Strategic Management

Management Policy and Systems Analysis

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Concepts and Techniques for Crafting and Executing Strategy
What Is Strategy and Why Is It Important?

Strategy means making clear-cut choices about how to compete.
—Jack Welch
Former CEO, General Electric

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

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

Without a strategy the organization is like a ship without a rudder.
—Joel Ross and Michael Kami
Authors and Consultants
Managers face three central questions in evaluating their company’s business prospects: What’s the company’s present situation? Where does the company need to go from here? How should it get there? Arriving at a probing answer to the question “What’s the company’s present situation?” prompts managers to evaluate industry conditions and competitive pressures, the company’s current performance and market standing, its resource strengths and capabilities, and its competitive weaknesses. The question “Where does the company need to go from here?” pushes managers to make choices about the direction the company should be headed—what new or different customer groups and customer needs it should endeavor to satisfy, what market positions it should be staking out, what changes in its business makeup are needed. The question “How should it get there?” challenges managers to craft and execute a strategy capable of moving the company in the intended direction, growing its business, and improving its financial and market performance.

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

**WHAT DO WE MEAN BY STRATEGY?**

A company’s strategy is management’s action plan for running the business and conducting operations. The crafting of a strategy represents a managerial commitment to pursue a particular set of actions in growing the business, attracting and pleasing customers, competing successfully, conducting operations, and improving the company’s financial and market performance. Thus a company’s strategy is all about how—how management intends to grow the business, how it will build a loyal clientele and outcompete rivals, how each functional piece of the business (research and development,
In most industries companies have considerable freedom in choosing the hows of strategy. Thus, some rivals strive to improve their performance and market standing by achieving lower costs than rivals, while others pursue product superiority or personalized customer service or the development of competencies and capabilities that rivals cannot match. Some target the high end of the market, while others go after the middle or low end; some opt for wide product lines, while others concentrate their energies on a narrow product lineup. Some competitors position themselves in only one part of the industry’s chain of production/distribution activities (preferring to be just in manufacturing or wholesale distribution or retailing), while others are partially or fully integrated, with operations ranging from components production to manufacturing and assembly to wholesale distribution or retailing. Some competitors deliberately confine their operations to local or regional markets; others opt to compete nationally, internationally (several countries), or globally (all or most of the major country markets worldwide). Some companies decide to operate in only one industry, while others diversify broadly or narrowly, into related or unrelated industries, via acquisitions, joint ventures, strategic alliances, or internal start-ups.

At companies intent on gaining sales and market share at the expense of competitors, managers typically opt for offensive strategies, frequently launching fresh initiatives of one kind or another to make the company’s product offering more distinctive and appealing to buyers. Companies already in a strong industry position are more prone to strategies that emphasize gradual gains in the marketplace, fortifying the company’s market position, and defending against the latest maneuvering of rivals and other developments that threaten the company’s well-being. Risk-averse companies often prefer conservative strategies, preferring to follow the successful moves of pioneering companies whose managers are more entrepreneurial and willing to take the risks of being first to make a bold and perhaps pivotal move that reshapes the contest among market rivals.

There is no shortage of opportunity to fashion a strategy that both tightly fits a company’s own particular situation and is discernibly different from the strategies of rivals. In fact, a company’s managers normally attempt to make strategic choices about the key building blocks of its strategy that differ from the choices made by competitors—not 100 percent different but at least different in several important respects. A strategy stands a better chance of succeeding when it is predicated on actions, business approaches, and competitive moves aimed at (1) appealing to buyers in ways that set a company apart from rivals and (2) carving out its own market position. Simply copying what successful companies in the industry are doing and trying to mimic their market position rarely works. Rather, there needs to be some distinctive “aha” element to the strategy that draws in customers and produces a competitive edge. Carbon-copy strategies among companies in the same industry are the exception rather than the rule.

For a concrete example of the actions and approaches that comprise strategy, see Illustration Capsule 1.1, which describes Comcast’s strategy to revolutionize the cable TV business.
In 2004–2005 cable TV giant Comcast put the finishing touches on a bold strategy to change the way people watched television and to grow its business by introducing Internet phone service. With revenues of $18 billion and almost 22 million of the 74 million U.S. cable subscribers, Comcast became the industry leader in the U.S. market in 2002 when it acquired AT&T Broadband, along with its 13 million cable subscribers, for about $50 billion. Comcast’s strategy had the following elements:

- **Continue to roll out high-speed Internet or broadband service to customers via cable modems.** With more than 8 million customers that generated revenues approaching $5 billion annually, Comcast was already America’s number one provider of broadband service. It had recently upgraded its broadband service to allow download speeds of up to six megabits per second—considerably faster than the DSL-type broadband service available over telephone lines.

- **Continue to promote a relatively new video-on-demand service that allowed digital subscribers to watch TV programs whenever they wanted to watch them.** The service allowed customers to use their remotes to choose from a menu of thousands of programs, stored on Comcast’s servers as they were first broadcast, and included network shows, news, sports, and movies. Viewers with a Comcast DVR set-top box had the ability to pause, stop, restart, and save programs, without having to remember to record them when they were broadcast. Comcast had signed up more than 10 million of its cable customers for digital service, and it was introducing enhanced digital and high-definition television (HDTV) service in additional geographic markets at a brisk pace.

- **Promote a video-on-demand service whereby digital customers with a set-top box could order and watch pay-per-view movies using a menu on their remote.** Comcast’s technology enabled viewers to call up the programs they wanted with a few clicks of the remote. In 2005, Comcast had almost 4000 program choices and customers were viewing about 120 million videos per month.

- **Partner with Sony, MGM, and others to expand Comcast’s library of movie offerings.** In 2004, Comcast agreed to develop new cable channels using MGM and Sony libraries, which had a combined 7,500 movies and 42,000 TV shows—it took about 300 movies to feed a 24-hour channel for a month.

- **Use Voice over Internet Protocol (VoIP) technology to offer subscribers Internet-based phone service at a fraction of the cost charged by other providers.** VoIP is an appealing low-cost technology widely seen as the most significant new communication technology since the invention of the telephone. Comcast was on track to make its Comcast Digital Voice (CDV) service available to 41 million homes by year-end 2006. CDV had many snazzy features, including call forwarding, caller ID, and conferencing, thus putting Comcast in position to go after the customers of traditional telephone companies.

- **Use its video-on-demand and CDV offerings to combat mounting competition from direct-to-home satellite TV providers.** Satellite TV providers such as EchoStar and DIRECTV had been using the attraction of lower monthly fees to steal customers away from cable TV providers. Comcast believed that the appeal of video-on-demand and low-cost CDV service would overcome its higher price. And satellite TV providers lacked the technological capability to provide either two-way communications connection to homes (necessary to offer video-on-demand) or reliable high-speed Internet access.

- **Employ a sales force (currently numbering about 3,200 people) to sell advertising to businesses that were shifting some of their advertising dollars from sponsoring network programs to sponsoring cable programs.** Ad sales generated revenues of about $1.6 billion, and Comcast had cable operations in 21 of the 25 largest markets in the United States.

- **Significantly improve Comcast’s customer service.** Most cable subscribers were dissatisfied with the caliber of customer service offered by their local cable companies. Comcast management believed that service would be a big issue given the need to support video-on-demand, cable modems, HDTV, phone service, and the array of customer inquiries and problems such services entailed. In 2004, Comcast employed about 12,500 people to answer an expected volume of 200 million phone calls. Newly hired customer service personnel were given five weeks of classroom training, followed by three weeks of taking calls while a supervisor listened in—it cost Comcast about $7 to handle each call. The company’s goal was to answer 90 percent of calls within 30 seconds.

Part 1  Concepts and Techniques for Crafting and Executing Strategy

Strategy and the Quest for Competitive Advantage

The heart and soul of any strategy are the actions and moves in the marketplace that managers are taking to improve the company’s financial performance, strengthen its long-term competitive position, and gain a competitive edge over rivals. A creative, distinctive strategy that sets a company apart from rivals and yields a competitive advantage is a company’s most reliable ticket for earning above-average profits. Competing in the marketplace with a competitive advantage tends to be more profitable than competing with no advantage. And a company is almost certain to earn significantly higher profits when it enjoys a competitive advantage as opposed to when it is hamstrung by competitive disadvantage. Furthermore, if a company’s competitive edge holds promise for being durable and sustainable (as opposed to just temporary), then so much the better for both the strategy and the company’s future profitability. It’s nice when a company’s strategy produces at least a temporary competitive edge, but a sustainable competitive advantage is plainly much better. What makes a competitive advantage sustainable as opposed to temporary are actions and elements in the strategy that cause an attractive number of buyers to have a lasting preference for a company’s products or services as compared to the offerings of competitors. Competitive advantage is the key to above-average profitability and financial performance because strong buyer preferences for the company’s product offering translate into higher sales volumes (Wal-Mart) and/or the ability to command a higher price (Häagen-Dazs), thus driving up earnings, return on investment, and other measures of financial performance.

Four of the most frequently used and dependable strategic approaches to setting a company apart from rivals, building strong customer loyalty, and winning a sustainable competitive advantage are:

1. Striving to be the industry’s low-cost provider, thereby aiming for a cost-based competitive advantage over rivals. Wal-Mart and Southwest Airlines have earned strong market positions because of the low-cost advantages they have achieved over their rivals and their consequent ability to underprice competitors. Achieving lower costs than rivals can produce a durable competitive edge when rivals find it hard to match the low-cost leader’s approach to driving costs out of the business. Despite years of trying, discounters like Kmart and Target have struck out trying to match Wal-Mart’s frugal operating practices, super-efficient distribution systems, and its finely honed supply chain approaches that allow it to obtain merchandise from manufacturers at super-low prices.

2. Outcompeting rivals based on such differentiating features as higher quality, wider product selection, added performance, value-added services, more attractive styling, technological superiority, or unusually good value for the money. Successful adopters of differentiation strategies include Johnson & Johnson in baby products (product reliability), Harley-Davidson (bad-boy image and king-of-the-road styling), Chanel and Rolex (top-of-the-line prestige), Mercedes-Benz and BMW (engineering design and performance), L. L. Bean (good value), and Amazon.com (wide selection and convenience). Differentiation strategies can be powerful so long as a company is sufficiently innovative to thwart clever rivals in finding ways to copy or closely imitate the features of a successful differentiator’s product offering.

3. Focusing on a narrow market niche and winning a competitive edge by doing a better job than rivals of serving the special needs and tastes of buyers comprising
the niche. Prominent companies that enjoy competitive success in a specialized
market niche include eBay in online auctions, Jiffy Lube International in quick oil
changes, McAfee in virus protection software, Starbucks in premium coffees and
coffee drinks, Whole Foods Market in natural and organic foods, CNBC and The
Weather Channel in cable TV.

4. Developing expertise and resource strengths that give the company competitive
capabilities that rivals can’t easily imitate or trump with capabilities of their
own. FedEx has superior capabilities in next-day delivery of small packages.
Walt Disney has hard-to-beat capabilities in theme park management and family
entertainment. Over the years, Toyota has developed a sophisticated production
system that allows it to produce reliable, largely defect-free vehicles at low cost.
IBM has wide-ranging expertise in helping corporate customers develop and install
cutting-edge information systems. Ritz-Carlton and Four Seasons have uniquely
strong capabilities in providing their hotel guests with an array of personalized
services. Very often, winning a durable competitive edge over rivals hinges more on
building competitively valuable expertise and capabilities than it does on having a
distinctive product. Clever rivals can nearly always copy the attributes of a popular
or innovative product, but for rivals to match experience, know-how, and specialized
competitive capabilities that a company has developed and perfected over a long
period of time is substantially harder to duplicate and takes much longer.

The tight connection between competitive advantage and profitability means that the
quest for sustainable competitive advantage always ranks center stage in crafting a
strategy. The key to successful strategy making is to come up with one or more differ-
entiating strategy elements that act as a magnet to draw customers and yield a lasting
competitive edge. Indeed, what separates a powerful strategy from a run-of-the-mill or
ineffective one is management’s ability to forge a series of moves, both in the market-
place and internally, that sets the company apart from its rivals, tilts the playing field
in the company’s favor by giving buyers reason to prefer its products or services, and
produces a sustainable competitive advantage over rivals. The bigger and more sus-
tainable the competitive advantage, the better the company’s prospects for winning in
the marketplace and earning superior long-term profits relative to its rivals. Without a
strategy that leads to competitive advantage, a company risks being outcompeted by
stronger rivals and/or locked in to mediocre financial performance. Hence, company
managers deserve no gold stars for coming up with a ho-hum strategy that results in
ho-hum financial performance and a ho-hum industry standing.

**Identifying a Company’s Strategy**

The best indicators of a company’s strategy are its actions in the marketplace and the
statements of senior managers about the company’s current business approaches, fu-
ture plans, and efforts to strengthen its competitiveness and performance. Figure 1.1
shows what to look for in identifying the key elements of a company’s strategy.

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

**Why a Company’s Strategy Evolves over Time**

Irrespective of where the strategy comes from—be it the product of top executives or the collaborative product of numerous company personnel—it is unlikely that the strategy, as originally conceived, will prove entirely suitable over time. Every company must be willing and ready to modify its strategy in response to changing market situations.
conditions, advancing technology, the fresh moves of competitors, shifting buyer needs and preferences, emerging market opportunities, new ideas for improving the strategy, and mounting evidence that the strategy is not working well. Thus, a company’s strategy is always a work in progress.

Most of the time a company’s strategy evolves incrementally from management’s ongoing efforts to fine-tune this or that piece of the strategy and to adjust certain strategy elements in response to unfolding events. But, on occasion, major strategy shifts are called for, such as when a strategy is clearly failing and the company faces a financial crisis, when market conditions or buyer preferences change significantly, or when important technological breakthroughs occur. In some industries, conditions change at a fairly slow pace, making it feasible for the major components of a good strategy to remain in place for long periods. But in industries where industry and competitive conditions change frequently and in sometimes dramatic ways, the life cycle of a given strategy is short. Industry environments characterized by high-velocity change require companies to rapidly adapt their strategies. For example, companies in industries with rapid-fire advances in technology—like medical equipment, electronics, and wireless devices—often find it essential to adjust one or more key elements of their strategies several times a year, sometimes even finding it necessary to reinvent their approach to providing value to their customers. Companies in online retailing and the travel and resort industries find it necessary to adapt their strategies to accommodate sudden bursts of new spending or sharp drop-offs in demand, often updating their market prospects and financial projections every few months.

But regardless of whether a company’s strategy changes gradually or swiftly, the important point is that a company’s present strategy is always temporary and on trial, pending new ideas for improvement from management, changing industry and competitive conditions, and any other new developments that management believes warrant strategy adjustments. Thus, a company’s strategy at any given point is fluid, representing the temporary outcome of an ongoing process that, on the one hand, involves reasoned and creative management efforts to craft an effective strategy and, on the other hand, involves ongoing responses to market change and constant experimentation and tinkering. Adapting to new conditions and constantly learning what is working well enough to continue and what needs to be improved is consequently a normal part of the strategy-making process and results in an evolving strategy.

A Company’s Strategy Is Partly Proactive and Partly Reactive

The evolving nature of a company’s strategy means that the typical company strategy is a blend of (1) proactive actions to improve the company’s financial performance and secure a competitive edge and (2) as-needed reactions to unanticipated developments and fresh market conditions (see Figure 1.2). The biggest portion of a company’s current strategy flows from previously initiated actions and business approaches that are working well enough to merit continuation and newly launched initiatives aimed at boosting financial performance and edging out rivals. Typically, managers proactively modify this or that aspect of their strategy as new learning emerges about which pieces of the strategy are working well and which aren’t, and as they hit upon new ideas for strategy improvement. This part of management’s action plan for running the company is deliberate and proactive, standing as the current product of management’s latest and best strategy ideas.
But managers must always be willing to supplement or modify all the proactive strategy elements with as-needed reactions to unanticipated developments. Inevitably, there will be occasions when market and competitive conditions take an unexpected turn that calls for some kind of strategic reaction or adjustment. Hence, a portion of a company’s strategy is always developed on the fly, coming as a response to fresh strategic maneuvers on the part of rival firms, unexpected shifts in customer requirements and expectations, fast-changing technological developments, newly appearing market opportunities, a changing political or economic climate, or other unanticipated happenings in the surrounding environment. These adaptive strategy adjustments form the reactive strategy elements.

As shown in Figure 1.2, a company’s strategy evolves from one version to the next as managers abandon obsolete or ineffective strategy elements, settle upon a set of proactive/intended strategy elements, and then adapt the strategy as new circumstances unfold, thus giving rise to reactive/adaptive strategy elements. A company’s strategy thus tends to be a combination of proactive and reactive elements. In the process, some strategy elements end up being abandoned because they have become obsolete or ineffective.

**STRATEGY AND ETHICS: PASSING THE TEST OF MORAL SCRUTINY**

In choosing from among strategic alternatives, company managers are well advised to embrace actions that are aboveboard and can pass the test of moral scrutiny. Just
keeping a company’s strategic actions within the bounds of what is legal does not mean the strategy is ethical. Ethical and moral standards are not governed by what is legal. Rather, they involve issues of both right versus wrong and duty—what one should do. A strategy is ethical only if (1) it does not entail actions and behaviors that cross the line from “should do” to “should not do” (because such actions are unsavory, unconscionable, or injurious to other people or unnecessarily harmful to the environment) and (2) it allows management to fulfill its ethical duties to all stakeholders—owners/shareholders, employees, customers, suppliers, the communities in which it operates, and society at large.

Admittedly, it is not always easy to categorize a given strategic behavior as definitely ethical or definitely unethical. Many strategic actions fall in a gray zone in between, and whether they are deemed ethical or unethical hinges on how clearly the boundaries are defined. For example, is it ethical for advertisers of alcoholic products to place ads in media having an audience of as much as 50 percent underage viewers? (In 2003, growing concerns about underage drinking prompted some beer and distilled spirits companies to agree to place ads in media with an audience at least 70 percent adult, up from a standard of 50 percent adult.) Is it ethical for an apparel retailer attempting to keep prices attractively low to source clothing from foreign manufacturers who pay substandard wages, use child labor, or subject workers to unsafe working conditions? Many people would say no, but some might argue that a company is not unethical simply because it does not police the business practices of its suppliers. Is it ethical for the makers of athletic uniforms, shoes, and other sports equipment to pay coaches large sums of money to induce them to use the manufacturer’s products in their sport? (The compensation contracts of many college coaches include substantial payments from sportswear and sports equipment manufacturers, and the teams subsequently end up wearing the uniforms and using the products of those manufacturers.) Is it ethical for manufacturers of life-saving drugs to charge higher prices in some countries than they charge in others? (This is a fairly common practice that has recently come under scrutiny because it raises the costs of health care for consumers who are charged higher prices.) Is it ethical for a company to turn a blind eye to the damage its operations do to the environment even though its operations are in compliance with current environmental regulations—especially if it has the know-how and the means to alleviate some of the environmental impacts by making relatively inexpensive changes in its operating practices?

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

Instances of corporate malfeasance, ethical lapses, and fraudulent accounting practices at Enron, WorldCom, Tyco, Adelphia, HealthSouth, and other companies leave no room to doubt the damage to a company’s reputation and business that can result from ethical misconduct, corporate misdeeds, and even criminal behavior on the part of company personnel. Aside from just the embarrassment and black marks that accompany headline exposure of a company’s unethical practices, the hard fact is that many customers and many suppliers are wary of doing business with a company that engages in sleazy practices or that turns a blind eye to illegal or unethical behavior.
on the part of employees. They are turned off by unethical strategies or behavior and, rather than become victims or get burned themselves, wary customers will quickly take their business elsewhere and wary suppliers will tread carefully. Moreover, employees with character and integrity do not want to work for a company whose strategies are shady or whose executives lack character and integrity. There’s little lasting benefit to unethical strategies and behavior, and the downside risks can be substantial. Besides, such actions are plain wrong.

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

Closely related to the concept of strategy is the concept of a company’s business model. While the word model conjures up images of ivory-tower ideas that may be loosely connected to the real world, such images do not apply here. A company’s business model is management’s story line for how the strategy will be a moneymaker. The story line sets forth the key components of the enterprise’s business approach, indicates how revenues will be generated, and makes a case for why the strategy can deliver value to customers in a profitable manner. A company’s business model thus explains why its business approach and strategy will generate ample revenues to cover costs and capture a profit.

The nitty-gritty issue surrounding a company’s business model is whether the chosen strategy makes good business sense. Why is there convincing reason to believe that the strategy is capable of producing a profit? How will the business generate its revenues? Will those revenues be sufficient to cover operating costs? Will customers see enough value in what the business does for them to pay a profitable price? The concept of a company’s business model is, consequently, more narrowly focused than the concept of a company’s business strategy. A company’s strategy relates broadly to its competitive initiatives and action plan for running the business (but it may or may not lead to profitability). However, a company’s business model zeros in on how and why the business will generate revenues sufficient to cover costs and produce attractive profits and return on investment. Absent the ability to deliver good profits, the strategy is not viable, the business model is flawed, and the business itself is in jeopardy of failing.

Companies that have been in business for a while and are making acceptable profits have a proven business model—because there is hard evidence that their strategies are capable of profitability. Companies that are in a start-up mode or that are losing money have questionable business models; their strategies have yet to produce good bottom-line results, putting their story line about how they intend to make money and their viability as business enterprises in doubt.

Magazines and newspapers employ a business model based on generating sufficient subscriptions and advertising to cover the costs of delivering their products to readers. Cable TV companies, cell-phone providers, record clubs, satellite radio companies, and Internet service providers also employ a subscription-based business model. The business model of network TV and radio broadcasters entails providing free programming to audiences but charging advertising fees based on audience size. McDonald’s invented the business model for fast food—economical quick-service meals at clean, convenient locations. Wal-Mart has perfected the business model for
big-box discount retailing—a model also used by Home Depot, Costco, and Target. Gillette’s business model in razor blades involves selling a “master product”—the razor—at an attractively low price and then making money on repeat purchases—the razor blades. Printer manufacturers like Hewlett-Packard, Lexmark, and Epson pursue much the same business model as Gillette—selling printers at a low (virtually break-even) price and making large profit margins on the repeat purchases of printer supplies, especially ink cartridges. Companies like Dell and Avon employ a direct sales business model that helps keep prices low by cutting out the costs of reaching consumers through distributors and retail dealers. Illustration Capsule 1.2 discusses the contrasting business models of Microsoft and Red Hat.

WHAT MAKES A STRATEGY A WINNER?

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

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

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

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

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

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

Other criteria for judging the merits of a particular strategy include internal consistency and unity among all the pieces of strategy, the degree of risk the strategy poses as compared to alternative strategies, and the degree to which it is flexible and adaptable to changing circumstances. These criteria are relevant and merit consideration, but they seldom override the importance of the three test questions posed above.
The strategies of rival companies are often predicated on strikingly different business models. Consider, for example, the business models for Microsoft and Red Hat in operating system software for personal computers (PCs).

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

- Employ a cadre of highly skilled programmers to develop proprietary code; keep the source code hidden so as to keep the inner workings of the software proprietary.
- Sell the resulting operating system and software package to PC makers and to PC users at relatively attractive prices (around $75 to PC makers and about $100 at retail to PC users); strive to maintain a 90 percent or more market share of the 150 million PCs sold annually worldwide.
- Strive for big-volume sales. Most of Microsoft’s costs arise on the front end in developing the software and are thus fixed; the variable costs of producing and packaging the CDs provided to users are only a couple of dollars per copy—once the break-even volume is reached, Microsoft’s revenues from additional sales are almost pure profit.
- Provide a modest level of technical support to users at no cost.
- Keep rejuvenating revenues by periodically introducing next-generation software versions with features that will induce PC users to upgrade the operating system on previously purchased PCs to the new version.

Microsoft’s business model—sell proprietary code software and give service away free—is a proven money-maker that generates billions in profits annually. In contrast, the jury is still out on Red Hat’s business model of selling subscriptions to open-source software to large corporations and deriving substantial revenues from the sales of technical support (included in the subscription cost), training, consulting, software customization, and engineering to generate revenues sufficient to cover costs and yield a profit. Red Hat posted losses of $140 million on revenues of $79 million in fiscal year 2002 and losses of $6.6 million on revenues of $91 million in fiscal year 2003, but it earned $14 million on revenues of $126 million in fiscal 2004. The profits came from a shift in Red Hat’s business model that involved putting considerably more emphasis on getting large corporations to purchase subscriptions to the latest Linux updates. In 2005, about 75 percent of Red Hat’s revenues came from large enterprise subscriptions, compared to about 53 percent in 2003.

WHY ARE CRAFTING AND EXECUTING STRATEGY IMPORTANT?

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

Second, a strategy-focused enterprise is more likely to be a strong bottom-line performer than a company whose management views strategy as secondary and puts its priorities elsewhere. There’s no escaping the fact that the quality of managerial strategy making and strategy execution has a highly positive impact on revenue growth, earnings, and return on investment. A company that lacks clear-cut direction, has vague or undemanding performance targets, has a muddled or flawed strategy, or can’t seem to execute its strategy competently is a company whose financial performance is probably suffering, whose business is at long-term risk, and whose management is sorely lacking. In contrast, when crafting and executing a winning strategy drive management’s whole approach to operating the enterprise, the odds are much greater that the initiatives and activities of different divisions, departments, managers, and work groups will be unified into a coordinated, cohesive effort. Mobilizing the full complement of company resources in a total team effort behind good execution of the chosen strategy and achievement of the targeted performance allows a company to operate at full power. The chief executive officer of one successful company put it well when he said:

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

Good Strategy + Good Strategy Execution = Good Management

Crafting and executing strategy are core management functions. Among all the things managers do, nothing affects a company’s ultimate success or failure more fundamentally than how well its management team charts the company’s direction, develops
Thompson−Strickland−Gamble:
Crafting and Executing
Strategy: Concepts and
Cases, 16th Edition

I. Concepts and
Techniques for Crafting
and Executing Strategy

1. What Is Strategy and
Why Is It Important?

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Companies, 2008

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Part 1 Concepts and Techniques for Crafting and Executing Strategy

competitively effective strategic moves and business approaches, and pursues what needs to be done internally to produce good day-in, day-out strategy execution and operating excellence. Indeed, good strategy and good strategy execution are the most trustworthy signs of good management. Managers don’t deserve a gold star for designing a potentially brilliant strategy but failing to put the organizational means in place to carry it out in high-caliber fashion—weak implementation and execution undermine the strategy’s potential and pave the way for shortfalls in customer satisfaction and company performance. Competent execution of a mediocre strategy scarcely merits enthusiastic applause for management’s efforts either. The rationale for using the twin standards of good strategy making and good strategy execution to determine whether a company is well managed is therefore compelling: The better conceived a company’s strategy and the more competently it is executed, the more likely that the company will be a standout performer in the marketplace.

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

The mission of this book is to provide a solid overview of what every business student and aspiring manager needs to know about crafting and executing strategy. This requires exploring what good strategic thinking entails; presenting the core concepts and tools of strategic analysis; describing the ins and outs of crafting and executing strategy; and, through the cases, helping you build your skills both in diagnosing how well the strategy-making, strategy-executing task is being performed in actual companies and in prescribing actions for how the companies in question can improve their approaches to crafting and executing their strategies. At the very least, we hope to convince you that capabilities in crafting and executing strategy are basic to managing successfully and merit a place in a manager’s tool kit.

As you tackle the following pages, ponder the following observation by the essayist and poet Ralph Waldo Emerson: “Commerce is a game of skill which many people play, but which few play well.” If the content of this book helps you become a more savvy player and equips you to succeed in business, then your journey through these pages will indeed be time well spent.

Key Points

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

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

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

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

**Exercises**

1. Go to Red Hat’s Web site (www.redhat.com) and check whether the company’s recent financial reports indicate that its business model is working. Is the company sufficiently profitable to validate its business model and strategy? Is its revenue stream from selling training, consulting, and engineering services growing or declining as a percentage of total revenues? Does your review of the company’s recent financial performance suggest that its business model and strategy are changing? Read the company’s latest statement about its business model and about why it is pursuing the subscription approach (as compared to Microsoft’s approach of selling copies of its operating software directly to PC manufacturers and individuals).

2. From your perspective as a cable or satellite service consumer, does Comcast’s strategy as described in Illustration Capsule 1.1 seem to be well matched to industry and competitive conditions? Does the strategy seem to be keyed to maintaining a cost advantage, offering differentiating features, serving the unique needs of a niche, or developing resource strengths and competitive capabilities rivals can’t imitate or trump (or a mixture of these)? Do you think Comcast’s strategy has evolved in recent years? Why or why not? What is there about Comcast’s strategy that can lead to sustainable competitive advantage?

3. In 2003, Levi Strauss & Company announced it would close its two remaining U.S. apparel plants to finalize its transition from a clothing manufacturer to a marketing, sales, and design company. Beginning in 2004, all Levi’s apparel would be produced by contract manufacturers located in low-wage countries. As recently as 1990, Levi Strauss had produced 90 percent of its apparel in company-owned plants in the United States employing over 20,000 production workers. With every plant closing, Levi Strauss & Company provided severance and job retraining packages to affected workers and cash payments to small communities where its plants were located. However, the economies of many small communities had yet to recover and some employees had found it difficult to match their previous levels of compensation and benefits.

Review Levi Strauss & Company’s discussion of its Global Sourcing and Operating Guidelines at www.levistrauss.com/responsibility/conduct. Does the company’s strategy fulfill the company’s ethical duties to all stakeholders—owners/shareholders, employees, customers, suppliers, the communities in which it operates, and society at large? Does Levi Strauss’s strategy to outsource all of its manufacturing operations to low-wage countries pass the moral scrutiny test given that 20,000 workers lost their jobs?
Unless we change our direction we are likely to end up where we are headed.
—Ancient Chinese proverb

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

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

Management’s job is not to see the company as it is . . . but as it can become.
—John W. Teets
Former CEO
Crafting and executing strategy are the heart and soul of managing a business enterprise. But exactly what is involved in developing a strategy and executing it proficiently? What are the various components of the strategy-making, strategy-executing process? And to what extent are company personnel—aside from top executives—involved in the process? In this chapter we present an overview of the managerial ins and outs of crafting and executing company strategies. Special attention will be given to management’s direction-setting responsibilities—charting a strategic course, setting performance targets, and choosing a strategy capable of producing the desired outcomes. We will also examine which kinds of strategic decisions are made at which levels of management and the roles and responsibilities of the company’s board of directors in the strategy-making, strategy-executing process.

WHAT DOES THE STRATEGY-MAKING, STRATEGY-EXECUTING PROCESS ENTAIL?

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

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

Figure 2.1 displays this five-phase process. Let’s examine each phase in enough detail to set the stage for the forthcoming chapters and give you a bird’s-eye view of what this book is about.
Very early in the strategy-making process, a company’s senior managers must wrestle with the issue of what path the company should take and what changes in the company’s product/market/customer/technology focus would improve its market position and future prospects. Deciding to commit the company to one path versus another pushes managers to draw some carefully reasoned conclusions about how to modify the company’s business makeup and what market position it should stake out. A number of direction-shaping factors need to be considered in deciding where to head and why such a direction makes good business sense—see Table 2.1.

Top management’s views and conclusions about the company’s direction and future product/market/customer/technology focus constitute a **strategic vision** for the company. A strategic vision delineates management’s aspirations for the business, providing a panoramic view of “where we are going” and a convincing rationale for why this makes good business sense for the company. A strategic vision thus points an organization in a particular direction, charts a strategic path, and molds organizational identity. A clearly articulated strategic vision communicates management’s aspirations to stakeholders and helps steer the energies of company personnel in a common direction. For instance, Henry Ford’s vision of a car in every garage had power because it captured the imagination of others, aided internal efforts to mobilize the Ford Motor Company’s resources, and served as a reference point for gauging the merits of the company’s strategic actions.
Well-conceived visions are *distinctive* and *specific* to a particular organization; they avoid generic feel-good statements like “We will become a global leader and the first choice of customers in every market we choose to serve”—which could apply to any of hundreds of organizations.¹ And they are not the product of a committee charged with coming up with an innocuous but well-meaning one-sentence vision that wins consensus approval from various stakeholders. Nicely worded vision statements with no specifics about the company’s product/market/customer/technology focus fall well short of what it takes for a vision to measure up. A strategic vision proclaiming management’s quest “to be the market leader” or “to be the first choice of customers” or “to be the most innovative” or “to be recognized as the best company in the industry” offers scant guidance about a company’s direction and what changes and challenges lie on the road ahead.

For a strategic vision to function as a valuable managerial tool, it must (1) provide understanding of what management wants its business to look like and (2) provide managers with a reference point in making strategic decisions and preparing the company for the future. It must say something definitive about how the company’s leaders intend to position the company beyond where it is today. A good vision always needs to be a bit beyond a company’s reach, but progress toward the vision is what unifies the efforts of company personnel. Table 2.2 lists some characteristics of an effectively worded strategic vision.

A sampling of strategic visions currently in use shows a range from strong and clear to overly general and generic. A surprising number of the visions found on company Web sites and in annual reports are vague and unrevealing, saying very little about the company’s future product/market/customer/technology focus. Some are nice-sounding but say little. Others read like something written by a committee to win the support of different stakeholders. And some are so short on specifics as to apply to most any company in any industry. Many read like a public relations statement—high-sounding words that someone came up with because it is fashionable for companies to have an official vision statement.² Table 2.3 provides a list of the most

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¹ Well-conceived visions are distinctive and specific to a particular organization; they avoid generic feel-good statements like “We will become a global leader and the first choice of customers in every market we choose to serve”—which could apply to any of hundreds of organizations.

² Table 2.3 provides a list of the most
common shortcomings in strategic vision statements. The one- or two-sentence vision statements most companies make available to the public, of course, provide only a glimpse of what company executives are really thinking and the strategic course they have charted—company personnel nearly always have a much better understanding of where the company is headed and why that is revealed in the official vision. But the real purpose of a strategic vision is to serve as a management tool for giving the organization a sense of direction. Like any tool, it can be used properly or improperly, either clearly conveying a company’s strategic course or not.

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vague or incomplete</td>
<td>Is short on specifics about where the company is headed or what the company is doing to prepare for the future.</td>
</tr>
<tr>
<td>Not forward-looking</td>
<td>Does not indicate whether or how management intends to alter the company’s current product/market/customer/technology focus.</td>
</tr>
<tr>
<td>Too broad</td>
<td>Is so umbrella-like and all-inclusive that the company could head in most any direction, pursue most any opportunity, or enter most any business.</td>
</tr>
<tr>
<td>Bland or uninspiring</td>
<td>Lacks the power to motivate company personnel or inspire shareholder confidence about the company’s direction or future prospects.</td>
</tr>
<tr>
<td>Not distinctive</td>
<td>Provides no unique company identity; could apply to companies in any of several industries (or at least several rivals operating in the same industry or market arena).</td>
</tr>
<tr>
<td>Too reliant on superlatives</td>
<td>Does not say anything specific about the company’s strategic course beyond the pursuit of such lofty accolades as best, most successful, recognized leader, global or worldwide leader, or first choice of customers.</td>
</tr>
</tbody>
</table>

Illustration Capsule 2.1

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

Using the information in Tables 2.2 and 2.3, critique the following strategic visions and rank them from 1 (best) to 7 (in need of substantial improvement).

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

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

**HILTON HOTELS CORPORATION**
Our vision is to be the first choice of the world’s travelers. Hilton intends to build on the rich heritage and strength of our brands by:
- Consistently delighting our customers
- Investing in our team members
- Delivering innovative products and services
- Continuously improving performance
- Increasing shareholder value

**THE DENTAL PRODUCTS DIVISION OF 3M CORPORATION**
Become THE supplier of choice to the global dental professional markets, providing world-class quality and innovative products. [Note: All employees of the division wear badges bearing these words, and whenever a new product or business procedure is being considered, management asks “Is this representative of THE leading dental company?”]

**CATERPILLAR**
Be the global leader in customer value.

**eBAY**
Provide a global trading platform where practically anyone can trade practically anything.

**H. J. HEINZ COMPANY**
Be the world’s premier food company, offering nutritious, superior tasting foods to people everywhere. Being the premier food company does not mean being the biggest but it does mean being the best in terms of consumer value, customer service, employee talent, and consistent and predictable growth.

- Creating a culture of pride
- Strengthening the loyalty of our constituents

**Sources:** Company documents and Web sites.

Illustration Capsule 2.1 provides examples of strategic visions of several prominent companies. See if you can tell which ones are mostly meaningless or nice-sounding and which ones are managerially useful in communicating “where we are headed and the kind of company we are trying to become”.

**A Strategic Vision Covers Different Ground than the Typical Mission Statement**

The defining characteristic of a well-conceived strategic vision is what it says about the company’s future strategic course—“the direction we are headed and what our future product/market/customer/technology focus will be.”

In contrast, the mission statements that one finds in company annual reports or posted on company Web sites typically provide a brief overview of the company’s present business purpose and raison d’être, and sometimes its geographic coverage.
or standing as a market leader. They may or may not single out the company’s present products/services, the buyer needs it is seeking to satisfy, the customer groups it serves, or its technological and business capabilities. But rarely do company mission statements say anything about where the company is headed, the anticipated changes in its business, or its aspirations; hence, they lack the essential forward-looking quality of a strategic vision in specifying a company’s direction and future product/market/customer/technology focus.

Consider, for example, the mission statement of Trader Joe’s (a specialty grocery chain):

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

Note that Trader Joe’s mission statement does a good job of conveying “who we are, what we do, and why we are here,” but provides no sense of “where we are headed.” (Some companies use the term business purpose instead of mission statement in describing themselves; in practice, there seems to be no meaningful difference between the terms mission statement and business purpose—which one is used is a matter of preference.)

There is value in distinguishing between the forward-looking concept of a strategic vision and the here-and-now theme of the typical mission statement. Thus, to mirror actual practice, we will use the term mission statement to refer to an enterprise’s description of its present business and its purpose for existence. Ideally, a company mission statement is sufficiently descriptive to identify the company’s products/services and specify the buyer needs it seeks to satisfy, the customer groups or markets it is endeavoring to serve, and its approach to pleasing customers. Not many company mission statements fully reveal all of these facets (and a few companies have worded their mission statements so obscurely as to mask what they are about), but most company mission statements do a decent job of indicating “who we are, what we do, and why we are here.”

An example of a well-formed mission statement with ample specifics is that of the U.S. government’s Occupational Safety and Health Administration (OSHA): “to assure the safety and health of America’s workers by setting and enforcing standards; providing training, outreach, and education; establishing partnerships; and encouraging continual improvement in workplace safety and health.” Google’s mission statement, while short, still captures the essence of the company: “to organize the world’s information and make it universally accessible and useful.” Likewise, Blockbuster has a brief mission statement that cuts right to the chase: “To help people transform ordinary nights into BLOCKBUSTER nights by being their complete source for movies and games.”

An example of a not-so-revealing mission statement is that of the present-day Ford Motor Company: “We are a global family with a proud heritage passionately committed to providing personal mobility for people around the world. We anticipate consumer need and deliver outstanding products and services that improve people’s lives.” A person who has never heard of Ford would not know from reading the company’s mission statement that it is a global producer of motor vehicles. Similarly, Microsoft’s mission statement—“to help people and businesses throughout the world realize their full potential”—says nothing about its products or business makeup and could apply
to many companies in many different industries. Coca-Cola, which markets nearly 400 beverage brands in over 200 countries, also has an overly general mission statement: “to benefit and refresh everyone it touches.” A mission statement that provides scant indication of “who we are and what we do” has no substantive value.

Occasionally, companies couch their mission statements in terms of making a profit. This is misguided. Profit is more correctly an objective and a result of what a company does. Moreover, earning a profit is the obvious intent of every commercial enterprise. Such companies as BMW, McDonald’s, Shell Oil, Procter & Gamble, Nintendo, and Nokia are each striving to earn a profit for shareholders; but plainly the fundamentals of their businesses are substantially different when it comes to “who we are and what we do.” It is management’s answer to “Make a profit doing what and for whom?” that reveals a company’s true substance and business purpose. A well-conceived mission statement distinguishes a company’s business makeup from that of other profit-seeking enterprises in language specific enough to give the company its own identity.

Communicating the Strategic Vision

Effectively communicating the strategic vision down the line to lower-level managers and employees is as important as choosing a strategically sound long-term direction. Not only do people have a need to believe that senior management knows where it’s trying to take the company and understand what changes lie ahead both externally and internally, but unless and until frontline employees understand why the strategic course that management has charted is reasonable and beneficial, they are unlikely to rally behind managerial efforts to get the organization moving in the intended direction.

Winning the support of organization members for the vision nearly always means putting “where we are going and why” in writing, distributing the written vision organizationwide, and having executives personally explain the vision and its rationale to as many people as feasible. Ideally, executives should present their vision for the company in a manner that reaches out and grabs people. An engaging and convincing strategic vision has enormous motivational value—for the same reason that a stonemason is more inspired by “building a great cathedral for the ages” than by “laying stones to create floors and walls.” When managers articulate a vivid and compelling case for where the company is headed, organization members begin to say, “This is interesting and has a lot of merit. I want to be involved and do my part to helping make it happen.” The more that a vision evokes positive support and excitement, the greater its impact in terms of arousing a committed organizational effort and getting company personnel to move in a common direction. Thus executive ability to paint a convincing and inspiring picture of a company’s journey and destination is an important element of effective strategic leadership.

Expressing the Essence of the Vision in a Slogan

The task of effectively conveying the vision to company personnel is assisted when management can capture the vision of where to head in a catchy or easily remembered slogan. A number of organizations have summed up their vision in a brief phrase:

- Levi Strauss & Company: “We will clothe the world by marketing the most appealing and widely worn casual clothing in the world.”
- Nike: “To bring innovation and inspiration to every athlete in the world.”
I. Concepts and Techniques for Crafting and Executing Strategy

2. The Managerial Process of Crafting and Executing Strategy

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Mayo Clinic: “The best care to every patient every day.”

Scotland Yard: “To make London the safest major city in the world.”

Greenpeace: “To halt environmental abuse and promote environmental solutions.”

Charles Schwab: “To provide customers with the most useful and ethical financial services in the world.”

Creating a short slogan to illuminate an organization’s direction and purpose and then using it repeatedly as a reminder of “where we are headed and why” helps rally organization members to hurdle whatever obstacles lie in the company’s path and maintain their focus.

Breaking Down Resistance to a New Strategic Vision

It is particularly important for executives to provide a compelling rationale for a dramatically new strategic vision and company direction. When company personnel don’t understand or accept the need for redirecting organizational efforts, they are prone to resist change. Hence, reiterating the basis for the new direction, addressing employee concerns head-on, calming fears, lifting spirits, and providing updates and progress reports as events unfold all become part of the task of mobilizing support for the vision and winning commitment to needed actions.

Just stating the case for a new direction once is not enough. Executives must repeat the reasons for the new direction often and convincingly at company gatherings and in company publications, and they must reinforce their pronouncements with updates about how the latest information confirms the choice of direction and the validity of the vision. Unless and until more and more people are persuaded of the merits of management’s new vision and the vision gains wide acceptance, it will be a struggle to move the organization down the newly chosen path.

Recognizing Strategic Inflection Points

Sometimes there’s an order-of-magnitude change in a company’s environment that dramatically alters its prospects and mandates radical revision of its strategic course. Intel’s former chairman Andrew Grove has called such occasions strategic inflection points—Illustration Capsule 2.2 relates Intel’s two encounters with strategic inflection points and the resulting alterations in its strategic vision. As the Intel example forcefully demonstrates, when a company reaches a strategic inflection point, management has some tough decisions to make about the company’s course. Often it is a question of what to do to sustain company success, not just how to avoid possible disaster. Responding quickly to unfolding changes in the marketplace lessens a company’s chances of becoming trapped in a stagnant or declining business or letting attractive new growth opportunities slip away.

Understanding the Payoffs of a Clear Vision Statement

In sum, a well-conceived, forcefully communicated strategic vision pays off in several respects: (1) it crystallizes senior executives’ own views about the firm’s long-term direction; (2) it reduces the risk of rudderless decision making; (3) it is a tool for winning the support of organizational members for internal changes that will help make the vision a reality; (4) it provides a beacon for lower-level managers in forming departmental missions, setting departmental objectives, and crafting functional and departmental strategies that are in sync with the company’s overall strategy; and (5) it helps an organization prepare for the future. When management is able to demonstrate significant progress in achieving these five benefits, the first step in organizational direction setting has been successfully completed.
Linking the Vision/Mission with Company Values

Many companies have developed a statement of values to guide the company’s pursuit of its vision/mission, strategy, and ways of operating. By **values** (or **core values**, as they are often called), we mean the beliefs, traits, and ways of doing things that management has determined should guide the pursuit of its vision and strategy, the conduct of company’s operations, and the behavior of company personnel.

Values, good and bad, exist in every organization. They relate to such things as fair treatment, integrity, ethical behavior, innovation, teamwork, top-notch quality, superior customer service, social responsibility, and community citizenship. Most companies have built their statements of values around four to eight traits that company personnel are expected to display and that are supposed to be mirrored in how the company conducts its business.
At Kodak, the core values are respect for the dignity of the individual, uncompromising integrity, unquestioned trust, constant credibility, continual improvement and personal renewal, and open celebration of individual and team achievements. Home Depot embraces eight values (entrepreneurial spirit, excellent customer service, giving back to the community, respect for all people, doing the right thing, taking care of people, building strong relationships, and creating shareholder value) in its quest to be the world’s leading home improvement retailer by operating warehouse stores filled with a wide assortment of products at the lowest prices with trained associates giving absolutely the best customer service in the industry. Toyota preaches respect for and development of its employees, teamwork, getting quality right the first time, learning, continuous improvement, and embracing change in its pursuit of low-cost, top-notch manufacturing excellence in motor vehicles. DuPont stresses four values—safety, ethics, respect for people, and environmental stewardship; the first three have been in place since the company was founded 200 years ago by the DuPont family. Heinz uses the acronym PREMIER to identify seven values that “define to the world and to ourselves who we are and what we stand for”:

- **P**assion . . . to be passionate about winning and about our brands, products and people, thereby delivering superior value to our shareholders.
- **R**isk Tolerance . . . to create a culture where entrepreneurship and prudent risk taking are encouraged and rewarded.
- **E**xcellence . . . to be the best in quality and in everything we do.
- **M**otivation . . . to celebrate success, recognizing and rewarding the achievements of individuals and teams.
- **I**nnovation . . . to innovate in everything, from products to processes.
- **E**mpowerment . . . to empower our talented people to take the initiative and to do what’s right.
- **R**espect . . . to act with integrity and respect towards all.

Do companies practice what they preach when it comes to their professed values? Sometimes no, sometimes yes—it runs the gamut. At one extreme are companies with window-dressing values; the values statement is merely a collection of nice words and phrases that may be given lip service by top executives but have little discernible impact on either how company personnel behave or how the company operates. Such companies have values statements because such statements are in vogue and are seen as making the company look good. At the other extreme are companies whose executives take the stated values very seriously—the values are widely adopted by company personnel, are ingrained in the corporate culture, and are mirrored in how company personnel conduct themselves and the company’s business on a daily basis. Top executives at companies on this end of the values-statement gamut genuinely believe in the importance of grounding company operations on sound values and ways of doing business. In their view, holding company personnel accountable for displaying the stated values is a way of infusing the company with the desired character, identity, and behavioral norms—the values become the company’s equivalent of DNA.

At companies where the stated values are real rather than cosmetic, managers connect values to the pursuit of the strategic vision and mission in one of two ways. In companies with long-standing values that are deeply entrenched in the corporate culture, senior managers are careful to craft a vision, mission, and strategy that match established values, and they reiterate how the values-based behavioral norms contribute to the company’s business success. If the company changes to a different
vision or strategy, executives take care to explain how and why the core values continue to be relevant. Few companies with sincere commitment to established core values ever undertake strategic moves that conflict with ingrained values.

In new companies or companies with weak or incomplete sets of values, top management considers what values, behaviors, and business conduct should characterize the company and that will help drive the vision and strategy forward. Then values and behaviors that complement and support vision are drafted and circulated among managers and employees for discussion and possible modification. A final values statement that incorporates the desired behaviors and traits and that connects to the vision/mission is then officially adopted. Some companies combine their vision and values into a single statement or document, circulate it to all organization members, and in many instances post the vision/mission and values statement on the company’s Web site. Illustration Capsule 2.3 describes the connection between Yahoo’s mission and its core values.

Of course, a wide gap sometimes opens between a company’s stated values and its actual business practices. Enron, for example, touted four corporate values—respect, integrity, communication, and excellence—but some top officials engaged in dishonest and fraudulent maneuvers that were concealed by “creative” accounting; the lack of integrity on the part of Enron executives and their deliberate failure to accurately communicate with shareholders and regulators in the company’s financial filings led directly to the company’s dramatic bankruptcy and implosion over a six-week period, along with criminal indictments, fines, or jail terms for over a dozen Enron executives. Once one of the world’s most distinguished public accounting firms, Arthur Andersen was renowned for its commitment to the highest standards of audit integrity, but its high-profile audit failures and ethical lapses at Enron, WorldCom, and other companies led to Andersen’s demise—in 2002, it was indicted for destroying Enron-related documents to thwart investigators.

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

The managerial purpose of setting objectives is to convert the strategic vision into specific performance targets—results and outcomes the company’s management wants to achieve. Objectives represent a managerial commitment to achieving particular results and outcomes. Well-stated objectives are quantifiable, or measurable, and contain a deadline for achievement. As Bill Hewlett, cofounder of Hewlett-Packard, shrewdly observed, “You cannot manage what you cannot measure. . . . And what gets measured gets done.” Concrete, measurable objectives are managerially valuable because they serve as yardsticks for tracking a company’s performance and progress—a company that consistently meets or beats its performance targets is generally a better overall performer than a company that frequently falls short of achieving its objectives. Indeed, the experiences of countless companies and managers teach that precisely spelling out how much of what kind of performance by when and then pressing forward with actions and incentives calculated to help achieve the targeted outcomes greatly improve a company’s actual performance. Such an approach definitely beats setting vague targets like “maximize profits,” “reduce costs,” “become more efficient,” or “increase sales,” which specify neither how much nor when. Similarly, exhorting
company personnel to try hard or do the best they can, and then living with whatever results they deliver, is clearly inadequate.

The Imperative of Setting Stretch Objectives  Ideally, managers ought to use the objective-setting exercise as a tool for stretching an organization to perform at its full potential and deliver the best possible results. Challenging company personnel to go all out and deliver “stretch” gains in performance pushes an enterprise to be more inventive, to exhibit more urgency in improving both its financial performance and its business position, and to be more intentional and focused in its actions. Stretch objectives spur exceptional performance and help companies guard against contentment with modest gains in organizational performance. As Mitchell Leibovitz, former CEO of the auto parts and service retailer Pep Boys, once said, “If you want to have ho-hum results, have ho-hum objectives.” There’s no better way to avoid ho-hum results than by setting stretch objectives and
using compensation incentives to motivate organization members to achieve the stretch performance targets.

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

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

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

Achieving acceptable financial results is a must. Without adequate profitability and financial strength, a company’s pursuit of its strategic vision, as well as its long-term health and ultimate survival, is jeopardized. Furthermore, subpar earnings and a weak balance sheet not only alarm shareholders and creditors but also put the jobs of senior executives at risk. However, good financial performance, by itself, is not enough. Of equal or greater importance is a company’s strategic performance—outcomes that indicate whether a company’s market position and competitiveness are deteriorating, holding steady, or improving.

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

Consequently, a balanced scorecard for measuring company performance—one that tracks the achievement of both financial objectives and strategic objectives—is optimal. Just tracking a company’s financial performance overlooks the fact that what ultimately enables a company to deliver better financial results from its operations is the achievement of strategic objectives that improve its competitiveness and market strength. Indeed, the surest path to boosting company profitability quarter after quarter and year after year is to relentlessly pursue strategic outcomes that strengthen the company’s market position and produce a growing competitive advantage over rivals.

Roughly 36 percent of global companies and over 100 nonprofit and governmental organizations used the balanced scorecard approach in 2001. A more recent survey of 708 companies on five continents found that 62 percent were using a balanced scorecard to track performance. Organizations that have adopted the balanced scorecard approach to setting objectives and measuring performance include Exxon Mobil, CIGNA, United Parcel Service, Sears, Nova Scotia Power, BMW, AT&T Canada, Chemical Bank, DaimlerChrysler, DuPont, Motorola, Siemens, Wells Fargo, Wendy’s, Saatchi & Saatchi, Duke Children’s Hospital, U.S. Department of the Army, Tennessee Valley Authority, the United Kingdom’s Ministry of Defense, the University of California at San Diego, and the City of Charlotte, North Carolina.

Illustration Capsule 2.4 shows selected objectives of five prominent companies—all employ a combination of strategic and financial objectives.

Both Short-Term and Long-Term Objectives Are Needed As a rule, a company’s set of financial and strategic objectives ought to include both near-term and longer-term performance targets. Having quarterly and annual objectives focuses attention on delivering immediate performance improvements. Targets to be achieved within three to five years prompt considerations of what to do now to put the company in position to perform better later. A company that has an objective of doubling its sales within five years can’t wait until the third or fourth year to begin growing its sales and customer base. By spelling out annual (or perhaps quarterly) performance targets, management indicates the speed at which longer range targets are to be approached. Long-term objectives take on particular importance because it is generally in the best interest of shareholders for companies to be managed for optimal long-term performance. When trade-offs have to be made between achieving long-run objectives and achieving short-run objectives, long-run objectives should take precedence (unless the achievement of one or more short-run performance targets have unique importance). Shareholders are seldom well-served by repeated management actions that sacrifice better long-term performance in order to make quarterly or annual targets.

Strategic Intent: Relentless Pursuit of an Ambitious Strategic Objective Very ambitious companies often establish a long-term strategic objective that clearly
signals **strategic intent** to be a winner in the marketplace, often against long odds. A company’s strategic intent can entail unseating the existing industry leader, becoming the dominant market share leader, delivering the best customer service of any company in the industry (or the world), or turning a new technology into products capable of changing the way people work and live. Nike’s strategic intent during the 1960s was to overtake Adidas; this intent connected nicely with Nike’s core purpose “to experience the emotion of competition, winning, and crushing competitors.” Canon’s strategic intent in copying equipment was to “beat Xerox.” For some years, Toyota has been driving to overtake General Motors as the world’s largest motor vehicle producer—and it surpassed Ford Motor Company in total vehicles sold in 2003, to move into second place. Toyota has expressed its strategic intent in the form of a global market share objective of 15 percent by 2010, up from 5 percent in 1980 and 10 percent in 2003. Starbucks’ strategic intent is to make the Starbucks brand the world’s most recognized and respected brand.
Ambitious companies that establish exceptionally bold strategic objectives and have an unshakable commitment to achieving them almost invariably begin with strategic intents that are out of proportion to their immediate capabilities and market grasp. But they pursue their strategic target relentlessly, sometimes even obsessively. They rally the organization around efforts to make the strategic intent a reality. They go all out to marshal the resources and capabilities to close in on their strategic target (which is often global market leadership) as rapidly as they can. They craft potent offensive strategies calculated to throw rivals off-balance, put them on the defensive, and force them into an ongoing game of catch-up. They deliberately try to alter the market contest and tilt the rules for competing in their favor. As a consequence, capably managed up-and-coming enterprises with strategic intents exceeding their present reach and resources are a force to be reckoned with, often proving to be more formidable competitors over time than larger, cash-rich rivals that have modest strategic objectives and market ambitions.

The Need for Objectives at All Organizational Levels

Objective setting should not stop with top management’s establishing of companywide performance targets. Company objectives need to be broken down into performance targets for each of the organization’s separate businesses, product lines, functional departments, and individual work units. Company performance can’t reach full potential unless each organizational unit sets and pursues performance targets that contribute directly to the desired companywide outcomes and results. Objective setting is thus a top-down process that must extend to the lowest organizational levels. And it means that each organizational unit must take care to set performance targets that support—rather than conflict with or negate—the achievement of companywide strategic and financial objectives.

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

Objective Setting Needs to Be Top-Down Rather than Bottom-Up

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

A top-down process of setting companywide performance targets first and then insisting that the financial and strategic performance targets established for business units, divisions, functional departments, and operating units be directly connected to the achievement of company objectives has two powerful advantages: One, it helps produce cohesion among the objectives and strategies of different parts of the organization. Two, it helps unify internal efforts to move the company along the chosen strategic path. If top management, desirous of involving many organization members, allows objective setting to start at the bottom levels of an organization without the benefit of companywide performance targets as a guide, then lower-level organizational units have no basis for connecting their performance targets to the company’s. Bottom-up objective setting, with little or no guidance from above, nearly always signals an absence of strategic leadership on the part of senior executives.

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

The task of crafting a strategy entails answering a series of hows: how to grow the business, how to please customers, how to outcompete rivals, how to respond to changing market conditions, how to manage each functional piece of the business and develop needed competencies and capabilities, how to achieve strategic and financial objectives. It also means exercising astute entrepreneurship in choosing among the various strategic alternatives—proactively searching for opportunities to do new things or to do existing things in new or better ways. The faster a company’s business environment is changing, the more critical the need for its managers to be good entrepreneurs in diagnosing the direction and force of the changes under way and in responding with timely adjustments in strategy. Strategy makers have to pay attention to early warnings of future change and be willing to experiment with dare-to-be-different ways to alter their market position in preparing for new market conditions. When obstacles unexpectedly appear in a company’s path, it is up to management to adapt rapidly and innovatively. Masterful strategies come partly (maybe mostly) by doing things differently from competitors where it counts—outinnovating them, being more efficient, being more imaginative, adapting faster—rather than running with the herd. Good strategy making is therefore inseparable from good business entrepreneurship. One cannot exist without the other.

Who Participates in Crafting a Company’s Strategy?

A company’s senior executives obviously have important strategy-making roles. The chief executive officer (CEO) wears the mantles of chief direction setter, chief objective setter, chief strategy maker, and chief strategy implementer for the total enterprise. Ultimate responsibility for leading the strategy-making, strategy-executing process rests with the CEO. In some enterprises the CEO functions as strategic visionary and chief architect of strategy, personally deciding what the key elements of the company’s strategy will be, although others may well assist with data gathering and analysis, and the CEO may seek the advice of other senior managers and key employees in fashioning
an overall strategy and deciding on important strategic moves. A CEO-centered approach to strategy development is characteristic of small owner-managed companies and sometimes large corporations that have been founded by the present CEO or that have CEOs with strong strategic leadership skills. Meg Whitman at eBay, Andrea Jung at Avon, Jeffrey Immelt at General Electric, and Howard Schultz at Starbucks are prominent examples of corporate CEOs who have wielded a heavy hand in shaping their company’s strategy.

In most companies, however, strategy is the product of more than just the CEO’s handiwork. Typically, other senior executives—business unit heads, the chief financial officer, and vice presidents for production, marketing, human resources, and other functional departments—have influential strategy-making roles and help fashion the chief strategy components. Normally, a company’s chief financial officer (CFO) is in charge of devising and implementing an appropriate financial strategy; the production vice president takes the lead in developing the company’s production strategy; the marketing vice president orchestrates sales and marketing strategy; a brand manager is in charge of the strategy for a particular brand in the company’s product lineup; and so on.

But even here it is a mistake to view strategy making as a top management function, the exclusive province of owner-entrepreneurs, CEOs, and other senior executives. The more that a company’s operations cut across different products, industries, and geographical areas, the more that headquarters executives have little option but to delegate considerable strategy-making authority to down-the-line managers in charge of particular subsidiaries, divisions, product lines, geographic sales offices, distribution centers, and plants. On-the-scene managers with authority over specific operating units are in the best position to evaluate the local situation in which the strategic choices must be made and can be expected to have detailed familiarity with local market and competitive conditions, customer requirements and expectations, and all the other aspects surrounding the strategic issues and choices in their arena of authority. This gives them an edge over headquarters executives in keeping the local aspects of the company’s strategy responsive to local market and competitive conditions.

Take a company like Toshiba, a $43 billion corporation with 300 subsidiaries, thousands of products, and operations extending across the world. While top-level Toshiba executives may well be personally involved in shaping Toshiba’s overall strategy and fashioning important strategic moves, it doesn’t follow that a few senior executives at Toshiba headquarters have either the expertise or a sufficiently detailed understanding of all the relevant factors to wisely craft all the strategic initiatives taken for 300 subsidiaries and thousands of products. They simply cannot know enough about the situation in every Toshiba organizational unit to decide upon every strategy detail and direct every strategic move made in Toshiba’s worldwide organization. Rather, it takes involvement on the part of Toshiba’s whole management team—top executives, subsidiary heads, division heads, and key managers in such geographic units as sales offices, distribution centers, and plants—to craft the thousands of strategic initiatives that end up comprising the whole of Toshiba’s strategy. The same can be said for a company like General Electric, which employs 300,000 people in businesses ranging from jet engines to plastics, power generation equipment to appliances, medical equipment to TV broadcasting, and locomotives to financial services (among many others) and that sells to customers in over 100 countries.

While managers farther down in the managerial hierarchy obviously have a narrower, more specific strategy-making role than managers closer to the top, the important understanding here is that in most of today’s companies every company manager typically has a strategy-making role—ranging from minor to major—for the area he or she
heads. Hence, any notion that an organization’s strategists are at the top of the management hierarchy and that midlevel and frontline personnel merely carry out the strategic directives of senior managers needs to be cast aside. In companies with wide-ranging operations, it is far more accurate to view strategy making as a collaborative or team effort involving managers (and sometimes key employees) down through the whole organizational hierarchy.

In fact, the necessity of delegating some strategy-making authority to down-the-line managers has resulted in it being fairly common for key pieces of a company’s strategy to originate in a company’s middle and lower ranks. Electronic Data Systems conducted a yearlong strategy review involving 2,500 of its 55,000 employees and coordinated by a core of 150 managers and staffers from all over the world. J. M. Smucker, best-known for its jams and jellies, formed a team of 140 employees (7 percent of its 2,000-person workforce) who spent 25 percent of their time over a six-month period looking for ways to rejuvenate the company’s growth. Involving teams of people to dissect complex situations and come up with strategic solutions is an often-used component of the strategy-making process because many strategic issues are complex or cut across multiple areas of expertise and operating units, thus calling for the contributions of many disciplinary experts and the collaboration of managers from different parts of the organization. A valuable strength of collaborative strategy-making is that the team of people charged with crafting the strategy can easily include the very people who will also be charged with implementing and executing it. Giving people an influential stake in crafting the strategy they must later help implement and execute not only builds motivation and commitment but also means those people can be held accountable for putting the strategy into place and making it work—the excuse of “It wasn’t my idea to do this” won’t fly.

The Strategy-Making Role of Corporate Intrapreneurs  In some companies, top management makes a regular practice of encouraging individuals and teams to develop and champion proposals for new product lines and new business ventures. The idea is to unleash the talents and energies of promising “corporate intrapreneurs,” letting them try out untested business ideas and giving them the room to pursue new strategic initiatives. Executives judge which proposals merit support, give the chosen intrapreneurs the organizational and budgetary support they need, and let them proceed freely. Thus, important pieces of company strategy can originate with those intrapreneurial individuals and teams who succeed in championing a proposal through the approval stage and then end up being charged with the lead role in launching new products, overseeing the company’s entry into new geographic markets, or heading up new business ventures. W. L. Gore and Associates, a privately owned company famous for its Gore-Tex waterproofing film, is an avid and highly successful practitioner of the corporate intrapreneur approach to strategy making. Gore expects all employees to initiate improvements and to display innovativeness. Each employee’s intrapreneurial contributions are prime considerations in determining raises, stock option bonuses, and promotions. Gore’s commitment to intrapreneurship has produced a stream of product innovations and new strategic initiatives that have kept the company vibrant and growing for nearly two decades.

**A Company’s Strategy-Making Hierarchy**

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

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

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

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

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

Lead responsibility for functional strategies within a business is normally delegated to the heads of the respective functions, with the general manager of
Orchestrated by the CEO and other senior executives.

Orchestrated by the general managers of each of the company’s different lines of business, often with advice and input from the heads of functional area activities within each business and other key people.

Crafted by the heads of major functional activities within a particular business—often in collaboration with other key people.

Crafted by brand managers; the operating managers of plants, distribution centers, and geographic units; and the managers of strategically important activities like advertising and Web site operations—often key employees are involved.

In the case of a single-business company, these two levels of the strategy-making hierarchy merge into one level—business strategy—that is orchestrated by the company’s CEO and other top executives.

Figure 2.2 A Company’s Strategy-Making Hierarchy

Corporate Strategy
The companywide game plan for managing a set of businesses

Two-Way Influence

Business Strategy
(one for each business the company has diversified into)
- How to strengthen market position and build competitive advantage
- Actions to build competitive capabilities

Two-Way Influence

Functional-area strategies within each business
- Add relevant detail to the hows of overall business strategy
- Provide a game plan for managing a particular activity in ways that support the overall business strategy

Two-Way Influence

Operating strategies within each business
- Add detail and completeness to business and functional strategy
- Provide a game plan for managing specific lower-echelon activities with strategic significance
the business having final approval and perhaps even exerting a strong influence over the content of particular pieces of the strategies. To some extent, functional managers have to collaborate and coordinate their strategy-making efforts to avoid uncoordinated or conflicting strategies. For the overall business strategy to have maximum impact, a business’s marketing strategy, production strategy, finance strategy, customer service strategy, product development strategy, and human resources strategy should be compatible and mutually reinforcing rather than each serving its own narrower purposes. If inconsistent functional-area strategies are sent up the line for final approval, the business head is responsible for spotting the conflicts and getting them resolved.

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

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

In single-business enterprises, the corporate and business levels of strategy making merge into one level—business strategy—because the strategy for the whole company involves only one distinct line of business. Thus, a single-business enterprise has three levels of strategy: business strategy for the company as a whole, functional-area strategies for each main area within the business, and operating strategies undertaken by lower-echelon managers to flesh out strategically significant aspects for the company’s business and functional-area strategies. Proprietorships, partnerships, and owner-managed enterprises may have only one or two strategy-making levels since their strategy-making, strategy-executing process can be handled by just a few key people.

**Uniting the Strategy-Making Effort**

Ideally, the pieces of a company’s strategy up and down the strategy hierarchy should be cohesive and mutually reinforcing, fitting together like a jigsaw puzzle. To achieve such unity, the strategizing process requires leadership from the top. It is the responsibility of top executives to provide strategy-making direction and clearly articulate key strategic themes that paint the white lines for lower-level strategy-making efforts. Mid-level and frontline managers cannot craft unified strategic moves without first
understanding the company’s long-term direction and knowing the major components of the overall and business strategies that their strategy-making efforts are supposed to support and enhance. Thus, as a general rule, strategy making must start at the top of the organization and then proceed downward through the hierarchy from the corporate level to the business level and then from the business level to the associated functional and operating levels. Strategy cohesion requires that business-level strategies complement and be compatible with the overall corporate strategy. Likewise, functional and operating strategies have to complement and support the overall business-level strategy of which they are a part. When the strategizing process is mostly top-down, with lower-level strategy-making efforts taking their cues from the higher-level strategy elements they are supposed to complement and support, there’s less potential for strategy conflict between different levels. An absence of strong strategic leadership from the top sets the stage for some degree of strategic disunity. The strategic disarray that occurs in an organization when there is weak leadership and too few strategy guidelines coming from top executives is akin to what would happen to a football team’s offensive performance if the quarterback decided not to call a play for the team but instead let each player do whatever he/thought would work best at his respective position. In business, as in sports, all the strategy makers in a company are on the same team and the many different pieces of the overall strategy crafted at various organizational levels need to be in sync. Anything less than a unified collection of strategies weakens the overall strategy and is likely to impair company performance.

There are two things that top-level executives can do to drive consistent strategic action down through the organizational hierarchy. One is to effectively communicate the company’s vision, objectives, and major strategy components to down-the-line managers and key personnel. The greater the numbers of company personnel who know, understand, and buy into the company’s long-term direction and overall strategy, the smaller the risk that organization units will go off in conflicting strategic directions when strategy making is pushed down to frontline levels and many people are given a strategy-making role. The second is to exercise due diligence in reviewing lower-level strategies for consistency and support of higher level strategies. Any strategy conflicts must be addressed and resolved, either by modifying the lower-level strategies with conflicting elements or by adapting the higher-level strategy to accommodate what may be more appealing strategy ideas and initiatives bubbling from below. Thus, the process of synchronizing the strategy initiatives up and down the organizational hierarchy does not necessarily mean that lower-level strategies must be changed whenever conflicts and inconsistencies are spotted. When more attractive strategies ideas originate at lower organizational levels, it makes sense to adapt higher-level strategies to accommodate them.

A Strategic Vision + Objectives + Strategy = A Strategic Plan

Developing a strategic vision and mission, setting objectives, and crafting a strategy are basic direction-setting tasks. They map out where a company is headed, the targeted strategic and financial outcomes, and the competitive moves and internal action approaches to be used in achieving the desired business results. Together, they constitute a strategic plan for coping with industry and competitive conditions, the expected actions of the industry’s key players, and the challenges and issues that stand as obstacles to the company’s success.15
In companies that do regular strategy reviews and develop explicit strategic plans, the strategic plan usually ends up as a written document that is circulated to most managers and perhaps selected employees. Near-term performance targets are the part of the strategic plan most often spelled out explicitly and communicated to managers and employees. A number of companies summarize key elements of their strategic plans in the company’s annual report to shareholders, in postings on their Web site, or in statements provided to the business media. Other companies, perhaps for reasons of competitive sensitivity, make only vague, general statements about their strategic plans. In small, privately owned companies, it is rare for strategic plans to exist in written form. Small companies’ strategic plans tend to reside in the thinking and directives of owners/executives, with aspects of the plan being revealed in meetings and conversations with company personnel, and the understandings and commitments among managers and key employees about where to head, what to accomplish, and how to proceed.

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

Managing the implementation and execution of strategy is an operations-oriented, make-things-happen activity aimed at performing core business activities in a strategy-supportive manner. It is easily the most demanding and time-consuming part of the strategy management process. Converting strategic plans into actions and results tests a manager’s ability to direct organizational change, motivate people, build and strengthen company competencies and competitive capabilities, create and nurture a strategy-supportive work climate, and meet or beat performance targets. Initiatives to put the strategy in place and execute it proficiently have to be launched and managed on many organizational fronts.

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

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

- Staffing the organization with the needed skills and expertise, consciously building and strengthening strategy-supportive competencies and competitive capabilities, and organizing the work effort.
- Allocating ample resources to those activities critical to strategic success.
- Ensuring that policies and procedures facilitate rather than impede effective execution.
• Using best practices to perform core business activities and pushing for continuous improvement. Organizational units have to periodically reassess how things are being done and diligently pursue useful changes and improvements.

• Installing information and operating systems that enable company personnel to better carry out their strategic roles day in and day out.

• Motivating people to pursue the target objectives energetically and, if need be, modifying their duties and job behavior to better fit the requirements of successful strategy execution.

• Tying rewards and incentives directly to the achievement of performance objectives and good strategy execution.

• Creating a company culture and work climate conducive to successful strategy execution.

• Exerting the internal leadership needed to drive implementation forward and keep improving on how the strategy is being executed. When stumbling blocks or weaknesses are encountered, management has to see that they are addressed and rectified in timely and effective fashion.

Good strategy execution requires diligent pursuit of operating excellence. It is a job for a company’s whole management team. And success hinges on the skills and cooperation of operating managers who can push needed changes in their organization units and consistently deliver good results. Strategy implementation can be considered successful if things go smoothly enough that the company meets or beats its strategic and financial performance targets and shows good progress in achieving management’s strategic vision.

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

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

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

Likewise, it is not unusual for a company to find that one or more aspects of its strategy implementation and execution are not going as well as intended. Proficient
strategy execution is always the product of much organizational learning. It is achieved unevenly—coming quickly in some areas and proving nettlesome in others. It is both normal and desirable to periodically assess strategy execution to determine which aspects are working well and which need improving. Successful strategy execution entails vigilantly searching for ways to improve and then making corrective adjustments whenever and wherever it is useful to do so.

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

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

1. Be inquiring critics and oversee the company’s direction, strategy, and business approaches. Board members must ask probing questions and draw on their business acumen to make independent judgments about whether strategy proposals have been adequately analyzed and whether proposed strategic actions appear to have greater promise than alternatives. If executive management is bringing well-supported and reasoned strategy proposals to the board, there’s little reason for board members to aggressively challenge or pick apart everything put before them. Asking incisive questions is usually sufficient to test whether the case for management’s proposals is compelling. However, when the company’s strategy is failing or is plagued with faulty execution, and certainly when there is a precipitous collapse in profitability, board members have a duty to express their concerns about the validity of the strategy and/or operating methods, initiate debate about the company’s strategic path, hold one-on-one discussions with key executives and other board members, and perhaps directly intervene as a group to alter the company’s executive leadership and, ultimately, its strategy and business approaches.

2. Evaluate the caliber of senior executives’ strategy-making and strategy-executing skills. The board is always responsible for determining whether the current CEO is doing a good job of strategic leadership (as a basis for awarding salary increases and bonuses and deciding on retention or removal). Boards must also exercise due diligence in evaluating the strategic leadership skills of other senior executives in line to succeed the CEO. When the incumbent CEO steps down or leaves for a position elsewhere, the board must elect a successor, either going with an insider or deciding that a better-qualified outsider is needed to perhaps radically change the company’s strategic course.

3. Institute a compensation plan for top executives that rewards them for actions and results that serve stakeholder interests, and most especially those of shareholders. A basic principle of corporate governance is that the owners of a corporation delegate operating authority and managerial control to top management in return for compensation. In their role as an agent of shareholders, top executives have a
clear and unequivocal duty to make decisions and operate the company in accord
with shareholder interests (but this does not mean disregarding the interests of other
stakeholders, particularly those of employees, with whom they also have an agency
relationship). Most boards of directors have a compensation committee, composed
entirely of outside directors, to develop a salary and incentive compensation plan
that makes it in the self-interest of executives to operate the business in a manner
that benefits the owners; the compensation committee’s recommendations are
presented to the full board for approval. But in addition to creating compensation
plans intended to align executive actions with owner interests, the board of directors
must put a halt to self-serving executive perks and privileges that simply line the
financial pockets of executives. Numerous media reports have recounted instances
in which boards of directors have gone along with opportunistic executive efforts
to secure excessive, if not downright obscene, compensation of one kind or another
(multimillion-dollar interest-free loans, personal use of corporate aircraft, lucrative
severance and retirement packages, outsized stock incentive awards, and so on).

4. **Oversee the company’s financial accounting and financial reporting practices.**
While top managers, particularly the company’s CEO and CFO, are primarily re-
sponsible for seeing that the company’s financial statements fairly and accurately
report the results of the company’s operations, it is well established that board
members have a fiduciary duty to protect shareholders by exercising oversight
of the company’s financial practices, ensuring that generally accepted accounting
principles (GAAP) are properly used in preparing the company’s financial state-
ments, and determining whether proper financial controls are in place to prevent
fraud and misuse of funds. Virtually all boards of directors monitor the financial
reporting activities by appointing an audit committee, always composed entirely
of outside directors. The members of the audit committee have lead responsibility
for overseeing the company’s financial officers and consulting with both internal
and external auditors to ensure accurate financial reporting and adequate financial
controls.

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

Every corporation should have a strong, independent board of directors that
(1) is well informed about the company’s performance, (2) guides and judges the CEO
and other top executives, (3) has the courage to curb inappropriate or unduly risky
management actions, (4) certifies to shareholders that the CEO is doing what the board
expects, (5) provides insight and advice to management, and (6) is intensely involved
in debating the pros and cons of key decisions and actions. Boards of directors that
lack the backbone to challenge a strong-willed or imperial CEO or that rubber-stamp
most anything the CEO recommends without probing inquiry and debate (perhaps
because the board is stacked with the CEO’s cronies) abdicate their duty to represent
and protect shareholder interests. The whole fabric of effective corporate governance
is undermined when boards of directors shirk their responsibility to maintain ultimate
control over the company’s strategic direction, the major elements of its strategy, the
business approaches management is using to implement and execute the strategy, executive compensation, and the financial reporting process. Thus, even though lead responsibility for crafting and executing strategy falls to top executives, boards of directors have a very important oversight role in the strategy-making, strategy-executing process.

**Key Points**

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

1. *Developing a strategic vision* of where the company needs to head and what its future product/market/customer/technology focus should be. This managerial step provides long-term direction, infuses the organization with a sense of purposeful action, and communicates management’s aspirations to stakeholders.

2. *Setting objectives* to spell out for the company how much of what kind of performance is expected, and by when. The objectives need to require a significant amount of organizational stretch. A balanced scorecard approach for measuring company performance entails setting both financial objectives and strategic objectives.

