primary activities. Inbound logistics refers to the arrival of raw materials. Although doughnuts are seen by most consumers as notoriously unhealthy, the Doughnut Plant in New York City has carved out a unique niche for itself by obtaining organic ingredients from a local farmer's market. Operations refers to the actual production process, while outbound logistics tracks the movement of a finished product to customers.

One of Southwest Airlines' unique capabilities is moving passengers more quickly than its rivals. This advantage in operations is based in part on Southwest's reliance on one type of airplane (which speeds maintenance) and its avoidance of advance seat assignments (which accelerates the passenger boarding process).

Attracting potential customers and convincing them to make purchases is the domain of marketing and sales. Finally, service refers to the extent to which a firm provides assistance to their customers. Voodoo Donuts in Portland, Oregon, has developed a clever website (voodoodoughnut.com) that helps customers understand their uniquely named products, such as the Voodoo Doll, the Texas Challenge, the Memphis Mafia, and the Dirty Snowball.

Secondary activities are not directly involved in the evolution of a product but instead provide important underlying support for primary activities. Firm infrastructure refers to how the firm is organized and led by executives. The effects of this organizing and leadership can be profound. For example, Ron Joyce's leadership of Canadian doughnut shop chain Tim Hortons was so successful that Canadians consume more doughnuts per person than all other countries. In terms of resource-based theory, Joyce's leadership was clearly a valuable and rare resource that helped his firm prosper.

Also important is human resource management, which involves the recruitment, training, and compensation of employees. A recent research study used data from more than twelve thousand organizations to demonstrate that the knowledge, skills, and abilities of a firm's employees can act as a strategic resource and strongly influence the firm's performance (Crook, et. al., 2011). Certainly, the unique level of dedication demonstrated by employees at Southwest Airlines has contributed to that firm's excellent performance over several decades.

Technology refers to the use of computerization and telecommunications to support primary activities. Although doughnut making is not a high-tech business, technology plays a variety of roles for doughnut shops, such as allowing customers to use credit cards. Procurement is the process of negotiating for and purchasing raw materials. Large doughnut chains such as Dunkin'

Donuts and Krispy Kreme can gain cost advantages over their smaller rivals by purchasing flour, sugar, and other ingredients in bulk. Meanwhile, Southwest Airlines has gained an advantage over its rivals by using futures contracts within its procurement process to minimize the effects of rising fuel prices.

From the Value Chain to Best Value Supply Chains

"Time is money!" warns a famous saying. This simple yet profound statement suggests that organizations that quickly complete their work will enjoy greater profits, while slower-moving firms will suffer. The belief that time is money has encouraged the modern emphasis on supply chain management. A supply chain is a system of people, activities, information, and resources involved in creating a product and moving it to the customer. A supply chain is a broader concept than a value chain; the latter refers to activities within one firm, while the former captures the entire process of creating and distributing a product, often across several firms.

Competition in the twenty-first century requires an approach that considers the supply chain concept in tandem with the value-creation process within a firm: best value supply chains. These chains do not fixate on speed or on any other single metric. Instead, relative to their peers, best value supply chains focus on the total value added to the customer.

Creating best value supply chains requires four componens: Supply chain management, enhance performance, agility, and adaptability.

The first is strategic supply chain management—the use of supply chains as a means to create competitive advantages and enhance firm performance. Such an approach contradicts the popular wisdom centered on the need to maximize speed. Instead, there is recognition that the fastest chain may not satisfy customers' needs. Best value supply chains strive to excel along four measures. Speed (or "cycle time") is the time duration from initiation to completion of the production and distribution process. Quality refers to the relative reliability of supply chain activities. Supply chains' efforts at managing cost involve enhancing value by either reducing expenses or increasing customer benefits for the same cost level. Flexibility refers to a supply chain's responsiveness to changes in customers' needs. Through balancing these four metrics, best value supply chains attempt to provide the highest level of total value added.

The value of strategic supply chain management is reflected in how firms such as Walmart have used their supply chains as competitive weapons to gain advantages over peers. Walmart excels in terms of speed and cost by locating all domestic stores within one day's drive of a warehouse while owning a trucking fleet. This creates distribution speed and economies of scale that competitors simply cannot match. When Kmart's executives decided in the late 1990s to compete head-to-head with Walmart on price, Walmart's sophisticated logistics system enabled it to easily withstand the price war. Unable to match its rival's speed and costs, Kmart soon plunged into bankruptcy. Walmart's supply chains also possess strong quality and flexibility. When Hurricane Katrina devastated the Gulf Coast in 2005, Walmart used not only its warehouses and trucks but also its satellite technology, radio frequency identification (RFID), and global positioning systems to quickly divert assets to affected areas. The result was that Walmart emerged as the first responder in many towns and provided essentials such as drinking water faster than local and federal governments could.

The second component is agility, the supply chain's relative capacity to act rapidly in response to dramatic changes in supply and demand (Lee, 2004). Agility can be achieved using buffers. Excess capacity, inventory, and management information systems all provide buffers that better enable a best value supply chain to service and to be more responsive to its customers. Rapid improvements and decreased costs in deploying information systems have enabled supply chains in recent years to reduce inventory as a buffer. Much popular thinking depicts inventory reduction as a goal in and of itself. However, this cannot occur without corresponding increases in buffer capacity elsewhere in the chain, or performance will suffer. A best value supply chain seeks to optimize the total costs of all buffers used. The costs of deploying each buffer differs across industries; therefore, no solution that works for one company can be directly applied to another in a different industry without adaptation.

Agility in a supply chain can also be improved and achieved by colocating with the customer. This arrangement creates an information flow that cannot be duplicated through other methods. Daily face-to-face contact for supply chain personnel enables quicker response times to customer demands due to the speed at which information can travel back and forth between the parties. Again, this buffer of increased and improved information flows comes at an expense, so executives seeking to build a best value supply chain will investigate the opportunity and determine whether this action optimizes total costs.

Adaptability refers to a willingness and capacity to reshape supply chains when necessary. Generally, creating one supply chain for a customer is desired because this helps minimize costs. Adaptable firms realize that this is not always a best value solution, however. For example, in the defense industry, the US Army requires one class of weapon simulators to be repaired within eight hours, while another class of items can be repaired and returned within one month. To service these varying requirements efficiently and effectively, Computer Science Corporation (the firm whose supply chains maintain the equipment) must devise adaptable supply chains. In this case, spare parts inventory is positioned in proximity to the class of simulators requiring quick turnaround, while the less-time-sensitive devices are sent to a centralized repair facility. This supply chain configuration allows Computer Science Corporation to satisfy customer demands while avoiding the excess costs that would be involved in localizing all repair activities.

In situations in which the interests of one firm in the chain and the chain as a whole conflict, most executives will choose an option that benefits their firm. This creates a need for alignment among chain members. Alignment refers to creating consistency in the interests of all participants in a supply chain. In many situations, this can be accomplished through carefully writing incentives into contracts. Collaborative forecasting with suppliers and customers can also help build alignment. Taking the time to sit together with participants in the supply chain to agree on anticipated business levels permits shared understanding and rapid information transfers between parties. This is particularly valuable when customer demand is uncertain, such as in the retail industry (Ketchen, et. al., 2008).

Enactment suggests that organizations can, in part, create their environment through outstanding strategies. This puts a firm in control of its destiny. Although no airline has ever been able to do so, Microsoft and Apple are two firms that seemed to have enacted their environments.

Environmental determinism contends that external factors drive a firm's fate. In its early days, the federal government controlled airlines' routes and prices. After the airline industry was deregulated in the late 1970s, a series of large airlines fell prey to bad environment conditions such as recession, overcapacity in the industry, and fuel shortages. Many industry experts claim that the demise of Braniff Airlines, and others was inevitable.

Institutional theory is interested in the extent to which firms copy each other's strategies. After American Airlines became the first major airline to create a frequent flyer program in 1981, its competitors quickly developed their own frequent flyer programs. In the late 2000s, a new idea of charging passengers to check their luggage was copied by one airline after another.

Transaction cost economics centers on whether it is cheaper for a firm to make or to buy the products that it needs. Choosing efficient options enhances profits. No airline has ever chosen "make" when needing new airplanes. Buying airplanes from Boeing or Airbus is much more efficient than would be trying to backwardly integrate into the airplane manufacturing business.

Table 9 Other Theories about Firm Performance. *Resource-based theory is currently perhaps the most popular way of explaining why some firms succeed and other fail, but it is far from the only explanation. In the box above, we illustrate several other prominent theories using examples from the airline industry.*

Although resource-based theory stands as perhaps the most popular explanation of why some organizations prosper while others do not, several other theories are popular. Enactment treats executives as the masters of their domains. Enactment contends that an organization can, at least in part, create an environment for itself that is beneficial to the organization. This is accomplished by putting strategies in place that reshape competitive conditions in a favorable way.

By the 1990s, Microsoft had been so successful at reshaping the software industry to its benefit that the firm was the subject of a lengthy antitrust investigation by the federal government. More recently, Apple has been able to reshape its environment by introducing products such as the iPhone and the iPad that transcend the traditional boundaries between the cell phone, digital camera, music player, and computer businesses. No airline has ever been able to enact the environment, however, perhaps because the airline industry is so fragmented.

Environmental determinism offers a completely opposite view from enactment on why some firms succeed and others fail. Environmental determinism views organizations much like biological theories view animals—organizations (and animals) are very limited in their ability to adapt to the conditions around them. Thus just as harsh environmental changes are believed to have made dinosaurs extinct, changes in the business environment can destroy organizations regardless of how clever and insightful executives are.

Until 1978, the federal government regulated the airline industry by dictating what routes each airline would fly and what prices it would charge. Once these controls were removed, airlines were subjected to a series of negative environmental trends, including recession, overcapacity in the industry, new entrants, fierce price competition, and fuel shortages. Perhaps not surprisingly, dozens of airlines have been crushed by these conditions..

To build passenger loyalty, American Airlines introduced a frequent flyer program called AAdvantage in 1981. After flying a certain number of miles on American flights, AAdvantage members were rewarded with a free flight. The idea was to make passengers less likely to shop around for the cheapest ticket. Ironically, AAdvantage turned out to be not much of an advantage at all. Many of American's rivals quickly developed their own frequent-flyer programs, and today most airlines reward frequent passengers. In recent years, ideas such as charging passengers to check their luggage and eliminating free food on flights have been copied by one airline after another.

Transaction cost economics is a theory that centers on just one element of business activity: whether it is cheaper for a firm to make or to buy the products that it needs. This is an important element, however, because choosing the more efficient option can enhance a firm's profits. Automakers such as Ford and General Motors face a wide variety of make-or-buy decisions because so many different parts are needed to build cars and trucks. Sometimes Ford and GM make these products, and other times they purchase them from outside suppliers. These firms' financial situations are improved when these decisions are made wisely and harmed when they are made poorly.

In contrast, airlines always buy (or rent) their airplanes. Large planes are generally bought from Boeing or Airbus, while modest-sized airliners are purchased from companies such as Brazil's Embraer. It would be simply too costly for an airline to pursue a backward integration strategy and enter the airplane manufacturing business. Insights such as these are powerful enough that the creator of transaction cost economics, Professor Oliver Williamson, was awarded a Nobel Prize in Economic Sciences in 2009.

Each of these theories—enactment, environmental determinism, institutional theory, and transaction cost economics—is useful for understanding some situations and some important business decisions. Thus executives should keep these perspectives in mind as they attempt to lead their firms to greater levels of success. However, one important advantage that resource-based theory offers over the alternatives is that only resource-based theory does a good job of explaining firm performance across a wide variety of contexts. Thus resource-based theory offers the point of view of business that has the strongest value for most executives.

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Business-Level Strategies

Business-level strategy addresses the question of how a firm will compete in a particular industry. On the surface this seems to be a simple question, but it is quite complex. The reason is that there are a great many possible answers to the question. Consider, for example, the restaurants in your town or city. Chances are that you live fairly close to some combination of McDonald's, Subway, Chili's, Applebee's, Panera Bread Company, dozens of other national brands, and a variety of locally based eateries that have just one location. Each of these restaurants competes using a business model that is at least somewhat unique. When an executive in the restaurant industry analyzes her company and her rivals, she needs to avoid getting distracted by all the nuances of different firm's business-level strategies and losing sight of the big picture.

The solution is to think about business-level strategy in terms of generic strategies. A generic strategy is a general way of positioning a firm within an industry. Focusing on generic strategies allows executives to concentrate on the core elements of firms' business-level strategies. The most popular set of generic strategies is based on the work of Professor Michael Porter of the Harvard Business School and subsequent researchers that have built on Porter's initial ideas (Porter, 1980; Zeng, 2009).

	Competitive Advantage: Cost	Competitive Advantage: Uniqueness
Scope of Operations: Broad Target	Walmart's **cost leadership** strategy depends on attracting a large customer base and keeping prices low by buying massive quantities of goods from suppliers.	Nordstrom builds its **differentiation** strategy around offering designer merchandise and providing exceptional service.
Scope of Operations: Narrow Target	In using a **focused cost leadership**, Dollar General does not offer a full array of consumer goods, but those that it does offer are priced to move.	Anthropologie follows a **focused differentiation** strategy by selling unique (and pricey) women's apparel, accessories, and home furnishings.

Table 1 Business-Level Strategies. *Firms compete on two general dimensions – the source of competitive advantage (cost or uniqueness) and the scope of operations (broad or narrow). Four possible generic business-level strategies emerge from these decisions. An example of each generic business-level strategy from the retail industry is illustrated above.*

According to Porter, two competitive dimensions are the keys to business-level strategy. The first dimension is a firm's source of competitive advantage. This dimension involves whether a firm tries to gain an edge on rivals by keeping costs down or by offering something unique in the market. The second dimension is firms' scope of operations. This dimension involves whether a firm tries to target customers in general or whether it seeks to attract just a segment of customers. Four generic business-level strategies emerge from these decisions: (1) cost leadership, (2) differentiation, (3) focused cost leadership, and (4) focused differentiation. In rare cases, firms are able to offer both low prices and unique features that customers find desirable. These firms are following a best-cost strategy. Firms that are not able to offer low prices or appealing unique features are referred to as "stuck in the middle."

Understanding the differences that underlie generic strategies is important because different generic strategies offer different value propositions to customers. A firm focusing on cost leadership will have a different value chain configuration than a firm whose strategy focuses on differentiation. For example, marketing and sales for a differentiation strategy often requires extensive effort while some firms that follow cost leadership such as Waffle House are successful with limited marketing efforts. This chapter presents each generic strategy and the “recipe” generally associated with success when using that strategy. When firms follow these recipes, the result can be a strategy that leads to superior performance. But when firms fail to follow logical actions associated with each strategy, the result may be a value proposition configuration that is expensive to implement and that does not satisfy enough customers to be viable.

Analyzing generic strategies enhances the understanding of how firms compete at the business level.

Limitations of Generic Strategies

Examining business-level strategy in terms of generic strategies has limitations. Firms that follow a particular generic strategy tend to share certain features. For example, one way that cost leaders generally keep costs low is by not spending much on advertising. Not every cost leader, however, follows this path. While cost leaders such as Waffle House spend very little on advertising, Walmart spends considerable money on print and television advertising despite following a cost leadership strategy. Thus a firm may not match every characteristic that its generic strategy entails. Indeed, depending on the nature of a firm’s industry, tweaking the recipe of a generic strategy may be essential to cooking up success.

The Nature of the Cost Leadership Strategy

It is tempting to think of cost leaders as companies that sell inferior, poor-quality goods and services for rock-bottom prices. Cost leaders can be very successful, a firm following a cost leadership strategy offers products or services with acceptable quality and features to a broad set of customers at a low price. Payless ShoeSource, for example, sells name-brand shoes at inexpensive prices. Its low-price strategy is communicated to customers through advertising slogans such as “Why pay more when you can Payless?” and “You could pay more, but why?” Little Debbie snack cakes offer another example. The brand was started in the 1930s when O. D. McKee began selling sugary treats for five cents. Most consumers today would view the quality of Little Debbie cakes as a step below similar offerings from Entenmann’s, but enough people believe that they offer acceptable quality that the brand is still around eight decades after its creation.

Perhaps the most famous cost leader is Walmart, which has used a cost leadership strategy to become the largest company in the world. The firm’s advertising slogans such as “Always Low Prices” and “Save Money. Live Better” communicate Walmart’s emphasis on price slashing to potential customers. Meanwhile, Walmart has the broadest customer base of any firm in the United States. Approximately one hundred million Americans visit a Walmart in a typical week (Zimmerman & Hudson, 2006). Incredibly, this means that roughly one-third of Americans are frequent Walmart customers. This huge customer base includes people from all demographic and social groups within society.

Cost leaders tend to share some important characteristics. The ability to charge low prices and still make a profit is challenging. Cost leaders manage to do so by emphasizing efficiency. At Waffle House restaurants, for example, customers are served cheap eats quickly to keep booths available for later customers. As part of the effort to be efficient, most cost leaders spend little on advertising, market research, or research and development. Waffle House, for example, limits its advertising to billboards along highways. Meanwhile, the simplicity of Waffle House’s menu requires little research and development.

Many cost leaders rely on economies of scale to achieve efficiency. Economies of scale are created when the costs of offering goods and services decreases as a firm is able to sell more items. This occurs because expenses are distributed across a greater number of items. Walmart spent approximately $2 billion on advertising in 2008. This is a huge number, but Walmart is so large that its advertising expenses equal just a tiny fraction of its sales. Also, cost leaders are often large companies, which allows them to demand price concessions from their suppliers. Walmart is notorious for squeezing suppliers such as Procter & Gamble to sell goods to Walmart for lower and lower prices over time. The firm passes some of these savings to customers in the form of reduced prices in its stores.

Advantages and Disadvantages of Cost Leadership

Each generic strategy offers advantages that firms can potentially leverage to enhance their success as well as disadvantages that may undermine their success. In the case of cost leadership, one advantage is that cost leaders' emphasis on efficiency makes them well positioned to withstand price competition from rivals. Kmart's ill-fated attempt to engage Walmart in a price war ended in disaster, in part because Walmart was so efficient in its operations that it could live with smaller profit margins far more easily than Kmart could.

Advantages	High profits can be enjoyed if a cost leader has a high market share. An example is Kampgrounds of America, a chain of nearly 500 low cost camping franchises in the United States. Low-cost firms such as many municipal golf courses can withstand price wars because high-priced competitors will not want to compete directly with a more efficient rival.
Disadvantages	If perceptions of quality become too low, business will suffer. Large volumes of sales are a must because margins are slim. The need to keep expenses low might lead cost leaders to be late in detecting key environment trends. Low-cost firms' emphasis on efficiency makes it difficult for them to change quickly if needed.

Table 2 Executing a Low-Cost Strategy. U*sing a cost leadership strategy offers firms important advantages and disadvantages. Below we illustrate a few examples in relation to entertainment and leisure.*

Beyond existing competitors, a cost leadership strategy also creates benefits relative to potential new entrants. Specifically, the presence of a cost leader in an industry tends to discourage new firms from entering the business because a new firm would struggle to attract customers by undercutting the cost leaders' prices. Thus a cost leadership strategy helps create barriers to entry that protect the firm—and its existing rivals—from new competition.

In many settings, cost leaders attract a large market share because a large portion of potential customers find paying low prices for goods and services of acceptable quality to be very appealing. The need for efficiency means that cost leaders' profit margins are often slimmer than the margins enjoyed by other firms. However, cost leaders' ability to make a little bit of profit from each of a large number of customers means that the total profits of cost leaders can be substantial.

In some settings, the need for high sales volume is a critical disadvantage of a cost leadership strategy. Highly fragmented markets and markets that involve a lot of brand loyalty may not offer much of an opportunity to attract a large segment of customers. In both the soft drink and cigarette industries, for example, customers appear to be willing to pay a little extra to enjoy the brand of their choice. Lower-end brands of soda and cigarettes appeal to a minority of consumers, but famous brands such as Coca-Cola, Pepsi, Marlboro, and Camel still dominate these markets. A related concern is that achieving a high sales volume usually requires significant upfront investments in production and/or distribution capacity. Not every firm is willing and able to make such investments.

Cost leaders tend to keep their costs low by minimizing advertising, market research, and research and development, but this approach can prove to be expensive in the long run. A relative lack of market research can lead cost leaders to be less skilled than other firms at detecting important environmental changes. Meanwhile, downplaying research and development can slow cost leaders' ability to respond to changes once they are detected. Lagging rivals in terms of detecting and reacting to external shifts can prove to be a deadly combination that leaves cost leaders out of touch with the market and out of answers.

The Nature of the Differentiation Strategy

A famous cliché contends that "you get what you pay for." This saying captures the essence of a differentiation strategy. A firm following a differentiation strategy attempts to convince customers to pay a premium price for its good or services by providing unique and desirable features. The message that such a firm conveys to customers is that you will pay a little bit more for our offerings, but you will receive a good value overall because our offerings provide something special.

In terms of the two competitive dimensions described by Michael Porter, using a differentiation strategy means that a firm is competing based on uniqueness rather than price and is seeking to attract a broad market (Porter, 1980). Coleman camping equipment offers a good example. If camping equipment such as sleeping bags, lanterns, and stoves fail during a camping trip, the result will be, well, unhappy campers. Coleman's sleeping bags, lanterns, and stoves are renowned for their reliability and durability. Cheaper brands are much more likely to have problems. Lovers of the outdoors must pay more to purchase Coleman's goods than they would to obtain lesser brands, but having equipment that you can count on to keep you warm and dry is worth a price premium in the minds of most campers.

Successful use of a differentiation strategy depends on offering unique features and communicating the value of these features to potential customers. As a result, advertising in general and brand building in particular are important to this strategy. Few goods are more basic and generic than table salt. This would seemingly make creating a differentiated brand in the salt business next to impossible. Through clever marketing, however, Morton Salt has done so. Morton has differentiated its salt by building a brand around its iconic umbrella girl and its trademark slogan of "When it rains, it pours." Would the typical consumer be able to tell the difference between Morton Salt and cheaper generic salt in a blind taste test? Not a chance. Yet Morton succeeds in convincing customers to pay a little extra for its salt through its brand-building efforts.

FedEx and Nike are two other companies that have done well at communicating to customers that they provide differentiated offerings. FedEx's former slogan "When it absolutely, positively has to be there overnight" highlights the commitment to speedy delivery that sets the firm apart from competitors such as UPS and the US Postal Service. Nike differentiates its athletic shoes and apparel through its iconic "swoosh" logo as well as an intense emphasis on product innovation through research and development.

Advantages	*Buyer loyalty* is common among handbag buyers. Many individuals enjoy seeing–and being seen with–a designer logo on the products they buy such as the iconic C that is shown on Coach bags.	Chanel enjoys *strong margins* because their well-known name allows them to charge a premium for their handbags.
Disadvantages	Less-expensive bags from retailers such as Target provide enough of a trendy look to satisfy many *price-sensitive buyers*. These individuals will choose to save their money by avoiding expensive bags from top-end designers.	*Imitations* may steal customers, such as is common with knock-off handbags sold by street vendors.