3. *Crafting a strategy to achieve the objectives* and move the company along the strategic course that management has charted. Crafting strategy is concerned principally with forming responses to changes under way in the external environment, devising competitive moves and market approaches aimed at producing sustainable competitive advantage, building competitively valuable competencies and capabilities, and uniting the strategic actions initiated in various parts of the company. The more that a company’s operations cut across different products, industries, and geographical areas, the more that strategy making becomes a team effort involving managers and company personnel at many organizational levels. The total strategy that emerges in such companies is really a collection of strategic actions and business approaches initiated partly by senior company executives, partly by the heads of major business divisions, partly by functional-area managers, and partly by frontline operating managers. The larger and more diverse the operations of an enterprise, the more points of strategic initiative it has and the more managers and employees at more levels of management that have a relevant strategy-making role. A single business enterprise has three levels of strategy—business strategy for the company as a whole, functional-area strategies for each main area within the business, and operating strategies undertaken by lower-echelon managers to flesh out strategically significant aspects for the company’s business and functional-area strategies. In diversified, multibusiness companies, the strategy-making task involves four distinct types or levels of strategy: corporate strategy for the company as a whole, business strategy (one for each business the company has diversified into), functional-area strategies within each business, and operating strategies. Typically, the strategy-making task is more top-down than bottom-up, with higher-level strategies serving as the guide for developing lower-level strategies.

4. *Implementing and executing the chosen strategy efficiently and effectively.* Managing the implementation and execution of strategy is an operations-oriented, make-things-happen activity aimed at shaping the performance of core business activities in a strategy-supportive manner. Management’s handling of the strategy implementation process can be considered successful if things go smoothly
enough that the company meets or beats its strategic and financial performance targets and shows good progress in achieving management’s strategic vision.

5. *Evaluating performance and initiating corrective adjustments* in vision, long-term direction, objectives, strategy, or execution in light of actual experience, changing conditions, new ideas, and new opportunities. This phase of the strategy management process is the trigger point for deciding whether to continue or change the company’s vision, objectives, strategy, and/or strategy execution methods.

A company’s strategic vision, objectives, and strategy constitute a *strategic plan* for coping with industry and competitive conditions, outcompeting rivals, and addressing the challenges and issues that stand as obstacles to the company’s success.

Boards of directors have a duty to shareholders to play a vigilant role in overseeing management’s handling of a company’s strategy-making, strategy-executing process. A company’s board is obligated to (1) critically appraise and ultimately approve strategic action plans; (2) evaluate the strategic leadership skills of the CEO and others in line to succeed the incumbent CEO; (3) institute a compensation plan for top executives that rewards them for actions and results that serve stakeholder interests, most especially those of shareholders; and (4) ensure that the company issues accurate financial reports and has adequate financial controls.

### Exercises

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

2. Consider the following mission statement of the American Association of Retired People (AARP):

**AARP Mission Statement**

- AARP is a nonprofit, nonpartisan membership organization for people age 50 and over.
- AARP is dedicated to enhancing quality of life for all as we age. We lead positive social change and deliver value to members through information, advocacy and service.
- AARP also provides a wide range of unique benefits, special products, and services for our members. These benefits include AARP Web site at [www.aarp.org](http://www.aarp.org), “AARP The Magazine,” the monthly “AARP Bulletin,” and a Spanish-language newspaper, “Segunda Juventud.”
- Active in every state, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands, AARP celebrates the attitude that age is just a number and life is what you make it.

Is AARP’s mission statement well-crafted? Does it do an adequate job of indicating “who we are, what we do, and why we are here”? Why or why not?

3. How would you rewrite/restate the strategic vision for Caterpillar in Illustration Capsule 2.1 so as to better exemplify the characteristics of effective vision statements presented in Tables 2.2 and 2.3? Visit [www.caterpillar.com](http://www.caterpillar.com) to get more information about Caterpillar and figure out how a more appropriate strategic vision might be worded.
Evaluating a Company’s External Environment

Analysis is the critical starting point of strategic thinking.
—Kenichi Ohmae
Consultant and Author

Things are always different—the art is figuring out which differences matter.
—Laszlo Birinyi
Investments Manager

Competitive battles should be seen not as one-shot skirmishes but as a dynamic multiround game of moves and countermoves.
—Anil K. Gupta
Professor
Managers are not prepared to act wisely in steering a company in a different direction or altering its strategy until they have a deep understanding of the pertinent factors surrounding the company’s situation. As indicated in the opening paragraph of Chapter 1, one of the three central questions that managers must address in evaluating their company’s business prospects is “What’s the company’s present situation?” Two facets of a company’s situation are especially pertinent: (1) the industry and competitive environment in which the company operates and the forces acting to reshape this environment, and (2) the company’s own market position and competitiveness—its resources and capabilities, its strengths and weaknesses vis-à-vis rivals, and its windows of opportunity.

Insightful diagnosis of a company’s external and internal environment is a prerequisite for managers to succeed in crafting a strategy that is an excellent fit with the company’s situation, is capable of building competitive advantage, and holds good prospect for boosting company performance—the three criteria of a winning strategy. As depicted in Figure 3.1, the task of crafting a strategy thus should always begin with an appraisal of the company’s external and internal situation (as a basis for developing strategic vision of where the company needs to head), then move toward an evaluation of the most promising alternative strategies and business models, and culminate in choosing a specific strategy.

This chapter presents the concepts and analytical tools for zeroing in on those aspects of a single-business company’s external environment that should be considered in making strategic choices. Attention centers on the competitive arena in which a company operates, the drivers of market change, and what rival companies are doing. In Chapter 4 we explore the methods of evaluating a company’s internal circumstances and competitiveness.

THE STRATEGICALLY RELEVANT COMPONENTS OF A COMPANY’S EXTERNAL ENVIRONMENT

All companies operate in a “macroenvironment” shaped by influences emanating from the economy at large; population demographics; societal values and lifestyles; governmental legislation and regulation; technological factors; and, closer to home, the
industry and competitive arena in which the company operates (see Figure 3.2). Strictly speaking, a company’s macroenvironment includes all relevant factors and influences outside the company’s boundaries; by relevant, we mean important enough to have a bearing on the decisions the company ultimately makes about its direction, objectives, strategy, and business model. Strategically relevant influences coming from the outer ring of the macroenvironment can sometimes have a high impact on a company’s business situation and have a very significant impact on the company’s direction and strategy. The strategic opportunities of cigarette producers to grow their business are greatly reduced by antismoking ordinances and the growing cultural stigma attached to smoking. Motor vehicle companies must adapt their strategies (especially as concerns the fuel mileage of their vehicles) to customer concerns about gasoline prices. The demographics of an aging population and longer life expectancies are having a dramatic impact on the business prospects and strategies of health care and prescription drug companies. Companies in most all industries have to craft strategies that are responsive to environmental regulations, growing use of the Internet and broadband technology, and energy prices. Companies in the food-processing, restaurant, sports, and fitness industries have to pay special attention to changes in lifestyles, eating habits, leisure-time preferences, and attitudes toward nutrition and exercise in fashioning their strategies.

Happenings in the outer ring of the macroenvironment may occur rapidly or slowly, with or without advance warning. The impact of outer-ring factors on a company’s choice of strategy can range from big to small. But even if the factors in the outer ring of the macroenvironment change slowly or have such a comparatively low impact on a company’s situation that only the edges of a company’s direction and strategy are affected, there are enough strategically relevant outer-ring trends and events to justify a watchful eye. As company managers scan the external environment, they must be alert for potentially important outer-ring developments, assess their impact and influence, and adapt the company’s direction and strategy as needed.
However, the factors and forces in a company’s macroenvironment having the biggest strategy-shaping impact typically pertain to the company’s immediate industry and competitive environment—competitive pressures, the actions of rival firms, buyer behavior, supplier-related considerations, and so on. Consequently, it is on a company’s industry and competitive environment that we concentrate our attention in this chapter.

**THINKING STRATEGICALLY ABOUT A COMPANY’S INDUSTRY AND COMPETITIVE ENVIRONMENT**

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

1. What are the industry’s dominant economic features?
2. What kinds of competitive forces are industry members facing and how strong is each force?
3. What forces are driving industry change and what impacts will they have on competitive intensity and industry profitability?
4. What market positions do industry rivals occupy—who is strongly positioned and who is not?
5. What strategic moves are rivals likely to make next?
6. What are the key factors for future competitive success?
7. Does the outlook for the industry present the company with sufficiently attractive prospects for profitability?

Analysis-based answers to these questions provide managers with the understanding needed to craft a strategy that fits the company’s external situation. The remainder of this chapter is devoted to describing the methods of obtaining solid answers to the seven questions and explaining how the nature of a company’s industry and competitive environment weighs upon the strategic choices of company managers.

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

Because industries differ so significantly, analyzing a company’s industry and competitive environment begins with identifying an industry’s dominant economic features and forming a picture of what the industry landscape is like. An industry’s dominant economic features are defined by such factors as market size and growth rate, the number and sizes of buyers and sellers, the geographic boundaries of the market (which can extend from local to worldwide), the degree to which sellers’ products are differentiated, the pace of product innovation, market supply/demand conditions, the pace of technological change, the extent of vertical integration, and the extent to which costs are affected by scale economies (i.e., situations in which large-volume operations result in lower unit costs) and learning/experience curve effects (i.e., situations in which costs decline as a company gains knowledge and experience). Table 3.1 provides a convenient summary of what economic features to look at and the corresponding questions to consider in profiling an industry’s landscape.

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

In industries like semiconductors, strong learning/experience curve effects in manufacturing cause unit costs to decline about 20 percent each time cumulative production
### Table 3.1 What to Consider in Identifying an Industry’s Dominant Economic Features

<table>
<thead>
<tr>
<th>Economic Feature</th>
<th>Questions to Answer</th>
</tr>
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| Market size and growth rate       | • How big is the industry and how fast is it growing?  
• What does the industry’s position in the life cycle (early development, rapid growth and takeoff, early maturity and slowing growth, saturation and stagnation, decline) reveal about the industry’s growth prospects? |
| Number of rivals                  | • Is the industry fragmented into many small companies or concentrated and dominated by a few large companies?  
• Is the industry going through a period of consolidation to a smaller number of competitors? |
| Scope of competitive rivalry      | • Is the geographic area over which most companies compete local, regional, national, multinational, or global?  
• Is having a presence in the foreign country markets becoming more important to a company’s long-term competitive success? |
| Number of buyers                  | • Is market demand fragmented among many buyers?  
• Do some buyers have bargaining power because they purchase in large volume? |
| Degree of product differentiation | • Are the products of rivals becoming more differentiated or less differentiated?  
• Are increasingly look-alike products of rivals causing heightened price competition? |
| Product innovation                | • Is the industry characterized by rapid product innovation and short product life cycles?  
• How important is R&D and product innovation?  
• Are there opportunities to overtake key rivals by being first-to-market with next-generation products? |
| Supply/demand conditions          | • Is a surplus of capacity pushing prices and profit margins down?  
• Is the industry overcrowded with too many competitors?  
• Are short supplies creating a sellers’ market? |
| Pace of technological change      | • What role does advancing technology play in this industry?  
• Are ongoing upgrades of facilities/equipment essential because of rapidly advancing production process technologies?  
• Do most industry members have or need strong technological capabilities? |
| Vertical integration              | • Do most competitors operate in only one stage of the industry (parts and components production, manufacturing and assembly, distribution, retailing) or do some competitors operate in multiple stages?  
• Is there any cost or competitive advantage or disadvantage associated with being fully or partially integrated? |
| Economies of scale                | • Is the industry characterized by economies of scale in purchasing, manufacturing, advertising, shipping, or other activities?  
• Do companies with large-scale operations have an important cost advantage over small-scale firms? |
| Learning/experience curve effects | • Are certain industry activities characterized by strong learning/experience curve effects (“learning by doing”) such that unit costs decline as a company’s experience in performing the activity builds?  
• Do any companies have significant cost advantages because of their learning/experience in performing particular activities? |
Part 1  Concepts and Techniques for Crafting and Executing Strategy

volume doubles. With a 20 percent experience curve effect, if the first 1 million chips cost $100 each, the unit cost would be $80 (80 percent of $100) by a production volume of 2 million, the unit cost would be $64 (80 percent of $80) by a production volume of 4 million, and so on.¹ The bigger the learning/experience curve effect, the bigger the cost advantage of the company with the largest cumulative production volume.

Thus, when an industry is characterized by important learning/experience curve effects (or by economies of scale), industry members are strongly motivated to adopt volume-increasing strategies to capture the resulting cost-saving economies and maintain their competitiveness. Unless small-scale firms succeed in pursuing strategic options that allow them to grow sales sufficiently to remain cost-competitive with larger-volume rivals, they are unlikely to survive. The bigger the learning/experience curve effects and/or scale economies in an industry, the more imperative it becomes for competing sellers to pursue strategies to win additional sales and market share—the company with the biggest sales volume gains sustainable competitive advantage as the low-cost producer.

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

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

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

The way one uses the five-forces model to determine the nature and strength of competitive pressures in a given industry is to build the picture of competition in three steps:

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

The strongest of the five competitive forces is nearly always the market maneuvering and jockeying for buyer patronage that goes on among rival sellers of a product or service. In effect, a market is a competitive battlefield where there’s no end to the jockeying for buyer patronage. Rival sellers are prone to employ whatever weapons they
have in their business arsenal to improve their market positions, strengthen their market position with buyers, and earn good profits. The challenge is to craft a competitive strategy that, at the very least, allows a company to hold its own against rivals and that, ideally, produces a competitive edge over rivals. But competitive contests are ongoing and dynamic. When one firm makes a strategic move that produces good results, its rivals typically respond with offensive or defensive countermoves, shifting their strategic emphasis from one combination of product attributes, marketing tactics, and capabilities to another. This pattern of action and reaction, move and countermove, adjust and readjust produces a continually evolving competitive landscape in which the market battle ebbs and flows, sometimes takes unpredictable twists and turns, and produces winners and losers. But the winners—the current market leaders—have no guarantees of continued leadership; their market success is no more durable than the power of their strategies to fend off the strategies of ambitious challengers. In every industry, the ongoing jockeying of rivals leads to one or another companies gaining or losing momentum in the marketplace according to whether their latest strategic maneuvers succeed or fail.

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

- **Rivalry intensifies when competing sellers are active in launching fresh actions to boost their market standing and business performance.** One indicator of active rivalry is lively price competition, a condition that puts pressure on industry members to drive costs out of the business and threatens the survival of high-cost companies. Another indicator of active rivalry is rapid introduction of next-generation products—when one or more rivals frequently introduce new or improved products, competitors that lack good product innovation capabilities feel considerable competitive heat to get their own new and improved products into the marketplace quickly. Other indicators of active rivalry among industry members include:
  - Whether industry members are racing to differentiate their products from rivals by offering better performance features or higher quality or improved customer service or a wider product selection.
  - How frequently rivals resort to such marketing tactics as special sales promotions, heavy advertising, rebates, or low-interest-rate financing to drum up additional sales.
  - How actively industry members are pursuing efforts to build stronger dealer networks or establish positions in foreign markets or otherwise expand their distribution capabilities and market presence.
  - How hard companies are striving to gain a market edge over rivals by developing valuable expertise and capabilities that rivals are hard pressed to match.

Normally, competitive jockeying among rival sellers is active and fairly intense because competing companies are highly motivated to launch whatever fresh actions and creative market maneuvers they can think of to try to strengthen their market positions and business performance.

- **Rivalry intensifies as the number of competitors increases and as competitors become more equal in size and capability.** Rivalry is not as vigorous in microprocessors for PCs, where Advanced Micro Devices (AMD) is one of the few...
challengers to Intel, as it is in fast-food restaurants, where numerous sellers are actively jockeying for buyer patronage. Up to a point, the greater the number of competitors, the greater the probability of fresh, creative strategic initiatives. In addition, when rivals are nearly equal in size and capability, they can usually compete on a fairly even footing, making it harder for one or two firms to win commanding market shares and confront weaker market challenges from rivals.

- Rivalry is usually stronger in slow-growing markets and weaker in fast-growing markets. Rapidly expanding buyer demand produces enough new business for
all industry members to grow. Indeed, in a fast-growing market, a company may find itself stretched just to keep abreast of incoming orders, let alone devote resources to stealing customers away from rivals. But in markets where growth is sluggish or where buyer demand drops off unexpectedly, expansion-minded firms and firms with excess capacity often are quick to cut prices and initiate other sales-increasing tactics, thereby igniting a battle for market share that can result in a shake-out of weak, inefficient firms.

- **Rivalry is usually weaker in industries comprised of so many rivals that the impact of any one company’s actions is spread thin across all industry members; likewise, it is often weak when there are fewer than five competitors.** A progressively larger number of competitors can actually begin to weaken head-to-head rivalry once an industry becomes populated with so many rivals that the impact of successful moves by any one company is spread thin across many industry members. To the extent that a company’s strategic moves ripple out to have little discernible impact on the businesses of its many rivals, then industry members soon learn that it is not imperative to respond every time one or another rival does something to enhance its market position—an outcome that weakens the intensity of head-to-head battles for market share. Rivalry also *tends* to be weak if an industry consists of just two or three or four sellers. In a market with few rivals, each competitor soon learns that aggressive moves to grow its sales and market share can have immediate adverse impact on rivals’ businesses, almost certainly provoking vigorous retaliation and risking an all-out battle for market share that is likely to lower the profits of all concerned. Companies that have a few strong rivals thus come to understand the merits of **restrained** efforts to wrest sales and market share from competitors as opposed to undertaking hard-hitting offensives that escalate into a profit-eroding arms-race or price war. However, some caution must be exercised in concluding that rivalry is weak just because there are only a few competitors. Thus, although occasional warfare can break out (the fierceness of the current battle between Red Hat and Microsoft and the decades-long war between Coca-Cola and Pepsi are prime examples), competition among the few normally produces a live-and-let-live approach to competing because rivals see the merits of restrained efforts to wrest sales and market share from competitors as opposed to undertaking hard-hitting offensives that escalate into a profit-eroding arms race or price war.

- **Rivalry increases when buyer demand falls off and sellers find themselves with excess capacity and/or inventory.** Excess supply conditions create a “buyers’ market,” putting added competitive pressure on industry rivals to scramble for profitable sales levels (often by price discounting).

- **Rivalry increases as it becomes less costly for buyers to switch brands.** The less expensive it is for buyers to switch their purchases from the seller of one brand to the seller of another brand, the easier it is for sellers to steal customers away from rivals. But the higher the costs buyers incur to switch brands, the less prone they are to brand switching. Even if consumers view one or more rival brands as more attractive, they may not be inclined to switch because of the added time and inconvenience or the psychological costs of abandoning a familiar brand. Distributors and retailers may not switch to the brands of rival manufacturers because they are hesitant to sever long-standing supplier relationships, incur any technical support costs or retraining expenses in making the switchover, go to the trouble of testing the quality and reliability of the rival brand, or devote resources to marketing the new brand (especially if the brand is lesser known).
Apple Computer, for example, has been unable to convince PC users to switch from Windows-based PCs because of the time burdens and inconvenience associated with learning Apple’s operating system and because so many Windows-based applications will not run on a MacIntosh due to operating system incompatibility. Consequently, unless buyers are dissatisfied with the brand they are presently purchasing, high switching costs can significantly weaken the rivalry among competing sellers.

- **Rivalry increases as the products of rival sellers become more standardized and diminishes as the products of industry rivals become more strongly differentiated.** When the offerings of rivals are identical or weakly differentiated, buyers have less reason to be brand-loyal—a condition that makes it easier for rivals to convince buyers to switch to their offering. And since the brands of different sellers have comparable attributes, buyers can shop the market for the best deal and switch brands at will. In contrast, strongly differentiated product offerings among rivals breed high brand loyalty on the part of buyers—because many buyers view the attributes of certain brands as better suited to their needs. Strong brand attachments make it tougher for sellers to draw customers away from rivals. Unless meaningful numbers of buyers are open to considering new or different product attributes being offered by rivals, the high degrees of brand loyalty that accompany strong product differentiation work against fierce rivalry among competing sellers.

- **Rivalry is more intense when industry conditions tempt competitors to use price cuts or other competitive weapons to boost unit volume.** When a product is perishable, seasonal, or costly to hold in inventory, competitive pressures build quickly any time one or more firms decide to cut prices and dump supplies on the market. Likewise, whenever fixed costs account for a large fraction of total cost, such that unit costs tend to be lowest at or near full capacity, then firms come under significant pressure to cut prices or otherwise try to boost sales whenever they are operating below full capacity. Unused capacity imposes a significant cost-increasing penalty because there are fewer units over which to spread fixed costs. The pressure of high fixed costs can push rival firms into price concessions, special discounts, rebates, low-interest-rate financing, and other volume-boosting tactics.

- **Rivalry increases when one or more competitors become dissatisfied with their market position and launch moves to bolster their standing at the expense of rivals.** Firms that are losing ground or in financial trouble often pursue aggressive (or perhaps desperate) turnaround strategies that can involve price discounts, more advertising, acquisition of or merger with other rivals, or new product introductions—such strategies can turn competitive pressures up a notch.

- **Rivalry becomes more volatile and unpredictable as the diversity of competitors increases in terms of visions, strategic intents, objectives, strategies, resources, and countries of origin.** A diverse group of sellers often contains one or more mavericks willing to try novel or high-risk or rule-breaking market approaches, thus generating a livelier and less predictable competitive environment. Globally competitive markets often contain rivals with different views about where the industry is headed and a willingness to employ perhaps radically different
competitive approaches. Attempts by cross-border rivals to gain stronger footholds in each other’s domestic markets usually boost the intensity of rivalry, especially when the aggressors have lower costs or products with more attractive features.

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

- **A powerful, successful competitive strategy employed by one company greatly intensifies the competitive pressures on its rivals to develop effective strategic responses or be relegated to also-ran status.**

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

**Competitive Pressures Associated with the Threat of New Entrants**

Several factors determine whether the threat of new companies entering the marketplace poses significant competitive pressure (see Figure 3.5). One factor relates to the size of the pool of likely entry candidates and the resources at their command. As a rule, the bigger the pool of entry candidates, the stronger the threat of potential entry. This is especially true when some of the likely entry candidates have ample resources and the potential to become formidable contenders for market leadership. Frequently, the strongest competitive pressures associated with potential entry come not from outsiders, but from current industry participants looking for growth opportunities. *Existing industry members are often strong candidates for entering market segments or geographic areas where they currently do not have a market presence.* Companies already well established in certain product categories or geographic areas often possess the resources, competencies, and competitive capabilities to hurdle the barriers of entering a different market segment or new geographic area.

A second factor concerns whether the likely entry candidates face high or low entry barriers. High barriers reduce the competitive threat of potential entry, while low barriers make entry more likely, especially if the industry is growing and offers attractive profit opportunities. The most widely encountered barriers that entry candidates must hurdle include:

- **The presence of sizable economies of scale in production or other areas of operation**—When incumbent companies enjoy cost advantages associated with
large-scale operation, outsiders must either enter on a large scale (a costly and perhaps risky move) or accept a cost disadvantage and consequently lower profitability. Trying to overcome the disadvantages of small size by entering on a large scale at the outset can result in long-term overcapacity problems for the new entrant (until sales volume builds up), and it can so threaten the market shares of existing firms that they launch strong defensive maneuvers (price cuts, increased advertising and sales promotion, and similar blocking actions) to maintain their positions and make things hard on a newcomer.

- Cost and resource disadvantages not related to scale of operation—Aside from enjoying economies of scale, there are other reasons why existing firms may have low unit costs that are hard to replicate by newcomers. Industry incumbents can have cost advantages that stem from learning/experience curve effects, the possession of key patents or proprietary technology, partnerships with the best and cheapest suppliers of raw materials and components, favorable locations, and low fixed costs (because they have older facilities that have been mostly depreciated).
• **Strong brand preferences and high degrees of customer loyalty**—The stronger the attachment of buyers to established brands, the harder it is for a newcomer to break into the marketplace. In such cases, a new entrant must have the financial resources to spend enough on advertising and sales promotion to overcome customer loyalties and build its own clientele. Establishing brand recognition and building customer loyalty can be a slow and costly process. In addition, if it is difficult or costly for a customer to switch to a new brand, a new entrant must persuade buyers that its brand is worth the switching costs. To overcome switching-cost barriers, new entrants may have to offer buyers a discounted price or an extra margin of quality or service. All this can mean lower expected profit margins for new entrants, which increases the risk to start-up companies dependent on sizable early profits to support their new investments.

• **High capital requirements**—The larger the total dollar investment needed to enter the market successfully, the more limited the pool of potential entrants. The most obvious capital requirements for new entrants relate to manufacturing facilities and equipment, introductory advertising and sales promotion campaigns, working capital to finance inventories and customer credit, and sufficient cash to cover start-up costs.

• **The difficulties of building a network of distributors or retailers and securing adequate space on retailers’ shelves**—A potential entrant can face numerous distribution channel challenges. Wholesale distributors may be reluctant to take on a product that lacks buyer recognition. Retailers have to be recruited and convinced to give a new brand ample display space and an adequate trial period. When existing sellers have strong, well-functioning distributor or retailer networks, a newcomer has an uphill struggle in squeezing its way in. Potential entrants sometimes have to “buy” their way into wholesale or retail channels by cutting their prices to provide dealers and distributors with higher markups and profit margins or by giving them big advertising and promotional allowances. As a consequence, a potential entrant’s own profits may be squeezed unless and until its product gains enough consumer acceptance that distributors and retailers are anxious to carry it.

• **Restrictive regulatory policies**—Government agencies can limit or even bar entry by requiring licenses and permits. Regulated industries like cable TV, telecommunications, electric and gas utilities, radio and television broadcasting, liquor retailing, and railroads entail government-controlled entry. In international markets, host governments commonly limit foreign entry and must approve all foreign investment applications. Stringent government-mandated safety regulations and environmental pollution standards are entry barriers because they raise entry costs.

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

• **The ability and inclination of industry incumbents to launch vigorous initiatives to block a newcomer’s successful entry**—Even if a potential entrant has or can acquire the needed competencies and resources to attempt entry, it must still worry about the reaction of existing firms. Sometimes, there’s little that incumbents can do to throw obstacles in an entrant’s path—for instance, existing restaurants have little in their arsenal to discourage a new restaurant from opening or to dissuade people from trying the new restaurant. But there
are times when incumbents do all they can to make it difficult for a new entrant, using price cuts, increased advertising, product improvements, and whatever else they can think of to prevent the entrant from building a clientele. Cable TV companies vigorously fight the entry of satellite TV companies; Sony and Nintendo have mounted strong defenses to thwart Microsoft’s entry in video games with its Xbox; existing hotels try to combat the opening of new hotels with loyalty programs, renovations of their own, the addition of new services, and so on. A potential entrant can have second thoughts when financially strong incumbent firms send clear signals that they will give newcomers a hard time.

Whether an industry’s entry barriers ought to be considered high or low depends on the resources and competencies possessed by the pool of potential entrants. Companies with sizable financial resources, proven competitive capabilities, and a respected brand name may be able to hurdle an industry’s entry barriers rather easily. Small start-up enterprises may find the same entry barriers insurmountable. Thus, how hard it will be for potential entrants to compete on a level playing field is always relative to the financial resources and competitive capabilities of likely entrants. For example, when Honda opted to enter the U.S. lawn-mower market in competition against Toro, Snapper, Craftsman, John Deere, and others, it was easily able to hurdle entry barriers that would have been formidable to other newcomers because it had long-standing expertise in gasoline engines and because its well-known reputation for quality and durability gave it instant credibility with shoppers looking to buy a new lawn mower. Honda had to spend relatively little on advertising to attract buyers and gain a market foothold, distributors and dealers were quite willing to handle the Honda lawn-mower line, and Honda had ample capital to build a U.S. assembly plant.

In evaluating whether the threat of additional entry is strong or weak, company managers must look at (1) how formidable the entry barriers are for each type of potential entrant—start-up enterprises, specific candidate companies in other industries, and current industry participants looking to expand their market reach—and (2) how attractive the growth and profit prospects are for new entrants. Rapidly growing market demand and high potential profits act as magnets, motivating potential entrants to commit the resources needed to hurdle entry barriers. When profits are sufficiently attractive, entry barriers are unlikely to be an effective entry deterrent. At most, they limit the pool of candidate entrants to enterprises with the requisite competencies and resources and with the creativity to fashion a strategy for competing with incumbent firms.

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

One additional point: The threat of entry changes as the industry’s prospects grow brighter or dimmer and as entry barriers rise or fall. For example, in the pharmaceutical industry the expiration of a key patent on a widely prescribed drug virtually guarantees that one or more drug makers will enter with generic offerings of their own. Growing use of the Internet for shopping is making it much easier for Web-based retailers to enter into competition with traditional retailers. High entry barriers and weak entry threats today do not always translate into high entry barriers and weak entry threats tomorrow.
against such well-known retail chains as Sears, Circuit City, and Barnes and Noble. In international markets, entry barriers for foreign-based firms fall as tariffs are lowered, as host governments open up their domestic markets to outsiders, as domestic wholesalers and dealers seek out lower-cost foreign-made goods, and as domestic buyers become more willing to purchase foreign brands.

**Competitive Pressures from the Sellers of Substitute Products**

Companies in one industry come under competitive pressure from the actions of companies in a closely adjoining industry whenever buyers view the products of the two industries as good substitutes. For instance, the producers of sugar experience competitive pressures from the sales and marketing efforts of the makers of artificial sweeteners. Similarly, the producers of eyeglasses and contact lenses are currently facing mounting competitive pressures from growing consumer interest in corrective laser surgery. Newspapers are feeling the competitive force of the general public turning to cable news channels for late-breaking news and using Internet sources to get information about sports results, stock quotes, and job opportunities. The makers of videotapes and VCRs have watched demand evaporate as more and more consumers have been attracted to substitute use of DVDs and DVD recorders/players. Traditional providers of telephone service like BellSouth, AT&T, Verizon, and Qwest are feeling enormous competitive pressure from cell phone providers, as more and more consumers find cell phones preferable to landline phones.

Just how strong the competitive pressures are from the sellers of substitute products depends on three factors:

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

2. **Whether buyers view the substitutes as being comparable or better in terms of quality, performance, and other relevant attributes.** The availability of substitutes inevitably invites customers to compare performance, features, ease of use, and other attributes as well as price. For example, ski boat manufacturers are experiencing strong competition from personal water-ski craft because water sports enthusiasts see personal water skis as fun to ride and less expensive. The users of paper cartons constantly weigh the performance trade-offs with plastic containers and metal cans. Camera users consider the convenience and performance trade-offs when deciding whether to substitute a digital camera for a film-based camera. Competition from good-performing substitutes unleashes competitive pressures on industry participants to incorporate new performance features and attributes that makes their product offerings more competitive.

3. **Whether the costs that buyers incur in switching to the substitutes are high or low.** High switching costs deter switching to substitutes, while low switching costs make it easier for the sellers of attractive substitutes to lure buyers to their offering. Typical switching costs include the time and inconvenience that may be involved, the costs of additional equipment, the time and cost in testing the quality
and reliability of the substitute, the psychological costs of severing old supplier relationships and establishing new ones, payments for technical help in making the changeover, and employee retraining costs. High switching costs can materially weaken the competitive pressures that industry members experience from substitutes unless the sellers of substitutes are successful in offsetting the high switching costs with enticing price discounts or additional performance enhancements.

Figure 3.6 summarizes the conditions that determine whether the competitive pressures from substitute products are strong, moderate, or weak.

As a rule, the lower the price of substitutes, the higher their quality and performance, and the lower the user’s switching costs, the more intense the competitive pressures posed by substitute products. Other market indicators of the competitive strength of substitute products include (1) whether the sales of substitutes are growing faster than the sales of the industry being analyzed (a sign that the sellers of substitutes may be drawing customers away from the industry in question), (2) whether the producers of substitutes are moving to add new capacity, and (3) whether the profits of the producers of substitutes are on the rise.
Competitive Pressures Stemming from Supplier Bargaining Power and Supplier–Seller Collaboration

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

How Supplier Bargaining Power Can Create Competitive Pressures

Whenever the major suppliers to an industry have considerable leverage in determining the terms and conditions of the item they are supplying, then they are in a position to exert competitive pressure on one or more rival sellers. For instance, Microsoft and Intel, both of which supply personal computer (PC) makers with products that most PC users consider essential, are known for using their dominant market status not only to charge PC makers premium prices but also to leverage PC makers in other ways. Microsoft pressures PC makers to load only Microsoft products on the PCs they ship and to position the icons for Microsoft software prominently on the screens of new computers that come with factory-loaded software. Intel pushes greater use of Intel microprocessors in PCs by granting PC makers sizable advertising allowances on PC models equipped with “Intel Inside” stickers; it also tends to give PC makers that use the biggest percentages of Intel chips in their PC models top priority in filling orders for newly introduced Intel chips. Being on Intel’s list of preferred customers helps a PC maker get an allocation of the first production runs of Intel’s latest and greatest chips and thus get new PC models equipped with these chips to market ahead of rivals who are heavier users of chips made by Intel’s rivals. The ability of Microsoft and Intel to pressure PC makers for preferential treatment of one kind or another in turn affects competition among rival PC makers.

Several other instances of supplier bargaining power are worth citing. Small-scale retailers must often contend with the power of manufacturers whose products enjoy prestigious and well-respected brand names; when a manufacturer knows that a retailer needs to stock the manufacturer’s product because consumers expect to find the product on the shelves of retail stores where they shop, the manufacturer usually has some degree of pricing power and can also push hard for favorable shelf displays. Motor vehicle manufacturers typically exert considerable power over the terms and conditions with which they supply new vehicles to their independent automobile dealerships. The operators of franchised units of such chains as McDonald’s, Dunkin’ Donuts, Pizza Hut, Sylvan Learning Centers, and Hampton Inns must frequently agree not only to source some of their supplies from the franchisor at prices and terms favorable to that franchisor but also to operate their facilities in a manner largely dictated by the franchisor.

Strong supplier bargaining power is a competitive factor in industries where unions have been able to organize the workforces of some industry members but not others; those industry members that must negotiate wages, fringe benefits, and working conditions with powerful unions (which control the supply of labor) often find themselves with higher labor costs than their competitors with nonunion labor forces. The bigger the gap between union and nonunion labor costs in an industry, the more that unionized industry members must scramble to find ways to relieve the competitive pressure associated with their disadvantage on labor costs. High labor costs are proving a huge competitive liability to unionized supermarket chains like Kroger and Safeway in trying to combat the market share gains being made by Wal-Mart in supermarket retailing—Wal-Mart has a nonunion workforce, and the prices for supermarket items
at its Supercenters tend to run 5 to 20 percent lower than those at unionized supermarket chains.

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

- **Whether the item being supplied is a commodity that is readily available from many suppliers at the going market price.** Suppliers have little or no bargaining power or leverage whenever industry members have the ability to source their requirements at competitive prices from any of several alternative and eager suppliers, perhaps dividing their purchases among two or more suppliers to promote lively competition for orders. The suppliers of commodity items have market power only when supplies become quite tight and industry members are so eager to secure what they need that they agree to terms more favorable to suppliers.

- **Whether a few large suppliers are the primary sources of a particular item.** The leading suppliers may well have pricing leverage unless they are plagued with excess capacity and are scrambling to secure additional orders for their products. Major suppliers with good reputations and strong demand for the items they supply are harder to wring concessions from than struggling suppliers striving to broaden their customer base or more fully utilize their production capacity.

- **Whether it is difficult or costly for industry members to switch their purchases from one supplier to another or to switch to attractive substitute inputs.** High switching costs signal strong bargaining power on the part of suppliers, whereas low switching costs and ready availability of good substitute inputs signal weak bargaining power. Soft-drink bottlers, for example, can counter the bargaining power of aluminum can suppliers by shifting or threatening to shift to greater use of plastic containers and introducing more attractive plastic container designs.

- **Whether certain needed inputs are in short supply.** Suppliers of items in short supply have some degree of pricing power, whereas a surge in the availability of particular items greatly weakens supplier pricing power and bargaining leverage.

- **Whether certain suppliers provide a differentiated input that enhances the performance or quality of the industry’s product.** The more valuable that a particular input is in terms of enhancing the performance or quality of the products of industry members or of improving the efficiency of their production processes, the more bargaining leverage its suppliers are likely to possess.

- **Whether certain suppliers provide equipment or services that deliver valuable cost-saving efficiencies to industry members in operating their production processes.** Suppliers who provide cost-saving equipment or other valuable or necessary production-related services are likely to possess bargaining leverage. Industry members that do not source from such suppliers may find themselves at a cost disadvantage and thus under competitive pressure to do so (on terms that are favorable to the suppliers).

- **Whether suppliers provide an item that accounts for a sizable fraction of the costs of the industry’s product.** The bigger the cost of a particular part or component, the more opportunity for the pattern of competition in the marketplace to be affected by the actions of suppliers to raise or lower their prices.

- **Whether industry members are major customers of suppliers.** As a rule, suppliers have less bargaining leverage when their sales to members of this one industry constitute a big percentage of their total sales. In such cases, the well-being of suppliers is closely tied to the well-being of their major customers.
Suppliers then have a big incentive to protect and enhance their customers’ competitiveness via reasonable prices, exceptional quality, and ongoing advances in the technology of the items supplied.

- Whether it makes good economic sense for industry members to integrate backward and self-manufacture items they have been buying from suppliers. The make-or-buy issue generally boils down to whether suppliers who specialize in the production of a particular part or component and make them in volume for many different customers have the expertise and scale economies to supply as good or better component at a lower cost than industry members could achieve via self-manufacture. Frequently, it is difficult for industry members to self-manufacture parts and components more economically than they can obtain them from suppliers who specialize in making such items. For instance, most producers of outdoor power equipment (lawn mowers, rotary tillers, leaf blowers, etc.) find it cheaper to source the small engines they need from outside manufacturers who specialize in small-engine manufacture rather than make their own engines because the quantity of engines they need is too small to justify the investment in manufacturing facilities, master the production process, and capture scale economies. Specialists in small-engine manufacture, by supplying many kinds of engines to the whole power equipment industry, can obtain a big enough sales volume to fully realize scale economies, become proficient in all the manufacturing techniques, and keep costs low. As a rule, suppliers are safe from the threat of self-manufacture by their customers until the volume of parts a customer needs becomes large enough for the customer to justify backward integration into self-manufacture of the component. Suppliers also gain bargaining power when they have the resources and profit incentive to integrate forward into the business of the customers they are supplying and thus become a strong rival.

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

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

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

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

**Competitive Pressures Stemming from Buyer Bargaining Power and Seller–Buyer Collaboration**

Whether seller–buyer relationships represent a weak or strong competitive force depends on (1) whether some or many buyers have sufficient bargaining leverage to obtain price concessions and other favorable terms and conditions of sale, and (2) the extent and competitive importance of seller–buyer strategic partnerships in the industry.
How Buyer Bargaining Power Can Create Competitive Pressures  As with suppliers, the leverage that certain types of buyers have in negotiating favorable terms can range from weak to strong. Individual consumers, for example, rarely have much bargaining power in negotiating price concessions or other favorable terms with sellers; the primary exceptions involve situations in which price haggling is customary, such as the purchase of new and used motor vehicles, homes, and certain big-ticket items like luxury watches, jewelry, and pleasure boats. For most consumer goods and services, individual buyers have no bargaining leverage—their option is to pay the seller’s posted price or take their business elsewhere.

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

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

- **If buyers’ costs of switching to competing brands or substitutes are relatively low**—Buyers who can readily switch brands or source from several sellers have more negotiating leverage than buyers who have high switching costs. When the products of rival sellers are virtually identical, it is relatively easy for buyers to switch from seller to seller at little or no cost and anxious sellers may be willing to make concessions to win or retain a buyer’s business.

- **If the number of buyers is small or if a customer is particularly important to a seller**—The smaller the number of buyers, the less easy it is for sellers to find alternative buyers when a customer is lost to a competitor. The prospect of losing a customer not easily replaced often makes a seller more willing to grant concessions of one kind or another.

- **If buyer demand is weak and sellers are scrambling to secure additional sales of their products**—Weak or declining demand creates a “buyers’ market”; conversely, strong or rapidly growing demand creates a “sellers’ market” and shifts bargaining power to sellers.

- **If buyers are well informed about sellers’ products, prices, and costs**—The more information buyers have, the better bargaining position they are in. The mushrooming availability of product information on the Internet is giving added bargaining power to individuals. Buyers can easily use the Internet to compare prices and features of vacation packages, shop for the best interest rates on mortgages and loans, and find the best prices on big-ticket items such as digital
cameras. Bargain-hunting individuals can shop around for the best deal on the Internet and use that information to negotiate a better deal from local retailers; this method is becoming commonplace in buying new and used motor vehicles. Further, the Internet has created opportunities for manufacturers, wholesalers, retailers, and sometimes individuals to join online buying groups to pool their purchasing power and approach vendors for better terms than could be gotten individually. A multinational manufacturer’s geographically scattered purchasing groups can use Internet technology to pool their orders with parts and components suppliers and bargain for volume discounts. Purchasing agents at some companies are banding together at third-party Web sites to pool corporate purchases to get better deals or special treatment.

- **If buyers pose a credible threat of integrating backward into the business of sellers**—Companies like Anheuser-Busch, Coors, and Heinz have integrated backward into metal can manufacturing to gain bargaining power in obtaining the balance of their can requirements from otherwise powerful metal can manufacturers. Retailers gain bargaining power by stocking and promoting their own private-label brands alongside manufacturers’ name brands. Wal-Mart, for example, has elected to compete against Procter & Gamble (P&G), its biggest supplier, with its own brand of laundry detergent, called Sam’s American Choice, which is priced 25 to 30 percent lower than P&G’s Tide.

- **If buyers have discretion in whether and when they purchase the product**—Many consumers, if they are unhappy with the present deals offered on major appliances or hot tubs or home entertainment centers, may be in a position to delay purchase until prices and financing terms improve. If business customers are not happy with the prices or security features of bill-payment software systems, they can either delay purchase until next-generation products become available or attempt to develop their own software in-house. If college students believe that the prices of new textbooks are too high, they can purchase used copies.

Figure 3.8 highlights the factors causing buyer bargaining power to be strong or weak.

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

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

**Is the Collective Strength of the Five Competitive Forces Conducive to Good Profitability?**

Scrutinizing each of the five competitive forces one by one provides a powerful diagnosis of what competition is like in a given market. Once the strategist has gained an understanding of the specific competitive pressures comprising each force and determined whether these pressures constitute a strong, moderate, or weak competitive
The stronger the forces of competition, the harder it becomes for industry members to earn attractive profits.

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

1. Pursuing avenues that shield the firm from as many of the different competitive pressures as possible.

2. Initiating actions calculated to produce sustainable competitive advantage, thereby shifting competition in the company’s favor, putting added competitive pressure on rivals, and perhaps even defining the business model for the industry.
Part 1 Concepts and Techniques for Crafting and Executing Strategy

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

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

An industry’s present conditions don’t necessarily reveal much about the strategically relevant ways in which the industry environment is changing. All industries are characterized by trends and new developments that gradually or speedily produce changes important enough to require a strategic response from participating firms. A popular hypothesis states that industries go through a life cycle of takeoff, rapid growth, early maturity and slowing growth, market saturation, and stagnation or decline. This hypothesis helps explain industry change—but it is far from complete. There are more causes of industry change than an industry’s normal progression through the life cycle—these need to be identified and their impacts understood.

**The Concept of Driving Forces**

While it is important to track where an industry is in the life cycle, there’s more analytical value in identifying the other factors that may be even stronger drivers of industry and competitive change. The point to be made here is that industry and competitive conditions change because forces are enticing or pressuring certain industry participants (competitors, customers, suppliers) to alter their actions in important ways. The most powerful of the change agents are called *driving forces* because they have the biggest influences in reshaping the industry landscape and altering competitive conditions. Some driving forces originate in the outer ring of the company’s macroenvironment (see Figure 3.2), but most originate in the company’s more immediate industry and competitive environment.

Driving-forces analysis has three steps: (1) identifying what the driving forces are; (2) assessing whether the drivers of change are, on the whole, acting to make the industry more or less attractive; and (3) determining what strategy changes are needed to prepare for the impacts of the driving forces. All three steps merit further discussion.

**Identifying an Industry’s Driving Forces**

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

- **Emerging new Internet capabilities and applications**—Since the late 1990s, the Internet has woven its way into everyday business operations and the social fabric of life all across the world. Mushrooming Internet use, growing acceptance of Internet shopping, the emergence of high-speed Internet service and Voice over Internet Protocol (VoIP) technology, and an ever-growing series of Internet...
applications and capabilities have been major drivers of change in industry after industry. Companies are increasingly using online technology (1) to collaborate closely with suppliers and streamline their supply chains and (2) to revamp internal operations and squeeze out cost savings. Manufacturers can use their Web sites to access customers directly rather than distribute exclusively through traditional wholesale and retail channels. Businesses of all types can use Web stores to extend their geographic reach and vie for sales in areas where they formerly did not have a presence. The ability of companies to reach consumers via the Internet increases the number of rivals a company faces and often escalates rivalry by pitting pure online sellers against combination brick-and-click sellers against pure brick-and-mortar sellers. The Internet gives buyers unprecedented ability to research the product offerings of competitors and shop the market for the best value. Mounting ability of consumers to download music from the Internet via either file sharing or online music retailers has profoundly and reshaped the music industry and the business of traditional brick-and-mortar music retailers. Widespread use of e-mail has forever eroded the business of providing fax services and the first-class mail delivery revenues of government postal services worldwide. Videoconferencing via the Internet can erode the demand for business travel. Online course offerings at universities have the potential to revolutionize higher education. The Internet of the future will feature faster speeds, dazzling applications, and over a billion connected gadgets performing an array of functions, thus driving further industry and competitive changes. But Internet-related impacts vary from industry to industry. The challenges here are to assess precisely how emerging Internet developments are altering a particular industry’s landscape and to factor these impacts into the strategy-making equation.

- **Increasing globalization**—Competition begins to shift from primarily a regional or national focus to an international or global focus when industry members begin seeking out customers in foreign markets or when production activities begin to migrate to countries where costs are lowest. Globalization of competition really starts to take hold when one or more ambitious companies precipitate a race for worldwide market leadership by launching initiatives to expand into more and more country markets. Globalization can also be precipitated by the blossoming of consumer demand in more and more countries and by the actions of government officials in many countries to reduce trade barriers or open up once-closed markets to foreign competitors, as is occurring in many parts of Europe, Latin America, and Asia. Significant differences in labor costs among countries give manufacturers a strong incentive to locate plants for labor-intensive products in low-wage countries and use these plants to supply market demand across the world. Wages in China, India, Singapore, Mexico, and Brazil, for example, are about one-fourth those in the United States, Germany, and Japan. The forces of globalization are sometimes such a strong driver that companies find it highly advantageous, if not necessary, to spread their operating reach into more and more country markets. Globalization is very much a driver of industry change in such industries as credit cards, cell phones, digital cameras, golf and ski equipment, motor vehicles, steel, petroleum, personal computers, video games, public accounting, and textbook publishing.

- **Changes in an industry’s long-term growth rate**—Shifts in industry growth up or down are a driving force for industry change, affecting the balance between
industry supply and buyer demand, entry and exit, and the character and strength of competition. An upsurge in buyer demand triggers a race among established firms and newcomers to capture the new sales opportunities; ambitious companies with trailing market shares may see the upturn in demand as a golden opportunity to launch offensive strategies to broaden their customer base and move up several notches in the industry standings. A slowdown in the rate at which demand is growing nearly always portends mounting rivalry and increased efforts by some firms to maintain their high rates of growth by taking sales and market share away from rivals. If industry sales suddenly turn flat or begin to shrink after years of rising at double-digit levels, competition is certain to intensify as industry members scramble for the available business and as mergers and acquisitions result in industry consolidation to a smaller number of competitively stronger participants. Stagnating sales usually prompt both competitively weak and growth-oriented companies to sell their business operations to those industry members who elect to stick it out; as demand for the industry’s product continues to shrink, the remaining industry members may be forced to close inefficient plants and retrench to a smaller production base—all of which results in a much-changed competitive landscape.

- Changes in who buys the product and how they use it—Shifts in buyer demographics and new ways of using the product can alter the state of competition by opening the way to market an industry’s product through a different mix of dealers and retail outlets; prompting producers to broaden or narrow their product lines; bringing different sales and promotion approaches into play; and forcing adjustments in customer service offerings (credit, technical assistance, maintenance, and repair). The mushrooming popularity of downloading music from the Internet, storing music files on PC hard drives, and burning custom discs has forced recording companies to reexamine their distribution strategies and raised questions about the future of traditional retail music stores; at the same time, it has stimulated sales of disc burners and blank discs. Longer life expectancies and growing percentages of relatively well-to-do retirees are driving changes in such industries as health care, prescription drugs, recreational living, and vacation travel. The growing percentage of households with PCs and Internet access is opening opportunities for banks to expand their electronic bill-payment services and for retailers to move more of their customer services online.

- Product innovation—Competition in an industry is always affected by rivals racing to be first to introduce one new product or product enhancement after another. An ongoing stream of product innovations tends to alter the pattern of competition in an industry by attracting more first-time buyers, rejuvenating industry growth, and/or creating wider or narrower product differentiation among rival sellers. Successful new product introductions strengthen the market positions of the innovating companies, usually at the expense of companies that stick with their old products or are slow to follow with their own versions of the new product. Product innovation has been a key driving force in such industries as digital cameras, golf clubs, video games, toys, and prescription drugs.

- Technological change and manufacturing process innovation—Advances in technology can dramatically alter an industry’s landscape, making it possible to produce new and better products at lower cost and opening up whole new industry frontiers. For instance, Voice over Internet Protocol (VoIP) technology has spawned low-cost, Internet-based phone networks that are stealing large
numbers of customers away from traditional telephone companies worldwide (whose higher cost technology depends on hardwired connections via overhead and underground telephone lines). Flat-screen technology for PC monitors is killing the demand for conventional cathode ray tube (CRT) monitors. Liquid crystal display (LCD), plasma screen technology, and high-definition technology are precipitating a revolution in the television industry and driving use of cathode ray technology (CRT) into the background. MP3 technology is transforming how people listen to music. Digital technology is driving huge changes in the camera and film industries. Satellite radio technology is allowing satellite radio companies with their largely commercial-free programming to draw millions of listeners away from traditional radio stations whose revenue streams from commercials are dependent on audience size. Technological developments can also produce competitively significant changes in capital requirements, minimum efficient plant sizes, distribution channels and logistics, and learning/experience curve effects. In the steel industry, ongoing advances in electric arc minimill technology (which involve recycling scrap steel to make new products) have allowed steelmakers with state-of-the-art minimills to gradually expand into the production of more and more steel products, steadily taking sales and market share from higher-cost integrated producers (which make steel from scratch using iron ore, coke, and traditional blast furnace technology). Nucor Corporation, the leader of the minimill technology revolution in the United States, began operations in 1970 and has ridden the wave of technological advances in minimill technology to become the biggest U.S. steel producer (as of 2004) and ranks among the lowest-cost producers in the world. In a space of 30 years, advances in minimill technology have changed the face of the steel industry worldwide.

- **Marketing innovation**—When firms are successful in introducing new ways to *market* their products, they can spark a burst of buyer interest, widen industry demand, increase product differentiation, and lower unit costs—any or all of which can alter the competitive positions of rival firms and force strategy revisions. Online marketing is shaking up competition in electronics (where there are dozens of online electronics retailers, often with deep-discount prices) and office supplies (where Office Depot, Staples, and Office Max are using their Web sites to market office supplies to corporations, small businesses, schools and universities, and government agencies). Increasing numbers of music artists are marketing their recordings at their own Web sites rather than entering into contracts with recording studios that distribute through online and brick-and-mortar music retailers.

- **Entry or exit of major firms**—The entry of one or more foreign companies into a geographic market once dominated by domestic firms nearly always shakes up competitive conditions. Likewise, when an established domestic firm from another industry attempts entry either by acquisition or by launching its own start-up venture, it usually applies its skills and resources in some innovative fashion that pushes competition in new directions. Entry by a major firm thus often produces a new ball game, not only with new key players but also with new rules for competing. Similarly, exit of a major firm changes the competitive structure by reducing the number of market leaders (perhaps increasing the dominance of the leaders who remain) and causing a rush to capture the exiting firm’s customers.
Diffusion of technical know-how across more companies and more countries—As knowledge about how to perform a particular activity or execute a particular manufacturing technology spreads, the competitive advantage held by firms originally possessing this know-how erodes. Knowledge diffusion can occur through scientific journals, trade publications, on-site plant tours, word of mouth among suppliers and customers, employee migration, and Internet sources. It can also occur when those possessing technological knowledge license others to use that knowledge for a royalty fee or team up with a company interested in turning the technology into a new business venture. Quite often, technological know-how can be acquired by simply buying a company that has the wanted skills, patents, or manufacturing capabilities. In recent years, rapid technology transfer across national boundaries has been a prime factor in causing industries to become more globally competitive. As companies worldwide gain access to valuable technical know-how, they upgrade their manufacturing capabilities in a long-term effort to compete head-on with established companies. Cross-border technology transfer has made the once domestic industries of automobiles, tires, consumer electronics, telecommunications, computers, and others increasingly global.

Changes in cost and efficiency—Widening or shrinking differences in the costs among key competitors tend to dramatically alter the state of competition. The low cost of fax and e-mail transmission has put mounting competitive pressure on the relatively inefficient and high-cost operations of the U.S. Postal Service—sending a one-page fax is cheaper and far quicker than sending a first-class letter; sending e-mail is faster and cheaper still. In the steel industry, the lower costs of companies using electric-arc furnaces to recycle scrap steel into new steel products has forced traditional manufacturers that produce steel from iron ore using blast furnace technology to overhaul their plants and to withdraw totally from making those steel products where they could no longer be cost competitive. Shrinking cost differences in producing multifeatured mobile phones is turning the mobile phone market into a commodity business and causing more buyers to base their purchase decisions on price.

Growing buyer preferences for differentiated products instead of a commodity product (or for a more standardized product instead of strongly differentiated products)—When buyer tastes and preferences start to diverge, sellers can win a loyal following with product offerings that stand apart from those of rival sellers. In recent years, beer drinkers have grown less loyal to a single brand and have begun to drink a variety of domestic and foreign beers; as a consequence, beer manufacturers have introduced a host of new brands and malt beverages with different tastes and flavors. Buyer preferences for motor vehicles are becoming increasingly diverse, with few models generating sales of more than 250,000 units annually. When a shift from standardized to differentiated products occurs, the driver of change is the contest among rivals to cleverly outdifferentiate one another.

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

- **Reductions in uncertainty and business risk**—An emerging industry is typically characterized by much uncertainty over potential market size, how much time and money will be needed to surmount technological problems, and what distribution channels and buyer segments to emphasize. Emerging industries tend to attract only risk-taking entrepreneurial companies. Over time, however, if the business model of industry pioneers proves profitable and market demand for the product appears durable, more conservative firms are usually enticed to enter the market. Often, these later entrants are large, financially strong firms looking to invest in attractive growth industries.

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

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

- **Changing societal concerns, attitudes, and lifestyles**—Emerging social issues and changing attitudes and lifestyles can be powerful instigators of industry change. Growing antismoking sentiment has emerged as a major driver of change in the tobacco industry; concerns about terrorism are having a big impact on the travel industry. Consumer concerns about salt, sugar, chemical additives, saturated fat, cholesterol, carbohydrates, and nutritional value have forced food producers to revamp food-processing techniques, redirect R&D efforts into the use of healthier ingredients, and compete in developing nutritious, good-tasting products. Safety concerns have driven product design changes in the automobile, toy, and outdoor power equipment industries, to mention a few. Increased interest in physical fitness has spawned new industries in exercise equipment, biking, outdoor apparel, sports gyms and recreation centers, vitamin and nutrition supplements, and medically supervised diet programs. Social concerns about air and water pollution have forced industries to incorporate expenditures for controlling pollution into their cost structures. Shifting societal concerns, attitudes, and lifestyles alter the pattern of competition, usually favoring those
players that respond quickly and creatively with products targeted to the new trends and conditions. As with the preceding driving force, this driving force springs from factors at work in a company’s macroenvironment.

Table 3.2 lists these 14 most common driving forces.

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

### Assessing the Impact of the Driving Forces

Just identifying the driving forces is not sufficient, however. The second, and more important, step in driving-forces analysis is to determine whether the prevailing driving forces are, on the whole, acting to make the industry environment more or less attractive. Answers to three questions are needed here:

1. Are the driving forces collectively acting to cause demand for the industry’s product to increase or decrease?
2. Are the driving forces acting to make competition more or less intense?
3. Will the combined impacts of the driving forces lead to higher or lower industry profitability?

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

**Developing a Strategy That Takes the Impacts of the Driving Forces into Account**

The third step of driving-forces analysis—where the real payoff for strategy making comes—is for managers to draw some conclusions about what strategy adjustments will be needed to deal with the impacts of the driving forces. The real value of doing driving-forces analysis is to gain better understanding of what strategy adjustments will be needed to cope with the drivers of industry change and the impacts they are likely to have on market demand, competitive intensity, and industry profitability. In short, the strategy-making challenge that flows from driving-forces analysis is what to do to prepare for the industry and competitive changes being wrought by the driving forces. Indeed, without understanding the forces driving industry change and the impacts these forces will have on the character of the industry environment and on the company’s business over the next one to three years, managers are ill-prepared to craft a strategy tightly matched to emerging conditions. Similarly, if managers are uncertain about the implications of one or more driving forces, or if their views are incomplete or off base, it’s difficult for them to craft a strategy that is responsive to the driving forces and their consequences for the industry. So driving-forces analysis is not something to take lightly; it has practical value and is basic to the task of thinking strategically about where the industry is headed and how to prepare for the changes ahead.

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

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

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

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

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

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

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

**What Can Be Learned from Strategic Group Maps?**

Strategic group maps are revealing in several respects. The most important has to do with which rivals are similarly positioned and are thus close rivals and which are distant rivals. Generally speaking, the closer strategic groups are to each other on the
map, the stronger the cross-group competitive rivalry tends to be. Although firms in the same strategic group are the closest rivals, the next closest rivals are in the immediately adjacent groups. Often, firms in strategic groups that are far apart on the map hardly compete at all. For instance, Wal-Mart’s clientele, merchandise selection, and pricing points are much too different to justify calling them close competitors of Neiman Marcus or Saks Fifth Avenue in retailing. For the same reason, Timex is not a meaningful competitive rival of Rolex, and Subaru is not a close competitor of Lincoln or Mercedes-Benz.

The second thing to be gleaned from strategic group mapping is that not all positions on the map are equally attractive. Two reasons account for why some positions can be more attractive than others:

1. **Prevailing competitive pressures and industry driving forces favor some strategic groups and hurt others.** Discerning which strategic groups are advantaged and disadvantaged requires scrutinizing the map in light of what has also been learned from the prior analysis of competitive forces and driving forces. Quite often the strength of competition varies from group to group—there’s little reason to believe that all firms in an industry feel the same degrees of competitive pressure, since their strategies and market positions may well differ in important respects. For instance, the competitive battle among Wal-Mart, Target, and Sears/Kmart (Kmart acquired Sears in 2005) is more intense (with consequently smaller profit margins) than the rivalry among Gucci, Chanel, Fendi, and other high-end fashion retailers. Likewise, industry driving forces may be acting to grow the demand for the products of firms in some strategic groups and shrink the demand for the products of firms in other strategic groups—as is the case in the radio broadcasting industry where satellite radio firms like XM and Sirius stand to gain market ground at the expense of commercial-based radio broadcasters due to the impacts of such driving forces as technological advances in satellite broadcasting, growing buyer preferences for more diverse radio programming, and product innovation in satellite radio devices. Firms in strategic groups that are being adversely impacted by intense competitive pressures or driving forces may try to shift to a more favorably situated group. But shifting to a different position on the map can prove difficult when entry barriers for the target strategic group are high. Moreover, attempts to enter a new strategic group nearly always increase competitive pressures in the target strategic group. If certain firms are known to be trying to change their competitive positions on the map, then attaching arrows to the circles showing the targeted direction helps clarify the picture of competitive maneuvering among rivals.

2. **The profit potential of different strategic groups varies due to the strengths and weaknesses in each group’s market position.** The profit prospects of firms in different strategic groups can vary from good to ho-hum to poor because of differing growth rates for the principal buyer segments served by each group, differing degrees of competitive rivalry within strategic groups, differing degrees of exposure to competition from substitute products outside the industry, and differing degrees of supplier or customer bargaining power from group to group.

Thus, part of strategic group map analysis always entails drawing conclusions about where on the map is the “best” place to be and why. Which companies/strategic groups are destined to prosper because of their positions? Which companies/strategic groups seem destined to struggle because of their positions? What accounts for why some parts of the map are better than others?
Unless a company pays attention to what competitors are doing and knows their strengths and weaknesses, it ends up flying blind into competitive battle. As in sports, scouting the opposition is essential. Competitive intelligence about rivals’ strategies, their latest actions and announcements, their resource strengths and weaknesses, the efforts being made to improve their situation, and the thinking and leadership styles of their executives is valuable for predicting or anticipating the strategic moves competitors are likely to make next in the marketplace. Having good information to predict the strategic direction and likely moves of key competitors allows a company to prepare defensive countermoves, to craft its own strategic moves with some confidence about what market maneuvers to expect from rivals, and to exploit any openings that arise from competitors’ missteps or strategy flaws.

**Identifying Competitors’ Strategies and Resource Strengths and Weaknesses**

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

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

In sizing up competitors, it makes sense for company strategists to make three assessments:

1. Which competitor has the best strategy? Which competitors appear to have flawed or weak strategies?
Part 1 Concepts and Techniques for Crafting and Executing Strategy

2. Which competitors are poised to gain market share, and which ones seem destined to lose ground?

3. Which competitors are likely to rank among the industry leaders five years from now? Do one or more up-and-coming competitors have powerful strategies and sufficient resource capabilities to overtake the current industry leader?

The industry’s current major players are generally easy to identify, but some of the leaders may be plagued with weaknesses that are causing them to lose ground; other notable rivals may lack the resources and capabilities to remain strong contenders given the superior strategies and capabilities of up-and-coming companies. In evaluating which competitors are favorably or unfavorably positioned to gain market ground, company strategists need to focus on why there is potential for some rivals to do better or worse than other rivals. Usually, a competitor’s prospects are a function of whether it is in a strategic group that is being favored or hurt by competitive pressures and driving forces, whether its strategy has resulted in competitive advantage or disadvantage, and whether its resources and capabilities are well suited for competing on the road ahead.

**Predicting Competitors’ Next Moves**

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

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

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

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

Managers who fail to study competitors closely risk being caught napping when rivals make fresh and perhaps bold strategic moves.

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

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

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

An industry’s key success factors can usually be deduced from what was learned from the previously described analysis of the industry and competitive environment. Which factors are most important to future competitive success flow directly from the industry’s dominant characteristics, what competition is like, the impacts of the driving forces, the comparative market positions of industry members, and the likely

Core Concept

Key success factors are the product attributes, competencies, competitive capabilities, and market achievements with the greatest impact on future competitive success in the marketplace.
### Table 3.3  Common Types of Industry Key Success Factors

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

1. On what basis do buyers of the industry’s product choose between the competing brands of sellers? That is, what product attributes are crucial?

2. Given the nature of competitive rivalry and the competitive forces prevailing in the marketplace, what resources and competitive capabilities does a company need to have to be competitively successful?

3. What shortcomings are almost certain to put a company at a significant competitive disadvantage?

Only rarely are there more than five or six key factors for future competitive success. And even among these, two or three usually outrank the others in importance. Managers should therefore bear in mind the purpose of identifying key success factors—to determine which factors are most important to future competitive success—and resist the temptation to label a factor that has only minor importance a KSF. To compile a list of every factor that matters even a little bit defeats the purpose of concentrating management attention on the factors truly critical to long-term competitive success.

Correctly diagnosing an industry’s KSFs raises a company’s chances of crafting a sound strategy. The goal of company strategists should be to design a strategy aimed at stacking up well on all of the industry’s future KSFs and trying to be *distinctively better* than rivals on one (or possibly two) of the KSFs. Indeed, companies that stand out or excel on a particular KSF are likely to enjoy a stronger market position—*being distinctively better than rivals on one or two key success factors tends to translate into competitive advantage*. Hence, using the industry’s KSFs as *cornerstones* for the company’s strategy and trying to gain sustainable competitive advantage by excelling at one particular KSF is a fruitful competitive strategy approach.

**Core Concept**

A sound strategy incorporates the intent to stack up well on all of the industry’s key success factors and to excel on one or two KSFs.

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

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

- The industry’s growth potential.
- Whether powerful competitive forces are squeezing industry profitability to subpar levels and whether competition appears destined to grow stronger or weaker.
- Whether industry profitability will be favorably or unfavorably affected by the prevailing driving forces.
- The degrees of risk and uncertainty in the industry’s future.
- Whether the industry as a whole confronts severe problems—regulatory or environmental issues, stagnating buyer demand, industry overcapacity, mounting competition, and so on.
• The company’s competitive position in the industry vis-à-vis rivals. (Being a well-entrenched leader or strongly positioned contender in a lackluster industry may present adequate opportunity for good profitability; however, having to fight a steep uphill battle against much stronger rivals may hold little promise of eventual market success or good return on shareholder investment, even though the industry environment is attractive.)

• The company’s potential to capitalize on the vulnerabilities of weaker rivals, perhaps converting a relatively unattractive industry situation into a potentially rewarding company opportunity.

• Whether the company has sufficient competitive strength to defend against or counteract the factors that make the industry unattractive.

• Whether continued participation in this industry adds importantly to the firm’s ability to be successful in other industries in which it may have business interests.

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

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

Key Points

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

1. **What are the industry’s dominant economic features?** Industries differ significantly on such factors as market size and growth rate, the number and relative sizes of both buyers and sellers, the geographic scope of competitive rivalry, the degree of product differentiation, the speed of product innovation, demand–supply conditions, the extent of vertical integration, and the extent of scale economies and learning-curve effects. In addition to setting the stage for the analysis to come,
identifying an industry’s economic features also promotes understanding of the kinds of strategic moves that industry members are likely to employ.

2. **What kinds of competitive forces are industry members facing, and how strong is each force?** The strength of competition is a composite of five forces: (1) competitive pressures stemming from the competitive jockeying and market maneuvering among industry rivals, (2) competitive pressures associated with the market inroads being made by the sellers of substitutes, (3) competitive pressures associated with the threat of new entrants into the market, (4) competitive pressures stemming from supplier bargaining power and supplier–seller collaboration, and (5) competitive pressures stemming from buyer bargaining power and seller–buyer collaboration. The nature and strength of the competitive pressures associated with these five forces have to be examined force by force to identify the specific competitive pressures they each comprise and to decide whether these pressures constitute a strong or weak competitive force. The next step in competition analysis is to evaluate the collective strength of the five forces and determine whether the state of competition is conducive to good profitability. Working through the five-forces model step by step not only aids strategy makers in assessing whether the intensity of competition allows good profitability but also promotes sound strategic thinking about how to better match company strategy to the specific competitive character of the marketplace. Effectively matching a company’s strategy to the particular competitive pressures and competitive conditions that exist has two aspects: (1) pursuing avenues that shield the firm from as many of the prevailing competitive pressures as possible, and (2) initiating actions calculated to produce sustainable competitive advantage, thereby shifting competition in the company’s favor, putting added competitive pressure on rivals, and perhaps even defining the business model for the industry.

3. **What factors are driving industry change and what impact will they have on competitive intensity and industry profitability?** Industry and competitive conditions change because forces are in motion that create incentives or pressures for change. The first phase is to identify the forces that are driving change in the industry; the most common driving forces include the Internet and Internet technology applications, globalization of competition in the industry, changes in the long-term industry growth rate, changes in buyer composition, product innovation, entry or exit of major firms, changes in cost and efficiency, changing buyer preferences for standardized versus differentiated products or services, regulatory influences and government policy changes, changing societal and lifestyle factors, and reductions in uncertainty and business risk. The second phase of driving-forces analysis is to determine whether the driving forces, taken together, are acting to make the industry environment more or less attractive. Are the driving forces causing demand for the industry’s product to increase or decrease? Are the driving forces acting to make competition more or less intense? Will the driving forces lead to higher or lower industry profitability?

4. **What market positions do industry rivals occupy—who is strongly positioned and who is not?** Strategic group mapping is a valuable tool for understanding the similarities, differences, strengths, and weaknesses inherent in the market positions of rival companies. Rivals in the same or nearby strategic groups are close competitors, whereas companies in distant strategic groups usually pose little or no immediate threat. The lesson of strategic group mapping is that some positions on the map are more favorable than others. The profit potential of different strategic groups varies due to strengths and weaknesses in each group’s market
position. Often, industry driving forces and competitive pressures favor some stra-
tegic groups and hurt others.

5. **What strategic moves are rivals likely to make next?** This analytical step involves identifying competitors’ strategies, deciding which rivals are likely to be strong contenders and which are likely to be weak, evaluating rivals’ competitive options, and predicting their next moves. Scouting competitors well enough to anticipate their actions can help a company prepare effective countermoves (perhaps even beating a rival to the punch) and allows managers to take rivals’ probable actions into account in designing their own company’s best course of action. Managers who fail to study competitors risk being caught unprepared by the strategic moves of rivals.

6. **What are the key factors for future competitive success?** An industry’s key success factors (KSFs) are the particular strategy elements, product attributes, competitive capabilities, and business outcomes that spell the difference between being a strong competitor and a weak competitor—and sometimes between profit and loss. KSFs by their very nature are so important to competitive success that all firms in the industry must pay close attention to them or risk becoming an industry also-ran. Correctly diagnosing an industry’s KSFs raises a company’s chances of crafting a sound strategy. The goal of company strategists should be to design a strategy aimed at stacking up well on all of the industry KSFs and trying to be **distinctively better** than rivals on one (or possibly two) of the KSFs. Indeed, using the industry’s KSFs as **cornerstones** for the company’s strategy and trying to gain sustainable competitive advantage by excelling at one particular KSF is a fruitful competitive strategy approach.

7. **Does the outlook for the industry present the company with sufficiently attractive prospects for profitability?** If an industry’s overall profit prospects are above average, the industry environment is basically attractive; if industry profit prospects are below average, conditions are unattractive. Conclusions regarding industry attractive are a major driver of company strategy. When a company decides an industry is fundamentally attractive and presents good opportunities, a strong case can be made that it should invest aggressively to capture the opportunities it sees and to improve its long-term competitive position in the business. When a strong competitor concludes an industry is relatively unattractive and lacking in opportu-
nity, it may elect to simply protect its present position, investing cautiously if at all and looking for opportunities in other industries. A competitively weak company in an unattractive industry may see its best option as finding a buyer, perhaps a rival, to acquire its business. On occasion, an industry that is unattractive overall is still very attractive to a favorably situated company with the skills and resources to take business away from weaker rivals.

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

Exercises

1. As the owner of a fast-food enterprise seeking a loan from a bank to finance the construction and operation of three new store locations, you have been asked to provide the loan officer with a brief analysis of the competitive environment in fast food. Draw a five-forces diagram for the fast-food industry, and briefly discuss the nature and strength of each of the five competitive forces in fast food. Do whatever Internet research is required to expand your understanding of competition in the fast-food industry and do a competent five-forces analysis.

2. Based on the strategic group map in Illustration Capsule 3.1: Who are Polo Ralph Lauren’s closest competitors? Between which two strategic groups is competition the strongest? Why do you think no retailers are positioned in the upper right-hand corner of the map? Which company/strategic group faces the weakest competition from the members of other strategic groups?

3. With regard to the ice cream industry, which of the following factors might qualify as possible driving forces capable of causing fundamental change in the industry’s structure and competitive environment?
   a. Increasing sales of frozen yogurt and frozen sorbets.
   b. The potential for additional makers of ice cream to enter the market.
   d. A slowdown in consumer purchases of ice cream products.
   e. Rising prices for milk, sugar, and other ice cream ingredients.
   f. A decision by Häagen-Dazs to increase its prices by 10 percent.
   g. A decision by Ben & Jerry’s to add five new flavors to its product line.
Evaluating a Company’s Resources and Competitive Position

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

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

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

Only firms who are able to continually build new strategic assets faster and cheaper than their competitors will earn superior returns over the long term.
—C. C. Markides and P. J. Williamson
In Chapter 3 we described how to use the tools of industry and competitive analysis to assess a company’s external environment and lay the groundwork for matching a company’s strategy to its external situation. In this chapter we discuss the techniques of evaluating a company’s resource capabilities, relative cost position, and competitive strength vis-à-vis its rivals. The analytical spotlight will be trained on five questions:

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

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

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

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

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

- Whether the firm’s sales are growing faster, slower, or about the same pace as the market as a whole, thus resulting in a rising, eroding, or stable market share.
Chapter 4  Evaluating a Company’s Resources and Competitive Position

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

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

Table 4.1 provides a compilation of the financial ratios most commonly used to evaluate a company’s financial performance and balance sheet strength.

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

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

**Identifying Company Resource Strengths and Competitive Capabilities**

A **resource strength** is something a company is good at doing or an attribute that enhances its competitiveness in the marketplace. Resource strengths can take any of several forms:
### Table 4.1  Key Financial Ratios: How to Calculate Them and What They Mean

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<tr>
<th>Ratio</th>
<th>How Calculated</th>
<th>What It Shows</th>
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<tr>
<td>Profitability ratios</td>
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<tr>
<td>1. Gross profit margin</td>
<td>Sales − Cost of goods sold / Sales</td>
<td>Shows the percentage of revenues available to cover operating expenses and yield a profit. Higher is better, and the trend should be upward.</td>
</tr>
<tr>
<td>2. Operating profit margin (or return on sales)</td>
<td>Sales − Operating expenses / Sales or Operating income / Sales</td>
<td>Shows the profitability of current operations without regard to interest charges and income taxes. Higher is better, and the trend should be upward.</td>
</tr>
<tr>
<td>3. Net profit margin (or net return on sales)</td>
<td>Profits after taxes / Sales</td>
<td>Shows after-tax profits per dollar of sales. Higher is better, and the trend should be upward.</td>
</tr>
<tr>
<td>4. Return on total assets</td>
<td>Profits after taxes + Interest / Total assets</td>
<td>A measure of the return on total investment in the enterprise. Interest is added to after-tax profits to form the numerator since total assets are financed by creditors as well as by stockholders. Higher is better, and the trend should be upward.</td>
</tr>
<tr>
<td>5. Return on stockholders’ equity</td>
<td>Profits after taxes / Total stockholders’ equity</td>
<td>Shows the return stockholders are earning on their investment in the enterprise. A return in the 12–15 percent range is “average,” and the trend should be upward.</td>
</tr>
<tr>
<td>6. Earnings per share</td>
<td>Profits after taxes / Number of shares of common stock outstanding</td>
<td>Shows the earnings for each share of common stock outstanding. The trend should be upward, and the bigger the annual percentage gains, the better.</td>
</tr>
<tr>
<td>Liquidity ratios</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Current ratio</td>
<td>Current assets / Current liabilities</td>
<td>Shows a firm’s ability to pay current liabilities using assets that can be converted to cash in the near term. Ratio should definitely be higher than 1.0; ratios of 2 or higher are better still.</td>
</tr>
<tr>
<td>2. Quick ratio (or acid-test ratio)</td>
<td>Current assets − Inventory / Current liabilities</td>
<td>Shows a firm’s ability to pay current liabilities without relying on the sale of its inventories.</td>
</tr>
<tr>
<td>3. Working capital</td>
<td>Current assets − Current liabilities</td>
<td>Bigger amounts are better because the company has more internal funds available to (1) pay its current liabilities on a timely basis and (2) finance inventory expansion, additional accounts receivable, and a larger base of operations without resorting to borrowing or raising more equity capital.</td>
</tr>
<tr>
<td>Leverage ratios</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Debt-to-assets ratio</td>
<td>Total debt / Total assets</td>
<td>Measures the extent to which borrowed funds have been used to finance the firm’s operations. Low fractions or ratios are better—high fractions indicate overuse of debt and greater risk of bankruptcy.</td>
</tr>
</tbody>
</table>
### Table 4.1  Continued

<table>
<thead>
<tr>
<th>Ratio</th>
<th>How Calculated</th>
<th>What It Shows</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Debt-to-equity ratio</td>
<td>Total debt / Total stockholders’ equity</td>
<td>Should usually be less than 1.0. High ratios (especially above 1.0) signal excessive debt, lower creditworthiness, and weaker balance sheet strength.</td>
</tr>
<tr>
<td>3. Long-term debt-to-equity ratio</td>
<td>Long-term debt / Total stockholders’ equity</td>
<td>Shows the balance between debt and equity in the firm’s long-term capital structure. Low ratios indicate greater capacity to borrow additional funds if needed.</td>
</tr>
<tr>
<td>4. Times-interest-earned (or coverage) ratio</td>
<td>Operating income / Interest expenses</td>
<td>Measures the ability to pay annual interest charges. Lenders usually insist on a minimum ratio of 2.0, but ratios above 3.0 signal better creditworthiness.</td>
</tr>
</tbody>
</table>

**Activity ratios**

<table>
<thead>
<tr>
<th>Ratio</th>
<th>How Calculated</th>
<th>What It Shows</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Days of inventory</td>
<td>Inventory / Cost of goods sold + 365</td>
<td>Measures inventory management efficiency. Fewer days of inventory are usually better.</td>
</tr>
<tr>
<td>2. Inventory turnover</td>
<td>Cost of goods sold / Inventory</td>
<td>Measures the number of inventory turns per year. Higher is better.</td>
</tr>
<tr>
<td>3. Average collection period</td>
<td>Accounts receivable / Total sales + 365 or Accounts receivable / Average daily sales</td>
<td>Indicates the average length of time the firm must wait after making a sale to receive cash payment. A shorter collection time is better.</td>
</tr>
</tbody>
</table>

**Other important measures of financial performance**

<table>
<thead>
<tr>
<th>Ratio</th>
<th>How Calculated</th>
<th>What It Shows</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Dividend yield on common stock</td>
<td>Annual dividends per share / Current market price per share</td>
<td>A measure of the return that shareholders receive in the form of dividends. A “typical” dividend yield is 2–3%. The dividend yield for fast-growth companies is often below 1% (may be even 0); the dividend yield for slow-growth companies can run 4–5%.</td>
</tr>
<tr>
<td>2. Price/earnings ratio</td>
<td>Current market price per share / Earnings per share</td>
<td>P/E ratios above 20 indicate strong investor confidence in a firm’s outlook and earnings growth; firms whose future earnings are at risk or likely to grow slowly typically have ratios below 12.</td>
</tr>
<tr>
<td>3. Dividend payout ratio</td>
<td>Annual dividends per share / Earnings per share</td>
<td>Indicates the percentage of after-tax profits paid out as dividends.</td>
</tr>
<tr>
<td>4. Internal cash flow</td>
<td>After tax profits + Depreciation</td>
<td>A quick and rough estimate of the cash a company’s business is generating after payment of operating expenses, interest, and taxes. Such amounts can be used for dividend payments or funding capital expenditures.</td>
</tr>
</tbody>
</table>

- A skill, specialized expertise, or competitively important capability—skills in low-cost operations, technological expertise, expertise in defect-free manufacture, proven capabilities in developing and introducing innovative products, cutting-edge supply chain management capabilities, expertise in getting new products
to market quickly, strong e-commerce expertise, expertise in providing consistently good customer service, excellent mass merchandising skills, or unique advertising and promotional talents.