Table 3 Executing a Differentiation Strategy. A *differentiation strategy offers important advantages and disadvantages for firms that adopt it. Below we illustrate a few examples in relation to an often differentiated product–women's handbags.*

Advantages and Disadvantages of Differentiation

Each generic strategy offers advantages that firms can potentially leverage to enjoy strong performance, as well as disadvantages that may damage their performance. In the case of differentiation, a key advantage is that effective differentiation creates an ability to obtain premium prices from customers. This enables a firm to enjoy strong profit margins. Coca-Cola, for example, currently enjoys a profit margin of approximately 33 percent, meaning that about thirty-three cents of every dollar it collects from customers is profit. In comparison, Walmart's cost leadership strategy delivered a margin of under 4 percent in 2010.

In turn, strong margins mean that the firm does not need to attract huge numbers of customers to have a good overall level of profit. Luckily for Coca-Cola, the firm does attract a great many buyers. Overall, the firm made a profit of just under $12 billion on sales of just over $35 billion in 2010. Interestingly, Walmart's profits were only 25 percent higher ($15 billion) than Coca-Cola's while its sales volume ($421 billion) was twelve times as large as Coca-Cola's.1 This comparison of profit margins and overall profit levels illustrates why a differentiation strategy is so attractive to many firms.

To the extent that differentiation remains in place over time, buyer loyalty may be created. Loyal customers are very desirable because they are not price sensitive. In other words, buyer loyalty makes a customer unlikely to switch to another firm's products if that firm tries to steal the customer away through lower prices. Many soda drinkers are fiercely loyal to Coca-Cola's products. Coca-Cola's headquarters are in Atlanta, and loyalty to the firm is especially strong in Georgia and surrounding states. Pepsi and other brands have a hard time convincing loyal Coca-Cola fans to buy their beverages, even when offering deep discounts. This helps keep Coca-Cola's profits high because the firm does not have to match any promotions that its rivals launch to keep its customers.

Meanwhile, Pepsi also has attracted a large set of brand-loyal customers that Coca-Cola struggles to steal. This enhances Pepsi's profits. In contrast, store-brand sodas such as Sam's Choice (which is sold at Walmart) seldom attract loyalty. As a result, they must be offered at very low prices to move from store shelves into shopping carts.

Beyond existing competitors, a differentiation strategy also creates benefits relative to potential new entrants. Specifically, the brand loyalty that customers feel to a differentiated product makes it difficult for a new entrant to lure these customers to adopt its product. A new soda brand, for example, would struggle to take customers away from Coca-Cola or Pepsi. Thus a differentiation strategy helps create barriers to entry that protect the firm and its industry from new competition.

The big risk when using a differentiation strategy is that customers will not be willing to pay extra to obtain the unique features that a firm is trying to build its strategy around. In 2007, department store Dillard's stopped carrying men's sportswear made by Nautica because the seafaring theme of Nautica's brand had lost much of its cache among many men (Kapner, 2007). Because Nautica's uniqueness had eroded, Dillard's believed that space in its stores that Nautica had been occupying could be better allocated to other brands.

In some cases, customers may simply prefer a cheaper alternative. For example, products that imitate the look and feel of offerings from Ray-Ban, Tommy Bahama, and Coach are attractive to many value-conscious consumers. Firms such as these must work hard at product development and marketing to ensure that enough customers are willing to pay a premium for their goods rather than settling for knockoffs.

In other cases, customers desire the unique features that a firm offers, but competitors are able to imitate the features well enough that they are no longer unique. If this happens, customers have no reason to pay a premium for the firm's offerings. IBM experienced the pain of this scenario when executives tried to follow a differentiation strategy in the personal computer market. The strategy had worked for IBM in other areas. Specifically, IBM had enjoyed a great deal of success in the mainframe computer market by providing superior service and charging customers a premium for their mainframes. A business owner who relied on a mainframe to run her company could not afford to have her mainframe out of operation for long. Meanwhile, few businesses had the skills to fix their own mainframes. IBM's message to customers was that they would pay more for IBM's products but that this was a good investment because when a mainframe needed repairs, IBM would provide faster and better service than its competitors could. The customer would thus be open for business again very quickly after a mainframe failure.

This positioning failed when IBM used it in the personal computer market. Rivals such as Dell were able to offer service that was just as good as IBM's while also charging lower prices for personal computers than IBM charged. From a customer's perspective, a person would be foolish to pay more for an IBM personal computer since IBM did not offer anything unique. IBM steadily lost market share as a result. By 2005, IBM's struggles led it to sell its personal computer business to Lenovo. The firm is still successful, however, within the mainframe market where its offerings remain differentiated.

Companies that use a cost leadership strategy and those that use a differentiation strategy share one important characteristic: both groups try to be attractive to customers in general. These efforts to appeal to broad markets can be contrasted with strategies that involve targeting a relatively narrow niche of potential customers. These latter strategies are known as focus strategies (Porter, 1980).

The Nature of the Focus Cost Leadership Strategy

Focused cost leadership is the first of two focus strategies. A focused cost leadership strategy requires competing based on price to target a narrow market. A firm that follows this strategy does not necessarily charge the lowest prices in the industry. Instead, it charges low prices relative to other firms that compete within the target market. Redbox, for example, uses vending machines placed outside grocery stores and other retail outlets to rent DVDs of movies for $1. There are ways to view movies even cheaper, such as through the flat-fee streaming video subscriptions offered by Netflix. But among firms that rent actual DVDs, Redbox offers unparalleled levels of low price and high convenience.

Another important point is that the nature of the narrow target market varies across firms that use a focused cost leadership strategy. In some cases, the target market is defined by demographics. Claire's, for example, seeks to appeal to young women by selling inexpensive jewelry, accessories, and ear piercings. Claire's use of a focused cost leadership strategy has been very successful; the firm has more than three thousand locations and has stores in 95 percent of US shopping malls.

In other cases, the target market is defined by the sales channel used to reach customers. Most pizza shops offer sit-down service, delivery, or both. In contrast, Papa Murphy's sells pizzas that customers cook at home. Because these inexpensive pizzas are baked at home rather than in the store, the law allows Papa Murphy's to accept food stamps as payment. This allows Papa Murphy's to attract customers that might not otherwise be able to afford a prepared pizza.

The Nature of the Focused Differentiation Strategy

Focused differentiation is the second of two focus strategies. A focused differentiation strategy requires offering unique features that fulfill the demands of a narrow market. As with a focused low-cost strategy, narrow markets are defined in different ways in different settings. Some firms using a focused differentiation strategy concentrate their efforts on a particular sales channel, such as selling over the Internet only. Others target particular demographic groups. One example is Breezes Resorts, a company that caters to couples without children. The firm operates seven tropical resorts where vacationers are guaranteed that they will not be annoyed by loud and disruptive children.

While a differentiation strategy involves offering unique features that appeal to a variety of customers, the need to satisfy the desires of a narrow market means that the pursuit of uniqueness is often taken to the proverbial "next level" by firms using a focused differentiation strategy. Thus the unique features provided by firms following a focused differentiation strategy are often specialized.

When it comes to uniqueness, few offerings can top Kopi Luwak coffee beans. High-quality coffee beans often sell for $10 to $15 a pound. In contrast, Kopi Luwak coffee beans sell for hundreds of dollars per pound (Cat's Ass Coffee). This price is driven by the rarity of the beans and their rather bizarre nature. As noted in a 2010 article in the *New York Times*, these beans are found in the droppings of the civet, a nocturnal, furry, long-tailed catlike animal that prowls Southeast Asia's coffee-growing lands for the tastiest, ripest coffee cherries. The civet eventually excretes the hard, indigestible innards of the fruit—essentially, incipient coffee beans—though only after they have been fermented in the animal's stomach acids and enzymes to produce a brew described as smooth, chocolaty and devoid of any bitter aftertaste (Onishi, 2010).

Although many consumers consider Kopi Luwak to be disgusting, a relatively small group of coffee enthusiasts has embraced the coffee and made it a profitable product. This illustrates the essence of a focused differentiation strategy—effectively serving the specialized needs of a niche market can create great riches.

Larger niches are served by Whole Foods Market and Mercedes-Benz. Although most grocery stores devote a section of their shelves to natural and organic products, Whole Foods Market works to sell such products exclusively. For customers, the large selection of organic goods comes at a steep price. Indeed, the supermarket's reputation for high prices has led to a wry nickname—"Whole Paycheck"—but a sizable number of consumers are willing to pay a premium to feel better about the food they buy.

The dedication of Mercedes-Benz to cutting-edge technology, styling, and safety innovations has made the firm's vehicles prized by those who are rich enough to afford them. This appeal has existing for many decades. In 1970, acid-rocker Janis Joplin recorded a song called "Mercedes Benz" that highlighted the automaker's allure. Since then Mercedes-Benz has used the song in several television commercials, including during the 2011 Super Bowl.

Advantages and Disadvantages of the Focused Strategies

Each generic strategy offers advantages that firms can potentially leverage to enhance their success as well as disadvantages that may undermine their success. In the case of focus differentiation, one advantage is that very high prices can be charged. Indeed, these firms often price their wares far above what is charged by firms following a differentiation strategy. REI (Recreational Equipment

Inc.), for example, commands a hefty premium for its outdoor sporting goods and clothes that feature name brands, such as The North Face and Marmot. Nat Nast's focus differentiation strategy centers on selling men's silk camp shirts with a 1950s retro flair. These shirts retail for more than $100. Focused cost leaders such as Checkers Drive In do not charge high prices like REI and Nat Nast do, but their low cost structures enable them to enjoy healthy profit margins.

A second advantage of using a focus strategy is that firms often develop tremendous expertise about the goods and services that they offer. In markets such as camping equipment where product knowledge is important, rivals and new entrants may find it difficult to compete with firms following a focus strategy.

Advantages	**Disadvantages**
• High prices can be charged. Recreational Equipment Incorporated (REI), for example, commands a premium for their outdoor sporting goods and clothes that feature name brands such as The North Face and Marmot. • Firms using a focus strategy often develop great expertise about the good or service being sold. Thus, customers may gravitate toward a specialty camping shop in order to learn how to best take advantage of limited vacation time.	• Limited demands exist for specialized goods and services, so every potential sale counts. • The area of focus may be taken over by others or even disappear over time. Many gun stores went out of business after large retailers such as Walmart started carrying an array of firearms. • Other firms may provide an even narrower focus. An outdoor sporting goods store, for example, might lose business to a store that focuses solely on ski apparel because the latter can provide more guidance about how skiers can stay warm and avoid broken bones.

Table 4 Executing a Focus Strategy. *Using one of the focus strategies offers firms important advantages and disadvantages. Below we illustrate a few examples in relation to an industry where many different types of focus exist–sporting goods.*

In terms of disadvantages, the limited demand available within a niche can cause problems. First, a firm could find its growth ambitions stymied. Once its target market is being well served, expansion to other markets might be the only way to expand, and this often requires developing a new set of skills. Also, the niche could disappear or be taken over by larger competitors. Many gun stores have struggled and even gone out of business since Walmart and sporting goods stores such as Academy Sports and Bass Pro Shops have started carrying an impressive array of firearms.

In contrast to tacky Hawaiian souvenirs, the quality of Kamaka ukuleles makes them a favorite of ukulele phenom Jake Shimabukuro and others who are willing to pay $1,000 or more for a high-end instrument.

Finally, damaging attacks may come not only from larger firms but also from smaller ones that adopt an even narrower focus. A sporting goods store that sells camping, hiking, kayaking, and skiing goods, for example, might lose business to a store that focuses solely on ski apparel because the latter can provide more guidance about how skiers can stay warm and avoid broken bones.

Strategy at the Movies

Zoolander

One man's trash is another man's fashion? That's what fashion mogul Jacobim Mugatu was counting on in the 2001 comedy *Zoolander*. In his continued effort to be the most cutting-edge designer in the fashion industry, Mugatu developed a new line of clothing inspired "by the streetwalkers and hobos that surround us." His new product line, Derelicte, characterized by dresses made of burlap and parking cones and pants made of garbage bags and tin cans, was developed for customers who valued the uniqueness of his…eclectic design. Emphasizing unique products is typical of a company following a differentiation strategy; however, Mugatu targeted a very specific set of customers. Few people would probably be enticed to wear garbage for the sake of fashion. By catering to a niche target market, Mugatu went from a simple differentiation strategy to a focused differentiation. Mugatu's

Derelicte campaign in *Zoolander* is one illustration of how a particular firm might develop a focused differentiation strategy.

Southwest Airlines provides low cost flights to vacations destinations such as San Antonio, San Diego, and Orland. While many airlines make passengers feel like cattle loaded on to a truck, Southwest creates fun by, for example, getting children excited about visiting Sea World when they see this custom Shamu plane design.	Chipotle Mexican Grill relies on organic ingredients to create very tasty burritos that are sold at prices comparable to those of fast-food restaurants. When noon arrives, many hungry people prefer to spend their lunch dollars on a top-shelf burrito rather than a greasy burger combo meal.
Target offers extremely competitive prices, but the firm also differentiates itself from other discount retailers by carrying products from trendy designers such as Michael Graves, Isaac Mizrahi, Fiorruci, and Liza Lange.	Pabst Blue Ribbon is offered at an extremely low price and its taste (or lack thereof) is comparable that to other inexpensive beers. "PBR" enjoys brand loyalty, however, due to its high name recognition. The frequent appearance of PBR's well-known logo on signs, T-shirts, and other merchandise has helped make PBR an enduring favorite among beer consumers with light wallets.

Table 4 Best-Cost Strategy. *Firms that charge relatively low prices and offer substantial differentiation are following a best-cost strategy. This strategy is difficult to execute, but it is also potentially very rewarding. Several examples of firms pursuing a best-cost strategy are illustrated below.*

The Challenge of Following a Best-Cost Strategy

Some executives are not content to have their firms compete based on offering low prices or unique features. They want it all! Firms that charge relatively low prices *and* offer substantial differentiation are following a best-cost strategy. This strategy is difficult to execute in part because creating unique features and communicating to customers why these features are useful generally raises a firm's costs of doing business. Product development and advertising can both be quite expensive. However, firms that manage to implement an effective best-cost strategy are often very successful.

Target appears to be following a best-cost strategy. The firm charges prices that are relatively low among retailers while at the same time attracting trend-conscious consumers by carrying products from famous designers, such as Michael Graves, Isaac Mizrahi, Fiorucci, Liz Lange, and others. This is a lucrative position for Target, but the position is under attack from all sides. Cost leader Walmart charges lower prices than Target. This makes Walmart a constant threat to steal the thriftiest of Target's customers. Focus differentiators such as Anthropologie that specialize in trendy clothing and home furnishings can take business from Target in those areas. Deep discounters such as T.J. Maxx and Marshalls offer another viable alternative to shoppers because they offer designer clothes and furnishings at closeout prices.

Pursuing the Best-Cost Strategy through a Low-Overhead Business Model

One route toward a best-cost strategy is for a firm to adopt a business model whose fixed costs and overhead are very low relative to the costs that competitors are absorbing. The Internet has helped make this possible for some firms. Amazon, for example, can charge low prices in part because it does not have to endure the expenses that firms such as Walmart and Target do in operating many hundreds of stores. Meanwhile, Amazon offers an unmatched variety of goods. This combination has made Amazon the unquestioned leader in e-commerce.

Another example is Netflix. This firm is able to offer customers a far greater variety of movies and charge lower prices than video rental stores by conducting all its business over the Internet and via mail. Netflix's best-cost strategy has been so successful that $10,000 invested in the firm's stock in May 2006 was worth more than $90,000 five years later.1

Moving toward a best-cost strategy by dramatically reducing expenses is also possible for firms that cannot rely on the Internet as a sales channel. Owning a restaurant requires significant overhead costs, such as rent and utilities. Some talented chefs are escaping these costs by taking their food to the streets. Food trucks that serve high-end specialty dishes at very economical prices are becoming a popular trend in cities around the country. In Portland, Oregon, a food truck called the Ninja Plate Lunch offers large portions of delectable Hawaiian foods such as pulled pork for around $5. Another Portland food truck is PBJ's, whose unique and inexpensive sandwiches often center on organic peanut butter. Beyond keeping costs low, the mobility of food trucks offers important advantages over a traditional restaurant. Some food trucks set up outside big-city nightclubs, for example, to sell partygoers a late-night snack before they head home.

Stuck in the Middle: Neither Inexpensive nor Differentiated

Some firms fail to effectively pursue one of the generic strategies. A firm is said to be stuck in the middle if it does not offer features that are unique enough to convince customers to buy its offerings, and its prices are too high to compete effectively based on price. Arby's appears to be a good example. Arby's signature roast beef sandwiches are neither cheaper than other fast-food sandwiches nor standouts in taste. Firms that are stuck in the middle generally perform poorly because they lack a clear market or competitive pricing. Perhaps not surprisingly, parent company Wendy's has been trying to sell Arby's despite having recently acquired the company in 2008. Stockholders apparently agreed with the plan to cut Arby's loose—the price of Wendy's stock rose 7 percent the day the plan was announced (McWilliams, 2011).

Doing Everything Means Doing Nothing Well

Michael Porter has noted that strategy is as much about executives deciding what a firm *is not* going to do as it is about deciding what the firm *is* going to do (Porter, 1996). In other words, a firm's business-level strategy should not involve trying to serve the varied needs of different segment of customers in an industry. No firm could possibly pull this off.

Getting Outmaneuvered by Competitors

In many cases, firms become stuck in the middle not because executives fail to arrive at a well-defined strategy but because firms are simply outmaneuvered by their rivals. After six decades as an electronics retailer, Circuit City went out of business in 2009. The firm had simply lost its appeal to customers. Rival electronics retailer Best Buy offered comparable prices to Circuit City's prices, but the former offered much better customer service. Meanwhile, the service offered by discount retailers such as Walmart and Target on electronics were no better that Circuit City's, but their prices were better.

The results were predictable—customers who made electronics purchases based on the service they received went to Best Buy, and value-driven buyers patronized Walmart and Target. Circuit City's demise was probably inevitable because it lacked a competitive advantage within the electronics business. Although Target was on the winning end of this battle, Target executives need to worry that their firm could become stuck in the middle between Walmart's better prices on one side and the trendiness of specialty shops on the other.

IBM's personal computer business offers another example. IBM tried to position its personal computers via a differentiation strategy. In particular, IBM's personal computers were offered at high prices, and the firm promised to offer excellent service to customers in return. Unfortunately for IBM, rivals such as Dell were able to provide equal levels of service while selling computers at lower prices. Nothing made IBM's computers stand out from the crowd, and the firm eventually exited the business.

At its peak in the mid-2000s, Movie Gallery operated approximately 4,700 video rental stores. By 2010, the firm was dead. This rapid demise can be traced to the firm becoming outmaneuvered by Netflix. When Netflix began offering inexpensive DVD rentals through the mail, customers defected in droves from Movie Gallery and other video rental stores such as Blockbuster. Netflix customers were delighted by the firm's low prices, vast selection, and the convenience of not having to visit a store to select and return videos. Movie Gallery was stuck in the middle—its prices were higher than those of Netflix, and Netflix's service was superior.

Once individuals lacked a compelling reason to be Movie Gallery customers, the firm's fate was sealed.

Netflix and Redbox have left video rental stores such as Movie Gallery and Blockbuster stuck in the middle. Blockbuster filed for bankruptcy in late 2010.

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Corporate-Level Strategies

Concentration Strategies

For many firms, concentration strategies are very sensible. These strategies involve trying to compete successfully only within a single industry. McDonald's, Starbucks, and Subway are three firms that have relied heavily on concentration strategies to become dominant players.

Market penetration involves trying to gain additional share of a firm's existing markets using existing products—often by relying on extensive advertising. Perhaps the most famous example of two close rivals simultaneously attempting market penetration is the "cola wars" where Coca-Cola and PepsiCo fight for share in the soft drink market. Pepsi's blind taste tests in 1975 called the Pepsi Challenge is one of the more famous attacks in this ongoing battle.
Market development involves taking existing products and trying to sell them within new markets. Starbucks engages in market development by selling their beans and bottled drinks in grocery stores. Apple engages in market development by allowing customers in Starbucks stores to connect directly to iTunes store and Starbucks Now Playing content. Customers are offered a free download to get them to visit iTunes—and to perhaps purchase more songs.
Product development involves creating new products to serve existing markets. King Gillette, an American businessman whose family hailed from France, pioneered the safety razor that bears his family name. His company's more recent innovations in the razor market include Trac II (the first two-bald razor), Altra (first razor with a pivoting head), Sensor (first razor with spring-loaded blades), Mach 3 (first three-blade razor), and Fusion (first six-blade razor). Is the ten-blade razor coming soon?

Table 1 Concentration Strategies. *Concentration strategies involve trying to grow by successfully competing only within a single industry. We illustrate the three concentration strategies in table 1.*

Market Penetration

There are three concentration strategies: (1) market penetration, (2) market development, and (3) product development. A firm can use one, two, or all three as part of their efforts to excel within an industry (Ansoff, 1957). Market penetration involves trying to gain additional share of a firm's existing markets using existing products.

Often firms will rely on advertising to attract new customers with existing markets.

Nike, for example, features famous athletes in print and television ads designed to take market share within the athletic shoes business from Adidas and other rivals. McDonald's has pursued market penetration in recent years by using Latino themes within some of its advertising. The firm also maintains a Spanish-language website at http://www.meencanta.com; the website's name is the Spanish translation of McDonald's slogan "I'm lovin' it." McDonald's hopes to gain more Latino customers through initiatives such as this website.

Market Development

Market development involves taking existing products and trying to sell them within new markets. One way to reach a new market is to enter a new retail channel. Starbucks, for example, has stepped beyond selling coffee beans only in its stores and now sells beans in grocery stores. This enables Starbucks to reach consumers that do not visit its coffeehouses.

Entering new geographic areas is another way to pursue market development. Philadelphia-based Tasty Baking Company has sold its Tastykake snack cakes since 1914 within Pennsylvania and adjoining states. The firm's products have become something of a cult hit among customers, who view the products as much tastier than the snack cakes offered by rivals such as Hostess and Little Debbie. In April 2011, Tastykake was purchased by Flowers Foods, a bakery firm based in Georgia. When it made this acquisition, Flower Foods announced its intention to begin extensively distributing Tastykake's products within the southeastern United States. Displaced Pennsylvanians in the south rejoiced.

Product Development

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

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

Seattle-based Jones Soda Co. takes a novel approach to product development. Each winter, the firm introduces a holiday-themed set of unusual flavors. Jones Soda's 2006 set focus on the flavors of Thanksgiving. It contained Green Pea, Sweet Potato, Dinner Roll, Turkey and Gravy, and Antacid sodas. The flavors of Christmas were the focus of 2007's set, which included Sugar Plum, Christmas Tree, Egg Nog, and Christmas Ham. In early 2011, Jones Soda let it customers choose the winter 2011 flavors via a poll on its website. The winners were Candy Cane, Gingerbread, Pear Tree, and Egg Nog. None of these holiday flavors are expected to be big hits, of course. The hope is that the buzz that surrounds the unusual flavors each year will grab customers' attention and get them to try—and become hooked on—Jones Soda's more traditional flavors.