- **Valuable physical assets**—state-of-the-art plants and equipment, attractive real estate locations, worldwide distribution facilities, or ownership of valuable natural resource deposits.

- **Valuable human assets and intellectual capital**—an experienced and capable workforce, talented employees in key areas, cutting-edge knowledge in technology or other important areas of the business, collective learning embedded in the organization and built up over time, or proven managerial know-how.\(^1\)

- **Valuable organizational assets**—proven quality control systems, proprietary technology, key patents, state-of-the-art systems for doing business via the Internet, ownership of important natural resources, a cadre of highly trained customer service representatives, a strong network of distributors or retail dealers, sizable amounts of cash and marketable securities, a strong balance sheet and credit rating (thus giving the company access to additional financial capital), or a comprehensive list of customers’ e-mail addresses.

- **Valuable intangible assets**—a powerful or well-known brand name, a reputation for technological leadership, or strong buyer loyalty and goodwill.

- **An achievement or attribute that puts the company in a position of market advantage**—low overall costs relative to competitors, market share leadership, a superior product, a wider product line than rivals, wide geographic coverage, or award-winning customer service.

- **Competitively valuable alliances or cooperative ventures**—fruitful partnerships with suppliers that reduce costs and/or enhance product quality and performance; alliances or joint ventures that provide access to valuable technologies, specialized know-how, or geographic markets.

A company’s resource strengths represent its endowment of competitive assets. The caliber of a firm’s resource strengths is a big determinant of its competitiveness—whether it has the wherewithal to be a strong competitor in the marketplace or whether its capabilities and competitive strengths are modest, thus relegating it to a trailing position in the industry.\(^2\) Plainly, a company’s resource strengths may or may not enable it to improve its competitive position and financial performance.

### Assessing a Company’s Competencies and Capabilities—What Activities Does It Perform Well?

One of the most important aspects of appraising a company’s resource strengths has to do with its competence level in performing key pieces of its business—such as supply chain management, research and development (R&D), production, distribution, sales and marketing, and customer service. Which activities does it perform especially well? And are there any activities it performs better than rivals? A company’s proficiency in conducting different facets of its operations can range from merely a competence in performing an activity to a core competence to a distinctive competence:

1. A **competence** is something an organization is good at doing. It is nearly always the product of experience, representing an accumulation of learning and the buildup
of proficiency in performing an internal activity. Usually a company competence originates with deliberate efforts to develop the organizational ability to do something, however imperfectly or inefficiently. Such efforts involve selecting people with the requisite knowledge and skills, upgrading or expanding individual abilities as needed, and then molding the efforts and work products of individuals into a cooperative group effort to create organizational ability. Then, as experience builds, such that the company gains proficiency in performing the activity consistently well and at an acceptable cost, the ability evolves into a true competence and company capability. Some competencies relate to fairly specific skills and expertise (like just-in-time inventory control or low-cost manufacturing efficiency or picking locations for new stores or designing an unusually appealing and user-friendly Web site); they spring from proficiency in a single discipline or function and may be performed in a single department or organizational unit. Other competencies, however, are inherently multidisciplinary and cross-functional—they are the result of effective collaboration among people with different expertise working in different organizational units. A competence in continuous product innovation, for example, comes from teaming the efforts of people and groups with expertise in market research, new product R&D, design and engineering, cost-effective manufacturing, and market testing.

2. A core competence is a proficiently performed internal activity that is central to a company’s strategy and competitiveness. A core competence is a more valuable resource strength than a competence because of the well-performed activity’s core role in the company’s strategy and the contribution it makes to the company’s success in the marketplace. A core competence can relate to any of several aspects of a company’s business: expertise in integrating multiple technologies to create families of new products, know-how in creating and operating systems for cost-efficient supply chain management, the capability to speed new or next-generation products to market, good after-sale service capabilities, skills in manufacturing a high-quality product at a low cost, or the capability to fill customer orders accurately and swiftly. A company may have more than one core competence in its resource portfolio, but rare is the company that can legitimately claim more than two or three core competencies. Most often, a core competence is knowledge-based, residing in people and in a company’s intellectual capital and not in its assets on the balance sheet. Moreover, a core competence is more likely to be grounded in cross-department combinations of knowledge and expertise rather than being the product of a single department or work group. 3M Corporation has a core competence in product innovation—its record of introducing new products goes back several decades and new product introduction is central to 3M’s strategy of growing its business. Ben & Jerry’s Homemade, a subsidiary of Unilever, has a core competence in creating unusual flavors of ice cream and marketing them with catchy names like Chunky Monkey, Wavy Gravy, Chubby Hubby, The Gobfather, Dublin Mudslide, and Marsha Marsha Marshmallow.

3. A distinctive competence is a competitively valuable activity that a company performs better than its rivals. A distinctive competence thus signifies even greater proficiency than a core competence. But what is especially important about a distinctive competence is that the company enjoys competitive superiority
A distinctive competence is a competitively important activity that a company performs better than its rivals—it thus represents a competitively superior resource strength.

Core Concept

in performing that activity—a distinctive competence represents a level of proficiency that rivals do not have. Because a distinctive competence represents uniquely strong capability relative to rival companies, it qualifies as a competitively superior resource strength with competitive advantage potential. This is particularly true when the distinctive competence enables a company to deliver standout value to customers (in the form of lower costs and prices or better product performance or superior service). Toyota has worked diligently over several decades to establish a distinctive competence in low-cost, high-quality manufacturing of motor vehicles; its “lean production” system is far superior to that of any other automaker’s, and the company is pushing the boundaries of its production advantage with a new type of assembly line—called the Global Body line—that costs 50 percent less to install and can be changed to accommodate a new model for 70 percent less than its previous production system. Starbucks’ distinctive competence in innovative coffee drinks and store ambience has propelled it to the forefront among coffee retailers.

The conceptual differences between a competence, a core competence, and a distinctive competence draw attention to the fact that a company’s resource strengths and competitive capabilities are not all equal. Some competencies and competitive capabilities merely enable market survival because most rivals have them—indeed, not having a competence or capability that rivals have can result in competitive disadvantage. If an apparel company does not have the competence to produce its apparel items cost-efficiently, it is unlikely to survive given the intensely price-competitive nature of the apparel industry. Every Web retailer requires a basic competence in designing an appealing and user-friendly Web site.

Core competencies are competitively more important resource strengths than competencies because they add power to the company’s strategy and have a bigger positive impact on its market position and profitability. Distinctive competencies are even more competitively important. A distinctive competence is a competitively potent resource strength for three reasons: (1) it gives a company competitively valuable capability that is unmatched by rivals, (2) it has potential for being the cornerstone of the company’s strategy, and (3) it can produce a competitive edge in the marketplace since it represents a level of proficiency that is superior to rivals. It is always easier for a company to build competitive advantage when it has a distinctive competence in performing an activity important to market success, when rival companies do not have offsetting competencies, and when it is costly and time-consuming for rivals to imitate the competence. A distinctive competence is thus potentially the mainspring of a company’s success—unless it is trumped by more powerful resources possessed by rivals.

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

1. Is the resource strength hard to copy? The more difficult and more expensive it is to imitate a company’s resource strength, the greater its potential competitive
value. Resources tend to be difficult to copy when they are unique (a fantastic real estate location, patent protection), when they must be built over time in ways that are difficult to imitate (a brand name, mastery of a technology), and when they carry big capital requirements (a cost-effective plant to manufacture cutting-edge microprocessors). Wal-Mart’s competitors have failed miserably in their attempts over the past two decades to match Wal-Mart’s super-efficient state-of-the-art distribution capabilities. Hard-to-copy strengths and capabilities are valuable competitive assets, adding to a company’s market strength and contributing to sustained profitability.

2. **Is the resource strength durable—does it have staying power?** The longer the competitive value of a resource lasts, the greater its value. Some resources lose their clout in the marketplace quickly because of the rapid speeds at which technologies or industry conditions are moving. The value of Eastman Kodak’s resources in film and film processing is rapidly being undercut by the growing popularity of digital cameras. The investments that commercial banks have made in branch offices is a rapidly depreciating asset because of growing use of direct deposits, debit cards, automated teller machines, and telephone and Internet banking options.

3. **Is the resource really competitively superior?** Companies have to guard against pridefully believing that their core competencies are distinctive competencies or that their brand name is more powerful than the brands names of rivals. Who can really say whether Coca-Cola’s consumer marketing prowess is better than Pepsi-Cola’s or whether the Mercedes-Benz brand name is more powerful than that of BMW or Lexus? Although many retailers claim to be quite proficient in product selection and in-store merchandising, a number run into trouble in the marketplace because they encounter rivals whose competencies in product selection and in-store merchandising are better than theirs. Apple’s operating system for its MacIntosh PCs is by most accounts a world beater (compared to Windows XP), but Apple has failed miserably in converting its resource strength in operating system design into competitive success in the global PC market—it is an also-ran with a paltry 2–3 percent market share worldwide.

4. **Can the resource strength be trumped by the different resource strengths and competitive capabilities of rivals?** Many commercial airlines have invested heavily in developing the resources and capabilities to offer passengers safe, reliable flights at convenient times, along with an array of in-flight amenities. However, Southwest Airlines and JetBlue in the United States and Ryanair and easyJet in Europe have been quite successful deploying their resources in ways that enable them to provide commercial air services at radically lower fares. Amazon.com’s strengths in online retailing of books have put a big dent in the business prospects of brick-and-mortar bookstores. Whole Foods Market has a resource lineup that enables it to merchandise a dazzling array of natural and organic food products in a supermarket setting, thus putting strong competitive pressure on Kroger, Safeway, Albertson’s, and other prominent supermarket chains. The prestigious brand names of Cadillac and Lincoln have faded because Mercedes, BMW, Audi, and Lexus have used their resources to design, produce, and market more appealing luxury vehicles.

The vast majority of companies are not well endowed with standout resource strengths, much less with one or more competitively superior resources (or distinctive competencies) capable of passing all four tests with high marks. Most firms have a mixed bag of resources—one or two quite valuable, some good, many satisfactory to mediocre.
Companies in the top tier of their industry may have as many as two core competencies in their resource strength lineup. But only a few companies, usually the strongest industry leaders or up-and-coming challengers, have a resource strength that truly qualifies as a distinctive competence. Even so, a company can still marshal the resource strengths to be competitively successful without having a competitively superior resource or distinctive competence. A company can achieve considerable competitive vitality, maybe even competitive advantage, from a collection of good-to-adequate resource strengths that collectively give it competitive power in the marketplace. A number of fast-food chains—for example, Wendy’s, Taco Bell, and Subway—have achieved a respectable market position competing against McDonald’s with satisfactory sets of resource strengths and no apparent distinctive competence. The same can be said for Lowe’s, which competes against industry leader Home Depot, and such regional banks as Compass, State Street, Keybank, PNC, BB&T, and AmSouth, which increasingly find themselves in competition with the top five U.S. banks—JPMorgan Chase, Bank of America, Citibank, Wachovia, and Wells Fargo.

Identifying Company Resource Weaknesses and Competitive Deficiencies

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

Table 4.2 lists the kinds of factors to consider in compiling a company’s resource strengths and weaknesses. Sizing up a company’s complement of resource capabilities and deficiencies is akin to constructing a strategic balance sheet, where resource strengths represent competitive assets and resource weaknesses represent competitive liabilities. Obviously, the ideal condition is for the company’s competitive assets to outweigh its competitive liabilities by an ample margin—a 50–50 balance is definitely not the desired condition!

Identifying a Company’s Market Opportunities

Market opportunity is a big factor in shaping a company’s strategy. Indeed, managers can’t properly tailor strategy to the company’s situation without first identifying its market opportunities and appraising the growth and profit potential each one holds. Depending on the prevailing circumstances, a company’s opportunities can be plentiful or scarce, fleeting or lasting, and can range from wildly attractive (an absolute “must” to pursue) to marginally interesting (because the growth and profit potential are questionable) to unsuitable (because there’s not a good match with the company’s
Table 4.2  What to Look for in Identifying a Company’s Strengths, Weaknesses, Opportunities, and Threats

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

<table>
<thead>
<tr>
<th>Potential Market Opportunities</th>
<th>Potential External Threats to a Company’s Future Prospects</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Openings to win market share from rivals</td>
<td>• Increasing intensity of competition among industry rivals—may squeeze profit margins</td>
</tr>
<tr>
<td>• Sharply rising buyer demand for the industry’s product</td>
<td>• Slowdowns in market growth</td>
</tr>
<tr>
<td>• Serving additional customer groups or market segments</td>
<td>• Likely entry of potent new competitors</td>
</tr>
<tr>
<td>• Expanding into new geographic markets</td>
<td>• Loss of sales to substitute products</td>
</tr>
<tr>
<td>• Expanding the company’s product line to meet a broader range of customer needs</td>
<td>• Growing bargaining power of customers or suppliers</td>
</tr>
<tr>
<td>• Using existing company skills or technological know-how to enter new product lines or new businesses</td>
<td>• A shift in buyer needs and tastes away from the industry’s product</td>
</tr>
<tr>
<td>• Online sales</td>
<td>• Adverse demographic changes that threaten to curtail demand for the industry’s product</td>
</tr>
<tr>
<td>• Integrating forward or backward</td>
<td>• Vulnerability to unfavorable industry driving forces</td>
</tr>
<tr>
<td>• Falling trade barriers in attractive foreign markets</td>
<td>• Restrictive trade policies on the part of foreign governments</td>
</tr>
<tr>
<td>• Acquiring rival firms or companies with attractive technological expertise or capabilities</td>
<td>• Costly new regulatory requirements</td>
</tr>
<tr>
<td>• Entering into alliances or joint ventures to expand the firm’s market coverage or boost its competitive capability</td>
<td></td>
</tr>
<tr>
<td>• Openings to exploit emerging new technologies</td>
<td></td>
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</tbody>
</table>
resource strengths and capabilities). A checklist of potential market opportunities is included in Table 4.2.

While stunningly big or “golden” opportunities appear fairly frequently in volatile, fast-changing markets (typically due to important technological developments or rapidly shifting consumer preferences), they are nonetheless hard to see before most all companies in the industry identify them. The more volatile and thus unpredictable market conditions are, the more limited a company’s ability to do market reconnaissance and spot important opportunities much ahead of rivals—there are simply too many variables in play for managers to peer into the fog of the future, identify one or more upcoming opportunities, and get a jump on rivals in pursuing it. In mature markets, unusually attractive market opportunities emerge sporadically, often after long periods of relative calm—but future market conditions may be less foggy, thus facilitating good market reconnaissance and making emerging opportunities easier for industry members to detect. But in both volatile and stable markets, the rise of a golden opportunity is almost never under the control of a single company or manufactured by company executives—rather, it springs from the simultaneous alignment of several external factors. For instance, in China the recent upsurge in demand for motor vehicles was spawned by a convergence of many factors—increased disposable income, rising middle-class aspirations, a major road-building program by the government, the demise of employer-provided housing, and easy credit. But golden opportunities are nearly always seized rapidly—and the companies that seize them are usually those that have been actively waiting, staying alert with diligent market reconnaissance, and preparing themselves to capitalize on shifting market conditions by patiently assembling an arsenal of competitively valuable resources—talented personnel, technical know-how, strategic partnerships, and a war chest of cash to finance aggressive action when the time comes.

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

**Identifying the External Threats to a Company’s Future Profitability**

Often, certain factors in a company’s external environment pose threats to its profitability and competitive well-being. Threats can stem from the emergence of cheaper or better technologies, rivals’ introduction of new or improved products, the entry of lower-cost foreign competitors into a company’s market stronghold, new regulations that are more burdensome to a company than to its competitors, vulnerability to a rise in interest rates, the potential of a hostile takeover, unfavorable demographic shifts, adverse changes in foreign exchange rates, political upheaval in a foreign country.
where the company has facilities, and the like. A list of potential threats to a company’s future profitability and market position is shown in Table 4.2.

External threats may pose no more than a moderate degree of adversity (all companies confront some threatening elements in the course of doing business), or they may be so imposing as to make a company’s situation and outlook quite tenuous. On rare occasions, market shocks can give birth to a *sudden-death* threat that throws a company into an immediate crisis and battle to survive. Many of the world’s major airlines have been plunged into unprecedented financial crisis by the perfect storm of the September 11, 2001, terrorist attacks, rising prices for jet fuel, mounting competition from low-fare carriers, shifting traveler preferences for low fares as opposed to lots of in-flight amenities, and out-of-control labor costs. It is management’s job to identify the threats to the company’s future prospects and to evaluate what strategic actions can be taken to neutralize or lessen their impact.

### What Do the SWOT Listings Reveal?

SWOT analysis involves more than making four lists. The two most important parts of SWOT analysis are *drawing conclusions* from the SWOT listings about the company’s overall situation, and *translating these conclusions into strategic actions* to better match the company’s strategy to its resource strengths and market opportunities, to correct the important weaknesses, and to defend against external threats. Figure 4.2 shows the three steps of SWOT analysis.

Just what story the SWOT listings tell about the company’s overall situation is often revealed in the answers to the following sets of questions:

- Does the company have an attractive set of resource strengths? Does it have any strong core competencies or a distinctive competence? Are the company’s strengths and capabilities well matched to the industry key success factors? Do they add adequate power to the company’s strategy, or are more or different strengths needed? Will the company’s current strengths and capabilities matter in the future?

- How serious are the company’s weaknesses and competitive deficiencies? Are they mostly inconsequential and readily correctable, or could one or more prove fatal if not remedied soon? Are some of the company’s weaknesses in areas that relate to the industry’s key success factors? Are there any weaknesses that if uncorrected, would keep the company from pursuing an otherwise attractive opportunity? Does the company have important resource gaps that need to be filled for it to move up in the industry rankings and/or boost its profitability?

- Do the company’s resource strengths and competitive capabilities (its competitive assets) outweigh its resource weaknesses and competitive deficiencies (its competitive liabilities) by an attractive margin?

- Does the company have attractive market opportunities that are well suited to its resource strengths and competitive capabilities? Does the company lack the resources and capabilities to pursue any of the most attractive opportunities?

- Are the threats alarming, or are they something the company appears able to deal with and defend against?
All things considered, how strong is the company’s overall situation? Where on a scale of 1 to 10 (1 being alarmedly weak and 10 exceptionally strong) should the firm’s position and overall situation be ranked? What aspects of the company’s situation are particularly attractive? What aspects are of the most concern?

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

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

• What should the company be doing to guard against the threats to its well-being?

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

At the same time, sound strategy making requires sifting through the available market opportunities and aiming strategy at capturing those that are most attractive and suited to the company’s circumstances. Rarely does a company have the resource depth to pursue all available market opportunities simultaneously without spreading itself too thin. How much attention to devote to defending against external threats to the company’s market position and future performance hinges on how vulnerable the company is, whether there are attractive defensive moves that can be taken to lessen their impact, and whether the costs of undertaking such moves represent the best use of company resources.

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

Company managers are often stunned when a competitor cuts its price to “unbelievably low” levels or when a new market entrant comes on strong with a very low price. The competitor may not, however, be “dumping” (an economic term for selling at prices that are below cost), buying its way into the market with a super-low price, or waging a desperate move to gain sales—it may simply have substantially lower costs. One of the most telling signs of whether a company’s business position is strong or precarious is whether its prices and costs are competitive with industry rivals. For a company to compete successfully, its costs must be in line with those of close rivals.

Price–cost comparisons are especially critical in a commodity-product industry where the value provided to buyers is the same from seller to seller, price competition is typically the ruling market force, and low-cost companies have the upper hand. But even in industries where products are differentiated and competition centers on the different attributes of competing brands as much as on price, rival companies have to keep their costs in line and make sure that any added costs they incur, and any price premiums they charge, create ample value that buyers are willing to pay extra for.
While some cost disparity is justified so long as the products or services of closely competing companies are sufficiently differentiated, a high-cost firm’s market position becomes increasingly vulnerable the more its costs exceed those of close rivals.

Two analytical tools are particularly useful in determining whether a company’s prices and costs are competitive: value chain analysis and benchmarking.

The Concept of a Company Value Chain

Every company’s business consists of a collection of activities undertaken in the course of designing, producing, marketing, delivering, and supporting its product or service. All of the various activities that a company performs internally combine to form a value chain—so called because the underlying intent of a company’s activities is to do things that ultimately create value for buyers. A company’s value chain also includes an allowance for profit because a markup over the cost of performing the firm’s value-creating activities is customarily part of the price (or total cost) borne by buyers—unless an enterprise succeeds in creating and delivering sufficient value to buyers to produce an attractive profit, it can’t survive for long.

As shown in Figure 4.3, a company’s value chain consists of two broad categories of activities: the primary activities that are foremost in creating value for customers and the requisite support activities that facilitate and enhance the performance of the primary activities. For example, the primary value-creating activities for a maker of bakery goods include supply chain management, recipe development and testing, mixing and baking, packaging, sales and marketing, and distribution; related support activities include quality control, human resource management, and administration. A wholesaler’s primary activities and costs deal with merchandise selection and purchasing, inbound shipping and warehousing from suppliers, and outbound distribution to retail customers. The primary activities for a department store retailer include merchandise selection and buying, store layout and product display, advertising, and customer service; its support activities include site selection, hiring and training, and store maintenance, plus the usual assortment of administrative activities. A hotel chain’s primary activities and costs are in site selection and construction, reservations, operation of its hotel properties (check-in and check-out, maintenance and housekeeping, dining and room service, and conventions and meetings), and managing its lineup of hotel locations; principal support activities include accounting, hiring and training hotel staff, advertising, building a brand and reputation, and general administration. Supply chain management is a crucial activity for Nissan and Amazon.com but is not a value chain component at Google or a TV and radio broadcasting company. Sales and marketing are dominant activities at Procter & Gamble and Sony but have minor roles at oil drilling companies and natural gas pipeline companies. Delivery to buyers is a crucial activity at Domino’s Pizza but comparatively insignificant at Starbucks. Thus, what constitutes a primary or secondary activity varies according to the specific nature of a company’s business, meaning that you should view the listing of the primary and support activities in Figure 4.3 as illustrative rather than definitive.

A Company’s Primary and Support Activities Identify the Major Components of Its Cost Structure Segregating a company’s operations into different types of primary and support activities is the first step in understanding its cost structure. Each activity in the value chain gives rise to costs and ties up assets.
Figure 4.3 A Representative Company Value Chain

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

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

Assigning the company’s operating costs and assets to each individual activity in the chain provides cost estimates and capital requirements—a process that accountants call activity-based cost accounting. Quite often, there are links between activities such that the manner in which one activity is done can affect the costs of performing other activities. For instance, how a product is designed has a huge impact on the number of different parts and components, their respective manufacturing costs, and the expense of assembling the various parts and components into a finished product.

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

**Why the Value Chains of Rival Companies Often Differ**

A company’s value chain and the manner in which it performs each activity reflect the evolution of its own particular business and internal operations, its strategy, the approaches it is using to execute its strategy, and the underlying economics of the activities themselves. Because these factors differ from company to company, the value chains of rival companies sometimes differ substantially—a condition that complicates the task of assessing rivals’ relative cost positions. For instance, music retailers like Blockbuster and Musicland, which purchase CDs from recording studios and wholesale distributors and sell them in their own retail store locations, have value chains and cost structures different from those of rival online music stores like Apple’s iTunes and Musicmatch, which sell downloadable music files directly to music shoppers. Competing companies may differ in their degrees of vertical integration. The operations component of the value chain for a manufacturer that makes all of its own parts and assembles them into a finished product differs from the operations component of a rival producer that buys the needed parts from outside suppliers and performs assembly operations only. Likewise, there is legitimate reason to expect value chain and cost differences between a company that is pursuing a low-cost/low-price strategy and a rival that is positioned on the high end of the market. The costs of certain activities along the low-cost company’s value chain should indeed be relatively low, whereas the high-end firm may understandably be spending relatively more to perform those activities that create the added quality and extra features of its products.

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

The Value Chain System for an Entire Industry

As the tire industry example makes clear, a company’s value chain is embedded in a larger system of activities that includes the value chains of its suppliers and the value chains of whatever distribution channel allies it uses in getting its product or service to end users. Suppliers’ value chains are relevant because suppliers perform activities and incur costs in creating and delivering the purchased inputs used in a company’s own value-creating activities. The costs, performance features, and quality of these inputs influence a company’s own costs and product differentiation capabilities. Anything a company can do to help its suppliers’ drive down the costs of their value chain activities or improve the quality and performance of the items being supplied can enhance its own competitiveness—a powerful reason for working collaboratively with suppliers in managing supply chain activities.

The value chains of forward channel partners and/or the customers to whom a company sells are relevant because (1) the costs and margins of a company’s distributors and retail dealers are part of the price the ultimate consumer pays, and (2) the activities that distribution allies perform affect customer satisfaction. For these reasons, companies normally work closely with their forward channel allies (who are their direct customers) to perform value chain activities in mutually beneficial ways. For instance, motor vehicle manufacturers work closely with their local automobile dealers to keep the retail prices of their vehicles competitive with rivals’ models and to ensure that owners are satisfied with dealers’ repair and maintenance services. Some aluminum can producers have constructed plants next to beer breweries and deliver cans on overhead conveyors directly to the breweries’ can-filling lines; this has resulted in significant savings in production scheduling, shipping, and inventory costs for both container producers and breweries. Many automotive parts suppliers have built plants near the auto assembly plants they supply to facilitate just-in-time deliveries, reduce warehousing and shipping costs, and promote close collaboration on parts design and production scheduling. Irrigation equipment companies, suppliers of grape-harvesting and winemaking equipment, and firms making barrels, wine bottles, caps, corks, and labels all have facilities in the California wine country to be close to the nearly 700 winemakers they supply. The lesson here is that a company’s value chain activities are often closely linked to the value chains of their suppliers and the forward allies or customers to whom they sell.

As a consequence, accurately assessing a company’s competitiveness from the perspective of the consumers who ultimately use its products or services thus requires that company managers understand an industry’s entire value chain system for delivering a product or service to customers, not just the company’s own value chain. A typical industry value chain that incorporates the value chains of suppliers and forward channel allies (if any) is shown in Figure 4.4. However, industry value chains
vary significantly by industry. The primary value chain activities in the pulp and paper industry (timber farming, logging, pulp mills, and papermaking) differ from the primary value chain activities in the home appliance industry (parts and components manufacture, assembly, wholesale distribution, retail sales). The value chain for the soft-drink industry (processing of basic ingredients and syrup manufacture, bottling and can filling, wholesale distribution, advertising, and retail merchandising) differs from that for the computer software industry (programming, disk loading, marketing, distribution). Producers of bathroom and kitchen faucets depend heavily on the activities of wholesale distributors and building supply retailers in winning sales to homebuilders and do-it-yourselfers, but producers of papermaking machines internalize their distribution activities by selling directly to the operators of paper plants. Illustration Capsule 4.1 shows representative costs for various activities performed by the producers and marketers of music CDs.

**Activity-Based Costing: A Tool for Assessing a Company’s Cost Competitiveness**

Once the company has identified its major value chain activities, the next step in evaluating its cost competitiveness involves determining the costs of performing specific value chain activities, using what accountants call activity-based costing. Traditional accounting identifies costs according to broad categories of expenses—wages and salaries, employee benefits, supplies, maintenance, utilities, travel, depreciation, R&D, interest, general administration, and so on. But activity-based cost accounting involves establishing expense categories for specific value chain activities and assigning costs to the activity responsible for creating the cost. An illustrative example is shown in Table 4.3 on page 116. Perhaps 25 percent of the companies that have explored the feasibility of activity-based costing have adopted this accounting approach.
The degree to which a company’s costs should be disaggregated into specific activities depends on how valuable it is to develop cross-company cost comparisons for narrowly defined activities as opposed to broadly defined activities. Generally speaking, cost estimates are needed at least for each broad category of primary and secondary activities, but finer classifications may be needed if a company discovers that it has a cost disadvantage vis-à-vis rivals and wants to pin down the exact source or activity causing the cost disadvantage. It can also be necessary to develop cost estimates for activities performed in the competitively relevant portions of suppliers’ and customers’ value chains—which requires going to outside sources for reliable cost information.

Once a company has developed good cost estimates for each of the major activities in its value chain, and perhaps has cost estimates for subactivities within each primary/secondary value chain activity, then it is ready to see how its costs for these activities compare with the costs of rival firms. This is where benchmarking comes in.

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**Illustration Capsule 4.1**

**Estimated Value Chain Costs for Recording and Distributing Music CDs through Traditional Music Retailers**

The following table presents the representative costs and markups associated with producing and distributing a music CD retailing for $15 in music stores (as opposed to Internet sources).

<table>
<thead>
<tr>
<th>Value Chain Activities and Costs in Producing and Distributing a CD</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Record company direct production costs:</td>
<td>$2.40</td>
</tr>
<tr>
<td>Artists and repertoire</td>
<td>$0.75</td>
</tr>
<tr>
<td>Pressing of CD and packaging</td>
<td>1.65</td>
</tr>
<tr>
<td>2. Royalties</td>
<td>0.99</td>
</tr>
<tr>
<td>3. Record company marketing expenses</td>
<td>1.50</td>
</tr>
<tr>
<td>4. Record company overhead</td>
<td>1.50</td>
</tr>
<tr>
<td>5. Total record company costs</td>
<td>6.39</td>
</tr>
<tr>
<td>6. Record company’s operating profit</td>
<td>1.86</td>
</tr>
<tr>
<td>7. Record company’s selling price to distributor/wholesaler</td>
<td>8.25</td>
</tr>
<tr>
<td>8. Average wholesale distributor markup to cover distribution activities and profit margins</td>
<td>1.50</td>
</tr>
<tr>
<td>9. Average wholesale price charged to retailer</td>
<td>9.75</td>
</tr>
<tr>
<td>10. Average retail markup over wholesale cost</td>
<td>5.25</td>
</tr>
<tr>
<td>11. Average price to consumer at retail</td>
<td>$15.00</td>
</tr>
</tbody>
</table>

*Source:* Developed from information in “Fight the Power,” a case study prepared by Adrian Aleyne, Babson College, 1999.
Benchmarking: A Tool for Assessing Whether a Company’s Value Chain Costs Are in Line

Many companies today are benchmarking their costs of performing a given activity against competitors’ costs (and/or against the costs of a noncompetitor that efficiently and effectively performs much the same activity in another industry). Benchmarking is a tool that allows a company to determine whether its performance of a particular function or activity represents the “best practice” when both cost and effectiveness are taken into account.

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

Xerox became one of the first companies to use benchmarking when, in 1979, Japanese manufacturers began selling midsize copiers in the United States for $9,600 each—less than Xerox’s production costs. Xerox management suspected its Japanese competitors were dumping, but it sent a team of line managers to Japan, including the head of manufacturing, to study competitors’ business processes and costs. With the aid of Xerox’s joint venture partner in Japan, Fuji-Xerox, which knew the competitors...
well, the team found that Xerox’s costs were excessive due to gross inefficiencies in the company’s manufacturing processes and business practices. The findings triggered a major internal effort at Xerox to become cost-competitive and prompted Xerox to begin benchmarking 67 of its key work processes against companies identified as employing the best practices. Xerox quickly decided not to restrict its benchmarking efforts to its office equipment rivals but to extend them to any company regarded as world class in performing any activity relevant to Xerox’s business. Other companies quickly picked up on Xerox’s approach. Toyota managers got their idea for just-in-time inventory deliveries by studying how U.S. supermarkets replenished their shelves. Southwest Airlines reduced the turnaround time of its aircraft at each scheduled stop by studying pit crews on the auto racing circuit. Over 80 percent of Fortune 500 companies reportedly use benchmarking for comparing themselves against rivals on cost and other competitively important measures.

The tough part of benchmarking is not whether to do it, but rather how to gain access to information about other companies’ practices and costs. Sometimes benchmarking can be accomplished by collecting information from published reports, trade groups, and industry research firms and by talking to knowledgeable industry analysts, customers, and suppliers. Sometimes field trips to the facilities of competing or noncompeting companies can be arranged to observe how things are done, ask questions, compare practices and processes, and perhaps exchange data on productivity, staffing levels, time requirements, and other cost components—but the problem here is that such companies, even if they agree to host facilities tours and answer questions, are unlikely to share competitively sensitive cost information. Furthermore, comparing one company’s costs to another’s costs may not involve comparing apples to apples if the two companies employ different cost accounting principles to calculate the costs of particular activities.

However, a third and fairly reliable source of benchmarking information has emerged. The explosive interest of companies in benchmarking costs and identifying best practices has prompted consulting organizations (e.g., Accenture, A. T. Kearney, Benchnet—The Benchmarking Exchange, Towers Perrin, and Best Practices) and several councils and associations (e.g., the American Productivity and Quality Center, the Qualserve Benchmarking Clearinghouse, and the Strategic Planning Institute’s Council on Benchmarking) to gather benchmarking data, distribute information about best practices, and provide comparative cost data without identifying the names of particular companies. Having an independent group gather the information and report it in a manner that disguises the names of individual companies avoid having the disclosure of competitively sensitive data and lessens the potential for unethical behavior on the part of company personnel in gathering their own data about competitors. Illustration Capsule 4.2 presents a widely recommended code of conduct for engaging in benchmarking that is intended to help companies avoid any improprieties in gathering and using benchmarking data.

**Strategic Options for Remediying a Cost Disadvantage**

Value chain analysis and benchmarking can reveal a great deal about a firm’s cost competitiveness. Examining the costs of a company’s own value chain activities and comparing them to rivals’ indicates who has how much of a cost advantage or
disadvantage and which cost components are responsible. Such information is vital in strategic actions to eliminate a cost disadvantage or create a cost advantage. One of the fundamental insights of value chain analysis and benchmarking is that a company’s competitiveness on cost depends on how efficiently it manages its value chain activities relative to how well competitors manage theirs.¹⁹ There are three main areas in a company’s overall value chain where important differences in the costs of competing firms can occur: a company’s own activity segments, suppliers’ part of the industry value chain, and the forward channel portion of the industry chain.
Remedying an Internal Cost Disadvantage When a company’s cost disadvantage stems from performing internal value chain activities at a higher cost than key rivals, then managers can pursue any of several strategic approaches to restore cost parity:\(^{20}\)

1. Implement the use of best practices throughout the company, particularly for high-cost activities.
2. Try to eliminate some cost-producing activities altogether by revamping the value chain. Examples include cutting out low-value-added activities or bypassing the value chains and associated costs of distribution allies and marketing directly to end users. Dell has used this approach in PCs, and airlines have begun bypassing travel agents by getting passengers to purchase their tickets directly at airline Web sites.
3. Relocate high-cost activities (such as manufacturing) to geographic areas—such as China, Latin America, or Eastern Europe—where they can be performed more cheaply.
4. See if certain internally performed activities can be outsourced from vendors or performed by contractors more cheaply than they can be done in-house.
5. Invest in productivity-enhancing, cost-saving technological improvements (robotics, flexible manufacturing techniques, state-of-the-art electronic networking).
6. Find ways to detour around the activities or items where costs are high—computer chip makers regularly design around the patents held by others to avoid paying royalties; automakers have substituted lower-cost plastic and rubber for metal at many exterior body locations.
7. Redesign the product and/or some of its components to facilitate speedier and more economical manufacture or assembly.
8. Try to make up the internal cost disadvantage by reducing costs in the supplier or forward channel portions of the industry value chain—usually a last resort.

Remedying a Supplier-Related Cost Disadvantage Supplier-related cost disadvantages can be attacked by pressuring suppliers for lower prices, switching to lower-priced substitute inputs, and collaborating closely with suppliers to identify mutual cost-saving opportunities.\(^{21}\) For example, just-in-time deliveries from suppliers can lower a company’s inventory and internal logistics costs and may also allow its suppliers to economize on their warehousing, shipping, and production scheduling costs—a win–win outcome for both. In a few instances, companies may find that it is cheaper to integrate backward into the business of high-cost suppliers and make the item in-house instead of buying it from outsiders. If a company strikes out in wringing savings out of its high-cost supply chain activities, then it must resort to finding cost savings either in-house or in the forward channel portion of the industry value chain to offset its supplier-related cost disadvantage.

Remedying a Cost Disadvantage Associated with Activities Performed by Forward Channel Allies There are three main ways to combat a cost disadvantage in the forward portion of the industry value chain:

1. Pressure dealer-distributors and other forward channel allies to reduce their costs and markups so as to make the final price to buyers more competitive with the prices of rivals.
2. Work closely with forward channel allies to identify win–win opportunities to reduce costs. For example, a chocolate manufacturer learned that by shipping its bulk chocolate in liquid form in tank cars instead of 10-pound molded bars, it could not only save its candy bar manufacturing customers the costs associated with unpacking and melting but also eliminate its own costs of molding bars and packing them.

3. Change to a more economical distribution strategy, including switching to cheaper distribution channels (perhaps direct sales via the Internet) or perhaps integrating forward into company-owned retail outlets.

If these efforts fail, the company can either try to live with the cost disadvantage or pursue cost-cutting earlier in the value chain system.

**Translating Proficient Performance of Value Chain Activities into Competitive Advantage**

A company that does a *first-rate job* of managing its value chain activities *relative to competitors* stands a good chance of achieving sustainable competitive advantage. As shown in Figure 4.5, outmanaging rivals in performing value chain activities can be accomplished in either or both of two ways: (1) by astutely developing core competencies and maybe a distinctive competence that rivals don’t have or can’t quite match and that are instrumental in helping it deliver attractive value to customers, and/or (2) by simply doing an overall better job than rivals of lowering its combined costs of performing all the various value chain activities, such that it ends up with a low-cost advantage over rivals.

The first of these two approaches begins with management efforts to build more organizational expertise in performing certain competitively important value chain activities, deliberately striving to develop competencies and capabilities that add power to its strategy and competitiveness. If management begins to make selected competencies and capabilities cornerstones of its strategy and continues to invest resources in building greater and greater proficiency in performing them, then over time one (or maybe several) of the targeted competencies/capabilities may rise to the level of a core competence. Later, following additional organizational learning and investments in gaining still greater proficiency, a core competence could evolve into a distinctive competence, giving the company superiority over rivals in performing an important value chain activity. Such superiority, if it gives the company significant competitive clout in the marketplace, can produce an attractive competitive edge over rivals and, more important, prove difficult for rivals to match or offset with competencies and capabilities of their own making. As a general rule, it is substantially harder for rivals to achieve best-in-industry proficiency in performing a key value chain activity than it is for them to clone the features and attributes of a hot-selling product or service.22 This is especially true when a company with a distinctive competence avoids becoming complacent and works diligently to maintain its industry-leading expertise and capability. GlaxoSmithKline, one of the world’s most competitively capable pharmaceutical companies, has built its business position around expert performance of a few competitively crucial activities: extensive R&D to achieve first discovery of new drugs, a carefully constructed approach to patenting, skill in gaining rapid and thorough clinical clearance through regulatory bodies, and unusually strong distribution and sales-force
Chapter 4  Evaluating a Company’s Resources and Competitive Position

Figure 4.5  Translating Company Performance of Value Chain Activities into Competitive Advantage

Option 1: Beat rivals in performing value chain activities more proficiently

Company performs activities in its value chain

Competencies and capabilities gradually emerge in performing certain competitively important value chain activities

Company proficiency in performing one or two value chain activities rises to the level of a core competence

Company gains a competitive advantage based on better competencies and capabilities

Option 2: Beat rivals in performing value chain activities more cheaply

Company performs activities in its value chain

Company managers decide to perform value chain activities in the most cost-efficient manner

The goal becomes to achieve continuous cost reduction—no value chain activity is ignored

Company personnel become skilled in finding innovative ways to perform activities very cost effectively

Company gains a competitive advantage based on lower costs than rivals

capabilities. FedEx’s astute management of its value chain has produced unmatched competencies and capabilities in overnight package delivery.

The second approach to building competitive advantage entails determined management efforts to be cost-efficient in performing value chain activities. Such efforts have to be ongoing and persistent, and they have to involve each and every value chain activity. The goal must be continuous cost reduction, not a one-time or on-again/off-again effort. Companies whose managers are truly committed to low-cost performance of value chain activities and succeed in engaging company personnel to discover innovative ways to drive costs out of the business have a real chance of gaining a durable low-cost edge over rivals. It is not as easy as it seems to imitate a company’s low-cost practices. Companies like Wal-Mart, Dell, Nucor Steel, Southwest Airlines,
Toyota, and French discount retailer Carrefour have been highly successful in managing their value chains in a low-cost manner.

**QUESTION 4: IS THE COMPANY COMPETITIVELY STRONGER OR WEAKER THAN KEY RIVALS?**

Using value chain analysis and benchmarking to determine a company’s competitiveness on price is necessary but not sufficient. A more comprehensive assessment needs to be made of the company’s overall competitive strength. The answers to two questions are of particular interest: First, how does the company rank relative to competitors on each of the important factors that determine market success? Second, all things considered, does the company have a net competitive advantage or disadvantage versus major competitors?

An easy-to-use method for answering the two questions posed above involves developing quantitative strength ratings for the company and its key competitors on each industry key success factor and each competitively pivotal resource capability. Much of the information needed for doing a competitive strength assessment comes from previous analyses. Industry and competitive analysis reveals the key success factors and competitive capabilities that separate industry winners from losers. Benchmarking data and scouting key competitors provide a basis for judging the competitive strength of rivals on such factors as cost, key product attributes, customer service, image and reputation, financial strength, technological skills, distribution capability, and other competitively important resources and capabilities. SWOT analysis reveals how the company in question stacks up on these same strength measures.

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

Table 4.5 provides two examples of competitive strength assessment, using the hypothetical ABC Company against four rivals. The first example employs an unweighted rating system. With unweighted ratings, each key success factor/competitive strength measure is assumed to be equally important (a rather dubious assumption). Whichever company has the highest strength rating on a given measure has an implied competitive edge on that factor; the size of its edge is mirrored in the margin of difference between its rating and the ratings assigned to rivals—a rating of 9 for one company versus ratings of 5, 4, and 3, respectively, for three other companies indicates a bigger advantage than a rating of 9 versus ratings of 8, 7, and 6. Summing a company’s ratings on all the measures produces an overall strength rating. The higher a company’s overall strength rating, the stronger its overall competitiveness versus rivals. The bigger the difference between a company’s overall rating and the scores of lower-rated rivals, the greater its implied net competitive advantage. Conversely, the bigger the difference between a company’s overall rating and the scores of higher-rated rivals, the greater its implied...
Table 4.5  Illustrations of Unweighted and Weighted Competitive Strength Assessments

### A. An Unweighted Competitive Strength Assessment

<table>
<thead>
<tr>
<th>Key Success Factor/Strength Measure</th>
<th>ABC Co.</th>
<th>Rival 1</th>
<th>Rival 2</th>
<th>Rival 3</th>
<th>Rival 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quality/product performance</td>
<td>8</td>
<td>5</td>
<td>10</td>
<td>1</td>
<td>6</td>
</tr>
<tr>
<td>Reputation/image</td>
<td>8</td>
<td>7</td>
<td>10</td>
<td>1</td>
<td>6</td>
</tr>
<tr>
<td>Manufacturing capability</td>
<td>2</td>
<td>10</td>
<td>4</td>
<td>5</td>
<td>1</td>
</tr>
<tr>
<td>Technological skills</td>
<td>10</td>
<td>1</td>
<td>7</td>
<td>3</td>
<td>8</td>
</tr>
<tr>
<td>Dealer network/distribution capability</td>
<td>9</td>
<td>4</td>
<td>10</td>
<td>5</td>
<td>1</td>
</tr>
<tr>
<td>New product innovation capability</td>
<td>9</td>
<td>4</td>
<td>10</td>
<td>5</td>
<td>1</td>
</tr>
<tr>
<td>Financial resources</td>
<td>5</td>
<td>10</td>
<td>7</td>
<td>3</td>
<td>1</td>
</tr>
<tr>
<td>Relative cost position</td>
<td>5</td>
<td>10</td>
<td>3</td>
<td>1</td>
<td>4</td>
</tr>
<tr>
<td>Customer service capabilities</td>
<td>5</td>
<td>7</td>
<td>10</td>
<td>1</td>
<td>4</td>
</tr>
<tr>
<td><strong>Unweighted overall strength rating</strong></td>
<td>61</td>
<td>58</td>
<td>71</td>
<td>25</td>
<td>32</td>
</tr>
</tbody>
</table>

### B. A Weighted Competitive Strength Assessment

(Rating Scale: 1 = Very weak; 10 = Very strong)

<table>
<thead>
<tr>
<th>Key Success Factor/Strength Measure</th>
<th>Importance Weight</th>
<th>ABC Co.</th>
<th>Rival 1</th>
<th>Rival 2</th>
<th>Rival 3</th>
<th>Rival 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quality/product performance</td>
<td>0.10</td>
<td>8</td>
<td>0.80</td>
<td>5</td>
<td>0.50</td>
<td>10</td>
</tr>
<tr>
<td>Reputation/image</td>
<td>0.10</td>
<td>8</td>
<td>0.80</td>
<td>7</td>
<td>0.70</td>
<td>10</td>
</tr>
<tr>
<td>Manufacturing capability</td>
<td>0.10</td>
<td>2</td>
<td>0.20</td>
<td>10</td>
<td>1.00</td>
<td>4</td>
</tr>
<tr>
<td>Technological skills</td>
<td>0.05</td>
<td>10</td>
<td>0.50</td>
<td>1</td>
<td>0.05</td>
<td>7</td>
</tr>
<tr>
<td>Dealer network/distribution capability</td>
<td>0.05</td>
<td>9</td>
<td>0.45</td>
<td>4</td>
<td>0.20</td>
<td>10</td>
</tr>
<tr>
<td>New product innovation capability</td>
<td>0.05</td>
<td>9</td>
<td>0.45</td>
<td>4</td>
<td>0.20</td>
<td>10</td>
</tr>
<tr>
<td>Financial resources</td>
<td>0.10</td>
<td>5</td>
<td>0.50</td>
<td>10</td>
<td>1.00</td>
<td>7</td>
</tr>
<tr>
<td>Relative cost position</td>
<td>0.30</td>
<td>5</td>
<td>1.50</td>
<td>10</td>
<td>3.00</td>
<td>3</td>
</tr>
<tr>
<td>Customer service capabilities</td>
<td>0.15</td>
<td>5</td>
<td>0.75</td>
<td>7</td>
<td>1.05</td>
<td>10</td>
</tr>
<tr>
<td><strong>Sum of importance weights</strong></td>
<td>1.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Weighted overall strength rating</strong></td>
<td>61</td>
<td>5.95</td>
<td>58</td>
<td>7.70</td>
<td>71</td>
<td>6.85</td>
</tr>
</tbody>
</table>
Part 1 Concepts and Techniques for Crafting and Executing Strategy

net competitive disadvantage. Thus, ABC’s total score of 61 (see the top half of Table 4.5) signals a much greater net competitive advantage over Rival 4 (with a score of 32) than over Rival 1 (with a score of 58) but indicates a moderate net competitive disadvantage against Rival 2 (with an overall score of 71).

However, a better method is a weighted rating system (shown in the bottom half of Table 4.5) because the different measures of competitive strength are unlikely to be equally important. In an industry where the products/services of rivals are virtually identical, for instance, having low unit costs relative to rivals is nearly always the most important determinant of competitive strength. In an industry with strong product differentiation, the most significant measures of competitive strength may be brand awareness, amount of advertising, product attractiveness, and distribution capability. In a weighted rating system each measure of competitive strength is assigned a weight based on its perceived importance in shaping competitive success. A weight could be as high as 0.75 (maybe even higher) in situations where one particular competitive variable is overwhelmingly decisive, or a weight could be as low as 0.20 when two or three strength measures are more important than the rest. Lesser competitive strength indicators can carry weights of 0.05 or 0.10. No matter whether the differences between the importance weights are big or little, the sum of the weights must equal 1.0.

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

Note in Table 4.5 that the unweighted and weighted rating schemes produce different orderings of the companies. In the weighted system, ABC Company drops from second to third in strength, and Rival 1 jumps from third to first because of its high strength ratings on the two most important factors. Weighting the importance of the strength measures can thus make a significant difference in the outcome of the assessment.

Interpreting the Competitive Strength Assessments

Competitive strength assessments provide useful conclusions about a company’s competitive situation. The ratings show how a company compares against rivals, factor by factor or capability by capability, thus revealing where it is strongest and weakest, and against whom. Moreover, the overall competitive strength scores indicate how all the different factors add up—whether the company is at a net competitive advantage or disadvantage against each rival. The firm with the largest overall competitive strength rating enjoys the strongest competitive position, with the size of its net competitive advantage reflected by how much its score exceeds the scores of rivals.

In addition, the strength ratings provide guidelines for designing wise offensive and defensive strategies. For example, consider the ratings and weighted scores in
the bottom half of Table 4.5. If ABC Company wants to go on the offensive to win additional sales and market share, such an offensive probably needs to be aimed directly at winning customers away from Rivals 3 and 4 (which have lower overall strength scores) rather than Rivals 1 and 2 (which have higher overall strength scores). Moreover, while ABC has high ratings for quality/product performance (an 8 rating), reputation/image (an 8 rating), technological skills (a 10 rating), dealer network/distribution capability (a 9 rating), and new product innovation capability (a 9 rating), these strength measures have low importance weights—meaning that ABC has strengths in areas that don’t translate into much competitive clout in the marketplace. Even so, it outclasses Rival 3 in all five areas, plus it enjoys lower costs than Rival 3: On relative cost position ABC has a 5 rating versus a 1 rating for Rival 3—and relative cost position carries the highest importance weight of all the strength measures. ABC also has greater competitive strength than Rival 3 as concerns customer service capabilities (which carries the second-highest importance weight). Hence, because ABC’s strengths are in the very areas where Rival 3 is weak, ABC is in good position to attack Rival 3—it may well be able to persuade a number of Rival 3’s customers to switch their purchases over to ABC’s product.

But in mounting an offensive to win customers away from Rival 3, ABC should note that Rival 1 has an excellent relative cost position—its rating of 10, combined with the importance weight of 0.30 for relative cost, means that Rival 1 has meaningfully lower costs in an industry where low costs are competitively important. Rival 1 is thus strongly positioned to retaliate against ABC with lower prices if ABC’s strategy offensive ends up drawing customers away from Rival 1. Moreover, Rival 1’s very strong relative cost position vis-à-vis all the other companies arms it with the ability to use its lower-cost advantage to underprice all of its rivals and gain sales and market share at their expense. If ABC wants to defend against its vulnerability to potential price cutting by Rival 1, then it needs to aim a portion of its strategy at lowering its costs.

The point here is that a competitively astute company should use the strength assessment in deciding what strategic moves to make—which strengths to exploit in winning business away from rivals and which competitive weaknesses to try to correct. When a company has important competitive strengths in areas where one or more rivals are weak, it makes sense to consider offensive moves to exploit rivals’ competitive weaknesses. When a company has important competitive weaknesses in areas where one or more rivals are strong, it makes sense to consider defensive moves to curtail its vulnerability.

**QUESTION 5: WHAT STRATEGIC ISSUES AND PROBLEMS MERIT FRONT-BURNER MANAGERIAL ATTENTION?**

The final and most important analytical step is to zero in on exactly what strategic issues that company managers need to address—and resolve—for the company to be more financially and competitively successful in the years ahead. This step involves drawing on the results of both industry and competitive analysis and the evaluations of the company’s own competitiveness. The task here is to get a clear fix on exactly what strategic and competitive challenges confront the company, which of the company’s competitive shortcomings need fixing, what obstacles stand in the way of improving the company’s competitive position in the marketplace, and what specific problems
Zeroing in on the strategic issues a company faces and compiling a “worry list” of problems and roadblocks creates a strategic agenda of problems that merit prompt managerial attention.

Actually deciding upon a strategy and what specific actions to take is what comes after developing the list of strategic issues and problems that merit front-burner management attention.

A good strategy must contain ways to deal with all the strategic issues and obstacles that stand in the way of the company’s financial and competitive success in the years ahead.

merit front-burner attention by company managers. Pinpointing the precise things that management needs to worry about sets the agenda for deciding what actions to take next to improve the company’s performance and business outlook.

The “worry list” of issues and problems that have to be wrestled with can include such things as how to stave off market challenges from new foreign competitors, how to combat the price discounting of rivals, how to reduce the company’s high costs and pave the way for price reductions, how to sustain the company’s present rate of growth in light of slowing buyer demand, whether to expand the company’s product line, whether to correct the company’s competitive deficiencies by acquiring a rival company with the missing strengths, whether to expand into foreign markets rapidly or cautiously, whether to reposition the company and move to a different strategic group, what to do about growing buyer interest in substitute products, and what to do to combat the aging demographics of the company’s customer base. The worry list thus always centers on such concerns as “how to . . .,” “what to do about . . .,” and “whether to . . .”—the purpose of the worry list is to identify the specific issues/problems that management needs to address, not to figure out what specific actions to take. Deciding what to do—which strategic actions to take and which strategic moves to make—comes later (when it is time to craft the strategy and choose from among the various strategic alternatives).

If the items on the worry list are relatively minor—which suggests the company’s strategy is mostly on track and reasonably well matched to the company’s overall situation—then company managers seldom need to go much beyond fine-tuning of the present strategy. If, however, the issues and problems confronting the company are serious and indicate the present strategy is not well suited for the road ahead, the task of crafting a better strategy has got to go to the top of management’s action agenda.

Key Points

There are five key questions to consider in analyzing a company’s own particular competitive circumstances and its competitive position vis-à-vis key rivals:

1. How well is the present strategy working? This involves evaluating the strategy from a qualitative standpoint (completeness, internal consistency, rationale, and suitability to the situation) and also from a quantitative standpoint (the strategic and financial results the strategy is producing). The stronger a company’s current overall performance, the less likely the need for radical strategy changes. The weaker a company’s performance and/or the faster the changes in its external situation (which can be gleaned from industry and competitive analysis), the more its current strategy must be questioned.

2. What are the company’s resource strengths and weaknesses, and its external opportunities and threats? A SWOT analysis provides an overview of a firm’s situation and is an essential component of crafting a strategy tightly matched to the company’s situation. The two most important parts of SWOT analysis are (a) drawing conclusions about what story the compilation of strengths, weaknesses, opportunities, and threats tells about the company’s overall situation, and
acting on those conclusions to better match the company’s strategy, to its resource strengths and market opportunities, to correct the important weaknesses, and to defend against external threats. A company’s resource strengths, competencies, and competitive capabilities are strategically relevant because they are the most logical and appealing building blocks for strategy; resource weaknesses are important because they may represent vulnerabilities that need correction. External opportunities and threats come into play because a good strategy necessarily aims at capturing a company’s most attractive opportunities and at defending against threats to its well-being.

3. Are the company’s prices and costs competitive? One telling sign of whether a company’s situation is strong or precarious is whether its prices and costs are competitive with those of industry rivals. Value chain analysis and benchmarking are essential tools in determining whether the company is performing particular functions and activities cost-effectively, learning whether its costs are in line with competitors, and deciding which internal activities and business processes need to be scrutinized for improvement. Value chain analysis teaches that how competently a company manages its value chain activities relative to rivals is a key to building a competitive advantage based on either better competencies and competitive capabilities or lower costs than rivals.

4. Is the company competitively stronger or weaker than key rivals? The key appraisals here involve how the company matches up against key rivals on industry key success factors and other chief determinants of competitive success and whether and why the company has a competitive advantage or disadvantage. Quantitative competitive strength assessments, using the method presented in Table 4.5, indicate where a company is competitively strong and weak, and provide insight into the company’s ability to defend or enhance its market position. As a rule a company’s competitive strategy should be built around its competitive strengths and should aim at shoring up areas where it is competitively vulnerable. When a company has important competitive strengths in areas where one or more rivals are weak, it makes sense to consider offensive moves to exploit rivals’ competitive weaknesses. When a company has important competitive weaknesses in areas where one or more rivals are strong, it makes sense to consider defensive moves to curtail its vulnerability.

5. What strategic issues and problems merit front-burner managerial attention? This analytical step zeros in on the strategic issues and problems that stand in the way of the company’s success. It involves using the results of both industry and competitive analysis and company situation analysis to identify a “worry list” of issues to be resolved for the company to be financially and competitively successful in the years ahead. The worry list always centers on such concerns as “how to . . .,” “what to do about . . .,” and “whether to . . .”—the purpose of the worry list is to identify the specific issues/problems that management needs to address. Actually deciding upon a strategy and what specific actions to take is what comes after the list of strategic issues and problems that merit front-burner management attention is developed.

Good company situation analysis, like good industry and competitive analysis, is a valuable precondition for good strategy making. A competently done evaluation of a company’s resource capabilities and competitive strengths exposes strong and weak points in the present strategy and how attractive or unattractive the company’s
Part 1  Concepts and Techniques for Crafting and Executing Strategy

competitive position is and why. Managers need such understanding to craft a strategy that is well suited to the company’s competitive circumstances.

**Exercises**

1. Review the information in Illustration Capsule 4.1 concerning the costs of the different value chain activities associated with recording and distributing music CDs through traditional brick-and-mortar retail outlets. Then answer the following questions:
   a. Does the growing popularity of downloading music from the Internet give rise to a new music industry value chain that differs considerably from the traditional value chain? Explain why or why not.
   b. What costs are cut out of the traditional value chain or bypassed when online music retailers (Apple, Sony, Microsoft, Musicmatch, Napster, Cdigix, and others) sell songs directly to online buyers? (Note: In 2005, online music stores were selling download-only titles for $0.79 to $0.99 per song and $9.99 for most albums.)
   c. What costs would be cut out of the traditional value chain or bypassed in the event that recording studios sell downloadable files of artists’ recordings directly to online buyers?
   d. What happens to the traditional value chain if more and more music lovers use peer-to-peer file-sharing software to download music from the Internet to play music on their PCs or MP3 players or make their own CDs? (Note: It was estimated that, in 2004, about 1 billion songs were available for online trading and file sharing via such programs as Kazaa, Grokster, Shareaza, BitTorrent, and eDonkey, despite the fact that some 4,000 people had been sued by the Recording Industry Association of America for pirating copyrighted music via peer-to-peer file sharing.)

2. Using the information in Table 4.1 and the following financial statement information for Avon Products, calculate the following ratios for Avon for both 2003 and 2004:
   a. Gross profit margin.
   b. Operating profit margin.
   c. Net profit margin.
   d. Return on total assets.
   e. Return on stockholders’ equity.
   f. Debt-to-equity ratio.
   g. Times-interest-earned.
   h. Days of inventory.
   i. Inventory turnover ratio.
   j. Average collection period.

Based on these ratios, did Avon’s financial performance improve, weaken, or remain about the same from 2003 to 2004?
### Avon Products Inc., Consolidated Statements of Income
(in millions, except per share data)

<table>
<thead>
<tr>
<th></th>
<th>Years Ended December 31</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2004</td>
</tr>
<tr>
<td>Net sales</td>
<td>$7,656.2</td>
</tr>
<tr>
<td>Other revenue</td>
<td>91.6</td>
</tr>
<tr>
<td>Total revenue</td>
<td>7,747.8</td>
</tr>
<tr>
<td>Costs, expenses and other:</td>
<td></td>
</tr>
<tr>
<td>Cost of sales</td>
<td>2,911.7</td>
</tr>
<tr>
<td>Marketing, distribution and administrative expenses</td>
<td>3,610.3</td>
</tr>
<tr>
<td>Special charges, net</td>
<td>(3.2)</td>
</tr>
<tr>
<td>Operating profit</td>
<td>1,229.0</td>
</tr>
<tr>
<td>Interest expense</td>
<td>33.8</td>
</tr>
<tr>
<td>Interest income</td>
<td>(20.6)</td>
</tr>
<tr>
<td>Other expense (income), net</td>
<td>28.3</td>
</tr>
<tr>
<td>Total other expenses</td>
<td>41.5</td>
</tr>
<tr>
<td>Income before taxes and minority interest</td>
<td>1,187.5</td>
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<tr>
<td>Income taxes</td>
<td>330.6</td>
</tr>
<tr>
<td>Income before minority interest</td>
<td>856.9</td>
</tr>
<tr>
<td>Minority interest</td>
<td>(10.8)</td>
</tr>
<tr>
<td>Net income</td>
<td>$846.1</td>
</tr>
<tr>
<td>Earnings per share:</td>
<td></td>
</tr>
<tr>
<td>Basic</td>
<td>$1.79</td>
</tr>
<tr>
<td>Diluted</td>
<td>$1.77</td>
</tr>
<tr>
<td>Weighted-average shares outstanding (in millions):</td>
<td></td>
</tr>
<tr>
<td>Basic</td>
<td>472.35</td>
</tr>
<tr>
<td>Diluted</td>
<td>477.96</td>
</tr>
</tbody>
</table>
### Avon Products Inc. Consolidated Balance Sheets (in millions)

<table>
<thead>
<tr>
<th></th>
<th>December 31</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2004</td>
</tr>
<tr>
<td><strong>Current assets</strong></td>
<td></td>
</tr>
<tr>
<td>Cash, including cash equivalents of $401.2 and $373.8</td>
<td>$769.6</td>
</tr>
<tr>
<td>Accounts receivable (less allowances of $101.0 and $81.1)</td>
<td>599.1</td>
</tr>
<tr>
<td>Inventories</td>
<td>740.5</td>
</tr>
<tr>
<td>Prepaid expenses and other</td>
<td>397.2</td>
</tr>
<tr>
<td><strong>Total current assets</strong></td>
<td>$2,506.4</td>
</tr>
<tr>
<td><strong>Property, plant and equipment, at cost:</strong></td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>$61.7</td>
</tr>
<tr>
<td>Buildings and improvements</td>
<td>886.8</td>
</tr>
<tr>
<td>Equipment</td>
<td>1,006.7</td>
</tr>
<tr>
<td><strong>Total property, plant and equipment, at cost:</strong></td>
<td>1,955.2</td>
</tr>
<tr>
<td>Less accumulated depreciation</td>
<td>(940.4)</td>
</tr>
<tr>
<td><strong>Other assets</strong></td>
<td>1,014.8</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$4,148.1</td>
</tr>
</tbody>
</table>

**Liabilities and shareholders’ equity**

|                          |       |       |
| Current liabilities      |       |       |
| Debt maturing within one year | $51.7  | $244.1 |
| Accounts payable         | 490.1  | 400.1 |
| Accrued compensation     | 164.5  | 149.5 |
| Other accrued liabilities | 360.1  | 332.6 |
| Sales and taxes other than income | 154.4  | 139.5 |
| Income taxes             | 304.7  | 341.2 |
| **Total current liabilities** | $1,525.5 | $1,607.0 |

|                          |       |       |
| Long-term debt           | $866.3 | $877.7 |
| Employee benefit plans   | 620.6  | 502.1 |
| Deferred income taxes    | 12.1   | 50.6  |
| Other liabilities (including minority interest of $42.5 and $46.0) | 173.4  | 172.9 |
| **Total liabilities**    | $3,197.9 | $3,210.3 |

(Continued)
### Shareholders’ equity

<table>
<thead>
<tr>
<th>Description</th>
<th>December 31 2004</th>
<th>December 31 2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock, par value $.25—authorized 1,500 shares; issued 728.61 and 722.25 shares</td>
<td>182.2</td>
<td>90.3</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>1,356.8</td>
<td>1,188.4</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>2,693.5</td>
<td>2,202.4</td>
</tr>
<tr>
<td>Accumulated other comprehensive loss</td>
<td>(679.5)</td>
<td>(729.4)</td>
</tr>
<tr>
<td>Treasury stock, at cost—257.08 and 251.66 shares</td>
<td>(2,602.8)</td>
<td>(2,380.4)</td>
</tr>
<tr>
<td>Total shareholders’ equity</td>
<td>950.2</td>
<td>371.3</td>
</tr>
<tr>
<td>Total liabilities and shareholders’ equity</td>
<td>$4,148.1</td>
<td>$3,581.6</td>
</tr>
</tbody>
</table>

Source: Avon Products Inc., 2004 10-K
Winners in business play rough and don’t apologize for it. The nicest part of playing hardball is watching your competitors squirm.
—George Stalk Jr. and Rob Lachenauer

The essence of strategy lies in creating tomorrow’s competitive advantages faster than competitors mimic the ones you possess today.
—Gary Hamel and C. K. Prahalad

Competitive strategy is about being different. It means deliberately choosing to perform activities differently or to perform different activities than rivals to deliver a unique mix of value.
—Michael E. Porter

Strategy . . . is about first analyzing and then experimenting, trying, learning, and experimenting some more.
—Ian C. McMillan and Rita Gunther McGrath

The Five Generic Competitive Strategies

Which One to Employ?
This chapter describes the five basic competitive strategy options—which of the five to employ is a company’s first and foremost choice in crafting an overall strategy and beginning its quest for competitive advantage. A company’s competitive strategy deals exclusively with the specifics of management’s game plan for competing successfully—its specific efforts to please customers, its offensive and defensive moves to counter the maneuvers of rivals, its responses to whatever market conditions prevail at the moment, its initiatives to strengthen its market position, and its approach to securing a competitive advantage vis-à-vis rivals. Companies the world over are imaginative in conceiving competitive strategies to win customer favor. At most companies the aim, quite simply, is to do a significantly better job than rivals of providing what buyers are looking for and thereby secure an upper hand in the marketplace.

A company achieves competitive advantage whenever it has some type of edge over rivals in attracting buyers and coping with competitive forces. There are many routes to competitive advantage, but they all involve giving buyers what they perceive as superior value compared to the offerings of rival sellers. Superior value can mean a good product at a lower price; a superior product that is worth paying more for; or a best-value offering that represents an attractive combination of price, features, quality, service, and other appealing attributes. Delivering superior value—whatever form it takes—nearly always requires performing value chain activities differently than rivals and building competencies and resource capabilities that are not readily matched.
THE FIVE GENERIC COMPETITIVE STRATEGIES

There are countless variations in the competitive strategies that companies employ, mainly because each company’s strategic approach entails custom-designed actions to fit its own circumstances and industry environment. The custom-tailored nature of each company’s strategy makes the chances remote that any two companies—even companies in the same industry—will employ strategies that are exactly alike in every detail. Managers at different companies always have a slightly different spin on future market conditions and how to best align their company’s strategy with these conditions; moreover, they have different notions of how they intend to outmaneuver rivals and what strategic options make the most sense for their particular company. However, when one strips away the details to get at the real substance, the biggest and most important differences among competitive strategies boil down to (1) whether a company’s market target is broad or narrow, and (2) whether the company is pursuing a competitive advantage linked to low costs or product differentiation. Five distinct competitive strategy approaches stand out:

1. A low-cost provider strategy—striving to achieve lower overall costs than rivals and appealing to a broad spectrum of customers, usually by underpricing rivals.

2. A broad differentiation strategy—seeking to differentiate the company’s product offering from rivals’ in ways that will appeal to a broad spectrum of buyers.

3. A best-cost provider strategy—giving customers more value for their money by incorporating good-to-excellent product attributes at a lower cost than rivals; the target is to have the lowest (best) costs and prices compared to rivals offering products with comparable attributes.

Figure 5.1  The Five Generic Competitive Strategies: Each Stakes Out a Different Market Position

4. A focused (or market niche) strategy based on low costs—concentrating on a narrow buyer segment and outcompeting rivals by having lower costs than rivals and thus being able to serve niche members at a lower price.

5. A focused (or market niche) strategy based on differentiation—concentrating on a narrow buyer segment and outcompeting rivals by offering niche members customized attributes that meet their tastes and requirements better than rivals’ products.

Each of these five generic competitive approaches stakes out a different market position, as shown in Figure 5.1. Each involves distinctively different approaches to competing and operating the business. The remainder of this chapter explores the ins and outs of the five generic competitive strategies and how they differ.

LOW-COST PROVIDER STRATEGIES

Striving to be the industry’s overall low-cost provider is a powerful competitive approach in markets with many price-sensitive buyers. A company achieves low-cost leadership when it becomes the industry’s lowest-cost provider rather than just being one of perhaps several competitors with comparatively low costs. A low-cost provider’s strategic target is meaningfully lower costs than rivals—but not necessarily the absolutely lowest possible cost. In striving for a cost advantage over rivals, managers must take care to include features and services that buyers consider essential—a product offering that is too frills-free sabotages the attractiveness of the company’s product and can turn buyers off even if it is priced lower than competing products.

For maximum effectiveness, companies employing a low-cost provider strategy need to achieve their cost advantage in ways difficult for rivals to copy or match. If rivals find it relatively easy or inexpensive to imitate the leader’s low-cost methods, then the leader’s advantage will be too short-lived to yield a valuable edge in the marketplace.

A company has two options for translating a low-cost advantage over rivals into attractive profit performance. Option 1 is to use the lower-cost edge to underprice competitors and attract price-sensitive buyers in great enough numbers to increase total profits. The trick to profitably underpricing rivals is either to keep the size of the price cut smaller than the size of the firm’s cost advantage (thus reaping the benefits of both a bigger profit margin per unit sold and the added profits on incremental sales) or to generate enough added volume to increase total profits despite thinner profit margins (larger volume can make up for smaller margins provided the underpricing of rivals brings in enough extra sales). Option 2 is to maintain the present price, be content with the present market share, and use the lower-cost edge to earn a higher profit margin on each unit sold, thereby raising the firm’s total profits and overall return on investment.

Illustration Capsule 5.1 describes Nucor Corporation’s strategy for gaining low-cost leadership in manufacturing a variety of steel products.

The Two Major Avenues for Achieving a Cost Advantage

To achieve a low-cost edge over rivals, a firm’s cumulative costs across its overall value chain must be lower than competitors’ cumulative costs—and the means of achieving
Illustration Capsule 5.1

Nucor Corporation’s Low-Cost Provider Strategy

Nucor Corporation is the world’s leading minimill producer of such steel products as carbon and alloy steel bars, beams, sheet, and plate; steel joists and joist girders; steel deck; cold finished steel; steel fasteners; metal building systems; and light gauge steel framing. In 2004, it had close to $10 billion in sales, 9,000 employees, and annual production capacity of nearly 22 million tons, making it the largest steel producer in the United States and one of the 10 largest in the world. The company has pursued a strategy that has made it among the world’s lowest-cost producers of steel and has allowed the company to consistently outperform its rivals in terms of financial and market performance.

Nucor’s low-cost strategy aims to give it a cost and pricing advantage in the commodity-like steel industry and leaves no part of the company’s value chain neglected. The key elements of the strategy include the following:

- **Using electric arc furnaces where scrap steel and directly reduced iron ore are melted and then sent to a continuous caster and rolling mill to be shaped into steel products, thereby eliminating an assortment of production processes from the value chain used by traditional integrated steel mills. Nucor’s minimill value chain makes the use of coal, coke, and iron ore unnecessary; cuts investment in facilities and equipment (eliminating coke ovens, blast furnaces, basic oxygen furnaces, and ingot casters); and requires fewer employees than integrated mills.**

- **Striving hard for continuous improvement in the efficiency of its plants and frequently investing in state-of-the-art equipment to reduce unit costs. Nucor is known for its technological leadership and its aggressive pursuit of production process innovation.**

- **Carefully selecting plant sites to minimize inbound and outbound shipping costs and to take advantage of low rates for electricity (electric arc furnaces are heavy users of electricity). Nucor tends to avoid locating new plants in geographic areas where labor unions are a strong influence.**

- **Hiring a nonunion workforce that uses team-based incentive compensation systems (often opposed by unions). Operating and maintenance employees and supervisors are paid weekly bonuses based on the productivity of their work group. The size of the bonus is based on the capabilities of the equipment employed and ranges from 80 percent to 150 percent of an employee’s base pay; no bonus is paid if the equipment is not operating. Nucor’s compensation program has boosted the company’s labor productivity to levels nearly double the industry average while rewarding productive employees with annual compensation packages that exceed what their union counterparts earn by as much as 20 percent. Nucor has been able to attract and retain highly talented, productive, and dedicated employees. In addition, the company’s healthy culture and results-oriented self-managed work teams allow the company to employ fewer supervisors than what would be needed with an hourly union workforce.**

- **Heavily emphasizing consistent product quality and has rigorous quality systems.**

- **Minimizing general and administrative expenses by maintaining a lean staff at corporate headquarters (fewer than 125 employees) and allowing only four levels of management between the CEO and production workers. Headquarters offices are modestly furnished and located in an inexpensive building. The company minimizes reports, paperwork, and meetings to keep managers focused on value-adding activities— the company’s top managers set the example by flying coach class, avoiding pricey hotels, and refraining from taking customers out for expensive dinners.**

In 2001–2003, when many U.S. producers of steel products were in dire economic straits because of weak demand for steel and deep price discounting by foreign rivals, Nucor began acquiring state-of-the-art steelmaking facilities from bankrupt or nearly bankrupt rivals at bargain-basement prices, often at 20 to 25 percent of what it cost to construct the facilities. This has given Nucor much lower depreciation costs than rivals having comparable plants.

Nucor management’s outstanding execution of its low-cost strategy and its commitment to drive down costs throughout its value chain has allowed it to compete aggressively on price, earn higher profit margins than rivals, and grow its business at a considerably faster rate than its integrated steel mill rivals.

**Source:** Company annual reports, news releases, and Web site.
the cost advantage must be durable. There are two ways to accomplish this:

1. Do a better job than rivals of performing value chain activities more cost-effectively.
2. Revamp the firm’s overall value chain to eliminate or bypass some cost-producing activities.

Let’s look at each of the two approaches to securing a cost advantage.

**Cost-Efficient Management of Value Chain Activities** For a company to do a more cost-efficient job of managing its value chain than rivals, managers must launch a concerted, ongoing effort to ferret out cost-saving opportunities in every part of the value chain. No activity can escape cost-saving scrutiny, and all company personnel must be expected to use their talents and ingenuity to come up with innovative and effective ways to keep costs down. All avenues for performing value chain activities at a lower cost than rivals have to be explored. Attempts to outmanage rivals on cost commonly involve such actions as:

1. **Striving to capture all available economies of scale.** Economies of scale stem from an ability to lower unit costs by increasing the scale of operation—there are many occasions when a large plant is more economical to operate than a small or medium-size plant or when a large distribution warehouse is more cost efficient than a small warehouse. Often, manufacturing economies can be achieved by using common parts and components in different models and/or by cutting back on the number of models offered (especially slow-selling ones) and then scheduling longer production runs for fewer models. In global industries, making separate products for each country market instead of selling a mostly standard product worldwide tends to boost unit costs because of lost time in model changeover, shorter production runs, and inability to reach the most economic scale of production for each country model.

2. **Taking full advantage of learning/experience curve effects.** The cost of performing an activity can decline over time as the learning and experience of company personnel builds. Learning/experience curve economies can stem from debugging and mastering newly introduced technologies, using the experiences and suggestions of workers to install more efficient plant layouts and assembly procedures, and the added speed and effectiveness that accrues from repeatedly picking sites for and building new plants, retail outlets, or distribution centers. Aggressively managed low-cost providers pay diligent attention to capturing the benefits of learning and experience and to keeping these benefits proprietary to whatever extent possible.

3. **Trying to operate facilities at full capacity.** Whether a company is able to operate at or near full capacity has a big impact on units costs when its value chain contains activities associated with substantial fixed costs. Higher rates of capacity utilization allow depreciation and other fixed costs to be spread over a larger unit volume, thereby lowering fixed costs per unit. The more capital-intensive the business, or the higher the percentage of fixed costs as a percentage of total costs, the more important that full-capacity operation becomes because there’s such a stiff unit-cost penalty for underutilizing existing capacity. In such cases, finding ways to operate close to full capacity year-round can be an important source of cost advantage.