Horizontal Integration: Mergers and Acquisitions

ExxonMobil is a direct descendant of John D. Rockefeller's Standard Oil Company. It was formed by the 1999 merger of Exxon and Mobil. As in many mergers, the new company name combines the old company names.
Starbucks acquired competitor Seattle's Best Coffee—which had a presence in Borders Bookstores and Subway Restaurants—in order to target a more working-class audience without diluting the Starbucks brand.
Bill Hewlett and Dave Packard formed Hewlett-Packard in a garage after graduating from Stanford in 1935. In recent years, HP has pursued horizontal integration through a merger with Compaq and the acquisition of Palm.
DaimlerChrysler was formed in 1998 when Chrysler entered into what was billed as a "merger of equals" with Germany's Daimler-Benz AG. The marriage failed, and Chrysler is currently owned by Italian automaker Fiat.
Global pharmaceutical firm GlaxoSmithKline plc was formed by the merger of GlaxoWellcome plc and SmithKline Beecham plc in 200.

Table 2 Horizontal Integration. *Horizontal integrations refers to pursuing a concentration strategy by acquiring or merging with a rival. The term* ***merger*** *is generally used when two similarly sized firms are integrated into a single entity. In an acquisition, a larger firm purchases and absorbs a smaller firm.*

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

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

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

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

Horizontal integration may provide access to new distribution channels. Some observers were puzzled when Zuffa, the parent company of the Ultimate Fighting Championship (UFC), purchased rival mixed martial arts (MMA) promotion Strikeforce. UFC had such a dominant position within MMA that Strikeforce seemed to add very little for Zuffa. Unlike UFC, Strikeforce had gained exposure on network television through broadcasts on CBS and its partner Showtime. Thus acquiring Strikeforce might help Zuffa gain mainstream exposure of its product (Wagenheim, 2011).

Despite the potential benefits of mergers and acquisitions, their financial results often are very disappointing. One study found that more than 60 percent of mergers and acquisitions erode shareholder wealth while fewer than one in six increases shareholder wealth (Henry, 2002). Some of these moves struggle because the cultures of the two companies cannot be meshed. This chapter's opening vignette suggests that Disney and Pixar may be experiencing this problem. Other acquisitions fail because the buyer pays more for a target company than that company is worth and the buyer never earns back the premium it paid.

In the end, between 30 percent and 45 percent of mergers and acquisitions are undone, often at huge losses (Hitt, et. al., 2001). For example, Mattel purchased The Learning Company in 1999 for $3.6 billion and sold it a year later for $430 million—12 percent of the original purchase price. Similarly, Daimler-Benz bought Chrysler in 1998 for $37 billion. When the acquisition was undone in 2007, Daimler recouped only $1.5 billion worth of value—a mere 4 percent of what it paid. Thus executives need to be cautious when considering using horizontal integration.

Vertical Integration Strategies

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

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

Backward vertical integration – entering a supplier's business–is evident as all clothing design is done in-house–often using employees as models.
Manufacturing is conducted in a 800,000 square foot factory in downtown Los Angeles.
Ironically, it was a Canadian named Dov Charney who founded American Apparel in 1989.
The vertical integration process allows the company to keep pace with the fast-moving world of fashion. It takes just a couple of weeks to go from idea to retail floor.
American Apparel uses **forward vertical integration**–entering a buyer's business–by operating 250 plus company-owned stores worldwide.

Table 3 Vertical Integration at American Apparel *When using vertical integration, firms get involved in different elements of the value chain. This concept gets top billing at American Apparel, a firm that describes its business model as "vertically integrated manufacturing." The elements of their integrated process for designing, manufacturing, wholesaling, and selling basic T-shirts, underwear, leggings, dresses, and other clothing and accessories for men, women, children, and dogs is illustrated below.*

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

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

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

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

Backward Vertical Integration

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

Although backward vertical integration is usually discussed within the context of manufacturing businesses, such as steelmaking and the auto industry, this strategy is also available to firms such as Disney that compete within the entertainment sector. ESPN is a key element of Disney's operations within the television business. Rather than depend on outside production companies to provide talk shows and movies centered on sports, ESPN created its own production company. ESPN Films is a subsidiary of ESPN that was created in 2001. ESPN Films has created many of ESPN's best-known programs, including *Around the Horn* and *Pardon the Interruption*. By owning its own production company, ESPN can ensure that it has a steady flow of programs that meet its needs.

Forward Vertical Integration

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

Forward vertical integration also can be useful for neutralizing the effect of powerful buyers. Rental car agencies are able to insist on low prices for the vehicles they buy from automakers because they purchase thousands of cars. If one automaker stubbornly tries to charge high prices, a rental car agency can simply buy cars from a more accommodating automaker. It is perhaps not surprising that Ford purchased Hertz Corporation, the world's biggest rental car agency, in 1994. This ensured that Hertz would not drive too hard of a bargain when buying Ford vehicles. By 2005, selling vehicles to rental car companies had become less important to Ford and Ford was struggling financially. The firm then reversed its forward vertical integration strategy by selling Hertz.

eBay's purchase of PayPal and Apple's creation of Apple Stores are two recent examples of forward vertical integration. Despite its enormous success, one concern for eBay is that many individuals avoid eBay because they are nervous about buying and selling goods online with strangers. PayPal addressed this problem by serving, in exchange for a fee, as an intermediary between online buyers and sellers. eBay's acquisition of PayPal signaled to potential customers that their online transactions were completely safe—eBay was now not only the place where business took place but eBay also protected buyers and sellers from being ripped off.

Apple's ownership of its own branded stores set the firm apart from computer makers such as Hewlett-Packard, Acer, and Gateway that only distribute their products through retailers like Best Buy and Office Depot. Employees at Best Buy and Office Depot are likely to know just a little bit about each of the various brands their store carries.

In contrast, Apple's stores are popular in part because store employees are experts about Apple products. They can therefore provide customers with accurate and insightful advice about purchases and repairs. This is an important advantage that has been created through forward vertical integration.

Diversification Strategies

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

Three Tests for Diversification

A proposed diversification move should pass three tests or it should be rejected (Porter, 1987).

1. How attractive is the industry that a firm is considering entering? Unless the industry has strong profit potential, entering it may be very risky.
2. How much will it cost to enter the industry? Executives need to be sure that their firm can recoup the expenses that it absorbs in order to diversify. When Philip Morris bought 7Up in the late 1970s, it paid four times what 7Up was actually worth. Making up these costs proved to be impossible and 7Up was sold in 1986.
3. Will the new unit and the firm be better off? Unless one side or the other gains a competitive advantage, diversification should be avoided. In the case of Philip Morris and 7Up, for example, neither side benefited significantly from joining together.

Related Diversification

Related diversification occurs when a firm moves into a new industry that has important similarities with the firm's existing industry or industries. Because films and television are both aspects of entertainment, Disney's purchase of ABC is an example of related diversification. Some firms that engage in related diversification aim to develop and exploit a core competency to become more successful. A core competency is a skill set that is difficult for competitors to imitate, can be leveraged in different businesses, and contributes to the benefits enjoyed by customers within each business (Prahalad & Hamel, 1990). For example, Newell Rubbermaid is skilled at identifying underperforming brands and integrating them into their three business groups: (1) home and family, (2) office products, and (3) tools, hardware, and commercial products.

Honda Motor Company provides a good example of leveraging a core competency through related diversification. Honda is best known for its cars and trucks but the company started in the motorcycle business. Through competing in the motorcycle business, Honda developed a unique ability to build small and reliable engines. When executives decided to diversify into the automobile industry, Honda was successful in part because it leveraged this ability within its new business.

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

Unrelated Diversification

Berkshire's insurance group includes firms such as General Re and GEICO. They maintain capital strength at exceptionally high levels, which gives them an advantage even a cave man could understand.	Berkshire's financial health is also fueled by utilities and energy companies that are part of the MidAmerican Energy Holdings Company.	Their apparel businesses include well-known names such as Fruit of the Loom and Justin Brands.
Building companies include Acme Building Brands, makes of the famous brick, as well as paint company Benjamin Moore & Co.	FlightSafety International Inc. is a Berkshire firm that engages in high-tech training to aircraft and ship operators.	Retail holdings include a number of furniture businesses such as R.C. Willey Home Furnishings, Star Furniture Company, and Jordan's Furniture, Inc.
Hungry for more businesses to manage, Berkshire acquired The Pampered Chef, Ltd.—the largest direct kitchen tools seller—in 2002.	Buffett had a sweet tooth for See's Candies, who he purchased from the See's family in 1972.	Shareholders were all on board for the purchase of the Burlington Northern Santa Fe Corporation in 2009.

Table 4 Unrelated Diversification at Berkshire Hathaway. "*Don't put all your eggs in one basket" is often a good motto for individual investors. By building a portfolio of stocks, an investor can minimize the chances of suffering a huge loss. Some executives take a similar approach. Rather than trying to develop synergy across businesses, they seek greater financial stability for their firms by owning an array of companies. Warren Buffett's Berkshire Hathaway has long enjoyed strong performance by purchasing companies and improving how they are run. Below we illustrate some of the different groups in their very diversified portfolio of firms*.

Why would a soft-drink company buy a movie studio? It's hard to imagine the logic behind such a move, but Coca-Cola did just this when it purchased Columbia Pictures in 1982 for $750 million. This is a good example of unrelated diversification, which occurs when a firm enters an industry that lacks any important similarities with the firm's existing industry or industries. Luckily for Coca-Cola, its investment paid off—Columbia was sold to Sony for $3.4 billion just seven years later.

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

Lighter firm Zippo is currently trying to avoid this scenario. According to CEO Geoffrey Booth, the Zippo is viewed by consumers as a "rugged, durable, made in America, iconic" brand (Townhall, 2010). This brand has fueled eighty years of success for the firm. But the future of the lighter business is bleak. Zippo executives expect to sell about 12 million lighters this year, which is a 50 percent decline from Zippo's sales levels in the 1990s. This downward trend is likely to continue as smoking becomes less and less attractive in many countries. To save their company, Zippo executives want to diversify.

Zippo wants to follow a path blazed by Eddie Bauer and Victorinox Swiss Army Brands Inc. The rugged outdoors image of Eddie Bauer's clothing brand has been used effectively to sell sport utility vehicles made by Ford. The high-quality image of Swiss Army knives has been used to sell Swiss Army–branded luggage and watches. As of March 2011, Zippo was examining a wide variety of markets where their brand could be leveraged, including watches, clothing, wallets, pens, liquor flasks, outdoor hand warmers, playing cards, gas grills, and cologne. Trying to figure out which of these diversification options would be winners, such as the Eddie Bauer–edition Ford Explorer, and which would be losers, such as Harley-branded bottled water, was a key challenge facing Zippo executives.

Strategy at the Movies

In Good Company

What do Techline cell phones, *Sports America* magazine, and Crispity Crunch cereals have in common? Not much, but that did not stop Globodyne from buying each of these companies in its quest for synergy in the 2004 movie *In Good Company*. Executive Carter Duryea was excited when his employer Globodyne purchased Waterman Publishing, the owner of *Sports America* magazine. The acquisition landed him a big promotion and increased his salary to “Porsche-leasing” size.

Synergy is created when two or more businesses produce benefits together that could not be produced separately. While Duryea was confident that a cross-promotional strategy between his advertising division and the other units within the Globodyne universe was a slam-dunk, Waterman employee Dan Foreman saw little congruence between advertisements in *Sports America* on the one hand and cell phones and breakfast cereals on the other. Despite his considerable efforts, Duryea was unable to increase ad pages in *Sports America* because the unrelated nature of Globodyne’s other business units inhibited his strategy of creating synergy. Seeing little value in owning a failing publishing company, Globodyne promptly sold the division to another conglomerate. After the sale, the executives that had been rewarded for the initial purchase of Waterman Publishing, including Duryea, were fired.

Globodyne’s inability to successfully manage Waterman Publishing illustrates the difficulties associated with unrelated diversification. While buying companies outside a parent company’s core competencies can increase the size of the company and in turn its executives’ bank accounts, managing firms unfamiliar to management is generally a risky and losing proposition. Decades of research on strategic management suggest that when firms diversify, it is best to “stick to the knitting.” That is, stay with businesses executives are familiar with and avoid moving into ventures where little expertise exists.

Strategies for Getting Smaller

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

Retrenchment

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

Retrenchment is often accomplished through laying off employees. In July 2011, for example, South African grocery store chain Pick n Pay announced plans to release more than 3,000 of its estimated 36,000 workers. Just over a month earlier, South African officials had approved Walmart's acquisition of a leading local retailer called Massmart. Rivalry in the South African grocery business seemed likely to become fiercer, and Pick n Pay executives needed to cut costs for their firm to remain competitive.

A Pick n Pay executive explained the layoffs by noting that "the decision was not taken lightly but was required to ensure the viability of the retail business and its employees into the future (Chilwane, 2011)." This is a common rationale for retrenchment—by shrinking the size of a firm, executives hope that the firm can survive as a profitable enterprise. Without becoming smaller and more cost effective, Pick n Pay and other firms that use retrenchment can risk total failure.

Restructuring

There are 17 billion of Freescale Semiconductor's chips in use around the world. The firm was spun-off from Motorola in 2004.
Toyota started in the car business, right? Wrong. The firm was spun-off in the 1930s from Toyoda Automatic Loom Works—a company that produced commercial weaving looms.
The 2000 merger between America Online (AOL) and Time Warner was one of the largest in history. The firms split in 2009. Net result? A staggering $99 billion loss.
Delphi Automotive—an automotive parts company headquartered in Troy, Michigan—is a spin-off from General Motors.
Guidant Corporation—a spin-off from Eli Lilly—designs and manufacturers artificial pacemakers, defibrillators, stents, and other heart-helpful medical products.

Table 5 Spin Offs. *Spin-offs occur when businesses create a new firm from a piece of their operations. Because some diversified firms are too complex for investors to understand, breaking them up can create wealth by resulting in greater stock market valuations. Spinning off a company also reduces management layers, which can lower costs and speed up decision making. Below we describe a variety of firms that were created as spin-offs.*

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

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

Fortune Brands provides a good example. Surprisingly, this company does not own *Fortune* magazine, but it has been involved in a diverse set of industries. As of 2010, the firm consisted of three businesses: spirits (including Jim Beam and Maker's Mark), household goods (including Masterlock and Moen Faucets), and golf equipment (including Titleist clubs and balls as well as FootJoy shoes). In December 2010, Fortune Brand's CEO announced a plan to separate the three businesses to "maximize long-term value for our shareholders and to create exciting opportunities within our businesses (Sauerhaft, 2011)." Fortune Brands took the first step toward overcoming the diversification discount in May 2011 when it reached an agreement to sell its gold business to Fila. In June 2011, plans to spin off the home products business were announced.

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

Portfolio Planning and Corporate-Level Strategy

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

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

<u>The Boston Consulting Group (BCG) Matrix</u>

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

The BCG matrix is just one portfolio planning technique. With the help of a leading consulting firm, GE developed the attractiveness-strength matrix to examine its diverse activities. This planning approach involves rating each of a firm's businesses in terms of the attractiveness of the industry and the firm's strength within the industry. Each dimension is divided into three categories, resulting in nine boxes. Each of these boxes has a set of recommendations associated with it.

	High Relative Market Share	Low Relative Market Share
High Industry Growth Rate	Stars should be funded and encourage to grow.	Question marks should be resolved by executives by deciding whether to foster or sell these units.
Low Industry Growth Rate	Cash cows should be "milked" to supply funds to more promising businesses.	It sounds mean, but dogs should be sold if possible and abandoned if necessary.

Table 6 The Boston Consulting Group (BCG) Matrix. *The Boston Consulting Group (BCG) matrix is the best-known approach to portfolio planning—assessing a firm's prospects for success within the industries in which it competes. The matrix categorizes businesses as high or low along two dimensions—the firm's market share in each industry and the growth rate of each industry. Suggestions are then offered about how to approach each industry.*

Limitations to Portfolio Planning

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

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Competitive and Cooperative Moves

Being a First Mover: Advantages and Disadvantages

First Move Successes	**First Move Failures**
Kosmo.com provided free delivery of a host of goods such as games, magazines, DVDs, and Starbucks coffee. While their first mover advantage allowed them to gain popularity during the dot.com boom, the company lasted only four years.	
At a time when using most personal computers required memorizing obscure commands, Apple pioneered a user-friendly interface. The firm gained a reputation as an innovator that persists today.	Netscape's web browser was a first mover that was popular in the 1990s, but nearly extinct by 2002 with the advent of Microsoft's competitive offering–Internet Explorer.
Following World War II, Japan's economy laid in ruin. Ibuka Masaru used this backdrop to build a company that would be the first in Japan to create tape recorders and transistors radios. The company he pioneered–Sony–has now been a fierce electronics competitor for over a half century.	Not all of Apple's first moves are triumphs. The firm's disastrous attempt to pioneer the personal digital assistand market through its "Newton" created a loss of around one-hundred million dollars.

Table 1 First Mover Advantage. *When confronted by a poisonous snake, should you strike first or wait for the serepent to make a move? Each option has advantages and disadvantages. In business, being a first mover might allow a firm to "rattle its rivals, but a first move might also attract the "venom" of skeptical customers. The table offer examples of successful–and not so successful–first movers.*

A famous cliché contends that "the early bird gets the worm." Applied to the business world, the cliché suggests that certain benefits are available to a first mover into a market that will not be available to later entrants. A first-mover advantage exists when making the initial move into a market allows a firm to establish a dominant position that other firms struggle to overcome. For example,

Apple's creation of a user-friendly, small computer in the early 1980s helped fuel a reputation for creativity and innovation that persists today.

Kentucky Fried Chicken (KFC) was able to develop a strong bond with Chinese officials by being the first Western restaurant chain to enter China. Today, KFC is the leading Western fast-food chain in this rapidly growing market.

Genentech's early development of biotechnology allowed it to overcome many of the pharmaceutical industry's traditional entry barriers (such as financial capital and distribution networks) and become a profitable firm. Decisions to be first movers helped all three firms to be successful in their respective industries (Ketchen, et. al., 2004).

On the other hand, a first mover cannot be sure that customers will embrace its offering, making a first move inherently risky. Apple's attempt to pioneer the personal digital assistant market, through its Newton, was a financial disaster. The first mover also bears the costs of developing the product and educating customers. Others may learn from the first mover's successes and failures, allowing them to cheaply copy or improve the product. In creating the Palm Pilot, for example, 3Com was able to build on Apple's earlier mistakes. Matsushita often refines consumer electronic products, such as compact disc players and projection televisions, after Sony or another first mover establishes demand. In many industries, knowledge diffusion and public-information requirements make such imitation increasingly easy.

One caution is that first movers must be willing to commit sufficient resources to follow through on their pioneering efforts. RCA and Westinghouse were the first firms to develop active-matrix LCD display technology, but their executives did not provide the resources needed to sustain the products spawned by this technology. Today, these firms are not even players in this important business segment that supplies screens for notebook computers, camcorders, medical instruments, and many other products.

To date, the evidence is mixed regarding whether being a first mover leads to success. One research study of 1,226 businesses over a fifty-five-year period found that first movers typically enjoy an advantage over rivals for about a decade, but other studies have suggested that first moving offers little or no advantages.

Perhaps the best question that executives can ask themselves when deciding whether to be a first mover is, how likely is this move to provide my firm with a sustainable competitive advantage? First moves that build on strategic resources such as patented technology are difficult for rivals to imitate and thus are likely to succeed. For example, Pfizer enjoyed a monopoly in the erectile dysfunction market for five years with its patented drug Viagra before two rival products (Cialis and Levitra) were developed by other pharmaceutical firms. Despite facing stiff competition, Viagra continues to raise about $1.9 billion in sales for Pfizer annually.1

In contrast, E-Trade Group's creation in 2003 of the portable mortgage seemed doomed to fail because it did not leverage strategic resources. This innovation allowed customers to keep an existing mortgage when they move to a new home. Bigger banks could easily copy the portable mortgage if it gained customer acceptance, undermining E-Trade's ability to profit from its first move.

Disruptive Innovation

Some firms have the opportunity to shake up their industry by introducing a disruptive innovation—an innovation that conflicts with, and threatens to replace, traditional approaches to competing within an industry. The iPad has proved to be a disruptive innovation since its introduction by Apple in 2010. Many individuals quickly abandoned clunky laptop computers in favor of the sleek tablet format offered by the iPad. And as a first mover, Apple was able to claim a large share of the market.

Tablet computers have the potential to disrupt laptop sales due to their versatility and portability. Reading books can be awkward on traditional computers, but user-friendly devices such as iPad, Nook, and Kindle are popular platforms for aggressive textbook publishers.
Many stores that relied on compact disc sales went under when downloadable digital media disrupted the music industry. Years earlier, CDs supplanted vinyl albums and cassette tapes due to their superior durability and quality. Will the cycle continue with a new technology replacing downloads?
Digital cameras disrupted the photography industry by offering instant gratification and eliminating the cost of getting film developed.
The emergence of personal computers disrupted the dominance of mainframes and made it possible for everyone to have a computer in their home.
Steamships replaced sailing ships, which must have been a relief to the prisoners who were often required to row when there was no wind.

Table 2 Shaking the Market with Disruptive Innovations. *Disruptive innovations occur when firms introduce offerings that are so unique and superior that they threaten to replace traditional approaches.*

The iPad story is unusual, however. Most disruptive innovations are not overnight sensations. Typically, a small group of customers embrace a disruptive innovation as early adopters and then a critical mass of customers builds over time. An example is digital cameras. Few photographers embraced digital cameras initially because they took pictures slowly and offered poor picture quality relative to traditional film cameras. As digital cameras have improved, however, they have gradually won over almost everyone that takes pictures. Executives who are deciding whether to pursue a disruptive innovation must first make sure that their firm can sustain itself during an initial period of slow growth.

Footholds

In warfare, many armies establish small positions in geographic territories that they have not occupied previously. These footholds provide value in at least two ways.

1. Owning a foothold can dissuade other armies from attacking in the region.

2. Owning a foothold gives an army a quick strike capability in a territory if the army needs to expand its reach.

Similarly, some organizations find it valuable to establish footholds in certain markets. Within the context of business, a foothold is a small position that a firm intentionally establishes within a market in which it does not yet compete (Upson, et. al.). Swedish furniture seller IKEA is a firm that relies on footholds. When IKEA enters a new country, it opens just one store. This store is then used as a showcase to establish IKEA's brand. Once IKEA gains brand recognition in a country, more stores are established (Hambrick & Fredrickson, 2005).

Pharmaceutical giants such as Merck often obtain footholds in emerging areas of medicine. In December 2010, for example, Merck purchased SmartCells Inc., a company that was developing a possible new treatment for diabetes. In May 2011, Merck acquired an equity stake in BeiGene Ltd., a Chinese firm that was developing novel cancer treatments and detection methods. Competitive moves such as these offer Merck relatively low-cost platforms from which it can expand if clinical studies reveal that the treatments are effective.

Blue Ocean Strategy

It is best to win without fighting.
Sun-Tzu, The Art of War

A blue ocean strategy involves creating a new, untapped market rather than competing with rivals in an existing market (Kim, 2004). This strategy follows the approach recommended by the ancient master of strategy Sun-Tzu in the quote above. Instead of trying to outmaneuver its competition, a firm using a blue ocean strategy tries to make the competition irrelevant. Baseball legend Wee Willie Keeler offered a similar idea when asked how to become a better hitter: "Hit 'em where they ain't." In other words, hit the baseball where there are no fielders rather than trying to overwhelm the fielders with a ball hit directly at them.

Nintendo openly acknowledges following a blue ocean strategy in its efforts to invent new markets. In 2006, Perrin Kaplan, Nintendo's vice president of marketing and corporate affairs for Nintendo of America noted in an interview, "We're making games that are expanding our base of consumers in Japan and America. Yes, those who've always played games are still playing, but we've got people who've never played to start loving it with titles like *Nintendogs*, *Animal Crossing* and *Brain Games*. These games are blue ocean in action (Rosmarin, 2006)." Other examples of companies creating new markets include FedEx's invention of the fast-shipping business and eBay's invention of online auctions.

Bricolage

Bricolage is a concept that is borrowed from the arts and that, like blue ocean strategy, stresses moves that create new markets. Bricolage means using whatever materials and resources happen to be available as the inputs into a creative process. A good example is offered by one of the greatest inventions in the history of civilization: the printing press. As noted in the *Wall Street Journal*, "The printing press is a classic combinatorial innovation. Each of its key elements—the movable type, the ink, the paper and the press itself—had been developed separately well before Johannes Gutenberg printed his first Bible in the 15th century. Movable type, for instance, had been independently conceived by a Chinese blacksmith named Pi Sheng four centuries earlier. The press itself was adapted from a screw press that was being used in Germany for the mass production of wine (Johnson)." Gutenberg took materials that others had created and used them in a unique and productive way.

Actor Johnny Depp uses bricolage when creating a character. Captain Jack Sparrow, for example, combines aspects of Rolling Stones guitarist Keith Richards and cartoon skunk Pepé Le Pew.

Executives apply the concept of bricolage when they combine ideas from existing businesses to create a new business. Think miniature golf is boring? Not when you play at one of Monster Mini Golf's more than twenty-five locations. This company couples a miniature golf course with the thrills of a haunted house. In April

2011, Monster Mini Golf announced plans to partner with the rock band KISS to create a "custom-designed, frightfully fun course [that] will feature animated KISS and monster props lurking in all 18 fairways" in Las Vegas (Monster Mini Golf, 2011).

Many an expectant mother has lamented the unflattering nature of maternity clothes and the boring stores that sell them. Coming to the rescue is Belly Couture, a boutique in Lubbock, Texas, that combines stylish fashion and maternity clothes. The store's clever slogan—"Motherhood is haute"—reflects the unique niche it fills through bricolage. A wilder example is TURISAS, a Finnish rock band that has created a niche for itself by combining heavy metal music with the imagery and costumes of Vikings. The band's website describes their effort at bricolage as "inspirational cinematic battle metal brilliance (Turisas)." No one ever claimed that rock musicians are humble.

Strategy at the Movies

<u>Love and Other Drugs</u>

Competitive moves are chosen within executive suites, but they are implemented by frontline employees. Organizational success thus depends just as much on workers such as salespeople excelling in their roles as it does on executives' ability to master strategy. A good illustration is provided in the 2010 film *Love and Other Drugs*, which was based on the nonfiction book *Hard Sell: The Evolution of a Viagra Salesman*.

As a new sales representative for drug giant Pfizer, Jamie Randall believed that the best way to increase sales of Pfizer's antidepressant Zoloft in his territory was to convince highly respected physician Dr. Knight to prescribe Zoloft rather than the good doctor's existing preference, Ely Lilly's drug Prozac. Once Dr. Knight began prescribing Zoloft, thought Randall, many other physicians in the area would follow suit.

This straightforward plan proved more difficult to execute than Randall suspected. Sales reps from Ely Lilly and other pharmaceutical firms aggressively pushed their firm's products, such as by providing all-expenses-paid trips to Hawaii for nurses in Dr. Knight's office. Prozac salesman Trey Hannigan went so far as to beat up Randall after finding out that Randall had stolen and destroyed Prozac samples. While assault is an extreme measure to defend a sales territory, the actions of Hannigan and the other salespeople depicted in *Love and Other Drugs* reflect the challenges that frontline employees face when implementing executives' strategic decisions about competitive moves.

Responding to Competitors' Moves

Speed of response is important when under attack. A slow response might lead a beverage firm, for example, to be crushed by the competition. However, despite that fact that RC Cola been responsible for many innovations in the soft drink industry such as diet and caffeine-free colas, the quick responses of Coca-Cola and Pepsi have kept RC Cola fro taking market share from them.
Multipoint competition is a situation where a firm faces the same rival in more than one market. Such dynamics can set off wildfires such as in the case of cigarette makers R.J. Reynolds (RJR) and Philip Morris, who compete head-to-head worldwide. When threatened in one market, firms often retaliate in other geographic regions.
Mutual forbearance arises when rivals each realize that they have more to lose through aggression against each other than they can gain. United Airlines' decision to not compete in some markets dominated by Southwest Airlines provides an example of this dynamic.
Three main options are available for **responding to a disruptive innovation:** ignore the disruption, engage in a counterattack using different goods and/or services, or directly match the competitor's move. When online stock trading emerged as a disruptive innovation in the brokerage industry, Merrill Lynch chose the third option and formed its own Internet-based unit.
Fighting brands are lower-end brands that a firm introduces to try to protect the firm's market share without damaging the firm's existing brands. General Motor's Geo line of inexpensive automobiles and Delta's Song brand were fighting brands intended to keep their owners from suffering knockout blows.

Table 3 Responding to Rivals' Moves. *Famed military strategist Carl von Clausewitz once quipped, "The best defense is a good offense." Table 3 illustrates a number of key issues surrounding whether and how firms respond when put on the defensive by rivals.*

In addition to choosing what moves their firm will make, executives also have to decide whether to respond to moves made by rivals. Figuring out how to react, if at all, to a competitor's move ranks among the most challenging decisions that executives must make. Research indicates that three factors determine the likelihood that a firm will respond to a competitive move: awareness, motivation, and capability. These three factors together determine the level of competition tension that exists between rivals.

Awareness	Like a patrolman walking his beat, executives must watch out for moves by competitors that can steal sales from their firm.
Motivation	Newton's third law of motion states that for every action there is an equal and opposite reaction. Just like a little kid who cries "He hit me first!" when being admonished for hitting a classmate, executives will be highly motivated to retaliate when a rival makes a competitive move.
Capability	Famed literary figure Johann Wolfgang von Goethe once said, "Thinking is easy, acting is difficult." Like a firefighter that puts as many tools at her disposal as possible, firms must possess plans, as well as resources, to respond to the actions of their rivals.

Table 4 Competitive Tension: The A-M-C Framework. *Bridges and rubber bands have been known to snap under too much tension. In a similar vein, firms experience competitive tension with their competitors. Three factors help to explain the likelihood that a firm will respond aggressively to rivals' competitive actions.*

An analysis of the "razor wars" illustrates the roles that these factors play (Ketchen, et. al., 2004). Consider Schick's attempt to grow in the razor-system market with its introduction of the Quattro. This move was widely publicized and supported by a $120 million advertising budget. Therefore, its main competitor, Gillette, was well *aware* of the move. Gillette's *motivation* to respond was also high. Shaving products are a vital market for Gillette, and Schick has become an increasingly formidable competitor since its acquisition by Energizer. Finally, Gillette was very *capable* of responding, given its vast resources and its dominant role in the industry. Because all three factors were high, a strong response was likely. Indeed, Gillette made a preemptive strike with the introduction of the Sensor 3 and Venus Devine a month before the Schick Quattro's projected introduction.

Although examining a firm's awareness, motivation, and capability is important, the results of a series of moves and countermoves are often difficult to predict and miscalculations can be costly. The poor response by Kmart and other retailers to Walmart's growth in the late 1970s illustrates this point. In discussing Kmart's parent corporation (Kresge), a stock analyst at that time wrote, "While we don't expect Kresge to stage any massive invasion of Walmart's existing territory, Kresge could logically act to contain Walmart's geographical expansion....Assuming some containment policy on Kresge's part, Walmart could run into serious problems in the next few years." Kmart executives also received but ignored early internal warnings about Walmart. A former member of Kmart's board of directors lamented, "I tried to advise the company's management of just what a serious threat I thought [Sam Walton, founder of Walmart] was. But it wasn't until fairly recently that they took him seriously." While the threat of Walmart growth was apparent to some observers, Kmart executives failed to respond. Competition with Walmart later drove Kmart into bankruptcy.

Speed Kills

Executives in many markets must cope with a rapid-fire barrage of attacks from rivals, such as head-to-head advertising campaigns, price cuts, and attempts to grab key customers. If a firm is going to respond to a competitor's move, doing so quickly is important. If there is a long delay between an attack and a response, this generally provides the attacker with an edge. For example, PepsiCo made the mistake of waiting fifteen months to copy Coca-Cola's May 2002 introduction of Vanilla Coke. In the interim, Vanilla Coke carved out a significant market niche; 29 percent of US households had purchased the beverage by August 2003, and 90 million cases had been sold.

In contrast, fast responses tend to prevent such an edge. Pepsi's spring 2004 announcement of a midcalorie cola introduction was quickly followed by a similar announcement by Coke, signaling that Coke would not allow this niche to be dominated by its longtime rival.

So…We Meet Again

Multipoint competition adds complexity to decisions about whether to respond to a rival's moves. With multipoint competition, a firm faces the same rival in more than one market. Cigarette makers R. J. Reynolds (RJR) and Philip Morris, for example, square off not only in the United States but also in many countries around the world. When a firm has one or more multipoint competitors, executives must realize that a competitive move in a market can have effects not only within that market but also within others. In the early 1990s, RJR started using lower-priced cigarette brands in the United States to gain customers. Philip Morris responded in two ways. The first response was cutting prices in the United States to protect its market share. This started a price war that ultimately hurt both companies. Second, Philip Morris started building market share in Eastern Europe where RJR had been establishing a strong position. This combination of moves forced RJR to protect its market share in the United States and neglect Eastern Europe.

If rivals are able to establish mutual forbearance, then multipoint competition can help them be successful. Mutual forbearance occurs when rivals do not act aggressively because each recognizes that the other can retaliate in multiple markets. In the late 1990s, Southwest Airlines and United Airlines competed in some but not all markets. United announced plans to form a new division that would move into some of Southwest's other routes. Southwest CEO Herb Kelleher publicly threatened to retaliate in several shared markets. United then backed down, and Southwest had no reason to attack. The result was better performance for both firms. Similarly, in hindsight, both RJR and Philip Morris probably would have been more profitable had RJR not tried to steal market share in the first place. Thus recognizing and acting on potential forbearance can lead to better performance through firms not competing away their profits, while failure to do so can be costly.

Responding to a Disruptive Innovation

When a rival introduces a disruptive innovation that conflicts with the industry's current competitive practices, such as the emergence of online stock trading in the late 1990s, executives choose from among three main responses.

- First, executives may believe that the innovation will not replace established offerings entirely and thus may choose to focus on their traditional modes of business while ignoring the disruption. For example, many traditional bookstores such as Barnes & Noble did not consider book sales on Amazon to be a competitive threat until Amazon began to take market share from them.
- Second, a firm can counter the challenge by attacking along a different dimension. For example, Apple responded to the direct sales of cheap computers by Dell and Gateway by adding power and versatility to its products
- The third possible response is to simply match the competitor's move. Merrill Lynch, for example, confronted online trading by forming its own Internet-based unit. Here the firm risks cannibalizing its traditional business, but executives may find that their response attracts an entirely new segment of customers.

<u>Fighting Brands: Get Ready to Rumble</u>

A firm's success can be undermined when a competitor tries to lure away its customers by charging lower prices for its goods or services. Such a scenario is especially scary if the quality of the competitor's offerings is reasonably comparable to the firm's. One possible response would be for the firm to lower its prices to prevent customers from abandoning it. This can be effective in the short term, but it creates a long-term problem. Specifically, the firm will have trouble increasing its prices back to their original level in the future because charging lower prices for a time will devalue the firm's brand and make customers question why they should accept price increases.

The creation of a fighting brand is a move that can prevent this problem. A fighting brand is a lower-end brand that a firm introduces to try to protect the firm's market share without damaging the firm's existing brands. In the late 1980s, General Motors (GM) was troubled by the extent to which the sales of small, inexpensive Japanese cars were growing in the United States. GM wanted to recapture lost sales, but it did not want to harm its existing brands, such as Chevrolet, Buick, and Cadillac, by putting their names on low-end cars. GM's solution was to sell small, inexpensive cars under a new brand: Geo.

Interestingly, several of Geo's models were produced in joint ventures between GM and the same Japanese automakers that the Geo brand was created to fight. A sedan called the Prizm was built side by side with the Toyota Corolla by the New United Motor Manufacturing Incorporated (NUMMI), a factory co-owned by GM and Toyota. The two cars were virtually identical except for minor cosmetic differences. A smaller car (the Metro) and a compact sport utility vehicle (the Tracker) were produced by a joint venture between GM and Suzuki. By 1998, the US car market revolved around higher-quality vehicles, and the low-end Geo brand was discontinued.

Some fighting brands are rather short lived. Merck's failed attempt to protect market share in Germany by creating a fighting brand is an example. Zocor, a treatment for high cholesterol, was set to lose its German patent in 2003. Merck tried to keep its high profit margin for Zocor intact until the patent expired as well as preparing for the inevitable competition with generic drugmakers by creating a lower-priced brand, Zocor MSD. Once the patent expired, however, the new brand was not priced low enough to keep customers from switching to generics. Merck soon abandoned the Zocor MSD brand (Ritson, 2009).

Two major airlines experienced similar futility. In response to the growing success of discount airlines such as Southwest, AirTran, Jet

Blue, and Frontier, both United Airlines and Delta Airlines created fighting brands. United launched Ted in 2004 and discontinued it in 2009. Delta's Song had an even shorter existence. It was started in 2003 and was ended in 2006. Southwest's acquisition of AirTran in 2011 created a large airline that may make United and Delta lament that they were not able to make their own discount brands successful.

Despite these missteps, the use of fighting brands is a time-tested competitive move. For example, very successful fighting brands were launched forty years apart by Anheuser-Busch and Intel. After Anheuser-Busch increased the prices charged by its existing brands in the mid-1950s (Budweiser and Michelob), smaller brewers started gaining market share. In response, Anheuser-Busch created a lower-priced brand: Busch. The new brand won back the market share that had been lost and remains an important part of Anheuser-Busch's brand portfolio today. In the late 1990s, silicon chipmaker Advanced Micro Devices started undercutting the prices charged by industry leader Intel. Intel responded by creating the Celeron brand of silicon chips, a brand that has preserved Intel's market share without undermining profits. Wise strategic moves such as the creation of the Celeron brand help explain why Intel ranks thirty-second on *Fortune* magazine's list of the "World's Most Admired Corporations." Meanwhile, Anheuser-Busch is the second most admired beverage firm, ranking behind Coca-Cola.

Making Cooperative Moves

<u>Joint Ventures</u>

A joint venture is a cooperative arrangement that involves two or more organizations each contributing to the creation of a new entity. The partners in a joint venture share decision-making authority, control of the operation, and any profits that the joint venture earns.

Sometimes two firms create a joint venture to deal with a shared opportunity. In April 2011, a joint venture was created between Merck and Sun Pharmaceutical Industries Ltd., an Indian pharmaceutical company. The purpose of the joint venture is to create and sell generic drugs in developing countries. In a press release, a top executive at Sun stressed that each side has important strengths to contribute: "This joint venture reinforces [Sun's] strategy of partnering to launch products using our highly innovative delivery technologies around the world. Merck has an unrivalled reputation as a world leading, innovative, research-driven pharmaceutical company (Merck, 2004)." Both firms contributed executives to the new organization, reflecting the shared decision making and control involved in joint ventures.

In other cases, a joint venture is designed to counter a shared threat. In 2007, brewers SABMiller and Molson Coors Brewing Company created a joint venture called MillerCoors that combines the firms' beer operations in the United States. Miller and Coors found it useful to join their US forces to better compete against their giant rival Anheuser-Busch, but the two parent companies remain separate. The joint venture controls a wide array of brands, including Miller Lite, Coors Light, Blue Moon Belgian White, Coors Banquet, Foster's, Henry Weinhard's, Icehouse, Keystone Premium, Leinenkugel's, Killian's Irish Red, Miller Genuine Draft, Miller High Life, Milwaukee's Best, Molson Canadian, Peroni Nastro Azzurro, Pilsner Urquell, and Red Dog. This diverse portfolio makes MillerCoors a more potent adversary for Anheuser-Busch than either Miller or Coors would be alone.

Join ventures involve two or more organizations that contribute to the creation of a new entity. For example, Hong Kong Disneyland is a joint venture between the government of Hong Kong and the Walt Disney Company. While the park consists of Disney mainstays such as Main Street, U.S.A., Fantasyland, Adventureland, and Tomorrowland, the park also incorporates elements of Chinese culture such as adherence to the rules of Feng Shui–a set of aesthetic design principles believe to promote positive energy.
Strategic alliances are cooperative arrangements between two or more organizations that do not involve creating new entities. For example, a strategic alliance between Merck and PAREXEL International Corporation was recently announced with the goal of collaborating on biotechnology efforts known as biosimilars–a term used to describe subsequent versions of innovative drugs.
Colocation refers to a situation when goods and services offered under different brands are located very close to each other. Noting once common example of colocation, a comedian once joke that La Quinta was Spanish for "Next to Denny's." Both hotels and restaurants are often colocated alongside freeway exits to allow numerous choices for road-weary travelers.
Coopetition is a term that refers to the blending of competition and cooperation between two firms. Toyota and General Motors' creation of jointly owned New United Motor Manufacturing incorporated (NUMMI) allowed for collaboration on automobile designs while Toyota and GM continued to compete for market share worldwide. The NUMMI experience also inspired the 1986 comedy *Gung Ho*.

Table 5 Making Cooperative Moves. *Franklin Roosevelt once quipped, "Competition has been shown to be useful up to a certain point and no further, but cooperation, which is the thing we must strive for today, begins where competition leaves off."*

Strategic Alliances

A strategic alliance is a cooperative arrangement between two or more organizations that does not involve the creation of a new entity. In June 2011, for example, Twitter announced the formation of a strategic alliance with Yahoo! Japan. The alliance involves relevant Tweets appearing within various functions offered by Yahoo! Japan (Rao, 2014). The alliance simply involves the two firms collaborating as opposed to creating a new entity together.

The pharmaceutical industry is the location of many strategic alliances. In January 2011, for example, a strategic alliance between Merck and PAREXEL International Corporation was announced.

Within this alliance, the two companies collaborate on biotechnology efforts known as biosimilars. This alliance could be quite important to Merck because the global market for biosimilars has been predicted to rise from $235 million in 2010 to $4.8 billion by 2015(PRWeb, 2011).

Colocation

Colocation occurs when goods and services offered under different brands are located close to one another. In many cities, for examples, theaters and art galleries are clustered together in one neighborhood. Auto malls that contain several different car dealerships are found in many areas. Restaurants and hotels are often located near on another too. By providing customers with a variety of choices, a set of colocated firms can attract a bigger set of customers collectively than the sum that could be attracted to individual locations. If a desired play is sold out, a restaurant overcrowded, or a hotel overbooked, many customers simply patronize another firm in the area.

Because of these benefits, savvy executives in some firms colocate their own brands. The industry that Brinker International competes within is revealed by its stock ticker symbol: EAT. This firm often sites outlets of the multiple restaurant chains it owns on the same street. Marriott's Courtyard and Fairfield Inn often sit side by side. Yum! Brands takes this clustering strategy one step further by locating more than one of its brands—A&W, Long John Silver's, Taco Bell, Kentucky Fried Chicken, and Pizza Hut—within a single store.

Co-opetition

Although competition and cooperation are usually viewed as separate processes, the concept of co-opetition highlights a complex interaction that is becoming increasingly popular in many industries. Ray Noorda, the founder of software firm Novell, coined the term to refer to a blending of competition and cooperation between two firms. As explained in this chapter's opening vignette, for example, Merck and Roche are rivals in some markets, but the firms are working together to develop tests to detect cancer and to promote a hepatitis treatment. NEC (a Japanese electronics company) has three different relationships with Hewlett-Packard Co.: customer, supplier, and competitor. Some units of each company work cooperatively with the other company, while other units are direct competitors. NEC and Hewlett-Packard could be described as "frienemies"—part friends and part enemies.

Toyota and General Motors provide a well-known example of co-opetition. In terms of cooperation, Toyota and GM vehicles were produced side by side for many years at the jointly owned New United Motor Manufacturing Incorporated (NUMMI) in Fremont, California. While Honda and Nissan used wholly owned plants to begin producing cars in the United States, NUMMI offered Toyota a lower-risk means of entering the US market. This entry mode was desirable to Toyota because its top executives were not confident that Japanese-style management would work in the United States. Meanwhile, the venture offered GM the chance to learn Japanese management and production techniques—skills that were later used in GM's facilities. NUMMI offered both companies economies of scale in manufacturing and the chance to collaborate on automobile designs. Meanwhile, Toyota and GM compete for market share around the world. In recent years, the firms have been the world's two largest automakers, and they have traded the top spot over time.

In their book titled, not surprisingly, *Co-opetition*, A. M. Brandenberger and B. J. Nalebuff suggest that cooperation is generally best suited for "creating a pie," while competition is best suited for "dividing it up (Brandenberger & Nalebuff, 1996)." In other words, firms tend to cooperate in activities located far in the value chain from customers, while competition generally occurs close to customers. The NUMMI example illustrates this tendency—GM and Toyota worked together on design and manufacturing but worked separately on distribution, sales, and marketing. Similarly, a research study focused on Scandinavian firms found that, in the mining equipment industry, firms cooperated in material development, but they competed in product development and marketing. In the brewing industry, firms worked together on the return of used bottles but not in distribution (Bengtsson & Kock, 2000).

Joseph Addison, an eighteenth-century poet, is often credited with coining the phrase "He who hesitates is lost." This proverb is especially meaningful in today's business world. It is easy for executives to become paralyzed by the dizzying array of competitive and cooperative moves available to them. Given the fast-paced nature of most industries today, hesitation can lead to disaster. Some observers have suggested that competition in many settings has transformed into hypercompetition, which involves very rapid and unpredictable moves and countermoves that can undermine competitive advantages. Under such conditions, it is often better to make a reasonable move quickly rather than hoping to uncover the perfect move through extensive and time-consuming analysis.

The importance of learning also contributes to the value of adopting a "get moving" mentality. This is illustrated in Miroslav Holub's poem "Brief Thoughts on Maps." The discovery that one soldier had a map gave the soldiers the confidence to start moving rather than continuing to hesitate and remaining lost. Once they started moving, the soldiers could rely on their skill and training to learn what would work and what would not. Similarly, success in business often depends on executives learning from a series of competitive and cooperative moves, not on selecting ideal moves.