4. **Pursuing efforts to boost sales volumes and thus spread such costs as R&D, advertising, and selling and administrative costs out over more units.** The more units
a company sells, the more it lowers its unit costs for R&D, sales and marketing, and administrative overhead.

5. Improving supply chain efficiency. Many companies pursue cost reduction by partnering with suppliers to streamline the ordering and purchasing process via online systems, reduce inventory carrying costs via just-in-time inventory practices, economize on shipping and materials handling, and ferret out other cost-saving opportunities. A company with a core competence (or better still a distinctive competence) in cost-efficient supply chain management can sometimes achieve a sizable cost advantage over less adept rivals.

6. Substituting the use of low-cost for high-cost raw materials or component parts. If the costs of raw materials and parts are too high, a company can either substitute the use of lower-cost items or maybe even design the high-cost components out of the product altogether.

7. Using online systems and sophisticated software to achieve operating efficiencies. Data sharing, starting with customer orders and going all the way back to components production, coupled with the use of enterprise resource planning (ERP) and manufacturing execution system (MES) software, can make custom manufacturing just as cheap as mass production—and sometimes cheaper. Online systems and software can also greatly reduce production times and labor costs. Lexmark used ERP and MES software to cut its production time for inkjet printers from four hours to 24 minutes. Southwest Airlines uses proprietary software to schedule flights and assign flight crews cost-effectively.

8. Adopting labor-saving operating methods. Examples of ways for a company to economize on labor costs include the following: installing labor-saving technology, shifting production from geographic areas where labor costs are high to geographic areas where labor costs are low, avoiding the use of union labor where possible (because of work rules that can stifle productivity and because of union demands for above-market pay scales and costly fringe benefits), and using incentive compensation systems that promote high labor productivity.

9. Using the company’s bargaining power vis-à-vis suppliers to gain concessions. Many large enterprises (e.g., Wal-Mart, Home Depot, the world’s major motor vehicle producers) have used their bargaining clout in purchasing large volumes to wrangle good prices on their purchases from suppliers. Having greater buying power than rivals can be an important source of cost advantage.

10. Being alert to the cost advantages of outsourcing and vertical integration. Outsourcing the performance of certain value chain activities can be more economical than performing them in-house if outside specialists, by virtue of their expertise and volume, can perform the activities at lower cost. Indeed, outsourcing has in recent years become a widely used cost-reduction approach. However, there can be times when integrating the activities of either suppliers or distribution channel allies can allow an enterprise to detour suppliers or buyers who have an adverse impact on costs because of their considerable bargaining power.

In addition to the above means of achieving lower costs than rivals, managers can also achieve important cost savings by deliberately opting for an inherently economical strategy keyed to a frills-free product offering. For instance, a company can bolster its attempts to open up a durable cost advantage over rivals by:

- Having lower specifications for purchased materials, parts, and components than rivals do. Thus, a maker of personal computers (PCs) can use the cheapest
hard drives, microprocessors, monitors, DVD drives, and other components it can find so as to end up with lower production costs than rival PC makers.

- Distributing the company’s product only through low-cost distribution channels and avoiding high-cost distribution channels.
- Choosing to use the most economical method for delivering customer orders (even if it results in longer delivery times).

These strategy-related means of keeping costs low don’t really involve “outmanaging” rivals, but they can nonetheless contribute materially to becoming the industry’s low-cost leader.

Revamping the Value Chain to Curb or Eliminate Unnecessary Activities
Dramatic cost advantages can emerge from finding innovative ways to cut back on or entirely bypass certain cost-producing value chain activities. There are six primary ways companies can achieve a cost advantage by reconfiguring their value chains:

1. **Cutting out distributors and dealers by selling directly to customers.** Selling directly and bypassing the activities and costs of distributors or dealers can involve (1) having the company’s own direct sales force (which adds the costs of maintaining and supporting a sales force but may well be cheaper than accessing customers through distributors or dealers) and/or (2) conducting sales operations at the company’s Web site (Web site operations may be substantially cheaper than distributor or dealer channels). Costs in the wholesale/retail portions of the value chain frequently represent 35–50 percent of the price final consumers pay. There are several prominent examples in which companies have instituted a sell-direct approach to cutting costs out of the value chain. Software developers allow customers to download new programs directly from the Internet, eliminating the costs of producing and packaging CDs and cutting out the host of activities, costs, and markups associated with shipping and distributing software through wholesale and retail channels. By cutting all these costs and activities out of the value chain, software developers have the pricing room to boost their profit margins and still sell their products below levels that retailers would have to charge. The major airlines now sell most of their tickets directly to passengers via their Web sites, ticket counter agents, and telephone reservation systems, allowing them to save hundreds of millions of dollars in commissions once paid to travel agents.

2. **Replacing certain value chain activities with faster and cheaper online technology.** In recent years the Internet and Internet technology applications have become powerful and pervasive tools for conducting business and reengineering company and industry value chains. For instance, Internet technology has revolutionized supply chain management, turning many time-consuming and labor-intensive activities into paperless transactions performed instantaneously. Company procurement personnel can—with only a few mouse clicks—check materials inventories against incoming customer orders, check suppliers’ stocks, check the latest prices for parts and components at auction and e-sourcing Web sites, and check FedEx delivery schedules. Various e-procurement software packages streamline the purchasing process by eliminating paper documents such as requests for quotations, purchase orders, order acceptances, and shipping notices. There’s software that permits the relevant details of incoming customer orders to be instantly shared with the suppliers of needed parts and components. All this facilitates
just-in-time deliveries of parts and components and matching the production of parts and components to assembly plant requirements and production schedules, cutting out unnecessary activities and producing savings for both suppliers and manufacturers. Retailers can install online systems that relay data from cash register sales at the check-out counter back to manufacturers and their suppliers. Manufacturers can use online systems to collaborate closely with parts and components suppliers in designing new products and shortening the time it takes to get them into production. Online systems allow warranty claims and product performance problems involving supplier components to be instantly relayed to the relevant suppliers so that corrections can be expedited. Online systems have the further effect of breaking down corporate bureaucracies and reducing overhead costs. The whole back-office data management process (order processing, invoicing, customer accounting, and other kinds of transaction costs) can be handled fast, accurately, and with less paperwork and fewer personnel.

3. **Streamlining operations by eliminating low-value-added or unnecessary work steps and activities.** Examples include using computer-assisted design techniques, standardizing parts and components across models and styles, having suppliers collaborate to combine parts and components into modules so that products can be assembled in fewer steps, and shifting to an easy-to-manufacture product design. At Wal-Mart, some items supplied by manufacturers are delivered directly to retail stores rather than being routed through Wal-Mart’s distribution centers and delivered by Wal-Mart trucks; in other instances, Wal-Mart unloads incoming shipments from manufacturers’ trucks arriving at its distribution centers directly onto outgoing Wal-Mart trucks headed to particular stores without ever moving the goods into the distribution center. Many supermarket chains have greatly reduced in-store meat butchering and cutting activities by shifting to meats that are cut and packaged at the meat-packing plant and then delivered to their stores in ready-to-sell form.

4. **Relocating facilities so as to curb the need for shipping and handling activities.** Having suppliers locate facilities adjacent to the company’s plant or locating the company’s plants or warehouses near customers can help curb or eliminate shipping and handling costs.

5. **Offering a frills-free product.** Deliberately restricting a company’s product offering to the essentials can help the company cut costs associated with snazzy attributes and a full lineup of options and extras. Activities and costs can also be eliminated by incorporating fewer performance and quality features into the product and by offering buyers fewer services. Stripping extras like first-class sections, meals, and reserved seating is a favorite technique of budget airlines like Southwest, Ryanair (Europe), easyJet (Europe), and Gol (Brazil).

6. **Offering a limited product line as opposed to a full product line.** Pruning slow-selling items from the product lineup and being content to meet the needs of most buyers rather than all buyers can eliminate activities and costs associated with numerous product versions and wide selection.

Illustration Capsule 5.2 describes how Wal-Mart has managed its value chain in the retail grocery portion of its business to achieve a dramatic cost advantage over rival supermarket chains and become the world’s biggest grocery retailer.

**Examples of Companies That Revamped Their Value Chains to Reduce Costs**

Iowa Beef Packers (IBP), now a subsidiary of Tyson Foods, pioneered the
development of a cheaper value chain system in the beef-packing industry. The traditional cost chain involved raising cattle on scattered farms and ranches; shipping them live to labor-intensive, unionized slaughtering plants; and then transporting whole sides of beef to grocery retailers whose butcher departments cut them into smaller pieces and packaged them for sale to grocery shoppers. IBP revamped the traditional chain with a radically different strategy: It built large automated plants employing nonunion workers near cattle supplies. Near the plants it arranged to set up large feed lots (or holding pens) where cattle were fed grain for a short time to fatten them up prior to slaughter. The meat was butchered at the processing plant into small, high-yield cuts. Some of the trimmed and boned cuts were vacuum-sealed in plastic casings for further butchering in supermarket meat departments, but others were trimmed and/or boned, put in plastic-sealed ready-to-sell trays, boxed, and shipped to retailers. IBP’s strategy was to increase the volume of prepackaged, “case-ready” cuts that retail grocers could unpack from boxes and place directly into the meat case. In addition, IBP provided meat retailers with individually wrapped quick-frozen steaks, as well as

precooked roasts, beef tip, and meatloaf selections that could be prepared in a matter of minutes. Iowa Beef’s inbound cattle transportation expenses, traditionally a major cost item, were cut significantly by avoiding the weight losses that occurred when live animals were shipped long distances just prior to slaughter. Sizable major outbound shipping cost savings were achieved by not having to ship whole sides of beef, which had a high waste factor. Meat retailers had to do far less butchering to stock their meat cases. IBP value chain revamping was so successful that the company became the largest U.S. meatpacker.

Southwest Airlines has reconfigured the traditional value chain of commercial airlines to lower costs and thereby offer dramatically lower fares to passengers. Its mastery of fast turnarounds at the gates (about 25 minutes versus 45 minutes for rivals) allows its planes to fly more hours per day. This translates into being able to schedule more flights per day with fewer aircraft, allowing Southwest to generate more revenue per plane on average than rivals. Southwest does not offer in-flight meals, assigned seating, baggage transfer to connecting airlines, or first-class seating and service, thereby eliminating all the cost-producing activities associated with these features. The company’s fast, user-friendly online reservation system facilitates e-ticketing and reduces staffing requirements at telephone reservation centers and airport counters. Its use of automated check-in equipment reduces staffing requirements for terminal check-in.

Dell has created the best, most cost-efficient value chain in the global personal computer industry. Whereas Dell’s major rivals (Hewlett-Packard, Lenovo, Sony, and Toshiba) produce their models in volume and sell them through independent resellers and retailers, Dell has elected to market directly to PC users, building its PCs to customer specifications as orders come in and shipping them to customers within a few days of receiving the order. Dell’s value chain approach has proved cost-effective in coping with the PC industry’s blink-of-an-eye product life cycle. The build-to-order strategy enables the company to avoid misjudging buyer demand for its various models and being saddled with quickly obsolete excess components and finished-goods inventories—all parts and components are obtained on a just-in-time basis from vendors, many of which deliver their items to Dell assembly plants several times a day in volumes matched to the Dell’s daily assembly schedule. Also, Dell’s sell-direct strategy slices reseller/retailer costs and margins out of the value chain (although some of these savings are offset by the cost of Dell’s direct marketing and customer support activities—functions that would otherwise be performed by resellers and retailers). Partnerships with suppliers that facilitate just-in-time deliveries of components and minimize Dell’s inventory costs, coupled with Dell’s extensive use of e-commerce technologies further reduce Dell’s costs. Dell’s value chain approach is widely considered to have made it the global low-cost leader in the PC industry.

**The Keys to Success in Achieving Low-Cost Leadership**

To succeed with a low-cost-provider strategy, company managers have to scrutinize each cost-creating activity and determine what factors cause costs to be high or low. Then they have to use this knowledge to keep the unit costs of each activity low, exhaustively pursuing cost efficiencies throughout the value chain. They have to be proactive in restructuring the value chain to eliminate nonessential work steps and low-value activities. Normally, low-cost producers work diligently to create cost-conscious corporate cultures that feature broad employee participation in continuous cost improvement efforts and limited perks and frills for executives. They strive to operate with exceptionally small corporate staffs to keep administrative costs to a minimum.
Many successful low-cost leaders also use benchmarking to keep close tabs on how their costs compare with rivals and firms performing comparable activities in other industries.

But while low-cost providers are champions of frugality, they are usually aggressive in investing in resources and capabilities that promise to drive costs out of the business. Wal-Mart, one of the foremost practitioners of low-cost leadership, employs state-of-the-art technology throughout its operations—its distribution facilities are an automated showcase, it uses online systems to order goods from suppliers and manage inventories, it equips its stores with cutting-edge sales-tracking and check-out systems, and it sends daily point-of-sale data to 4,000 vendors. Wal-Mart’s information and communications systems and capabilities are more sophisticated than those of virtually any other retail chain in the world.

Other companies noted for their successful use of low-cost provider strategies include Lincoln Electric in arc welding equipment, Briggs & Stratton in small gasoline engines, Bic in ballpoint pens, Black & Decker in power tools, Stride Rite in footwear, Beaird-Poulan in chain saws, and General Electric and Whirlpool in major home appliances.

### When a Low-Cost Provider Strategy Works Best

A competitive strategy predicated on low-cost leadership is particularly powerful when:

1. *Price competition among rival sellers is especially vigorous*—Low-cost providers are in the best position to compete offensively on the basis of price, to use the appeal of lower price to grab sales (and market share) from rivals, to win the business of price-sensitive buyers, to remain profitable in the face of strong price competition, and to survive price wars.

2. *The products of rival sellers are essentially identical and supplies are readily available from any of several eager sellers*—Commodity-like products and/or ample supplies set the stage for lively price competition; in such markets, it is less efficient, higher-cost companies whose profits get squeezed the most.

3. *There are few ways to achieve product differentiation that have value to buyers*—When the differences between brands do not matter much to buyers, buyers are nearly always very sensitive to price differences and shop the market for the best price.

4. *Most buyers use the product in the same ways*—With common user requirements, a standardized product can satisfy the needs of buyers, in which case low selling price, not features or quality, becomes the dominant factor in causing buyers to choose one seller’s product over another’s.

5. *Buyers incur low costs in switching their purchases from one seller to another*—Low switching costs give buyers the flexibility to shift purchases to lower-priced sellers having equally good products or to attractively priced substitute products. A low-cost leader is well positioned to use low price to induce its customers not to switch to rival brands or substitutes.

6. *Buyers are large and have significant power to bargain down prices*—Low-cost providers have partial profit-margin protection in bargaining with high-volume buyers, since powerful buyers are rarely able to bargain price down past the survival level of the next most cost-efficient seller.

7. *Industry newcomers use introductory low prices to attract buyers and build a customer base*—The low-cost leader can use price cuts of its own to make it harder
A low-cost provider is in the best position to win the business of price-sensitive buyers, set the floor on market price, and still earn a profit.

The Pitfalls of a Low-Cost Provider Strategy

Perhaps the biggest pitfall of a low-cost provider strategy is getting carried away with overly aggressive price cutting and ending up with lower, rather than higher, profitability. A low-cost/low-price advantage results in superior profitability only if (1) prices are cut by less than the size of the cost advantage or (2) the added gains in unit sales are large enough to bring in a bigger total profit despite lower margins per unit sold. A company with a 5 percent cost advantage cannot cut prices 20 percent, end up with a volume gain of only 10 percent, and still expect to earn higher profits!

A second big pitfall is not emphasizing avenues of cost advantage that can be kept proprietary or that relegate rivals to playing catch-up. The value of a cost advantage depends on its sustainability. Sustainability, in turn, hinges on whether the company achieves its cost advantage in ways difficult for rivals to copy or match.

A third pitfall is becoming too fixated on cost reduction. Low cost cannot be pursued so zealously that a firm’s offering ends up being too features-poor to generate buyer appeal. Furthermore, a company driving hard to push its costs down has to guard against misreading or ignoring increased buyer interest in added features or service, declining buyer sensitivity to price, or new developments that start to alter how buyers use the product. A low-cost zealot risks losing market ground if buyers start opting for more upscale or features-rich products.

Even if these mistakes are avoided, a low-cost competitive approach still carries risk. Cost-saving technological breakthroughs or the emergence of still-lower-cost value chain models can nullify a low-cost leader’s hard-won position. The current leader may have difficulty in shifting quickly to the new technologies or value chain approaches because heavy investments lock it in (at least temporarily) to its present value chain approach.

BROAD DIFFERENTIATION STRATEGIES

Differentiation strategies are attractive whenever buyers’ needs and preferences are too diverse to be fully satisfied by a standardized product or by sellers with identical capabilities. A company attempting to succeed through differentiation must study buyers’ needs and behavior carefully to learn what buyers consider important, what they think has value, and what they are willing to pay for. Then the company has to incorporate buyer-desired attributes into its product or service offering that will clearly set it apart from rivals.

Competitive advantage results once a sufficient number of buyers become strongly attached to the differentiated attributes.

Successful differentiation allows a firm to:

- Command a premium price for its product, and/or
- Increase unit sales (because additional buyers are won over by the differentiating features), and/or
• Gain buyer loyalty to its brand (because some buyers are strongly attracted to the differentiating features and bond with the company and its products).

Differentiation enhances profitability whenever the extra price the product commands outweighs the added costs of achieving the differentiation. Company differentiation strategies fail when buyers don’t value the brand’s uniqueness and when a company’s approach to differentiation is easily copied or matched by its rivals.

Types of Differentiation Themes

Companies can pursue differentiation from many angles: a unique taste (Dr Pepper, Listerine); multiple features (Microsoft Windows, Microsoft Office); wide selection and one-stop shopping (Home Depot, Amazon.com); superior service (FedEx); spare parts availability (Caterpillar); engineering design and performance (Mercedes, BMW); prestige and distinctiveness (Rolex); product reliability (Johnson & Johnson in baby products); quality manufacture (Karastan in carpets, Michelin in tires, Toyota and Honda in automobiles); technological leadership (3M Corporation in bonding and coating products); a full range of services (Charles Schwab in stock brokerage); a complete line of products (Campbell’s soups); and top-of-the-line image and reputation (Ralph Lauren and Starbucks).

The most appealing approaches to differentiation are those that are hard or expensive for rivals to duplicate. Indeed, resourceful competitors can, in time, clone almost any product or feature or attribute. If Coca-Cola introduces a vanilla-flavored soft drink, so can Pepsi; if Ford offers a 50,000-mile bumper-to-bumper warranty on its new vehicles, so can Volkswagen and Nissan. If Nokia introduces cell phones with cameras and Internet capability, so can Motorola and Samsung. As a rule, differentiation yields a longer-lasting and more profitable competitive edge when it is based on product innovation, technical superiority, product quality and reliability, comprehensive customer service, and unique competitive capabilities. Such differentiating attributes tend to be tough for rivals to copy or offset profitably, and buyers widely perceive them as having value.

Where along the Value Chain to Create the Differentiating Attributes

Differentiation is not something hatched in marketing and advertising departments, nor is it limited to the catchalls of quality and service. Differentiation opportunities can exist in activities all along an industry’s value chain; possibilities include the following:

• Supply chain activities that ultimately spill over to affect the performance or quality of the company’s end product. Starbucks gets high ratings on its coffees partly because it has very strict specifications on the coffee beans purchased from suppliers.

• Product R&D activities that aim at improved product designs and performance features, expanded end uses and applications, more frequent first-on-the-market victories, wider product variety and selection, added user safety, greater recycling capability, or enhanced environmental protection.

• Production R&D and technology-related activities that permit custom-order manufacture at an efficient cost; make production methods safer for the
environment; or improve product quality, reliability, and appearance. Many manufacturers have developed flexible manufacturing systems that allow different models and product versions to be made on the same assembly line. Being able to provide buyers with made-to-order products can be a potent differentiating capability.

- **Manufacturing activities** that reduce product defects, prevent premature product failure, extend product life, allow better warranty coverages, improve economy of use, result in more end-user convenience, or enhance product appearance. The quality edge enjoyed by Japanese automakers stems partly from their distinctive competence in performing assembly-line activities.

- **Distribution and shipping activities** that allow for fewer warehouse and on-the-shelf stockouts, quicker delivery to customers, more accurate order filling, and/or lower shipping costs.

- **Marketing, sales, and customer service activities** that result in superior technical assistance to buyers, faster maintenance and repair services, more and better product information provided to customers, more and better training materials for end users, better credit terms, quicker order processing, or greater customer convenience.

Managers need keen understanding of the sources of differentiation and the activities that drive uniqueness to evaluate various differentiation approaches and design durable ways to set their product offering apart from those of rival brands.

### The Four Best Routes to Competitive Advantage via a Broad Differentiation Strategy

While it is easy enough to grasp that a successful differentiation strategy must entail creating buyer value in ways unmatched by rivals, the big issue in crafting a differentiation strategy is which of four basic routes to take in delivering unique buyer value via a broad differentiation strategy. Usually, building a sustainable competitive advantage via differentiation involves pursuing one of four basic routes to delivering superior value to buyers.

One route is to **incorporate product attributes and user features that lower the buyer’s overall costs of using the company’s product.** Making a company’s product more economical for a buyer to use can be done by reducing the buyer’s raw materials waste (providing cut-to-size components), reducing a buyer’s inventory requirements (providing just-in-time deliveries), increasing maintenance intervals and product reliability so as to lower a buyer’s repair and maintenance costs, using online systems to reduce a buyer’s procurement and order processing costs, and providing free technical support. Rising costs for gasoline have dramatically spurred the efforts of motor vehicle manufacturers worldwide to introduce models with better fuel economy and reduce operating costs for motor vehicle owners.

A second route is to **incorporate features that raise product performance.** This can be accomplished with attributes that provide buyers greater reliability, ease of use, convenience, or durability. Other performance-enhancing options include making the company’s product or service cleaner, safer, quieter, or more maintenance-free than rival brands. Cell phone manufacturers are in a race to introduce next-generation phones with trendsetting features and options.
A third route to a differentiation-based competitive advantage is to incorporate features that enhance buyer satisfaction in noneconomic or intangible ways. Goodyear’s Aquatread tire design appeals to safety-conscious motorists wary of slick roads. Rolls Royce, Ralph Lauren, Gucci, Tiffany, Cartier, and Rolex have differentiation-based competitive advantages linked to buyer desires for status, image, prestige, upscale fashion, superior craftsmanship, and the finer things in life. L. L. Bean makes its mail-order customers feel secure in their purchases by providing an unconditional guarantee with no time limit: “All of our products are guaranteed to give 100 percent satisfaction in every way. Return anything purchased from us at any time if it proves otherwise. We will replace it, refund your purchase price, or credit your credit card, as you wish.”

The fourth route is to deliver value to customers by differentiating on the basis of competencies and competitive capabilities that rivals don’t have or can’t afford to match.5 The importance of cultivating competencies and capabilities that add power to a company’s resource strengths and competitiveness comes into play here. Core and/or distinctive competencies not only enhance a company’s ability to compete successfully in the marketplace but can also be unique in delivering value to buyers. There are numerous examples of companies that have differentiated themselves on the basis of capabilities. Because Fox News and CNN have the capability to devote more air time to breaking news stories and get reporters on the scene very quickly compared to the major networks, many viewers turn to the cable networks when a major news event occurs. Microsoft has stronger capabilities to design, create, distribute, and advertise an array of software products for PC applications than any of its rivals. Avon and Mary Kay Cosmetics have differentiated themselves from other cosmetics and personal care companies by assembling a sales force numbering in the hundreds of thousands that gives them direct sales capability—their sales associates can demonstrate products to interested buyers, take their orders on the spot, and deliver the items to buyers’ homes. Japanese automakers have the capability to satisfy changing consumer preferences for one vehicle style versus another because they can bring new models to market faster than American and European automakers.

The Importance of Perceived Value and Signaling Value

Buyers seldom pay for value they don’t perceive, no matter how real the unique extras may be.6 Thus, the price premium commanded by a differentiation strategy reflects the value actually delivered to the buyer and the value perceived by the buyer (even if not actually delivered). Actual and perceived value can differ whenever buyers have trouble assessing what their experience with the product will be. Incomplete knowledge on the part of buyers often causes them to judge value based on such signals as price (where price connotes quality), attractive packaging, extensive ad campaigns (i.e., how well-known the product is), ad content and image, the quality of brochures and sales presentations, the seller’s facilities, the seller’s list of customers, the firm’s market share, the length of time the firm has been in business, and the professionalism, appearance, and personality of the seller’s employees. Such signals of value may be as important as actual value (1) when the nature of differentiation is subjective or hard to quantify, (2) when buyers are making a first-time purchase, (3) when repurchase is infrequent, and (4) when buyers are unsophisticated.
When a Differentiation Strategy Works Best

Differentiation strategies tend to work best in market circumstances where:

- **Buyer needs and uses of the product are diverse**—Diverse buyer preferences present competitors with a bigger window of opportunity to do things differently and set themselves apart with product attributes that appeal to particular buyers. For instance, the diversity of consumer preferences for menu selection, ambience, pricing, and customer service gives restaurants exceptionally wide latitude in creating a differentiated product offering. Other companies having many ways to strongly differentiate themselves from rivals include the publishers of magazines, the makers of motor vehicles, and the manufacturers of cabinetry and countertops.

- **There are many ways to differentiate the product or service and many buyers perceive these differences as having value**—There is plenty of room for retail apparel competitors to stock different styles and quality of apparel merchandise but very little room for the makers of paper clips, copier paper, or sugar to set their products apart. Likewise, the sellers of different brands of gasoline or orange juice have little differentiation opportunity compared to the sellers of high-definition TVs, patio furniture, or breakfast cereal. Unless different buyers have distinguishably different preferences for certain features and product attributes, profitable differentiation opportunities are very restricted.

- **Few rival firms are following a similar differentiation approach**—The best differentiation approaches involve trying to appeal to buyers on the basis of attributes that rivals are not emphasizing. A differentiator encounters less head-to-head rivalry when it goes its own separate way in creating uniqueness and does not try to outdifferentiate rivals on the very same attributes—when many rivals are all claiming “Ours tastes better than theirs” or “Ours gets your clothes cleaner than theirs,” the most likely result is weak brand differentiation and “strategy overcrowding”—a situation in which competitors end up chasing the same buyers with very similar product offerings.

- **Technological change is fast-paced and competition revolves around rapidly evolving product features**—Rapid product innovation and frequent introductions of next-version products not only provide space for companies to pursue separate differentiating paths but also heighten buyer interest. In video game hardware and video games, golf equipment, PCs, cell phones, and MP3 players, competitors are locked into an ongoing battle to set themselves apart by introducing the best next-generation products—companies that fail to come up with new and improved products and distinctive performance features quickly lose out in the marketplace. In network TV broadcasting in the United States, NBC, ABC, CBS, Fox, and several others are always scrambling to develop a lineup of TV shows that will win higher audience ratings and pave the way for charging higher advertising rates and boosting ad revenues.

The Pitfalls of a Differentiation Strategy

Differentiation strategies can fail for any of several reasons. *A differentiation strategy is always doomed when competitors are able to quickly copy most or all of the appealing product attributes a company comes up with.* Rapid imitation means that no rival
achieves differentiation, since whenever one firm introduces some aspect of uniqueness that strikes the fancy of buyers, fast-following copycats quickly reestablish similarity. This is why a firm must search out sources of uniqueness that are time-consuming or burdensome for rivals to match if it hopes to use differentiation to win a competitive edge over rivals.

A second pitfall is that the company’s differentiation strategy produces a ho-hum market reception because buyers see little value in the unique attributes of a company’s product. Thus, even if a company sets the attributes of its brand apart from the brands of rivals, its strategy can fail because of trying to differentiate on the basis of something that does not deliver adequate value to buyers (such as lowering a buyer’s cost to use the product or enhancing a buyer’s well-being). Anytime many potential buyers look at a company’s differentiated product offering and conclude “So what?” the company’s differentiation strategy is in deep trouble—buyers will likely decide the product is not worth the extra price, and sales will be disappointingly low.

The third big pitfall of a differentiation strategy is overspending on efforts to differentiate the company’s product offering, thus eroding profitability. Company efforts to achieve differentiation nearly always raise costs. The trick to profitable differentiation is either to keep the costs of achieving differentiation below the price premium the differentiating attributes can command in the marketplace (thus increasing the profit margin per unit sold) or to offset thinner profit margins per unit by selling enough additional units to increase total profits. If a company goes overboard in pursuing costly differentiation efforts and then unexpectedly discovers that buyers are unwilling to pay a sufficient price premium to cover the added costs of differentiation, it ends up saddled with unacceptably thin profit margins or even losses. The need to contain differentiation costs is why many companies add little touches of differentiation that add to buyer satisfaction but are inexpensive to institute. Upscale restaurants often provide valet parking. Ski resorts provide skiers with complimentary coffee or hot apple cider at the base of the lifts in the morning and late afternoon. FedEx, UPS, and many catalog and online retailers have installed software capabilities that allow customers to track packages in transit. Some hotels and motels provide free continental breakfasts, exercise facilities, and in-room coffeemaking amenities. Publishers are using their Web sites to deliver supplementary educational materials to the buyers of their textbooks. Laundry detergent and soap manufacturers add pleasing scents to their products.

Other common pitfalls and mistakes in crafting a differentiation strategy include:

- **Overdifferentiating so that product quality or service levels exceed buyers’ needs.** Even if buyers like the differentiating extras, they may not find them sufficiently valuable for their purposes to pay extra to get them. Many shoppers shy away from buying top-of-the-line items because they have no particular interest in all the bells and whistles; for them, a less deluxe model or style makes better economic sense.

- **Trying to charge too high a price premium.** Even if buyers view certain extras or deluxe features as nice to have, they may still conclude that the added cost is excessive relative to the value they deliver. A differentiator must guard against turning off would-be buyers with what is perceived as price gouging. Normally, the bigger the price premium for the differentiating extras, the harder it is to keep buyers from switching to the lower-priced offerings of competitors.

- **Being timid and not striving to open up meaningful gaps in quality or service or performance features vis-à-vis the products of rivals.** Tiny differences
between rivals’ product offerings may not be visible or important to buyers. If a company wants to generate the fiercely loyal customer following needed to earn superior profits and open up a differentiation-based competitive advantage over rivals, then its strategy must result in strong rather than weak product differentiation. In markets where differentiators do no better than achieve weak product differentiation (because the attributes of rival brands are fairly similar in the minds of many buyers), customer loyalty to any one brand is weak, the costs of buyers to switch to rival brands are fairly low, and no one company has enough of a market edge that it can get by with charging a price premium over rival brands.

A low-cost provider strategy can defeat a differentiation strategy when buyers are satisfied with a basic product and don’t think extra attributes are worth a higher price.

**BEST-COST PROVIDER STRATEGIES**

Best-cost provider strategies aim at giving customers *more value for the money*. The objective is to deliver superior value to buyers by satisfying their expectations on key quality/features/performance/service attributes and beating their expectations on price (given what rivals are charging for much the same attributes). *A company achieves best-cost status from an ability to incorporate attractive or upscale attributes at a lower cost than rivals*. The attractive attributes can take the form of appealing features, good-to-excellent product performance or quality, or attractive customer service. When a company has the resource strengths and competitive capabilities to incorporate these upscale attributes into its product offering *at a lower cost than rivals*, it enjoys best-cost status—it is the low-cost provider of an upscale product.

Being a best-cost provider is different from being a low-cost provider because the additional upscale features entail additional costs (that a low-cost provider can avoid by offering buyers a basic product with few frills). As Figure 5.1 indicates, best-cost provider strategies stake out a middle ground between pursuing a low-cost advantage and a differentiation advantage and between appealing to the broad market as a whole and a narrow market niche. From a competitive positioning standpoint, best-cost strategies are thus a *hybrid*, balancing a strategic emphasis on low cost against a strategic emphasis on differentiation (upscale features delivered at a price that constitutes superior value).

The competitive advantage of a best-cost provider is its capability to include upscale attributes at a lower cost than rivals whose products have comparable attributes. A best-cost provider can use its low-cost advantage to underprice rivals whose products have similar upscale attributes—it is usually not difficult to entice customers away from rivals charging a higher price for an item with highly comparable features, quality, performance, and/or customer service attributes. To achieve competitive advantage with a best-cost provider strategy, it is critical that a company have the resources and capabilities to incorporate upscale attributes at a lower cost than rivals. In other words, it must be able to (1) incorporate attractive features at a lower cost than rivals whose products have similar features, (2) manufacture a good-to-excellent quality product at a lower cost than rivals with good-to-excellent product quality, (3) develop a product that delivers good-to-excellent performance at a lower cost than rivals whose products also entail good-to-excellent performance, or (4) provide attractive customer service at a lower cost than rivals who provide comparably attractive customer service.
What makes a best-cost provider strategy so appealing is being able to incorporate upscale attributes at a lower cost than rivals and then using the company’s low-cost advantage to underprice rivals whose products have similar upscale attributes.

*The target market for a best-cost provider is value-conscious buyers*—buyers that are looking for appealing extras at an appealingly low price. Value-hunting buyers (as distinct from buyers looking only for bargain-basement prices) often constitute a very sizable part of the overall market. Normally, value-conscious buyers are willing to pay a fair price for extra features, but they shy away from paying top dollar for items having all the bells and whistles. It is the desire to cater to *value-conscious buyers* as opposed to *budget-conscious buyers* that sets a best-cost provider apart from a low-cost provider—the two strategies aim at distinguishably different market targets.

**When a Best-Cost Provider Strategy Works Best**

*A best-cost provider strategy works best in markets where buyer diversity makes product differentiation the norm and where many buyers are also sensitive to price and value.* This is because a best-cost provider can position itself near the middle of the market with either a medium-quality product at a below-average price or a high-quality product at an average or slightly higher price. Often, substantial numbers of buyers prefer midrange products rather than the cheap, basic products of low-cost producers or the expensive products of top-of-the-line differentiators. But unless a company has the resources, know-how, and capabilities to incorporate upscale product or service attributes at a lower cost than rivals, adopting a best-cost strategy is ill advised—a winning strategy must always be matched to a company’s resource strengths and capabilities.

Illustration Capsule 5.3 describes how Toyota has applied the principles of a best-cost provider strategy in producing and marketing its Lexus brand.

**The Big Risk of a Best-Cost Provider Strategy**

A company’s biggest vulnerability in employing a best-cost provider strategy is getting squeezed between the strategies of firms using low-cost and high-end differentiation strategies. Low-cost providers may be able to siphon customers away with the appeal of a lower price (despite their less appealing product attributes). High-end differentiators may be able to steal customers away with the appeal of better product attributes (even though their products carry a higher price tag). Thus, to be successful, a best-cost provider must offer buyers *significantly* better product attributes in order to justify a price above what low-cost leaders are charging. Likewise, it has to achieve *significantly* lower costs in providing upscale features so that it can outcompete high-end differentiators on the basis of a *significantly* lower price.

**FOCUSED (OR MARKET NICHE) STRATEGIES**

What sets focused strategies apart from low-cost leadership or broad differentiation strategies is concentrated attention on a narrow piece of the total market. The target segment, or niche, can be defined by geographic uniqueness, by specialized requirements in using the product, or by special product attributes that appeal only to niche members. Community Coffee, the largest family-owned specialty coffee retailer in the United States, is a company that focused on a geographic market niche; despite having a national market share of only 1.1 percent, Community has won a 50 percent share of the coffee business in supermarkets in southern Louisiana in competition
against Starbucks, Folger’s, Maxwell House, and asserted specialty coffee retailers. Community Coffee’s geographic version of a focus strategy has allowed it to capture sales in excess of $100 million annually by catering to the tastes of coffee drinkers across an 11-state region. Examples of firms that concentrate on a well-defined market niche keyed to a particular product or buyer segment include Animal Planet and the History Channel (in cable TV); Google (in Internet search engines); Porsche (in sports cars); Cannondale (in top-of-the-line mountain bikes); Domino’s Pizza (in pizza delivery); Enterprise Rent-a-Car (a specialist in providing rental cars to repair garage customers); Bandag (a specialist in truck tire recapping that promotes its recaps aggressively at over 1,000 truck stops), CGA Inc. (a specialist in providing insurance to cover the cost of lucrative hole-in-one prizes at golf tournaments); Match.com (the world’s largest online dating service); and Avid Technology (the world leader in digital technology products to create 3D animation and to edit films, videos, TV broadcasts, video games, and audio recordings). Microbreweries, local bakeries, bed-and-breakfast inns, and local owner-managed retail boutiques are all good examples of enterprises that have scaled their operations to serve narrow or local customer segments.
A Focused Low-Cost Strategy

A focused strategy based on low cost aims at securing a competitive advantage by serving buyers in the target market niche at a lower cost and lower price than rival competitors. This strategy has considerable attraction when a firm can lower costs significantly by limiting its customer base to a well-defined buyer segment. The avenues to achieving a cost advantage over rivals also serving the target market niche are the same as for low-cost leadership—outmanage rivals in keeping the costs of value chain activities contained to a bare minimum and search for innovative ways to reconfigure the firm’s value chain and bypass or reduce certain value chain activities. The only real difference between a low-cost provider strategy and a focused low-cost strategy is the size of the buyer group that a company is trying to appeal to—the former involves a product offering that appeals broadly to most all buyer groups and market segments whereas the latter at just meeting the needs of buyers in a narrow market segment.

Focused low-cost strategies are fairly common. Producers of private-label goods are able to achieve low costs in product development, marketing, distribution, and advertising by concentrating on making generic items imitative of name-brand merchandise and selling directly to retail chains wanting a basic house brand to sell to price-sensitive shoppers. Several small printer-supply manufacturers have begun making low-cost clones of the premium-priced replacement ink and toner cartridges sold by Hewlett-Packard, Lexmark, Canon, and Epson; the clone manufacturers disect the cartridges of the name-brand companies and then reengineer a similar version that won’t violate patents. The components for remanufactured replacement cartridges are aquired from various outside sources, and the clones are then marketed at prices as much as 50 percent below the name-brand cartridges. Cartridge remanufacturers have been lured to focus on this market because replacement cartridges constitute a multibillion-dollar business with considerable profit potential given their low costs and the premium pricing of the name-brand companies. Illustration Capsule 5.4 describes how Motel 6 has kept its costs low in catering to budget-conscious travelers.

A Focused Differentiation Strategy

A focused strategy keyed to differentiation aims at securing a competitive advantage with a product offering carefully designed to appeal to the unique preferences and needs of a narrow, well-defined group of buyers (as opposed to a broad differentiation strategy aimed at many buyer groups and market segments). Successful use of a focused differentiation strategy depends on the existence of a buyer segment that is looking for special product attributes or seller capabilities and on a firm’s ability to stand apart from rivals competing in the same target market niche.

Companies like Godiva Chocolates, Chanel, Gucci, Rolls-Royce, Häagen-Dazs, and W. L. Gore (the maker of Gore-Tex) employ successful differentiation-based focused strategies targeted at upscale buyers wanting products and services with world-class attributes. Indeed, most markets contain a buyer segment willing to pay a big price premium for the very finest items available, thus opening the strategic window for some competitors to pursue differentiation-based focused strategies aimed at the very top of the market pyramid. Another successful focused differentiator is Trader Joe’s, a 150-store East and West Coast “fashion food retailer” that is a combination gourmet deli and grocery warehouse. Customers shop Trader Joe’s as much for entertainment as for conventional grocery items—the store stocks out-of-the-ordinary culinary treats like raspberry salsa, salmon burgers, and jasmine fried rice,
as well as the standard goods normally found in supermarkets. What sets Trader Joe’s apart is not just its unique combination of food novelties and competitively priced grocery items but also its capability to turn an otherwise mundane grocery excursion into a whimsical treasure hunt that is just plain fun.

Illustration Capsule 5.5 describes Progressive Insurance’s focused differentiation strategy.

When a Focused Low-Cost or Focused Differentiation Strategy Is Attractive

A focused strategy aimed at securing a competitive edge based on either low cost or differentiation becomes increasingly attractive as more of the following conditions are met:

- The target market niche is big enough to be profitable and offers good growth potential.
- Industry leaders do not see that having a presence in the niche is crucial to their own success—in which case focusers can often escape battling head-to-head against some of the industry’s biggest and strongest competitors.
- It is costly or difficult for multisegment competitors to put capabilities in place to meet the specialized needs of buyers comprising the target market niche and at the same time satisfy the expectations of their mainstream customers.
- The industry has many different niches and segments, thereby allowing a focuser to pick a competitively attractive niche suited to its resource strengths and capabilities. Also, with more niches, there is more room for focusers to avoid each other in competing for the same customers.
Few, if any, other rivals are attempting to specialize in the same target segment—a condition that reduces the risk of segment overcrowding.

The focuser has a reservoir of customer goodwill and loyalty (accumulated from having catered to the specialized needs and preferences of niche members over many years) that it can draw on to help stave off ambitious challengers looking to horn in on its business.

The advantages of focusing a company’s entire competitive effort on a single market niche are considerable, especially for smaller and medium-sized companies that may lack the breadth and depth of resources to tackle going after a broad customer base with a “something for everyone” lineup of models, styles, and product selection. eBay has made a huge name for itself and very attractive profits for shareholders by focusing its attention on online auctions—at one time a very small niche in the overall auction business that eBay’s focus strategy turned into the dominant piece of the global auction industry. Google has capitalized on its specialized expertise in Internet search engines to become one of the most spectacular growth companies of the past 10 years. Two hippie entrepreneurs, Ben Cohen and Jerry Greenfield, built Ben & Jerry’s Homemade into an impressive business by focusing their energies and resources solely on the superpremium segment of the ice cream market.
The Risks of a Focused Low-Cost or Focused Differentiation Strategy

Focusing carries several risks. One is the chance that competitors will find effective ways to match the focused firm’s capabilities in serving the target niche—perhaps by coming up with products or brands specifically designed to appeal to buyers in the target niche or by developing expertise and capabilities that offset the focuser’s strengths. In the lodging business, large chains like Marriott and Hilton have launched multibrand strategies that allow them to compete effectively in several lodging segments simultaneously. Marriott has flagship hotels with a full complement of services and amenities that allow it to attract travelers and vacationers going to major resorts, it has J. W. Marriott hotels usually located in downtown metropolitan areas that cater to business travelers; the Courtyard by Marriott brand is for business travelers looking for moderately priced lodging; Marriott Residence Inns are designed as a home away from home for travelers staying five or more nights; and the 530 Fairfield Inn locations cater to travelers looking for quality lodging at an affordable price. Similarly, Hilton has a lineup of brands (Conrad Hotels, Doubletree Hotels, Embassy Suites, Hampton Inns, Hilton Hotels, Hilton Garden Inns, and Homewood Suites) that enable it to operate in multiple segments and compete head-to-head against lodging chains that operate only in a single segment. Multibrand strategies are attractive to large companies like Marriott and Hilton precisely because they enable a company to enter a market niche and siphon business away from companies that employ a focus strategy.

A second risk of employing a focus strategy is the potential for the preferences and needs of niche members to shift over time toward the product attributes desired by the majority of buyers. An erosion of the differences across buyer segments lowers entry barriers into a focuser’s market niche and provides an open invitation for rivals in adjacent segments to begin competing for the focuser’s customers. A third risk is that the segment may become so attractive it is soon inundated with competitors, intensifying rivalry and splintering segment profits.

THE CONTRASTING FEATURES OF THE FIVE GENERIC COMPETITIVE STRATEGIES: A SUMMARY

Deciding which generic competitive strategy should serve as the framework for hanging the rest of the company’s strategy is not a trivial matter. Each of the five generic competitive strategies positions the company differently in its market and competitive environment. Each establishes a central theme for how the company will endeavor to outcompete rivals. Each creates some boundaries or guidelines for maneuvering as market circumstances unfold and as ideas for improving the strategy are debated. Each points to different ways of experimenting and tinkering with the basic strategy—for example, employing a low-cost leadership strategy means experimenting with ways that costs can be cut and value chain activities can be streamlined, whereas a broad differentiation strategy means exploring ways to add new differentiating features or to perform value chain activities differently if the result is to add value for customers in ways they are willing to pay for. Each entails differences in terms of product line, production emphasis, marketing emphasis, and means of sustaining the strategy—as shown in Table 5.1.
<table>
<thead>
<tr>
<th></th>
<th>Low-Cost Provider</th>
<th>Broad Differentiation</th>
<th>Best-Cost Provider</th>
<th>Focused Low-Cost Provider</th>
<th>Focused Differentiation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Strategic target</strong></td>
<td>A broad cross-section of the market</td>
<td>A broad cross-section of the market</td>
<td>Value-conscious buyers</td>
<td>A narrow market niche where buyer needs and preferences are distinctively different</td>
<td>A narrow market niche where buyer needs and preferences are distinctively different</td>
</tr>
<tr>
<td><strong>Basis of competitive advantage</strong></td>
<td>Lower overall costs than competitors</td>
<td>Ability to offer buyers something attractively different from competitors</td>
<td>Ability to give customers more value for the money</td>
<td>Lower overall cost than rivals in serving niche members</td>
<td>Attributes that appeal specifically to niche members</td>
</tr>
<tr>
<td><strong>Product line</strong></td>
<td>A good basic product with few frills (acceptable quality and limited selection)</td>
<td>Many product variations, wide selection; emphasis on differentiating features</td>
<td>Items with appealing attributes; assorted upscale features</td>
<td>Features and attributes tailored to the tastes and requirements of niche members</td>
<td>Features and attributes tailored to the tastes and requirements of niche members</td>
</tr>
<tr>
<td><strong>Production emphasis</strong></td>
<td>A continuous search for cost reduction without sacrificing acceptable quality and essential features</td>
<td>Build in whatever differentiating features buyers are willing to pay for; strive for product superiority</td>
<td>Build in upscale features and appealing attributes at lower cost than rivals</td>
<td>A continuous search for cost reduction while incorporating features and attributes matched to niche member preferences</td>
<td>Custom-made products that match the tastes and requirements of niche members</td>
</tr>
<tr>
<td><strong>Marketing emphasis</strong></td>
<td>Try to make a virtue out of product features that lead to low cost</td>
<td>Tout differentiating features</td>
<td>Tout delivery of best value</td>
<td>Tout delivery of best value</td>
<td>Communicate how product offering does the best job of meeting niche buyers’ expectations</td>
</tr>
<tr>
<td><strong>Keys to sustaining the strategy</strong></td>
<td>Economical prices/ good value</td>
<td>Stress constant innovation to stay ahead of imitative competitors</td>
<td>Unique expertise in simultaneously managing costs down while incorporating upscale features and attributes</td>
<td>Stay committed to serving the niche at lowest overall cost; don’t blur the firm’s image by entering other market segments or adding other products to widen market appeal</td>
<td>Stay committed to serving the niche better than rivals; don’t blur the firm’s image by entering other market segments or adding other products to widen market appeal</td>
</tr>
</tbody>
</table>

Table 5.1  Distinguishing Features of the Five Generic Competitive Strategies
Thus, a choice of which generic strategy to employ spills over to affect several aspects of how the business will be operated and the manner in which value chain activities must be managed. Deciding which generic strategy to employ is perhaps the most important strategic commitment a company makes—it tends to drive the rest of the strategic actions a company decides to undertake.

One of the big dangers in crafting a competitive strategy is that managers, torn between the pros and cons of the various generic strategies, will opt for stuck-in-the-middle strategies that represent compromises between lower costs and greater differentiation and between broad and narrow market appeal. Compromise or middle-ground strategies rarely produce sustainable competitive advantage or a distinctive competitive position—a well-executed, best-cost producer strategy is the only compromise between low cost and differentiation that succeeds. Usually, companies with compromise strategies end up with a middle-of-the-pack industry ranking—they have average costs, some but not a lot of product differentiation relative to rivals, an average image and reputation, and little prospect of industry leadership. Having a competitive edge over rivals is the single most dependable contributor to above-average company profitability. Hence, only if a company makes a strong and unwavering commitment to one of the five generic competitive strategies does it stand much chance of achieving sustainable competitive advantage that such strategies can deliver if properly executed.

**Key Points**

Early in the process of crafting a strategy company managers have to decide which of the five basic competitive strategies to employ—overall low-cost, broad differentiation, best-cost, focused low-cost, or focused differentiation.

In employing a low-cost provider strategy and trying to achieve a low-cost advantage over rivals, a company must do a better job than rivals of cost-effectively managing value chain activities and/or find innovative ways to eliminate or bypass cost-producing activities. Low-cost provider strategies work particularly well when the products of rival sellers are virtually identical or very weakly differentiated and supplies are readily available from eager sellers, when there are not many ways to differentiate that have value to buyers, when many buyers are price sensitive and shop the market for the lowest price, and when buyer switching costs are low.

Broad differentiation strategies seek to produce a competitive edge by incorporating attributes and features that set a company’s product/service offering apart from rivals in ways that buyers consider valuable and worth paying for. Successful differentiation allows a firm to (1) command a premium price for its product, (2) increase unit sales (because additional buyers are won over by the differentiating features), and/or (3) gain buyer loyalty to its brand (because some buyers are strongly attracted to the differentiating features and bond with the company and its products). Differentiation strategies work best in markets with diverse buyer preferences where there are big windows of opportunity to strongly differentiate a company’s product offering from those of rival brands, in situations where few other rivals are pursuing a similar differentiation approach, and in circumstances where companies are racing to bring out the most appealing next-generation product. A differentiation strategy is doomed when competitors are able to quickly copy most or all of the appealing product attributes a company comes up with, when a company’s differentiation efforts meet with a ho-hum or “so what” market reception, or when a company erodes profitability by overspending on efforts to differentiate its product offering.
Best-cost provider strategies combine a strategic emphasis on low cost with a strategic emphasis on more than minimal quality, service, features, or performance. The aim is to create competitive advantage by giving buyers more value for the money—an approach that entails matching close rivals on key quality/service/features/performance attributes and beating them on the costs of incorporating such attributes into the product or service. A best-cost provider strategy works best in markets where buyer diversity makes product differentiation the norm and where many buyers are also sensitive to price and value.

A focus strategy delivers competitive advantage either by achieving lower costs than rivals in serving buyers comprising the target market niche or by developing specialized ability to offer niche buyers an appealingly differentiated offering than meets their needs better than rival brands. A focused strategy based on either low cost or differentiation becomes increasingly attractive when the target market niche is big enough to be profitable and offers good growth potential, when it is costly or difficult for multi-segment competitors to put capabilities in place to meet the specialized needs of the target market niche and at the same time satisfy the expectations of their mainstream customers, when there are one or more niches that present a good match with a focuser’s resource strengths and capabilities, and when few other rivals are attempting to specialize in the same target segment.

Deciding which generic strategy to employ is perhaps the most important strategic commitment a company makes—it tends to drive the rest of the strategic actions a company decides to undertake and it sets the whole tone for the pursuit of a competitive advantage over rivals.

**Exercises**

1. Go to [www.google.com](http://www.google.com) and do a search for “low-cost producer.” See if you can identify five companies that are pursuing a low-cost strategy in their respective industries.

2. Using the advanced search function at [www.google.com](http://www.google.com), enter “best-cost producer” in the exact-phrase box and see if you can locate three companies that indicate they are employing a best-cost producer strategy.

3. Go to BMW’s Web site ([www.bmw.com](http://www.bmw.com)) click on the link for BMW Group. The site you find provides an overview of the company’s key functional areas, including R&D and production activities. Explore each of the links on the Research & Development page—People & Networks, Innovation & Technology, and Mobility & Traffic—to better understand the company’s approach. Also review the statements under Production focusing on vehicle production and sustainable production. How do these activities contribute to BMW’s differentiation strategy and the unique position in the auto industry that BMW has achieved?

4. Which of the five generic competitive strategies do you think the following companies are employing (do whatever research at the various company Web sites might be needed to arrive at and support your answer):
   a. The Saturn division of General Motors
   b. Abercrombie & Fitch
   c. Amazon.com
   d. Home Depot
   e. Mary Kay Cosmetics
   f. USA Today
Supplementing the Chosen Competitive Strategy

Other Important Strategy Choices

Don’t form an alliance to correct a weakness and don’t ally with a partner that is trying to correct a weakness of its own. The only result from a marriage of weaknesses is the creation of even more weaknesses.

—Michel Robert

Strategies for taking the hill won’t necessarily hold it.

—Amar Bhide

The sure path to oblivion is to stay where you are.

—Bernard Fauber

Successful business strategy is about actively shaping the game you play, not just playing the game you find.

—Adam M. Brandenburger and Barry J. Nalebuff
Once a company has settled on which of the five generic strategies to employ, attention turns to what other *strategic actions* it can take to complement its choice of a basic competitive strategy. Several decisions have to be made:

- What use to make of strategic alliances and collaborative partnerships.
- Whether to bolster the company’s market position via merger or acquisitions.
- Whether to integrate backward or forward into more stages of the industry value chain.
- Whether to outsource certain value chain activities or perform them in-house.
- Whether and when to employ offensive and defensive moves.
- Which of several ways to use the Internet as a distribution channel in positioning the company in the marketplace.

This chapter contains sections discussing the pros and cons of each of the above complementary strategic options. The next-to-last section in the chapter discusses the need for strategic choices in each functional area of a company’s business (R&D, production, sales and marketing, finance, and so on) to support its basic competitive approach and complementary strategic moves. The chapter concludes with a brief look at the competitive importance of timing strategic moves—when it is advantageous to be a first-mover and when it is better to be a fast-follower or late-mover.

Figure 6.1 shows the menu of strategic options a company has in crafting a strategy and the order in which the choices should generally be made. The portion of Figure 6.1 below the five generic competitive strategy options illustrates the structure of this chapter and the topics that will be covered.
Figure 6.1  A Company’s Menu of Strategy Options

Generic Competitive Strategy Options
(A company’s first strategic choice)

- Overall Low-Cost Provider?
- Broad Differentiation?
- Best-Cost Provider?
- Focused Differentiation?
- Focused Low-Cost?

Complementary Strategic Options
(A company’s second set of strategic choices)

- Employ strategic alliances and collaborative partnerships?
- Merge with or acquire other companies?
- Integrate backward or forward?
- Outsource selected value chain activities?
- Initiate offensive strategic moves?
- Employ defensive strategic moves?
- What Web site strategy to employ?

Functional-Area Strategies to Support the Above Strategic Choices

(A company’s third set of strategic choices)

- R&D
- Engineering
- Production
- Marketing & Sales
- Human Resources
- Finance

Timing a Company’s Strategic Moves in the Marketplace

(A company’s fourth set of strategic choices)

- First-Mover?
- Fast-Follower?
- Late-Mover?
Companies in all types of industries and in all parts of the world have elected to form strategic alliances and partnerships to complement their own strategic initiatives and strengthen their competitiveness in domestic and international markets. This is an about-face from times past, when the vast majority of companies were content to go it alone, confident that they already had or could independently develop whatever resources and know-how were needed to be successful in their markets. But globalization of the world economy; revolutionary advances in technology across a broad front; and untapped opportunities in Asia, Latin America, and Europe—whose national markets are opening up, deregulating, and/or undergoing privatization—have made strategic partnerships of one kind or another integral to competing on a broad geographic scale.

Many companies now find themselves thrust into two very demanding competitive races: (1) the global race to build a market presence in many different national markets and join the ranks of companies recognized as global market leaders, and (2) the race to seize opportunities on the frontiers of advancing technology and build the resource strengths and business capabilities to compete successfully in the industries and product markets of the future. Even the largest and most financially sound companies have concluded that simultaneously running the races for global market leadership and for a stake in the industries of the future requires more diverse and expansive skills, resources, technological expertise, and competitive capabilities than they can assemble and manage alone. Such companies, along with others that are missing the resources and competitive capabilities needed to pursue promising opportunities, have determined that the fastest way to fill the gap is often to form alliances with enterprises having the desired strengths. Consequently, these companies form strategic alliances or collaborative partnerships in which two or more companies jointly work to achieve mutually beneficial strategic outcomes. Thus, a strategic alliance is a formal agreement between two or more separate companies in which there is strategically relevant collaboration of some sort, joint contribution of resources, shared risk, shared control, and mutual dependence. Often, alliances involve joint marketing, joint sales or distribution, joint production, design collaboration, joint research, or projects to jointly develop new technologies or products. The relationship between the partners may be contractual or merely collaborative; the arrangement commonly stops short of formal ownership ties between the partners (although there are a few strategic alliances where one or more allies have minority ownership in certain of the other alliance members). Five factors make an alliance strategic, as opposed to just a convenient business arrangement:

1. It is critical to the company’s achievement of an important objective.
2. It helps build, sustain, or enhance a core competence or competitive advantage.
3. It helps block a competitive threat.
4. It helps open up important new market opportunities.
5. It mitigates a significant risk to a company’s business.

Strategic cooperation is a much-favored, indeed necessary, approach in industries where new technological developments are occurring at a furious pace along many different paths and where advances in one technology spill over to affect others (often
Companies in many different industries all across the world have made strategic alliances a core part of their overall strategy; U.S. companies alone announced nearly 68,000 alliances from 1996 through 2003. In the personal computer (PC) industry, alliances are pervasive because the different components of PCs and the software to run them are supplied by so many different companies—one set of companies provides the microprocessors, another group makes the motherboards, another the monitors, another the disk drives, another the memory chips, and so on. Moreover, their facilities are scattered across the United States, Japan, Taiwan, Singapore, Malaysia, and parts of Europe. Strategic alliances among companies in the various parts of the PC industry facilitate the close cross-company collaboration required on next-generation product development, logistics, production, and the timing of new product releases.

Toyota has forged long-term strategic partnerships with many of its suppliers of automotive parts and components, both to achieve lower costs and to improve the quality and reliability of its vehicles. Microsoft collaborates very closely with independent software developers to ensure that their programs will run on the next-generation versions of Windows. Genentech, a leader in biotechnology and human genetics, has a partnering strategy to increase its access to novel biotherapeutics products and technologies and has formed alliances with over 30 companies to strengthen its research and development (R&D) pipeline. During the 1998–2004 period, Samsung Electronics, a South Korean corporation with $54 billion in sales, entered into over 50 major strategic alliances involving such companies as Sony, Yahoo, Hewlett-Packard, Nokia, Motorola, Intel, Microsoft, Dell, Mitsubishi, Disney, IBM, Maytag, and Rockwell Automation; the alliances involved joint investments, technology transfer arrangements, joint R&D projects, and agreements to supply parts and components—all of which facilitated Samsung’s strategic efforts to transform itself into a global enterprise and establish itself as a leader in the worldwide electronics industry.

Studies indicate that large corporations are commonly involved in 30 to 50 alliances and that some have hundreds of alliances. One recent study estimated that about 35 percent of corporate revenues in 2003 came from activities involving strategic alliances, up from 15 percent in 1995. Another study reported that the typical large corporation relied on alliances for 15 to 20 percent of its revenues, assets, or income. Companies that have formed a host of alliances have a need to manage their alliances like a portfolio—terminating those that no longer serve a useful purpose or that have produced meager results, forming promising new alliances, and restructuring certain existing alliances to correct performance problems and/or redirect the collaborative effort.

**Why and How Strategic Alliances Are Advantageous**

The most common reasons why companies enter into strategic alliances are to expedite the development of promising new technologies or products, to overcome deficits in their own technical and manufacturing expertise, to bring together the personnel and expertise needed to create desirable new skill sets and capabilities, to improve supply chain efficiency, to gain economies of scale in production and/or marketing, and to
acquire or improve market access through joint marketing agreements.7 In bringing together firms with different skills and knowledge bases, alliances open up learning opportunities that help partner firms better leverage their own resource strengths.8 In industries where technology is advancing rapidly, alliances are all about fast cycles of learning, staying abreast of the latest developments, and gaining quick access to the latest round of technological know-how and capability.

There are several other instances in which companies find strategic alliances particularly valuable. A company that is racing for global market leadership needs alliances to:

- Get into critical country markets quickly and accelerate the process of building a potent global market presence.
- **Gain inside knowledge about unfamiliar markets and cultures** through alliances with local partners. For example, U.S., European, and Japanese companies wanting to build market footholds in the fast-growing Chinese market have pursued partnership arrangements with Chinese companies to help in getting products through the tedious and typically corrupt customs process, to help guide them through the maze of government regulations, to supply knowledge of local markets, to provide guidance on adapting their products to better match the buying preferences of Chinese consumers, to set up local manufacturing capabilities, and to assist in distribution, marketing, and promotional activities. The Chinese government has long required foreign companies operating in China to have a state-owned Chinese company as a minority or maybe even 50 percent partner—only recently has it backed off this requirement for foreign companies operating in selected parts of the Chinese economy.
- Access valuable skills and competencies that are concentrated in particular geographic locations (such as software design competencies in the United States, fashion design skills in Italy, and efficient manufacturing skills in Japan and China).

A company that is racing to **stake out a strong position in an industry of the future** needs alliances to:

- **Establish a stronger beachhead** for participating in the target industry.
- **Master new technologies and build new expertise and competencies** faster than would be possible through internal efforts.
- **Open up broader opportunities** in the target industry by melding the firm’s own capabilities with the expertise and resources of partners.

Allies can learn much from one another in performing joint research, sharing technological know-how, and collaborating on complementary new technologies and products—sometimes enough to enable them to pursue other new opportunities on their own.9 Manufacturers frequently pursue alliances with parts and components suppliers to gain the efficiencies of better supply chain management and to speed new products to market. By joining forces in components production and/or final assembly, companies may be able to realize cost savings not achievable with their own small volumes—German automakers Volkswagen, Audi, and Porsche formed a strategic alliance to spur mutual development of a gasoline-electric hybrid engine and transmission system that they could each then incorporate into their motor vehicle models; BMW, General

The best alliances are highly selective, focusing on particular value chain activities and on obtaining a particular competitive benefit. They tend to enable a firm to build on its strengths and to learn.

The competitive attraction of alliances is in allowing companies to bundle competencies and resources that are more valuable in a joint effort than when kept separate.
Motors, and DaimlerChrysler formed a similar partnership. Both alliances were aimed at closing the gap on Toyota, generally said to be the world leader in fuel-efficient hybrid engines. Information systems consultant Accenture has developed strategic alliances with such leading technology providers as SAP, Oracle, Siebel, Microsoft, BEA, and Hewlett-Packard to give it greater capabilities in designing and integrating information systems for its corporate clients. Johnson & Johnson and Merck entered into an alliance to market Pepcid AC; Merck developed the stomach distress remedy, and Johnson & Johnson functioned as marketer—the alliance made Pepcid products the best-selling remedies for acid indigestion and heartburn. United Airlines, American Airlines, Continental, Delta, and Northwest created an alliance to form Orbitz, an Internet travel site to compete head-to-head against Expedia and Travelocity, thereby strengthening their access to travelers and vacationers shopping online for airfares, rental cars, lodging, cruises, and vacation packages.

**Capturing the Benefits of Strategic Alliances**

The extent to which companies benefit from entering into alliances and collaborative partnerships seems to be a function of six factors:

1. **Picking a good partner**—A good partner not only has the desired expertise and capabilities but also shares the company’s vision about the purpose of the alliance. Experience indicates that it is generally wise to avoid a partnership in which there is strong potential of direct competition because of overlapping product lines or other conflicting interests—agreements to jointly market each other’s products hold much potential for conflict unless the products are complements rather than substitutes and unless there is good chemistry among key personnel. Experience also indicates that alliances between strong and weak companies rarely work because the alliance is unlikely to provide the strong partner with useful resources or skills and because there’s a greater chance of the alliance producing mediocre results.

2. **Being sensitive to cultural differences**—Unless the outsider exhibits respect for the local culture and local business practices, productive working relationships are unlikely to emerge.

3. **Recognizing that the alliance must benefit both sides**—Information must be shared as well as gained, and the relationship must remain forthright and trustful. Many alliances fail because one or both partners grow unhappy with what they are learning. Also, if either partner plays games with information or tries to take advantage of the other, the resulting friction can quickly erode the value of further collaboration.

4. **Ensuring that both parties live up to their commitments**—Both parties have to deliver on their commitments for the alliance to produce the intended benefits. The division of work has to be perceived as fairly apportioned, and the caliber of the benefits received on both sides has to be perceived as adequate.

5. **Structuring the decision-making process so that actions can be taken swiftly when needed**—In many instances, the fast pace of technological and competitive changes dictates an equally fast decision-making process. If the parties get bogged down in discussion or in gaining internal approval from higher-ups, the alliance can turn into an anchor of delay and inaction.

6. **Managing the learning process and then adjusting the alliance agreement over time to fit new circumstances**—One of the keys to long-lasting success is adapting the nature and structure of the alliance to be responsive to shifting market conditions, emerging technologies, and changing customer requirements. Wise allies are quick
to recognize the merit of an evolving collaborative arrangement, where adjustments are made to accommodate changing market conditions and to overcome whatever problems arise in establishing an effective working relationship. Most alliances encounter troubles of some kind within a couple of years—those that are flexible enough to evolve are better able to recover.

Most alliances that aim at technology sharing or providing market access turn out to be temporary, fulfilling their purpose after a few years because the benefits of mutual learning have occurred and because the businesses of both partners have developed to the point where they are ready to go their own ways. In such cases, it is important for each partner to learn thoroughly and rapidly about the other partner’s technology, business practices, and organizational capabilities and then promptly transfer valuable ideas and practices into its own operations. Although long-term alliances sometimes prove mutually beneficial, most partners don’t hesitate to terminate the alliance and go it alone when the payoffs run out.

Alliances are more likely to be long-lasting when (1) they involve collaboration with suppliers or distribution allies and each party’s contribution involves activities in different portions of the industry value chain, or (2) both parties conclude that continued collaboration is in their mutual interest, perhaps because new opportunities for learning are emerging or perhaps because further collaboration will allow each partner to extend its market reach beyond what it could accomplish on its own.

**Why Many Alliances Are Unstable or Break Apart**

The stability of an alliance depends on how well the partners work together, their success in responding and adapting to changing internal and external conditions, and their willingness to renegotiate the bargain if circumstances so warrant. A successful alliance requires real in-the-trenches collaboration, not merely an arm’s-length exchange of ideas. Unless partners place a high value on the skills, resources, and contributions each brings to the alliance and the cooperative arrangement results in valuable win-win outcomes, it is doomed. A surprisingly large number of alliances never live up to expectations. A 1999 study by Accenture, a global business consulting organization, revealed that 61 percent of alliances were either outright failures or “limping along.” In 2004, McKinsey & Company estimated that the overall success rate of alliances was around 50 percent, based on whether the alliance achieved the stated objectives. Many alliances are dissolved after a few years. The high “divorce rate” among strategic allies has several causes—diverging objectives and priorities, an inability to work well together (an alliance between Disney and Pixar came apart because of clashes between high-level executives—in 2005, after one of the feuding executives retired, Disney acquired Pixar), changing conditions that render the purpose of the alliance obsolete, the emergence of more attractive technological paths, and marketplace rivalry between one or more allies.

Experience indicates that alliances stand a reasonable chance of helping a company reduce competitive disadvantage, but very rarely have they proved a strategic option for gaining a durable competitive edge over rivals.

**The Strategic Dangers of Relying Heavily on Alliances and Collaborative Partnerships**

The Achilles heel of alliances and collaborative partnerships is dependence on another company for essential expertise and capabilities. To be a market leader (and perhaps even a serious market contender), a company must ultimately develop its own
capabilities in areas where internal strategic control is pivotal to protecting its competitiveness and building competitive advantage. Moreover, some alliances hold only limited potential because the partner guards its most valuable skills and expertise; in such instances, acquiring or merging with a company possessing the desired know-how and resources is a better solution.

**MERGER AND ACQUISITION STRATEGIES**

Mergers and acquisitions are much-used strategic options—for example, U.S. companies alone made 90,000 acquisitions from 1996 through 2003. Mergers and acquisitions are especially suited for situations in which alliances and partnerships do not go far enough in providing a company with access to needed resources and capabilities. Ownership ties are more permanent than partnership ties, allowing the operations of the merger/acquisition participants to be tightly integrated and creating more in-house control and autonomy. A merger is a pooling of equals, with the newly created company often taking on a new name. An acquisition is a combination in which one company, the acquirer, purchases and absorbs the operations of another, the acquired. The difference between a merger and an acquisition relates more to the details of ownership, management control, and financial arrangements than to strategy and competitive advantage. The resources, competencies, and competitive capabilities of the newly created enterprise end up much the same whether the combination is the result of acquisition or merger.

Many mergers and acquisitions are driven by strategies to achieve any of five strategic objectives:

1. *To create a more cost-efficient operation out of the combined companies*—When a company acquires another company in the same industry, there’s usually enough overlap in operations that certain inefficient plants can be closed or distribution activities partly combined and downsized (when nearby centers serve some of the same geographic areas), or sales-force and marketing activities combined and downsized (when each company has salespeople calling on the same customer). The combined companies may also be able to reduce supply chain costs because of buying in greater volume from common suppliers and from closer collaboration with supply chain partners. Likewise, it is usually feasible to squeeze out cost savings in administrative activities, again by combining and downsizing such administrative activities as finance and accounting, information technology, and human resources. The merger that formed DaimlerChrysler was motivated in large part by the fact that the motor vehicle industry had far more production capacity worldwide than was needed; top executives at both Daimler-Benz and Chrysler believed that the efficiency of the two companies could be significantly improved by shutting some plants and laying off workers; realigning which models were produced at which plants; and squeezing out efficiencies by combining supply chain activities, product design, and administration. Quite a number of acquisitions are undertaken with the objective of transforming two or more otherwise high-cost companies into one lean competitor with average or below-average costs.

2. *To expand a company’s geographic coverage*—One of the best and quickest ways to expand a company’s geographic coverage is to acquire rivals with operations in the desired locations. And if there is some geographic overlap, then a side benefit is being able to reduce costs by eliminating duplicate facilities in those geographic areas where undesirable overlap exists. Banks like Wells Fargo, Bank
of America, Wachovia, and Suntrust have pursued geographic expansion by making a series of acquisitions over the years, enabling them to establish a market presence in an ever-growing number of states and localities. Many companies use acquisitions to expand internationally; for example, food products companies like Nestlé, Kraft, Unilever, and Procter & Gamble—all racing for global market leadership—have made acquisitions an integral part of their strategies to widen their geographic reach.

3. To extend the company’s business into new product categories—Many times a company has gaps in its product line that need to be filled. Acquisition can be a quicker and more potent way to broaden a company’s product line than going through the exercise of introducing a company’s own new product to fill the gap. PepsiCo acquired Quaker Oats chiefly to bring Gatorade into the Pepsi family of beverages. While Coca-Cola has expanded its beverage lineup by introducing its own new products (like Powerade and Dasani), it has also expanded its lineup by acquiring Fanta (carbonated fruit beverages), Minute Maid (juices and juice drinks), Odwalla (juices), and Hi-C (ready-to-drink fruit beverages).

4. To gain quick access to new technologies or other resources and competitive capabilities—Making acquisitions to bolster a company’s technological know-how or to fill resource holes is a favorite of companies racing to establish a position in an industry or product category about to be born. Making acquisitions aimed at filling meaningful gaps in technological expertise allows a company to bypass a time-consuming and perhaps expensive R&D effort (which might not succeed). Cisco Systems purchased over 75 technology companies to give it more technological reach and product breadth, thereby buttressing its standing as the world’s biggest supplier of systems for building the infrastructure of the Internet. Intel has made over 300 acquisitions in the past five or so years to broaden its technological base, obtain the resource capabilities to produce and market a variety of Internet-related and electronics-related products, and make it less dependent on supplying microprocessors for PCs.

5. To try to invent a new industry and lead the convergence of industries whose boundaries are being blurred by changing technologies and new market opportunities—Such acquisitions are the result of a company’s management betting that two or more distinct industries are converging into one and deciding to establish a strong position in the consolidating markets by bringing together the resources and products of several different companies. Examples include the merger of AOL and media giant Time Warner—a move predicated on the belief that entertainment content would ultimately converge into a single industry (much of which would be distributed over the Internet)—and News Corporation’s purchase of satellite TV companies to complement its media holdings in TV broadcasting (the Fox network and TV stations in various countries); cable TV (Fox News, Fox Sports, and FX); filmed entertainment (Twentieth Century Fox and Fox Studios); and newspaper, magazine, and book publishing.

Numerous companies have employed an acquisition strategy to catapult themselves from the ranks of the unknown into positions of market leadership. During the 1990s, North Carolina National Bank (NCNB) pursued a series of acquisitions to transform itself into a major regional bank in the Southeast. But NCNB’s strategic vision was to become a bank with offices across most of the United States, so the company changed its name to NationsBank. In 1998, NationsBank acquired Bank of America for $66 billion and adopted its name. In 2004, Bank of America acquired Fleet Boston Financial for $48 billion. Then in mid-2005, Bank of America spent $35 billion to acquire MBNA,
Illustration Capsule 6.1

Clear Channel Communications: Using Mergers and Acquisitions to Become a Global Market Leader

Going into 2006, Clear Channel Communications was the world’s fourth largest media company, behind Disney, Time Warner, and Viacom/CBS. The company, founded in 1972 by Lowry Mays and Billy Joe McCombs, got its start by acquiring an unprofitable country-music radio station in San Antonio, Texas. Over the next 10 years, Mays learned the radio business and slowly bought other radio stations in a variety of states. Going public in 1984 helped the company raise the equity capital needed to continue acquiring radio stations in additional geographic markets.

In the late 1980s, when the Federal Communications Commission loosened the rules regarding the ability of one company to own both radio and TV stations, Clear Channel broadened its strategy and began acquiring small, struggling TV stations. By 1998, Clear Channel had used acquisitions to build a leading position in radio and television stations. Domestically, it owned, programmed, or sold airtime for 69 AM radio stations, 135 FM stations, and 18 TV stations in 48 local markets in 24 states. Clear Channel’s big move was to begin expanding internationally, chiefly by acquiring interests in radio station properties in a variety of countries.

In 1997, Clear Channel used acquisitions to establish a major position in outdoor advertising. Its first acquisition was Phoenix-based Eller Media Company, an outdoor advertising company with over 100,000 billboard facings. This was quickly followed by additional acquisitions of outdoor advertising companies, the most important of which were ABC Outdoor in Milwaukee, Wisconsin; Paxton Communications (with operations in Tampa and Orlando, Florida); Universal Outdoor; the More Group, with outdoor operations and 90,000 displays in 24 countries; and the Ackerley Group.

Then in October 1999, Clear Channel made a major move by acquiring AM-FM Inc. and changed its name to Clear Channel Communications; the AM-FM acquisition gave Clear Channel operations in 32 countries, including 830 radio stations, 19 TV stations, and more than 425,000 outdoor displays.

Additional acquisitions were completed during the 2000–2003 period. The emphasis was on buying radio, TV, and outdoor advertising properties with operations in many of the same local markets, which made it feasible to (1) cut costs by sharing facilities and staffs, (2) improve programming, and (3) sell advertising to customers in packages for all three media simultaneously. Packaging ads for two or three media not only helped Clear Channel’s advertising clients distribute their messages more effectively but also allowed the company to combine its sales activities and have a common sales force for all three media, achieving significant cost savings and boosting profit margins. But in 2000 Clear Channel broadened its media strategy by acquiring SFX Entertainment, one of the world’s largest promoters, producers, and presenters of live entertainment events.

At year-end 2005, Clear Channel owned radio and television stations, outdoor displays, and entertainment venues in 66 countries around the world. It operated approximately 1,200 radio and 40 television stations in the United States and had equity interests in over 240 radio stations internationally. It also operated a U.S. radio network of syndicated talk shows with about 180 million weekly listeners. In addition, the company owned or operated over $20,000 outdoor advertising displays, including billboards, street furniture, and transit panels around the world. In late 2005, the company spun off its Clear Channel Entertainment division (which was a leading promoter, producer, and marketer of about 32,000 live entertainment events annually and also owned leading athlete management and sports marketing companies) as a separate entity via an initial public offering of stock.

Sources: Information posted at www.clearchannel.com (accessed September 2005), and BusinessWeek, October 19, 1999, p. 56.
All too frequently, mergers and acquisitions do not produce the hoped-for outcomes. Cost savings may prove smaller than expected. Gains in competitive capabilities may take substantially longer to realize or, worse, may never materialize at all. Efforts to mesh the corporate cultures can stall due to formidable resistance from organization members. Managers and employees at the acquired company may argue forcefully for continuing to do certain things the way they were done prior to the acquisition. Key employees at the acquired company can quickly become disenchanted and leave; morale can drop to disturbingly low levels because personnel who remain disagree with newly instituted changes. Differences in management styles and operating procedures can prove hard to resolve. The managers appointed to oversee the integration of a newly acquired company can make mistakes in deciding what activities to leave alone and what activities to meld into their own operations and systems.