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Strategy through Organizational Design

The Basic Building Blocks of Organizational Structure

Division of labor is a process of splitting up a task into a series of smaller tasks, each of which is performed by a specialist. In ancient Greece, historian Xenophon wrote about the division of labor in shoe making: one person cut out the shoes, another sewed the uppers together, and a third person assembled the parts.
An **organizational chart** is a diagram that depicts a firm's structure.
Do you know what happens each year on the Wednesday of the last full week of April? It's Administrative Professionals' Day. Savvy workers mark this day with generosity. The reason involves **informal linkages**, which are unofficial relationships such as friendships that do not appear in organizational charts. Administrative professionals such as secretaries tend to be well informed about both policies and office politics. So keep them on your side!
Vertical linkages tie supervisors and subordinates together. These linkages show the lines of responsibility through which a supervisor delegates authority to subordinates, oversees their activities, evaluates their performance, and guides them toward improvement.
Horizontal linkages are formal relationships between equals in an organization. They often take the form of committees and task forces.
Employees may receive conflicting guidance about how to do their jobs if they work in a situation where multiple bosses are present. This problem can be avoided by following the **unity of command** principle, which states that each person should only report directly to one supervisor.

Table 1 The Building Blocks of Organizational Structure. *Legendary football coach Vince Lombardi once noted, "The achievements of an organization are the results of the combined effort of each individual." Understanding how people can be most efficiently organized is the basis for modern management thought, and we illustrate the building blocks of organizational structure below.*

Division of Labor

General Electric (GE) offers a dizzying array of products and services, including lightbulbs, jet engines, and loans. One way that GE could produce its lightbulbs would be to have individual employees work on one lightbulb at a time from start to finish. This would be very inefficient, however, so GE and most other organizations avoid this approach. Instead, organizations rely on division of labor when creating their products. Division of labor is a process of splitting up a task (such as the creation of lightbulbs) into a series of smaller tasks, each of which is performed by a specialist.

Organizational chart

This is perhaps the first recorded example of a clear **hierarchy of authority**—an arrangement of individuals based on rank. A similar idea is used today in the U.S. justice system where there are lower courts for easy-to-resolve cases and the Supreme Court only handles the most difficult cases.

The leaders at the top of organizations have long known that division of labor can improve efficiency. In the eighteenth century, Adam Smith's book *The Wealth of Nations* quantified the tremendous advantages that division of labor offered for a pin factory. If a worker performed all the various steps involved in making pins himself, he could make about twenty pins per day. By breaking the process into multiple steps, however, ten workers could make forty-eight thousand pins a day. In other words, the pin factory was a staggering 240 times more productive than it would have been without relying on division of labor. In the early twentieth century, Smith's ideas strongly influenced Henry Ford and other industrial pioneers who sought to create efficient organizations.

While division of labor fuels efficiency, it also creates a challenge—figuring out how to coordinate different tasks and the people who perform them. The solution is organizational structure, which is defined as how tasks are assigned and grouped together with formal reporting relationships. Creating a structure that effectively coordinates a firm's activities increases the firm's likelihood of success. Meanwhile, a structure that does not match well with a firm's needs undermines the firm's chances of prosperity.

Division of labor was central to Henry Ford's development of assembly lines in his automobile factory. Ford noted, “Nothing is particularly hard if you divide it into small jobs.”

Vertical and Horizontal Linkages

Most organizations use a diagram called an organizational chart to depict their structure. These organizational charts show how firms’ structures are built using two basic building blocks: vertical linkages and horizontal linkages. Vertical linkages tie supervisors and subordinates together. These linkages show the lines of responsibility through which a supervisor delegates authority to subordinates, oversees their activities, evaluates their performance, and guides them toward improvement when necessary. Every supervisor except for the person at the very top of the organization chart also serves as a subordinate to someone else. In the typical business school, for example, a department chair supervises a set of professors. The department chair in turn is a subordinate of the dean.

Most executives rely on the unity of command principle when mapping out the vertical linkages in an organizational structure. This principle states that each person should only report directly to one supervisor. If employees have multiple bosses, they may receive conflicting guidance about how to do their jobs. The unity of command principle helps organizations to avoid such confusion. In the case of General Electric, for example, the head of the Energy division reports only to the chief executive officer. If problems were to arise with executing the strategic move discussed in this chapter’s opening vignette—joining the John Wood Group PLC with GE’s Energy division—the head of the Energy division reports would look to the chief executive officer for guidance.

Horizontal linkages are relationships between equals in an organization. Often these linkages are called committees, task forces, or teams. Horizontal linkages are important when close coordination is needed across different segments of an organization. For example, most business schools revise their undergraduate curriculum every five or so years to ensure that students are receiving an education that matches the needs of current business conditions. Typically, a committee consisting of at least one professor from every academic area (such as management, marketing, accounting, and finance) will be appointed to perform this task. This approach helps ensure that all aspects of business are represented appropriately in the new curriculum.

Organic grocery store chain Whole Foods Market relies heavily on horizontal linkages. As noted on their website, "At Whole Foods Market we recognize the importance of smaller tribal groupings to maximize familiarity and trust. We organize our stores and company into a variety of interlocking teams. Most teams have between 6 and 100 Team Members and the larger teams are divided further into a variety of sub-teams. The leaders of each team are also members of the Store Leadership Team and the Store Team Leaders are members of the Regional Leadership Team. This interlocking team structure continues all the way upwards to the Executive Team at the highest level of the company (Mackey, 2010)." Their emphasis on teams is intended to develop trust throughout the organization, as well as to make full use of the talents and creativity possessed by every employee.

<u>Informal Linkages</u>

Informal linkages refer to unofficial relationships such as personal friendships, rivalries, and politics. In the long-running comedy series *The Simpsons*, Homer Simpson is a low-level—and very low-performing—employee at a nuclear power plant. In one episode, Homer gains power and influence with the plant's owner, Montgomery Burns, which far exceeds Homer's meager position in the organization chart, because Mr. Burns desperately wants to be a member of the bowling team that Homer captains. Homer tries to use his newfound influence for his own personal gain and naturally the organization as a whole suffers. Informal linkages such as this one do not appear in organizational charts, but they nevertheless can have (and often do have) a significant influence on how firms operate.

Creating an Organizational Structure

Within most firms, executives rely on vertical and horizontal linkages to create a structure that they hope will match the needs of their firm's strategy. Four types of structures are available to executives: (1) simple, (2) functional, (3) multidivisional, and (4) matrix. No two organizational structures are exactly alike. When creating a structure for their firm, executives will take one of these types and adapt it to fit the firm's unique circumstances. As they do this, executives must realize that the choice of structure will influences their firm's strategy in the future. Once a structure is created, it constrains future strategic moves. If a firm's structure is designed to maximize efficiency, for example, the firm may lack the flexibility needed to react quickly to exploit new opportunities.

Simple Strucutre	Simple structures do not rely on formal systems of division of labor, and organizational charts are not generally needed. If the firm is a sole proprietorship, one person performs all of the tasks that the organization needs to accomplish. Consequently, this structure is common for many small businesses.
Functional Structure	Within a functional structure, employees are divided into departments that each handles activities related to a functional area of the business, such as marketing, production, human resources, information technology, and customer service.
Multidivisional Structure	In this type of structure, employees are divided into departments based on product areas and/or geographic regions. General Electric, for example, has six product divisions: Energy, Capital, Home & Business Solutions, Healthcare, Aviation, and Transportation.
Matrix Structure	Firms that engage in projects of limited duration often use a matrix structure where employees can be put on different teams to maximize creativity and idea flow. As parodied in the move *Office Space*, this structure is common in high tech and engineering firms.

Table 2 Common Organizational Structures. *Executives rely on vertical and horizontal linkages to create a structure that they hope will match the firm's needs. While no two organizational structures are exactly alike, four general types of structures are available to executives: simple functional, multidivisional, and matrix.*

<u>Simple Structure</u>

Many organizations start out with a simple structure. In this type of structure, an organizational chart is usually not needed. Simple structures do not rely on formal systems of division of labor. If the firm is a sole proprietorship, one person performs all the tasks the organization needs to accomplish. For example, on the TV series *The Simpsons*, both bar owner Moe Szyslak and the Comic Book Guy are shown handling all aspects of their respective businesses.

There is a good reason most sole proprietors do not bother creating formal organizational charts. If the firm consists of more than one person, tasks tend to be distributed among them in an informal manner rather than each person developing a narrow area of specialization. In a family-run restaurant or bed and breakfast, for example, each person must contribute as needed to tasks, such as cleaning restrooms, food preparation, and serving guests (hopefully not in that order). Meanwhile, strategic decision making in a simple structure tends to be highly centralized, the owner of the firm makes all the important decisions. Because there is little emphasis on hierarchy within a simple structure, organizations that use this type of structure tend to have very few rules and regulations. The process of evaluating and rewarding employees' performance also tends to be informal.

The informal simple structures creates both advantages and disadvantages. On the plus side, the flexibility offered by simple structures encourages employees' creativity and individualism. Informality has potential negative aspects, too. Important tasks may be ignored if no one person is specifically assigned accountability for them. A lack of clear guidance from the top of the organization can create confusion for employees, undermine their motivation, and make them dissatisfied with their jobs. Thus when relying on a simple structure, the owner of a firm must be sure to communicate often and openly with employees.

Functional Structure

As a small organization grows, the one in charge often finds that a simple structure is no longer adequate to meet the organization's needs. Organizations become more complex as they grow, and this can require more formal division of labor and a strong emphasis on hierarchy and vertical links. In many cases, these firms evolve from using a simple structure to relying on a functional structure.

Grocery Store Functions	Spa Functions
Grocery stockers often work at night to make sure shelves stay full during the day.	Some spa employees manicure fingernails, a practice that is over four thousand years old. Many also provide pedicures, a service whose popularity has nearly doubled in the past decade.
Pharmacists' specialized training allows them to command pay that can exceed $50 an hour.	Compared to other spa functions, little training is required of a tanning bed operator–although the ability to tell time may help.
Bakers wake up early to give shoppers their daily bread.	Almost anyone can buy a shotgun or parent a child without any training, but every state requires a license in order to cut hair.
Bagging groceries requires a friendly personality as well as knowing that eggs should not go on the bottom.	Cucumber masks are usually applied by a skin care specialist who has taken a professional training program.
Folks that work checkout aisles should be trusted to handle cash.	The license required of massage therapists in many states ensures that spa visits end happily.
The creation of produce, deli, and butcher departments provides an efficient way to divide a grocery store physically as well as functionally.	

Table 3 Functional Structure. *Functional structures rely on a division of labor whereby groups of people handle activities related to a specific function of the overall business. We illustrate functional structures in action within two types of organizations that commonly use them.*

Within a functional structure, employees are divided into departments that each handle activities related to a functional area of the business, such as marketing, production, human resources, information technology, and customer service. Each of these five areas would be headed up by a manager who coordinates all activities related to her functional area. Everyone in a company that works on marketing the company's products, for example, would report to the manager of the marketing department. The marketing managers and the managers in charge of the other four areas in turn would report to the chief executive officer.

Using a functional structure creates advantages and disadvantages. An important benefit is that each person tends to learn a great deal about their particular function. When placed in a department that consists entirely of marketing professionals, an individual has a great opportunity to become an expert in marketing. Thus a functional structure tends to create highly skilled specialists. Second, grouping everyone that serves a particular function into one department tends to keep costs low and to create efficiency. Conflicts are rare in departments because everyone generally shares the same background training so they tend to get along with one another.

Using a functional structure also has a significant downside: executing strategic changes can be very slow when compared with other structures. Suppose, for example, that a textbook publisher decides to introduce a new form of textbook that includes "scratch and sniff" photos that let students smell various products in addition to reading about them. If the publisher relies on a simple structure, the leader of the firm can simply assign someone to shepherd this unique new product through all aspects of the publication process.

If the publisher is organized using a functional structure, every department in the organization will have to be involved in the creation of the textbooks. Because the new product lies outside each department's routines, it may become lost in the proverbial shuffle. Unfortunately, the publication process may be halted whenever a functional area does not live up to its responsibilities. More generally, because functional structures are slow to execute change, they tend to work best for organizations that offer narrow and stable product lines.

The specific functional departments that appear in an organizational chart vary across organizations that use functional structures. In the example offered earlier in this section, the firm was divided into five functional areas: (1) marketing, (2) production, (3) human resources, (4) information technology, and (5) customer service. In the TV show *The Office*, a different approach to a functional structure is used at the Scranton, Pennsylvania, branch of Dunder Mifflin. As of 2009, the branch was divided into six functional areas: (1) sales, (2) warehouse, (3) quality control, (4) customer service, (5) human resources, and (6) accounting. A functional structure was a good fit for the branch at the time because its product line was limited to just selling office paper.

Multidivisional Structure

Many organizations offer a wide variety of products and services. Some of these organizations sell their offerings across an array of geographic regions. These approaches require firms to be very responsive to customers' needs. Yet, as noted, functional structures tend to be fairly slow to change. As a result, many firms abandon the use of a functional structure as their offerings expand. Often the new choice is a multidivisional structure. In this type of structure, employees are divided into departments based on product areas and/or geographic regions.

General Electric (GE) is an example of a company organized this way. As shown in the organization chart that accompanies this chapter's opening vignette, most of the company's employees belong to one of six product divisions (Energy, Capital, Home & Business Solutions, Health Care, Aviation, and Transportation) or to a division that is devoted to all GE's operations outside the United States (Global Growth & Operations).

A big advantage of a multidivisional structure is that it allows a firm to act quickly. When GE makes a strategic move such as acquiring the well-support division of John Wood Group PLC, only the relevant division (in this case, Energy) needs to be involved in integrating the new unit into GE's hierarchy. In contrast, if GE was organized using a functional structure, the transition would be much slower because all the divisions in the company would be involved. A multidivisional structure also helps an organization to better serve customers' needs.

Of course, empowering divisions to act quickly can backfire if people in those divisions take actions that do not fit with the company's overall strategy. McDonald's experienced this kind of situation in 2002. In particular, the French division of McDonald's ran a surprising advertisement in a magazine called *Femme Actuelle*. The ad included a quote from a nutritionist that asserted children should *not* eat at a McDonald's more than once per week. Executives at McDonald's headquarters in suburban Chicago were concerned about the message sent to their customers and they made it clear that they strongly disagreed with the nutritionist.

Another downside of multidivisional structures is that they tend to be more costly to operate. While functional structures offer the opportunity to gain efficiency by having just one department handle all activities in an area, such as marketing, a firm using a multidivisional structure needs to have marketing units within each of its divisions. In GE's case, for example, each of its seven divisions must develop marketing skills. Absorbing the extra expenses that are created reduces a firm's profit margin.

GE's organizational chart highlights a way that firms can reduce some of these expenses: the centralization of some functional services. As shown in the organizational chart, departments devoted to important aspects of public relations, business development, legal, global research, human resources, and finance are maintained centrally to provide services to the six product divisions and the geographic division. By consolidating some human resource activities in one location, for example, GE creates efficiency and saves money.

An additional benefit is that consistency is created across divisions. In 2011, Coca-Cola created an Office of Sustainability to coordinate sustainability initiatives across the entire company. Bea Perez was named Coca-Cola's chief sustainability officer. At the time, Coca-Cola's chief executive officer Muhtar Kent noted that Coca-Cola had "made significant progress with our sustainability initiatives, but our current approach needs focus and better integration (McWilliams, 2011)." In other words, a department devoted to creating consistency across Coca-Cola's sustainability efforts was needed for Coca-Cola to meet its sustainability goals.

Matrix Structure

Within functional and multidivisional structures, vertical linkages between bosses and subordinates are the most elements. Matrix structures, in contrast, rely heavily on horizontal relationships (Ketchen & Short, 2011). In particular, these structures create cross-functional teams that each work on a different project. This offers several benefits: maximizing the organization's flexibility, enhancing communication across functional lines, and creating a spirit of teamwork and collaboration. A matrix structure can also help develop new managers. In particular, a person without managerial experience can be put in charge of a relatively small project as a test to see whether the person has a talent for leading others.

Using a matrix structure can create difficulties too. One concern is that a matrix structure violates the unity of command principle because each employee is assigned multiple bosses. Specifically, any given individual reports to a functional area supervisor as well as one or more project supervisors. This creates confusion for employees because they are left unsure who should give them direction. Violating the unity of command principle also creates opportunities for unsavory employees to avoid responsibility by claiming to each supervisor that a different supervisor is currently depending on their efforts.

The potential for conflicts arising between project managers within a matrix structure is another concern. The mix of employee experiences reflects a fundamental reality of management: in any organization, some workers are more talented and motivated than others. Within a matrix structure, each project manager naturally will want the best people in the company assigned to her project because their boss evaluates these managers based on how well their projects perform. Because the best people are a scarce resource, infighting and politics can easily flare up around which people are assigned to each project.

Given these problems, not every organization is a good candidate to use a matrix structure. Organizations such as engineering and consulting firms that need to maximize their flexibility to service projects of limited duration can benefit from the use of a matrix. Matrix structures are also used to organize research and development departments within many large corporations. In each of these settings, the benefits of organizing around teams are so great that they often outweigh the risks of doing so.

Strategy at the Movies

<u>Office Space</u>

How much work can a man accomplish with eight bosses breathing down his neck? For Peter Gibbons, an employee at information technology firm Initech in the 1999 movie *Office Space*, the answer was zero. Initech's use of a matrix structure meant that each employee had multiple bosses, each representing a different aspect of Initech's business. High-tech firms often use matrix to gain the flexibility needed to manage multiple projects simultaneously. Successfully using a matrix structure requires excellent communication among various managers—however, excellence that Initech could not reach. When Gibbons forgot to put the appropriate cover sheet on his TPS report, each of his eight bosses—and a parade of his coworkers—admonished him. This fiasco and others led to Gibbons to become cynical about his job.

Office Space illustrates the importance of organizational design decisions to an organization's culture and to employees' motivation levels. A matrix structure can facilitate resource sharing and collaboration but may also create complicated working relationships and impose excessive stress on employees. Chotchkie's organizational structure involved simpler working relationships, but these relationships were strained beyond the breaking point by a manager's eccentricities. In a more general sense, *Office Space* shows that all organizational structures involve a series of trade-offs that must be carefully managed.

Boundaryless Organizations

Most organizational charts show clear divisions and boundaries between different units. The value of a much different approach was highlighted by former GE CEO Jack Welch when he created the term boundaryless organization. A boundaryless organization is one that removes the usual barriers between parts of the organization as well as barriers between the organization and others (Askenas, et. al., 1995).

Eliminating all internal and external barriers is impossible, but making progress toward becoming boundaryless can help an organization become more flexible and responsive. One example is W.L. Gore, a maker of fabrics, medical implants, industrial sealants, filtration systems, and consumer products. This firm avoids organizational charts, management layers, and supervisors despite having approximately nine thousand employees across thirty countries. Rather than granting formal titles to certain people, leaders with W.L. Gore emerge based on performance and they attract followers to their ideas over time. As one employee noted, "We vote with our feet. If you call a meeting, and people show up, you're a leader (Hamel, 2007)."

An illustration of how removing barriers can be valuable has its roots in a very unfortunate event. During 2005's Hurricane Katrina, rescue efforts were hampered by a lack of coordination between responders from the National Guard (who are controlled by state governments) and from active-duty military units (who are controlled by federal authorities). According to one National Guard officer, "It was just like a solid wall was between the two entities (Elliott, 2011)." Efforts were needlessly duplicated in some geographic areas while attention to other areas was delayed or inadequate. For example, poor coordination caused the evacuation of thousands of people from the New Orleans Superdome to be delayed by a full day. The results were immense human suffering and numerous fatalities.

To avoid similar problems from arising in the future, barriers between the National Guard and active-duty military units are bridged by special military officers called dual-status commanders. These individuals will be empowered to lead both types of units during a disaster recovery effort, helping to ensure that all areas receive the attention they need in a timely manner.

Reasons for Changing an Organization's Structure

Creating an organizational structure is not a onetime activity. Executives must revisit an organization's structure over time and make changes to it if certain danger signs arise. For example, a structure might need to be adjusted if decisions with the organization are being made too slowly or if the organization is performing poorly. Both these problems plagued Sears Holdings in 2008, leading executives to reorganize the company.

Sears's new structure organized the firm around five types of divisions: (1) operating businesses (such as clothing, appliances, and electronics), (2) support units (certain functional areas such as marketing and finance), (3) brands (which focus on nurturing the firm's various brands such as Lands' End, Joe Boxer, Craftsman, and Kenmore), (4) online, and (5) real estate. At the time, Sears's chairman Edward S. Lampert noted that "by creating smaller focused teams that are clearly responsible for their units, we [will] increase autonomy and accountability, create greater ownership and enable faster, better decisions (Retail Net)." Unfortunately, structural changes cannot cure all a company's ills. As of July 2011, Sears's stock was worth just over half what it had been worth five years earlier.

Creating Organizational Control Systems

In addition to creating an appropriate organizational structure, effectively executing strategy depends on the skillful use of organizational control systems. Executives create strategies to try to achieve their organization's vision, mission, and goals. Organizational control systems allow executives to track how well the organization is performing, identify areas of concern, and then take action to address the concerns. Three basic types of control systems are available to executives: (1) output control, (2) behavioral control, and (3) clan control. Different organizations emphasize different types of control, but most organizations use a mix of all three types.

Output Control

Output control focuses on measurable results within an organization. Examples might include the number of hits a website receives per day, the number of microwave ovens an assembly line produces per week, or the number of vehicles a car salesman sells per month. In each of these cases, executives must decide what level of performance is acceptable, communicate expectations to the relevant employees, track whether performance meets expectations, and then make any needed changes.

In early 2011, Delta Air Lines was forced to face some facts as part of its use of output control. Data gathered by the federal government revealed that only 77.4 percent of Delta's flights had arrived on time during 2010. This performance led Delta to rank dead last among the major US airlines and fifteenth out of eighteen total carriers (Yamanouchi, 2011). In response, Delta took important corrective steps. The airline added to its ability to service airplanes and provided more customer service training for its employees. Because some delays are inevitable, Delta also announced plans to staff a Twitter account called Delta Assist around the clock to help passengers whose flights are delayed. These changes and others paid off. For the second quarter of 2011, Delta enjoyed a $198 million profit, despite having to absorb a $1 billion increase in its fuel costs due to rising prices (Yamanouchi, 2011).

Output control also plays a big part in the college experience. For example, test scores and grade point averages are good examples of output measures. If you perform badly on a test, you might take corrective action by studying harder or by studying in a group for the next test. At most colleges and universities, a student is put on academic probation when his grade point average drops below a certain level. If the student's performance does not improve, he may be removed from his major and even dismissed. On the positive side, output measures can trigger rewards too. A very high grade point average can lead to placement on the dean's list and graduating with honors.

Behavioral Control

While output control focuses on results, behavioral control focuses on controlling the actions that ultimately lead to results. In particular, various rules and procedures are used to standardize or to dictate behavior. In most states, signs are posted in restaurant bathrooms reminding employees that they must wash their hands before returning to work. Dress codes within many organizations are another example of behavioral control. To try to prevent employee theft, many firms have a rule that requires checks to be signed by two people.

Creating an effective reward structure is key to effectively managing behavior because people tend to focus on the rewarded behaviors. Problems can arise when people are rewarded for behaviors that seem positive on the surface but that can actually undermine organizational goals under some circumstances. For example, restaurant servers are highly motivated to serve their tables quickly because doing so can increase their tips. But if a server devotes all his or her attention to providing fast service, other tasks that are vital to running a restaurant, such as communicating effectively with managers, host staff, chefs, and other servers, may suffer. Managers need to be aware of such trade-offs and strive to align rewards with behaviors. For example, waitstaff who consistently behave as team players could be assigned to the most desirable and lucrative shifts, such as nights and weekends.

Clan Control

Instead of measuring results (as in outcome control) or dictating behavior (as in behavioral control), clan control is an informal type of control. Specifically, clan control relies on shared traditions, expectations, values, and norms to lead people to work toward the good of their organization. Clan control is often used heavily in settings where creativity is vital, such as in high-tech businesses. In these companies, output is tough to dictate, and many rules are not appropriate. The creativity of a research scientist would be likely to be stifled, for example, if she were given a quota of patents that she must meet each year (output control) or if a strict dress code were enforced (behavioral control).

Google relies on clan control, employees are permitted to spend 20 percent of their workweek on their own innovative projects. The company offers an "ideas mailing list" for employees to submit new ideas and to comment on others' ideas. Google executives routinely make themselves available two to three times per week for employees to visit with them to present their ideas. These informal meetings have generated a number of innovations, including personalized home pages and Google News, which might otherwise have never been adopted.

Some executives look to clan control to improve the performance of struggling organizations. In 2005, Florida officials became fed up with complaints about surly clerks within the state's driver's license offices. Their solution was to look for help with training employees from two companies that are well-known for friendly, engaged employees and excellent customer service: Walt Disney Company and the regional supermarket chain Publix (their motto stressed that "shopping is a pleasure" in its stores). The goal of the training was to build the sort of positive team spirit. The state's highway safety director summarized the need for clan control when noting that "we've just got to change a little culture out there (Bousquet, 2005)."

Management Fads: Out of Control?

Management by objectives	A supervisor and an employee create a series of goals that provide structure and motivation for the employee. A huge set of studies shows that setting challenging but attainable goals leads to good performance, but not every aspect of work can be captured by a goal.
Sensitivity training	Free-flowing group discussions are used to lead individuals toward greater understanding of themselves and others. Because a "mob mentality" can take over a group, sensitivity training too often degenerates into hostility and humiliation.
Quality circles	Volunteer employee groups developed to brainstorm new methods or processes to improve quality. Quality is important, but managers face trade-offs among quality, cost, flexibility, and speed. A singular obsession with quality sacrifices too much along other dimensions.
Strong culture	Fueled by 1982's *In Search of Excellence* and fascination with Japanese management systems, having a strong culture became viewed as crucial to organizational success. Within a few years, many of the "excellent" companies highlighted in the book had fallen on hard times. However, firms such as Disney continue to gain competitive advantage through their strong cultures.

Table 4 Managing Management Fads.*The emergence and disappearance of fads appears to be a predictable aspect of modern society. A fad arises when some element of culture–such as fashion, a toy, or a hairstyle–becomes enthusiastically embraced by a group of people. Fads also seem to be a predictable aspect of the business world. Below we illustrate several fads that executives have latched onto in an effort to improve their organizations' control systems.*

Don't chase the latest management fads. The situation dictates which approach best accomplishes the team's mission.

The emergence and disappearance of fads appears to be a predictable aspect of modern society. A fad arises when some element of popular culture becomes enthusiastically embraced by a group of people. Ironically, the reason a fad arises is also usually the cause of its demise. The uniqueness (or even outrageousness) of a fashion, toy, or hairstyle creates "buzz" and publicity but also ensures that its appeal is only temporary (Ketchen & Short, 2011).

Fads also seem to be a predictable aspect of the business world. As with cultural fads, many provocative business ideas go through a life cycle of creating buzz, captivating a group of enthusiastic adherents, and then giving way to the next fad. Bookstore shelves offer a seemingly endless supply of popular management books whose premises range from the intriguing to the absurd.

Beyond the striking similarities between cultural and business fads, there are also important differences. Most cultural fads are harmless, and they rarely create any long-term problems for those that embrace them. In contrast, embracing business fads could lead executives to make bad decisions.

Many management fads have been closely tied to organizational control systems. For example, one of the best-known fads was an attempt to use output control to improve performance. Management by objectives (MBO) is a process wherein managers and employees work together to create goals. These goals guide employees' behaviors and serve as the benchmarks for assessing their performance. Following the presentation of MBO in Peter Drucker's 1954 book *The Practice of Management*, many executives embraced the process as a cure-all for organizational problems and challenges.

Like many fads,MBO became a good idea run amok. Companies that attempted to create an objective for every aspect of employees' activities discovered that this was unrealistic. The creation of explicit goals can conflict with activities involving tacit knowledge about the organization. Intangible notions such as "providing excellent customer service," "treating people right," and "going the extra mile" are central to many organizations' success, but these notions are difficult if not impossible to quantify. Thus, in some cases, getting employees to embrace certain values and other aspects of clan control is more effective than MBO.

Improving clan control was the basis for the fascination with organizational culture that was all the rage in the 1980s. This fad was fueled by a best-selling 1982 book titled *In Search of Excellence: Lessons from America's Best-Run Companies*. Authors Tom Peters and Robert Waterman studied companies that they viewed as stellar performers and distilled eight similarities that were shared across the companies. Most of the similarities, including staying "close to the customer" and "productivity through people," arose from powerful corporate cultures. The book quickly became an international sensation; more than three million copies were sold in the first four years after its publication.

Soon it became clear that organizational culture's importance was being exaggerated. Before long, both the popular press and academic research revealed that many of Peters and Waterman's "excellent" companies quickly had fallen on hard times. Basic themes such as customer service and valuing one's company are quite useful, but these clan control elements often cannot take the place of holding employees accountable for their performance.

Spirited games of kickball can help build an organization's culture, but such events should not substitute for holding employees accountable for delivering results.

The history of fads allows us to make certain predictions about today's hot ideas. Overall, executives should understand that management fads usually contain a core truth that can help organizations improve but that a balance of output, behavioral, and clan control is needed within most organizations. As legendary author Jack Kerouac noted, "Great things are not accomplished by those who yield to trends and fads and popular opinion."

Legal Forms of Business

Choosing a Form of Business

The legal form a firm chooses to operate under is an important decision with implications for how a firm structures its resources and assets. Several legal forms of business are available to executives. Each involves a different approach to dealing with profits and losses.

There are three basic forms of business. A sole proprietorship is a firm that is owned by one person. From a legal perspective, the firm and its owner are considered one and the same. On the plus side, this means that all profits are the property of the owner (after taxes are paid, of course). On the minus side, however, the owner is personally responsible for the firm's losses and debts. This presents a tremendous risk. If a sole proprietor is on the losing end of a significant lawsuit, for example, the owner could find his personal assets forfeited. Most sole proprietorships are small and many have no employees. In most towns, for example, there are a number of self-employed repair people, plumbers, and electricians who work alone on home repair jobs. Also, many sole proprietors run their businesses from their homes to avoid expenses associated with operating an office.

In a partnership, two or more partners share ownership of a firm. A partnership is similar to a sole proprietorship in that the partners are the only beneficiaries of the firm's profits, but they are also responsible for any losses and debts. Partnerships can be especially attractive if each person's expertise complements the others. For example, an accountant who specializes in preparing individual tax returns and another who has mastered business taxes might choose to join forces to offer customers a more complete set of tax services than either could offer alone.

From a practical standpoint, a partnership allows a person to take time off without closing down the business temporarily. Sander & Lawrence is a partnership of two home builders in Tallahassee, Florida. When Lawrence suffered a serious injury a few years ago, Sander was able to take over supervising his projects and see them through to completion. Had Lawrence been a sole proprietor, his customers would have suffered greatly. However, a person who chooses to be part of a partnership rather than operating alone as a sole proprietor also takes on some risk; your partner could make bad decisions that end up costing you a lot of money. Thus developing trust and confidence in one's partner is very important.

Most large firms, such as Southwest Airlines, are organized as corporations. A key difference between a corporation on the one hand and a sole proprietorship and a partnership on the other is that corporations involve the separation of ownership and management. Corporations sell shares of ownership that are publicly traded in stock markets, and they are managed by professional executives. These executives may own a significant portion of the corporation's stock, but this is not a legal requirement.

Another unique feature of corporations is how they deal with profits and losses. Unlike in sole proprietorships and partnerships, a corporation's owners (i.e., shareholders) do not directly receive profits or absorb losses. Instead, profits and losses indirectly affect shareholders in two ways. First, profits and losses tend to be reflected in whether the firm's stock price rises or falls. When a shareholder sells her stock, the firm's performance while she has owned the stock will influence whether she makes a profit relative to her stock purchase. Shareholders can also benefit from profits if a firm's executives decide to pay cash dividends to shareholders. Unfortunately, for shareholders, corporate profits and any dividends that these profits support are both taxed. This double taxation is a big disadvantage of corporations.

A specialized type of corporation called an S corporation avoids double taxation. Much like in a partnership, the firm's profits and losses are reported on owners' personal tax returns in proportion with each owner's share of the firm. Although this is an attractive feature, an S corporation would be impractical for most large firms because the number of shareholders in an S corporation is capped, usually at one hundred. In contrast, Southwest Airlines has more than ten thousand shareholders. For smaller firms, such as many real-estate agencies, the S corporation is an attractive form of business.

A final form of business is very popular, yet it is not actually recognized by the federal government as a form of business. Instead, the ability to create a limited liability company (LLC) is granted in state laws. LLCs mix attractive features of corporations and partnerships. The owners of an LLC are not personally responsible for debts that the LLC accumulates (like in a corporation) and the LLC can be run in a flexible manner (like in a partnership). When paying federal taxes, however, an LLC must choose to be treated as a corporation, a partnership, or a sole proprietorship. Many home builders (including Sander & Lawrence), architectural businesses, and consulting firms are LLCs.

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The Three Processes of Strategy

Strategic management is a combination of three main processes which are as follows:

- Performing a situation analysis, self-evaluation and competitor analysis: both internal and external; both micro-environmental and macro-environmental.
- Concurrent with this assessment, objectives are set. These objectives should be parallel to a timeline; some are in the short-term and others on the long-term. This involves crafting vision statements (long term view of a possible future), mission statements (the role that the organization gives itself in society), overall corporate objectives (both financial and strategic), strategic business unit objectives (both financial and strategic), and tactical objectives.
- These objectives should, in the light of the situation analysis, suggest a strategic plan. The plan provides the details of how to achieve these objectives..

Strategy implementation

- Performing a situation analysis, self-evaluation and competitor analysis: both internal and external; both micro-environmental and macro-environmental.
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strategic), and tactical objectives.

- These objectives should, in the light of the situation analysis, suggest a strategic plan. The plan provides the details of how to achieve these objectives.

Strategy evaluation

- Measuring the effectiveness of the organizational strategy, it's extremely important to conduct a SWOT analysis to figure out the strengths, weaknesses, opportunities and threats (both internal and external) of the entity in question. This may require to take certain precautionary measures or even to change the entire strategy.

In corporate strategy, Johnson and Scholes present a model in which strategic options are evaluated against three key success criteria:

- Suitability (would it work?)
- Feasibility (can it be made to work?)
- Acceptability (will they work it?)

<u>Suitability</u>

Suitability deals with the overall rationale of the strategy. The key point to consider is whether the strategy would address the key strategic issues underlined by the organisation's strategic position.

- Does it make economic sense?
- Would the organisation obtain economies of scale, economies of scope or experience economy?
- Would it be suitable in terms of environment and capabilities?

Tools that can be used to evaluate suitability include:

- Feasibility

    - Feasibility is concerned with the resources required to implement the strategy are available, can be developed or obtained. Resources include **funding**, **people**, **time** and **information**.
    - Tools that can be used to evaluate feasibility include:
        - cash flow analysis and forecasting
        - break-even analysis
        - resource deployment analysis

- Acceptability
    - Acceptability is concerned with the expectations of the identified stakeholders (mainly shareholders, employees and customers) with the expected performance outcomes, which can be return, risk and stakeholder reactions.

- Return
    - The benefits expected by the stakeholders (financial and non-financial). For example, shareholders would expect the increase of their wealth, employees would expect improvement in their careers and customers would expect better value for money.
- Risk
    - The probability and consequences of failure of a strategy (financial and non-financial).
- Stakeholder reactions
    - The likely reaction of stakeholders. Shareholders could oppose the issuing of new shares, employees and unions could oppose outsourcing for fear of losing their jobs, customers could have concerns over a merger with regards to quality and support.Try and test.

The three process strategy https://en.wikibooks.org/wiki/

Business_Strategy/The_Three_Processes_of_Strategy https://en.wikibooks.org/wiki/Business_Strategy/The_Three_Processes_of_Strategy

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Marketing Plans and Strategies

A marketing plan is a written document that details the necessary actions to achieve one or more marketing objectives. It can be for a product or Service (economics)|service, a brand, or a product line. Marketing plans cover between one and five years.

A marketing plan may be part of an overall business plan. Solid marketing strategy is the foundation of a well-written marketing plan. While a marketing plan contains a list of actions, a marketing plan without a sound strategic foundation is of little use.

The marketing planning process

The marketing process model based on the publications of Philip Kotler. It consists of 5 steps, beginning with the market & environment research. After fixing the targets and setting the strategies, they will be realised by the marketing mix in step 4. The last step in the process is the marketing controlling.

In most organizations, "strategic planning" is an annual process, typically covering just the year ahead. Occasionally, a few organizations may look at a practical plan which stretches three or more years ahead.

To be most effective, the marketing plan has to be formalized, usually it is in a written form. The essence of the process is that it moves from the general to the specific; from the overall objectives of the organization down to the individual Objective (goal)|action plan for a part of one marketing program. It is also an interactive process, so that the draft output of each stage is checked to see what impact it has on the earlier stages – and is amended.

Marketing planning aims and objectives

Behind the corporate objectives, which in themselves offer the main context for the marketing plan, will lay the "corporate mission"; which in turn provides the context for these corporate objectives. This "corporate mission" can be thought of as a definition of what the organization is; of what it does: "Our business is …".

This definition should not be too narrow, or it will constrict the development of the organization; a too rigorous concentration on the view that "We are in the business of making meat-scales," as IBM was during the early 1900s, might have limited its subsequent development into other areas. On the other hand, it should not be too wide or it will become meaningless; "We want to make a profit" is not too helpful in developing specific plans.

Abell suggested that the definition should cover three dimensions: "customer groups" to be served, "customer needs" to be served, and "technologies" to be utilized [1]. Thus, the definition of IBM's "corporate mission" in the 1940s might well have been: "We are in the business of handling accounting information [customer need] for the larger US organizations [customer group] by means of Punch card|punched cards [technology]."

Perhaps the most important factor in successful marketing is the "corporate vision." Surprisingly, it is largely neglected by marketing textbooks; although not by the popular exponents of corporate strategy – indeed, it was perhaps the main theme of the book by Peters and Waterman, in the form of their "Superordinate Goals." "In Search of Excellence" said: "Nothing drives progress like the imagination. The idea precedes the deed." [2] If the organization in general, and its chief executive in particular, has a strong vision of where its future lies, then there is a good chance that the organization will achieve a strong position in its markets (and attain that future). This will be not least because its strategies will be consistent; and will be supported by its staff at all levels. In this context, all of IBM's marketing activities were underpinned by its philosophy of "customer service"; a vision originally promoted by the charismatic Watson dynasty.

The emphasis at this stage is on obtaining a complete and accurate picture. In a single organization, however, it is likely that only a few aspects will be sufficiently important to have any significant impact on the marketing plan; but all may need to be reviewed to determine just which "are" the few.

A "traditional" – albeit product-based – format for a "brand reference book" (or, indeed, a "marketing facts book") was suggested by Godley more than three decades ago:

1. Financial data –Facts for this section will come from management accounting, costing and finance sections.
2. Product data –From production, research and development.
3. Sales and distribution data – Sales, packaging, distribution sections.
4. Advertising, sales promotion, merchandising data – Information from these departments.
5. Market data and miscellany – From market research, who would in most cases act as a source for this information.

His sources of data, however, assume the resources of a very large organization. In most organizations they would be obtained from a much smaller set of people (and not a few of them would be generated by the marketing manager alone). It is apparent that a marketing audit can be a complex process, but the aim is simple: "it is only to identify those existing (external and internal) factors which will have a significant impact on the future plans of the company."

It is clear that the basic material to be input to the marketing audit should be comprehensive. Accordingly, the best approach is to accumulate this material continuously, as and when it becomes available; since this avoids the otherwise heavy workload involved in collecting it as part of the regular, typically annual, planning process itself – when time is usually at a premium. Even so, the first task of this “annual” process should be to check that the material held in the current “facts book” or “facts files” actually “is” comprehensive and accurate, and can form a sound basis for the marketing audit itself.

The structure of the facts book will be designed to match the specific needs of the organization, but one simple format – suggested by Malcolm McDonald – may be applicable in many cases. This splits the material into three groups:

1. “Review of the marketing environment.” A study of the organization’s markets, customers, competitors and the overall economic, political, cultural and technical environment; covering developing trends, as well as the current situation.
2. “Review of the detailed marketing activity.” A study of the company’s marketing mix; in terms of the 7 Ps – (see below)
3. “Review of the marketing system.” A study of the marketing organization, marketing research systems and the current marketing objectives and strategies.

The last of these is too frequently ignored. The marketing system itself needs to be regularly questioned, because the validity of the whole marketing plan is reliant upon the accuracy of the input from this system, and `garbage in, garbage out’ applies with a vengeance.

- “Portfolio planning.” In addition, the coordinated planning of the individual products and services can contribute towards the balanced portfolio.
- “80:20 rule.” To achieve the maximum impact, the marketing plan must be clear, concise and simple. It needs to concentrate on the 20 per cent of products or services, and on the 20 per cent of customers, which will account for 80 per cent of the volume and 80 per cent of the profit.
- “7 P’s”: Product, Place, Price and Promotion, Physical Environment, People, Process. The 7 P’s can sometimes divert attention from the customer, but the framework they offer can

be very useful in building the action plans.

It is only at this stage (of deciding the marketing objectives) that the active part of the marketing planning process begins'.

This next stage in marketing planning is indeed the key to the whole marketing process. The "marketing objectives" state just where the company intends to be; at some specific time in the future. James Quinn succinctly defined objectives in general as: "Goals (or objectives) state 'what' is to be achieved and 'when' results are to be accomplished, but they do not state 'how' the results are to be achieved."[3]

They typically relate to what products (or services) will be where in what markets (and must be realistically based on customer behavior in those markets). They are essentially about the match between those "products" and "markets." Objectives for pricing, distribution, advertising and so on are at a lower level, and should not be confused with marketing objectives. They are part of the marketing strategy needed to achieve marketing objectives.

To be most effective, objectives should be capable of measurement and therefore "quantifiable." This measurement may be in terms of sales volume, money value, market share, percentage penetration of distribution outlets and so on. An example of such a measurable marketing objective might be "to enter the market with product Y and capture 10 per cent of the market by value within one year." As it is quantified it can, within limits, be unequivocally monitored; and Corrective Action|corrective action taken as necessary.

The marketing objectives must usually be based, above all, on the organization's financial objectives; converting these financial measurements into the related marketing measurements.

He went on to explain his view of the role of "policies," with which strategy is most often confused: "Policies are rules or guidelines that express the 'limits' within which action should occur."

Simplifying somewhat, marketing strategies can be seen as the means, or "game plan," by which marketing objectives will be achieved and, in the framework that we have chosen to use, are generally concerned with the 7 P’s. Examples are:

- Price- The amount of money needed to buy products
- Product- The actual product
- Promotion (advertising)- Getting the product known
- Placement- Where the product is located
- People- Represent the business
- Physical environment- The ambiance, mood, or tone of the environment
- Process- How do people obtain your product

In principle, these strategies describe how the objectives will be achieved. The 7 P’s are a useful framework for deciding how the company’s resources will be manipulated (strategically) to achieve the objectives. It should be noted, however, that they are not the only framework, and may divert attention from the real issues. The focus of the strategies must be the objectives to be achieved – not the process of planning itself. Only if it fits the needs of these objectives should you choose, as we have done, to use the framework of the 7 P’s.

The strategy statement can take the form of a purely verbal description of the strategic options which have been chosen. Alternatively, and perhaps more positively, it might include a structured list of the major options chosen.

One aspect of strategy which is often overlooked is that of “timing.” Exactly when it is the best time for each element of the strategy to be implemented is often critical. Taking the right action at the wrong time can sometimes be almost as bad as taking the wrong action at the right time. Timing is, therefore, an essential part of any plan; and should normally appear as a schedule of planned activities.

Having completed this crucial stage of the planning process, you will need to re-check the feasibility of your objectives and strategies in terms of the market share, sales, costs, profits and so on which these demand in practice. As in the rest of the marketing discipline, you will need to employ judgment, experience, market research or anything else which helps you to look at your conclusions from all possible angles.

Detailed plans and programs

At this stage, you will need to develop your overall marketing strategies into detailed plans and program. Although these detailed plans may cover each of the 7 P's, the focus will vary, depending upon your organization's specific strategies. A product-oriented company will focus its plans for the 7 P's around each of its products. A market or geographically oriented company will concentrate on each market or geographical area. Each will base its plans upon the detailed needs of its customers, and on the strategies chosen to satisfy these needs.

Again, the most important element is, indeed, that of the detailed plans; which spell out exactly what programs and individual activities will take place over the period of the plan (usually over the next year). Without these specified – and preferably quantified – activities the plan cannot be monitored, even in terms of success in meeting its objectives.

It is these programs and activities which will then constitute the "marketing" of the organization over the period. As a result, these detailed marketing programs are the most important, practical outcome of the whole planning process. These plans should therefore be:

- **Clear** – They should be an unambiguous statement of 'exactly' what is to be done.
- **Quantified** – The predicted outcome of each activity should be, as far as possible, quantified; so that its performance can be monitored.
- **Focused** – The temptation to proliferate activities beyond the numbers which can be realistically controlled should be avoided. The Pareto principle|80:20 Rule applies in this context too.

- **Realistic** – They should be achievable.
- **Agreed** – Those who are to implement them should be committed to them, and agree that they are achievable.

The resulting plans should become a working document which will guide the campaigns taking place throughout the organization over the period of the plan. If the marketing plan is to work, every exception to it (throughout the year) must be questioned; and the lessons learned, to be incorporated in the next year's planning.