A number of previously applauded mergers/acquisitions have yet to live up to expectations—the merger of America Online (AOL) and Time Warner, the merger of Daimler-Benz and Chrysler, Hewlett-Packard’s acquisition of Compaq Computer, Ford’s acquisition of Jaguar, and Kmart’s acquisition of Sears are prime examples. The AOL-Time Warner merger has proved to be mostly a disaster, partly because AOL’s once-rapid growth has evaporated, partly because of a huge clash of corporate cultures, and partly because most of the expected benefits from industry convergence have yet to materialize. Ford paid a handsome price to acquire Jaguar but has yet to make the Jaguar brand a major factor in the luxury-car segment in competition against Mercedes, BMW, and Lexus. Novell acquired WordPerfect for $1.7 billion in stock in 1994, but the combination never generated enough punch to compete against Microsoft Word and Microsoft Office—Novell sold WordPerfect to Corel for $124 million in cash and stock less than two years later. In 2001 electronics retailer Best Buy paid $685 million to acquire Musicland, a struggling 1,300-store music retailer that included stores operating under the names Musicland, Sam Goody, Suncoast, Media Play, and On Cue. But Musicland’s sales, already declining, dropped even further. In June 2003, Best Buy “sold” Musicland to a Florida investment firm—no cash changed hands and the “buyer” received shares of stock in Best Buy in return for assuming Musicland’s liabilities.

VERTICAL INTEGRATION STRATEGIES: OPERATING ACROSS MORE STAGES OF THE INDUSTRY VALUE CHAIN

Vertical integration extends a firm’s competitive and operating scope within the same industry. It involves expanding the firm’s range of activities backward into sources of supply and/or forward toward end users. Thus, if a manufacturer invests in facilities to produce certain component parts that it formerly purchased from outside suppliers, it remains in essentially the same industry as before. The only change is that it has operations in two stages of the industry value chain. Similarly, if a paint manufacturer, Sherwin-Williams for example, elects to integrate forward by opening 100 retail stores to market its paint products directly to consumers, it remains in the paint business even though its competitive scope extends from manufacturing to retailing.

Vertical integration strategies can aim at full integration (participating in all stages of the industry value chain) or partial integration (building positions in selected stages of the industry’s total value chain). A firm can pursue vertical integration by starting its
The Advantages of a Vertical Integration Strategy

The two best reasons for investing company resources in vertical integration are to strengthen the firm’s competitive position and/or boost its profitability. Vertical integration has no real payoff profitwise or strategywise unless it produces sufficient cost savings or profit increases to justify the extra investment, adds materially to a company’s technological and competitive strengths, or helps differentiate the company’s product offering.

Integrating Backward to Achieve Greater Competitiveness

It is harder than one might think to generate cost savings or boost profitability by integrating backward into activities such as manufacturing parts and components (which could otherwise be purchased from suppliers with specialized expertise in making these parts and components). For backward integration to be a viable and profitable strategy, a company must be able to (1) achieve the same scale economies as outside suppliers and (2) match or beat suppliers’ production efficiency with no drop-off in quality. Neither outcome is a slam-dunk. To begin with, a company’s in-house requirements are often too small to reach the optimum size for low-cost operation—for instance, if it takes a minimum production volume of 1 million units to achieve mass-production economies and a company’s in-house requirements are just 250,000 units, then the company falls way short of being able to capture the scale economies of outside suppliers (which may readily find buyers for 1 million or more units). Furthermore, matching the production efficiency of suppliers is fraught with problems when suppliers have considerable production experience of their own, when the technology they employ has elements that are hard to master, or when substantial R&D expertise is required to develop next-version parts and components or keep pace with advancing technology in parts/components production.

But that being said, there are still occasions when a company can improve its cost position and competitiveness by performing a broad range of value chain activities in-house. The best potential for being able to reduce costs via a backward integration strategy exists in situations where suppliers have outsized profit margins, where the item being supplied is a major cost component, and where the requisite technological skills are easily mastered or can be gained by acquiring a supplier with the desired technological know-how. Furthermore, when a company has proprietary know-how that it is beneficial to keep away from rivals, then in-house performance of value chain activities related to this know-how is beneficial even if such activities could be performed by outsiders. For example, Krispy Kreme Doughnuts has successfully employed a backward vertical integration strategy that involves internally producing both the doughnut-making equipment and ready-mixed doughnut ingredients that company-owned and franchised retail stores used in making Krispy Kreme doughnuts—the company earned substantial profits from producing these items internally rather than having them supplied by outsiders. Furthermore, Krispy Kreme’s vertical integration strategy made good competitive sense because both its doughnut-making equipment and its doughnut recipe were proprietary; keeping its equipment manufacturing know-how and its secret recipe out of the hands of outside suppliers helped Krispy Kreme protect its doughnut offering from would-be imitators.

Backward vertical integration can produce a differentiation-based competitive advantage when a company, by performing activities internally rather than using outside
suppliers, ends up with a better-quality product/service offering, improves the caliber of its customer service, or in other ways enhances the performance of its final product. On occasion, integrating into more stages along the industry value chain can add to a company’s differentiation capabilities by allowing the company to build or strengthen its core competencies, better master key skills or strategy-critical technologies, or add features that deliver greater customer value. Other potential advantages of backward integration include sparing a company the uncertainty of being dependent on suppliers for crucial components or support services and lessening a company’s vulnerability to powerful suppliers inclined to raise prices at every opportunity.

**Integrating Forward to Enhance Competitiveness** The strategic impetus for forward integration is to gain better access to end users and better market visibility. In many industries, independent sales agents, wholesalers, and retailers handle competing brands of the same product; having no allegiance to any one company’s brand, they tend to push whatever sells and earns them the biggest profits. An independent insurance agency, for example, represents a number of different insurance companies—in trying to find the best match between a customer’s insurance requirements and the policies of alternative insurance companies, there’s plenty of opportunity for independent agents to end up promoting certain insurance companies’ policies ahead of others’. An insurance company may therefore conclude that it is better off setting up its own local sales offices with its own local agents to exclusively promote its policies. Likewise, a manufacturer can be frustrated in its attempts to win higher sales and market share or get rid of unwanted inventory or maintain steady, near-capacity production if it must distribute its products through distributors and/or retailers who are only halfheartedly committed to promoting and marketing its brand as opposed to those of rivals. In such cases, it can be advantageous for a manufacturer to integrate forward into wholesaling or retailing via company-owned distributorships or a chain of retail stores. For instance, both Goodyear and Bridgestone opted to integrate forward into tire retailing rather than to use independent distributors and retailers that stocked multiple brands because the independent distributors/retailers stressed selling the tire brands on which they earned the highest profit margins. A number of housewares and apparel manufacturers have integrated forward into retailing so as to move seconds, overstocked items, and slow-selling merchandise through their own branded retail outlet stores located in discount malls. Some producers have opted to integrate forward into retailing by selling directly to customers at the company’s Web site. Bypassing regular wholesale/retail channels in favor of direct sales and Internet retailing can have appeal if it lowers distribution costs, produces a relative cost advantage over certain rivals, and results in lower selling prices to end users.

**The Disadvantages of a Vertical Integration Strategy**

Vertical integration has some substantial drawbacks, however. As it boosts a firm’s capital investment in the industry, it increases business risk (what if industry growth and profitability go sour?) and increases the company’s vested interests in sticking with its vertically integrated value chain (what if some aspects of its technology and production facilities become obsolete before they are worn out or fully depreciated?). Vertically integrated companies that have invested heavily in a particular technology or in parts/components manufacture are often slow to embrace technological advances or more efficient production methods compared to partially integrated or nonintegrated firms. This is because less integrated firms can pressure suppliers to provide only the latest and best parts and components (even going so far as to shift their purchases from
one supplier to another if need be), whereas a vertically integrated firm that is saddled with older technology or facilities that make items it no longer needs is looking at the high costs of premature abandonment. Second, integrating forward or backward locks a firm into relying on its own in-house activities and sources of supply (which later may prove more costly than outsourcing) and potentially results in less flexibility in accommodating shifting buyer preferences or a product design that doesn’t include parts and components that it makes in-house. In today’s world of close working relationships with suppliers and efficient supply chain management systems, very few businesses can make a case for integrating backward into the business of suppliers to ensure a reliable supply of materials and components or to reduce production costs. The best materials and components suppliers stay abreast of advancing technology and are adept in boosting their efficiency and keeping their costs and prices as low as possible. A company that pursues a vertical integration strategy and tries to produce many parts and components in-house is likely to find itself hard-pressed to keep up with technological advances and cutting-edge production practices for each part and component used in making its product.

Third, vertical integration poses all kinds of capacity-matching problems. In motor vehicle manufacturing, for example, the most efficient scale of operation for making axles is different from the most economic volume for radiators, and different yet again for both engines and transmissions. Building the capacity to produce just the right number of axles, radiators, engines, and transmissions in-house—and doing so at the lowest unit cost for each—is much easier said than done. If internal capacity for making transmissions is deficient, the difference has to be bought externally. Where internal capacity for radiators proves excessive, customers need to be found for the surplus. And if by-products are generated—as occurs in the processing of many chemical products—they require arrangements for disposal. Consequently, integrating across several production stages in ways that achieve the lowest feasible costs is not as easy as it might seem.

Fourth, integration forward or backward often calls for radical changes in skills and business capabilities. Parts and components manufacturing, assembly operations, wholesale distribution and retailing, and direct sales via the Internet are different businesses with different key success factors. Managers of a manufacturing company should consider carefully whether it makes good business sense to invest time and money in developing the expertise and merchandising skills to integrate forward into wholesaling and retailing. Many manufacturers learn the hard way that company-owned wholesale/retail networks present many headaches, fit poorly with what they do best, and don’t always add the kind of value to their core business they thought they would. Selling to customers via the Internet poses still another set of problems—it is usually easier to use the Internet to sell to business customers than to consumers.

Finally, integrating backward into parts and components manufacture can impair a company’s operating flexibility when it comes to changing out the use of certain parts and components. It is one thing to design out a component made by a supplier and another to design out a component being made in-house (which can mean laying off employees and writing off the associated investment in equipment and facilities). Companies that alter designs and models frequently in response to shifting buyer preferences often find that outsourcing the needed parts and components is cheaper and less complicated than producing them in-house. Most of the world’s automakers, despite their expertise in automotive technology and manufacturing, have concluded that purchasing many of their key parts and components from manufacturing specialists results in higher quality, lower costs, and greater design flexibility than does the vertical integration option.
Weighing the Pros and Cons of Vertical Integration  

All in all, therefore, a strategy of vertical integration can have both important strengths and weaknesses. The tip of the scales depends on (1) whether vertical integration can enhance the performance of strategy-critical activities in ways that lower cost, build expertise, protect proprietary know-how, or increase differentiation; (2) the impact of vertical integration on investment costs, flexibility and response times, and the administrative costs of coordinating operations across more value chain activities; and (3) whether vertical integration substantially enhances a company’s competitiveness and profitability. Vertical integration strategies have merit according to which capabilities and value-chain activities truly need to be performed in-house and which can be performed better or cheaper by outsiders. Absent solid benefits, integrating forward or backward is not likely to be an attractive strategy option.

OUTSOURCING STRATEGIES: NARROWING THE BOUNDARIES OF THE BUSINESS

Outsourcing involves a conscious decision to abandon or forgo attempts to perform certain value chain activities internally and instead to farm them out to outside specialists and strategic allies. The two big drivers for outsourcing are that (1) outsiders can often perform certain activities better or cheaper and (2) outsourcing allows a firm to focus its entire energies on those activities at the center of its expertise (its core competencies) and that are the most critical to its competitive and financial success.

The current interest of many companies in making outsourcing a key component of their overall strategy and their approach to supply chain management represents a big departure from the way that companies used to deal with their suppliers and vendors. In years past, it was common for companies to maintain arm’s-length relationships with suppliers and outside vendors, insisting on items being made to precise specifications and negotiating long and hard over price. Although a company might place orders with the same supplier repeatedly, there was no expectation that this would be the case; price usually determined which supplier was awarded an order, and companies used the threat of switching suppliers to get the lowest possible prices. To enhance their bargaining power and, to make the threat of switching credible, it was standard practice for companies to source key parts and components from several suppliers as opposed to dealing with only a single supplier. But today most companies are abandoning such approaches in favor of forging alliances and strategic partnerships with a small number of highly capable suppliers. Collaborative relationships are replacing contractual, purely price-oriented relationships because companies have discovered that many of the advantages of performing value chain activities in-house can be captured and many of the disadvantages avoided by forging close, long-term cooperative partnerships with able suppliers and vendors and tapping into the expertise and capabilities that they have painstakingly developed.

When Outsourcing Strategies Are Advantageous

Outsourcing pieces of the value chain to narrow the boundaries of a firm’s business makes strategic sense whenever:

- An activity can be performed better or more cheaply by outside specialists.
  Many PC makers, for example, have shifted from assembling units in-house
to using contract assemblers because of the sizable scale economies associated with purchasing PC components in large volumes and assembling PCs. German shoemaker Birkenstock, by outsourcing the distribution of shoes made in its two plants in Germany to UPS, cut the time for delivering orders to U.S. footwear retailers from seven weeks to three weeks.20

• The activity is not crucial to the firm’s ability to achieve sustainable competitive advantage and won’t hollow out its core competencies, capabilities, or technical know-how. Outsourcing of maintenance services, data processing and data storage, fringe benefit management, Web site operations, and similar administrative support activities to specialists has become commonplace. American Express, for instance, recently entered into a seven-year, $4 billion deal whereby IBM’s Services division would host American Express’s Web site, network servers, data storage, and help desk; American Express indicated that it would save several hundred million dollars by paying only for the services it needed when it needed them (as opposed to funding its own full-time staff). A number of companies have begun outsourcing their call center operations to foreign-based contractors who have access to lower-cost labor supplies and can employ lower-paid call center personnel to respond to customer inquiries or requests for technical support.

• It reduces the company’s risk exposure to changing technology and/or changing buyer preferences. When a company outsources certain parts, components, and services, its suppliers must bear the burden of incorporating state-of-the-art technologies and/or undertaking redesigns and upgrades to accommodate a company’s plans to introduce next-generation products. If what a supplier provides falls out of favor with buyers or is designed out of next-generation products, it is the supplier’s business that suffers rather than a company’s own internal operations.

• It improves a company’s ability to innovate. Collaborative partnerships with world-class suppliers who have cutting-edge intellectual capital and are early adopters of the latest technology give a company access to ever better parts and components—such supplier-driven innovations, when incorporated into a company’s own product offering, fuel a company’s ability to introduce its own new and improved products.

• It streamlines company operations in ways that improve organizational flexibility and cuts the time it takes to get new products into the marketplace. Outsourcing gives a company the flexibility to switch suppliers in the event that its present supplier falls behind competing suppliers. To the extent that its suppliers can speedily get next-generation parts and components into production, then a company can get its own next-generation product offerings into the marketplace quicker. Moreover, seeking out new suppliers with the needed capabilities already in place is frequently quicker, easier, less risky, and cheaper than hurriedly retooling internal operations to replace obsolete capabilities or try to install and master new technologies.

• It allows a company to assemble diverse kinds of expertise speedily and efficiently. A company can nearly always gain quicker access to first-rate capabilities and expertise by partnering with suppliers who already have them in place than it can by trying to build them from scratch with its own company personnel.

• It allows a company to concentrate on its core business, leverage its key resources, and do even better what it already does best. A company is better able
to build and develop its own competitively valuable competencies and capabilities when it concentrates its full resources and energies on performing those activities internally that it can perform better than outsiders and/or that it needs to have under its direct control. Cisco Systems, for example, devotes its energy to designing new generations of switches, routers, and other Internet-related equipment, opting to outsource the more mundane activities of producing and assembling its routers and switching equipment to contract manufacturers that together operate 37 factories, all closely monitored and overseen by Cisco personnel via online systems. Cisco’s contract suppliers work so closely with Cisco that they can ship Cisco products to Cisco customers without a Cisco employee ever touching the gear. This system of alliances saves $500 million to $800 million annually.21

Dell Computer’s partnerships with the suppliers of PC components have allowed it to operate with only three days of inventory (just a couple of hours of inventory in the case of some components), to realize substantial savings in inventory costs, and to get PCs equipped with next-generation components into the marketplace in less than a week after the newly upgraded components start shipping. Hewlett-Packard, IBM, Silicon Graphics (now SGI), and others have sold plants to suppliers and then contracted to purchase the output. Starbucks has found purchasing coffee beans from independent growers far more advantageous than trying to integrate backward into the coffee-growing business.

The Big Risk of an Outsourcing Strategy

The biggest danger of outsourcing is that a company will farm out too many or the wrong types of activities and thereby hollow out its own capabilities.22 In such cases, a company loses touch with the very activities and expertise that over the long run determine its success. But most companies are alert to this danger and take actions to protect against being held hostage by outside suppliers. Cisco Systems guards against loss of control and protects its manufacturing expertise by designing the production methods that its contract manufacturers must use. Cisco keeps the source code for its designs proprietary, thereby controlling the initiation of all improvements and safeguarding its innovations from imitation. Further, Cisco uses the Internet to monitor the factory operations of contract manufacturers around the clock and can therefore know immediately when problems arise and whether to get involved.

OFFENSIVE STRATEGIES: IMPROVING MARKET POSITION AND BUILDING COMPETITIVE ADVANTAGE

Most every company must at times go on the offensive to improve its market position and try to build a competitive advantage or widen an existing one. Companies like Dell, Wal-Mart, and Toyota play hardball, aggressively pursuing competitive advantage and trying to reap the benefits a competitive edge offers—a leading market share, excellent profit margins and rapid growth (as compared to rivals), and all the intangibles of being known as a company on the move and one that plays to win.23 The best offensives tend to incorporate several behaviors and principles: (1) focusing relentlessly on building competitive advantage and then striving to convert competitive advantage into decisive advantage, (2) employing the element of surprise as opposed to doing what rivals expect and are prepared for, (3) applying resources where rivals
are least able to defend themselves, and (4) being impatient with the status quo and displaying a strong bias for swift, decisive actions to boost a company’s competitive position vis-à-vis rivals.24

Offensive strategies are also important when a company has no choice but to try to whittle away at a strong rival’s competitive advantage and when it is possible to gain profitable market share at the expense of rivals despite whatever resource strengths and capabilities they have. How long it takes for an offensive to yield good results varies with the competitive circumstances.25 It can be short if buyers respond immediately (as can occur with a dramatic price cut, an imaginative ad campaign, or an especially appealing new product). Securing a competitive edge can take much longer if winning consumer acceptance of an innovative product will take some time or if the firm may need several years to debug a new technology or put new production capacity in place or develop and perfect new competitive capabilities. Ideally, an offensive move will improve a company’s market standing or result in a competitive edge fairly quickly; the longer it takes, the more likely it is that rivals will spot the move, see its potential, and begin a counterresponse.

The principal offensive strategy options include the following:

1. Offering an equally good or better product at a lower price. This is the classic offensive for improving a company’s market position vis-à-vis rivals. Advanced Micro Devices (AMD), wanting to grow its sales of microprocessors for PCs, has on several occasions elected to attack Intel head-on, offering a faster alternative to Intel’s Pentium chips at a lower price. Believing that the company’s survival depends on eliminating the performance gap between AMD chips and Intel chips, AMD management has been willing to risk that a head-on offensive might prompt Intel to counter with lower prices of its own and accelerated development of next-generation chips. Lower prices can produce market share gains if competitors don’t respond with price cuts of their own and if the challenger convinces buyers that its product is just as good or better. However, such a strategy increases total profits only if the gains in additional unit sales are enough to offset the impact of lower prices and thinner margins per unit sold. Price-cutting offensives generally work best when a company first achieves a cost advantage and then hits competitors with a lower price.26

2. Leapfrogging competitors by being the first adopter of next-generation technologies or being first to market with next-generation products. In 2004–2005, Microsoft waged an offensive to get its next-generation Xbox to market four to six months ahead of Sony’s PlayStation 3, anticipating that such a lead time would allow help it convince video gamers to switch to the Xbox rather than wait for the new PlayStation to hit the market in 2006.

3. Pursuing continuous product innovation to draw sales and market share away from less innovative rivals. Aggressive and sustained efforts to trump the products of rivals by introducing new or improved products with features calculated to win customers away from rivals can put rivals under tremendous competitive pressure, especially when their new product development capabilities are weak or suspect. But such offensives work only if a company has potent product innovation skills of its own and can keep its pipeline full of ideas that are consistently well received in the marketplace.

4. Adopting and improving on the good ideas of other companies (rivals or otherwise).27 The idea of warehouse-type hardware and home improvement centers did not
originate with Home Depot founders Arthur Blank and Bernie Marcus; they got the big-box concept from their former employer Handy Dan Home Improvement. But they were quick to improve on Handy Dan’s business model and strategy and take Home Depot to the next plateau in terms of product line breadth and customer service. Casket maker Hillenbrand greatly improved its market position by adapting Toyota’s production methods to casket making. Ryanair has succeeded as a low-cost airline in Europe by imitating many of Southwest Airlines’ operating practices and applying them in a different geographic market. Companies that like to play hardball are willing to take any good idea (not nailed down by a patent or other legal protection), make it their own, and then aggressively apply it to create competitive advantage for themselves.28

5. **Deliberately attacking those market segments where a key rival makes big profits.**29 Dell Computer’s recent entry into printers and printer cartridges—the market arena where number-two PC maker Hewlett-Packard (HP) enjoys hefty profit margins and makes the majority of its profits—while mainly motivated by Dell’s desire to broaden its product line and save its customers money (because of Dell’s lower prices), nonetheless represented a hardball offensive calculated to weaken HP’s market position in printers. To the extent that Dell might be able to use lower prices to woo away some of HP’s printer customers, the move would erode HP’s “profit sanctuary,” distract HP’s attention away from PCs, and reduce the financial resources HP has available for battling Dell in the global market for PCs.

6. **Attacking the competitive weaknesses of rivals.** Offensives aimed at rivals’ weaknesses present many options. One is to go after the customers of those rivals whose products lag on quality, features, or product performance. If a company has especially good customer service capabilities, it can make special sales pitches to the customers of those rivals who provide subpar customer service. Aggressors with a recognized brand name and strong marketing skills can launch efforts to win customers away from rivals with weak brand recognition. There is considerable appeal in emphasizing sales to buyers in geographic regions where a rival has a weak market share or is exerting less competitive effort. Likewise, it may be attractive to pay special attention to buyer segments that a rival is neglecting or is weakly equipped to serve.

7. **Maneuvering around competitors and concentrating on capturing unoccupied or less contested market territory.** Examples include launching initiatives to build strong positions in geographic areas where close rivals have little or no market presence and trying to create new market segments by introducing products with different attributes and performance features to better meet the needs of selected buyers.

8. **Using hit-and-run or guerrilla warfare tactics to grab sales and market share from complacent or distracted rivals.** Options for “guerrilla offensives” include occasional lowballing on price (to win a big order or steal a key account from a rival); surprising key rivals with sporadic but intense bursts of promotional activity (offering a 20 percent discount for one week to draw customers away from rival brands); or undertaking special campaigns to attract buyers away from rivals plagued with a strike or problems in meeting buyer demand.30 Guerrilla offensives are particularly well suited to small challengers who have neither the resources nor the market visibility to mount a full-fledged attack on industry leaders.

9. **Launching a preemptive strike to secure an advantageous position that rivals are prevented or discouraged from duplicating.**31 What makes a move preemptive...
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is its one-of-a-kind nature—whoever strikes first stands to acquire competitive assets that rivals can’t readily match. Examples of preemptive moves include (1) securing the best distributors in a particular geographic region or country; (2) moving to obtain the most favorable site along a heavily traveled thoroughfare, at a new interchange or intersection, in a new shopping mall, in a natural beauty spot, close to cheap transportation or raw material supplies or market outlets, and so on; (3) tying up the most reliable, high-quality suppliers via exclusive partnership, long-term contracts, or even acquisition; and (4) moving swiftly to acquire the assets of distressed rivals at bargain prices. To be successful, a preemptive move doesn’t have to totally block rivals from following or copying; it merely needs to give a firm a prime position that is not easily circumvented.

Blue Ocean Strategy: A Special Kind of Offensive

A “blue ocean strategy” seeks to gain a dramatic and durable competitive advantage by abandoning efforts to beat out competitors in existing markets and, instead, inventing a new industry or distinctive market segment (a wide-open blue ocean of possibility) that renders existing competitors largely irrelevant and allows a company to create and capture altogether new demand. This strategy views the business universe as consisting of two distinct types of market space. One is where industry boundaries are defined and accepted, the competitive rules of the game are well understood by all industry members, and companies try to outperform rivals by capturing a bigger share of existing demand; in such markets, lively competition constrains a company’s prospects for rapid growth and superior profitability since rivals move quickly to either imitate or counter the successes of competitors. In the second type of market space, the industry does not really exist yet, is untainted by competition, and offers wide-open opportunity for profitable and rapid growth if a company can come up with a product offering and strategy that allows it to create new demand rather than fight over existing demand. A terrific example of such a blue ocean market space is the online auction industry that eBay created and now dominates.

Another company that has employed a blue ocean strategy is Cirque du Soleil, which increased its revenues by 22 times during the 1993–2003 period in the circus business, an industry that had been in long-term decline for 20 years. How did Cirque du Soleil pull this off against legendary industry leader Ringling Bros. and Barnum & Bailey? By reinventing the circus, creating a distinctively different market space for its performances (Las Vegas nightclubs and theater-type settings), and pulling in a whole new group of customers—adults and corporate clients—who were noncustomers of traditional circuses and were willing to pay several times more than the price of a conventional circus ticket to have an “entertainment experience” featuring sophisticated clowns and star-quality acrobatic acts in a comfortable big-tent atmosphere. Cirque studiously avoided the use of animals because of costs and because of concerns over their treatment by traditional circus organizations. Cirque’s market research led management to conclude that the lasting allure of the traditional circus came down to just three factors: the clowns, classic acrobatic acts, and a tentlike stage. As of 2005, Cirque du Soleil was presenting nine different shows, each with its own theme and story line; was performing before audiences of about 7 million people annually; and had performed 250 engagements in 100 cities before 50 million spectators since its formation in 1984.

Other examples of companies that have achieved competitive advantages by creating blue ocean market spaces include AMC via its pioneering of megaplex movie theaters, The Weather Channel in cable TV, Home Depot in big-box retailing of
hardware and building supplies, and FedEx in overnight package delivery. Companies that create blue ocean market spaces can usually sustain their initially won competitive advantage without encountering major competitive challenge for 10 to 15 years because of high barriers to imitation and the strong brand-name awareness that a blue ocean strategy can produce.

**Choosing Which Rivals to Attack**

Offense-minded firms need to analyze which of their rivals to challenge as well as how to mount that challenge. The following are the best targets for offensive attacks:

- **Market leaders that are vulnerable**—Offensive attacks make good sense when a company that leads in terms of size and market share is not a true leader in terms of serving the market well. Signs of leader vulnerability include unhappy buyers, an inferior product line, a weak competitive strategy with regard to low-cost leadership or differentiation, strong emotional commitment to an aging technology the leader has pioneered, outdated plants and equipment, a preoccupation with diversification into other industries, and mediocre or declining profitability. Offensives to erode the positions of market leaders have real promise when the challenger is able to revamp its value chain or innovate to gain a fresh cost-based or differentiation-based competitive advantage. To be judged successful, attacks on leaders don’t have to result in making the aggressor the new leader; a challenger may “win” by simply becoming a stronger runner-up. Caution is well advised in challenging strong market leaders—there’s a significant risk of squandering valuable resources in a futile effort or precipitating a fierce and profitless industrywide battle for market share.

- **Runner-up firms with weaknesses in areas where the challenger is strong**—Runner-up firms are an especially attractive target when a challenger’s resource strengths and competitive capabilities are well suited to exploiting their weaknesses.

- **Struggling enterprises that are on the verge of going under**—Challenging a hard-pressed rival in ways that further sap its financial strength and competitive position can weaken its resolve and hasten its exit from the market.

- **Small local and regional firms with limited capabilities**—Because small firms typically have limited expertise and resources, a challenger with broader capabilities is well positioned to raid their biggest and best customers—particularly those who are growing rapidly, have increasingly sophisticated requirements, and may already be thinking about switching to a supplier with more full-service capability.

**Choosing the Basis for Competitive Attack**

As a rule, challenging rivals on competitive grounds where they are strong is an uphill struggle. Offensive initiatives that exploit competitor weaknesses stand a better chance of succeeding than do those that challenge competitor strengths, especially if the weaknesses represent important vulnerabilities and weak rivals can be caught by surprise with no ready defense. Strategic offensives should, as a general rule, be grounded in a company’s competitive assets and strong points—its core competencies, competitive capabilities, and such resource strengths as a better-known brand name, a cost advantage in manufacturing or distribution, greater technological capability,

Core Concept

The best offensives use a company’s resource strengths to attack rivals in those competitive areas where they are weak.
or a superior product. If the attacker’s resource strengths give it a competitive advantage over the targeted rivals, so much the better. Ignoring the need to tie a strategic offensive to a company’s competitive strengths is like going to war with a popgun—the prospects for success are dim. For instance, it is foolish for a company with relatively high costs to employ a price-cutting offensive—price-cutting offensives are best left to financially strong companies whose costs are relatively low in comparison to those of the companies being attacked. Likewise, it is ill advised to pursue a product innovation offensive without having proven expertise in R&D, new product development, and speeding new or improved products to market.

DEFENSIVE STRATEGIES: PROTECTING MARKET POSITION AND COMPETITIVE ADVANTAGE

In a competitive market, all firms are subject to offensive challenges from rivals. The purposes of defensive strategies are to lower the risk of being attacked, weaken the impact of any attack that occurs, and influence challengers to aim their efforts at other rivals. While defensive strategies usually don’t enhance a firm’s competitive advantage, they can definitely help fortify its competitive position, protect its most valuable resources and capabilities from imitation, and defend whatever competitive advantage it might have. Defensive strategies can take either of two forms: actions to block challengers and signaling the likelihood of strong retaliation.

Blocking the Avenues Open to Challengers

The most frequently employed approach to defending a company’s present position involves actions that restrict a challenger’s options for initiating competitive attack. There are any number of obstacles that can be put in the path of would-be challengers.\(^{27}\) A defender can participate in alternative technologies as a hedge against rivals attacking with a new or better technology. A defender can introduce new features, add new models, or broaden its product line to close off gaps and vacant niches to opportunity-seeking challengers. It can thwart the efforts of rivals to attack with a lower price by maintaining economy-priced options of its own. It can try to discourage buyers from trying competitors’ brands by lengthening warranties, offering free training and support services, developing the capability to deliver spare parts to users faster than rivals can, providing coupons and sample giveaways to buyers most prone to experiment, and making early announcements about impending new products or price changes to induce potential buyers to postpone switching. It can challenge the quality or safety of rivals’ products. Finally, a defender can grant volume discounts or better financing terms to dealers and distributors to discourage them from experimenting with other suppliers, or it can convince them to handle its product line exclusively and force competitors to use other distribution outlets.

Signaling Challengers that Retaliation Is Likely

The goal of signaling challengers that strong retaliation is likely in the event of an attack is either to dissuade challengers from attacking at all or to divert them to less
threatening options. Either goal can be achieved by letting challengers know the battle will cost more than it is worth. Would-be challengers can be signaled by:

- Publicly announcing management’s commitment to maintain the firm’s present market share.
- Publicly committing the company to a policy of matching competitors’ terms or prices.
- Maintaining a war chest of cash and marketable securities.
- Making an occasional strong counterresponse to the moves of weak competitors to enhance the firm’s image as a tough defender.

WEB SITE STRATEGIES

One of the biggest strategic issues facing company executives across the world is just what role the company’s Web site should play in a company’s competitive strategy. In particular, to what degree should a company use the Internet as a distribution channel for accessing buyers? Should a company use its Web site only as a means of disseminating product information (with traditional distribution channel partners making all sales to end users), as a secondary or minor channel for selling directly to buyers of its product, as one of several important distribution channels for accessing customers, as the primary distribution channel for accessing customers, or as the exclusive channel for transacting sales with customers? Let’s look at each of these strategic options in turn.

**Product Information–Only Web Strategies:**

**Avoiding Channel Conflict**

Operating a Web site that contains extensive product information but that relies on click-throughs to the Web sites of distribution channel partners for sales transactions (or that informs site users where nearby retail stores are located) is an attractive market positioning option for manufacturers and/or wholesalers that have invested heavily in building and cultivating retail dealer networks and that face nettlesome channel conflict issues if they try to sell online in direct competition with their dealers. A manufacturer or wholesaler that aggressively pursues online sales to end users is signaling both a weak strategic commitment to its dealers and a willingness to cannibalize dealers’ sales and growth potential.

To the extent that strong partnerships with wholesale and/or retail dealers are critical to accessing end users, selling directly to end users via the company’s Web site is a very tricky road to negotiate. A manufacturer’s efforts to use its Web site to sell around its dealers is certain to anger its wholesale distributors and retail dealers, which may respond by putting more effort into marketing the brands of rival manufacturers that don’t sell online. In sum, the manufacturer may stand to lose more sales by offending its dealers than it gains from its own online sales effort. Moreover, dealers may be in better position to employ a brick-and-click strategy than a manufacturer is because dealers have a local presence to complement their online sales approach (which consumers may find appealing). Consequently, in industries where the strong support and goodwill of dealer networks is essential, manufacturers may conclude that their Web
site should be designed to partner with dealers rather than compete with them—just as the auto manufacturers are doing with their franchised dealers.

**Web Site e-Stores as a Minor Distribution Channel**

A second strategic option is to use online sales as a relatively minor distribution channel for achieving incremental sales, gaining online sales experience, and doing marketing research. If channel conflict poses a big obstacle to online sales, or if only a small fraction of buyers can be attracted to make online purchases, then companies are well advised to pursue online sales with the strategic intent of gaining experience, learning more about buyer tastes and preferences, testing reaction to new products, creating added market buzz about their products, and boosting overall sales volume a few percentage points. Sony and Nike, for example, sell most all of their products at their Web sites without provoking resistance from their retail dealers since most buyers of their products prefer to do their buying at retail stores rather than online. They use their Web site not so much to make sales as to glean valuable marketing research data from tracking the browsing patterns of Web site visitors. The behavior and actions of Web surfers are a veritable gold mine of information for companies seeking to keep their finger on the market pulse and respond more precisely to buyer preferences and interests.

Despite the channel conflict that exists when a manufacturer sells directly to end users at its Web site in head-to-head competition with its distribution channel allies, manufacturers might still opt to pursue online sales at their Web sites and try to establish online sales as an important distribution channel because (1) their profit margins from online sales are bigger than they earned from selling to their wholesale/retail customers; (2) encouraging buyers to visit the company’s Web site helps educate them to the ease and convenience of purchasing online and, over time, prompts more and more buyers to purchase online (where company profit margins are greater)—which makes incurring channel conflict in the short term and competing against traditional distribution allies potentially worthwhile—and (3) selling directly to end users allows a manufacturer to make greater use of build-to-order manufacturing and assembly, which, if met with growing buyer acceptance of and satisfaction, would increase the rate at which sales migrate from distribution allies to the company’s Web site—such migration could lead to streamlining the company’s value chain and boosting its profit margins.

**Brick-and-Click Strategies**

Brick-and-click strategies have two big strategic appeals for wholesale and retail enterprises: They are an economic means of expanding a company’s geographic reach, and they give both existing and potential customers another choice of how to communicate with the company, shop for product information, make purchases, or resolve customer service problems. Software developers, for example, have come to rely on the Internet as a highly effective distribution channel to complement sales through brick-and-mortar wholesalers and retailers. Selling online directly to end users has the advantage of eliminating the costs of producing and packaging CDs, as well as cutting out the costs and margins of software wholesalers and retailers (often 35 to 50 percent of the retail price). However, software developers are still strongly motivated to continue to distribute their products through wholesalers and retailers (to maintain broad access to existing and potential users who, for whatever reason, may be reluctant to buy online). Chain retailers like Wal-Mart and Circuit City operate online stores for their products primarily as a convenience to customers who want to buy online rather than making a shopping trip to nearby stores.
Many brick-and-mortar companies can enter online retailing at relatively low cost—all they need is a Web store and systems for filling and delivering individual customer orders. Brick-and-mortar distributors and retailers (as well as manufacturers with company-owned retail stores) can employ brick-and-click strategies by using their current distribution centers and/or retail stores for picking orders from on-hand inventories and making deliveries. Blockbuster, the world’s largest chain of video and DVD rental stores, uses the inventories at its stores to fill orders for its online subscribers, who pay a monthly fee for unlimited DVDs delivered by mail carrier; using local stores to fill orders typically allows delivery in 24 hours versus 48 hours for shipments made from a regional shipping center. Walgreen’s, a leading drugstore chain, allows customers to order a prescription online and then pick it up at the drive-through window or inside counter of a local store. In banking, a brick-and-click strategy allows customers to use local branches and ATMs for depositing checks and getting cash while using online systems to pay bills, check account balances, and transfer funds. Many industrial distributors are finding it efficient for customers to place their orders over the Web rather than phoning them in or waiting for salespeople to call in person. Illustration Capsule 6.2 describes how office supply chains like Office Depot, Staples, and OfficeMax have successfully migrated from a traditional brick-and-mortar distribution strategy to a combination brick-and-click distribution strategy.

**Strategies for Online Enterprises**

A company that elects to use the Internet as its exclusive channel for accessing buyers is essentially an online enterprise from the perspective of the customer. The Internet becomes the vehicle for transacting sales and delivering customer services; except for advertising, the Internet is the sole point of all buyer–seller contact. Many so-called pure dot-com enterprises have chosen this strategic approach—prominent examples include eBay, Yahoo, Amazon.com, Buy.com, Overstock.com, and Priceline.com. For a company to succeed in using the Internet as its exclusive distribution channel, its product or service must be one for which buying online holds strong appeal.

A company that decides to use online sales as its exclusive method for sales transactions must address several strategic issues:

- **How it will deliver unique value to buyers**—Online businesses must usually attract buyers on the basis of low price, convenience, superior product information, build-to-order options, or attentive online service.

- **Whether it will pursue competitive advantage based on lower costs, differentiation, or better value for the money**—For an online-only sales strategy to succeed in head-to-head competition with brick-and-mortar and brick-and-click rivals, an online seller’s value chain approach must hold potential for a low-cost advantage, comparatively valuable differentiating attributes, or a best-cost provider advantage. If an online firm’s strategy is to attract customers by selling at cut-rate prices, then it must possess cost advantages in those activities it performs, and it must outsource the remaining activities to low-cost specialists. If an online seller is going to differentiate itself on the basis of a superior buying experience and top-notch customer service, then it needs to concentrate on having an easy-to-navigate Web site, an array of functions and conveniences for customers, Web reps who can answer questions online, and logistical capabilities to deliver products quickly and accommodate returned merchandise. If it is going to deliver more value for the money, then it must manage value chain activities so as to deliver upscale products and services at lower costs than rivals.
Office Depot was in the first wave of retailers to adopt a combination brick-and-click strategy. Management quickly saw the merits of allowing business customers to use the Internet to place orders instead of having to make a call, generate a purchase order, and pay an invoice—while still getting same-day or next-day delivery from one of Office Depot’s local stores.

Office Depot already had an existing network of retail stores, delivery centers and warehouses, delivery trucks, account managers, sales offices, and regional call centers that handled large business customers. In addition, it had a solid brand name and enough purchasing power with its suppliers to counter discount-minded online rivals trying to attract buyers of office supplies on the basis of super-low prices. Office Depot’s incremental investment to enter the e-commerce arena was minimal since all it needed to add was a Web site where customers could see pictures and descriptions of the 14,000 items it carried, their prices, and in-stock availability. Marketing costs to make customers aware of its Web store option ran less than $10 million.

Office Depot’s online prices were the same as its store prices, the strategy being to promote Web sales on the basis of service, convenience, and lower customer costs for order processing and inventories. Customers reported that doing business with Office Depot online cut their transaction costs by up to 80 percent; plus, Office Depot’s same-day or next-day delivery capability allowed them to reduce office supply inventories.

The company set up customized Web pages for 37,000 corporate and educational customers that allowed the customer’s employees varying degrees of freedom to buy supplies. A clerk might be able to order only copying paper, toner cartridges, computer disks, and paper clips up to a preset dollar limit per order, while a vice president might have carte blanche to order any item Office Depot sold.

Web site sales cost Office Depot less than $1 per $100 of goods ordered, compared with about $2 for phone and fax orders. And since Web sales eliminate the need to key in transactions, order-entry errors were virtually eliminated and product returns cut by 50 percent. Billing is handled electronically.

In 2005, over 50 percent of Office Depot’s major customers were ordering most of their supplies online. Online sales accounted for almost $3 billion in 2004 (about 24 percent of Office Depot’s total revenues), up from $982 million in 2000 and making Office Depot the third-largest online retailer. Its online operations were profitable from the start.

Office Depot’s successful brick-and-click strategy prompted its two biggest rivals—Staples and OfficeMax—to adopt brick-and-click strategies too. In 2005, all three companies were enjoying increasing success with selling online to business customers and using local stores to fill orders and make deliveries.


- Whether it will have a broad or a narrow product offering—A one-stop shopping strategy like that employed by Amazon.com (which offers over 30 million items for sale at its Web sites in the United States, Britain, France, Germany, Denmark, and Japan) has the appealing economics of helping spread fixed operating costs over a wide number of items and a large customer base. Other e-tailers, such as E-Loan and Hotel.com, have adopted classic focus strategies and cater to a sharply defined target audience shopping for a particular product or product category.
- Whether to perform order fulfillment activities internally or to outsource them—Building central warehouses, stocking them with adequate inventories, and developing systems to pick, pack, and ship individual orders all require substantial start-up capital but may result in lower overall unit costs than would paying the fees of order fulfillment specialists who make a business of providing warehouse space, stocking inventories, and shipping orders for e-tailers. However,
outsourcing order fulfillment activities is likely to be more economical unless an
e-tailer has high unit volume and the capital to invest in its own order fulfillment
capabilities. Buy.com, an online superstore consisting of some 30,000 items,
obtains products from name-brand manufacturers and uses outsiders to stock
and ship those products; thus, its focus is not on manufacturing or order
fulfillment but rather on selling.

• *How it will draw traffic to its Web site and then convert page views into
revenues*—Web sites have to be cleverly marketed. Unless Web surfers hear
about the site, like what they see on their first visit, and are intrigued enough
to return again and again, the site is unlikely to generate adequate revenues.
Marketing campaigns that result only in heavy site traffic and lots of page views
are seldom sufficient; the best test of effective marketing and the appeal of an
online company’s product offering is the ratio at which page views are converted
into revenues (the “look-to-buy” ratio). For example, in 2001 Yahoo’s site traffic
averaged 1.2 billion page views daily but generated only about $2 million in
daily revenues; in contrast, the traffic at brokerage firm Charles Schwab’s Web
site averaged only 40 million page views per day but resulted in an average of
$5 million daily in online commission revenues.

### CHOOSING APPROPRIATE FUNCTIONAL-AREA STRATEGIES

A company’s strategy is not complete until company managers have made strategic
choices about how the various functional parts of the business—R&D, production,
human resources, sales and marketing, finance, and so on—will be managed in sup-
port of its basic competitive strategy approach and the other important competitive
moves being taken. Normally, functional-area strategy choices rank third on the menu
of choosing among the various strategy options, as shown in Figure 6.1 (see p. 162).
But whether commitments to particular functional strategies are made before or af-
ter the choices of complementary strategic options shown in Figure 6.1 is beside the
point—what’s really important is what the functional strategies are and how they mesh
to enhance the success of the company’s higher-level strategic thrusts.

In many respects, the nature of functional strategies is dictated by the choice of
competitive strategy. For example, a manufacturer employing a low-cost provider
strategy needs an R&D and product design strategy that emphasizes cheap-to-
incorporate features and facilitates economical assembly and a production strategy
that stresses capture of scale economies and actions to achieve low-cost manufacture
(such as high labor productivity, efficient supply chain management, and automated
production processes), and a low-budget marketing strategy. A business pursuing
a high-end differentiation strategy needs a production strategy geared to top-notch
quality and a marketing strategy aimed at touting differentiating features and using
advertising and a trusted brand name to “pull” sales through the chosen distribution
channels. A company using a focused differentiation strategy needs a marketing
strategy that stresses growing the niche. For example, the Missouri-based franchise
Panera Bread has been growing its business by getting more people hooked on fresh-
baked specialty breads and patronizing its bakery-cafés, keeping buyer interest in
Panera’s all-natural specialty breads at a high level, and protecting its specialty bread
niche against invasion by outsiders.

Beyond very general prescriptions, it is difficult to say just what the content of the
different functional-area strategies should be without first knowing what higher-level
strategic choices a company has made, the industry environment in which it operates,
When to make a strategic move is often as crucial as what move to make. Timing is especially important when first-mover advantages or disadvantages exist. Being first to initiate a strategic move can have a high payoff when (1) pioneering helps build a firm’s image and reputation with buyers; (2) early commitments to new technologies, new-style components, new or emerging distribution channels, and so on can produce an absolute cost advantage over rivals; (3) first-time customers remain strongly loyal to pioneering firms in making repeat purchases; and (4) moving first constitutes a preemptive strike, making imitation extra hard or unlikely. The bigger the first-mover advantages, the more attractive making the first move becomes. In e-commerce, companies like America Online, Amazon.com, Yahoo, eBay, and Priceline.com that were first with a new technology, network solution, or business model enjoyed lasting first-mover advantages in gaining the visibility and reputation needed to remain market leaders. However, other first-movers such as Xerox in fax machines, eToys (an online toy retailer), Webvan and Peapod (in online groceries), and scores of other dot-com companies never converted their first-mover status into any sort of competitive advantage. Sometimes markets are slow to accept the innovative product offering of a first-mover; sometimes, a fast-follower with greater resources and marketing muscle can easily overtake the first-mover (as Microsoft was able to do when it introduced Internet Explorer against Netscape, the pioneer of Internet browsers with the lion’s share of the market); and sometimes furious technological change or product innovation makes a first-mover vulnerable to quickly appearing next-generation technology or products. Hence, just being a first-mover by itself is seldom enough to win a sustainable competitive advantage.

To sustain any advantage that may initially accrue to a pioneer, a first-mover needs to be a fast learner and continue to move aggressively to capitalize on any initial pioneering advantage. It helps immensely if the first-mover has deep financial pockets, important competencies and competitive capabilities, and astute managers. If a first-mover’s skills, know-how, and actions are easily copied or even surpassed, then fast-followers and even late-movers can catch or overtake the first-mover in a relatively short period. What makes being a first-mover strategically important is not being the first company to do something but rather being the first competitor to put together the precise combination of features, customer value, and sound revenue/cost/profit economics that gives it an edge over rivals in the battle for market leadership. If the marketplace quickly takes to a first-mover’s innovative product offering, a first-mover must have large-scale production, marketing, and distribution capabilities if it is to stave off fast-followers who possess these resources capabilities. If technology is advancing at torrid pace, a first-mover cannot hope to sustain its lead without having strong capabilities in R&D, design, and new product development, along with the financial strength to fund these activities.
The Potential for Late-Mover Advantages or First-Mover Disadvantages

There are instances when there are actually advantages to being an adept follower rather than a first-mover. Late-mover advantages (or first-mover disadvantages) arise in four instances:

- When pioneering leadership is more costly than imitating followership and only negligible learning/experience curve benefits accrue to the leader—a condition that allows a follower to end up with lower costs than the first-mover.
- When the products of an innovator are somewhat primitive and do not live up to buyer expectations, thus allowing a clever follower to win disenchanted buyers away from the leader with better-performing products.
- When the demand side of the marketplace is skeptical about the benefits of a new technology or product being pioneered by a first-mover.
- When rapid market evolution (due to fast-paced changes in either technology or buyer needs and expectations) gives fast-followers and maybe even cautious late-movers the opening to leapfrog a first-mover’s products with more attractive next-version products.

To Be a First-Mover or Not

In weighing the pros and cons of being a first-mover versus a fast-follower versus a slow-mover, it matters whether the race to market leadership in a particular industry is a marathon or a sprint. In marathons, a slow-mover is not unduly penalized—first-mover advantages can be fleeting, and there is ample time for fast-followers and sometimes even late-movers to play catch-up. Thus, the speed at which the pioneering innovation is likely to catch on matters considerably as companies struggle with whether to pursue a particular emerging market opportunity aggressively (as a first-mover or fast-follower) or cautiously (as a late-mover). For instance, it took 18 months for 10 million users to sign up for Hotmail, 5.5 years for worldwide mobile phone use to grow from 10 million to 100 million worldwide, 7 years for videocassette recorders to find their way into 1 million U.S. homes, and close to 10 years for the number of at-home broadband subscribers to grow to 100 million worldwide. The lesson here is that there is a market-penetration curve for every emerging opportunity; typically, the curve has an inflection point at which all the pieces of the business model fall into place, buyer demand explodes, and the market takes off. The inflection point can come early on a fast-rising curve (like use of e-mail) or further up on a slow-rising curve (like the use of broadband). Any company that seeks competitive advantage by being a first-mover thus needs to ask some hard questions:

- Does market takeoff depend on the development of complementary products or services that currently are not available?
- Is new infrastructure required before buyer demand can surge?
- Will buyers need to learn new skills or adopt new behaviors? Will buyers encounter high switching costs?
- Are there influential competitors in a position to delay or derail the efforts of a first-mover?
Illustration Capsule 6.3

The Battle in Consumer Broadband: First-Movers versus Late-Movers

In 1988 an engineer at the Bell companies’ research labs figured out how to rush signals along ordinary copper wire at high speed using digital technology, thus creating the digital subscriber line (DSL). But the regional Bells, which dominated the local telephone market in the United States, showed little interest over the next 10 years, believing it was more lucrative to rent T-1 lines to businesses that needed fast data transmission capability and rent second phone lines to households wanting an Internet connection that didn’t disrupt their regular telephone service. Furthermore, telephone executives were skeptical about DSL technology—there were a host of technical snarls to overcome, and early users encountered annoying glitches. Many executives doubted that it made good sense to invest billions of dollars in the infrastructure needed to roll out DSL to residential and small business customers, given the success they were having with T-1 and second-line rentals. As a consequence, the Bells didn’t seriously begin to market DSL until the late 1990s, two years after the cable TV companies began their push to market cable broadband.

Cable companies were more than happy to be the first-movers in marketing broadband service via their copper cable wires, chiefly because their business was threatened by satellite TV technology and they saw broadband as an innovative service they could provide that the satellite companies couldn’t. (Delivering broadband service via satellites has yet to become a factor in the marketplace, winning only a 1 percent share in 2003.) Cable companies were able to deploy broadband on their copper wire economically because during the 1980s and early 1990s most cable operators had spent about $60 billion to upgrade their systems with fiber-optic technology in order to handle two-way traffic rather than just one-way TV signals and thereby make good on their promises to local governments to develop “interactive” cable systems if they were awarded franchises. Although the early interactive services were duds, technicians discovered in the mid-1990s that the two-way systems enabled high-speed Internet hookups.

With Internet excitement surging in the late 1990s, cable executives saw high-speed Internet service as a no-brainer and began rolling it out to customers in 1998, securing about 362,000 customers by year-end versus only about 41,000 for DSL. Part of the early success of cable broadband was due to a cost advantage in modems—cable executives, seeing the potential of cable broadband several years earlier, had asked CableLabs to standardize the technology for cable modems, a move that lowered costs and made cable modems marketable in consumer electronics stores. DSL modems were substantially more complicated, and it took longer to drive the costs down from several hundred dollars each to under $100—in 2004, both cable and phone companies paid about $50 for modems, but cable modems got there much sooner.

As cable broadband began to attract more and more attention in the 1998–2002 period, the regional Bells continued to move slowly on DSL. The technical problems lingered, and early users were disgruntled by a host of annoying and sometimes horrendous installation difficulties and service glitches. Not only did providing users with convenient and reliable service prove to be a formidable challenge, but some regulatory issues stood in the way as well. Even in 2003 phone company executives found it hard to justify multibillion-dollar investments to install the necessary equipment and support systems to offer, market, manage, and maintain DSL service on the vast scale of a regional Bell company. SBC Communications figured it would cost at least $6 billion to roll out DSL to its customers. Verizon estimated that it would take 3.5 to 4 million customers to make DSL economics work, a number it would probably not reach until the end of 2005.

In 2003–2004, high-speed consumer access to the Internet was a surging business with a bright outlook—the number of U.S. Internet users upgrading to high-speed service increased by close to 500,000 monthly. In 2005, cable broadband was the preferred choice—70 percent of U.S. broadband users had opted for cable modems supplied by cable TV companies, with cable modem subscribers outnumbering DSL subscribers 30 million to 10.6 million. Its late start made it questionable whether DSL would be able to catch cable broadband in the U.S. marketplace, although DSL providers added 1.4 million subscribers in the first three months of 2005 compared to 1.2 million new subscribers for cable. In the rest of the world, however, DSL was the broadband connection of choice—there were an estimated 200 million broadband subscribers worldwide at the end of 2005.

When the answers to any of these questions are yes, then a company must be careful not to pour too many resources into getting ahead of the market opportunity—the race is likely going to be more of a 10-year marathon than a 2-year sprint. Being first out of the starting block is competitively important only when pioneering early introduction of a technology or product delivers clear and substantial benefits to early adopters and buyers, thus winning their immediate support, perhaps giving the pioneer a reputational head-start advantage, and forcing competitors to quickly follow the pioneer’s lead. In the remaining instances where the race is more of a marathon, the companies that end up capturing and dominating new-to-the-world markets are almost never the pioneers that gave birth to those markets—there is time for a company to marshal the needed resources and to ponder its best time and method of entry. Furthermore, being a late-mover into industries of the future has the advantages of being less risky and skirting the costs of pioneering.

But while a company is right to be cautious about quickly entering virgin territory, where all kinds of risks abound, rarely does a company have much to gain from consistently being a late-mover whose main concern is avoiding the mistakes of first-movers. Companies that are habitual late-movers regardless of the circumstances, while often able to survive, can find themselves scrambling to keep pace with more progressive and innovative rivals and fighting to retain their customers. For a habitual late-mover to catch up, it must count on first-movers to be slow learners and complacent in letting their lead dwindle. It also has to hope that buyers will be slow to gravitate to the products of first-movers, again giving it time to catch up. And it has to have competencies and capabilities that are sufficiently strong to allow it to close the gap fairly quickly once it makes its move. Counting on all first-movers to stumble or otherwise be easily overtaken is usually a bad bet that puts a late-mover’s competitive position at risk.

Illustration Capsule 6.3 describes the challenges that late-moving telephone companies have in winning the battle to supply at-home high-speed Internet access and overcoming the first-mover advantages of cable companies.

Key Points

Once a company has selected which of the five basic competitive strategies to employ in its quest for competitive advantage, then it must decide whether to supplement its choice of a basic competitive strategy approach, as shown in Figure 6.1 (p. 162).

Many companies are using strategic alliances and collaborative partnerships to help them in the race to build a global market presence or be a leader in the industries of the future. Strategic alliances are an attractive, flexible, and often cost-effective means by which companies can gain access to missing technology, expertise, and business capabilities. Mergers and acquisitions are another attractive strategic option for strengthening a firm’s competitiveness. When the operations of two companies are combined via merger or acquisition, the new company’s competitiveness can be enhanced in any of several ways—lower costs; stronger technological skills; more or better competitive capabilities; a more attractive lineup of products and services; wider geographic coverage; and/or greater financial resources with which to invest in R&D, add capacity, or expand into new areas.

Vertically integrating forward or backward makes strategic sense only if it strengthens a company’s position via either cost reduction or creation of a differentiation-based advantage. Otherwise, the drawbacks of vertical integration (increased investment,
greater business risk, increased vulnerability to technological changes, and less flexibility in making product changes) are likely to outweigh any advantages.

Outsourcing pieces of the value chain formerly performed in-house can enhance a company’s competitiveness whenever an activity (1) can be performed better or more cheaply by outside specialists; (2) is not crucial to the firm’s ability to achieve sustainable competitive advantage and won’t hollow out its core competencies, capabilities, or technical know-how; (3) reduces the company’s risk exposure to changing technology or changing buyer preferences; (4) streamlines company operations in ways that improve organizational flexibility, cut cycle time, speed decision making, and reduce coordination costs; or (5) allows a company to concentrate on its core business and do what it does best.

One of the most pertinent strategic issues that companies face is how to use the Internet in positioning the company in the marketplace—whether to use the Internet as only a means of disseminating product information (with traditional distribution channel partners making all sales to end users), as a secondary or minor channel, as one of several important distribution channels, as the company’s primary distribution channel, or as the company’s exclusive channel for accessing customers.

Companies have a number of offensive strategy options for improving their market positions and trying to secure a competitive advantage: offering an equal or better product at a lower price, leapfrogging competitors by being first to adopt next-generation technologies or the first to introduce next-generation products, pursuing sustained product innovation, attacking competitors weaknesses, going after less contested or unoccupied market territory, using hit-and-run tactics to steal sales away from unsuspecting rivals, and launching preemptive strikes. A blue ocean strategy seeks to gain a dramatic and durable competitive advantage by abandoning efforts to beat out competitors in existing markets and, instead, inventing a new industry or distinctive market segment that renders existing competitors largely irrelevant and allows a company to create and capture altogether new demand.

Defensive strategies to protect a company’s position usually take the form of making moves that put obstacles in the path of would-be challengers and fortify the company’s present position while undertaking actions to dissuade rivals from even trying to attack (by signaling that the resulting battle will be more costly to the challenger than it is worth).

Once all the higher-level strategic choices have been made, company managers can turn to the task of crafting functional and operating-level strategies to flesh out the details of the company’s overall business and competitive strategy.

The timing of strategic moves also has relevance in the quest for competitive advantage. Company managers are obligated to carefully consider the advantages or disadvantages that attach to being a first-mover versus a fast-follower versus a late-mover.

**Exercises**

1. Go to Google or another Internet search engine and do a search on “strategic alliances.” Identify at least two companies in different industries that are making a significant use of strategic alliances as a core part of their strategies. In addition, identify who their alliances are with and describe the purpose of the alliances.

2. Go to Google or another Internet search engine and do a search on “acquisition strategy.” Identify at least two companies in different industries that are using
acquisitions to strengthen their market positions. Identify some of the companies that have been acquired, and research the purpose behind the acquisitions.

3. Go to www.goodyear.com/investor and read Goodyear’s most recent annual report. To what extent is the company vertically integrated? What segments of the industry value chain has the company chosen to perform? Based on the company’s discussion of business unit performance, does it appear the company is becoming more vertically integrated or choosing to narrow its range of internally performed activities?

4. Illustration Capsule 6.3 describes how cable companies used fiber-optic networks to gain a first-mover advantage over telephone companies in providing high-speed Internet access to home subscribers. Telephone companies are attempting to catch up with cable companies in the broadband access market with the widespread rollout of DSL to telephone customers. In addition, phone companies are pursuing fiber-to-the-premises (FTTP) and outdoor wireless networks (outdoor WLAN) technologies to supplement or replace DSL. Conduct Web searches on FTTP and outdoor WLAN, and discuss how use of these technologies by telephone companies might offset the first-mover advantage currently held by cable companies in the high-speed Internet market.

5. Go to the Web sites of various companies (such as those appearing on the Fortune 500) and identify two companies using each of the following Web site strategies and explain why the approach is well matched to the company’s business model:
   a. Product information only.
   b. E-store as a minor distribution strategy.
   c. Brick-and-click.
   d. Online enterprise.
You have no choice but to operate in a world shaped by globalization and the information revolution. There are two options: Adapt or die.

—Andrew S. Grove
Former Chairman, Intel Corporation

You do not choose to become global. The market chooses for you; it forces your hand.

—Alain Gomez
CEO, Thomson SA

Industries actually vary a great deal in the pressures they put on a company to sell internationally.

—Niraj Dawar and Tony Frost
Professors, Richard Ivey School of Business

Competing in Foreign Markets
Any company that aspires to industry leadership in the 21st century must think in terms of global, not domestic, market leadership. The world economy is globalizing at an accelerating pace as countries previously closed to foreign companies open up their markets, as the Internet shrinks the importance of geographic distance, and as ambitious, growth-minded companies race to build stronger competitive positions in the markets of more and more countries. Companies in industries that are already globally competitive or in the process of becoming so are under the gun to come up with a strategy for competing successfully in foreign markets.

This chapter focuses on strategy options for expanding beyond domestic boundaries and competing in the markets of either a few or a great many countries. The spotlight will be on four strategic issues unique to competing multinationally:

1. Whether to customize the company’s offerings in each different country market to match the tastes and preferences of local buyers or to offer a mostly standardized product worldwide.

2. Whether to employ essentially the same basic competitive strategy in all countries or modify the strategy country by country.

3. Where to locate the company’s production facilities, distribution centers, and customer service operations so as to realize the greatest location advantages.

4. How to efficiently transfer the company’s resource strengths and capabilities from one country to another in an effort to secure competitive advantage.

In the process of exploring these issues, we will introduce a number of core concepts—multicountry competition, global competition, profit sanctuaries, and cross-market subsidization. The chapter includes sections on cross-country differences in cultural, demographic, and market conditions; strategy options for entering and competing in foreign markets; the growing role of alliances with foreign partners; the importance of locating operations in the most advantageous countries; and the special circumstances of competing in such emerging markets as China, India, Brazil, Russia, and Eastern Europe.
WHY COMPANIES EXPAND INTO FOREIGN MARKETS

A company may opt to expand outside its domestic market for any of four major reasons:

1. *To gain access to new customers*—Expanding into foreign markets offers potential for increased revenues, profits, and long-term growth and becomes an especially attractive option when a company’s home markets are mature. Firms like Cisco Systems, Dell, Sony, Nokia, Avon, and Toyota, which are racing for global leadership in their respective industries, are moving rapidly and aggressively to extend their market reach into all corners of the world.

2. *To achieve lower costs and enhance the firm’s competitiveness*—Many companies are driven to sell in more than one country because domestic sales volume is not large enough to fully capture manufacturing economies of scale or learning/experience curve effects and thereby substantially improve the firm’s cost-competitiveness. The relatively small size of country markets in Europe explains why companies like Michelin, BMW, and Nestlé long ago began selling their products all across Europe and then moved into markets in North America and Latin America.

3. *To capitalize on its core competencies*—A company may be able to leverage its competencies and capabilities into a position of competitive advantage in foreign markets as well as just domestic markets. Nokia’s competencies and capabilities in mobile phones have propelled it to global market leadership in the wireless telecommunications business. Wal-Mart is capitalizing on its considerable expertise in discount retailing to expand into China, Latin America, and parts of Europe—Wal-Mart executives believe the company has tremendous growth opportunities in China.

4. *To spread its business risk across a wider market base*—A company spreads business risk by operating in a number of different foreign countries rather than depending entirely on operations in its domestic market. Thus, if the economies of certain Asian countries turn down for a period of time, a company with operations across much of the world may be sustained by buoyant sales in Latin America or Europe.

In a few cases, companies in industries based on natural resources (e.g., oil and gas, minerals, rubber, and lumber) often find it necessary to operate in the international arena because attractive raw material supplies are located in foreign countries.

**The Difference Between Competing Internationally and Competing Globally**

Typically, a company will start to compete internationally by entering just one or maybe a select few foreign markets. Competing on a truly global scale comes later, after the company has established operations on several continents and is racing against rivals for global market leadership. Thus, there is a meaningful distinction between the competitive scope of a company that operates in a few foreign countries (with perhaps modest ambitions to enter several more country markets) and a company that markets its products in 50 to 100 countries and is expanding its operations into additional country markets annually. The former is most accurately termed an *international competitor*, whereas the latter qualifies as a *global competitor*. In the discussion that follows, we’ll continue to make a distinction between strategies for competing internationally and strategies for competing globally.
CROSS-COUNTRY DIFFERENCES IN CULTURAL, DEMOGRAPHIC, AND MARKET CONDITIONS

Regardless of a company’s motivation for expanding outside its domestic markets, the strategies it uses to compete in foreign markets must be situation-driven. Cultural, demographic, and market conditions vary significantly among the countries of the world. Cultures and lifestyles are the most obvious areas in which countries differ; market demographics and income levels are close behind. Consumers in Spain do not have the same tastes, preferences, and buying habits as consumers in Norway; buyers differ yet again in Greece, Chile, New Zealand, and Taiwan. Less than 20 percent of the populations of Brazil, India, and China have annual purchasing power equivalent to $25,000. Middle-class consumers represent a much smaller portion of the population in these and other emerging countries than in North America, Japan, and much of Western Europe—China’s middle class numbers about 125 million out of a population of 1.3 billion.

Sometimes product designs suitable in one country are inappropriate in another—for example, in the United States electrical devices run on 110-volt systems, but in some European countries the standard is a 240-volt system, necessitating the use of different electrical designs and components. In France consumers prefer top-loading washing machines, while in most other European countries consumers prefer front-loading machines. Northern Europeans want large refrigerators because they tend to shop once a week in supermarkets; southern Europeans can get by on small refrigerators because they shop daily. In parts of Asia refrigerators are a status symbol and may be placed in the living room, leading to preferences for stylish designs and colors—in India bright blue and red are popular colors. In other Asian countries household space is constrained and many refrigerators are only four feet high so that the top can be used for storage. In Hong Kong the preference is for compact European-style appliances, but in Taiwan large American-style appliances are more popular. In Italy, most people use automatic washing machines but prefer to hang the clothes out to dry on a clothesline—there is a strongly entrenched tradition and cultural belief that sun-dried clothes are fresher, which virtually shuts down any opportunities for appliance makers to market clothes dryers in Italy. In China, many parents are reluctant to purchase personal computers (PCs) even when they can afford them because of concerns that their children will be distracted from their schoolwork by surfing the Web, playing PC-based video games, and downloading and listening to pop music.

Similarly, market growth varies from country to country. In emerging markets like India, China, Brazil, and Malaysia, market growth potential is far higher than in the more mature economies of Britain, Denmark, Canada, and Japan. In automobiles, for example, the potential for market growth is explosive in China, where 2005 sales of new vehicles amounted to less than 5 million in a country with 1.3 billion people. In India there are efficient, well-developed national channels for distributing trucks, scooters, farm equipment, groceries, personal care items, and other packaged products to the country’s 3 million retailers, whereas in China distribution is primarily local and there is no national network for distributing most products. The marketplace is intensely competitive in some countries and only moderately contested in others. Industry driving forces may be one thing in Spain, quite another in Canada, and different yet again in Turkey or Argentina or South Korea.

One of the biggest concerns of companies competing in foreign markets is whether to customize their offerings in each different country market to match the tastes and preferences of local buyers or whether to offer a mostly standardized product.
worldwide. While making products that are closely matched to local tastes makes them more appealing to local buyers, customizing a company’s products country by country may have the effect of raising production and distribution costs due to the greater variety of designs and components, shorter production runs, and the complications of added inventory handling and distribution logistics. Greater standardization of a global company’s product offering, however, can lead to scale economies and experience/learning curve effects, thus contributing to the achievement of a low-cost advantage.

The tension between the market pressures to localize a company’s product offerings country by country and the competitive pressures to lower costs is one of the big strategic issues that participants in foreign markets have to resolve.

Aside from the basic cultural and market differences among countries, a company also has to pay special attention to location advantages that stem from country-to-country variations in manufacturing and distribution costs, the risks of adverse shifts in exchange rates, and the economic and political demands of host governments.

**Gaining Competitive Advantage Based on Where Activities Are Located**

Differences in wage rates, worker productivity, inflation rates, energy costs, tax rates, government regulations, and the like create sizable variations in manufacturing costs from country to country. Plants in some countries have major manufacturing cost advantages because of lower input costs (especially labor), relaxed government regulations, the proximity of suppliers, or unique natural resources. In such cases, the low-cost countries become principal production sites, with most of the output being exported to markets in other parts of the world. Companies that build production facilities in low-cost countries (or that source their products from contract manufacturers in these countries) have a competitive advantage over rivals with plants in countries where costs are higher. The competitive role of low manufacturing costs is most evident in low-wage countries like China, India, Pakistan, Cambodia, Vietnam, Mexico, Brazil, Guatemala, the Philippines, and several countries in Africa that have become production havens for manufactured goods with high labor content (especially textiles and apparel). Labor costs in China averaged about $0.70 an hour in 2004–2005 versus about $1.50 in Russia, $4.60 in Hungary, $4.90 in Portugal, $16.50 in Canada, $21.00 in the United States, $23.00 in Norway, and $25.00 in Germany. China is fast becoming the manufacturing capital of the world—virtually all of the world’s major manufacturing companies now have facilities in China, and China attracted more foreign direct investment in 2002 and 2003 than any other country in the world. Likewise, concerns about short delivery times and low shipping costs make some countries better locations than others for establishing distribution centers.

The quality of a country’s business environment also offers locational advantages—the governments of some countries are anxious to attract foreign investments and go all out to create a business climate that outsiders will view as favorable. A good example is Ireland, which has one of the world’s most pro-business environments. Ireland offers companies very low corporate tax rates, has a government that is responsive to the needs of industry, and aggressively recruits high-tech manufacturing facilities and multinational companies. Such policies were a significant force in making Ireland the most dynamic, fastest-growing nation in Europe during the 1990s. Ireland’s policies were a major factor in Intel’s decision to choose Leixlip, County Kildare, as the site for a $2.5 billion chip manufacturing plant that employs over 4,000 people. Another
locational advantage is the clustering of suppliers of components and capital equipment; infrastructure suppliers (universities, vocational training providers, research enterprises); trade associations; and makers of complementary products in a geographic area—such clustering can be an important source of cost savings in addition to facilitating close collaboration with key suppliers.

**The Risks of Adverse Exchange Rate Shifts**

The volatility of exchange rates greatly complicates the issue of geographic cost advantages. Currency exchange rates often move up or down 20 to 40 percent annually. Changes of this magnitude can either totally wipe out a country’s low-cost advantage or transform a former high-cost location into a competitive-cost location. For instance, in the mid-1980s, when the dollar was strong relative to the Japanese yen (meaning that $1 would purchase, say, 125 yen as opposed to only 100 yen), Japanese heavy-equipment maker Komatsu was able to undercut U.S.-based Caterpillar’s prices by as much as 25 percent, causing Caterpillar to lose sales and market share. But starting in 1985, when exchange rates began to shift and the dollar grew steadily weaker against the yen (meaning that $1 was worth fewer and fewer yen, and that a Komatsu product made in Japan at a cost of 20 million yen translated into costs of many more dollars than before), Komatsu had to raise its prices to U.S. buyers six times over two years. With its competitiveness against Komatsu restored because of the weaker dollar and Komatsu’s higher prices, Caterpillar regained sales and market share. The lesson of fluctuating exchange rates is that companies that export goods to foreign countries always gain in competitiveness when the currency of the country in which the goods are manufactured is weak. Exporters are disadvantaged when the currency of the country where goods are being manufactured grows stronger. Sizable long-term shifts in exchange rates thus shuffle the global cards of which rivals have the upper hand in the marketplace and which countries represent the low-cost manufacturing location.

As a further illustration of the risks associated with fluctuating exchange rates, consider the case of a U.S. company that has located manufacturing facilities in Brazil (where the currency is reals—pronounced ray-alls) and that exports most of the Brazilian-made goods to markets in the European Union (where the currency is euros). To keep the numbers simple, assume that the exchange rate is 4 Brazilian reals for 1 euro and that the product being made in Brazil has a manufacturing cost of 4 Brazilian reals (or 1 euro). Now suppose that for some reason the exchange rate shifts from 4 reals per euro to 5 reals per euro (meaning that the real has declined in value and that the euro is stronger). Making the product in Brazil is now more cost-competitive because a Brazilian good costing 4 reals to produce has fallen to only 0.8 euros at the new exchange rate. If, in contrast, the value of the Brazilian real grows stronger in relation to the euro—resulting in an exchange rate of 3 reals to 1 euro—the same good costing 4 reals to produce now has a cost of 1.33 euros. Clearly, the attraction of manufacturing a good in Brazil and selling it in Europe is far greater when the euro is strong (an exchange rate of 1 euro for 5 Brazilian reals) than when the euro is weak and exchanges for only 3 Brazilian reals.

Insofar as U.S.-based manufacturers are concerned, declines in the value of the U.S. dollar against foreign currencies act to reduce or eliminate whatever cost advantage foreign manufacturers might have over U.S. manufacturers and can even prompt foreign companies to establish production plants in the United States. Likewise, a
weak euro enhances the cost competitiveness of companies manufacturing goods in Europe for export to foreign markets; a strong euro versus other currencies weakens the cost competitiveness of European plants that manufacture goods for export.

In 2002, when the Brazilian real declined in value by about 25 percent against the dollar, the euro, and several other currencies, the ability of companies with manufacturing plants in Brazil to compete in world markets was greatly enhanced—of course, in the future years this windfall gain in cost advantage might well be eroded by sustained rises in the value of the Brazilian real against these same currencies. Herein lies the risk: Currency exchange rates are rather unpredictable, swinging first one way and then another way, so the competitiveness of any company’s facilities in any country is partly dependent on whether exchange rate changes over time have a favorable or unfavorable cost impact. Companies producing goods in one country for export abroad always improve their cost competitiveness when the country’s currency grows weaker relative to currencies of the countries where the goods are being exported to, and they find their cost competitiveness eroded when the local currency grows stronger. In contrast, domestic companies that are under pressure from lower-cost imports become more cost competitive when their currency grows weaker in relation to the currencies of the countries where the imported goods are made—in other words, a U.S. manufacturer views a weaker U.S. dollar as a favorable exchange rate shift because such shifts help make its costs more competitive versus those of foreign rivals.

**Core Concept**

Fluctuating exchange rates pose significant risks to a company’s competitiveness in foreign markets. Exporters win when the currency of the country where goods are being manufactured grows weaker, and they lose when the currency grows stronger. Domestic companies under pressure from lower-cost imports are benefited when their government’s currency grows weaker in relation to the countries where the imported goods are being made.

**Host Governments’ Policies**

National governments enact all kinds of measures affecting business conditions and the operation of foreign companies in their markets. Host governments may set local content requirements on goods made inside their borders by foreign-based companies, have rules and policies that protect local companies from foreign competition, put restrictions on exports to ensure adequate local supplies, regulate the prices of imported and locally produced goods, enact deliberately burdensome procedures and requirements for imported goods to pass customs inspection, and impose tariffs or quotas on the imports of certain goods—until 2002, when it joined the World Trade Organization, China imposed a 100 percent tariff on motor vehicle imports. The European Union imposes quotas on textile and apparel imports from China, as a measure to protect European producers in southern Europe. India imposed excise taxes on newly purchased motor vehicles in 2005 ranging from 24 to 40 percent—a policy that has significantly dampened the demand for new vehicles in India (though down from as much as 50 percent in prior years). Governments may or may not have burdensome tax structures, stringent environmental regulations, or strictly enforced worker safety standards. Sometimes outsiders face a web of regulations regarding technical standards, product certification, prior approval of capital spending projects, withdrawal of funds from the country, and required minority (sometimes majority) ownership of foreign company operations by local companies or investors. A few governments may be hostile to or suspicious of foreign companies operating within their borders. Some governments provide subsidies and low-interest loans to domestic companies to help them compete against foreign-based companies. Other governments, anxious to obtain new plants and jobs, offer foreign companies a helping hand in the form of subsidies, privileged market access, and technical assistance. All of these possibilities explain
why the managers of companies opting to compete in foreign markets have to take a close look at a country’s politics and policies toward business in general, and foreign companies in particular, in deciding which country markets to participate in and which ones to avoid.

THE CONCEPTS OF MULTICOUNTRY COMPETITION AND GLOBAL COMPETITION

There are important differences in the patterns of international competition from industry to industry. At one extreme is **multicountry competition**, in which there’s so much cross-country variation in market conditions and in the companies contending for leadership that the market contest among rivals in one country is not closely connected to the market contests in other countries. The standout features of multicountry competition are that (1) buyers in different countries are attracted to different product attributes, (2) sellers vary from country to country, and (3) industry conditions and competitive forces in each national market differ in important respects. Take the banking industry in Italy, Brazil, and Japan as an example—the requirements and expectations of banking customers vary among the three countries, the lead banking competitors in Italy differ from those in Brazil or in Japan, and the competitive battle going on among the leading banks in Italy is unrelated to the rivalry taking place in Brazil or Japan. Thus, with multicountry competition, rival firms battle for national championships, and winning in one country does not necessarily signal the ability to fare well in other countries. In multicountry competition, the power of a company’s strategy and resource capabilities in one country may not enhance its competitiveness to the same degree in other countries where it operates. Moreover, any competitive advantage a company secures in one country is largely confined to that country; the spillover effects to other countries are minimal to nonexistent. Industries characterized by multicountry competition include radio and TV broadcasting, consumer banking, life insurance, apparel, metals fabrication, many types of food products (coffee, cereals, breads, canned goods, frozen foods), and retailing.

At the other extreme is **global competition**, in which prices and competitive conditions across country markets are strongly linked and the term *global market* has true meaning. In a globally competitive industry, much the same group of rival companies competes in many different countries, but especially so in countries where sales volumes are large and where having a competitive presence is strategically important to building a strong global position in the industry. Thus, a company’s competitive position in one country both affects and is affected by its position in other countries. In global competition, a firm’s overall competitive advantage grows out of its entire worldwide operations; the competitive advantage it creates at its home base is supplemented by advantages growing out of its operations in other countries (having plants in low-wage countries, being able to transfer expertise from country to country, having the capability to serve customers who also have multinational operations, and brand-name recognition in many parts of the world). Rival firms in globally competitive industries vie for worldwide leadership. Global competition exists in motor vehicles, television sets, tires, mobile phones, personal computers, copiers, watches, digital cameras, bicycles, and commercial aircraft.
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An industry can have segments that are globally competitive and segments in
which competition is country by country. In the hotel/motel industry, for example, the
low- and medium-priced segments are characterized by multicountry competition—
competitors serve travelers mainly within the same country. In the business and luxury
segments, however, competition is more globalized. Companies like Nikki, Marriott,
Sheraton, and Hilton have hotels at many international locations, use worldwide reserva-
tion systems, and establish common quality and service standards to gain marketing
advantages in serving businesspeople and other travelers who make frequent interna-
tional trips. In lubricants, the marine engine segment is globally competitive—ships
move from port to port and require the same oil everywhere they stop. Brand reputa-
tions in marine lubricants have a global scope, and successful marine engine lubricant
producers (ExxonMobil, BP Amoco, and Shell) operate globally. In automotive motor
oil, however, multicountry competition dominates—countries have different weather
conditions and driving patterns, production of motor oil is subject to limited scale
economies, shipping costs are high, and retail distribution channels differ markedly
from country to country. Thus, domestic firms—like Quaker State and Pennzoil in
the United States and Castrol in Great Britain—can be leaders in their home markets
without competing globally.

It is also important to recognize that an industry can be in transition from multi-
country competition to global competition. In a number of today’s industries—beer
and major home appliances are prime examples—leading domestic competitors have
begun expanding into more and more foreign markets, often acquiring local companies
or brands and integrating them into their operations. As some industry members start
to build global brands and a global presence, other industry members find themselves
pressed to follow the same strategic path—especially if establishing multinational
operations results in important scale economies and a powerhouse brand name. As
the industry consolidates to fewer players, such that many of the same companies find
themselves in head-to-head competition in more and more country markets, global
competition begins to replace multicountry competition.

At the same time, consumer tastes in a number of important product categories
are converging across the world. Less diversity of tastes and preferences opens the
way for companies to create global brands and sell essentially the same products in
most all countries of the world. Even in industries where consumer tastes remain
fairly diverse, companies are learning to use “custom mass production” to economi-
cally create different versions of a product and thereby satisfy the tastes of people in
different countries.

In addition to taking the obvious cultural and political differences between coun-
tries into account, a company has to shape its strategic approach to competing in foreign
markets according to whether its industry is characterized by multicountry competition,
global competition, or a transition from one to the other.

**STRATEGY OPTIONS FOR ENTERING AND COMPETING IN FOREIGN MARKETS**

There are a host of generic strategic options for a company that decides to expand out-
side its domestic market and compete internationally or globally:

1. **Maintain a national (one-country) production base and export goods to foreign markets**, using either company-owned or foreign-controlled forward distribution channels.
2. License foreign firms to use the company’s technology or to produce and distribute the company’s products.

3. Employ a franchising strategy.

4. Follow a multicountry strategy, varying the company’s strategic approach (perhaps a little, perhaps a lot) from country to country in accordance with local conditions and differing buyer tastes and preferences.

5. Follow a global strategy, using essentially the same competitive strategy approach in all country markets where the company has a presence.

6. Use strategic alliances or joint ventures with foreign companies as the primary vehicle for entering foreign markets and perhaps also using them as an ongoing strategic arrangement aimed at maintaining or strengthening its competitiveness.

The following sections discuss the first five options in more detail; the sixth option is discussed in a separate section later in the chapter.

Export Strategies

Using domestic plants as a production base for exporting goods to foreign markets is an excellent initial strategy for pursuing international sales. It is a conservative way to test the international waters. The amount of capital needed to begin exporting is often quite minimal; existing production capacity may well be sufficient to make goods for export. With an export strategy, a manufacturer can limit its involvement in foreign markets by contracting with foreign wholesalers experienced in importing to handle the entire distribution and marketing function in their countries or regions of the world. If it is more advantageous to maintain control over these functions, however, a manufacturer can establish its own distribution and sales organizations in some or all of the target foreign markets. Either way, a home-based production and export strategy helps the firm minimize its direct investments in foreign countries. Such strategies are commonly favored by Chinese, Korean, and Italian companies—products are designed and manufactured at home and then distributed through local channels in the importing countries; the primary functions performed abroad relate chiefly to establishing a network of distributors and perhaps conducting sales promotion and brand awareness activities.

Whether an export strategy can be pursued successfully over the long run hinges on the relative cost competitiveness of the home-country production base. In some industries, firms gain additional scale economies and experience/learning curve benefits from centralizing production in one or several giant plants whose output capability exceeds demand in any one country market; obviously, a company must export to capture such economies. However, an export strategy is vulnerable when (1) manufacturing costs in the home country are substantially higher than in foreign countries where rivals have plants, (2) the costs of shipping the product to distant foreign markets are relatively high, or (3) adverse shifts occur in currency exchange rates. Unless an exporter can both keep its production and shipping costs competitive with rivals and successfully hedge against unfavorable changes in currency exchange rates, its success will be limited.

Licensing Strategies

Licensing makes sense when a firm with valuable technical know-how or a unique patented product has neither the internal organizational capability nor the resources to enter foreign markets. Licensing also has the advantage of avoiding the risks of
committing resources to country markets that are unfamiliar, politically volatile, economically unstable, or otherwise risky. By licensing the technology or the production rights to foreign-based firms, the firm does not have to bear the costs and risks of entering foreign markets on its own, yet it is able to generate income from royalties. The big disadvantage of licensing is the risk of providing valuable technological know-how to foreign companies and thereby losing some degree of control over its use; monitoring licensees and safeguarding the company’s proprietary know-how can prove quite difficult in some circumstances. But if the royalty potential is considerable and the companies to whom the licenses are being granted are both trustworthy and reputable, then licensing can be a very attractive option. Many software and pharmaceutical companies use licensing strategies.

Franchising Strategies

While licensing works well for manufacturers and owners of proprietary technology, franchising is often better suited to the global expansion efforts of service and retailing enterprises. McDonald’s, Yum! Brands (the parent of Pizza Hut, KFC, and Taco Bell), The UPS Store, Jani-King International (the world’s largest commercial cleaning franchisor), Roto-Rooter, 7-Eleven, and Hilton Hotels have all used franchising to build a presence in foreign markets. Franchising has much the same advantages as licensing. The franchisee bears most of the costs and risks of establishing foreign locations; a franchisor has to expend only the resources to recruit, train, support, and monitor franchisees. The big problem a franchisor faces is maintaining quality control; foreign franchisees do not always exhibit strong commitment to consistency and standardization, especially when the local culture does not stress the same kinds of quality concerns. Another problem that can arise is whether to allow foreign franchisees to make modifications in the franchisor’s product offering so as to better satisfy the tastes and expectations of local buyers. Should McDonald’s allow its franchised units in Japan to modify Big Macs slightly to suit Japanese tastes? Should the franchised KFC units in China be permitted to substitute spices that appeal to Chinese consumers? Or should the same menu offerings be rigorously and unvaryingly required of all franchisees worldwide?

Localized Multicountry Strategies or a Global Strategy?

The issue of whether to vary the company’s competitive approach to fit specific market conditions and buyer preferences in each host country or whether to employ essentially the same strategy in all countries is perhaps the foremost strategic issue that companies must address when they operate in two or more foreign markets. Figure 7.1 shows a company’s options for resolving this issue.

Think-Local, Act-Local Approaches to Strategy Making  The bigger the differences in buyer tastes, cultural traditions, and market conditions in different countries, the stronger the case for a think-local, act-local approach to strategy making, in which a company tailors its product offerings and perhaps its basic competitive strategy to fit buyer tastes and market conditions in each country where it opts to compete. The strength of employing a set of localized or multicountry strategies is that the company’s actions and business approaches are deliberately crafted to accommodate the
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Figure 7.1  A Company's Strategic Options for Dealing with Cross-Country Variations in Buyer Preferences and Market Conditions

Employing the same strategy worldwide:
- Pursue the same basic competitive strategy theme (low-cost, differentiation, best-cost, or focused) in all country markets—a global strategy.
- Offer the same products worldwide, with only very minor deviations from one country to another when local market conditions dictate.
- Utilize the same capabilities, distribution channels, and marketing approaches worldwide.
- Coordinate strategic actions from central headquarters.

Employing a combination global-local strategy:
- Employ essentially the same basic competitive strategy theme (low-cost, differentiation, best-cost, or focused) in all country markets.
- Develop the capability to customize product offerings and sell different product versions in different countries (perhaps even under different brand names).
- Give local managers the latitude to adapt the global approach as needed to accommodate local buyer preferences and be responsive to local market and competitive conditions.

Employing localized strategies—one for each country market:
- Tailor the company’s competitive approach and product offering to fit specific market conditions and buyer preferences in each host country.
- Delegate strategy making to local managers with firsthand knowledge of local conditions.

Ways to Deal with Cross-Country Variations in Buyer Preferences and Market Conditions

Strategic Posturing Options

Think Local, Act Local

Think Global, Act Local

Think Global, Act Local

differing tastes and expectations of buyers in each country and to stake out the most attractive market positions vis-à-vis local competitors. A think-local, act-local approach means giving local managers considerable strategy-making latitude. It means having plants produce different product versions for different local markets, and adapting marketing and distribution to fit local customs and cultures. The bigger the country-to-country variations, the more that a company’s overall strategy is a collection of its localized country strategies rather than a common or global strategy.
A think-local, act-local approach to strategy making is essential when there are significant country-to-country differences in customer preferences and buying habits, when there are significant cross-country differences in distribution channels and marketing methods, when host governments enact regulations requiring that products sold locally meet strict manufacturing specifications or performance standards, and when the trade restrictions of host governments are so diverse and complicated that they preclude a uniform, coordinated worldwide market approach. With localized strategies, a company often has different product versions for different countries and sometimes sells them under different brand names. Sony markets a different Walkman in Norway than in Sweden to better meet the somewhat different preferences and habits of the users in each market. Castrol, a specialist in oil lubricants, has over 3,000 different formulas of lubricants, many of which have been tailored for different climates, vehicle types and uses, and equipment applications that characterize different country markets. In the food products industry, it is common for companies to vary the ingredients in their products and sell the localized versions under local brand names in order to cater to country-specific tastes and eating preferences. Motor vehicle manufacturers routinely produce smaller, more fuel-efficient vehicles for markets in Europe where roads are often narrower and gasoline prices two or three times higher than they produce for the North American market; the models they manufacture for the Asian market are different yet again. DaimlerChrysler, for example, equips all of the Jeep Grand Cherokees and many of its Mercedes cars sold in Europe with fuel-efficient diesel engines. The Buicks that General Motors sells in China are small compacts, whereas those sold in the United States are large family sedans and SUVs.

However, think-local, act-local strategies have two big drawbacks: They hinder transfer of a company’s competencies and resources across country boundaries (since the strategies in different host countries can be grounded in varying competencies and capabilities), and they do not promote building a single, unified competitive advantage—especially one based on low cost. Companies employing highly localized or multicountry strategies face big hurdles in achieving low-cost leadership unless they find ways to customize their products and still be in position to capture scale economies and experience/learning curve effects. Companies like Dell Computer and Toyota, because they have mass customization production capabilities, can cost effectively adapt their product offerings to local buyer tastes.

Think-Global, Act-Global Approaches to Strategy Making While multicountry or localized strategies are best suited for industries where multicountry competition dominates and a fairly high degree of local responsiveness is competitively imperative, global strategies are best suited for globally competitive industries. A global strategy is one in which the company’s approach is predominantly the same in all countries—it sells the same products under the same brand names everywhere, uses much the same distribution channels in all countries, and competes on the basis of the same capabilities and marketing approaches worldwide. Although the company’s strategy or product offering may be adapted in very minor ways to accommodate specific situations in a few host countries, the company’s fundamental competitive approach (low-cost, differentiation, best-cost, or focused) remains very much intact worldwide, and local managers stick close to the global strategy. A think-global, act-global strategic theme prompts company managers to integrate and coordinate the company’s strategic moves worldwide and to expand into most if not all nations where there is significant buyer demand. It puts considerable strategic
emphasis on building a *global* brand name and aggressively pursuing opportunities to transfer ideas, new products, and capabilities from one country to another. Indeed, with a think global, act global approach to strategy making, a company’s operations in each country can be viewed as experiments that result in learning and in capabilities that may merit transfer to other country markets.

Whenever country-to-country differences are small enough to be accommodated within the framework of a global strategy, a global strategy is preferable to localized strategies because a company can more readily unify its operations and focus on establishing a brand image and reputation that is uniform from country to country. Moreover, with a global strategy a company is better able to focus its full resources on building the resource strengths and capabilities to secure a sustainable low-cost or differentiation-based competitive advantage over both domestic rivals and global rivals racing for world market leadership. Figure 7.2 summarizes the basic differences between a localized or multicountry strategy and a global strategy.

**Think-Global, Act-Local Approaches to Strategy Making** Often, a company can accommodate cross-country variations in buyer tastes, local customs, and market conditions with a think-global, act-local approach to developing strategy. This middle-ground approach entails using the same basic competitive theme (low-cost, differentiation, best-cost, or focused) in each country but allowing local managers the latitude to (1) incorporate whatever country-specific variations in product attributes are needed to best satisfy local buyers and (2) make whatever adjustments in production, distribution, and marketing are needed to be responsive to local market conditions and compete successfully against local rivals. Slightly different product versions sold under the same brand name may suffice to satisfy local tastes, and it may be feasible to accommodate these versions rather economically in the course of designing and manufacturing the company’s product offerings. The build-to-order component of Dell’s strategy in PCs for example, makes it simple for Dell to be responsive to how buyers in different parts of the world want their PCs equipped. However, Dell has not wavered in its strategy to sell directly to customers rather than through local retailers, even though the majority of buyers in countries such as China are concerned about ordering online and prefer to personally inspect PCs at stores before making a purchase.

As a rule, most companies that operate multinationally endeavor to employ as global a strategy as customer needs and market conditions permit. Philips Electronics, the Netherlands-based electronics and consumer products company, operated successfully with localized strategies for many years but has recently begun moving more toward a unified strategy within the European Union and within North America. Philips Electronics, the Netherlands-based electronics and consumer products company, operated successfully with localized strategies for many years but has recently begun moving more toward a unified strategy within the European Union and within North America. Whirlpool has been globalizing its low-cost leadership strategy in home appliances for over 15 years, striving to standardize parts and components and move toward worldwide designs for as many of its appliance products as possible. But it has found it necessary to continue producing significantly different versions of refrigerators, washing machines, and cooking appliances for consumers in different regions of the world because the needs and tastes of local buyers for appliances of different sizes and designs have not converged sufficiently to permit standardization of Whirlpool’s product offerings worldwide. General Motors began an initiative in 2004 to insist that its worldwide units share basic parts and work together to design vehicles that can be sold, with modest variations, anywhere around the world; by reducing the types of radios used in its cars and trucks from 270 to 50, it expected to save 40 percent in radio costs.

Illustration Capsule 7.1 on page 209 describes how two companies localize their strategies for competing in country markets across the world.
Customize the company’s competitive approach as needed to fit market and business circumstances in each host country—strong responsiveness to local conditions.

- Sell different product versions in different countries under different brand names—adapt product attributes to fit buyer tastes and preferences country by country.
- Scatter plants across many host countries, each producing product versions for local markets.
- Preferably use local suppliers (some local sources may be required by host government).
- Adapt marketing and distribution to local customs and culture of each country.
- Transfer competencies and capabilities from country to country where feasible.
- Give country managers fairly wide strategy-making latitude and autonomy over local operations.

Pursue same basic competitive strategy worldwide (low-cost, differentiation, best-cost, focused low-cost, focused differentiation), with minimal responsiveness to local conditions.

- Sell same products under same brand name worldwide; focus efforts on building global brands as opposed to strengthening local/regional brands sold in local/regional markets.
- Locate plants on basis of maximum locational advantage, usually in countries where production costs are lowest but plants may be scattered if shipping costs are high or other locational advantages dominate.
- Use best suppliers from anywhere in world.
- Coordinate marketing and distribution worldwide; make minor adaptation to local countries where needed.
- Compete on basis of same technologies, competencies, and capabilities worldwide; stress rapid transfer of new ideas, products, and capabilities to other countries.
- Coordinate major strategic decisions worldwide; expect local managers to stick close to global strategy.
Chapter 7 Competing in Foreign Markets

THE QUEST FOR COMPETITIVE ADVANTAGE IN FOREIGN MARKETS

There are three important ways in which a firm can gain competitive advantage (or offset domestic disadvantages) by expanding outside its domestic market:

1. It can use location to lower costs or achieve greater product differentiation.
2. It can transfer competitively valuable competencies and capabilities from its domestic markets to foreign markets.
3. It can use cross-border coordination in ways that a domestic-only competitor cannot.

Using Location to Build Competitive Advantage

To use location to build competitive advantage, a company must consider two issues: (1) whether to concentrate each activity it performs in a few select countries or to disperse performance of the activity to many nations, and (2) in which countries to locate particular activities.

When to Concentrate Activities in a Few Locations

Companies tend to concentrate their activities in a limited number of locations in the following circumstances:

- When the costs of manufacturing or other activities are significantly lower in some geographic locations than in others—For example, much of the world’s

Illustration Capsule 7.1

Multicountry Strategies at Electronic Arts and Coca-Cola

ELECTRONIC ARTS’ MULTICOUNTRY STRATEGY IN VIDEO GAMES

Electronic Arts (EA), the world’s largest independent developer and marketer of video games, designs games that are suited to the differing tastes of game players in different countries and also designs games in multiple languages. EA has two major design studios—one in Vancouver, British Columbia, and one in Los Angeles—and smaller design studios in San Francisco, Orlando, London, and Tokyo. This dispersion of design studios helps EA to design games that are specific to different cultures—for example, the London studio took the lead in designing the popular FIFA Soccer game to suit European tastes and to replicate the stadiums, signage, and team rosters; the U.S. studio took the lead in designing games involving NFL football, NBA basketball, and NASCAR racing. No other game software company had EA’s ability to localize games or to launch games on multiple platforms in multiple countries in multiple languages. EA’s game Harry Potter and the Chamber of Secrets was released simultaneously in 75 countries, in 31 languages, and on seven platforms.

COCA-COLA’S MULTICOUNTRY STRATEGY IN BEVERAGES

Coca-Cola strives to meet the demands of local tastes and cultures, offering 300 brands in some 200 countries. Its network of bottlers and distributors is distinctly local, and the company’s products and brands are formulated to cater to local tastes. The ways in which Coca-Cola’s local operating units bring products to market, the packaging that is used, and the company’s advertising messages are all intended to match the local culture and fit in with local business practices. Many of the ingredients and supplies for Coca-Cola’s products are sourced locally.

athletic footwear is manufactured in Asia (China and Korea) because of low labor costs; much of the production of motherboards for PCs is located in Taiwan because of both low costs and the high-caliber technical skills of the Taiwanese labor force.

- **When there are significant scale economies**—The presence of significant economies of scale in components production or final assembly means that a company can gain major cost savings from operating a few superefficient plants as opposed to a host of small plants scattered across the world. Important marketing and distribution economies associated with multinational operations can also yield low-cost leadership. In situations where some competitors are intent on global dominance, being the worldwide low-cost provider is a powerful competitive advantage. Achieving low-cost provider status often requires a company to have the largest worldwide manufacturing share, with production centralized in one or a few world-scale plants in low-cost locations. Some companies even use such plants to manufacture units sold under the brand names of rivals. Manufacturing share (as distinct from brand share or market share) is significant because it provides more certain access to production-related scale economies. Japanese makers of VCRs, microwave ovens, TVs, and DVD players have used their large manufacturing share to establish a low-cost advantage.10

- **When there is a steep learning curve associated with performing an activity in a single location**—In some industries experience/learning curve effects in parts manufacture or assembly are so great that a company establishes one or two large plants from which it serves the world market. The key to riding down the learning curve is to concentrate production in a few locations to increase the accumulated volume at a plant (and thus the experience of the plant’s workforce) as rapidly as possible.

- **When certain locations have superior resources, allow better coordination of related activities, or offer other valuable advantages**—A research unit or a sophisticated production facility may be situated in a particular nation because of its pool of technically trained personnel. Samsung became a leader in memory chip technology by establishing a major R&D facility in Silicon Valley and transferring the know-how it gained back to headquarters and its plants in South Korea. Where just-in-time inventory practices yield big cost savings and/or where an assembly firm has long-term partnering arrangements with its key suppliers, parts manufacturing plants may be clustered around final assembly plants. An assembly plant may be located in a country in return for the host government’s allowing freer import of components from large-scale, centralized parts plants located elsewhere. A customer service center or sales office may be opened in a particular country to help cultivate strong relationships with pivotal customers located nearby.

**When to Disperse Activities Across Many Locations** There are several instances when dispersing activities is more advantageous than concentrating them. Buyer-related activities—such as distribution to dealers, sales and advertising, and after-sale service—usually must take place close to buyers. This means physically locating the capability to perform such activities in every country market where a global firm has major customers (unless buyers in several adjoining countries can be served quickly from a nearby central location). For example, firms that make mining and oil-drilling equipment maintain operations in many international locations to support customers’
needs for speedy equipment repair and technical assistance. The four biggest public accounting firms have numerous international offices to service the foreign operations of their multinational corporate clients. A global competitor that effectively disperses its buyer-related activities can gain a service-based competitive edge in world markets over rivals whose buyer-related activities are more concentrated—this is one reason the Big Four public accounting firms (PricewaterhouseCoopers, KPMG, Deloitte & Touche, and Ernst & Young) have been so successful relative to regional and national firms. Dispersing activities to many locations is also competitively advantageous when high transportation costs, diseconomies of large size, and trade barriers make it too expensive to operate from a central location. Many companies distribute their products from multiple locations to shorten delivery times to customers. In addition, it is strategically advantageous to disperse activities to hedge against the risks of fluctuating exchange rates; supply interruptions (due to strikes, mechanical failures, and transportation delays); and adverse political developments. Such risks are greater when activities are concentrated in a single location.

The classic reason for locating an activity in a particular country is low cost. Even though multinational and global firms have strong reason to disperse buyer-related activities to many international locations, such activities as materials procurement, parts manufacture, finished goods assembly, technology research, and new product development can frequently be decoupled from buyer locations and performed wherever advantage lies. Components can be made in Mexico; technology research done in Frankfurt; new products developed and tested in Phoenix; and assembly plants located in Spain, Brazil, Taiwan, or South Carolina. Capital can be raised in whatever country it is available on the best terms.

Using Cross-Border Transfers of Competencies and Capabilities to Build Competitive Advantage

One of the best ways for a company with valuable competencies and resource strengths to secure competitive advantage is to use its considerable resource strengths to enter additional country markets. A company whose resource strengths prove particularly potent in competing successfully in newly entered country markets not only grows sales and profits but also may find that its competitiveness is sufficiently enhanced to produce competitive advantage over one or more rivals and contend for global market leadership. Transferring competencies, capabilities, and resource strengths from country to country contributes to the development of broader or deeper competencies and capabilities—ideally helping a company achieve dominating depth in some competitively valuable area. Dominating depth in a competitively valuable capability, resource, or value chain activity is a strong basis for sustainable competitive advantage over other multinational or global competitors, and especially so over domestic-only competitors. A one-country customer base is often too small to support the resource buildup needed to achieve such depth; this is particularly true when the market is just emerging and sophisticated resources have not been required.

Whirlpool, the leading global manufacturer of home appliances, with plants in 14 countries and sales in 170 countries, has used the Internet to create a global information technology platform that allows the company to transfer key product innovations and production processes across regions and brands quickly and effectively. Wal-Mart is slowly but forcefully expanding its operations with a strategy that involves transferring its considerable domestic expertise in distribution and discount retailing to
store operations recently established in China, Japan, Latin America, and Europe. Its status as the largest, most resource-deep, and most sophisticated user of distribution/retailing know-how has served it well in building its foreign sales and profitability. But Wal-Mart is not racing madly to position itself in many foreign markets; rather, it is establishing a strong presence in select country markets and learning how to be successful in these before tackling entry into other countries well-suited to its business model.

However, cross-border resource transfers are not a guaranteed recipe for success. Philips Electronics sells more color TVs and DVD recorders in Europe than any other company does; its biggest technological breakthrough was the compact disc, which it invented in 1982. Philips has worldwide sales of about 38 billion euros, but as of 2005 Philips had lost money for 17 consecutive years in its U.S. consumer electronics business. In the United States, the company’s color TVs and DVD recorders (sold under the Magnavox and Philips brands) are slow sellers. Philips notoriously lags in introducing new products into the U.S. market and has been struggling to develop an able sales force that can make inroads with U.S. electronics retailers and change its image as a low-end brand.

**Using Cross-Border Coordination to Build Competitive Advantage**

Coordinating company activities across different countries contributes to sustainable competitive advantage in several different ways. Multinational and global competitors can choose where and how to challenge rivals. They may decide to retaliate against an aggressive rival in the country market where the rival has its biggest sales volume or its best profit margins in order to reduce the rival’s financial resources for competing in other country markets. They may also decide to wage a price-cutting offensive against weak rivals in their home markets, capturing greater market share and subsidizing any short-term losses with profits earned in other country markets.

If a firm learns how to assemble its product more efficiently at, say, its Brazilian plant, the accumulated expertise can be quickly communicated via the Internet to assembly plants in other world locations. Knowledge gained in marketing a company’s product in Great Britain can readily be exchanged with company personnel in New Zealand or Australia. A global or multinational manufacturer can shift production from a plant in one country to a plant in another to take advantage of exchange rate fluctuations, to enhance its leverage with host-country governments, and to respond to changing wage rates, components shortages, energy costs, or changes in tariffs and quotas. Production schedules can be coordinated worldwide; shipments can be diverted from one distribution center to another if sales rise unexpectedly in one place and fall in another.

Using online systems, companies can readily gather ideas for new and improved products from customers and company personnel all over the world, permitting informed decisions about what can be standardized and what should be customized. Likewise, online systems enable multinational companies to involve their best design and engineering personnel (wherever they are located) in collectively coming up with next-generation products—it is easy for company personnel in one location to use the Internet to collaborate closely with personnel in other locations in performing all sorts of strategically relevant activities. Efficiencies can also be achieved by shifting workloads from where they are unusually heavy to locations where personnel are
underutilized. Whirlpool’s efforts to link its product R&D and manufacturing operations in North America, Latin America, Europe, and Asia allowed it to accelerate the discovery of innovative appliance features, coordinate the introduction of these features in the appliance products marketed in different countries, and create a cost-efficient worldwide supply chain. Whirlpool’s conscious efforts to integrate and coordinate its various operations around the world have helped it become a low-cost producer and also speed product innovations to market, thereby giving Whirlpool an edge over rivals in designing and rapidly introducing innovative and attractively priced appliances worldwide.

Furthermore, a multinational company that consistently incorporates the same differentiating attributes in its products worldwide has enhanced potential to build a global brand name with significant power in the marketplace. The reputation for quality that Honda established worldwide first in motorcycles and then in automobiles gave it competitive advantage in positioning Honda lawn mowers at the upper end of the U.S. outdoor power equipment market—the Honda name gave the company immediate credibility with U.S. buyers of power equipment and enabled it to become an instant market contender without all the fanfare and cost of a multimillion-dollar ad campaign to build brand awareness.

**PROFIT SANCTUARIES, CROSS-MARKET SUBSIDIZATION, AND GLOBAL STRATEGIC OFFENSIVES**

**Profit sanctuaries** are country markets (or geographic regions) in which a company derives substantial profits because of its strong or protected market position. McDonald’s serves about 50 million customers daily at nearly 32,000 locations in 119 countries on five continents; not surprisingly, its biggest profit sanctuary is the United States, which generated 61.2 percent of 2004 profits, despite accounting for just 34.2 percent of 2004 revenues. Nike, which markets its products in 160 countries, has two big profit sanctuaries: the United States (where it earned 41.5 percent of its operating profits in 2005) and Europe, the Middle East, and Africa (where it earned 34.8 percent of 2005 operating profits). Discount retailer Carrefour, which has stores across much of Europe plus stores in Asia and the Americas, also has two principal profit sanctuaries; its biggest is in France (which in 2004 accounted for 49.2 percent of revenues and 60.8 percent of earnings before interest and taxes), and its second biggest is Europe outside of France (which in 2004 accounted for 37.3 percent of revenues and 33.1 percent of earnings before interest and taxes). Japan is the chief profit sanctuary for most Japanese companies because trade barriers erected by the Japanese government effectively block foreign companies from competing for a large share of Japanese sales. Protected from the threat of foreign competition in their home market, Japanese companies can safely charge somewhat higher prices to their Japanese customers and thus earn attractively large profits on sales made in Japan. In most cases, a company’s biggest and most strategically crucial profit sanctuary is its home market, but international and global companies may also enjoy profit sanctuary status in other nations where they have a strong competitive position, big sales volume, and attractive profit margins. Companies that compete globally are likely to have more profit sanctuaries than companies that compete in just a few country markets; a domestic-only competitor, of course, can have only one profit sanctuary (see Figure 7.3).
Using Cross-Market Subsidization to Wage a Strategic Offensive

Profit sanctuaries are valuable competitive assets, providing the financial strength to support strategic offensives in selected country markets and fuel a company’s race for global market leadership. The added financial capability afforded by multiple profit sanctuaries gives a global or multicountry competitor the financial strength to
wage a market offensive against a domestic competitor whose only profit sanctuary is its home market. Consider the case of a purely domestic company in competition with a company that has multiple profit sanctuaries and that is racing for global market leadership. The global company has the flexibility of lowballing its prices in the domestic company’s home market and grabbing market share at the domestic company’s expense, subsidizing razor-thin margins or even losses with the healthy profits earned in its profit sanctuaries—a practice called cross-market subsidization. The global company can adjust the depth of its price cutting to move in and capture market share quickly, or it can shave prices slightly to make gradual market inroads (perhaps over a decade or more) so as not to threaten domestic firms precipitously or trigger protectionist government actions. If the domestic company retaliates with matching price cuts, it exposes its entire revenue and profit base to erosion; its profits can be squeezed substantially and its competitive strength sapped, even if it is the domestic market leader.

**Offensive Strategies Suitable for Competing in Foreign Markets**

Companies that compete in multiple foreign markets can, of course, fashion an offensive strategy based on any of the approaches discussed in Chapter 6 (pages 160–193)—these types of offensive strategies are universally applicable and are just as suitable for competing in foreign markets as for domestic markets. But there are three additional types of offensive strategies that are suited to companies competing in foreign markets:13

- **Attack a foreign rival’s profit sanctuaries.** Launching an offensive in a country market where a rival earns its biggest profits can put the rival on the defensive, forcing it to perhaps spend more on marketing/advertising, trim its prices, boost product innovation efforts, or otherwise undertake actions that raise its costs and erode its profits. If a company’s offensive succeeds in eroding a rival’s profits in its chief profit sanctuary, the rival’s financial resources may be sufficiently weakened to enable the attacker to gain the upper hand and build market momentum. While attacking a rival’s profit sanctuary violates the principle of attacking competitor weaknesses instead of competitor strengths, it can nonetheless prove valuable when there is special merit in pursuing actions that cut into a foreign rival’s profit margins and force it to defend a market that is important to its competitive well-being. This is especially true when the attacker has important resource strengths and profit sanctuaries of its own that it can draw on to support its offensive.

- **Employ cross-market subsidization to win customers and sales away from select rivals in select country markets.** This can be a particularly attractive offensive strategy for companies that compete in multiple country markets with multiple products (several brands of cigarettes or different brands of food products). Competing in multiple country markets gives a company the luxury of drawing upon the resources, profits, and cash flows derived from particular country markets (especially its profit sanctuaries) to support offensives aimed at winning customers away from select rivals in those country markets that it wants either to enter or to boost its sales and market share. Alternatively, a company whose product lineup consists of different items can shift resources from a product category where it is competitively strong and resource deep (say soft drinks) to
add firepower to an offensive in those countries with bright growth prospects in another product category (say bottled water or fruit juices).

- **Dump goods at cut-rate prices in the markets of foreign rivals.** A company is said to be dumping when it sells its goods in foreign markets at prices that are (1) well below the prices at which it normally sells in its home market or (2) well below its full costs per unit. Companies that engage in dumping usually keep their selling prices high enough to cover variable costs per unit, thereby limiting their losses on each unit to some percentage of fixed costs per unit. Dumping can be an appealing offensive strategy in either of two instances. One is when dumping drives down the price so far in the targeted country that domestic firms are quickly put in dire financial straits and end up declaring bankruptcy or being driven out of business—for dumping to pay off in this instance, however, the dumping company needs to have deep enough financial pockets to cover any losses from selling at below-market prices, and the targeted domestic companies need to be financially weak. The second instance in which dumping becomes an attractive strategy is when a company with unused production capacity discovers that it is cheaper to keep producing (as long as the selling prices cover average variable costs per unit) than it is to incur the costs associated with idle plant capacity. By keeping its plants operating at or near capacity, a dumping company not only may be able to cover variable costs and earn a contribution to fixed costs but also may be able to use its below-market prices to draw price-sensitive customers away from foreign rivals, then attentively court these new customers and retain their business when prices later begin a gradual rise back to normal market levels. Thus, dumping may prove useful as a way of entering the market of a particular foreign country and establishing a customer base.

However, dumping strategies run a high risk of host government retaliation on behalf of the adversely affected domestic companies. Indeed, as the trade among nations has mushroomed over the past 10 years, most governments have joined the World Trade Organization (WTO), which promotes fair trade practices among nations and actively polices dumping. The WTO allows member governments to take actions against dumping wherever there is material injury to domestic competitors. In 2002, for example, the U.S. government imposed tariffs of up to 30 percent on selected steel products that Asian and European steel manufacturers were said to be selling at ultra-low prices in the U.S. market. Canada recently investigated charges that companies in Austria, Belgium, France, Germany, Poland and China were dumping supplies of laminate flooring in Canada to the detriment of Canadian producers and concluded that companies in France and China were indeed selling such flooring in Canada at unreasonably low prices. Most all governments can be expected to retaliate against dumping by imposing special tariffs on goods being imported from the countries of the guilty companies. Companies deemed guilty of dumping frequently come under pressure from their government to cease and desist, especially if the tariffs adversely affect innocent companies based in the same country or if the advent of special tariffs raises the specter of a trade war.

A company desirous of employing some type of offensive strategy in foreign markets is well advised to observe the principles for employing offensive strategies in general. For instance, it usually wise to attack foreign rivals on grounds that pit the challenger’s competitive strengths against the defender’s weaknesses and vulnerabilities. As a rule, trying to steal customers away from foreign rivals with strategies aimed at besting rivals where they are strongest stand a lower chance of succeeding than
strategies that attack their competitive weaknesses, especially when the challenger has resource strengths that enable it to exploit rivals’ weaknesses and when its attack involves an element of surprise. It nearly always makes good strategic sense to use the challenger’s core competencies and best competitive capabilities to spearhead the offensive. Furthermore, strategic offensives in foreign markets should, as a general rule, be predicated on exploiting the challenger’s core competencies and best competitive capabilities. The ideal condition for a strategic offensive is when the attacker’s resource strengths give it a competitive advantage over the targeted foreign rivals. The only two exceptions to these offensive strategy principles come when a competitively strong company with deep financial pockets sees considerable benefit in attacking a foreign rival’s profit sanctuary and/or has the ability to employ cross-market subsidization—both of these offensive strategies can involve attacking a foreign rival’s strengths (but they also are grounded in important strengths of the challenger and don’t fall into the trap of challenging a competitively strong rival with a strategic offensive based on unproven expertise or inferior technology or a relatively unknown brand name or other resource weaknesses).

**STRATEGIC ALLIANCES AND JOINT VENTURES WITH FOREIGN PARTNERS**

Strategic alliances, joint ventures, and other cooperative agreements with foreign companies are a favorite and potentially fruitful means for entering a foreign market or strengthening a firm’s competitiveness in world markets. Historically, export-minded firms in industrialized nations sought alliances with firms in less-developed countries to import and market their products locally—such arrangements were often necessary to win approval for entry from the host country’s government. Both Japanese and American companies are actively forming alliances with European companies to strengthen their ability to compete in the 25-nation European Union (and the five countries that are seeking to become EU members) and to capitalize on the opening up of Eastern European markets. Many U.S. and European companies are allying with Asian companies in their efforts to enter markets in China, India, Malaysia, Thailand, and other Asian countries. Companies in Europe, Latin America, and Asia are using alliances and joint ventures as a means of strengthening their mutual ability to compete across a wider geographical area—for instance, all the countries in the European Union or whole continents or most all country markets where there is sizable demand for the industry’s product. Many foreign companies, of course, are particularly interested in strategic partnerships that will strengthen their ability to gain a foothold in the U.S. market.

However, cooperative arrangements between domestic and foreign companies have strategic appeal for reasons besides gaining better access to attractive country markets. A second big appeal of cross-border alliances is to capture economies of scale in production and/or marketing—cost reduction can be the difference that allows a company to be cost-competitive. By joining forces in producing components, assembling models, and marketing their products, companies can realize cost savings not achievable with their own small volumes. A third motivation for entering into a cross-border alliance is to fill gaps in technical expertise and/or knowledge of local markets (buying habits and product preferences of consumers, local customs, and so on). Allies learn much from one another in performing joint research, sharing technological know-how, studying one another’s manufacturing methods, and understanding how to

Cross-border alliances have proved to be popular and viable vehicles for companies to edge their way into the markets of foreign countries.
tailor sales and marketing approaches to fit local cultures and traditions. Indeed, one of the win–win benefits of an alliance is to learn from the skills, technological know-how, and capabilities of alliance partners and implant the knowledge and know-how of these partners in personnel throughout the company.

A fourth motivation for cross-border alliances is to share distribution facilities and dealer networks, thus mutually strengthening their access to buyers. A fifth benefit is that cross-border allies can direct their competitive energies more toward mutual rivals and less toward one another; teaming up may help them close the gap on leading companies. A sixth driver of cross-border alliances comes into play when companies desirous of entering a new foreign market conclude that alliances with local companies are an effective way to tap into a partner’s local market knowledge and help it establish working relationships with key officials in the host-country government. And, finally, alliances can be a particularly useful way for companies across the world to gain agreement on important technical standards—they have been used to arrive at standards for DVD players, assorted PC devices, Internet-related technologies, high-definition televisions, and mobile phones.

What makes cross-border alliances an attractive strategic means of gaining the above types of benefits (as compared to acquiring or merging with foreign-based companies to gain much the same benefits) is that entering into alliances and strategic partnerships to gain market access and/or expertise of one kind or another allows a company to preserve its independence (which is not the case with a merger), retain veto power over how the alliance operates, and avoid using perhaps scarce financial resources to fund acquisitions. Furthermore, an alliance offers the flexibility to readily disengage once its purpose has been served or if the benefits prove elusive, whereas an acquisition is more permanent sort of arrangement (although the acquired company can, of course, be divested).

Illustration Capsule 7.2 provides six examples of cross-border strategic alliances.

The Risks of Strategic Alliances with Foreign Partners

Alliances and joint ventures with foreign partners have their pitfalls, however. Cross-border allies typically have to overcome language and cultural barriers and figure out how to deal with diverse (or perhaps conflicting) operating practices. The communication, trust-building, and coordination costs are high in terms of management time. It is not unusual for there to be little personal chemistry among some of the key people on whom success or failure of the alliance depends—the rapport such personnel need to work well together may never emerge. And even if allies are able to develop productive personal relationships, they can still have trouble reaching mutually agreeable ways to deal with key issues or resolve differences. There is a natural tendency for allies to struggle to collaborate effectively in competitively sensitive areas, thus spawning suspicions on both sides about forthright exchanges of information and expertise. Occasionally, the egos of corporate executives can clash—an alliance between Northwest Airlines and KLM Royal Dutch Airlines resulted in a bitter feud among both companies’ top officials (who, according to some reports, refused to speak to each other). In addition, there is the thorny problem of getting alliance partners to sort through issues and reach decisions fast enough to stay abreast of rapid advances in technology or fast-changing market conditions.
1. Two auto firms, Renault of France and Nissan of Japan, formed a broad-ranging global partnership in 1999 and then strengthened and expanded the alliance in 2002. The initial objective was to gain sales for new Nissan vehicles introduced in the European market, but the alliance now extends to full cooperation in all major areas, including the use of common platforms, joint development and use of engines and transmissions, fuel cell research, purchasing and use of common suppliers, and exchange of best practices. When the alliance was formed in 1999, Renault acquired a 36.8 percent ownership stake in Nissan; this was extended to 44.4 percent in 2002 when the alliance was expanded. Also, in 2002, the partners formed a jointly and equally owned strategic management company, named Renault-Nissan, to coordinate cooperative efforts.

2. Intel, the world’s largest chip maker, has formed strategic alliances with leading software application providers and computer hardware providers to bring more innovativeness and expertise to the architecture underlying Intel’s family of microprocessors and semiconductors. Intel’s partners in the effort to enhance Intel’s next-generation products include SAP, Oracle, SAS, BEA, IBM, Hewlett-Packard, Dell, Microsoft, Cisco Systems, and Alcatel. One of the alliances between Intel and Cisco involves a collaborative effort in Hong Kong to build next-generation infrastructure for Electronic Product Code/ Radio Frequency Identification (EPC/RFID) solutions used to link manufacturers and logistics companies in the Hong Kong region with retailers worldwide. Intel and France-based Alcatel (a leading provider of fixed and mobile broadband access products, marketed in 130 countries) formed an alliance in 2004 to advance the definition, standardization, development, integration, and marketing of WiMAX broadband services solutions. WiMAX was seen as a cost-effective wireless or mobile broadband solution for deployment in both emerging markets and developed countries when, for either economic or technical reasons, it was not feasible to provide urban or rural customers with hardwired DSL broadband access.

3. Verio, a subsidiary of Japan-based NTT Communications and one of the leading global providers of Web hosting services and IP data transport, operates with the philosophy that in today’s highly competitive and challenging technology market, companies must gain and share skills, information, and technology with technology leaders across the world. Believing that no company can be all things to all customers in the Web hosting industry, Verio executives have developed an alliance-oriented business model that combines the company’s core competencies with the skills and products of best-of-breed technology partners. Verio’s strategic partners include Accenture, Cisco Systems, Microsoft, Sun Microsystems, Oracle, Arsenal Digital Solutions (a provider of worry-free tape backup, data restore, and data storage services), Internet Security Systems (a provider of firewall and intrusion detection systems), and Mercantec (a developer of storefront and shopping cart software). Verio management believes that its portfolio of strategic alliances allows it to use innovative, best-of-class technologies in providing its customers with fast, efficient, accurate data transport and a complete set of Web hosting services. An independent panel of 12 judges recently selected Verio as the winner of the Best Technology Foresight Award for its efforts in pioneering new technologies.

4. Toyota and First Automotive Works, China’s biggest automaker, entered into an alliance in 2002 to make luxury sedans, sport-utility vehicles (SUVs), and minivehicles for the Chinese market. The intent was to make as many as 400,000 vehicles annually by 2010, an amount equal to the number that Volkswagen, the company with the largest share of the Chinese market, was making as of 2002. The alliance envisioned a joint investment of about $1.2 billion. At the time of the announced alliance, Toyota was lagging behind Honda, General Motors, and Volkswagen in setting up production facilities in China. Capturing a bigger share of the Chinese market was seen as crucial to Toyota’s success in achieving its strategic objective of having a 15 percent share of the world’s automotive market by 2010.

5. Airbus Industrie was formed by an alliance of aerospace companies from Britain, Spain, Germany, and France that included British Aerospace, Daimler-Benz Aerospace, and Aerospatiale. The objective of the alliance was to create a European aircraft company capable of competing with U.S.-based Boeing Corporation. The alliance has proved highly successful, infusing Airbus with the know-how and resources to compete head-to-head with Boeing for world leadership in large commercial aircraft (over 100 passengers).

6. General Motors, DaimlerChrysler, and BMW have entered into an alliance to develop a hybrid gasoline-electric engine that is simpler and less expensive to produce than the hybrid engine technology being pioneered by Toyota. Toyota, the acknowledged world leader in hybrid engines, is endeavoring to establish its design as the industry standard by signing up other automakers to use it. But the technology favored by the General Motors/DaimlerChrysler/BMW alliance is said to be less costly to produce and easier to configure for large trucks and SUVs than Toyota’s (although it is also less fuel efficient). Europe’s largest automaker, Volkswagen, has allied with Porsche to pursue the development of hybrid engines. Ford Motor and Honda, so far, have elected to go it alone in developing hybrid engine technology.

It requires many meetings of many people working in good faith over time to iron out what is to be shared, what is to remain proprietary, and how the cooperative arrangements will work. Often, once the bloom is off the rose, partners discover they have conflicting objectives and strategies, deep differences of opinion about how to proceed, or important differences in corporate values and ethical standards. Tensions build up, working relationships cool, and the hoped-for benefits never materialize. Even if the alliance becomes a win–win proposition for both parties, there is the danger of becoming overly dependent on foreign partners for essential expertise and competitive capabilities. If a company is aiming for global market leadership and needs to develop capabilities of its own, then at some juncture cross-border merger or acquisition may have to be substituted for cross-border alliances and joint ventures.

One of the lessons about cross-border alliances is that they are more effective in helping a company establish a beachhead of new opportunity in world markets than they are in enabling a company to achieve and sustain global market leadership. Global market leaders, while benefiting from alliances, usually must guard against becoming overly dependent on the assistance they get from alliance partners—otherwise, they are not masters of their own destiny.

**When a Cross-Border Alliance May Be Unnecessary**

Experienced multinational companies that market in 50 to 100 or more countries across the world find less need for entering into cross-border alliances than do companies in the early stages of globalizing their operations. Multinational companies make it a point to develop senior managers who understand how “the system” works in different countries; these companies can also avail themselves of local managerial talent and know-how by simply hiring experienced local managers and thereby detouring the hazards of collaborative alliances with local companies. If a multinational enterprise with considerable experience in entering the markets of different countries wants to detour the hazards and hassles of allying with local businesses, it can simply assemble a capable management team consisting of both senior managers with considerable international experience and local managers. The responsibilities of its own in-house managers with international business savvy are (1) to transfer technology, business practices, and the corporate culture into the company’s operations in the new country market, and (2) to serve as conduits for the flow of information between the corporate office and local operations. The responsibilities of local managers are (1) to contribute needed understanding of the local market conditions, local buying habits, and local ways of doing business, and (2) in many cases, to head up local operations.

Hence, one cannot automatically presume that a company needs the wisdom and resources of a local partner to guide it through the process of successfully entering the markets of foreign countries. Indeed, experienced multinationals often discover that local partners do not always have adequate local market knowledge—much of the so-called experience of local partners can predate the emergence of current market trends and conditions, and sometimes their operating practices can be archaic.

**Strategies That Fit the Markets of Emerging Countries**

Companies racing for global leadership have to consider competing in emerging markets like China, India, Brazil, Indonesia, and Mexico—countries where the business risks are considerable but where the opportunities for growth are huge, especially as their
economies develop and living standards climb toward levels in the industrialized world.\textsuperscript{25} With the world now comprising more than 6 billion people—fully one-third of whom are in India and China, and hundreds of millions more in other less-developed countries of Asia and in Latin America—a company that aspires to world market leadership (or to sustained rapid growth) cannot ignore the market opportunities or the base of technical and managerial talent such countries offer. For example, in 2003 China’s population of 1.3 billion people consumed nearly 33 percent of the world’s annual cotton production, 51 percent of the world’s pork, 35 percent of all the cigarettes, 31 percent of worldwide coal production, 27 percent of the world’s steel production, 19 percent of the aluminum, 23 percent of the TVs, 20 percent of the cell phones, and 18 percent of the washing machines.\textsuperscript{26} China is the world’s largest consumer of copper, aluminum, and cement and the second largest importer of oil; it is the world’s biggest market for mobile phones and the second biggest for PCs, and it is on track to become the second largest market for motor vehicles by 2010.

Illustration Capsule 7.3 describes Coca-Cola’s strategy to boost its sales and market share in China.

Tailoring products to fit conditions in an emerging-country market, however, often involves more than making minor product changes and becoming more familiar with local cultures.\textsuperscript{27} Ford’s attempt to sell a Ford Escort in India at a price of $21,000—a luxury-car price, given that India’s best-selling Maruti-Suzuki model sold at the time for $10,000 or less, and that fewer than 10 percent of Indian households have annual purchasing power greater than $20,000—met with a less-than-enthusiastic market
response. McDonald’s has had to offer vegetable burgers in parts of Asia and to rethink its prices, which are often high by local standards and affordable only by the well-to-do. Kellogg has struggled to introduce its cereals successfully because consumers in many less-developed countries do not eat cereal for breakfast—changing habits is difficult and expensive. In several emerging countries, Coca-Cola has found that advertising its world image does not strike a chord with the local populace in a number of emerging-country markets. Single-serving packages of detergents, shampoos, pickles, cough syrup, and cooking oils are very popular in India because they allow buyers to conserve cash by purchasing only what they need immediately. Thus, many companies find that trying to employ a strategy akin to that used in the markets of developed countries is hazardous. Experimenting with some, perhaps many, local twists is usually necessary to find a strategy combination that works.

**Strategy Options**

Several strategy options for tailoring a company’s strategy to fit the sometimes unusual or challenging circumstances presented in emerging-country markets:

- **Prepare to compete on the basis of low price.** Consumers in emerging markets are often highly focused on price, which can give low-cost local competitors the edge unless a company can find ways to attract buyers with bargain prices as well as better products. For example, when Unilever entered the market for laundry detergents in India, it realized that 80 percent of the population could not afford the brands it was selling to affluent consumers there (or the brands it was selling in wealthier countries). To compete against a low-priced detergent made by a local company, Unilever came up with a low-cost formula that was not harsh to the skin, constructed new low-cost production facilities, packaged the detergent (named Wheel) in single-use amounts so that it could be sold very cheaply, distributed the product to local merchants by handcarts, and crafted an economical marketing campaign that included painted signs on buildings and demonstrations near stores—the new brand quickly captured $100 million in sales and was the number one detergent brand in India in 2004 based on dollar sales. Unilever later replicated the strategy with low-priced packets of shampoos and deodorants in India and in South America with a detergent brand named Ala.

- **Be prepared to modify aspects of the company’s business model to accommodate local circumstances (but not so much that the company loses the advantage of global scale and global branding).** For instance when Dell entered China, it discovered that individuals and businesses were not accustomed to placing orders through the Internet (in North America, over 50 percent of Dell’s sales in 2002–2005 were online). To adapt, Dell modified its direct sales model to rely more heavily on phone and fax orders and decided to be patient in getting Chinese customers to place Internet orders. Further, because numerous Chinese government departments and state-owned enterprises insisted that hardware vendors make their bids through distributors and systems integrators (as opposed to dealing directly with Dell salespeople as did large enterprises in other countries), Dell opted to use third parties in marketing its products to this buyer segment (although it did sell through its own sales force where it could). But Dell was careful not to abandon those parts of its business model that gave it a competitive edge over rivals. When McDonald’s moved into Russia in the 1990s, it was forced to alter its practice of obtaining needed supplies from...
outside vendors because capable local suppliers were not available; to supply its Russian outlets and stay true to its core principle of serving consistent quality fast food, McDonald’s set up its own vertically integrated supply chain (cattle were imported from Holland, russet potatoes were imported from the United States); worked with a select number of Russian bakers for its bread; brought in agricultural specialists from Canada and Europe to improve the management practices of Russian farmers; built its own 100,000-square-foot McComplex to produce hamburgers, French fries, ketchup, mustard, and Big Mac sauce; and set up a trucking fleet to move supplies to restaurants.

• Try to change the local market to better match the way the company does business elsewhere. A multinational company often has enough market clout to drive major changes in the way a local country market operates. When Hong Kong–based STAR launched its first satellite TV channel in 1991, it profoundly impacted the TV marketplace in India: The Indian government lost its monopoly on TV broadcasts, several other satellite TV channels aimed at Indian audiences quickly emerged, and the excitement of additional channels triggered a boom in TV manufacturing in India. When Japan’s Suzuki entered India in 1981, it triggered a quality revolution among Indian auto parts manufacturers. Local parts and components suppliers teamed up with Suzuki’s vendors in Japan and worked with Japanese experts to produce higher-quality products. Over the next two decades, Indian companies became very proficient in making top-notch parts and components for vehicles, won more prizes for quality than companies in any country other than Japan, and broke into the global market as suppliers to many automakers in Asia and other parts of the world.

• Stay away from those emerging markets where it is impractical or uneconomic to modify the company’s business model to accommodate local circumstances. Home Depot has avoided entry into most Latin American countries because its value proposition of good quality, low prices, and attentive customer service relies on (1) good highways and logistical systems to minimize store inventory costs, (2) employee stock ownership to help motivate store personnel to provide good customer service, and (3) high labor costs for housing construction and home repairs to encourage homeowners to engage in do-it-yourself projects. Relying on these factors in the U.S. market has worked spectacularly for Home Depot, but the company has found that it cannot count on these factors in much of Latin America. Thus, to enter the market in Mexico, Home Depot switched to an acquisition strategy; it has acquired two building supply retailers in Mexico with a total of 40-plus stores. But it has not tried to operate them in the style of its U.S. big-box stores, and it doesn’t have retail operations in any other developing nations (although it is exploring entry into China).

Company experiences in entering developing markets like China, India, Russia, and Brazil indicate that profitability seldom comes quickly or easily. Building a market for the company’s products can often turn into a long-term process that involves reeducation of consumers, sizable investments in advertising and promotion to alter tastes and buying habits, and upgrades of the local infrastructure (the supplier base, transportation systems, distribution channels, labor markets, and capital markets). In such cases, a company must be patient, work within the system to improve the infrastructure, and lay the foundation for generating sizable revenues and profits once conditions are ripe for market takeoff.

Profitability in emerging markets rarely comes quickly or easily—new entrants have to adapt their business models and strategies to local conditions and be patient in earning a profit.
Defending Against Global Giants: Strategies for Local Companies in Emerging Markets

If opportunity-seeking, resource-rich multinational companies are looking to enter emerging markets, what strategy options can local companies use to survive? As it turns out, the prospects for local companies facing global giants are by no means grim. They can employ any of four generic strategic approaches depending on (1) whether their competitive assets are suitable only for the home market or can be transferred abroad, and (2) whether industry pressures to move toward global competition are strong or weak, as shown in Figure 7.4.

Using Home-Field Advantages When the pressures for competing globally are low and a local firm has competitive strengths well suited to the local market, a good strategy option is to concentrate on the advantages enjoyed in the home market, cater to customers who prefer a local touch, and accept the loss of customers attracted to global brands.33 A local company may be able to astutely exploit its local orientation—its familiarity with local preferences, its expertise in traditional products, its long-standing customer relationships. In many cases, a local company enjoys a significant cost advantage over global rivals (perhaps because of simpler product design or lower operating and overhead costs), allowing it to compete on the basis of price. Its global competitors often aim their products at upper- and middle-income urban buyers, who tend to be more fashion-conscious, more willing to experiment with new products, and more attracted to global brands.
Another competitive approach is to cater to the local market in ways that pose difficulties for global rivals. A small Middle Eastern cell phone manufacturer competes successfully against industry giants Nokia, Samsung, and Motorola by selling a model designed especially for Muslims—it is loaded with the Koran, alerts people at prayer times, and is equipped with a compass that points them toward Mecca. Several Chinese PC makers have been able to retain customers in competition against global leader Dell because Chinese PC buyers strongly prefer to personally inspect PCs before making a purchase; local PC makers with their extensive retailer networks that allow prospective buyers to check out their offerings in nearby stores have a competitive edge in winning the business of first-time PC buyers vis-à-vis Dell with its build-to-order, sell-direct business strategy (where customers are encouraged to place their orders online or via phone or fax). Bajaj Auto, India’s largest producer of scooters, has defended its turf against Honda (which entered the Indian market with local joint venture partner Hero Group to sell scooters, motorcycles, and other vehicles on the basis of its superior technology, quality, and the appeal) by focusing on buyers who wanted low-cost, durable scooters and easy access to maintenance in the countryside. Bajaj designed a rugged, cheap-to-build scooter for India’s rough roads, increased its investments in R&D to improve reliability and quality, and created an extensive network of distributors and roadside-mechanic stalls, a strategic approach that allowed it to remain the market leader with a 70–75 percent market share through 2004 despite growing unit sales of Hero Honda motorcycles and scooters.

Transferring the Company’s Expertise to Cross-Border Markets When a company has resource strengths and capabilities suitable for competing in other country markets, launching initiatives to transfer its expertise to cross-border markets becomes a viable strategic option. Televisa, Mexico’s largest media company, used its expertise in Spanish culture and linguistics to become the world’s most prolific producer of Spanish-language soap operas. Jollibee Foods, a family-owned company with 56 percent of the fast-food business in the Philippines, combated McDonald’s entry first by upgrading service and delivery standards and then by using its expertise in seasoning hamburgers with garlic and soy sauce and making noodle and rice meals with fish to open outlets catering to Asian residents in Hong Kong, the Middle East, and California.

Shifting to a New Business Model or Market Niche When industry pressures to globalize are high, any of the following three options makes the most sense: (1) shift the business to a piece of the industry value chain where the firm’s expertise and resources provide competitive advantage, (2) enter into a joint venture with a globally competitive partner, or (3) sell out to (be acquired by) a global entrant into the home market who concludes the company would be a good entry vehicle. When Microsoft entered China, local software developers shifted from cloning Windows products to developing Windows application software customized to the Chinese market. When the Russian PC market opened to IBM, Compaq, and Hewlett-Packard, local Russian PC maker Vist focused on assembling low-cost models, marketing them through exclusive distribution agreements with selected local retailers, and opening company-owned full-service centers in dozens of Russian cities. Vist focused on providing low-cost PCs, giving lengthy warranties, and catering to buyers who felt the need for local service and support. Vist’s strategy allowed it to remain the market leader, with a 20 percent share.
An India-based electronics company has been able to carve out a market niche for itself by developing an all-in-one business machine designed especially for India’s 1.2 million small shopkeepers that tolerates heat, dust, and power outages and that sells for a modest $180 for the smallest of its three models.36

Contending on a Global Level If a local company in an emerging market has transferable resources and capabilities, it can sometimes launch successful initiatives to meet the pressures for globalization head-on and start to compete on a global level itself.37 Lenovo, China’s biggest PC maker, recently purchased IBM’s PC business, moved its headquarters to New York City, put the Lenovo brand on IBM’s PCs, and launched initiative to become a global PC maker alongside leaders Dell and Hewlett-Packard. When General Motors (GM) decided to outsource the production of radiator caps for all of its North American vehicles, Sundaram Fasteners of India pursued the opportunity; it purchased one of GM’s radiator cap production lines, moved it to India, and became GM’s sole supplier of radiator caps in North America—at 5 million units a year. As a participant in GM’s supplier network, Sundaram learned about emerging technical standards, built its capabilities, and became one of the first Indian companies to achieve QS 9000 certification, a quality standard that GM now requires for all suppliers. Sundaram’s acquired expertise in quality standards enabled it then to pursue opportunities to supply automotive parts in Japan and Europe. Chinese communications equipment maker Huawei has captured a 16 percent share in the global market for Internet routers because its prices are up to 50 percent lower than those of industry leaders like Cisco Systems; Huawei’s success in low-priced Internet networking gear has allowed it to expand aggressively outside China, into such country markets as Russia and Brazil, and achieve the number two worldwide market share in broadband networking gear.38 In 2005 Chinese automakers were laying plans to begin exporting fuel-efficient small cars to the United States and begin the long-term process of competing internationally against the world’s leading automakers.

Key Points

Most issues in competitive strategy that apply to domestic companies apply also to companies that compete internationally. But there are four strategic issues unique to competing across national boundaries:

1. Whether to customize the company’s offerings in each different country market to match the tastes and preferences of local buyers or offer a mostly standardized product worldwide.

2. Whether to employ essentially the same basic competitive strategy in all countries or modify the strategy country by country to fit the specific market conditions and competitive circumstances it encounters.

3. Where to locate the company’s production facilities, distribution centers, and customer service operations so as to realize the greatest locational advantages.

4. Whether and how to efficiently transfer the company’s resource strengths and capabilities from one country to another in an effort to secure competitive advantage.
Multicountry competition refers to situations where competition in one national market is largely independent of competition in another national market—there is no “international market,” just a collection of self-contained country (or maybe regional) markets. Global competition exists when competitive conditions across national markets are linked strongly enough to form a true world market and when leading competitors compete head-to-head in many different countries.

In posturing to compete in foreign markets, a company has three basic options: (1) a think-local, act-local approach to crafting a strategy, (2) a think-global, act-global approach to crafting a strategy, and (3) a combination think-global, act-local approach. A think-local, act-local, or multicountry, strategy is appropriate for industries where multicountry competition dominates; a localized approach to strategy making calls for a company to vary its product offering and competitive approach from country to country in order to accommodate differing buyer preferences and market conditions. A think-global, act-global approach (or global strategy) works best in markets that are globally competitive or beginning to globalize; global strategies involve employing the same basic competitive approach (low-cost, differentiation, best-cost, focused) in all country markets and marketing essentially the same products under the same brand names in all countries where the company operates. A think-global, act-local approach can be used when it is feasible for a company to employ essentially the same basic competitive strategy in all markets but still customize its product offering and some aspect of its operations to fit local market circumstances.

Other strategy options for competing in world markets include maintaining a national (one-country) production base and exporting goods to foreign markets, licensing foreign firms to use the company’s technology or produce and distribute the company’s products, employing a franchising strategy, and using strategic alliances or other collaborative partnerships to enter a foreign market or strengthen a firm’s competitiveness in world markets.

Strategic alliances with foreign partners have appeal from several angles: gaining wider access to attractive country markets, allowing capture of economies of scale in production and/or marketing, filling gaps in technical expertise and/or knowledge of local markets, saving on costs by sharing distribution facilities and dealer networks, helping gain agreement on important technical standards, and helping combat the impact of alliances that rivals have formed. Cross-border strategic alliances are fast reshaping competition in world markets, pitting one group of allied global companies against other groups of allied global companies.

There are three ways in which a firm can gain competitive advantage (or offset domestic disadvantages) in global markets. One way involves locating various value chain activities among nations in a manner that lowers costs or achieves greater product differentiation. A second way involves efficient and effective transfer of competitively valuable competencies and capabilities from its domestic markets to foreign markets. A third way draws on a multinational or global competitor’s ability to deepen or broaden its resource strengths and capabilities and to coordinate its dispersed activities in ways that a domestic-only competitor cannot.

Profit sanctuaries are country markets in which a company derives substantial profits because of its strong or protected market position. They are valuable competitive assets. A company with multiple profit sanctuaries has the financial strength to support competitive offensives in one market with resources and profits diverted from its operations in other markets—a practice called cross-market subsidization. The ability
of companies with multiple profit sanctuaries to employ cross-subsidization gives them a powerful offensive weapon and a competitive advantage over companies with a single sanctuary.

Companies racing for global leadership have to consider competing in emerging markets like China, India, Brazil, Indonesia, and Mexico—countries where the business risks are considerable but the opportunities for growth are huge. To succeed in these markets, companies often have to (1) compete on the basis of low price, (2) be prepared to modify aspects of the company’s business model to accommodate local circumstances (but not so much that the company loses the advantage of global scale and global branding), and/or (3) try to change the local market to better match the way the company does business elsewhere. Profitability is unlikely to come quickly or easily in emerging markets, typically because of the investments needed to alter buying habits and tastes and/or the need for infrastructure upgrades. And there may be times when a company should simply stay away from certain emerging markets until conditions for entry are better suited to its business model and strategy.

Local companies in emerging country markets can seek to compete against multinational companies by (1) defending on the basis of home-field advantages, (2) transferring their expertise to cross-border markets, (3) dodging large rivals by shifting to a new business model or market niche, or (4) launching initiatives to compete on a global level themselves.

Exercises

1. Go to Caterpillar’s Web site (www.caterpillar.com) and search for information about the company’s strategy in foreign markets. Is Caterpillar pursuing a global strategy or a localized multicountry strategy? Support your answer.

2. Assume you are in charge of developing the strategy for a multinational company selling products in some 50 different countries around the world. One of the issues you face is whether to employ a multicountry strategy or a global strategy.
   a. If your company’s product is personal computers, do you think it would make better strategic sense to employ a multicountry strategy or a global strategy? Why?
   b. If your company’s product is dry soup mixes and canned soups, would a multicountry strategy seem to be more advisable than a global strategy? Why?
   c. If your company’s product is washing machines, would it seem to make more sense to pursue a multicountry strategy or a global strategy? Why?
   d. If your company’s product is basic work tools (hammers, screwdrivers, pliers, wrenches, saws), would a multicountry strategy or a global strategy seem to have more appeal? Why?

3. The Hero Group is among the 10 largest corporations in India, with 19 business segments and annual revenues of $2.75 billion in fiscal 2004–2005. Many of the corporation’s business units have used strategic alliances with foreign partners to compete in new product and geographic markets. Review the company’s statements concerning its alliances and international business operations at www.herogroup.com and prepare a two-page report that outlines Hero’s successful use of international strategic alliances.
4. Using this chapter’s discussion of strategies for local companies competing against global rivals and Figure 7.4, develop a strategic approach for a manufacturer or service company in your community that might be forced to compete with a global firm. How might the local company exploit a home-field advantage? Would it make sense for the local company to attempt to transfer its capabilities or expertise to cross-border markets? Or change its business model or market niche? Or join the fight on a global level? Explain.
Tailoring Strategy to Fit Specific Industry and Company Situations

Strategy is all about combining choices of what to do and what not to do into a system that creates the requisite fit between what the environment needs and what the company does.
—Costas Markides

Competing in the marketplace is like war. You have injuries and casualties, and the best strategy wins.
—John Collins

It is much better to make your own products obsolete than allow a competitor to do it.
—Michael A. Cusamano and Richard W. Selby

In a turbulent age, the only dependable advantage is reinventing your business model before circumstances force you to.
—Gary Hamel and Liisa Välikangas
Prior chapters have emphasized the analysis and options that go into matching a company’s choice of strategy to (1) industry and competitive conditions and (2) its own resource strengths and weaknesses, competitive capabilities, opportunities and threats, and market position. But there’s more to be revealed about the hows of matching the choices of strategy to a company’s circumstances. This chapter looks at the strategy-making task in 10 commonly encountered situations:

1. Companies competing in emerging industries.
2. Companies competing in rapidly growing markets.
3. Companies competing in maturing industries.
4. Companies competing in stagnant or declining industries.
5. Companies competing in turbulent, high-velocity markets.
6. Companies competing in fragmented industries.
7. Companies striving to sustain rapid growth.
8. Companies in industry leadership positions.
9. Companies in runner-up positions.
10. Companies in competitively weak positions or plagued by crisis conditions.

We selected these situations to shed still more light on the factors that managers need to consider in tailoring a company’s strategy. When you finish this chapter, you will have a stronger grasp of the factors that managers have to weigh in choosing a strategy and what the pros and cons are for some of the heretofore unexplored strategic options that are open to a company.

STRATEGIES FOR COMPETING IN EMERGING INDUSTRIES

An emerging industry is one in the formative stage. Examples include Voice over Internet Protocol (VoIP) telephone communications, high-definition TV, assisted living for the elderly, online education, organic food products, e-book publishing, and electronic banking. Many companies striving to establish a strong foothold in an emerging industry are start-up enterprises busily engaged in perfecting technology, gearing up
operations, and trying to broaden distribution and gain buyer acceptance. Important product design issues or technological problems may still have to be worked out. The business models and strategies of companies in an emerging industry are unproved—they may look promising but may or may not ever result in attractive profitability.

The Unique Characteristics of an Emerging Industry

Competing in emerging industries presents managers with some unique strategy-making challenges:

- Because the market is in its infancy, there’s usually much speculation about how it will function, how fast it will grow, and how big it will get. The little historical information available is virtually useless in making sales and profit projections. There’s lots of guesswork about how rapidly buyers will be attracted and how much they will be willing to pay. For example, there is much uncertainty about how many users of traditional telephone service will be inclined to switch over to VoIP telephone technology and how rapidly any such switchovers will occur.

- In many cases, much of the technological know-how underlying the products of emerging industries is proprietary and closely guarded, having been developed in-house by pioneering firms. In such cases, patents and unique technical expertise are key factors in securing competitive advantage. In other cases, numerous companies have access to the requisite technology and may be racing to perfect it, often in collaboration with others. In still other instances, there can be competing technological approaches, with much uncertainty over whether multiple technologies will end up competing alongside one another or whether one approach will ultimately win out because of lower costs or better performance—such a battle is currently under way in the emerging market for gasoline-electric hybrid engines (where demand is mushrooming because of greater fuel efficiency without a loss of power and acceleration). Toyota has pioneered one design; an alliance among General Motors, DaimlerChrysler, and BMW is pursuing another design; a Volkswagen-Porsche alliance is looking at a third technological approach; and Ford and Honda have their own slightly different hybrid engine designs.

- Just as there may be uncertainties surrounding an emerging industry’s technology, there may also be no consensus regarding which product attributes will prove decisive in winning buyer favor. Rivalry therefore centers on each firm’s efforts to get the market to ratify its own strategic approach to technology, product design, marketing, and distribution. Such rivalry can result in wide differences in product quality and performance from brand to brand.

- Since in an emerging industry all buyers are first-time users, the marketing task is to induce initial purchase and to overcome customer concerns about product features, performance reliability, and conflicting claims of rival firms.

- Many potential buyers expect first-generation products to be rapidly improved, so they delay purchase until technology and product design mature and second- or third-generation products appear on the market.

- Entry barriers tend to be relatively low, even for entrepreneurial start-up companies. Large, well-known, opportunity-seeking companies with ample resources and competitive capabilities are likely to enter if the industry has promise for
explosive growth or if its emergence threatens their present business. For instance, many traditional local telephone companies, seeing the potent threat of wireless communications technology and VoIP, have opted to enter the mobile communications business and begin offering landline customers a VoIP option.

- Strong experience/learning curve effects may be present, allowing significant price reductions as volume builds and costs fall.
- Sometimes firms have trouble securing ample supplies of raw materials and components (until suppliers gear up to meet the industry’s needs).
- Undercapitalized companies, finding themselves short of funds to support needed R&D and get through several lean years until the product catches on, end up merging with competitors or being acquired by financially strong outsiders looking to invest in a growth market.

### Strategy Options for Emerging Industries

The lack of established rules of the game in an emerging industry gives industry participants considerable freedom to experiment with a variety of different strategic approaches. Competitive strategies keyed either to low cost or differentiation are usually viable. Focusing makes good sense when resources and capabilities are limited and the industry has too many technological frontiers or too many buyer segments to pursue at once. Broad or focused differentiation strategies keyed to technological or product superiority typically offer the best chance for early competitive advantage.

In addition to choosing a competitive strategy, companies in an emerging industry usually have to fashion a strategy containing one or more of the following actions:

1. Push to perfect the technology, improve product quality, and develop additional attractive performance features. Out-innovating the competition is often one of the best avenues to industry leadership.
2. Consider merging with or acquiring another firm to gain added expertise and pool resource strengths.
3. As technological uncertainty clears and a dominant technology emerges, try to capture any first-mover advantages by adopting it quickly. However, while there’s merit in trying to be the industry standard-bearer on technology and to pioneer the dominant product design, firms have to beware of betting too heavily on their own preferred technological approach or product design—especially when there are many competing technologies, R&D is costly, and technological developments can quickly move in surprising new directions.
4. Acquire or form alliances with companies that have related or complementary technological expertise as a means of helping outcompete rivals on the basis of technological superiority.
5. Pursue new customer groups, new user applications, and entry into new geographical areas (perhaps using strategic partnerships or joint ventures if financial resources are constrained).
6. Make it easy and cheap for first-time buyers to try the industry’s first-generation product.
7. As the product becomes familiar to a wide portion of the market, shift the advertising emphasis from creating product awareness to increasing frequency of use and building brand loyalty.
8. Use price cuts to attract the next layer of price-sensitive buyers into the market.

9. Form strategic alliances with key suppliers whenever effective supply chain management provides important access to specialized skills, technological capabilities, and critical materials or components.

Young companies in emerging industries face four strategic hurdles: (1) raising the capital to finance initial operations until sales and revenues take off, profits appear, and cash flows turn positive; (2) developing a strategy to ride the wave of industry growth (what market segments and competitive advantages to go after?); (3) managing the rapid expansion of facilities and sales in a manner that positions them to contend for industry leadership; and (4) defending against competitors trying to horn in on their success.3 Up-and-coming companies can help their cause by selecting knowledgeable members for their boards of directors and by hiring entrepreneurial managers with experience in guiding young businesses through the start-up and takeoff stages. A firm that develops solid resource capabilities, an appealing business model, and a good strategy has a golden opportunity to shape the rules and establish itself as the recognized industry front-runner.

But strategic efforts to win the early race for growth and market share leadership in an emerging industry have to be balanced against the longer-range need to build a durable competitive edge and a defendable market position.4 The initial front-runners in a fast-growing emerging industry that shows signs of good profitability will almost certainly have to defend their positions against ambitious challengers striving to overtake the current market leaders. Well-financed outsiders can be counted on to enter with aggressive offensive strategies once industry sales take off, the perceived risk of investing in the industry lessens, and the success of current industry members becomes apparent. Sometimes a rush of new entrants, attracted by the growth and profit potential, overpowers the market and forces industry consolidation to a smaller number of players. Resource-rich latecomers, aspiring to industry leadership, may become major players by acquiring and merging the operations of weaker competitors and then using their own perhaps considerable brand name recognition to draw customers and build market share. Hence, the strategies of the early leaders must be aimed at competing for the long haul and making a point of developing the resources, capabilities, and market recognition needed to sustain early successes and stave off competition from capable, ambitious newcomers.

**STRATEGIES FOR COMPETING IN RAPIDLY GROWING MARKETS**

Companies that have the good fortune to be in an industry growing at double-digit rates have a golden opportunity to achieve double-digit revenues and profit growth. If market demand is expanding 20 percent annually, a company can grow 20 percent annually simply by doing little more than contentedly riding the tide of market growth—it has to simply be aggressive enough to secure enough new customers to realize a 20 percent gain in sales, not a particularly impressive strategic feat. What is more interesting, however, is to craft a strategy that enables sales to grow at 25 or 30 percent when the overall market is growing by 20 percent, such that the company’s market share and competitive position improve relative to rivals, on average. Should a company’s strategy only deliver sales growth of 12 percent in a market growing at...
Chapter 8 Tailoring Strategy to Fit Specific Industry and Company Situations

20 percent, then it is actually losing ground in the marketplace—a condition that signals a weak strategy and an unappealing product offering. The point here is that, in a rapidly growing market, a company must aim its strategy at producing gains in revenue that exceed the market average; otherwise, the best it can hope for is to maintain its market standing (if it is able to boost sales at a rate equal to the market average) and its market standing may indeed erode if its sales rise by less than the market average.

To be able to grow at a pace exceeding the market average, a company generally must have a strategy that incorporates one or more of the following elements:

- **Driving down costs per unit so as to enable price reductions that attract droves of new customers.** Charging a lower price always has strong appeal in markets where customers are price-sensitive, and lower prices can help push up buyers demand by drawing new customers into the marketplace. But since rivals can lower their prices also, a company must really be able to drive its unit costs down faster than rivals, such that it can use its low-cost advantage to underprice rivals. The makers of liquid crystal display (LCD) and high-definition TVs are aggressively pursuing cost reduction to bring the prices of their TV sets down under $1,000 and thus make their products more affordable to more consumers.

- **Pursuing rapid product innovation, both to set a company’s product offering apart from rivals and to incorporate attributes that appeal to growing numbers of customers.** Differentiation strategies, when keyed to product attributes that draw in large numbers of new customers, help bolster a company’s reputation for product superiority and lay the foundation for sales gains in excess of the overall rate of market growth. If the market is one where technology is advancing rapidly and product life cycles are short, then it becomes especially important to be first-to-market with next-generation products. But product innovation strategies require competencies in R&D and new product development and design, plus organizational agility in getting new and improved products to market quickly. At the same time they are pursuing cost reductions, the makers of LCD and high-definition TVs are pursuing all sorts of product improvements to enhance product quality and performance and boost screen sizes, so as to match or beat the picture quality and reliability of conventional TVs (with old-fashioned cathode-ray tubes) and drive up sales at an even faster clip.

- **Gaining access to additional distribution channels and sales outlets.** Pursuing wider distribution access so as to reach more potential buyers is a particularly good strategic approach for realizing above-average sales gains. But usually this requires a company to be a first-mover in positioning itself in new distribution channels and forcing rivals into playing catch-up.

- **Expanding the company’s geographic coverage.** Expanding into areas, either domestic or foreign, where the company does not have a market presence can also be an effective way to reach more potential buyers and pave the way for gains in sales that outpace the overall market average.