Content of the marketing plan

A marketing plan for a small business typically includes Small Business Administration Description of competitors, including the level of demand for the product or service and the strengths and weaknesses of competitors

1. Description of the product or service, including special features
2. Marketing budget, including the advertising and promotional plan
3. Description of the business location, including advantages and disadvantages for marketing
4. Pricing strategy
5. Market Segmentation

Medium-sized and large organizations

The main contents of a marketing plan are:

1. Executive Summary
2. Situational Analysis
3. Opportunities / Issue Analysis – SWOT Analysis
4. Objectives
5. Strategy
6. Action Programme (the operational marketing plan itself for the period under review)
7. Financial Forecast

8. Controls

In detail, a complete marketing plan typically includes:

1. Title page
2. Executive Summary
3. Current Situation – environmental scanning|Macroenvironment
    - economy
    - legal
    - government
    - technology
    - ecological
    - sociocultural
    - supply chain
4. Current Situation – industry or market research|Market Analysis
    - market definition
    - market size
    - market segmentation
    - industry structure and strategic groupings
    - Porter 5 forces analysis
    - competition and market share
    - competitor analysis|competitors' strengths and weaknesses
    - market trends
5. Current Situation – Consumer Analysis [4]
    - nature of the buying decision
    - participants
    - demographics
    - psychographics

- buyer motivation and expectations
- loyalty segments

6. Current Situation – Internal

    - company resources
        - financial
        - people
        - time
        - skills
    - objectives
        - mission statement and vision statement
        - corporate objectives
        - financial objective
        - marketing objectives
        - long term objectives
        - description of the basic business philosophy
    - corporate culture

7. Summary of Situation Analysis

    - external threats
    - external opportunities
    - internal strengths
    - internal weaknesses
    - Critical success factors in the industry
    - our sustainable competitive advantage

8. Marketing research

    - information requirements
    - research methodology
    - research results

9. Marketing Strategy – Product management Product

    - product line|product mix
    - product strengths and weaknesses
        - perceptual mapping
    - Product Life Cycle Management|product life cycle management and new product development
    - brand Brand name, brand image, and brand equity
    - the product (business) augmented product
    - product Product portfolio portfolio analysis
        - B.C.G. Analysis
        - contribution margin analysis
        - G.E. Multi Factoral analysis
        - Quality Function Deployment

10. Marketing Strategy [5] – Market segment|segmented marketing actions and market share objectives
    - by product,
    - by customer segment,
    - by geographical market,
    - by distribution channel.

11. Marketing Strategy – Pricing|Price
    - pricing objectives
    - pricing method (e.g.: cost plus, demand based, or competitor indexing)
    - pricing strategy (e.g.: skimming, or penetration)
    - discounts and allowances
    - price elasticity of demand|price elasticity and customer sensitivity
    - geographical pricing|price zoning
    - break even analysis at various prices

12. Marketing Strategy – promotion (marketing)|promotion

- promotional goals
- Promotional_mix|promotional mix
- advertising reach, frequency, flights, theme, and media
- sales|sales force requirements, techniques, and management
- sales promotion
- publicity and public relations
- electronic promotion (e.g.: e-marketing|Web, or direct marketing|telephone)
- word of mouth marketing (buzz)
- viral marketing

13. Marketing Strategy – Distribution (business)|Distribution

    - geographical coverage
    - distribution channels
    - physical distribution and logistics
    - electronic distribution

14. Implementation

    - personnel requirements
        - assign responsibilities
        - give incentives
        - training on selling methods
    - financial requirements
    - management information systems requirements
    - month-by-month agenda
        - Program Evaluation and Review Technique|PERT or critical path analysis
    - monitoring results and benchmarks
    - adjustment mechanism
    - contingencies (What if's)

15. Financial Summary

- assumptions
- pro-forma monthly income statement
- contribution margin analysis
- breakeven analysis
- Monte Carlo methods in finance|Monte Carlo method
- ISI: Internet Strategic Intelligence

16. Scenarios

    - Prediction of Future Scenarios
    - Plan of Action for each Scenario

17. Appendix

    - pictures and specifications of the new product
    - results from research already completed

Measurement of progress

The final stage of any marketing planning process is to establish targets (or standards) so that progress can be monitored. Accordingly, it is important to put both quantities and timescales into the marketing objectives (for example, to capture 20 per cent by value of the market within two years) and into the corresponding strategies.

Changes in the environment mean that the forecasts often have to be changed. Along with these, the related plans may well also need to be changed. Continuous monitoring of performance, against predetermined targets, represents a most important aspect of this. However, perhaps even more important is the enforced discipline of a regular formal review. Again, as with forecasts, in many cases the best (most realistic) planning cycle will revolve around a quarterly review. Best of all, at least in terms of the quantifiable aspects of the plans, if not the wealth of backing detail, is probably a quarterly rolling review – planning one full year ahead each new quarter. Of course, this does absorb more planning resource; but it also ensures that the plans embody the latest information, and – with attention focused on them so regularly – forces both the plans and their implementation to be realistic.

Plans only have validity if they are actually used to control the progress of a company: their success lies in their implementation, not in the writing'.

Performance analysis

The most important elements of marketing performance, which are normally tracked, are:

<u>Sales analysis</u>

Most organizations track their sales results; or, in non-profit organizations for example, the number of clients. The more sophisticated track them in terms of 'sales variance' – the deviation from the target figures – which allows a more immediate picture of deviations to become evident.. `Micro- analysis', which is a nicely pseudo-scientific term for the normal management process of investigating detailed problems, then investigates the individual elements (individual products, sales territories, customers and so on) which are failing to meet targets.

<u>Market share analysis</u>

Few organizations track market share though it is often an important metric. Though absolute sales might grow in an expanding market, a firm's share of the market can decrease which bodes ill for future sales when the market starts to drop. Where such market share is tracked, there may be a number of aspects which will be followed:

- overall market share
- segment share – that in the specific, targeted segment
- relative share -in relation to the market leaders
- annual fluctuation rate of market share

<u>Expense analysis</u>

The key ratio to watch in this area is usually the `marketing expense to sales ratio'; although this may be broken down into other elements (advertising to sales, sales administration to sales, and so on).

Financial analysis

The `bottom line' of marketing activities should at least in theory, be the net profit (for all except non-profit organizations, where the comparable emphasis may be on remaining within budgeted costs). There are a number of separate performance figures and key ratios which need to be tracked:

- gross contribution<>net profit
- gross profit<>return on investment
- net contribution<>profit on sales

There can be considerable benefit in comparing these figures with those achieved by other organizations (especially those in the same industry); using, for instance, the figures which can be obtained (in the UK) from `The Centre for Interfirm Comparison'. The most sophisticated use of this approach, however, is typically by those making use of PIMS (Profit Impact of Management Strategies), initiated by the General Electric Company and then developed by Harvard Business School, but now run by the Strategic Planning Institute.

The above performance analyses concentrate on the quantitative measures which are directly related to short-term performance. But there are a number of indirect measures, essentially tracking customer attitudes, which can also indicate the organization's performance in terms of its longer-term marketing strengths and may accordingly be even more important indicators. Some useful measures are:

- market research – including customer panels (which are used to track changes over time)
- lost business – the orders which were lost because, for example, the stock was not available or the product did not meet the customer's exact requirements

- customer complaints – how many customers complain about the products or services, or the organization itself, and about what

Use of marketing plans

A formal, written marketing plan is essential; in that it provides an unambiguous reference point for activities throughout the planning period. However, perhaps the most important benefit of these plans is the planning process itself. This typically offers a unique opportunity, a forum, for information-rich and productively focused discussions between the various managers involved. The plan, together with the associated discussions, then provides an agreed context for their subsequent management activities, even for those not described in the plan itself.

Budgets as managerial tools

The classic quantification of a marketing plan appears in the form of budgets. Because these are so rigorously quantified, they are particularly important. They should, thus, represent an unequivocal projection of actions and expected results. What is more, they should be capable of being monitored accurately; and, indeed, performance against budget is the main (regular) management review process.

The purpose of a marketing budget is, thus, to pull together all the revenues and costs involved in marketing into one comprehensive document. It is a managerial tool that balances what is needed to be spent against what can be afforded, and helps make choices about priorities. It is then used in monitoring performance in practice.

The marketing budget is usually the most powerful tool by which you think through the relationship between desired results and available means. Its starting point should be the marketing strategies and plans, which have already been formulated in the marketing plan itself; although, in practice, the two will run in parallel and will interact. At the very least, the rigorous, highly quantified, budgets may cause a rethink of some of the more optimistic elements of the plans.

Marketing Strategy

A **marketing strategy** is a process that can allow an organization to concentrate its limited resources on the greatest opportunities to increase sales and achieve a sustainable competitive advantage. A marketing strategy should be centered around the key concept that customer satisfaction is the main goal.

Key part of the general corporate strategy

A marketing strategy is most effective when it is an integral component of corporate strategy, defining how the organization will successfully engage customers, prospects, and competitors in the market arena. Strategic management|corporate strategies, corporate missions, and corporate goals. As the customer constitutes the source of a company's revenue, marketing strategy is closely linked with sales. A key component of marketing strategy is often to keep marketing in line with a company's overarching mission statement.

Basic theory: 1) Target Audience 2) Proposition/Key Element 3) Implementation

Sectorial tactics and actions

A marketing strategy can serve as the foundation of a marketing plan. A marketing plan contains a set of specific actions required to successfully implement a marketing strategy. For example: "Use a low cost product to attract consumers. Once our organization, via our low cost product, has established a relationship with consumers, our organization will sell additional, higher-margin products and services that enhance the consumer's interaction with the low-cost product or service."

A strategy consists of a well thought out series of tactics to make a marketing plan more effective. Marketing strategies serve as the fundamental underpinning of marketing plans designed to fill market needs and reach marketing objectives. Plans and objectives are generally tested for measurable results.

A marketing strategy often integrates an organization's marketing goals, policies, and action sequences (tactics) into a cohesive whole. Similarly, the various strands of the strategy , which might include advertising, channel (marketing)|channel marketing, internet marketing, promotion (marketing)|promotion and public relations can be orchestrated. Many companies cascade a strategy throughout an organization, by creating strategy tactics that then become strategy goals for the next level or group. Each one group is expected to take that strategy goal and develop a set of tactics to achieve that goal. This is why it is important to make each strategy goal measurable.

Marketing strategies are dynamic and interactive. They are partially planned and partially unplanned. See strategy dynamics.

Types of strategies

Marketing strategies may differ depending on the unique situation of the individual business. However there are a number of ways of categorizing some generic strategies. A brief description of the most common categorizing schemes is presented below:

- Strategies based on market dominance – In this scheme, firms are classified based on their market share or dominance of an industry. Typically there are three types of market dominance strategies:
    - Leader
    - Challenger
    - Follower
- Porter generic strategies – strategy on the dimensions of strategic scope and strategic strength. Strategic scope refers to the market penetration while strategic strength refers to the firm's sustainable competitive advantage.
    - Product differentiation
    - Market segmentation
- Innovation strategies – This deals with the firm's rate of the new product development and business model innovation. It asks whether the company is on the cutting edge of technology and business innovation. There are three types:
    - Pioneers

    - Close followers
    - Late followers
- Growth strategies – In this scheme we ask the question, “How should the firm grow?”. There are a number of different ways of answering that question, but the most common gives four answers:
    - Horizontal integration
    - Vertical integration
    - Diversification
    - Intensification

  A more detailed scheme uses the categories:

    - Prospector
    - Analyzer
    - Defender
    - Reactor

  Marketing warfare strategies – This scheme draws parallels between marketing strategies and military strategies.

Strategic models

Marketing participants often employ strategic models and tools to analyze marketing decisions. When beginning a strategic analysis, the 3C’s|3Cs can be employed to get a broad understanding of the strategic environment. An Ansoff Matrix is also often used to convey an organization’s strategic positioning of their marketing mix. The 4P’s|4Ps can then be utilized to form a marketing plan to pursue a defined strategy.

Marketing in Practice

The Consumer-Centric Business

There are a many companies especially those in the Consumer Package Goods (CPG) market that adopt the theory of running their business centered around Consumer, Shopper & Retailer needs. Their Marketing departments spend quality time looking for

“Growth Opportunities” in their categories by identifying relevant insights (both mindsets and behaviors) on their target Consumers, Shoppers and retail partners. These Growth Opportunities emerge from changes in market trends, segment dynamics changing and also internal brand or operational business challenges.The Marketing team can then prioritize these Growth Opportunities and begin to develop strategies to exploit the opportunities that could include new or adapted products, services as well as changes to the 7Ps.

Real-life marketing primarily revolves around the application of a great deal of common-sense; dealing with a limited number of factors, in an environment of imperfect information and limited resources complicated by uncertainty and tight timescales. Use of classical marketing techniques, in these circumstances, is inevitably partial and uneven.

Thus, for example, many new products will emerge from irrational processes and the rational development process may be used (if at all) to screen out the worst non-runners. The design of the advertising, and the packaging, will be the output of the creative minds employed; which management will then screen, often by ‘gut-reaction’, to ensure that it is reasonable.

For most of their time, marketing managers use intuition and experience to analyze and handle the complex, and unique, situations being faced; without easy reference to theory. This will often be ‘flying by the seat of the pants’, or ‘gut-reaction’; where the overall strategy, coupled with the knowledge of the customer which has been absorbed almost by a process of osmosis, will determine the quality of the marketing employed. This, almost instinctive management, is what is sometimes called ‘coarse marketing’; to distinguish it from the refined, aesthetically pleasing, form favored by the theorists.

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Competing in International Markets

Advantages and Disadvantages of Competing in International Markets

Access to new customers	China's population is roughly four times as large as that of the United States. While political, cultural, and economic differences add danger to trade with China, the immense size of the Chinese market appeals to American firms.
Lowering costs	Access to cheaper raw materials and labor have led to considerable outsourcing and offshoring. Call centers in India have become so sophisticated that many Indian customer service representatives take extensive language training to learn regional U.S. dialects.
Diversification of business risk	Business risk refers to the risk of an operation failing. Competing in multiple markets allows this risk to be spread out among many economies and customers. Coca-Cola, for example, has a presence in over 200 markets worldwide.

Table 1 Why Compete in New Markets? *The domestication of the camel by Arabian travelers fueled two early examples of international trade: spices and silk. Today, camels have been replaced by airplanes, trains, and ships, and international trade is more alluring than ever. Here are three key reasons why executives are enticed to enter new markets.*

The United States enjoys the world's largest economy. As an illustration of the power of the American economy, consider that, as of early 2011, the economy of just one state—California—would be the eighth largest in the world if it were a country, ranking between Italy and Brazil (The Economist, 2011). The size of the US economy has led its commerce to be intertwined with international markets. In fact, it is fair to say that every business is affected by international markets to some degree. Tiny businesses such as individual convenience stores and clothing boutiques sell products that are imported from abroad. Meanwhile, corporate goliaths such as General Motors (GM), Coca-Cola, and Microsoft conduct a great volume of business overseas.

Access to New Customers

Perhaps the most obvious reason to compete in international markets is gaining access to new customers. Although the United States enjoys the largest economy in the world, it accounts for only about 5 percent of the world's population. Selling goods and services to the other 95 percent of people on the planet can be appealing, especially for companies whose industry within their home market are saturated.

Few companies have a stronger "All-American" identity than McDonald's. Yet McDonald's is increasingly reliant on sales outside the United States. In 2011, Europe was McDonald's biggest source of revenue (40 percent), the US share 32 percent, and the collective contribution of Asia, the Middle East, and Africa had jumped to 23 percent. With less than one-third of its sales being generated in its home country, McDonald's is a global powerhouse.

China and India are increasingly attractive markets to US firms. The countries are the two most populous in the world. Both nations have growing middle classes, which means that more and more people are able to purchase goods and services. This trend has created tremendous opportunities for some firms. In the first half of 2010, GM sold more vehicles in China than it sold in the United States (1.2 million vs. 1.08 million). This gap seemed likely to expand; in the first half of 2010, GM's sales in China increased nearly 50 percent relative to 2009 levels, while sales in the United States rose 15 percent (Isidore, 2010).

Lowering Costs

Many firms compete in international markets in hope to gain cost advantages. If a firm can increase it sales volume by entering a new country, for example, it may attain economies of scale that lower its production costs. Going international also has implications for dealing with suppliers. The growth that overseas expansion creates leads many businesses to purchase supplies in greater numbers. This can provide a firm with stronger leverage when negotiating prices with its suppliers.

Offshoring has become a popular yet controversial means for trying to reduce costs. Offshoring involves relocating a business activity to another country. Many American companies have closed down operations at home in favor of creating new operations in countries such as China and India that offer cheaper labor. While offshoring can reduce a firm's costs of doing business, the job losses in the firm's home country can devastate local communities. For example, West Point, Georgia, lost approximately 16,000 jobs in the 1990s and 2000s as local textile factories were shut down in favor of offshoring (Copeland, 2010). Fortunately for the town, Kia's decision to locate its first US factory in West Point has improved the economy in the past few years. In another example, Fortune Brands saved $45 million a year by relocating several factories to Mexico, but the employee count in just one of the affected US plants dropped from 1,160 to 350.

A growing number of US companies are finding that offshoring does not provide the expected benefits. This has led to a new phenomenon known as reshoring, whereby jobs that had been sent overseas are returning home. In some cases, the quality provided by workers overseas is not good enough. Carbonite, a seller of computer backup services, found that its call center in Boston was providing much strong customer satisfaction than its call center in India. The Boston operation's higher rating was attained even though it handled the more challenging customer complaints. As a result, Carbonite plans to shift 250 call center jobs back to the United States by the end of 2012.

In other cases, the expected cost savings have not materialized. NCR had been making ATMs and self-service checkout systems in China, Hungary, and Brazil. These machines can weigh more than a ton, and NCR found that shipping them from overseas plants back to the United States was extremely expensive. NCR hired 500 workers to start making the ATMs and checkout systems at a plant in Columbus, Georgia. NCR's plans call for 370 more jobs to be added at the plant by 2014 (Isidore, 2011).

Diversification of Business Risk

A familiar cliché warns "don't put all of your eggs in one basket." Applied to business, this cliché suggests that it is dangerous for a firm to operate in only one country. Business risk refers to the potential that an operation might fail. If a firm is completely dependent on one country, negative events in that country could ruin the firm.

Consider, natural disasters such as the earthquakes and tsunami that hit Japan in 2011. If Japanese automakers such as Toyota, Nissan, and Honda sold cars only in their home country, the financial consequences could have been grave. Because these firms operate in many countries, they were protected from devestation by events in Japan. These firms diversified their business risk by not being overly dependent on their Japanese operation.

American cigarette companies such as Philip Morris and R. J. Reynolds are challenged by trends within the United States and Europe. Tobacco use in these areas is declining as more laws are passed that ban smoking in public areas and in restaurants. In response, cigarette makers are attempting to increase their operations within countries where smoking remains popular to remain profitable over time.

In 2006, for example, Philip Morris spent $5.2 billion to purchase a controlling interest in Indonesian cigarette maker Sampoerna. This was the biggest acquisition ever in Indonesia by a foreign company. Tapping into Indonesia's population of approximately 230 million people was attractive to Philip Morris in part because nearly two-thirds of men are smokers, and smoking among women is on the rise. As of 2007, Indonesia was the fifth-largest tobacco market in the world, trailing only China, the United States, Russia, and Japan. To appeal to local preferences for cigarettes flavored with cloves, Philip Morris introduced a variety of its signature Marlboro brand called Marlboro Mix 9 that includes cloves in its formulation (The Two Malcontents, 2007).

Political Risk

Although competing in international markets offers potential benefits, such as access to new customers, the opportunity to lower costs, and the diversification of business risk, going overseas also poses daunting challenges. Political risk refers to the potential for government upheaval or interference with business to harm an operation within a country. Unstable governments and uprisings make it difficult for firms to plan for the future. Over time, a government could become increasingly hostile to foreign businesses by imposing new taxes and new regulations. In extreme cases, a firm's assets in a country are seized by the national government. This process is called nationalization. In recent years, for example, Venezuela has nationalized foreign-controlled operations in the oil, cement, steel, and glass industries.

Firms may choose to concentrate their efforts in countries such as Canada, Australia, and Japan that have very low levels of political risk, but opportunities in such settings are often more modest (Kostigen, 2011).

Economic Risk

Economic risk refers to the potential for a country's economic conditions and policies, property rights protections, and currency exchange rates to harm a firm's operations within a country. Executives who lead companies that conduct business indifferent countries have to take stock of these various dimensions and try to anticipate how the dimensions will affect their companies. Because economies are unpredictable, economic risk presents executives with tremendous challenges.

In May 2009, Kia reported increased sales in ten European countries relative to May 2008. The firm enjoyed a 62 percent year-to-year increase in Slovakia, 58 percent in Austria, 50 percent in Gibraltar, 49 percent in Sweden, 43 percent in Poland, 24 percent in Germany, 21 percent in the United Kingdom, 13 percent in the Czech Republic, 6 percent in Belgium, and 3 percent in Italy (Kia). As Kia's executives planned for the future, they needed to wonder how economic conditions would influence Kia's future performance in Europe. If inflation and interest rates were to increase in a particular country, this would make it more difficult for consumers to purchase new Kias. If currency exchange rates were to change such that the euro became weaker relative to the South Korean won, this would make a Kia more expensive for European buyers.

Cultural Risk

If you want to signal “Check please!” to catch the attention of your garçon in France and Belgium, remember that snapping your fingers is vulgar there.	In many Asian and Arabian countries, showing the sole of your shoe is considered rude.
Provocative dress is embraced by many Americans, but many people in Muslim countries consider a woman’s clothing to be inappropriate if it reveals anything besides the face and hands.	If everything is OK when you’re in Brazil, avoid making the “OK” hand signal. It’s the equivalent to giving someone the middle finger.
Do you pride yourself on your punctuality? You may be wasting your time in Latin American countries, where the locals tend to be about 20 minutes behind schedule.	Do not clean your plate in China. Leaving food on the plate indicates the host was so generous that the meal could not be finished.
Do not eat with your left hand in India or Malaysia. That hand is associated with unclean activities reserved for the bathroom.	In Japan, direct eye contact is viewed as impolite.

Table 2 Cultural Risk: When in Rome. *The phrase “When in Rome, do as the Romans do” is used to encourage travelers to embrace local customs. An important part of fitting in is avoiding behaviors that locals consider offensive. Below we illustrate a number of activities that would go largely unnoticed in the United States but could raise concerns in other countries.*

Cultural risk refers to the potential for a company’s operations in a country to struggle because of differences in language, customs, norms, and customer preference. The history of business is full of colorful examples of cultural differences undermining companies. For example, a laundry detergent company was surprised by its poor sales in the Middle East. Executives believed that their product was being skillfully promoted using print advertisements that showed dirty clothing on the left, a box of detergent in the middle, and clean clothing on the right.

A simple and effective message, right? Not exactly. Unlike English and other Western languages, the languages used in the Middle East, such as Hebrew and Arabic, involve reading from right to left. To consumers, the implication of the detergent ads was that the product could be used to take clean clothes and make the dirty. Not surprisingly, few boxes of the detergent were sold before this cultural blunder was discovered.