- **Expanding the product line to add models/styles that appeal to a wider range of buyers.** Offering buyers a wider selection can be an effective way to draw new customers in numbers sufficient to realize above-average sales gains. Makers of MP3 players and cell phones are adding new models to stimulate buyer demand; Starbucks is adding new drinks and other menu selections to build store traffic; and marketers of VoIP technology are rapidly introducing a wider variety of plans to broaden their appeal to customers with different calling habits and needs.
STRATEGIES FOR COMPETING IN MATURING INDUSTRIES

A maturing industry is one that is moving from rapid growth to significantly slower growth. An industry is said to be mature when nearly all potential buyers are already users of the industry’s products and growth in market demand closely parallels that of the population and the economy as a whole. In a mature market, demand consists mainly of replacement sales to existing users, with growth hinging on the industry’s abilities to attract the few remaining new buyers and to convince existing buyers to up their usage. Consumer goods industries that are mature typically have a growth rate under 5 percent—roughly equal to the growth of the customer base or economy as a whole.

How Slowing Growth Alters Market Conditions

An industry’s transition to maturity does not begin on an easily predicted schedule. Industry maturity can be forestalled by the emergence of new technological advances, product innovations, or other driving forces that keep rejuvenating market demand. Nonetheless, when growth rates do slacken, the onset of market maturity usually produces fundamental changes in the industry’s competitive environment:

1. Slowing growth in buyer demand generates more head-to-head competition for market share. Firms that want to continue on a rapid-growth track start looking for ways to take customers away from competitors. Outbreaks of price cutting, increased advertising, and other aggressive tactics to gain market share are common.

2. Buyers become more sophisticated, often driving a harder bargain on repeat purchases. Since buyers have experience with the product and are familiar with competing brands, they are better able to evaluate different brands and can use their knowledge to negotiate a better deal with sellers.

3. Competition often produces a greater emphasis on cost and service. As sellers all begin to offer the product attributes buyers prefer, buyer choices increasingly depend on which seller offers the best combination of price and service.

4. Firms have a “topping-out” problem in adding new facilities. Reduced rates of industry growth mean slowdowns in capacity expansion for manufacturers—adding too much plant capacity at a time when growth is slowing can create oversupply conditions that adversely affect manufacturers’ profits well into the future. Likewise, retail chains that specialize in the industry’s product have to cut back on the number of new stores being opened to keep from saturating localities with too many stores.

5. Product innovation and new end-use applications are harder to come by. Producers find it increasingly difficult to create new product features, find further uses for the product, and sustain buyer excitement.

6. International competition increases. Growth-minded domestic firms start to seek out sales opportunities in foreign markets. Some companies, looking for ways to cut costs, relocate plants to countries with lower wage rates. Greater product standardization and diffusion of technological know-how reduce entry barriers and make it possible for enterprising foreign companies to become serious market contenders in more countries. Industry leadership passes to companies that succeed in building strong competitive positions in most of the world’s major geographic markets and in winning the biggest global market shares.
7. **Industry profitability falls temporarily or permanently.** Slower growth, increased competition, more sophisticated buyers, and occasional periods of overcapacity put pressure on industry profit margins. Weaker, less-efficient firms are usually the hardest hit.

8. **Stiffening competition induces a number of mergers and acquisitions among former competitors, driving industry consolidation to a smaller number of larger players.** Inefficient firms and firms with weak competitive strategies can achieve respectable results in a fast-growing industry with booming sales. But the intensifying competition that accompanies industry maturity exposes competitive weakness and throws second- and third-tier competitors into a survival-of-the-fittest contest.

**Strategies that Fit Conditions in Maturing Industries**

As the new competitive character of industry maturity begins to hit full force, any of several strategic moves can strengthen a firm’s competitive position: pruning the product line, improving value chain efficiency, trimming costs, increasing sales to present customers, acquiring rival firms, expanding internationally, and strengthening capabilities.

**Pruning Marginal Products and Models** A wide selection of models, features, and product options sometimes has competitive value during the growth stage, when buyers’ needs are still evolving. But such variety can become too costly as price competition stiffens and profit margins are squeezed. Maintaining many product versions works against achieving design, parts inventory, and production economies at the manufacturing levels and can increase inventory stocking costs for distributors and retailers. In addition, the prices of slow-selling versions may not cover their true costs. Pruning marginal products from the line opens the door for cost savings and permits more concentration on items whose margins are highest and/or where a firm has a competitive advantage. General Motors has been cutting slow-selling models and brands from its lineup of offerings—it has eliminated the entire Oldsmobile division and is said to be looking at whether it can eliminate its Saab lineup. Textbook publishers are discontinuing publication of those books that sell only a few thousand copies annually (where profits are marginal at best) and instead focusing their resources on texts that generate sales of at least 5,000 copies per edition.

**Improving Value Chain Efficiency** Efforts to reinvent the industry value chain can have a fourfold payoff: lower costs, better product or service quality, greater capability to turn out multiple or customized product versions, and shorter design-to-market cycles. Manufacturers can mechanize high-cost activities, redesign production lines to improve labor efficiency, build flexibility into the assembly process so that customized product versions can be easily produced, and increase use of advanced technology (robotics, computerized controls, and automated assembly). Suppliers of parts and components, manufacturers, and distributors can collaboratively deploy online systems and product coding techniques to streamline activities and achieve cost savings all along the value chain—from supplier-related activities all the way through distribution, retailing, and customer service.
Trimming Costs  Stiffening price competition gives firms extra incentive to drive down unit costs. Company cost-reduction initiatives can cover a broad front. Some of the most frequently pursued options are pushing suppliers for better prices, implementing tighter supply chain management practices, cutting low-value activities out of the value chain, developing more economical product designs, reengineering internal processes using e-commerce technology, and shifting to more economical distribution arrangements.

Increasing Sales to Present Customers  In a mature market, growing by taking customers away from rivals may not be as appealing as expanding sales to existing customers. Strategies to increase purchases by existing customers can involve adding more sales promotions, providing complementary items and ancillary services, and finding more ways for customers to use the product. Convenience stores, for example, have boosted average sales per customer by adding video rentals, automated teller machines, gasoline pumps, and deli counters.

Acquiring Rival Firms at Bargain Prices  Sometimes a firm can acquire the facilities and assets of struggling rivals quite cheaply. Bargain-priced acquisitions can help create a low-cost position if they also present opportunities for greater operating efficiency. In addition, an acquired firm’s customer base can provide expanded market coverage and opportunities for greater scale economies. The most desirable acquisitions are those that will significantly enhance the acquiring firm’s competitive strength.

Expanding Internationally  As its domestic market matures, a firm may seek to enter foreign markets where attractive growth potential still exists and competitive pressures are not so strong. Many multinational companies are expanding into such emerging markets as China, India, Brazil, Argentina, and the Philippines, where the long-term growth prospects are quite attractive. Strategies to expand internationally also make sense when a domestic firm’s skills, reputation, and product are readily transferable to foreign markets. For example, even though the U.S. market for soft drinks is mature, Coca-Cola has remained a growth company by upping its efforts to penetrate emerging markets where soft-drink sales are expanding rapidly.

Building New or More Flexible Capabilities  The stiffening pressures of competition in a maturing or already mature market can often be combated by strengthening the company’s resource base and competitive capabilities. This can mean adding new competencies or capabilities, deepening existing competencies to make them harder to imitate, or striving to make core competencies more adaptable to changing customer requirements and expectations. Microsoft has responded to challenges by such competitors as Google and Linux by expanding its competencies in search engine software and revamping its entire approach to programming next-generation operating systems. Chevron has developed a best-practices discovery team and a best-practices resource map to enhance the speed and effectiveness with which it is able to transfer efficiency improvements from one oil refinery to another.

Strategic Pitfalls in Maturing Industries  Perhaps the biggest strategic mistake a company can make as an industry matures is steering a middle course between low cost, differentiation, and focusing—blending efforts to achieve low cost with efforts to incorporate differentiating features and efforts to focus on a limited target market. Such strategic compromises typically leave
the firm stuck in the middle with a fuzzy strategy, too little commitment to winning a competitive advantage, an average image with buyers, and little chance of springing into the ranks of the industry leaders.

Other strategic pitfalls include being slow to mount a defense against stiffening competitive pressures, concentrating more on protecting short-term profitability than on building or maintaining long-term competitive position, waiting too long to respond to price cutting by rivals, overexpanding in the face of slowing growth, overspending on advertising and sales promotion efforts in a losing effort to combat the growth slowdown, and failing to pursue cost reduction soon enough or aggressively enough.

### STRATEGIES FOR COMPETING IN STAGNANT OR DECLINING INDUSTRIES

Many firms operate in industries where demand is growing more slowly than the economy-wide average or is even declining. The demand for an industry’s product can decline for any of several reasons: (1) advancing technology gives rise to better-performing substitute products (slim LCD monitors displace bulky CRT monitors; DVD players replace VCRs; wrinkle-free fabrics replace the need for laundry/dry-cleaning services) or lower costs (cheaper synthetics replace expensive leather); (2) the customer group shrinks (baby foods are in less demand when birthrates fall); (3) changing lifestyles and buyer tastes (cigarette smoking and wearing dress hats go out of vogue); (4) the rising costs of complementary products (higher gasoline prices drive down purchases of gas-guzzling vehicles). The most attractive declining industries are those in which sales are eroding only slowly, there are pockets of stable or even growing demand, and some market niches present good profit opportunities. But in some stagnant or declining industries, decaying buyer demand precipitates a desperate competitive battle among industry members for the available business, replete with price discounting, costly sales promotions, growing amounts of idle plant capacity, and fast-eroding profit margins. It matters greatly whether buyer demand falls gradually or sharply and whether competition proves to be fierce or moderate.

Businesses competing in stagnant or declining industries have to make a fundamental strategic choice—whether to remain committed to the industry for the long term despite the industry’s dim prospects or whether to pursue an end-game strategy to withdraw gradually or quickly from the market. Deciding to stick with the industry despite eroding market demand can have considerable merit. Stagnant demand by itself is not enough to make an industry unattractive. Market demand may be decaying slowly. Some segments of the market may still present good profit opportunities. Cash flows from operations may still remain strongly positive. Strong competitors may well be able to grow and boost profits by taking market share from weaker competitors. Furthermore, the acquisition or exit of weaker firms creates opportunities for the remaining companies to capture greater market share. On the one hand, striving to become the market leader and be one of the few remaining companies in a declining industry can lead to above-average profitability even though overall market demand is stagnant or eroding. On the other hand, if the market environment of a declining industry is characterized by bitter warfare for customers and lots of overcapacity, such that companies are plagued with heavy operating losses, then an early exit makes much more strategic sense.

If a company decides to stick with a declining industry—because top management is encouraged by the remaining opportunities or sees merit in striving for market share...
leadership (or even just being one of the few remaining companies in the industry), then its three best strategic alternatives are usually the following:

1. **Pursue a focused strategy aimed at the fastest-growing or slowest-decaying market segments within the industry.** Stagnant or declining markets, like other markets, are composed of numerous segments or niches. Frequently, one or more of these segments is growing rapidly (or at least decaying much more slowly), despite stagnation in the industry as a whole. An astute competitor who zeros in on fast-growing segments and does a first-rate job of meeting the needs of buyers comprising these segments can often escape stagnating sales and profits and even gain decided competitive advantage. For instance, both Ben & Jerry’s and Häagen-Dazs have achieved success by focusing on the growing luxury or superpremium segment of the otherwise stagnant market for ice cream; revenue growth and profit margins are substantially higher for high-end ice creams sold in supermarkets and in scoop shops than is the case in other segments of the ice cream market. Companies that focus on the one or two most attractive market segments in a declining business may well decide to ignore the other segments altogether—withdraw from them entirely or at least gradually or rapidly disinvesting in them. But the key is to move aggressively to establish a strong position in the most attractive parts of the stagnant or declining industry.

2. **Stress differentiation based on quality improvement and product innovation.** Either enhanced quality or innovation can rejuvenate demand by creating important new growth segments or inducing buyers to trade up. Successful product innovation opens up an avenue for competing that bypasses meeting or beating rivals’ prices. Differentiation based on successful innovation has the additional advantage of being difficult and expensive for rival firms to imitate. New Covent Garden Soup has met with success by introducing packaged fresh soups for sale in major supermarkets, where the typical soup offerings are canned or dry mixes. Procter & Gamble has rejuvenated sales of its toothbrushes with its new line of Crest battery-powered spin toothbrushes, and it has revitalized interest in tooth care products with a series of product innovations related to teeth whitening. Bread makers are fighting declining sales of white breads that use bleached flour by introducing all kinds of whole-grain breads (which have far more nutritional value).

3. **Strive to drive costs down and become the industry’s low-cost leader.** Companies in stagnant industries can improve profit margins and return on investment by pursuing innovative cost reduction year after year. Potential cost-saving actions include (a) cutting marginally beneficial activities out of the value chain; (b) outsourcing functions and activities that can be performed more cheaply by outsiders; (c) redesigning internal business processes to exploit cost-reducing e-commerce technologies; (d) consolidating underutilized production facilities; (e) adding more distribution channels to ensure the unit volume needed for low-cost production; (f) closing low-volume, high-cost retail outlets; and (g) pruning marginal products from the firm’s offerings. Japan-based Asahi Glass (a low-cost producer of flat glass), PotashCorp and IMC Global (two low-cost leaders in potash production), Alcan Aluminum, Nucor Steel, and Safety Components International (a low-cost producer of air bags for motor vehicles) have all been successful in driving costs down in competitively tough and largely stagnant industry environments.

These three strategic themes are not mutually exclusive. Introducing innovative versions of a product can create a fast-growing market segment. Similarly, relentless pursuit of greater operating efficiencies permits price reductions that create price-conscious
growth segments. Note that all three themes are spinoffs of the five generic competitive strategies, adjusted to fit the circumstances of a tough industry environment.

**End-Game Strategies for Declining Industries**

An *end-game strategy* can take either of two paths: (1) a *slow-exit strategy* that involves a gradual phasing down of operations coupled with an objective of getting the most cash flow from the business even if it means sacrificing market position or profitability and (2) a *fast-exit* or *sell-out-quickly strategy* to disengage from the industry during the early stages of the decline and recover as much of the company’s investment as possible for deployment elsewhere.11

**A Slow-Exit Strategy** With a slow-exit strategy, the key objective is to generate the greatest possible harvest of cash from the business for as long as possible. Management either eliminates or severely curtails new investment in the business. Capital expenditures for new equipment are put on hold or given low financial priority (unless replacement needs are unusually urgent); instead, efforts are made to stretch the life of existing equipment and make do with present facilities as long as possible. Old plants with high costs may be retired from service. The operating budget is chopped to a rock-bottom level. Promotional expenses may be cut gradually, quality reduced in not-so-visible ways, nonessential customer services curtailed, and maintenance of facilities held to a bare minimum. The resulting increases in cash flow (and perhaps even bottom-line profitability and return on investment) compensate for whatever declines in sales might be experienced. Withering buyer demand is tolerable if sizable amounts of cash can be reaped in the interim. If and when cash flows dwindle to meager levels as sales volumes decay, the business can be sold or, if no buyer can be found, closed down.

**A Fast-Exit Strategy** The challenge of a sell-out-quickly strategy is to find a buyer willing to pay an agreeable price for the company’s business assets. Buyers may be scarce since there’s a tendency for investors to shy away from purchasing a stagnant or dying business. And even if willing buyers appear, they will be in a strong bargaining position once it’s clear that the industry’s prospects are permanently waning. How much prospective buyers will pay is usually a function of how rapidly they expect the industry to decline, whether they see opportunities to rejuvenate demand (at least temporarily), whether they believe that costs can be cut enough to still produce attractive profit margins or cash flows, whether there are pockets of stable demand where buyers are not especially price sensitive, and whether they believe that fading market demand will weaken competition (which could enhance profitability) or trigger strong competition for the remaining business (which could put pressure on profit margins). Thus, the expectations of prospective buyers will tend to drive the price they are willing to pay for the business assets of a company wanting to sell out quickly.

**STRATEGIES FOR COMPETING IN TURBULENT, HIGH-VELOCITY MARKETS**

Many companies operate in industries characterized by rapid technological change, short product life cycles, the entry of important new rivals, lots of competitive maneuvering by rivals, and fast-evolving customer requirements and expectations—all occurring in a manner that creates swirling market conditions. Since news of this or that
important competitive development arrives daily, it is an imposing task just to monitor and assess developing events. High-velocity change is plainly the prevailing condition in computer/server hardware and software, video games, networking, wireless telecommunications, medical equipment, biotechnology, prescription drugs, and online retailing.

### Ways to Cope with Rapid Change

The central strategy-making challenge in a turbulent market environment is managing change. As illustrated in Figure 8.1, a company can assume any of three strategic postures in dealing with high-velocity change:

- **It can react to change.** The company can respond to a rival’s new product with a better product. It can counter an unexpected shift in buyer tastes and buyer demand by redesigning or repackaging its product, or shifting its advertising emphasis to different product attributes. Reacting is a defensive strategy and is therefore unlikely to create fresh opportunity, but it is nonetheless a necessary component in a company’s arsenal of options.

- **It can anticipate change.** The company can make plans for dealing with the expected changes and follow its plans as changes occur (fine-tuning them as may be needed). Anticipation entails looking ahead to analyze what is likely to occur and then preparing and positioning for that future. It entails studying buyer behavior, buyer needs, and buyer expectations to get insight into how the market will evolve, then lining up the necessary production and distribution capabilities ahead of time. Like reacting to change, anticipating change is still fundamentally defensive in that forces outside the enterprise are in the driver’s seat. Anticipation, however, can open up new opportunities and thus is a better way to manage change than just pure reaction.

- **It can lead change.** Leading change entails initiating the market and competitive forces that others must respond to—it is an offensive strategy aimed at putting a company in the driver’s seat. Leading change means being first to market with an important new product or service. It means being the technological leader, rushing next-generation products to market ahead of rivals, and having products whose features and attributes shape customer preferences and expectations. It means proactively seeking to shape the rules of the game.

As a practical matter, a company’s approach to managing change should, ideally, incorporate all three postures (though not in the same proportion). The best-performing companies in high-velocity markets consistently seek to lead change with proactive strategies that often entail the flexibility to pursue any of several strategic options, depending on how the market actually evolves. Even so, an environment of relentless change makes it incumbent on any company to anticipate and prepare for the future and to react quickly to unpredictable or uncontrollable new developments.

### Strategy Options for Fast-Changing Markets

Competitive success in fast-changing markets tends to hinge on a company’s ability to improvise, experiment, adapt, reinvent, and regenerate as market and competitive conditions shift rapidly and sometimes unpredictably. It has to constantly reshape its
strategy and its basis for competitive advantage. While the process of altering offensive and defensive moves every few months or weeks to keep the overall strategy closely matched to changing conditions is inefficient, the alternative—a fast-obsolescing strategy—is worse. The following five strategic moves seem to offer the best payoffs:

1. **Invest aggressively in R&D to stay on the leading edge of technological know-how.**
   Translating technological advances into innovative new products (and remaining
close on the heels of whatever advances and features are pioneered by rivals) is a necessity in industries where technology is the primary driver of change. But it is often desirable to focus the R&D effort on a few critical areas, not only to avoid stretching the company’s resources too thin but also to deepen the firm’s expertise, master the technology, fully capture experience/learning curve effects, and become the dominant leader in a particular technology or product category.15 When a fast-evolving market environment entails many technological areas and product categories, competitors have little choice but to employ some type of focus strategy and concentrate on being the leader in a particular product/technology category.

2. **Keep the company’s products and services fresh and exciting enough to stand out in the midst of all the change that is taking place.** One of the risks of rapid change is that products and even companies can get lost in the shuffle. The marketing challenge here is to keep the firm’s products and services in the limelight and, further, to keep them innovative and well matched to the changes that are occurring in the marketplace.

3. **Develop quick-response capability.** Because no company can predict all of the changes that will occur, it is crucial to have the organizational capability to be able to react quickly, improvising if necessary. This means shifting resources internally, adapting existing competencies and capabilities, creating new competencies and capabilities, and not falling far behind rivals. Companies that are habitual late-movers are destined to be industry also-rans.

4. **Rely on strategic partnerships with outside suppliers and with companies making tie-in products.** In many high-velocity industries, technology is branching off to create so many new technological paths and product categories that no company has the resources and competencies to pursue them all. Specialization (to promote the necessary technical depth) and focus (to preserve organizational agility and leverage the firm’s expertise) are desirable strategies. Companies build their competitive position not just by strengthening their own internal resource base but also by partnering with those suppliers making state-of-the-art parts and components and by collaborating closely with both the developers of related technologies and the makers of tie-in products. For example, personal computer companies like Gateway, Dell, Compaq, and Acer rely heavily on the developers and manufacturers of chips, monitors, hard drives, DVD players, and software for innovative advances in PCs. None of the PC makers have done much in the way of integrating backward into parts and components because they have learned that the most effective way to provide PC users with a state-of-the-art product is to outsource the latest, most advanced components from technologically sophisticated suppliers who make it their business to stay on the cutting edge of their specialization and who can achieve economies of scale by mass-producing components for many PC assemblers. An outsourcing strategy also allows a company the flexibility to replace suppliers that fall behind on technology or product features or that cease to be competitive on price. The managerial challenge here is to strike a good balance between building a rich internal resource base that, on the one hand, keeps the firm from being at the mercy of its suppliers and allies and, on the other hand, maintains organizational agility by relying on the resources and expertise of capable (and perhaps best-in-world) outsiders.

5. **Initiate fresh actions every few months, not just when a competitive response is needed.** In some sense, change is partly triggered by the passage of time rather
than solely by the occurrence of events. A company can be proactive by making
time-paced moves—introducing a new or improved product every four months,
rather than when the market tapers off or a rival introduces a next-generation
model. Similarly, a company can expand into a new geographic market every
six months rather than waiting for a new market opportunity to present itself; it
can also refresh existing brands every two years rather than waiting until their
popularity wanes. The keys to successfully using time pacing as a strategic weapon
are choosing intervals that make sense internally and externally, establishing an
internal organizational rhythm for change, and choreographing the transitions. 3M
Corporation has long pursued an objective of having 25 percent of its revenues
come from products less than four years old, a force that established the rhythm of
change and created a relentless push for new products. Recently, the firm’s CEO
upped the tempo of change at 3M by increasing the goal from 25 to 30 percent.

Cutting-edge know-how and first-to-market capabilities are very valuable competitive
assets in fast-evolving markets. Moreover, action-packed competition demands that a
company have quick reaction times and flexible, adaptable resources—organizational
agility is a huge competitive asset. Even so, companies will make mistakes and take
some actions that do not work out well. When a company’s strategy doesn’t seem to
be working well, it has to quickly regroup—probing, experimenting, improvising, and
trying again and again until it finds something that strikes the right chord with buyers
and that puts it in sync with market and competitive realities.

STRATEGIES FOR COMPETING IN
FRAGMENTED INDUSTRIES

A number of industries are populated by hundreds, even thousands, of small and
medium-sized companies, many privately held and none with a substantial share of
total industry sales. The standout competitive feature of a fragmented industry is the
absence of market leaders with king-sized market shares or widespread buyer recogni-
tion. Examples of fragmented industries include book publishing, landscaping and plant
nurseries, real estate development, convenience stores, banking, health and medical
care, mail order catalog sales, computer software development, custom printing, kitch-
en cabinets, trucking, auto repair, restaurants and fast food, public accounting, apparel
manufacture and apparel retailing, paperboard boxes, hotels and motels, and furniture.

Reasons for Supply-Side Fragmentation

Any of several reasons can account for why the supply side of an industry comprises
hundreds or even thousands of companies:

- **The product or service is delivered at neighborhood locations so as to be conveniently accessible to local residents.** Retail and service businesses, for example, are inherently local—gas stations and car washes, pharmacies, dry-cleaning services, nursing homes, auto repair firms, furniture stores, flower shops, and lawn care enterprises. Whenever it takes thousands of locations to adequately serve the market, the way is opened for many enterprises to be engaged in providing products/services to local residents and businesses (and such enterprises can operate at just one location or at multiple locations).
• **Buyer preferences and requirements are so diverse that very large numbers of firms can easily coexist trying to accommodate differing buyer tastes, expectations, and pocketbooks.** This is true in the market for apparel, where there are thousands of apparel manufacturers making garments of various styles and price ranges. There’s a host of different hotels and restaurants in places like New York City, London, Buenos Aires, Mexico City, and Tokyo. The software development industry is highly fragmented because there are so many types of software applications and because the needs and expectations of software users are so highly diverse—hence, there’s ample market space for a software company to concentrate its attention on serving a particular market niche.

• **Low entry barriers allow small firms to enter quickly and cheaply.** Such tends to be the case in many areas of retailing, residential real estate, insurance sales, beauty shops, and the restaurant business.

• **An absence of scale economies permits small companies to compete on an equal cost footing with larger firms.** The markets for business forms, interior design, kitchen cabinets, and picture framing are fragmented because buyers require relatively small quantities of customized products; since demand for any particular product version is small, sales volumes are not adequate to support producing, distributing, or marketing on a scale that yields cost advantages to a large-scale firm. A locally owned pharmacy can be cost competitive with the pharmacy operations of large drugstore chains like Walgreen’s or Rite Aid or CVS. Small trucking companies can be cost-competitive with companies that have huge truck fleets. A local pizzeria is not cost-disadvantaged in competing against such chains as Pizza Hut, Domino’s, and Papa John’s.

• **The scope of the geographic market for the industry’s product or service is transitioning from national to global.** A broadening of geographic scope puts companies in more and more countries in the same competitive market arena (as in the apparel industry, where increasing numbers of garment makers across the world are shifting their production operations to low-wage countries and then shipping their goods to retailers in several countries).

• **The technologies embodied in the industry’s value chain are exploding into so many new areas and along so many different paths that specialization is essential just to keep abreast in any one area of expertise.** Technology branching accounts for why the manufacture of electronic parts and components is fragmented and why there’s fragmentation in prescription drug research.

• **The industry is young and crowded with aspiring contenders.** In most young industries, no firm has yet developed the resource base, competitive capabilities, and market recognition to command a significant market share (as in online e-tailing).

### Competitive Conditions in a Fragmented Industry

Competitive rivalry in fragmented industries can vary from moderately strong to fierce. Low barriers tend to make entry of new competitors an ongoing threat. Competition from substitutes may or may not be a major factor. The relatively small size of companies in fragmented industries puts them in a relatively weak position to bargain with powerful suppliers and buyers, although sometimes they can become members of a cooperative formed for the purpose of using their combined leverage to negotiate
better sales and purchase terms. In such an environment, the best a firm can expect is to cultivate a loyal customer base and grow a bit faster than the industry average.

Some fragmented industries consolidate over time as growth slows and the market matures. The stiffer competition that accompanies slower growth produces a shake-out of weak, inefficient firms and a greater concentration of larger, more visible sellers. Others remain atomistic because it is inherent in their businesses. And still others remain stuck in a fragmented state because existing firms lack the resources or ingenuity to employ a strategy powerful enough to drive industry consolidation.

**Strategy Options for Competing in a Fragmented Industry**

In fragmented industries, firms generally have the strategic freedom to pursue broad or narrow market targets and low-cost or differentiation-based competitive advantages. Many different strategic approaches can exist side by side (unless the industry’s product is highly standardized or a commodity—like concrete blocks, sand and gravel, or paperboard boxes). Fragmented industry environments are usually ideal for focusing on a well-defined market niche—a particular geographic area or buyer group or product type. In an industry that is fragmented due to highly diverse buyer tastes or requirements, focusing usually offers more competitive advantage potential than trying to come up with a product offering that has broad market appeal.

Some of the most suitable strategy options for competing in a fragmented industry include:

- **Constructing and operating “formula” facilities**—This strategic approach is frequently employed in restaurant and retailing businesses operating at multiple locations. It involves constructing standardized outlets in favorable locations at minimum cost and then operating them cost-effectively. This is a favorite approach for locally owned fast-food enterprises and convenience stores that have multiple locations serving a geographically limited market area. Major fast-food chains like Yum! Brands—the parent of Pizza Hut, Taco Bell, KFC, Long John Silver’s, and A&W restaurants—and big convenience store retailers like 7-Eleven have, of course, perfected the formula facilities strategy.

- **Becoming a low-cost operator**—When price competition is intense and profit margins are under constant pressure, companies can stress no-frills operations featuring low overhead, high-productivity/low-cost labor, lean capital budgets, and dedicated pursuit of total operating efficiency. Successful low-cost producers in a fragmented industry can play the price-discounting game and still earn profits above the industry average. Many e-tailers compete on the basis of bargain prices; so do budget motel chains like Econo Lodge, Super 8, and Days Inn.

- **Specializing by product type**—When a fragmented industry’s products include a range of styles or services, a strategy to focus on one product or service category can be effective. Some firms in the furniture industry specialize in only one furniture type such as brass beds, rattan and wicker, lawn and garden, or Early American. In auto repair, companies specialize in transmission repair, body work, or speedy oil changes.

- **Specializing by customer type**—A firm can stake out a market niche in a fragmented industry by catering to those customers who are interested in low prices,
unique product attributes, customized features, carefree service, or other extras. A number of restaurants cater to take-out customers; others specialize in fine dining, and still others cater to the sports bar crowd. Bed-and-breakfast inns cater to a particular type of traveler/vacationer (and also focus on a very limited geographic area).

- **Focusing on a limited geographic area**—Even though a firm in a fragmented industry can’t win a big share of total industrywide sales, it can still try to dominate a local or regional geographic area. Concentrating company efforts on a limited territory can produce greater operating efficiency, speed delivery and customer services, promote strong brand awareness, and permit saturation advertising, while avoiding the diseconomies of stretching operations out over a
much wider area. Several locally owned banks, drugstores, and sporting goods retailers successfully operate multiple locations within a limited geographic area. Numerous local restaurant operators have pursued operating economies by opening anywhere from 4 to 10 restaurants (each with each its own distinctive theme and menu) scattered across a single metropolitan area like Atlanta or Denver or Houston.

Illustration Capsule 8.1 describes how a new start-up company in Great Britain has employed a product niche type of focus strategy in the fragmented exercise equipment industry.

**STRATEGIES FOR SUSTAINING RAPID COMPANY GROWTH**

Companies that strive to grow their revenues and earnings at double-digit rates year after year (or at rates exceeding the overall market average so that they are growing faster than rivals and gaining market share) generally have to craft a portfolio of strategic initiatives covering three horizons:18

- **Horizon 1:** “Short-jump” strategic initiatives to fortify and extend the company’s position in existing businesses—Short-jump initiatives typically include adding new items to the company’s present product line, expanding into new geographic areas where the company does not yet have a market presence, and launching offensives to take market share away from rivals. The objective is to capitalize fully on whatever growth potential exists in the company’s present business arenas.

- **Horizon 2:** “Medium-jump” strategic initiatives to leverage existing resources and capabilities by entering new businesses with promising growth potential—Growth companies have to be alert for opportunities to jump into new businesses where there is promise of rapid growth and where their experience, intellectual capital, and technological know-how will prove valuable in gaining rapid market penetration. While Horizon 2 initiatives may take a back seat to Horizon 1 initiatives as long as there is plenty of untapped growth in the company’s present businesses, they move to the front as the onset of market maturity dims the company’s growth prospects in its present business(es).

- **Horizon 3:** “Long-jump” strategic initiatives to plant the seeds for ventures in businesses that do not yet exist—Long-jump initiatives can entail pumping funds into long-range R&D projects, setting up an internal venture capital fund to invest in promising start-up companies attempting to create the industries of the future, or acquiring a number of small start-up companies experimenting with technologies and product ideas that complement the company’s present businesses. Intel, for example, set up a multibillion-dollar venture fund to invest in over 100 different projects and start-up companies, the intent being to plant seeds for Intel’s future, broadening its base as a global leader in supplying building blocks for PCs and the worldwide Internet economy. Royal Dutch/Shell, with over $140 billion in revenues and over 100,000 employees, spent over $20 million on rule-breaking, game-changing ideas put forth by free-thinking employees; the objective was to inject a new spirit of entrepreneurship into the company and sow the seeds of faster growth.19
The three strategy horizons are illustrated in Figure 8.2. Managing such a portfolio of strategic initiatives to sustain rapid growth is not easy, however. The tendency of most companies is to focus on Horizon 1 strategies and devote only sporadic and uneven attention to Horizon 2 and 3 strategies. But a recent McKinsey & Company study of 30 of the world’s leading growth companies revealed a relatively balanced portfolio of strategic initiatives covering all three horizons. The lesson of successful growth companies is that keeping a company’s record of rapid growth intact over the long term entails crafting a diverse population of strategies, ranging from short-jump incremental strategies to grow present businesses to long-jump initiatives with a 5- to 10-year growth payoff horizon. Having a mixture of short-jump, medium-jump, and long-jump initiatives not only increases the odds of hitting a few home runs but also provides some protection against unexpected adversity in present or newly entered businesses.

**The Risks of Pursuing Multiple Strategy Horizons**

There are, of course, risks to pursuing a diverse strategy portfolio aimed at sustained growth. A company cannot, of course, place bets on every opportunity that appears on its radar screen, lest it stretch its resources too thin. And medium-jump and long-jump initiatives can cause a company to stray far from its core competencies and end up trying to compete in businesses for which it is ill-suited. Moreover, it can be difficult to achieve competitive advantage in medium- and long-jump product families and businesses that prove not to mesh well with a company’s present businesses and resource strengths. The payoffs of long-jump initiatives often prove elusive; not all of the seeds
a company sows will bear fruit, and only a few may evolve into truly significant contributors to the company’s revenue and profit growth. The losses from those long-jump ventures that do not take root may significantly erode the gains from those that do, resulting in disappointingly modest gains in overall profits.

**STRATEGIES FOR INDUSTRY LEADERS**

The competitive positions of industry leaders normally range from “stronger than average” to “powerful.” Leaders typically are well known, and strongly entrenched leaders have proven strategies (keyed either to low-cost leadership or to differentiation). Some of the best-known industry leaders are Anheuser-Busch (beer), Starbucks (coffee drinks), Microsoft (computer software), Callaway (golf clubs), McDonald’s (fast food), Procter & Gamble (laundry detergents and soaps), Campbell’s (canned soups), Gerber (baby food), Hewlett-Packard (printers), Sony (video game consoles), Black & Decker (power tools), Intel (semiconductors and chip sets), Wal-Mart and Carrefour (discount retailing), Amazon.com (online shopping), eBay (online auctions), Apple (MP3 players), and Ocean Spray (cranberries).

The main strategic concern for a leader revolves around how to defend and strengthen its leadership position, perhaps becoming the dominant leader as opposed to just a leader. However, the pursuit of industry leadership and large market share is primarily important because of the competitive advantage and profitability that accrue to being the industry’s biggest company. Three contrasting strategic postures are open to industry leaders:21

1. **Stay-on-the-offensive strategy**—The central goal of a stay-on-the-offensive strategy is to be a first-mover and a proactive market leader.22 It rests on the principle that playing hardball, moving early and frequently, and forcing rivals into a catch-up mode is the surest path to industry prominence and potential market dominance—as the saying goes, the best defense is a good offense. Furthermore, an offensive-minded industry leader relentlessly concentrates on achieving a competitive advantage over rivals and then widening this advantage over time to achieve extreme competitive advantage.23 Being the industry standard setter thus requires being impatient with the status quo, seizing the initiative, and pioneering continuous improvement and innovation—this can mean being first-to-market with technological improvements, new or better products, more attractive performance features, quality enhancements, or customer service improvements. It can mean aggressively seeking out ways to cut operating costs, ways to establish competitive capabilities that rivals cannot match, or ways to make it easier and less costly for potential customers to switch their purchases from runner-up firms to the leader’s own products. It can mean aggressively attacking the profit sanctuaries of important rivals, perhaps with bursts of advertising or price-cutting or approaching its customers with special deals.24

A low-cost leader must set the pace for cost reduction, and a differentiator must constantly initiate new ways to keep its product set apart from the brands of imitative rivals in order to be the standard against which rivals’ products are judged. The array of options for a potent stay-on-the-offensive strategy can also include initiatives to expand overall industry demand—spurring the creation of new families of products, making the product more suitable for consumers in emerging-country markets, discovering new uses for the product, attracting new users of the product, and promoting more frequent use.
A stay-on-the-offensive strategy cannot be considered successful unless it results in growing sales and revenues faster than the industry as a whole and wresting market share from rivals—a leader whose sales growth is only 5 percent in a market growing at 8 percent is losing ground to some of its competitors. Only if an industry’s leader’s market share is already so dominant that it presents a threat of antitrust action (a market share under 60 percent is usually safe) should an industry leader deliberately back away from aggressively pursuing market share gains.

Illustration Capsule 8.2 describes ESPN’s stay-on-the-offensive strategy to dominate the sports entertainment business.

2. **Fortify-and-defend strategy**—The essence of “fortify and defend” is to make it harder for challengers to gain ground and for new firms to enter. The goals of a
A strong defense are to hold on to the present market share, strengthen current market position, and protect whatever competitive advantage the firm has. Specific defensive actions can include:

- Attempting to raise the competitive ante for challengers and new entrants via increased spending for advertising, higher levels of customer service, and bigger R&D outlays.
- Introducing more product versions or brands to match the product attributes that challenger brands have or to fill vacant niches that competitors could slip into.
- Adding personalized services and other extras that boost customer loyalty and make it harder or more costly for customers to switch to rival products.
- Keeping prices reasonable and quality attractive.
- Building new capacity ahead of market demand to discourage smaller competitors from adding capacity of their own.
- Investing enough to remain cost-competitive and technologically progressive.
- Patenting the feasible alternative technologies.
- Signing exclusive contracts with the best suppliers and dealer/distributors.

A fortify-and-defend strategy best suits firms that have already achieved industry dominance and don’t wish to risk antitrust action. It is also well suited to situations where a firm wishes to milk its present position for profits and cash flow because the industry’s prospects for growth are low or because further gains in market share do not appear profitable enough to go after. But a fortify-and-defend strategy always entails trying to grow as fast as the market as a whole (to stave off market-share slippage) and requires reinvesting enough capital in the business to protect the leader’s ability to compete.

3. Muscle-flexing strategy—Here a dominant leader plays competitive hardball (presumably in an ethical and competitively legal manner) when smaller rivals rock the boat with price cuts or mount new market offensives that directly threaten its position. Specific responses can include quickly matching and perhaps exceeding challengers’ price cuts, using large promotional campaigns to counter challengers’ moves to gain market share, and offering better deals to their major customers. Dominant leaders may also court distributors assiduously to dissuade them from carrying rivals’ products, provide salespersons with documented information about the weaknesses of competing products, or try to fill any vacant positions in their own firms by making attractive offers to the better executives of rivals that get out of line.

The leader may also use various arm-twisting tactics to pressure present customers not to use the products of rivals. This can range from simply forcefully communicating its displeasure should customers opt to use the products of rivals to pushing them to agree to exclusive arrangements in return for better prices to charging them a higher price if they use any competitors’ products. As a final resort, a leader may grant certain customers special discounts or preferred treatment if they do not use any products of rivals.

The obvious risks of a muscle-flexing strategy are running afoul of laws prohibiting monopoly practices and unfair competition and using bullying tactics that arouse adverse public opinion. Microsoft paid Real Networks $460 million in 2005 to resolve all of Real Network’s antitrust complaints and settle a long-standing feud over Microsoft’s repeated bullying of PC makers to include Windows Media Player instead of Real’s media player as standard installed software on their PCs. In 2005 AMD filed an antitrust suit against Intel, claiming that Intel unfairly and monopolistically
coerced 38 named companies on three continents in efforts to get them to use Intel chips instead of AMD chips in the computer products they manufactured or marketed. Consequently, a company that throws its weight around to protect and enhance its market dominance has got to be judicious, lest it cross the line from allowable muscle-flexing to unethical or illegal competitive bullying.

**STRATEGIES FOR RUNNER-UP FIRMS**

Runner-up, or second-tier, firms have smaller market shares than first-tier industry leaders. Some runner-up firms are often advancing market challengers, employing offensive strategies to gain market share and build a stronger market position. Other runner-up competitors are focusers, seeking to improve their lot by concentrating their attention on serving a limited portion of the market. There are, of course, always a number of firms in any industry that are destined to be perennial runners-up, either because they are content to follow the trendsetting moves of the market leaders or because they lack the resources and competitive strengths to do much better in the marketplace than they are already doing. But it is erroneous to view runner-up firms as inherently less profitable or unable to hold their own against the biggest firms. Many small and medium-sized firms earn healthy profits and enjoy good reputations with customers.

**Obstacles for Firms with Small Market Shares**

There are times when runner-up companies face significant hurdles in contending for market leadership. In industries where big size is definitely a key success factor, firms with small market shares have four obstacles to overcome: (1) less access to economies of scale in manufacturing, distribution, or marketing and sales promotion; (2) difficulty in gaining customer recognition (since the products and brands of the market leaders are much better known); (3) less money to spend on mass-media advertising; and (4) limited funds for capital expansion or making acquisitions. Some runner-up companies may be able to surmount these obstacles. Others may not. When significant scale economies give large-volume competitors a dominating cost advantage, small-share firms have only two viable strategic options: initiate offensive moves aimed at building sufficient sales volume to approach the scale economies and lower unit costs enjoyed by larger rivals or withdraw from the business (gradually or quickly) because of the inability to achieve low enough costs to compete effectively against the market leaders.

**Offensive Strategies to Build Market Share**

A runner-up company desirous of closing in on the market leaders has to make some waves in the marketplace if it wants to make big market share gains—this means coming up with distinctive strategy elements that set it apart from rivals and draw buyer attention. If a challenger has a 5 percent market share and needs a 15 to 20 percent share to contend for leadership and earn attractive profits, it requires a more creative approach to competing than just “Try harder” or “Follow in the footsteps of current industry leaders.” Rarely can a runner-up significantly improve its competitive position by imitating the strategies of leading firms. A cardinal rule in offensive strategy is to avoid attacking a leader head-on with an imitative strategy, regardless of the resources and staying power an underdog may have. What an aspiring challenger really needs is a strategy aimed at building a competitive advantage of its own (and certainly a strategy capable of quickly eliminating any important competitive disadvantages).
Chapter 8 Tailoring Strategy to Fit Specific Industry and Company Situations

The best “mover-and-shaker” offensives for a second-tier challenger aiming to join the first-tier ranks usually involve one of the following five approaches:

1. **Making a series of acquisitions of smaller rivals to greatly expand the company’s market reach and market presence.** *Growth via acquisition* is perhaps the most frequently used strategy employed by ambitious runner-up companies to form an enterprise that has greater competitive strength and a larger share of the overall market. For an enterprise to succeed with this strategic approach, senior management must be skilled in quickly assimilating the operations of the acquired companies, eliminating duplication and overlap, generating efficiencies and cost savings, and structuring the combined resources in ways that create substantially stronger competitive capabilities. Many banks and public accounting firms owe their growth during the past decade to acquisition of smaller regional and local banks. Likewise, a number of book publishers have grown by acquiring small publishers, and public accounting firms have grown by acquiring lesser-sized accounting firms with attractive client lists.

2. **Finding innovative ways to dramatically drive down costs and then using the attraction of lower prices to win customers from higher-cost, higher-priced rivals.** This is a necessary offensive move when a runner-up company has higher costs than larger-scale enterprises (either because the latter possess scale economies or have benefited from experience/learning curve effects). A challenger firm can pursue aggressive cost reduction by eliminating marginal activities from its value chain, streamlining supply chain relationships, improving internal operating efficiency, using various e-commerce techniques, and merging with or acquiring rival firms to achieve the size needed to capture greater scale economies.

3. **Crafting an attractive differentiation strategy based on premium quality, technological superiority, outstanding customer service, rapid product innovation, or convenient online shopping options.**

4. **Pioneering a leapfrog technological breakthrough—an attractive option if an important technological breakthrough is within a challenger’s reach and rivals are not close behind.**

5. **Being first-to-market with new or better products and building a reputation for product leadership.** A strategy of product innovation has appeal if the runner-up company possesses the necessary resources—cutting-edge R&D capability and organizational agility in speeding new products to market.

Other possible, but likely less effective, offensive strategy options include (1) outmaneuvering slow-to-change market leaders in adapting to evolving market conditions and customer expectations and (2) forging productive strategic alliances with key distributors, dealers, or marketers of complementary products.

Without a potent offensive strategy to capture added market share, runner-up companies have to patiently nibble away at the lead of market leaders and build sales at a moderate pace over time.

**Other Strategic Approaches for Runner-Up Companies**

There are five other strategies that runner-up companies can employ. While none of the five is likely to move a company from second-tier to first-tier status, all are capable of producing attractive profits and returns for shareholders.
Vacant-Niche Strategy  A version of a focused strategy, the vacant-niche strategy involves concentrating on specific customer groups or end-use applications that market leaders have bypassed or neglected. An ideal vacant niche is of sufficient size and scope to be profitable, has some growth potential, is well suited to a firm’s own capabilities, and for one reason or another is hard for leading firms to serve. Two examples where vacant-niche strategies have worked successfully are (1) regional commuter airlines serving cities with too few passengers to fill the large jets flown by major airlines and (2) health-food producers (like Health Valley, Hain, and Tree of Life) that cater to local health-food stores—a market segment that until recently has been given little attention by such leading companies as Kraft, Nestlé, and Unilever.

Specialist Strategy  A specialist firm trains its competitive effort on one technology, product or product family, end use, or market segment (often one in which buyers have special needs). The aim is to train the company’s resource strengths and capabilities on building competitive advantage through leadership in a specific area. Smaller companies that successfully use this focused strategy include Formby’s (a specialist in stains and finishes for wood furniture, especially refinishing); Blue Diamond (a California-based grower and marketer of almonds); Cuddledown (a specialty producer and retailer of down and synthetic comforters, featherbeds, and other bedding products); and American Tobacco (a leader in chewing tobacco and snuff). Many companies in high-tech industries concentrate their energies on being the clear leader in a particular technological niche; their competitive advantage is superior technological depth, technical expertise that is highly valued by customers, and the capability to consistently beat out rivals in pioneering technological advances.

Superior Product Strategy  The approach here is to use a differentiation-based focused strategy keyed to superior product quality or unique attributes. Sales and marketing efforts are aimed directly at quality-conscious and performance-oriented buyers. Fine craftsmanship, prestige quality, frequent product innovations, and/or close contact with customers to solicit their input in developing a better product usually undergird the superior product approach. Some examples include Samuel Adams in beer, Tiffany in diamonds and jewelry, Chicago Cutlery in premium-quality kitchen knives, Baccarat in fine crystal, Cannondale in mountain bikes, Bally in shoes, and Patagonia in apparel for outdoor recreation enthusiasts.

Distinctive-Image Strategy  Some runner-up companies build their strategies around ways to make themselves stand out from competitors. A variety of distinctive-image strategies can be used: building a reputation for charging the lowest prices (Dollar General), providing high-end quality at a good price (Orvis, Lands’ End, and L. L. Bean), going all out to give superior customer service (Four Seasons hotels), incorporating unique product attributes (Omega-3 enriched eggs), making a product with distinctive styling (General Motors’ Hummer), or devising unusually creative advertising (AFLAC’s duck ads on TV). Other examples include Dr Pepper’s strategy in calling attention to its distinctive taste, Apple Computer’s making it easier and more interesting for people to use its Macintosh PCs, and Mary Kay Cosmetics’ distinctive use of the color pink.

Content Follower Strategy  Content followers deliberately refrain from initiating trendsetting strategic moves and from aggressive attempts to steal customers away from the leaders. Followers prefer approaches that will not provoke competitive retaliation, often opting for focus and differentiation strategies that keep them out of the leaders’
paths. They react and respond rather than initiate and challenge. They prefer defense to offense. And they rarely get out of line with the leaders on price. They are content to simply maintain their market position, albeit sometimes struggling to do so. Followers have no urgent strategic questions to confront beyond “What strategic changes are the leaders initiating and what do we need to do to follow along and maintain our present position?” The marketers of private-label products tend to be followers, imitating many of the newly introduced features of name brand products and content to sell to price-conscious buyers at prices modestly below those of well-known brands.

**STRATEGIES FOR WEAK AND CRISIS-RIDDEN BUSINESSES**

A firm in an also-ran or declining competitive position has four basic strategic options. If it can come up with the financial resources, it can launch a turnaround strategy keyed either to “low-cost” or “new” differentiation themes, pouring enough money and talent into the effort to move up a notch or two in the industry rankings and become a respectable market contender within five years or so. It can employ a fortify-and-defend strategy, using variations of its present strategy and fighting hard to keep sales, market share, profitability, and competitive position at current levels. It can opt for a fast-exit strategy and get out of the business, either by selling out to another firm or by closing down operations if a buyer cannot be found. Or it can employ an end-game or slow-exit strategy, keeping reinvestment to a bare-bones minimum and taking actions to maximize short-term cash flows in preparation for orderly market withdrawal.

**Turnaround Strategies for Businesses in Crisis**

Turnaround strategies are needed when a business worth rescuing goes into crisis. The objective is to arrest and reverse the sources of competitive and financial weakness as quickly as possible. Management’s first task in formulating a suitable turnaround strategy is to diagnose what lies at the root of poor performance. Is it an unexpected downturn in sales brought on by a weak economy? An ill-chosen competitive strategy? Poor execution of an otherwise viable strategy? High operating costs? Important resource deficiencies? An overload of debt? The next task is to decide whether the business can be saved or whether the situation is hopeless. Understanding what is wrong with the business and how serious its strategic problems are is essential because different diagnoses lead to different turnaround strategies.

Some of the most common causes of business trouble are taking on too much debt, overestimating the potential for sales growth, ignoring the profit-depressing effects of an overly aggressive effort to “buy” market share with deep price cuts, being burdened with heavy fixed costs because weak sales don’t permit near-full capacity utilization, betting on R&D efforts but failing to come up with effective innovations, betting on technological long shots, being too optimistic about the ability to penetrate new markets, making frequent changes in strategy (because the previous strategy didn’t work out), and being overpowered by more successful rivals. Curing these kinds of problems and achieving a successful business turnaround can involve any of the following actions:

- Selling off assets to raise cash to save the remaining part of the business.
- Revising the existing strategy.
- Launching efforts to boost revenues.
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- Pursuing cost reduction.
- Using a combination of these efforts.

**Selling Off Assets**  Asset-reduction strategies are essential when cash flow is a critical consideration and when the most practical ways to generate cash are (1) through sale of some of the firm’s assets (plant and equipment, land, patents, inventories, or profitable subsidiaries) and (2) through retrenchment (pruning of marginal products from the product line, closing or selling older plants, reducing the workforce, withdrawing from outlying markets, cutting back customer service). Sometimes crisis-ridden companies sell off assets not so much to unload losing operations as to raise funds to save and strengthen the remaining business activities. In such cases, the choice is usually to dispose of noncore business assets to support strategy renewal in the firm’s core businesses.

**Strategy Revision**  When weak performance is caused by bad strategy, the task of strategy overhaul can proceed along any of several paths: (1) shifting to a new competitive approach to rebuild the firm’s market position; (2) overhauling internal operations and functional-area strategies to better support the same overall business strategy; (3) merging with another firm in the industry and forging a new strategy keyed to the newly merged firm’s strengths; and (4) retrenching into a reduced core of products and customers more closely matched to the firm’s strengths. The most appealing path depends on prevailing industry conditions, the firm’s particular strengths and weaknesses, its competitive capabilities vis-à-vis rival firms, and the severity of the crisis. A situation analysis of the industry, the major competitors, and the firm’s own competitive position is a prerequisite for action. As a rule, successful strategy revision must be tied to the ailing firm’s strengths and near-term competitive capabilities and directed at its best market opportunities.

**Boosting Revenues**  Revenue-increasing turnaround efforts aim at generating increased sales volume. The chief revenue-building options include price cuts, increased advertising, a bigger sales force, added customer services, and quickly achieved product improvements. Attempts to increase revenues and sales volumes are necessary (1) when there is little or no room in the operating budget to cut expenses and still break even, and (2) when the key to restoring profitability is increased use of existing capacity. If buyers are not especially price-sensitive (because many are strongly attached to various differentiating features in the company’s product offering), the quickest way to boost short-term revenues may be to raise prices rather than opt for volume-building price cuts. A price increase in the 2–4 percent range may well be feasible if the company’s prices are already below those of key rivals.

**Cutting Costs**  Cost-reducing turnaround strategies work best when an ailing firm’s value chain and cost structure are flexible enough to permit radical surgery, when operating inefficiencies are identifiable and readily correctable, when the firm’s costs are obviously bloated, and when the firm is relatively close to its break-even point. Accompanying a general belt-tightening can be an increased emphasis on paring administrative overheads, elimination of nonessential and low-value-added activities in the firm’s value chain, modernization of existing plant and equipment to gain greater productivity, delay of nonessential capital expenditures, and debt restructuring to reduce interest costs and stretch out repayments.
Combination Efforts  Combination turnaround strategies are usually essential in grim situations that require fast action on a broad front. Likewise, combination actions frequently come into play when new managers are brought in and given a free hand to make whatever changes they see fit. The tougher the problems, the more likely it is that the solutions will involve multiple strategic initiatives—see the story of turnaround efforts at Sony in Illustration Capsule 8.3.

The Chances of a Successful Turnaround Are Not High  Turnaround efforts tend to be high-risk undertakings; some return a company to good profitability, but most don’t. A landmark study of 64 companies found no successful turnarounds among the most troubled companies in eight basic industries.28 Many of the troubled businesses waited too long to begin a turnaround. Others found themselves short of both the cash and entrepreneurial talent needed to compete in a slow-growth industry characterized by a fierce battle for market share. Better-positioned rivals simply proved too strong to defeat in a long, head-to-head contest. Even when successful, turnaround may involve numerous attempts and management changes before long-term competitive viability and profitability are finally restored. A recent study found that troubled companies that did nothing and elected to wait out hard times had only a 10 percent chance of recovery.29 This same study also found that, of the companies studied, the chances of recovery were boosted 190 percent if the turnaround strategy involved buying assets that strengthened the company’s business in its core markets; companies that both bought assets or companies in their core markets while selling off noncore assets increased their chances of recovery by 250 percent.
Harvest Strategies for Weak Businesses

When a struggling company’s chances of pulling off a successful turnaround are poor, the wisest option may be to forget about trying to restore the company’s competitiveness and profitability and, instead employ a harvesting strategy that aims at generating the largest possible cash flows from the company’s operations for as long as possible. A losing effort to transform a competitively weak company into a viable market contender has little appeal when there are opportunities to generate potentially sizable amounts of cash by running the business in a manner calculated to either maintain the status quo or even let the business slowly deteriorate over a long period.

As is the case with a slow-exit strategy, a harvesting strategy entails trimming operating expenses to the bone and spending the minimum amount on capital projects to keep the business going. Internal cash flow becomes the key measure of how well the company is performing, and top priority is given to cash-generating actions. Thus, advertising and promotional costs are kept at minimal levels; personnel who leave for jobs elsewhere or retire may not be replaced; and maintenance is performed with an eye toward stretching the life of existing facilities and equipment. Even though a harvesting strategy is likely to lead to a gradual decline in the company’s business over time, the ability to harvest sizable amounts of cash in the interim makes such an outcome tolerable.

The Conditions That Make a Harvesting Strategy Attractive

A strategy of harvesting the cash flows from a weak business is a reasonable option in the following circumstances:30

1. When industry demand is stagnant or declining and there’s little hope that either market conditions will improve—The growing popularity of digital cameras has forever doomed market demand for camera film.
2. When rejuvenating the business would be too costly or at best marginally profitable—A struggling provider of dial-up Internet access is likely to realize more benefit from harvesting than from a losing effort to grow its business in the face of the unstoppable shift to high-speed broadband service.
3. When trying to maintain or grow the company’s present sales is becoming increasingly costly—A money-losing producer of pipe tobacco and cigars is unlikely to make market headway in gaining sales and market share against the top-tier producers (which have more resources to compete for the business that is still available).
4. When reduced levels of competitive effort will not trigger an immediate or rapid falloff in sales—the makers of corded telephones will not likely experience much of a decline in sales if they spend all of their R&D and marketing budgets on wireless phone systems.
5. When the enterprise can redeploy the freed resources in higher-opportunity areas—The makers of food products with “bad-for-you” ingredients (saturated fats, high transfats, and sugar) are better off devoting their resources to the development, production, and sale of “good-for-you” products (those with no transfats, more fiber, and good types of carbohydrates).
6. When the business is not a crucial or core component of a diversified company’s overall lineup of businesses—Harvesting a sideline business and perhaps
hastening its decay is strategically preferable to harvesting a mainline or core business (where even a gradual decline may not be a very attractive outcome).

The more of these six conditions that are present, the more ideal the business is for harvesting.

**Liquidation: The Strategy of Last Resort**

Sometimes a business in crisis is too far gone to be salvaged and presents insufficient harvesting potential to be interesting. Closing down a crisis-ridden business and liquidating its assets is sometimes the best and wisest strategy. But it is also the most unpleasant and painful strategic alternative due to the hardships of job eliminations and the economic effects of business closings on local communities. Nonetheless, in hopeless situations, an early liquidation effort usually serves owner-stockholder interests better than an inevitable bankruptcy. Prolonging the pursuit of a lost cause further erodes an organization’s resources and leaves less to salvage, not to mention the added stress and potential career impairment for all the people involved. The problem, of course, is differentiating between when a turnaround is achievable and when it isn’t. It is easy for owners or managers to let their emotions and pride overcome sound judgment when a business gets in such deep trouble that a successful turnaround is remote.

**10 COMMANDMENTS FOR CRAFTING SUCCESSFUL BUSINESS STRATEGIES**

Company experiences over the years prove again and again that disastrous strategies can be avoided by adhering to good strategy-making principles. We’ve distilled the lessons learned from the strategic mistakes companies most often make into 10 commandments that serve as useful guides for developing sound strategies:

1. **Place top priority on crafting and executing strategic moves that enhance the company’s competitive position for the long term.** The glory of meeting one quarter’s or one year’s financial performance targets quickly fades, but an ever-stronger competitive position pays off year after year. Shareholders are never well served by managers who let short-term financial performance considerations rule out strategic initiatives that will meaningfully bolster the company’s longer-term competitive position and competitive strength. The best way to ensure a company’s long-term profitability is with a strategy that strengthens the company’s long-term competitiveness and market position.

2. **Be prompt in adapting to changing market conditions, unmet customer needs, buyer wishes for something better, emerging technological alternatives, and new initiatives of competitors.** Responding late or with too little often puts a company in the precarious position of having to play catch-up. While pursuit of a consistent strategy has its virtues, adapting strategy to changing circumstances is normal and necessary. Moreover, long-term strategic commitments to achieve top quality or lowest cost should be interpreted relative to competitors’ products as well as customers’ needs and expectations; the company should avoid singlemindedly striving to make the absolute highest-quality or lowest-cost product no matter what.

3. **Invest in creating a sustainable competitive advantage.** Having a competitive edge over rivals is the single most dependable contributor to above-average profitability.
As a general rule, a company must play aggressive offense to build competitive advantage and aggressive defense to protect it.

4. Avoid strategies capable of succeeding only in the most optimistic circumstances. Expect competitors to employ countermeasures and expect times of unfavorable market conditions. A good strategy works reasonably well and produces tolerable results even in the worst of times.

5. Consider that attacking competitive weakness is usually more profitable and less risky than attacking competitive strength. Attacking capable, resourceful rivals is likely to fail unless the attacker has deep financial pockets and a solid basis for competitive advantage despite the strengths of the competitor being attacked.

6. Strive to open up very meaningful gaps in quality or service or performance features when pursuing a differentiation strategy. Tiny differences between rivals’ product offerings may not be visible or important to buyers.

7. Be wary of cutting prices without an established cost advantage. Price cuts run the risk that rivals will retaliate with matching or deeper price cuts of their own. The best chance for remaining profitable if the price-cutting contest turns into a price war is to have lower costs than rivals.

8. Don’t underestimate the reactions and the commitment of rival firms. Rivals are most dangerous when they are pushed into a corner and their well-being is threatened.

9. Avoid stuck-in-the-middle strategies that represent compromises between lower costs and greater differentiation and between broad and narrow market appeal. Compromise strategies rarely produce sustainable competitive advantage or a distinctive competitive position—a well-executed best-cost producer strategy is the only exception in which a compromise between low cost and differentiation succeeds. Companies with compromise strategies most usually end up with average costs, an average product, an average reputation, and no distinctive image in the marketplace. Lacking any strategy element that causes them to stand out in the minds of buyers, companies with compromise strategies are destined for a middle-of-the-pack industry ranking, with little prospect of ever becoming an industry leader.

10. Be judicious in employing aggressive moves to wrest market share away from rivals that often provoke retaliation in the form of escalating marketing and sales promotion, a furious race to be first-to-market with next-version products or a price war—to the detriment of everyone’s profits. Aggressive moves to capture a bigger market share invite cutthroat competition, especially when many industry members, plagued with high inventories and excess production capacity, are also scrambling for additional sales.

Key Points

The lessons of this chapter are that (1) some strategic options are better suited to certain specific industry and competitive environments than others and (2) some strategic options are better suited to certain specific company situations than others. Crafting a strategy tightly matched to a company’s situation thus involves being alert to which
strategy alternatives are likely to work well and which alternatives are unlikely to work well. Specifically:

1. What basic type of industry environment (emerging, rapid-growth, mature/slow-growth, stagnant/declining, high-velocity/turbulent, fragmented) does the company operate in? What strategic options and strategic postures are usually best suited to this generic type of environment?

2. What position does the firm have in the industry (leader, runner-up, or weak/distressed)? Given this position, which strategic options merit strong consideration and which options should definitely be ruled out?

In addition, creating a tight strategy-situation fit entails considering all the external and internal situational factors discussed in Chapters 3 and 4 and then revising the list of strategy options accordingly to take account of competitive conditions, industry driving forces, the expected moves of rivals, and the company’s own competitive strengths and weaknesses. Listing the pros and cons of the candidate strategies is nearly always a helpful step. In weeding out the least attractive strategic alternatives and weighing the pros and cons of the most attractive ones, the answers to four questions often help point to the best course of action:

1. What kind of competitive edge can the company realistically achieve, given its resource strengths, competencies, and competitive capabilities? Is the company in a position to lead industry change and set the rules by which rivals must compete?

2. Which strategy alternative best addresses all the issues and problems the firm confronts.

3. Are any rivals particularly vulnerable and, if so, what sort of an offensive will it take to capitalize on these vulnerabilities? Will rivals counterattack? What can be done to blunt their efforts?

4. Are any defensive actions needed to protect against rivals’ likely moves or other external threats to the company’s future profitability?

In picking and choosing among the menu of strategic options, there are four pitfalls to avoid:

1. Designing an overly ambitious strategic plan—one that overtaxes the company’s resources and capabilities.

2. Selecting a strategy that represents a radical departure from or abandonment of the cornerstones of the company’s prior success—a radical strategy change need not be rejected automatically, but it should be pursued only after careful risk assessment.

3. Choosing a strategy that goes against the grain of the organization’s culture.

4. Being unwilling to commit wholeheartedly to one of the five competitive strategies—picking and choosing features of the different strategies usually produces so many compromises between low cost, best cost, differentiation, and focusing that the company fails to achieve any kind of advantage and ends up stuck in the middle.

Table 8.1 provides a generic format for outlining a strategic action plan for a single-business enterprise. It contains all of the pieces of a comprehensive strategic action plan that we discussed at various places in these first eight chapters.
Table 8.1 Sample Format for a Strategic Action Plan

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>2. Strategic Objectives</td>
<td>• Production</td>
</tr>
<tr>
<td>• Short-term</td>
<td>• Marketing/sales</td>
</tr>
<tr>
<td>• Long-term</td>
<td>• Finance</td>
</tr>
<tr>
<td>3. Financial Objectives</td>
<td>• Personnel/human resources</td>
</tr>
<tr>
<td>• Short-term</td>
<td>• Other</td>
</tr>
<tr>
<td>• Long-term</td>
<td></td>
</tr>
<tr>
<td>4. Overall Business Strategy</td>
<td>6. Recommended Actions to Improve Company Performance</td>
</tr>
<tr>
<td></td>
<td>• Immediate</td>
</tr>
<tr>
<td></td>
<td>• Longer-range</td>
</tr>
</tbody>
</table>

Exercises

1. Listed below are 10 industries. Classify each one as (a) emerging, (b) rapid-growth, (c) mature/slow-growth, (d) stagnant/declining, (e) high-velocity/turbulent, and (f) fragmented. Do research on the Internet, if needed, to locate information on industry conditions and reach a conclusion on what classification to assign each of the following:

   a. Exercise and fitness industry.
   b. Dry-cleaning industry.
   c. Poultry industry.
   d. Camera film and film-developing industry.
   e. Wine, beer, and liquor retailing.
   f. Watch industry.
   g. Cell-phone industry.
   h. Recorded music industry (DVDs, CDs, tapes).
   i. Computer software industry.
   j. Newspaper industry.
2. Toyota overtook Ford Motor Company in 2003 to become the world’s second-largest maker of motor vehicles, behind General Motors. Toyota is widely regarded as having aspirations to overtake General Motors as the global leader in motor vehicles within the next 10 years. Do research on the Internet or in the library to determine what strategy General Motors is pursuing to maintain its status as the industry leader. Then research Toyota’s strategy to overtake General Motors.

3. Review the discussion in Illustration Capsule 8.1 concerning the focused differentiation strategy that Exertris has employed in the exercise equipment industry. Then answer the following:
   a. What reasons can you give for why sales of the Exertris exercise bike have not taken off?
   b. What strategic actions would you recommend to the cofounders of Exertris to spark substantially greater sales of its innovative exercise bike and overcome the apparent market apathy for its video-game-equipped exercise bike? Should the company consider making any changes in its product offering? What distribution channels should it emphasize? What advertising and promotional approaches should be considered? How can it get gym owners to purchase or at least try its bikes?
   c. Should the company just give up on its product innovation (because the bike is not ever likely to get good reception in the marketplace)? Or should the cofounders try to sell their fledgling business to another exercise equipment company with a more extensive product line and wider geographic coverage?

4. Review the information in Illustration Capsule 8.3 concerning the turnaround strategy Sony launched in the fall of 2005. Go to the company’s Web site and check out other Internet sources to see how Sony’s strategy to revitalize its electronics business is coming along. Does your research indicate that Sony’s turnaround strategy is a success or a failure, or is it still too early to tell? Explain.

5. Yahoo competes in an industry characterized by high-velocity change. Read the company’s press releases at [http://yhoo.client.shareholder.com/releases.cfm](http://yhoo.client.shareholder.com/releases.cfm) and answer the following questions:
   a. Does it appear that the company has dealt with change in the industry by reacting to change, anticipating change, or leading change? Explain.
   b. What are its key strategies for competing in fast-changing markets? Describe them.
Chapter Nine

Diversification

Strategies for Managing a Group of Businesses

To acquire or not to acquire: that is the question.
—Robert J. Terry

Fit between a parent and its businesses is a two-edged sword: a good fit can create value; a bad one can destroy it.
—Andrew Campbell, Michael Goold, and Marcus Alexander

Achieving superior performance through diversification is largely based on relatedness.
—Philippe Véry

Make winners out of every business in your company. Don’t carry losers.
—Jack Welch
Former CEO, General Electric

We measure each of our businesses against strict criteria: growth, margin, and return-on-capital hurdle rate, and does it have the ability to become number one or two in its industry? We are quite pragmatic. If a business does not contribute to our overall vision, it has to go.
—Richard Wambold
CEO, Pactiv
In this chapter, we move up one level in the strategy-making hierarchy, from strategy making in a single-business enterprise to strategy making in a diversified enterprise. Because a diversified company is a collection of individual businesses, the strategy-making task is more complicated. In a one-business company, managers have to come up with a plan for competing successfully in only a single industry environment—the result is what we labeled in Chapter 2 as business strategy (or business-level strategy). But in a diversified company, the strategy-making challenge involves assessing multiple industry environments and developing a set of business strategies, one for each industry arena in which the diversified company operates. And top executives at a diversified company must still go one step further and devise a company-wide or corporate strategy for improving the attractiveness and performance of the company’s overall business lineup and for making a rational whole out of its diversified collection of individual businesses.

In most diversified companies, corporate-level executives delegate considerable strategy-making authority to the heads of each business, usually giving them the latitude to craft a business strategy suited to their particular industry and competitive circumstances and holding them accountable for producing good results. But the task of crafting a diversified company’s overall or corporate strategy falls squarely in the lap of top-level executives and involves four distinct facets:

1. **Picking new industries to enter and deciding on the means of entry**—The first concerns in diversifying are what new industries to get into and whether to enter by starting a new business from the ground up, acquiring a company already in the target industry, or forming a joint venture or strategic alliance with another company. A company can diversify narrowly into a few industries or broadly into many industries. The choice of whether to enter an industry via a start-up operation; a joint venture; or the acquisition of an established leader, an up-and-coming company, or a troubled company with turnaround potential shapes what position the company will initially stake out for itself.
2. Initiating actions to boost the combined performance of the businesses the firm has entered—As positions are created in the chosen industries, corporate strategists typically zero in on ways to strengthen the long-term competitive positions and profits of the businesses the firm has invested in. Corporate parents can help their business subsidiaries by providing financial resources, by supplying missing skills or technological know-how or managerial expertise to better perform key value chain activities, and by providing new avenues for cost reduction. They can also acquire another company in the same industry and merge the two operations into a stronger business, or acquire new businesses that strongly complement existing businesses. Typically, a company will pursue rapid-growth strategies in its most promising businesses, initiate turnaround efforts in weak-performing businesses with potential, and divest businesses that are no longer attractive or that don’t fit into management’s long-range plans.

3. Pursuing opportunities to leverage cross-business value chain relationships and strategic fits into competitive advantage—A company that diversifies into businesses with competitively important value chain matchups (pertaining to technology, supply chain logistics, production, overlapping distribution channels, or common customers) gains competitive advantage potential not open to a company that diversifies into businesses whose value chains are totally unrelated. Capturing this competitive advantage potential requires that corporate strategists spend considerable time trying to capitalize on such cross-business opportunities as transferring skills or technology from one business to another, reducing costs via sharing use of common facilities and resources, and using the company’s well-known brand names and distribution muscle to grow the sales of newly acquired products.

4. Establishing investment priorities and steering corporate resources into the most attractive business units—A diversified company’s different businesses are usually not equally attractive from the standpoint of investing additional funds. It is incumbent on corporate management to (a) decide on the priorities for investing capital in the company’s different businesses, (b) channel resources into areas where earnings potentials are higher and away from areas where they are lower, and (c) divest business units that are chronically poor performers or are in an increasingly unattractive industry. Divesting poor performers and businesses in unattractive industries frees up unproductive investments either for redeployment to promising business units or for financing attractive new acquisitions.

The demanding and time-consuming nature of these four tasks explains why corporate executives generally refrain from becoming immersed in the details of crafting and implementing business-level strategies, preferring instead to delegate lead responsibility for business strategy to the heads of each business unit.

In the first portion of this chapter we describe the various means a company can use to become diversified and explore the pros and cons of related versus unrelated diversification strategies. The second part of the chapter looks at how to evaluate the attractiveness of a diversified company’s business lineup, decide whether it has a good diversification strategy, and identify ways to improve its future performance. In the chapter’s concluding section, we survey the strategic options open to already-diversified companies.
WHEN TO DIVERSIFY

So long as a company has its hands full trying to capitalize on profitable growth opportunities in its present industry, there is no urgency to pursue diversification. The big risk of a single-business company, of course, is having all of the firm’s eggs in one industry basket. If demand for the industry’s product is eroded by the appearance of alternative technologies, substitute products, or fast-shifting buyer preferences, or if the industry becomes competitively unattractive and unprofitable, then a company’s prospects can quickly dim. Consider, for example, what digital cameras have done to erode the revenues of companies dependent on making camera film and doing film processing, what CD and DVD technology have done to business outlook for producers of cassette tapes and 3.5-inch disks, and what cell-phone companies with their no-long-distance-charge plans and marketers of Voice over Internet Protocol (VoIP) are doing to the revenues of such once-dominant long-distance providers as AT&T, British Telecommunications, and NTT in Japan.

Thus, diversifying into new industries always merits strong consideration whenever a single-business company encounters diminishing market opportunities and stagnating sales in its principal business—most landline-based telecommunications companies across the world are quickly diversifying their product offerings to include wireless and VoIP services. But there are four other instances in which a company becomes a prime candidate for diversifying:

1. When it spots opportunities for expanding into industries whose technologies and products complement its present business.
2. When it can leverage existing competencies and capabilities by expanding into businesses where these same resource strengths are key success factors and valuable competitive assets.
3. When diversifying into closely related businesses opens new avenues for reducing costs.
4. When it has a powerful and well-known brand name that can be transferred to the products of other businesses and thereby used as a lever for driving up the sales and profits of such businesses.

The decision to diversify presents wide-open possibilities. A company can diversify into closely related businesses or into totally unrelated businesses. It can diversify its present revenue and earning base to a small extent (such that new businesses account for less than 15 percent of companywide revenues and profits) or to a major extent (such that new businesses produce 30 or more percent of revenues and profits). It can move into one or two large new businesses or a greater number of small ones. It can achieve multibusiness/multi-industry status by acquiring an existing company already in a business/industry it wants to enter, starting up a new business subsidiary from scratch, or forming a joint venture with one or more companies to enter new businesses.

BUILDING SHAREHOLDER VALUE: THE ULTIMATE JUSTIFICATION FOR DIVERSIFYING

Diversification must do more for a company than simply spread its business risk across various industries. In principle, diversification cannot be considered a success unless
it results in **added shareholder value**—value that shareholders cannot capture on their own by purchasing stock in companies in different industries or investing in mutual funds so as to spread their investments across several industries.

For there to be reasonable expectations that a company’s diversification efforts can produce added value, a move to diversify into a new business must pass three tests:

1. **The industry attractiveness test**—The industry to be entered must be attractive enough to yield consistently good returns on investment. Whether an industry is attractive depends chiefly on the presence of industry and competitive conditions that are conducive to earning as good or better profits and return on investment than the company is earning in its present business(es). It is hard to justify diversifying into an industry where profit expectations are **lower** than in the company’s present businesses.

2. **The cost-of-entry test**—The cost to enter the target industry must not be so high as to erode the potential for good profitability. A catch-22 can prevail here, however. The more attractive an industry’s prospects are for growth and good long-term profitability, the more expensive it can be to get into. Entry barriers for start-up companies are likely to be high in attractive industries; were barriers low, a rush of new entrants would soon erode the potential for high profitability. And buying a well-positioned company in an appealing industry often entails a high acquisition cost that makes passing the cost-of-entry test less likely. For instance, suppose that the price to purchase a company is $3 million and that the company is earning after-tax profits of $200,000 on an equity investment of $1 million (a 20 percent annual return). Simple arithmetic requires that the profits be tripled if the purchaser (paying $3 million) is to earn the same 20 percent return. Building the acquired firm’s earnings from $200,000 to $600,000 annually could take several years—and require additional investment on which the purchaser would also have to earn a 20 percent return. Since the owners of a successful and growing company usually demand a price that reflects their business’s profit prospects, it’s easy for such an acquisition to fail the cost-of-entry test.

3. **The better-off test**—Diversifying into a new business must offer potential for the company’s existing businesses and the new business to perform better together under a single corporate umbrella than they would perform operating as independent, stand-alone businesses. For example, let’s say that company A diversifies by purchasing company B in another industry. If A and B’s consolidated profits in the years to come prove no greater than what each could have earned on its own, then A’s diversification won’t provide its shareholders with added value. Company A’s shareholders could have achieved the same 1 + 1 = 2 result by merely purchasing stock in company B. Shareholder value is not created by diversification unless it produces a 1 + 1 = 3 effect where sister businesses **perform better together** as part of the same firm than they could have performed as independent companies.

Diversification moves that satisfy all three tests have the greatest potential to grow shareholder value over the long term. Diversification moves that can pass only one or two tests are suspect.

### STRATEGIES FOR ENTERING NEW BUSINESSES

The means of entering new businesses can take any of three forms: acquisition, internal start-up, or joint ventures with other companies.
Acquisition of an Existing Business

Acquisition is the most popular means of diversifying into another industry. Not only is it quicker than trying to launch a brand-new operation, but it also offers an effective way to hurdle such entry barriers as acquiring technological know-how, establishing supplier relationships, becoming big enough to match rivals’ efficiency and unit costs, having to spend large sums on introductory advertising and promotions, and securing adequate distribution. Buying an ongoing operation allows the acquirer to move directly to the task of building a strong market position in the target industry, rather than getting bogged down in going the internal start-up route and trying to develop the knowledge, resources, scale of operation, and market reputation necessary to become an effective competitor within a few years.

The big dilemma an acquisition-minded firm faces is whether to pay a premium price for a successful company or to buy a struggling company at a bargain price. If the buying firm has little knowledge of the industry but ample capital, it is often better off purchasing a capable, strongly positioned firm—unless the price of such an acquisition flunks the cost-of-entry test. However, when the acquirer sees promising ways to transform a weak firm into a strong one and has the resources, the know-how, and the patience to do it, a struggling company can be the better long-term investment.