A refrigerator manufacturer experienced poor sales in the Middle East because of another cultural difference. The firm used a photo of an open refrigerator in its prints ads to demonstrate the large amount of storage offered by the appliance. Unfortunately, the photo prominently featured pork, a type of meat that is not eaten by the Jews and Muslims who make up most of the area's population (Ricks, 1993). To get a sense of consumers' reactions, imagine if you saw a refrigerator ad that showed meat from a horse or a dog. You would likely be disgusted. In some parts of world, however, horse and dog meat are accepted parts of diets. Firms must take cultural differences such as these into account when competing in international markets.

Cultural differences can cause problems even when the cultures involved are very similar and share the same language. RecycleBank is an American firm that specializes in creating programs that reward people for recycling, similar to airlines' frequent-flyer programs. In 2009, RecycleBank expanded its operations into the United Kingdom. Executives at RecycleBank became offended when the British press referred to RecycleBank's rewards program as a "scheme." Their concern was unwarranted, however. The word *scheme* implies sneakiness when used in the United States, but a scheme simply means a service in the United Kingdom (Maltby, 2010). Differences in the meaning of English words between the United States and the United Kingdom are also vexing to American men named Randy, who wonder why Brits giggle at the mention of their name.

Book and movie titles are often changed in different markets to appeal to different cultural sensibilities. For example, British author J.K. Rowling's *Harry Potter and the Philosopher's Stone* was changed to *Harry Potter and the Sorcerer's Stone* in the United States because of the belief that American children would find a philosopher to be boring.
Moms in the states can be seen walking with strollers in their neighborhoods, while "mums" in Ireland and the United Kingdom keep their children moving in a buggy.
In India, you are more likely to hear "no problem" than "no" as Indian nationals avoid the disappointment associated with using the word no.
The area called a trunk in America is known as the a boot in England.
Wondering what it means when a British friend asks, "What's under your bonnet?" Open the hood of your car to offer an answer.
While Americans look for a flashlight when power goes out, a torch is the preferred term for those outside of North America.
Urban legend says that the Chevrolet Nova did not do well in Spanish speaking countries because the name translates as "no go." The truth is that the car sold well in both Mexico and Venezuela.

Table 3 Watch Your Language. *Cultural differences rooted in language—even across English-speaking countries—can affect how firms do business internationally.*

Drivers of Success and Failure When Competing in International Markets

The title of a book written by newspaper columnist Thomas Friedman attracted a great deal of attention when the book was released. In *The World Is Flat: A Brief History of the 21st Century*, Friedman argued that technological advances and increased interconnectedness is leveling the competitive playing field between developed and emerging countries. This means that companies exist in a "flat world" because economies across the globe are converging on a single integrated global system (Friedman, 2005). For executives, a key implication is that a firm's being based in a particular country is ceasing to be an advantage or disadvantage.

While Friedman's notion of business becoming a flat world is flashy and attention grabbing, it does not match reality. Research studies conducted since 2005 have found that some firms enjoy advantages based on their country of origin while others suffer disadvantages. A powerful framework for understanding how likely it is that firms based in a particular country will be successful when competing in international markets was provided by Professor Michael Porter of the Harvard Business School (Porter, 1990). The framework is formally known as "the determinants of national advantage," but it is often referred to more simply as "the diamond model" because of its shape.

Strategy, Structure, and Rivalry	The United States has an overall trade deficit, but it enjoys a trade surplus within the service sector. Fierce domestic competition in industries such as hotels and restaurants has helped make American firms such as Marriott and Subway important players on the world stage.
Factor Conditions	The inputs present in a country shape firm's global competitiveness. The rapid growth of Chinese manufacturers has been fueled by the availability of cheap labor.
Demand Conditions	Fussy domestic customers help firms prepare for the global arena. Japanese firms must create excellent goods to meet Japanese consumers' high expectations about quality, aesthetics, and reliability.
Related and Supporting Industries	Firms benefit when their domestic suppliers and other complementary industries are developed and helpful. Italy's fashion industry is enhance by the abundance of fine Italian leather and well-known designers.

Table 4 Diamond Model of National Advantage. *Diamonds may be a country's best friend. Around half of the world's diamonds are mined in South Africa, giving that country a unique advantage in the global diamond industry. Porter's Determinants of National advantage (often referred to as the diamond model) includes four key dimensions that help explain why firms located in certain countries are more successful than others in particular industries.*

According to the model, the ability of the firms in an industry whose origin is in a particular country (e.g., South Korean automakers or Italian shoemakers) to be successful in the international arena is shaped by four factors: (1) their home country's demand conditions, (2) their home country's factor conditions, (3) related and supporting industries within their home country, and (4) strategy, structure, and rivalry among their domestic competitors.

Demand Conditions

Within the diamond model, demand conditions refer to the nature of domestic customers. It is tempting to believe that firms benefit when their domestic customers are perfectly willing to purchase inferior products. This would be a faulty belief! Instead, firms benefit when their domestic customers have *high* expectations.

Japanese consumers are known for insisting on very high levels of quality, aesthetics, and reliability. Japanese automakers such as Honda, Toyota, and Nissan reap rewards from this situation. These firms have to work hard to satisfy their domestic buyers. Living up to lofty quality standards at home prepares these firms to offer high-quality products when competing in international markets. In contrast, French car buyers do not stand out as particularly fussy. It is probably not a coincidence that French automakers Renault and Peugeot have struggled to gain traction within the global auto industry.

Demand conditions also help to explain why German automakers such as Porsche, Mercedes-Benz, and BMW create excellent luxury and high-performance vehicles. German consumers value superb engineering. While a car is simply a means of transportation in some cultures, Germans place value on the concept of *fahrvergnügen*, which means "driving pleasure." Meanwhile, demand for fast cars is high in Germany because the country has built nearly eight thousand miles of superhighways known as autobahns. No speed limits for cars are enforced on more than half of the eight thousand miles. Many Germans enjoy driving at 150 miles per hour or more, and German automakers must build cars capable of safely reaching and maintaining such speeds. When these companies compete in the international arena, the engineering and performance of their vehicles stand out.

Factor Conditions

Factor conditions refer to the nature of raw material and other inputs that firms need to create goods and services. Examples include land, labor, capital markets, and infrastructure. Firms benefit when they have good access to factor conditions and face challenges when they do not. Companies based in the United States, for example, are able to draw on plentiful natural resources, a skilled labor force, highly developed transportation systems, and sophisticated capital markets to be successful. The dramatic growth of Chinese manufacturers in recent years has been fueled in part by the availability of cheap labor.

Land	Russia has the greatest land mass of any country in the world and it enjoys vast oil deposits. This abundance of natural resources has helped Russia's petroleum industry become one of the largest in the world.
Labor	India is the seventh largest country in terms of land mass, but its population size is second only to China. Because India graduates more English speakers annually than the United States, it should come as no surprise that Indian firms have gained ground in the international arena within industries that rely on engineering and computer skills.
Capital	The capital market in the United States is one of the largest and most sophisticated in the world. This has helped American companies fund expansion and innovation over time, making them better prepared for international competition.
Entrepreneurial Ability	Entrepreneurial ability creates national wealth when entrepreneurs develop new innovations that support key industries. Denmark's low start-up costs and high research and development spending have fueled success in industries such as pharmaceuticals and medical equipment.

Table 5 Factor Conditions. *The factor conditions in a country serve as the basic building blocks of doing business within the country. Below we provide examples of how important factor conditions have provided competitive advantages for firms based in certain different countries.*

In some cases, overcoming disadvantages in factor conditions leads companies to develop unique skills. Japan is a relatively small island nation with little room to spare. This situation has led Japanese firms to be pioneers in the efficient use of warehouse space through systems such as just-in-time inventory management (JIT). Rather than storing large amounts of parts and material, JIT management conserves space—and lowers costs—by requiring inputs to a production process to arrive at the moment they are needed. Their use of JIT management has given Japanese manufacturers an advantage when they compete in international markets.

Related and Supporting Industries

A very strong agriculture business helps support the cattle industry—which accounted for approximately four billion dollars worth of exports in 2010.
The same competitive spirit that arises within intramural and varsity sports at the collegiate level fuels the financial services sector and other American industries.
Excellent steel makers and engine manufacturers support the production of one of America's most lucrative exports—commercial aircraft.
The pharmaceutical industry benefits from the research skills possessed by university-affiliated hospitals.
America's excellent performing arts schools such as the Juilliard School cultivate the talents of world-famous American performers.

Table 6 Related and Supporting Industries. *In Porter's diamond model, the presence of strong friends in the form of related and supporting industries is one of the keys to national advantage. We provide examples of American industries that excel internationally due in part to help form supporting industries*

Could Italian shoemakers create some of the world's best shoes if Italian leather makers were not among the world's best? Possibly, but it would be much more difficult. The concept of related and supporting industries refers to the extent to which firms' domestic suppliers and other complementary industries are developed and helpful. Italian shoemakers such as Salvatore Ferragamo, Prada, Gucci, and Versace benefit from the availability of top-quality leather within their home country. If these shoemakers needed to rely on imported leather, they would lose flexibility and speed.

The auto industry is a setting where related and supporting industries are very important. Electronics are key components of modern vehicles. South Korean automakers Kia and Hyundai can leverage the excellent electronics provided by South Korean firms Samsung and LG. Similarly, Honda, Nissan, and Toyota are able to draw on the skills of Sony and other Japanese electronics firms. Unfortunately, for French automakers Renault and Peugeot, no French electronics firms are standouts in the international arena. This situation makes it difficult for Renault and Peugeot to integrate electronics into their vehicles as effectively as their South Korean and Japanese rivals.

Firm Strategy, Structure, and Rivalry

The concept of firm strategy, structure, and rivalry refers to how challenging it is to survive domestic competition. Companies that have survived intense rivalry within their home markets are likely to have developed strategies and structures that will facilitate their success when they compete in international markets. Hyundai and Kia had to keep pace with each other within the South Korean market before expanding overseas. The leading Japanese automakers—Honda, Nissan, and Toyota—have had to compete not only with one another but also with smaller yet still potent domestic firms such as Isuzu, Mazda, Mitsubishi, Subaru, and Suzuki. In both examples, the need to navigate potent domestic rivals has helped firms later become fearsome international players.

If the domestic competition is fairly light, a company may enjoy admirable profits within its home market. However, the lack of being pushed by rivals will likely mean that the firm struggles to reach its potential in creativity and innovation. This undermines the firm's ability to compete overseas and makes it vulnerable to foreign entry into its home market. Because neither Renault nor Peugeot has been a remarkable innovator historically, these French automakers have enjoyed fairly gentle domestic competition. Once the auto industry became a global competition, however, these firms found themselves trailing their Asian rivals.

Types of International Strategies

A firm that has operations in more than one country is known as a multinational corporation (MNC). The largest MNCs are major players within the international arena. Walmart's annual worldwide sales, for example, are larger than the dollar value of the entire economies of Austria, Norway, and Saudi Arabia. Although Walmart tends to be viewed as an American retailer, the firm earns more than one-quarter of its revenues outside the United States. Even more modestly sized MNCs are still very powerful. If Kia were a country, its current sales level of approximately $21 billion would place it in the top 100 among the more than 180 nations in the world.

Multinationals such as Walmart and Kia must choose an international strategy to guide their efforts in various countries. There are three main international strategies available: (1) multidomestic, (2) global, and (3) transnational. Each strategy involves a different approach to trying to build efficiency across nations and trying to be responsiveness to variation in customer preferences and market conditions across nations.

Multidomestic Strategy

A firm using a multidomestic strategy sacrifices efficiency in favor of emphasizing responsiveness to local requirements within each of its markets. Rather than trying to force all of its American-made shows on viewers around the globe, MTV customizes the programming that is shown on its channels within dozens of countries, including New Zealand, Portugal, Pakistan, and India. Similarly, food company H. J. Heinz adapts its products to match local preferences. Because some Indians will not eat garlic and onion, for example, Heinz offers them a version of its signature ketchup that does not include these two ingredients.

Global Strategy

A firm using a global strategy sacrifices responsiveness to local requirements within each of its markets in favor of emphasizing efficiency. This strategy is the complete opposite of a multidomestic strategy. Some minor modifications to products and services may be made in various markets, but a global strategy stresses the need to gain economies of scale by offering essentially the same products or services in each market.

Microsoft, for example, offers the same software programs around the world but adjusts the programs to match local languages. Similarly, consumer goods maker Procter & Gamble attempts to gain efficiency by creating global brands whenever possible. Global strategies also can be very effective for firms whose product or service is largely hidden from the customer's view, such as silicon chip maker Intel. For such firms, variance in local preferences is not very important.

Transnational Strategy

A firm using a transnational strategy seeks a middle ground between a multidomestic strategy and a global strategy. Such a firm tries to balance the desire for efficiency with the need to adjust to local preferences within various countries. For example, large fast-food chains such as McDonald's and Kentucky Fried Chicken (KFC) rely on the same brand names and the same core menu items around the world. These firms make some concessions to local tastes too. In France, for example, wine can be purchased at McDonald's. This approach makes sense for McDonald's because wine is a central element of French diets.

Options for Competing in International Markets

Table 7.11 Market Entry Options

When the executives of a firm decide to enter a new country, they must decide how to enter the country. There are five basic options available: (1) exporting, (2) creating a wholly owned subsidiary, (3) franchising, (4) licensing, and (5) creating a joint venture or strategic alliance. These options vary in terms of how much control a firm has over its operation, how much risk is involved, and what share of the operation's profits the firm gets to keep.

Exporting

Exporting involves creating goods within a firm's home country and shipping them to another country. Once the goods reach foreign shores, the exporter's role is over. A local firm then sells the goods to local customers. Many firms that expand overseas start out as exporters because exporting offers a low-cost method to find out whether a firm's products are appealing to customers in other lands. Some Asian automakers, for example, first entered the US market though exporting. Small firms may rely on exporting because it is a low-cost option.

Once a firm's products are found to be viable in a particular country, exporting often becomes undesirable. A firm that exports its goods loses control of them once they are turned over to a local firm for sale locally. This local distributor may treat customers poorly and thereby damage the firm's brand. Also, an exporter only makes money when it sells its goods to a local firm, not when end users buy the goods. Executives may want their firm rather than a local distributor to enjoy the profits that are made when products are sold to individual customers.

Creating a Wholly Owned Subsidiary

A wholly owned subsidiary is a business operation in a foreign country that a firm fully owns. A firm can develop a wholly owned subsidiary through a greenfield venture, meaning that the firm creates the entire operation itself. Another possibility is purchasing an existing operation from a local company or another foreign operator.

A wholly owned subsidiary can be attractive because the firm maintains complete control over the operation and retains all of the profits. A wholly owned subsidiary can be quite risky, because the firm must pay all of the expenses required to set it up and operate it. Kia, for example, spent $1 billion to build its US factory. Many firms are reluctant to spend such sums in more volatile countries because they fear that they may never recoup their investments

Franchising

Franchising has been used by many firms competing in service industries to develop a worldwide presence. Subway, The UPS Store, and Hilton Hotels are just a few of the firms that have done so. Franchising involves an organization (called a franchisor) granting the right to use its brand name, products, and processes to other organizations (known as franchisees) in exchange for an up-front payment (a franchise fee) and a percentage of franchisees' revenues (a royalty fee).

Franchising is an attractive way to enter foreign markets because it requires little financial investment by the franchisor. Local franchisees pay the vast majority of the expenses associated with getting their businesses up and running. On the downside, the decision to franchise means that a firm will get to enjoy only a small portion of the profits made under its brand name. Also, local franchisees may behave in ways that the franchisor does not approve. For example, Kentucky Fried Chicken (KFC) was angered by some of its franchisees in Asia when they started selling fish dishes without KFC's approval. It is often difficult to fix such problems because laws in many countries are stacked in favor of local businesses. Franchises are only successful if franchisees are provided with a simple and effective business model. Executives need to avoid expanding internationally through franchising until their formula has been perfected.

Licensing

While franchising is an option within service industries, licensing is most frequently used in manufacturing industries. Licensing involves granting a foreign company the right to create a company's product within a foreign country in exchange for a fee. These relationships often center on patented technology. A firm that grants a license avoids absorbing a lot of costs, but its profits are limited to the fees that it collects from the local firm. The firm also loses some control over how its technology is used.

A historical example involving licensing illustrates how rapidly events can change within the international arena. By the time Japan surrendered to the United States and its Allies in 1945, World War II had crippled the country's industrial infrastructure. In response to this problem, Japanese firms imported a great deal of technology, especially from American firms. When the Korean War broke out in the early 1950s, the American military relied on Jeeps made in Japan using licensed technology. In just a few years, a mortal enemy had become a valuable ally.

Strategy at the Movies

Gung Ho

Can American workers survive under Japanese management? Although this sounds like the premise for a bad reality TV show, the question was a legitimate consideration for General Motors (GM) and Toyota in the early 1980s. GM was struggling at the time to compete with the inexpensive, reliable, and fuel-efficient cars produced by Japanese firms. Meanwhile, Toyota was worried that the US government would limit the number of foreign cars that could be imported. To address these issues, these companies worked together to reopen a defunct GM plant in Fremont, California, in 1984 that would manufacture both companies' automobiles in one facility. The plant had been the worst performer in the GM system; however, under Toyota's management, the New United Motor Manufacturing Incorporated (NUMMI) plant became the best factory associated with GM—using the same workers as before! Despite NUMMI's eventual success, the joint production plant experienced significant growing pains stemming from the cultural differences between Japanese managers and American workers.

The NUMMI story inspired the 1986 movie *Gung Ho* in which a closed automobile manufacturing plant in Hadleyville, Pennsylvania, was reopened by Japanese car company Assan Motors. While Assan Motors and the workers of Hadleyville were both excited about the venture, neither was prepared for the differences between the two cultures. For example, Japanese workers feel personally ashamed when they make a mistake. When manager Oishi Kazihiro failed to meet production targets, he was punished with "ribbons of shame" and forced to apologize to his employees for letting them down. In contrast, American workers were presented in the film as likely to reject management authority, prone to fighting at work, and not opposed to taking shortcuts.

When Assan Motors' executives attempted to institute morning calisthenics and insisted that employees work late without overtime pay, the American workers challenged these policies and eventually walked off the production line. Assan Motors' near failure was the result of differences in cultural norms and values. *Gung Ho* illustrates the value of understanding and bridging cultural differences to facilitate successful cross-cultural collaboration, value that was realized in real life by NUMMI.

Joint Ventures and Strategic Alliances

Within each market entry option described, a firm either maintains strong control of operations (wholly owned subsidiary) or it turns most control over to a local firm (exporting, franchising, and licensing). In some cases, executives find it beneficial to work closely with one or more local partners in a joint venture or a strategic alliance. In a joint venture, two or more organizations each contribute to the creation of a new entity. In a strategic alliance, firms work together cooperatively, but no new organization is formed. In both cases, the firm and its local partner or partners share decision-making authority, control of the operation, and any profits that the relationship creates.

Joint ventures and strategic alliances are especially attractive when a firm believes that working closely with locals will provide it important knowledge about local conditions, facilitate acceptance of their involvement by government officials, or both. In the late 1980s, China was a difficult market for American businesses to enter. Executives at KFC saw China as an attractive country because chicken is a key element of Chinese diets. After considering the various options for entering China with its first restaurant, KFC decided to create a joint venture with three local organizations. KFC owned 51 percent of the venture; having more than half of the operation was advantageous in case disagreements arose. A Chinese bank owned 25 percent, the local tourist bureau owned 14 percent, and the final 10 percent was owned by a local chicken producer that would supply the restaurant with its signature food item.

Having these three local partners helped KFC navigate the cumbersome regulatory process that was in place and allowed the

American firm to withstand the scrutiny of wary Chinese officials. Despite these advantages, it took more than a year for the store to be built and approved. Once open in 1987, KFC was an instant success in China. As China's economy gradually became more and more open, KFC was a major beneficiary. By the end of 1997, KFC operated 191 restaurants in 50 Chinese cities. By the start of 2011, there were approximately 3,200 KFCs spread across 850 Chinese cites. Roughly 90 percent of these restaurants are wholly owned subsidiaries of KFC—a stark indication of how much doing business in China has changed over the past twenty-five years.

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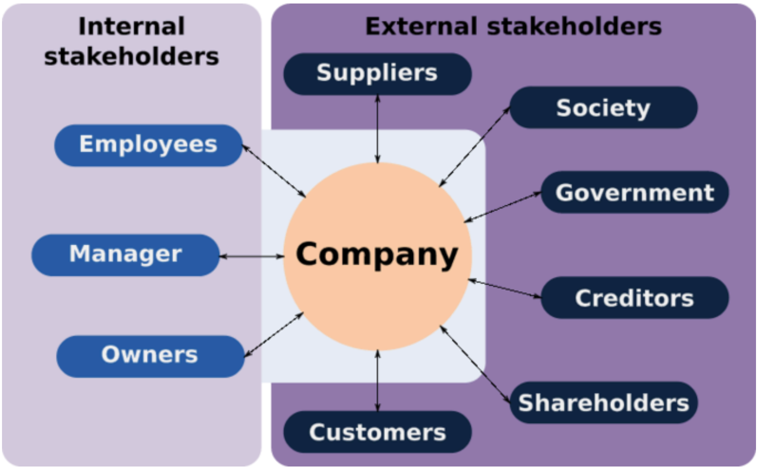
Promoting Ethical Behavior through the Planning Process

Strategy and Ethics

Setting an organizational strategy, vision, and set of values is the starting point of any new venture. Building in a strong sense of ethics, and an alignment with the well-being of all existing stakeholders (and society at large) is an integral aspect of the strategic planning process. The concept of aligning with the needs, ethics, and well-being of all stakeholders is referred to as Stakeholder Theory.

Stakeholder Theory

All organizations have a wide variety of stakeholders. Basically any group, individual, or organization impacted by operations is considered a stakeholder. This includes governmental bodies, customers, suppliers, employees, shareholders, financiers, communities, economies, and the general ecosystem. A board of directors is often elected to oversee the strategy to ensure alignment with values and ethics.



Stakeholders: *This chart underlines a few key stakeholder groups.*

Ethical Integration

Building ethical considerations into a business strategy via the planning process is an important element of ethics management. Strategy lays the foundation for how an organization carries out its operations. Building ethics into strategic planning is important to ensure that every facet of the organization is aligned with the ethos and values of the broader organization.

There are four elements strategic planners should develop when considering ethical alignment:

1. Developing a Code of Ethics: This serves as a central point of reference for everyone in the organization. This code of ethics should take stakeholders concerns into consideration, and evolve organically over time as the organization grows.
2. Ethical Training: Investing in training employees and managers in how integrate ethics into their process is a critical aspect of developing a strong ethical culture. Training equips employees and managers with the tools necessary to address ethically complex issues in the workplace.

3. Situational Advice (Ethics Officers): Having ethics officers available for consultation is a great way to handle ethical issues as they arise internally. Employees and managers may encounter ethical dilemmas that the Code of Ethics and ethics training don't address. In these situations, going to an ethics officer to determine best practices is a great strategic resource. The ethics officer can also use these situations to improve the organization's ethical strategy.
4. Confidential Reporting System: Not all ethical situations are easy to bring up in a professional setting. As a result, organizations should create an infrastructure for anonymous reporting to allow the organization to address problems as they arise without putting anyone on the spot.

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