Internal Start-Up

Achieving diversification through internal start-up involves building a new business subsidiary from scratch. This entry option takes longer than the acquisition option and poses some hurdles. A newly formed business unit not only has to overcome entry barriers but also has to invest in new production capacity, develop sources of supply, hire and train employees, build channels of distribution, grow a customer base, and so on. Generally, forming a start-up subsidiary to enter a new business has appeal only when (1) the parent company already has in-house most or all of the skills and resources it needs to piece together a new business and compete effectively; (2) there is ample time to launch the business; (3) internal entry has lower costs than entry via acquisition; (4) the targeted industry is populated with many relatively small firms such that the new start-up does not have to compete head-to-head against larger, more powerful rivals; (5) adding new production capacity will not adversely impact the supply–demand balance in the industry; and (6) incumbent firms are likely to be slow or ineffective in responding to a new entrant’s efforts to crack the market.

Joint Ventures

Joint ventures entail forming a new corporate entity owned by two or more companies, where the purpose of the joint venture is to pursue a mutually attractive opportunity. The terms and conditions of a joint venture concern joint operation of a mutually owned business, which tends to make the arrangement more definitive and perhaps more durable than a strategic alliance—in a strategic alliance, the arrangement between the partners is one of limited collaboration for a limited purpose and a partner can choose to simply walk away or reduce its commitment at any time.

A joint venture to enter a new business can be useful in at least three types of situations. First, a joint venture is a good vehicle for pursuing an opportunity that is too complex, uneconomical, or risky for one company to pursue alone. Second, joint
ventures make sense when the opportunities in a new industry require a broader range of competencies and know-how than a company can marshal. Many of the opportunities in satellite-based telecommunications, biotechnology, and network-based systems that blend hardware, software, and services call for the coordinated development of complementary innovations and tackling an intricate web of financial, technical, political, and regulatory factors simultaneously. In such cases, pooling the resources and competencies of two or more companies is a wiser and less risky way to proceed.

Third, companies sometimes use joint ventures to diversify into a new industry when the diversification move entails having operations in a foreign country—several governments require foreign companies operating within their borders to have a local partner that has minority, if not majority, ownership in the local operations. Aside from fulfilling host government ownership requirements, companies usually seek out a local partner with expertise and other resources that will aid the success of the newly established local operation.

However, as discussed in Chapters 6 and 7, partnering with another company—in either a joint venture or a collaborative alliance—has significant drawbacks due to the potential for conflicting objectives, disagreements over how to best operate the venture, culture clashes, and so on. Joint ventures are generally the least durable of the entry options, usually lasting only until the partners decide to go their own ways.

CHOOSING THE DIVERSIFICATION PATH: RELATED VERSUS UNRELATED BUSINESSES

Once a company decides to diversify, its first big strategy decision is whether to diversify into related businesses, unrelated businesses, or some mix of both (see Figure 9.1). Businesses are said to be related when their value chains possess competitively valuable cross-business relationships that present opportunities for the businesses to perform better under the same corporate umbrella than they could by operating as stand-alone entities. The big appeal of related diversification is to build shareholder value by leveraging these cross-business relationships into competitive advantage, thus allowing the company as a whole to perform better than just the sum of its individual businesses. Businesses are said to be unrelated when the activities comprising their respective value chains are so dissimilar that no competitively valuable cross-business relationships are present.

The next two sections of this chapter explore the ins and outs of related and unrelated diversification.

THE CASE FOR DIVERSIFYING INTO RELATED BUSINESSES

A related diversification strategy involves building the company around businesses whose value chains possess competitively valuable strategic fits, as shown in Figure 9.2. Strategic fit exists whenever one or more activities comprising the value chains of different businesses are sufficiently similar as to present opportunities for:

- Transferring competitively valuable expertise, technological know-how, or other capabilities from one business to another.
Combining the related value chain activities of separate businesses into a single operation to achieve lower costs. For instance, it is often feasible to manufacture the products of different businesses in a single plant or use the same warehouses for shipping and distribution or have a single sales force for the products of different businesses (because they are marketed to the same types of customers).

Exploiting common use of a well-known and potent brand name. For example, Honda’s name in motorcycles and automobiles gave it instant credibility and recognition in entering the lawn-mower business, allowing it to achieve a significant market share without spending large sums on advertising to establish a brand identity for its lawn mowers. Canon’s reputation in photographic equipment was a competitive asset that facilitated the company’s diversification into copying equipment. Sony’s name in consumer electronics made it easier and cheaper for Sony to enter the market for video games with its PlayStation console and lineup of PlayStation video games.

Cross-business collaboration to create competitively valuable resource strengths and capabilities.
Related diversification thus has strategic appeal from several angles. It allows a firm to reap the competitive advantage benefits of skills transfer, lower costs, a powerful brand name, and/or stronger competitive capabilities and still spread investor risks over a broad business base. Furthermore, the relatedness among the different businesses provides sharper focus for managing diversification and a useful degree of strategic unity across the company’s various business activities.

**Identifying Cross-Business Strategic Fits along the Value Chain**

Cross-business strategic fits can exist anywhere along the value chain—in R&D and technology activities, in supply chain activities and relationships with suppliers, in manufacturing, in sales and marketing, in distribution activities, or in administrative support activities.7

**Strategic Fits in R&D and Technology Activities** Diversifying into businesses where there is potential for sharing common technology, exploiting the full range of business opportunities associated with a particular technology and its derivatives,
or transferring technological know-how from one business to another has considerable appeal. Businesses with technology-sharing benefits can perform better together than apart because of potential cost savings in R&D and potentially shorter times in getting new products to market; also, technological advances in one business can lead to increased sales for both. Technological innovations have been the driver behind the efforts of cable TV companies to diversify into high-speed Internet access (via the use of cable modems) and, further, to explore providing local and long-distance telephone service to residential and commercial customers in either a single wire or using VoIP technology.

**Strategic Fits in Supply Chain Activities** Businesses that have supply chain strategic fits can perform better together because of the potential for skills transfer in procuring materials, greater bargaining power in negotiating with common suppliers, the benefits of added collaboration with common supply chain partners, and/or added leverage with shippers in securing volume discounts on incoming parts and components. Dell Computer’s strategic partnerships with leading suppliers of microprocessors, motherboards, disk drives, memory chips, flat-panel displays, wireless capabilities, long-life batteries, and other PC-related components have been an important element of the company’s strategy to diversify into servers, data storage devices, MP3 players, and LCD TVs—products that include many components common to PCs and that can be sourced from the same strategic partners that provide Dell with PC components.

**Manufacturing-Related Strategic Fits** Cross-business strategic fits in manufacturing-related activities can represent an important source of competitive advantage in situations where a diversifier’s expertise in quality manufacture and cost-efficient production methods can be transferred to another business. When Emerson Electric diversified into the chain-saw business, it transferred its expertise in low-cost manufacture to its newly acquired Beaird-Poulan business division; the transfer drove Beaird-Poulan’s new strategy—to be the low-cost provider of chain-saw products—and fundamentally changed the way Beaird-Poulan chain saws were designed and manufactured. Another benefit of production-related value chain matchups is the ability to consolidate production into a smaller number of plants and significantly reduce overall production costs. When snowmobile maker Bombardier diversified into motorcycles, it was able to set up motorcycle assembly lines in the same manufacturing facility where it was assembling snowmobiles. When Smuckers acquired Procter & Gamble’s Jif peanut butter business, it was able to combine the manufacture of its own Smucker’s peanut butter products with those of Jif; in addition, it gained greater leverage with vendors in purchasing its peanut supplies.

**Distribution-Related Strategic Fits** Businesses with closely related distribution activities can perform better together than apart because of potential cost savings in sharing the same distribution facilities or using many of the same wholesale distributors and retail dealers to access customers. When Sunbeam acquired Mr. Coffee, it was able to consolidate its own distribution centers for small household appliances with those of Mr. Coffee, thereby generating considerable cost savings. Likewise, since Sunbeam products were sold to many of the same retailers as Mr. Coffee products (Wal-Mart, Kmart, Target, department stores, home centers, hardware chains, supermarket chains, and drugstore chains), Sunbeam was able to convince many of the retailers carrying Sunbeam appliances to also take on the Mr. Coffee line and vice versa.
Strategic Fits in Sales and Marketing Activities  Various cost-saving opportunities spring from diversifying into businesses with closely related sales and marketing activities. The same distribution centers can be used for warehousing and shipping the products of different businesses. When the products are sold directly to the same customers, sales costs can often be reduced by using a single sales force and avoiding having two different salespeople call on the same customer. The products of related businesses can be promoted at the same Web site, and included in the same media ads and sales brochures. After-sale service and repair organizations for the products of closely related businesses can often be consolidated into a single operation. There may be opportunities to reduce costs by consolidating order processing and billing and using common promotional tie-ins (cents-off couponing, free samples and trial offers, seasonal specials, and the like). When global power-tool maker Black & Decker acquired General Electric’s domestic small household appliance business, it was able to use its own global sales force and distribution facilities to sell and distribute the newly acquired GE line of toasters, irons, mixers, and coffeemakers because the types of customers that carried its power tools (discounters like Wal-Mart and Target, home centers, and hardware stores) also stocked small appliances. The economies Black & Decker achieved for both product lines were substantial.

A second category of benefits arises when different businesses use similar sales and marketing approaches; in such cases, there may be competitively valuable opportunities to transfer selling, merchandising, advertising, and product differentiation skills from one business to another. Procter & Gamble’s product lineup includes Folgers coffee, Tide laundry detergent, Crest toothpaste, Ivory soap, Charmin toilet tissue, Gillette razors and blades, Duracell batteries, Oral-B toothbrushes, and Head & Shoulders shampoo. All of these have different competitors and different supply chain and production requirements, but they all move through the same wholesale distribution systems, are sold in common retail settings to the same shoppers, are advertised and promoted in much the same ways, and require the same marketing and merchandising skills.

Strategic Fits in Managerial and Administrative Support Activities  Often, different businesses require comparable types managerial know-how, thereby allowing know-how in one line of business to be transferred to another. At General Electric (GE), managers who were involved in GE’s expansion into Russia were able to expedite entry because of information gained from GE managers involved in expansions into other emerging markets. The lessons GE managers learned in China were passed along to GE managers in Russia, allowing them to anticipate that the Russian government would demand that GE build production capacity in the country rather than enter the market through exporting or licensing. In addition, GE’s managers in Russia were better able to develop realistic performance expectations and make tough upfront decisions since experience in China and elsewhere warned them (1) that there would likely be increased short-term costs during the early years of start-up and (2) that if GE committed to the Russian market for the long term and aided the country’s economic development it could eventually expect to be given the freedom to pursue profitable penetration of the Russian market.¹

Likewise, different businesses can often use the same administrative and customer service infrastructure. For instance, an electric utility that diversifies into natural gas, water, appliance sales and repair services, and home security services can use the same customer data network, the same customer call centers and local offices, the same
billing and customer accounting systems, and the same customer service infrastructure to support all of its products and services.

Illustration Capsule 9.1 lists the businesses of five companies that have pursued a strategy of related diversification.

**L’ORÉAL**
- Maybelline, Lancôme, Helena Rubenstein, Kiehl’s, Garner, and Shu Uemura cosmetics.
- L’Oréal and Soft Sheen/Carson hair care products.
- Redken, Matrix, L’Oréal Professional, and Kerastase Paris professional hair care and skin care products.
- Ralph Lauren and Giorgio Armani fragrances.
- Biotherm skin care products.
- La Roche-Posay and Vichy Laboratories dermocosmetics.

**JOHNSON & JOHNSON**
- Baby products (powder, shampoo, oil, lotion).
- Band-Aids and other first-aid products.
- Women’s health and personal care products (Stayfree, Carefree, Sure & Natural).
- Neutrogena and Aveeno skin care products.
- Nonprescription drugs (Tylenol, Motrin, Pepcid AC, Mylanta, Monistat).
- Prescription drugs.
- Prosthetic and other medical devices.
- Surgical and hospital products.
- Accuvue contact lenses.

**PEPSICO**
- Soft drinks (Pepsi, Diet Pepsi, Pepsi One, Mountain Dew, Mug, Slice).
- Fruit juices (Tropicana and Dole).
- Sports drinks (Gatorade).
- Other beverages (Aquafina bottled water, SoBe, Lipton ready-to-drink tea, Frappucino—in partnership with Starbucks, international sales of 7UP).
- Snack foods (Fritos, Lay’s, Ruffles, Doritos, Tostitos, Santitas, Smart Food, Rold Gold pretzels, Chee-tos, Grandma’s cookies, Sun Chips, Cracker Jack, Frito-Lay dips and salsas).
- Cereals, rice, and breakfast products (Quaker oatmeal, Cap’n Crunch, Life, Rice-A-Roni, Quaker rice cakes, Aunt Jemima mixes and syrups, Quaker grits).

**DARDEN RESTAURANTS**
- Olive Garden restaurant chain (Italian-themed).
- Red Lobster restaurant chain (seafood-themed).
- Bahama Breeze restaurant chain (Caribbean-themed).

See if you can identify the value chain relationships that make the businesses of the following companies related in competitively relevant ways. In particular, you should consider whether there are cross-business opportunities for (1) transferring skills/technology, (2) combining related value chain activities to achieve lower costs, (3) leveraging use of a well-respected brand name, and/or (4) establishing cross-business collaboration to create new resource strengths and capabilities.

**Strategic Fit, Economies of Scope, and Competitive Advantage**

What makes related diversification an attractive strategy is the opportunity to convert cross-business strategic fits into a competitive advantage over business rivals.
whose operations do not offer comparable strategic-fit benefits. The greater the relatedness among a diversified company’s sister businesses, the bigger a company’s window for converting strategic fits into competitive advantage via (1) skills transfer, (2) combining related value chain activities to achieve lower costs, (3) leveraging use of a well-respected brand name, and/or (4) cross-business collaboration to create new resource strengths and capabilities.

**Economies of Scope: A Path to Competitive Advantage** One of the most important competitive advantages that a related diversification strategy can produce is lower costs than competitors. Related businesses often present opportunities to eliminate or reduce the costs of performing certain value chain activities; such cost savings are termed **economies of scope**—a concept distinct from **economies of scale**. Economies of scale are cost savings that accrue directly from a larger-sized operation; for example, unit costs may be lower in a large plant than in a small plant, lower in a large distribution center than in a small one, and lower for large-volume purchases of components than for small-volume purchases. Economies of scope, however, stem directly from cost-saving strategic fits along the value chains of related businesses. Such economies are open only to a multibusiness enterprise and are the result of a related diversification strategy that allows sister businesses to share technology, perform R&D together, use common manufacturing or distribution facilities, share a common sales force or distributor/dealer network, use the same established brand name, and/or share the same administrative infrastructure. The greater the cross-business economies associated with cost-saving strategic fits, the greater the potential for a related diversification strategy to yield a competitive advantage based on lower costs than rivals.

**From Competitive Advantage to Added Profitability and Gains in Shareholder Value** The competitive advantage potential that flows from economies of scope and the capture of other strategic-fit benefits is what enables a company pursuing related diversification to achieve $1 + 1 = 3$ financial performance and the hoped-for gains in shareholder value. The strategic and business logic is compelling: Capturing strategic fits along the value chains of its related businesses gives a diversified company a clear path to achieving competitive advantage over undiversified competitors and competitors whose own diversification efforts don’t offer equivalent strategic-fit benefits. Such competitive advantage potential provides a company with a dependable basis for earning profits and a return on investment that exceed what the company’s businesses could earn as stand-alone enterprises. Converting the competitive advantage potential into greater profitability is what fuels $1 + 1 = 3$ gains in shareholder value—the necessary outcome for satisfying the better-off test and proving the business merit of a company’s diversification effort.

There are three things to bear in mind here. One, capturing cross-business strategic fits via a strategy of related diversification builds shareholder value in ways that shareholders cannot undertake by simply owning a portfolio of stocks of companies in different industries. Two, the capture of cross-business strategic-fit benefits is possible only via a strategy of related diversification. Three, the benefits of cross-business strategic fits are not automatically realized when a company diversifies into related businesses; the benefits materialize only after management has successfully pursued internal actions to capture them.
Figure 9.3  Unrelated Businesses Have Unrelated Value Chains and No Strategic Fits

An unrelated diversification strategy discounts the merits of pursuing cross-business strategic fits and, instead, focuses squarely on entering and operating businesses in industries that allow the company as a whole to grow its revenues and earnings. Companies that pursue a strategy of unrelated diversification generally exhibit a willingness to diversify into any industry where senior managers see opportunity to realize consistently good financial results—the basic premise of unrelated diversification is that any company or business that can be acquired on good financial terms and that has satisfactory growth and earnings potential represents a good acquisition and a good business opportunity. With a strategy of unrelated diversification, the emphasis is on satisfying the attractiveness and cost-of-entry tests and each business’s prospects for good financial performance. As indicated in Figure 9.3, there’s no deliberate effort to satisfy the better-off test in the sense of diversifying only into businesses having strategic fits with the firm’s other businesses.

Thus, with an unrelated diversification strategy, company managers spend much time and effort screening acquisition candidates and evaluating the pros and cons of keeping or divesting existing businesses, using such criteria as:

- Whether the business can meet corporate targets for profitability and return on investment.
Companies that pursue unrelated diversification nearly always enter new businesses by acquiring an established company rather than by forming a start-up subsidiary within their own corporate structures. The premise of acquisition-minded corporations is that growth by acquisition can deliver enhanced shareholder value through upward-trending corporate revenues and earnings and a stock price that on average rises enough year after year to amply reward and please shareholders. Three types of acquisition candidates are usually of particular interest: (1) businesses that have bright growth prospects but are short on investment capital—cash-poor, opportunity-rich businesses are highly coveted acquisition targets for cash-rich companies scouting for good market opportunities; (2) undervalued companies that can be acquired at a bargain price; and (3) struggling companies whose operations can be turned around with the aid of the parent company’s financial resources and managerial know-how.

A key issue in unrelated diversification is how wide a net to cast in building a portfolio of unrelated businesses. In other words, should a company pursuing unrelated diversification seek to have few or many unrelated businesses? How much business diversity can corporate executives successfully manage? A reasonable way to resolve the issue of how much diversification comes from answering two questions: “What is the least diversification it will take to achieve acceptable growth and profitability?” and “What is the most diversification that can be managed, given the complexity it adds?” The optimal amount of diversification usually lies between these two extremes.

Illustration Capsule 9.2 lists the businesses of three companies that have pursued unrelated diversification. Such companies are frequently labeled conglomerates because their business interests range broadly across diverse industries.

**The Merits of an Unrelated Diversification Strategy**

A strategy of unrelated diversification has appeal from several angles:

1. Business risk is scattered over a set of truly diverse industries. In comparison to related diversification, unrelated diversification more closely approximates pure diversification of financial and business risk because the company’s investments are spread over businesses whose technologies and value chain activities bear no close relationship and whose markets are largely disconnected.

2. The company’s financial resources can be employed to maximum advantage by (a) investing in whatever industries offer the best profit prospects (as opposed to considering only opportunities in industries with related value chain activities) and (b) diverting cash flows from company businesses with lower growth and profit prospects to acquiring and expanding businesses with higher growth and profit potentials.
The defining characteristic of unrelated diversification is few competitively valuable cross-business relationships. Peruse the business group listings for General Electric, United Technologies, American Standard, and Lancaster Colony and see if you can confirm why these four companies have unrelated diversification strategies.

**GENERAL ELECTRIC**
- Advanced materials (engineering thermoplastics, silicon-based products and technology platforms, and fused quartz and ceramics)—revenues of $8.3 billion in 2004.
- Commercial and consumer finance (loans, operating leases, financing programs and financial services provided to corporations, retailers, and consumers in 38 countries)—revenues of $39.2 billion in 2004.
- Major appliances, lighting, and integrated industrial equipment, systems and services—revenues of $13.8 billion in 2004.
- Commercial insurance and reinsurance products and services for insurance companies, Fortune 1000 companies, self-insurers, health care providers and other groups—revenues of $23.1 billion in 2004.
- Jet engines for military and civil aircraft, freight and passenger locomotives, motorized systems for mining trucks and drills, and gas turbines for marine and industrial applications—revenues of $15.6 billion in 2004.
- Electric power generation equipment, power transformers, high-voltage breakers, distribution transformers and breakers, capacitors, relays, regulators, substation equipment, metering products—revenues of $17.3 billion in 2004.
- Medical imaging and information technologies, medical diagnostics, patient monitoring systems, disease research, drug discovery and biopharmaceuticals—revenues of $13.5 billion in 2004.

**UNITED TECHNOLOGIES**
- Pratt & Whitney aircraft engines—2005 revenues of $9.3 billion.
- Carrier heating and air-conditioning equipment—2005 revenues of $12.5 billion.
- Otis elevators and escalators—2005 revenues of $9.6 billion.
- Sikorsky helicopters and Hamilton Sunstrand aerospace systems—2005 revenues of $7.2 billion.
- Chubb fire detection and security systems—2005 revenues of $4.3 billion.

**AMERICAN STANDARD**
- Trane and American Standard furnaces, heat pumps, and air conditioners—2005 revenues of $6.0 billion.
- Commercial and utility vehicle braking and control systems—2005 revenues of $1.8 billion.

**LANCASTER COLONY**
- Specialty food products: Cardini, Marzetti, Girard's, and Pheiffer salad dressings; Chatham Village croutons; New York Brand, Sister Schubert, and Mamma Bella frozen breads and rolls; Reames and Aunt Vi's frozen noodles and pastas; Inn Maid and Amish dry egg noodles; and Romanoff caviar—fiscal 2005 revenues of $674 million.
- Candles and glassware: Candle-lite candles; Indiana Glass and Fostoria drinkware and tabletop items; Colony giftware; and Brody floral containers—fiscal 2005 revenues of $234 million.
- Automotive products: Rubber Queen automotive floor mats; Dee Zee aluminum accessories and running boards for light trucks; Protecta truck bed mats; and assorted other truck accessories—fiscal 2005 revenues of $224 million.

**Source:** Company Web sites, annual reports, and 10-K reports.
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3. To the extent that corporate managers are exceptionally astute at spotting bargain-priced companies with big upside profit potential, shareholder wealth can be enhanced by buying distressed businesses at a low price, turning their operations around fairly quickly with infusions of cash and managerial know-how supplied by the parent company, and then riding the crest of the profit increases generated by the newly acquired businesses.

4. Company profitability may prove somewhat more stable over the course of economic upswings and downswings because market conditions in all industries don’t move upward or downward simultaneously—in a broadly diversified company, there’s a chance that market downtrends in some of the company’s businesses will be partially offset by cyclical upswings in its other businesses, thus producing somewhat less earnings volatility. (In actual practice, however, there’s no convincing evidence that the consolidated profits of firms with unrelated diversification strategies are more stable or less subject to reversal in periods of recession and economic stress than the profits of firms with related diversification strategies.)

Unrelated diversification certainly merits consideration when a firm is trapped in or overly dependent on an endangered or unattractive industry, especially when it has no competitively valuable resources or capabilities it can transfer to an adjacent industry. A case can also be made for unrelated diversification when a company has a strong preference for spreading business risks widely and not restricting itself to investing in a family of closely related businesses.

Building Shareholder Value via Unrelated Diversification

Given the absence of cross-business strategic fits with which to capture added competitive advantage, the task of building shareholder value via unrelated diversification ultimately hinges on the business acumen of corporate executives. To succeed in using a strategy of unrelated diversification to produce companywide financial results above and beyond what the businesses could generate operating as stand-alone entities, corporate executives must:

- Do a superior job of diversifying into new businesses that can produce consistently good earnings and returns on investment (thereby satisfying the attractiveness test).
- Do an excellent job of negotiating favorable acquisition prices (thereby satisfying the cost-of-entry test).
- Do such a good job overseeing the firm’s business subsidiaries and contributing to how they are managed—by providing expert problem-solving skills, creative strategy suggestions, and high caliber decision-making guidance to the heads of the various business subsidiaries—that the subsidiaries perform at a higher level than they would otherwise be able to do through the efforts of the business-unit heads alone (a possible way to satisfy the better-off test).
- Be shrewd in identifying when to shift resources out of businesses with dim profit prospects and into businesses with above-average prospects for growth and profitability.
- Be good at discerning when a business needs to be sold (because it is on the verge of confronting adverse industry and competitive conditions and probable declines in long-term profitability) and also finding buyers who will pay a price higher than the company’s net investment in the business (so that the sale of divested businesses will result in capital gains for shareholders rather than capital losses).
To the extent that corporate executives are able to craft and execute a strategy of unrelated diversification that produces enough of the above outcomes to result in a stream of dividends and capital gains for stockholders greater than a $1 + 1 = 2$ outcome, a case can be made that shareholder value has truly been enhanced.

### The Drawbacks of Unrelated Diversification

Unrelated diversification strategies have two important negatives that undercut the pluses: demanding managerial requirements and limited competitive advantage potential.

**Demanding Managerial Requirements** Successfully managing a set of fundamentally different businesses operating in fundamentally different industry and competitive environments is an exceptionally challenging proposition for corporate-level managers. It is difficult because key executives at the corporate level, while perhaps having personally worked in one or two of the company’s businesses, rarely have the time and expertise to be sufficiently familiar with all the circumstances surrounding each of the company’s businesses to be in a position to give high-caliber guidance to business-level managers. Indeed, the greater the number of businesses a company is in and the more diverse they are, the harder it is for corporate managers to:

1. Stay abreast of what’s happening in each industry and each subsidiary and thus judge whether a particular business has bright prospects or is headed for trouble,
2. Know enough about the issues and problems facing each subsidiary to pick business-unit heads having the requisite combination of managerial skills and know-how,
3. Be able to tell the difference between those strategic proposals of business-unit managers that are prudent and those that are risky or unlikely to succeed,
4. Know what to do if a business unit stumbles and its results suddenly head downhill.

In a company like General Electric (see Illustration Capsule 9.2) or Tyco International (which acquired over 1,000 companies during the 1990–2001 period), corporate executives are constantly scrambling to stay on top of fresh industry developments and the strategic progress and plans of each subsidiary, often depending on briefings by business-level managers for many of the details. As a rule, the more unrelated businesses that a company has diversified into, the more corporate executives are dependent on briefings from business unit heads and “managing by the numbers”—that is, keeping a close track on the financial and operating results of each subsidiary and assuming that the heads of the various subsidiaries have most everything under control so long as the latest key financial and operating measures look good. Managing by the numbers works if the heads of the various business units are quite capable and consistently meet their numbers. But the problem comes when things start to go awry in a business despite the best effort of business-unit managers and corporate management has to get deeply involved in turning around a business it does not know all that much about—as the former chairman of a Fortune 500 company advised, “Never acquire a business you don’t know how to run.” Because every business tends to encounter rough sledding, a good way to gauge the merits of acquiring a company in an unrelated industry is to ask, “If the business got into trouble, is corporate management likely to know how to bail it out?” When the answer is no (or even a qualified yes or maybe), growth via acquisition into unrelated businesses is a chancy strategy. Just one or two unforeseen declines or big strategic mistakes (misjudging the importance of certain
competitive forces or the impact of driving forces or key success factors, encountering unexpected problems in a newly acquired business, or being too optimistic about turning around a struggling subsidiary) can cause a precipitous drop in corporate earnings and crash the parent company’s stock price.

Hence, competently overseeing a set of widely diverse businesses can turn out to be much harder than it sounds. In practice, comparatively few companies have proved up to the task. There are far more companies whose corporate executives have failed at delivering consistently good financial results with an unrelated diversification strategy than there are companies with corporate executives who have been successful. It is simply very difficult for corporate executives to achieve $1 + 1 = 3$ gains in shareholder value based on their expertise in (a) picking which industries to diversify into and which companies in these industries to acquire, (b) shifting resources from low-performing businesses into high-performing businesses, and (c) giving high-caliber decision-making guidance to the general managers of their business subsidiaries. The odds are that the result of unrelated diversification will be $1 + 1 = 2$ or less.

**Limited Competitive Advantage Potential** The second big negative is that unrelated diversification offers no potential for competitive advantage beyond what each individual business can generate on its own. Unlike a related diversification strategy, there are no cross-business strategic fits to draw on for reducing costs, beneficially transferring skills and technology, leveraging use of a powerful brand name, or collaborating to build mutually beneficial competitive capabilities and thereby adding to any competitive advantage possessed by individual businesses. Yes, a cash-rich corporate parent pursuing unrelated diversification can provide its subsidiaries with much-needed capital and maybe even the managerial know-how to help resolve problems in particular business units, but otherwise it has little to offer in the way of enhancing the competitive strength of its individual business units. Without the competitive advantage potential of strategic fits, consolidated performance of an unrelated group of businesses stands to be little or no better than the sum of what the individual business units could achieve if they were independent.

**COMBINATION RELATED–UNRELATED DIVERSIFICATION STRATEGIES**

There’s nothing to preclude a company from diversifying into both related and unrelated businesses. Indeed, in actual practice the business makeup of diversified companies varies considerably. Some diversified companies are really dominant-business enterprises—one major “core” business accounts for 50 to 80 percent of total revenues and a collection of small related or unrelated businesses accounts for the remainder. Some diversified companies are narrowly diversified around a few (two to five) related or unrelated businesses. Others are broadly diversified around a wide-ranging collection of related businesses, unrelated businesses, or a mixture of both. And a number of multibusiness enterprises have diversified into unrelated areas but have a collection of related businesses within each area—thus giving them a business portfolio consisting of several unrelated groups of related businesses. There’s ample room for companies to customize their diversification strategies to incorporate elements of both related and unrelated diversification, as may suit their own risk preferences and strategic vision.
Figure 9.4 indicates what to look for in identifying the main elements of a company’s diversification strategy. Having a clear fix on the company’s current corporate strategy sets the stage for evaluating how good the strategy is and proposing strategic moves to boost the company’s performance.

**EVALUATING THE STRATEGY OF A DIVERSIFIED COMPANY**

Strategic analysis of diversified companies builds on the concepts and methods used for single-business companies. But there are some additional aspects to consider and a couple of new analytical tools to master. The procedure for evaluating the pluses and minuses of a diversified company’s strategy and deciding what actions to take to improve the company’s performance involves six steps:

1. Assessing the attractiveness of the industries the company has diversified into, both individually and as a group.
2. Assessing the competitive strength of the company’s business units and determining how many are strong contenders in their respective industries.
3. Checking the competitive advantage potential of cross-business strategic fits among the company’s various business units.

4. Checking whether the firm’s resources fit the requirements of its present business lineup.

5. Ranking the performance prospects of the businesses from best to worst and determining what the corporate parent’s priority should be in allocating resources to its various businesses.


The core concepts and analytical techniques underlying each of these steps merit further discussion.

**Step 1: Evaluating Industry Attractiveness**

A principal consideration in evaluating a diversified company’s business makeup and the caliber of its strategy is the attractiveness of the industries in which it has business operations. Answers to several questions are required:

1. **Does each industry the company has diversified into represent a good business for the company to be in?** Ideally, each industry in which the firm operates will pass the attractiveness test.

2. **Which of the company’s industries are most attractive and which are least attractive?** Comparing the attractiveness of the industries and ranking them from most to least attractive is a prerequisite to wise allocation of corporate resources across the various businesses.

3. **How appealing is the whole group of industries in which the company has invested?** The answer to this question points to whether the group of industries holds promise for attractive growth and profitability. A company whose revenues and profits come chiefly from businesses in relatively unattractive industries probably needs to look at divesting businesses in unattractive industries and entering industries that qualify as highly attractive.

The more attractive the industries (both individually and as a group) a diversified company is in, the better its prospects for good long-term performance.

**Calculating Industry Attractiveness Scores for Each Industry into Which the Company Has Diversified**

A simple and reliable analytical tool involves calculating quantitative industry attractiveness scores, which can then be used to gauge each industry’s attractiveness, rank the industries from most to least attractive, and make judgments about the attractiveness of all the industries as a group.

The following measures are typically used to gauge an industry’s attractiveness:

- **Market size and projected growth rate**—Big industries are more attractive than small industries, and fast-growing industries tend to be more attractive than slow-growing industries, other things being equal.

- **The intensity of competition**—Industries where competitive pressures are relatively weak are more attractive than industries where competitive pressures are strong.

- **Emerging opportunities and threats**—Industries with promising opportunities and minimal threats on the near horizon are more attractive than industries with modest opportunities and imposing threats.
The presence of cross-industry strategic fits—The more the industry’s value chain and resource requirements match up well with the value chain activities of other industries in which the company has operations, the more attractive the industry is to a firm pursuing related diversification. However, cross-industry strategic fits may be of no consequence to a company committed to a strategy of unrelated diversification.

Resource requirements—Industries having resource requirements within the company’s reach are more attractive than industries where capital and other resource requirements could strain corporate financial resources and organizational capabilities.

Seasonal and cyclical factors—Industries where buyer demand is relatively steady year-round and not unduly vulnerable to economic ups and downs tend to be more attractive than industries where there are wide swings in buyer demand within or across years. However, seasonality may be a plus for a company that is in several seasonal industries, if the seasonal highs in one industry correspond to the lows in another industry, thus helping even out monthly sales levels. Likewise, cyclical market demand in one industry can be attractive if its up-cycle runs counter to the market down-cycles in another industry where the company operates, thus helping reduce revenue and earnings volatility.

Social, political, regulatory, and environmental factors—Industries with significant problems in such areas as consumer health, safety, or environmental pollution or that are subject to intense regulation are less attractive than industries where such problems are not burning issues.

Industry profitability—Industries with healthy profit margins and high rates of return on investment are generally more attractive than industries where profits have historically been low or unstable.

Industry uncertainty and business risk—Industries with less uncertainty on the horizon and lower overall business risk are more attractive than industries whose prospects for one reason or another are quite uncertain, especially when the industry has formidable resource requirements.

After settling on a set of attractiveness measures that suit a diversified company’s circumstances, each attractiveness measure is assigned a weight reflecting its relative importance in determining an industry’s attractiveness—it is weak methodology to assume that the various attractiveness measures are equally important. The intensity of competition in an industry should nearly always carry a high weight (say, 0.20 to 0.30). Strategic-fit considerations should be assigned a high weight in the case of companies with related diversification strategies; but, for companies with an unrelated diversification strategy, strategic fits with other industries may be given a low weight or even dropped from the list of attractiveness measures altogether. Seasonal and cyclical factors generally are assigned a low weight (or maybe even eliminated from the analysis) unless a company has diversified into industries strongly characterized by seasonal demand and/or heavy vulnerability to cyclical upswings and downswings. The importance weights must add up to 1.0.

Next, each industry is rated on each of the chosen industry attractiveness measures, using a rating scale of 1 to 10 (where a high rating signifies high attractiveness and a low rating signifies low attractiveness). Keep in mind here that the more intensely competitive an industry is, the lower the attractiveness rating for that industry. Likewise, the higher the capital and resource requirements associated with being in a particular industry, the lower the attractiveness rating. And an industry that is subject
to stringent pollution control regulations or that causes societal problems (like cigarettes or alcoholic beverages) should usually be given a low attractiveness rating. Weighted attractiveness scores are then calculated by multiplying the industry’s rating on each measure by the corresponding weight. For example, a rating of 8 times a weight of 0.25 gives a weighted attractiveness score of 2.00. The sum of the weighted scores for all the attractiveness measures provides an overall industry attractiveness score. This procedure is illustrated in Table 9.1.

**Interpreting the Industry Attractiveness Scores**  
Industries with a score much below 5.0 probably do not pass the attractiveness test. If a company’s industry attractiveness scores are all above 5.0, it is probably fair to conclude that the group of industries the company operates in is attractive as a whole. But the group of industries takes on a decidedly lower degree of attractiveness as the number of industries with scores below 5.0 increases, especially if industries with low scores account for a sizable fraction of the company’s revenues.

For a diversified company to be a strong performer, a substantial portion of its revenues and profits must come from business units with relatively high attractiveness scores. It is particularly important that a diversified company’s principal businesses be in industries with a good outlook for growth and above-average profitability. Having a big fraction of the company’s revenues and profits come from industries with slow growth, low profitability, or intense competition tends to drag overall company performance down. Business units in the least attractive industries are potential candidates for divestiture, unless they are positioned strongly enough to overcome the unattractive aspects of their industry environments or they are a strategically important component of the company’s business makeup.

**The Difficulties of Calculating Industry Attractiveness Scores**  
There are two hurdles to calculating industry attractiveness scores. One is deciding on appropriate weights for the industry attractiveness measures. Not only may different analysts have
different views about which weights are appropriate for the different attractiveness measures but also different weightings may be appropriate for different companies—based on their strategies, performance targets, and financial circumstances. For instance, placing a low weight on industry resource requirements may be justifiable for a cash-rich company, whereas a high weight may be more appropriate for a financially strapped company. The second hurdle is gaining sufficient command of the industry to assign accurate and objective ratings. Generally, a company can come up with the statistical data needed to compare its industries on such factors as market size, growth rate, seasonal and cyclical influences, and industry profitability. Cross-industry fits and resource requirements are also fairly easy to judge. But the attractiveness measure where judgment weighs most heavily is that of intensity of competition. It is not always easy to conclude whether competition in one industry is stronger or weaker than in another industry because of the different types of competitive influences that prevail and the differences in their relative importance. In the event that the available information is too skimpy to confidently assign a rating value to an industry on a particular attractiveness measure, then it is usually best to use a score of 5, which avoids biasing the overall attractiveness score either up or down.

But despite the hurdles, calculating industry attractiveness scores is a systematic and reasonably reliable method for ranking a diversified company’s industries from most to least attractive—numbers like those shown for the four industries in Table 9.1 help pin down the basis for judging which industries are more attractive and to what degree.

**Step 2: Evaluating Business-Unit Competitive Strength**

The second step in evaluating a diversified company is to appraise how strongly positioned each of its business units are in their respective industry. Doing an appraisal of each business unit’s strength and competitive position in its industry not only reveals its chances for industry success but also provides a basis for ranking the units from competitively strongest to competitively weakest and sizing up the competitive strength of all the business units as a group.

**Calculating Competitive Strength Scores for Each Business Unit**

Quantitative measures of each business unit’s competitive strength can be calculated using a procedure similar to that for measuring industry attractiveness. The following factors are used in quantifying the competitive strengths of a diversified company’s business subsidiaries:

- **Relative market share**—A business unit’s relative market share is defined as the ratio of its market share to the market share held by the largest rival firm in the industry, with market share measured in unit volume, not dollars. For instance, if business A has a market-leading share of 40 percent and its largest rival has 30 percent, A’s relative market share is 1.33. (Note that only business units that are market share leaders in their respective industries can have relative market shares greater than 1.0.) If business B has a 15 percent market share and B’s largest rival has 30 percent, B’s relative market share is 0.5. The further below 1.0 a business unit’s relative market share is, the weaker its competitive strength and market position vis-à-vis rivals. A 10 percent market share, for example, does not signal much competitive strength if the leader’s share is 50 percent.
(a 0.20 relative market share), but a 10 percent share is actually quite strong if the leader’s share is only 12 percent (a 0.83 relative market share)—this is why a company’s relative market share is a better measure of competitive strength than a company’s market share based on either dollars or unit volume.

- **Costs relative to competitors’ costs**—Business units that have low costs relative to key competitors’ costs tend to be more strongly positioned in their industries than business units struggling to maintain cost parity with major rivals. Assuming that the prices charged by industry rivals are about the same, there’s reason to expect that business units with higher relative market shares have lower unit costs than competitors with lower relative market shares because their greater unit sales volumes offer the possibility of economies from larger-scale operations and the benefits of any experience/learning curve effects. Another indicator of low cost can be a business unit’s supply chain management capabilities. The only time when a business unit’s competitive strength may not be undermined by having higher costs than rivals is when it has incurred the higher costs to strongly differentiate its product offering and its customers are willing to pay premium prices for the differentiating features.

- **Ability to match or beat rivals on key product attributes**—A company’s competitiveness depends in part on being able to satisfy buyer expectations with regard to features, product performance, reliability, service, and other important attributes.

- **Ability to benefit from strategic fits with sister businesses**—Strategic fits with other businesses within the company enhance a business unit’s competitive strength and may provide a competitive edge.

- **Ability to exercise bargaining leverage with key suppliers or customers**—Having bargaining leverage signals competitive strength and can be a source of competitive advantage.

- **Caliber of alliances and collaborative partnerships with suppliers and/or buyers**—Well-functioning alliances and partnerships may signal a potential competitive advantage vis-à-vis rivals and thus add to a business’s competitive strength. Alliances with key suppliers are often the basis for competitive strength in supply chain management.

- **Brand image and reputation**—A strong brand name is a valuable competitive asset in most industries.

- **Competitively valuable capabilities**—Business units recognized for their technological leadership, product innovation, or marketing prowess are usually strong competitors in their industry. Skills in supply chain management can generate valuable cost or product differentiation advantages. So can unique production capabilities. Sometimes a company’s business units gain competitive strength because of their knowledge of customers and markets and/or their proven managerial capabilities. An important thing to look for here is how well a business unit’s competitive assets match industry key success factors. The more a business unit’s resource strengths and competitive capabilities match the industry’s key success factors, the stronger its competitive position tends to be.

- **Profitability relative to competitors**—Business units that consistently earn above-average returns on investment and have bigger profit margins than their rivals usually have stronger competitive positions. Moreover, above-average profitability signals competitive advantage, while below-average profitability usually denotes competitive disadvantage.
After settling on a set of competitive strength measures that are well matched to the circumstances of the various business units, weights indicating each measure’s importance need to be assigned. A case can be made for using different weights for different business units whenever the importance of the strength measures differs significantly from business to business, but otherwise it is simpler just to go with a single set of weights and avoid the added complication of multiple weights. As before, the importance weights must add up to 1.0. Each business unit is then rated on each of the chosen strength measures, using a rating scale of 1 to 10 (where a high rating signifies competitive strength and a low rating signifies competitive weakness). In the event that the available information is too skimpy to confidently assign a rating value to a business unit on a particular strength measure, then it is usually best to use a score of 5, which avoids biasing the overall score either up or down. Weighted strength ratings are calculated by multiplying the business unit’s rating on each strength measure by the assigned weight. For example, a strength score of 6 times a weight of 0.15 gives a weighted strength rating of 0.90. The sum of weighted ratings across all the strength measures provides a quantitative measure of a business unit’s overall market strength and competitive standing. Table 9.2 provides sample calculations of competitive strength ratings for four businesses.

### Table 9.2 Calculating Weighted Competitive Strength Scores for a Diversified Company’s Business Units

<table>
<thead>
<tr>
<th>Competitive Strength Measure</th>
<th>Importance Weight</th>
<th>Business A in Industry A Rating/Score</th>
<th>Business B in Industry B Rating/Score</th>
<th>Business C in Industry C Rating/Score</th>
<th>Business D in Industry D Rating/Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Relative market share</td>
<td>0.15</td>
<td>10/1.50</td>
<td>1/0.15</td>
<td>6/0.90</td>
<td>2/0.30</td>
</tr>
<tr>
<td>Costs relative to competitors’ costs</td>
<td>0.20</td>
<td>7/1.40</td>
<td>2/0.40</td>
<td>5/1.00</td>
<td>3/0.60</td>
</tr>
<tr>
<td>Ability to match or beat rivals on key product attributes</td>
<td>0.05</td>
<td>9/0.45</td>
<td>4/0.20</td>
<td>8/0.40</td>
<td>4/0.20</td>
</tr>
<tr>
<td>Ability to benefit from strategic fits with sister businesses</td>
<td>0.20</td>
<td>8/1.60</td>
<td>4/0.80</td>
<td>8/0.80</td>
<td>2/0.60</td>
</tr>
<tr>
<td>Bargaining leverage with suppliers/buyers; caliber of alliances</td>
<td>0.05</td>
<td>9/0.90</td>
<td>3/0.30</td>
<td>6/0.30</td>
<td>2/0.10</td>
</tr>
<tr>
<td>Brand image and reputation</td>
<td>0.10</td>
<td>9/0.90</td>
<td>2/0.20</td>
<td>7/0.70</td>
<td>5/0.50</td>
</tr>
<tr>
<td>Competitively valuable capabilities</td>
<td>0.15</td>
<td>7/1.05</td>
<td>2/0.20</td>
<td>5/0.75</td>
<td>3/0.45</td>
</tr>
<tr>
<td>Profitability relative to competitors</td>
<td>0.10</td>
<td>5/0.50</td>
<td>1/0.10</td>
<td>4/0.40</td>
<td>4/0.40</td>
</tr>
<tr>
<td>Sum of the assigned weights</td>
<td>1.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Overall industry attractiveness scores</td>
<td></td>
<td>8.30</td>
<td>2.35</td>
<td>5.25</td>
<td>3.15</td>
</tr>
</tbody>
</table>

Rating scale: 1 = Very weak; 10 = Very strong.

**Interpreting the Competitive Strength Scores**  Business units with competitive strength ratings above 6.7 (on a scale of 1 to 10) are strong market contenders in their industries. Businesses with ratings in the 3.3 to 6.7 range have moderate competitive strength vis-à-vis rivals. Businesses with ratings below 3.3 are in competitively weak market positions. If a diversified company’s business units all have competitive strength scores above 5.0, it is fair to conclude that its business units are all fairly strong market contenders in their respective industries. But as the number of business units with scores below 5.0 increases, there’s reason to question...
whether the company can perform well with so many businesses in relatively weak competitive positions. This concern takes on even more importance when business units with low scores account for a sizable fraction of the company’s revenues.

Using a Nine-Cell Matrix to Simultaneously Portray Industry Attractiveness and Competitive Strength The industry attractiveness and competitive strength scores can be used to portray the strategic positions of each business in a diversified company. Industry attractiveness is plotted on the vertical axis, and competitive strength on the horizontal axis. A nine-cell grid emerges from dividing the vertical axis into three regions (high, medium, and low attractiveness) and the horizontal axis into three regions (strong, average, and weak competitive strength). As shown in Figure 9.5, high attractiveness is associated with scores of 6.7 or greater on a rating scale of 1 to 10, medium attractiveness to scores of 3.3 to 6.7, and low attractiveness to scores below 3.3. Likewise, high competitive strength is defined as a score greater than 6.7, average strength as scores of 3.3 to 6.7, and low strength as scores below 3.3. Each business unit is plotted on the nine-cell matrix according to its overall attractiveness score and strength score, and then shown as a bubble. The size of each bubble is scaled to what percentage of revenues the business generates relative to total corporate revenues. The bubbles in Figure 9.5 were located on the grid using the four industry attractiveness scores from Table 9.1 and the strength scores for the four business units in Table 9.2.

The locations of the business units on the attractiveness–strength matrix provide valuable guidance in deploying corporate resources to the various business units. In general, a diversified company’s prospects for good overall performance are enhanced by concentrating corporate resources and strategic attention on those business units having the greatest competitive strength and positioned in highly attractive industries—specifically, businesses in the three cells in the upper left portion of the attractiveness–strength matrix, where industry attractiveness and competitive strength/market position are both favorable. The general strategic prescription for businesses falling in these three cells (for instance, business A in Figure 9.5) is “grow and build,” with businesses in the high–strong cell standing first in line for resource allocations by the corporate parent.

Next in priority come businesses positioned in the three diagonal cells stretching from the lower left to the upper right (businesses B and C in Figure 9.5). Such businesses usually merit medium or intermediate priority in the parent’s resource allocation ranking. However, some businesses in the medium-priority diagonal cells may have brighter or dimmer prospects than others. For example, a small business in the upper right cell of the matrix (like business B), despite being in a highly attractive industry, may occupy too weak a competitive position in its industry to justify the investment and resources needed to turn it into a strong market contender and shift its position leftward in the matrix over time. If, however, a business in the upper right cell has attractive opportunities for rapid growth and a good potential for winning a much stronger market position over time, it may merit a high claim on the corporate parent’s resource allocation ranking and be given the capital it needs to pursue a grow-and-build strategy—the strategic objective here would be to move the business leftward in the attractiveness–strength matrix over time.

Businesses in the three cells in the lower right corner of the matrix (like business D in Figure 9.5) typically are weak performers and have the lowest claim on corporate resources. Most such businesses are good candidates for being divested (sold to other companies) or else managed in a manner calculated to squeeze out the maximum cash flows from operations—the cash flows from low-performing/low-potential businesses
Figure 9.5  A Nine-Cell Industry Attractiveness–Competitive Strength Matrix

![Nine-Cell Industry Attractiveness–Competitive Strength Matrix](image)

can then be diverted to financing expansion of business units with greater market opportunities. In exceptional cases where a business located in the three lower right cells is nonetheless fairly profitable (which it might be if it is in the low–average cell) or has the potential for good earnings and return on investment, the business merits retention and the allocation of sufficient resources to achieve better performance.

The nine-cell attractiveness–strength matrix provides clear, strong logic for why a diversified company needs to consider both industry attractiveness and business strength in allocating resources and investment capital to its different businesses. A good case can be made for concentrating resources in those businesses that enjoy higher degrees of attractiveness and competitive strength, being very selective in making investments in businesses with intermediate positions on the grid, and
withdrawing resources from businesses that are lower in attractiveness and strength unless they offer exceptional profit or cash flow potential.

**Step 3: Checking the Competitive Advantage Potential of Cross-Business Strategic Fits**

While this step can be bypassed for diversified companies whose businesses are all unrelated (since, by design, no strategic fits are present), a high potential for converting strategic fits into competitive advantage is central to concluding just how good a company’s related diversification strategy is. Checking the competitive advantage potential of cross-business strategic fits involves searching for and evaluating how much benefit a diversified company can gain from value chain matchups that present (1) opportunities to combine the performance of certain activities, thereby reducing costs and capturing economies of scope; (2) opportunities to transfer skills, technology, or intellectual capital from one business to another, thereby leveraging use of existing resources; (3) opportunities to share use of a well-respected brand name; and (4) opportunities for sister businesses to collaborate in creating valuable new competitive capabilities (such as enhanced supply chain management capabilities, quicker first-to-market capabilities, or greater product innovation capabilities).

Figure 9.6 illustrates the process of comparing the value chains of sister businesses and identifying competitively valuable cross-business strategic fits. But more than just strategic fit identification is needed. The real test is what competitive value can be generated from these fits. To what extent can cost savings be realized? How much competitive value will come from cross-business transfer of skills, technology, or intellectual capital? Will transferring a potent brand name to the products of sister businesses grow sales significantly? Will cross-business collaboration to create or strengthen competitive capabilities lead to significant gains in the marketplace or in financial performance? Absent significant strategic fits and dedicated company efforts to capture the benefits, one has to be skeptical about the potential for a diversified company’s businesses to perform better together than apart.

**Step 4: Checking for Resource Fit**

The businesses in a diversified company’s lineup need to exhibit good resource fit. Resource fit exists when (1) businesses add to a company’s overall resource strengths and (2) a company has adequate resources to support its entire group of businesses without spreading itself too thin. One important dimension of resource fit concerns whether a diversified company can generate the internal cash flows sufficient to fund the capital requirements of its businesses, pay its dividends, meet its debt obligations, and otherwise remain financially healthy.

**Financial Resource Fits: Cash Cows versus Cash Hogs** Different businesses have different cash flow and investment characteristics. For example, business units in rapidly growing industries are often cash hogs—so labeled because the cash flows they are able to generate from internal operations aren’t big enough to fund their expansion. To keep pace with rising buyer demand, rapid-growth businesses frequently need sizable annual capital investments—for new facilities and equipment, for
new product development or technology improvements, and for additional working capital to support inventory expansion and a larger base of operations. A business in a fast-growing industry becomes an even bigger cash hog when it has a relatively low market share and is pursuing a strategy to become an industry leader. Because a cash hog’s financial resources must be provided by the corporate parent, corporate managers have to decide whether it makes good financial and strategic sense to keep pouring new money into a business that continually needs cash infusions.

In contrast, business units with leading market positions in mature industries may, however, be cash cows—businesses that generate substantial cash surpluses over what is needed to adequately fund their operations. Market leaders in slow-growth industries often generate sizable positive cash flows over and above what is needed for growth and reinvestment because their industry-leading positions tend to give them the sales volumes and reputation to earn attractive profits and because the slow-growth nature of their industry often entails relatively modest annual investment requirements. Cash cows, though not always attractive from a growth standpoint, are valuable businesses from a financial resource perspective. The surplus cash flows they generate can be used to pay corporate dividends, finance acquisitions, and provide

**Core Concept**
A cash hog generates cash flows that are too small to fully fund its operations and growth; a cash hog requires cash infusions to provide additional working capital and finance new capital investment.
funds for investing in the company’s promising cash hogs. It makes good financial and strategic sense for diversified companies to keep cash cows in healthy condition, fortifying and defending their market position so as to preserve their cash-generating capability over the long term and thereby have an ongoing source of financial resources to deploy elsewhere. The cigarette business is one of the world’s biggest cash cows. General Electric, whose business lineup is shown in Illustration Capsule 9.2, considers that its advanced materials, equipment services, and appliance and lighting businesses are cash cows.

Viewing a diversified group of businesses as a collection of cash flows and cash requirements (present and future) is a major step forward in understanding what the financial ramifications of diversification are and why having businesses with good financial resource fit is so important. For instance, a diversified company’s businesses exhibit good financial resource fit when the excess cash generated by its cash cows is sufficient to fund the investment requirements of promising cash hogs. Ideally, investing in promising cash hog businesses over time results in growing the hogs into self-supporting star businesses that have strong or market-leading competitive positions in attractive, high-growth markets and high levels of profitability. Star businesses are often the cash cows of the future—when the markets of star businesses begin to mature and their growth slows, their competitive strength should produce self-generated cash flows more than sufficient to cover their investment needs. The “success sequence” is thus cash hog to young star (but perhaps still a cash hog) to self-supporting star to cash cow.

If, however, a cash hog has questionable promise (either because of low industry attractiveness or a weak competitive position), then it becomes a logical candidate for divestiture. Pursuing an aggressive invest-and-expand strategy for a cash hog with an uncertain future seldom makes sense because it requires the corporate parent to keep pumping more capital into the business with only a dim hope of eventually turning the cash hog into a future star and realizing a good return on its investments. Such financially draining businesses fail the resource fit test because they strain the corporate parent’s ability to adequately fund its other businesses. Divesting a cash hog is usually the best alternative unless (1) it has valuable strategic fits with other business units or (2) the capital infusions needed from the corporate parent are modest relative to the funds available and there’s a decent chance of growing the business into a solid bottom-line contributor yielding a good return on invested capital.

Other Tests of Resource Fit Aside from cash flow considerations, there are four other factors to consider in determining whether the businesses comprising a diversified company’s portfolio exhibit good resource fit:

- **Does the business adequately contribute to achieving companywide performance targets?** A business has good financial fit when it contributes to the achievement of corporate performance objectives (growth in earnings per share, above-average return on investment, recognition as an industry leader, etc.) and when it materially enhances shareholder value via helping drive increases in the company’s stock price. A business exhibits poor financial fit if it soaks up a disproportionate share of the company’s financial resources, makes subpar or inconsistent bottom-line contributions, is unduly risky and failure would jeopardize the entire enterprise, or remains too small to make a material earnings contribution even though it performs well.
• Does the company have adequate financial strength to fund its different businesses and maintain a healthy credit rating? A diversified company’s strategy fails the resource fit test when its financial resources are stretched across so many businesses that its credit rating is impaired. Severe financial strain sometimes occurs when a company borrows so heavily to finance new acquisitions that it has to trim way back on capital expenditures for existing businesses and use the big majority of its financial resources to meet interest obligations and to pay down debt. Time Warner, Royal Ahold, and AT&T, for example, have found themselves so financially overextended that they have had to sell off some of their business units to raise the money to pay down burdensome debt obligations and continue to fund essential capital expenditures for the remaining businesses.

• Does the company have or can it develop the specific resource strengths and competitive capabilities needed to be successful in each of its businesses? Sometimes the resource strengths a company has accumulated in its core or mainstay business prove to be a poor match with the key success factors and competitive capabilities needed to succeed in one or more businesses it has diversified into. For instance, BTR, a multibusiness company in Great Britain, discovered that the company’s resources and managerial skills were quite well suited for parenting industrial manufacturing businesses but not for parenting its distribution businesses (National Tyre Services and Texas-based Summers Group); as a consequence, BTR decided to divest its distribution businesses and focus exclusively on diversifying around small industrial manufacturing. One company with businesses in restaurants and retailing decided that its resource capabilities in site selection, controlling operating costs, management selection and training, and supply chain logistics would enable it to succeed in the hotel business and in property management; but what management missed was that these businesses had some significantly different key success factors—namely, skills in controlling property development costs, maintaining low overheads, product branding (hotels), and ability to recruit a sufficient volume of business to maintain high levels of facility use. Thus, a mismatch between the company’s resource strengths and the key success factors in a particular business can be serious enough to warrant divesting an existing business or not acquiring a new business. In contrast, when a company’s resources and capabilities are a good match with the key success factors of industries it is not presently in, it makes sense to take a hard look at acquiring companies in these industries and expanding the company’s business lineup.

• Are recently acquired businesses acting to strengthen a company’s resource base and competitive capabilities or are they causing its competitive and managerial resources to be stretched too thin? A diversified company has to guard against overtaxing its resource strengths, a condition that can arise when (1) it goes on an acquisition spree and management is called on to assimilate and oversee many new businesses very quickly or (2) when it lacks sufficient resource depth to do a creditable job of transferring skills and competences from one of its businesses to another (especially, a large acquisition or several lesser ones). The broader the diversification, the greater the concern about whether the company has sufficient managerial depth to cope with the diverse range of operating problems its wide business lineup presents. And the more a company’s diversification strategy is tied to transferring its existing know-how or technologies to new businesses, the more it has to develop a big enough and deep enough resource pool to supply
these businesses with sufficient capability to create competitive advantage. Otherwise its strengths end up being thinly spread across many businesses and the opportunity for competitive advantage slips through the cracks.

A Cautionary Note About Transferring Resources from One Business to Another Just because a company has hit a home run in one business doesn’t mean it can easily enter a new business with similar resource requirements and hit a second home run. Noted British retailer Marks & Spencer, despite possessing a range of impressive resource capabilities (ability to choose excellent store locations, having a supply chain that gives it both low costs and high merchandise quality, loyal employees, an excellent reputation with consumers, and strong management expertise) that have made it one of Britain’s premier retailers for 100 years, has failed repeatedly in its efforts to diversify into department store retailing in the United States. Even though Philip Morris (now named Altria) had built powerful consumer marketing capabilities in its cigarette and beer businesses, it floundered in soft drinks and ended up divesting its acquisition of 7UP after several frustrating years of competing against strongly entrenched and resource-capable rivals like Coca-Cola and PepsiCo. Then in 2002 it decided to divest its Miller Brewing business—despite its long-standing marketing successes in cigarettes and in its Kraft Foods subsidiary—because it was unable to grow Miller’s market share in head-to-head competition against the considerable marketing prowess of Anheuser-Busch.

Step 5: Ranking the Performance Prospects of Business Units and Assigning a Priority for Resource Allocation

Once a diversified company’s strategy has been evaluated from the perspective of industry attractiveness, competitive strength, strategic fit, and resource fit, the next step is to rank the performance prospects of the businesses from best to worst and determine which businesses merit top priority for resource support and new capital investments by the corporate parent.

The most important considerations in judging business-unit performance are sales growth, profit growth, contribution to company earnings, and return on capital invested in the business. Sometimes cash flow is a big consideration. Information on each business’s past performance can be gleaned from a company’s financial records. While past performance is not necessarily a good predictor of future performance, it does signal whether a business already has good-to-excellent performance or has problems to overcome.

Furthermore, the industry attractiveness/business strength evaluations provide a solid basis for judging a business’s prospects. Normally, strong business units in attractive industries have significantly better prospects than weak businesses in unattractive industries. And, normally, the revenue and earnings outlook for businesses in fast-growing industries is better than for businesses in slow-growing industries—one important exception is when a business in a slow-growing industry has the competitive strength to draw sales and market share away from its rivals and thus achieve much faster growth than the industry as whole. As a rule, the prior analyses, taken together, signal which business units are likely to be strong performers on the road ahead and which are likely to be laggards. And it is a short step from ranking the prospects of business units to drawing conclusions about whether the company as a whole is capable of strong, mediocre, or weak performance in upcoming years.
The rankings of future performance generally determine what priority the corporate parent should give to each business in terms of resource allocation. The task here is to decide which business units should have top priority for corporate resource support and new capital investment and which should carry the lowest priority. Business subsidiaries with the brightest profit and growth prospects and solid strategic and resource fits generally should head the list for corporate resource support. More specifically, corporate executives need to consider whether and how corporate resources can be used to enhance the competitiveness of particular business units. And they must be diligent in steering resources out of low-opportunity areas and into high-opportunity areas. Divesting marginal businesses is one of the best ways of freeing unproductive assets for redeployment. Surplus funds from cash cows also add to the corporate treasury.

Figure 9.7 shows the chief strategic and financial options for allocating a diversified company’s financial resources. Ideally, a company will have enough funds to do what is needed, both strategically and financially. If not, strategic uses of corporate resources should usually take precedence unless there is a compelling reason to strengthen the firm’s balance sheet or divert financial resources to pacify shareholders.

Step 6: Crafting New Strategic Moves to Improve Overall Corporate Performance

The diagnosis and conclusions flowing from the five preceding analytical steps set the agenda for crafting strategic moves to improve a diversified company’s overall performance. The strategic options boil down to five broad categories of actions:

1. Sticking closely with the existing business lineup and pursuing the opportunities these businesses present.
2. Broadening the company’s business scope by making new acquisitions in new industries.

3. Divesting certain businesses and retrenching to a narrower base of business operations.

4. Restructuring the company’s business lineup and putting a whole new face on the company’s business makeup.

5. Pursuing multinational diversification and striving to globalize the operations of several of the company’s business units.

The option of sticking with the current business lineup makes sense when the company’s present businesses offer attractive growth opportunities and can be counted on to generate good earnings and cash flows. As long as the company’s set of existing businesses puts it in good position for the future and these businesses have good strategic and/or resource fits, then rocking the boat with major changes in the company’s business mix is usually unnecessary. Corporate executives can concentrate their attention on getting the best performance from each of its businesses, steering corporate resources into those areas of greatest potential and profitability. The specifics of “what to do” to wring better performance from the present business lineup have to be dictated by each business’s circumstances and the preceding analysis of the corporate parent’s diversification strategy.

However, in the event that corporate executives are not entirely satisfied with the opportunities they see in the company’s present set of businesses and conclude that changes in the company’s direction and business makeup are in order, they can opt for any of the four other strategic alternatives listed above. These options are discussed in the following section.

**AFTER A COMPANY DIVERSIFIES:**

**THE FOUR MAIN STRATEGY ALTERNATIVES**

Diversifying is by no means the final chapter in the evolution of a company’s strategy. Once a company has diversified into a collection of related or unrelated businesses and concludes that some overhaul is needed in the company’s present lineup and diversification strategy, there are four main strategic paths it can pursue (see Figure 9.8). To more fully understand the strategic issues corporate managers face in the ongoing process of managing a diversified group of businesses, we need to take a brief look at the central thrust of each of the four postdiversification strategy alternatives.

**Strategies to Broaden a Diversified Company’s Business Base**

Diversified companies sometimes find it desirable to build positions in new industries, whether related or unrelated. There are several motivating factors. One is sluggish growth that makes the potential revenue and profit boost of a newly acquired business look attractive. A second is vulnerability to seasonal or recessionary influences or to threats from emerging new technologies. A third is the potential for transferring resources and capabilities to other related or complementary businesses. A fourth is rapidly changing conditions in one or more of a company’s core businesses brought on by technological, legislative, or new product innovations that alter buyer requirements and preferences. For instance, the passage of legislation in the United States allowing
banks, insurance companies, and stock brokerages to enter each other’s businesses spurred a raft of acquisitions and mergers to create full-service financial enterprises capable of meeting the multiple financial needs of customers. Citigroup, already the largest U.S. bank, with a global banking franchise, acquired Salomon Smith Barney to position itself in the investment banking and brokerage business and acquired insurance giant Travelers Group to enable it to offer customers insurance products.

A fifth, and often very important, motivating factor for adding new businesses is to complement and strengthen the market position and competitive capabilities of one or more of its present businesses. Procter & Gamble’s recent acquisition of Gillette strengthened and extended P&G’s reach into personal care and household products—Gillette’s businesses included Oral-B toothbrushes, Gillette razors and razor blades, Duracell batteries, Braun shavers and small appliances (coffeemakers, mixers, hair dryers, and electric toothbrushes), and toiletries (Right Guard, Foamy, Soft & Dry, White Rain, and Dry Idea). Unilever, a leading maker of food and personal care products, expanded its business lineup by acquiring SlimFast, Ben & Jerry’s Homemade,
Illustration Capsule 9.3

Managing Diversification at Johnson & Johnson: The Benefits of Cross-Business Strategic Fits

Johnson & Johnson (J&J), once a consumer products company known for its Band-Aid line and its baby care products, has evolved into a $42 billion diversified enterprise consisting of some 200-plus operating companies organized into three divisions: drugs, medical devices and diagnostics, and consumer products. Over the past decade J&J has acquired 56 businesses at a cost of about $30 billion; about 10 to 15 percent of J&J’s annual growth in revenues has come from acquisitions. Much of the company’s recent growth has been in the pharmaceutical division, which in 2004 accounted for 47 percent of J&J’s revenues and 57 percent of its operating profits.

While each of J&J’s business units sets its own strategies and operates with its own finance and human resource departments, corporate management strongly encourages cross-business cooperation and collaboration, believing that many of the advances in 21st century medicine will come from applying advances in one discipline to another. J&J had 9,300 scientists working in 40 research labs in 2003, and the frequency of cross-disciplinary collaboration was increasing. One of J&J’s new drug-coated stents grew out of a discussion between a drug researcher and a researcher in the company’s stent business. (When stents are inserted to prop open arteries following angioplasty, the drug coating helps prevent infection.) A gene technology database compiled by the company’s gene research lab was shared with personnel from the diagnostics division, who developed a test that the drug R&D people could use to predict which patients would most benefit from an experimental cancer therapy. J&J experts in various diseases have been meeting quarterly for the past five years to share information, and top management is setting up cross-disciplinary groups to focus on new treatments for particular diseases. J&J’s new liquid Band-Aid product (a liquid coating applied to hard-to-cover places like fingers and knuckles) is based on a material used in a wound-closing product sold by the company’s hospital products company.

J&J’s corporate management maintains that close collaboration among people in its diagnostics, medical devices, and pharmaceuticals businesses—where numerous cross-business strategic fits exist—gives J&J an edge on competitors, most of whom cannot match the company’s breadth and depth of expertise.

valves, undersea telecommunications systems, plastics, and adhesives. Tyco made over 700 acquisitions of small companies in the 1999–2001 period alone. As a group, Tyco’s businesses were cash cows, generating a combined free cash flow in 2005 of around $4.4 billion.

Illustration Capsule 9.3 describes how Johnson & Johnson has used acquisitions to diversify far beyond its well-known Band-Aid and baby care businesses and become a major player in pharmaceuticals, medical devices, and medical diagnostics.

**Divestiture Strategies Aimed at Retrenching to a Narrower Diversification Base**

A number of diversified firms have had difficulty managing a diverse group of businesses and have elected to get out of some of them. Retrenching to a narrower diversification base is usually undertaken when top management concludes that its diversification strategy has ranged too far afield and that the company can improve long-term performance by concentrating on building stronger positions in a smaller number of core businesses and industries.

Hewlett-Packard spun off its testing and measurement businesses into a standalone company called Agilent Technologies so that it could better concentrate on its PC, workstation, server, printer and peripherals, and electronics businesses. PepsiCo divested its cash-hog group of restaurant businesses, consisting of KFC, Pizza Hut, Taco Bell, and California Pizza Kitchens, to provide more resources for strengthening its soft-drink business (which was losing market share to Coca-Cola) and growing its more profitable Frito-Lay snack foods business. Kmart divested OfficeMax, Sports Authority, and Borders Bookstores in order to refocus management attention and all of the company’s resources on restoring luster to its distressed discount retailing business, which was (and still is) being totally outclassed in the marketplace by Wal-Mart and Target. In 2003–2004, Tyco International began a program to divest itself of some 50 businesses, including its entire undersea fiber-optics telecommunications network and an assortment of businesses in its fire and security division; the initiative also involved consolidating 219 manufacturing, sales, distribution, and other facilities and reducing its workforce of some 260,000 people by 7,200. Lucent Technology’s retrenchment strategy is described in Illustration Capsule 9.4.

But there are other important reasons for divesting one or more of a company’s present businesses. Sometimes divesting a business has to be considered because market conditions in a once-attractive industry have badly deteriorated. A business can become a prime candidate for divestiture because it lacks adequate strategic or resource fit, because it is a cash hog with questionable long-term potential, or because it is weakly positioned in its industry with little prospect the corporate parent can realize a decent return on its investment in the business. Sometimes a company acquires businesses that, down the road, just do not work out as expected even though management has tried all it can think of to make them profitable—mistakes cannot be completely avoided because it is hard to foresee how getting into a new line of business will actually work out. Subpar performance by some business units is bound to occur, thereby raising questions of whether to divest them or keep them and attempt a turnaround. Other business units, despite adequate financial performance, may not mesh as well with the rest of the firm as was originally thought.
On occasion, a diversification move that seems sensible from a strategic-fit standpoint turns out to be a poor cultural fit. Several pharmaceutical companies had just this experience. When they diversified into cosmetics and perfume, they discovered their personnel had little respect for the “frivolous” nature of such products compared to the far nobler task of developing miracle drugs to cure the ill. The absence of shared values and cultural compatibility between the medical research and chemical-compounding expertise of the pharmaceutical companies and the fashion/marketing orientation of the cosmetics business was the undoing of what otherwise was diversification into access (CDMA) technology (a technology prevalent in the United States and some developing nations). As of 2004 Lucent had an estimated 45 percent share in the CDMA market and the CDMA gear division was the company’s chief revenue and profit producer.

- The wireline and wireless business units were combined to form a single, unified organization called Network Solutions.
- All the remaining businesses were grouped into a unit called Lucent Worldwide Services that was engaged in designing, implementing, integrating, and managing sophisticated voice and data networks for service providers in 45 countries.
- The role of Bell Labs was narrowed to supporting the efforts of both the Network Solutions group and the Worldwide Services group.

Lucent’s strategic moves to retrench stemmed a string of 13 straight money-losing quarters. In fiscal 2004 Lucent reported profits of $2 billion from continuing operations (equal to EPS of $0.47 but still far below the levels of $0.93 in 2000 and $1.12 in 1999). In May 2004, Lucent announced its first acquisition in four years, buying a maker of Internet transmission technology for $300 million to help it become a leader in Internet telephony technology. Going into 2006, Lucent was a company with sales of about $9 billion (versus $38 billion in 1999) and a workforce of about 30,000 (versus 157,000 in 1999). The company’s stock price, which reached a high of $62 in 1999 before crashing to below $1 in 2002, languished in the $3–$4 range for most of 2004–2005, indicating continuing investor skepticism about Lucent’s prospects despite its having retreated to businesses where it was strongest.

businesses with technology-sharing potential, product-development fit, and some overlap in distribution channels.

There’s evidence indicating that pruning businesses and narrowing a firm’s diversification base improves corporate performance. Corporate parents often end up selling off businesses too late and at too low a price, sacrificing shareholder value. A useful guide to determine whether or when to divest a business subsidiary is to ask, “If we were not in this business today, would we want to get into it now?” When the answer is no or probably not, divestiture should be considered. Another signal that a business should become a divestiture candidate is whether it is worth more to another company than to the present parent; in such cases, shareholders would be well served if the company sells the business and collects a premium price from the buyer for whom the business is a valuable fit.

The Two Options for Divesting a Business: Selling It or Spinning It Off as an Independent Company

Selling a business outright to another company is far and away the most frequently used option for divesting a business. But sometimes a business selected for divestiture has ample resource strengths to compete successfully on its own. In such cases, a corporate parent may elect to spin the unwanted business off as a financially and managerially independent company, either by selling shares to the investing public via an initial public offering or by distributing shares in the new company to existing shareholders of the corporate parent. When a corporate parent decides to spin off one of its businesses as a separate company, it must decide whether or not to retain partial ownership. Retaining partial ownership makes sense when the business to be divested has a hot product or technological capabilities that give it good profit prospects. When 3Com elected to divest its PalmPilot business, which investors then saw as having very promising profit potential, it elected to retain a substantial ownership interest so as to provide 3Com shareholders a way of participating in whatever future market success that PalmPilot (now Palm Inc.) might have on its own. In 2001, when Philip Morris (now Altria) became concerned that its popular Kraft Foods subsidiary was suffering because of its affiliation with Philip Morris’s cigarette business (antismoking groups were leading a national boycott of Kraft macaroni and cheese, and a Harris poll revealed that about 16 percent of people familiar with Philip Morris had boycotted its products), Philip Morris executives opted to spin Kraft Foods off as an independent public company but retained a controlling ownership interest. R. J. Reynolds Tobacco was also spun off from Nabisco Foods in 1999 in an effort to distance the tobacco operations part of the company from the food operations part. (Nabisco was then acquired by Philip Morris in 2000 and integrated into Kraft Foods.) In 2005, Cendant announced it would split its diversified businesses into four separate publicly traded companies—one for vehicle rental services (which consisted of Avis and Budget car rental companies); one for real estate and mortgage services (which included Century 21, Coldwell Banker, ERA, Sotheby’s International Realty, and NRT—a residential real estate brokerage company); one for hospitality and lodging (consisting of such hotels and motel chains as Wyndam, Ramada, Days Inn, Howard Johnson, Travelodge, AmeriHost Inn, and Knights Inn, plus an assortment of time-share resort properties); and one for travel (consisting of various travel agencies, online ticket and vacation travel sites like Orbitz and Cheap Tickets, and vacation rental operations handling some 55,000 villas and condos). Cendant said the reason for the split-up was that shareholders would realize more value from operating the businesses independently—a clear sign that
Strategies to Restructure a Company’s Business Lineup

Restructuring strategies involve divesting some businesses and acquiring others so as to put a whole new face on the company’s business lineup. Performing radical surgery on a company’s group of businesses is an appealing strategy alternative when its financial performance is being squeezed or eroded by:

- Too many businesses in slow-growth, declining, low-margin, or otherwise unattractive industries (a condition indicated by the number and size of businesses with industry attractiveness ratings below 5 and located on the bottom half of the attractiveness–strength matrix—see Figure 9.5).
- Too many competitively weak businesses (a condition indicated by the number and size of businesses with competitive strength ratings below 5 and located on the right half of the attractiveness–strength matrix).
- Ongoing declines in the market shares of one or more major business units that are falling prey to more market-savvy competitors.
- An excessive debt burden with interest costs that eat deeply into profitability.
- Ill-chosen acquisitions that haven’t lived up to expectations.

Restructuring can also be mandated by the emergence of new technologies that threaten the survival of one or more of a diversified company’s important businesses or by the appointment of a new CEO who decides to redirect the company. On occasion, restructuring can be prompted by special circumstances—as when a firm has a unique opportunity to make an acquisition so big and important that it has to sell several existing business units to finance the new acquisition, or when a company needs to sell off some businesses in order to raise the cash for entering a potentially big industry with wave-of-the-future technologies or products.

Candidates for divestiture in a corporate restructuring effort typically include not only weak or up-and-down performers or those in unattractive industries but also business units that lack strategic fit with the businesses to be retained, businesses that are cash hogs or that lack other types of resource fit, and businesses incompatible with the company’s revised diversification strategy (even though they may be profitable in an attractive industry). As businesses are divested, corporate restructuring generally involves aligning the remaining business units into groups with the best strategic fits.
and then redeploying the cash flows from the divested business to either pay down debt or make new acquisitions to strengthen the parent company’s business position in the industries it has chosen to emphasize.\textsuperscript{26}

Over the past decade, corporate restructuring has become a popular strategy at many diversified companies, especially those that had diversified broadly into many different industries and lines of business. For instance, one struggling diversified company over a two-year period divested four business units, closed down the operations of four others, and added 25 new lines of business to its portfolio (16 through acquisition and 9 through internal start-up). PerkinElmer used a series of divestitures and new acquisitions to transform itself from a supplier of low-margin services sold to the government agencies into an innovative high-tech company with operations in over 125 countries and businesses in four industry groups—life sciences (drug research and clinical screening), optoelectronics, medical instruments, and fluid control and containment services (for customers in aerospace, power generation, and semiconductors). In 2005, PerkinElmer took a second restructuring step by divesting its entire fluid control and containment business group so that it could concentrate on its higher-growth health sciences and optoelectronics businesses; the company’s CEO said, “While fluid services is an excellent business, it does not fit with our long-term strategy.”\textsuperscript{27} Before beginning a restructuring effort in 1995, British-based Hanson PLC owned companies with more than $20 billion in revenues in industries as diverse as beer, exercise equipment, tools, construction cranes, tobacco, cement, chemicals, coal mining, electricity, hot tubs and whirlpools, cookware, rock and gravel, bricks, and asphalt. By early 1997, Hanson had restructured itself into a $3.8 billion enterprise focused more narrowly on gravel, crushed rock, cement, asphalt, bricks, and construction cranes; the remaining businesses were divided into four groups and divested.

During Jack Welch’s first four years as CEO of General Electric (GE), the company divested 117 business units, accounting for about 20 percent of GE’s assets; these divestitures, coupled with several important acquisitions, provided GE with 14 major business divisions and led to Welch’s challenge to the managers of GE’s divisions to become number one or number two in their industry. Ten years after Welch became CEO, GE was a different company, having divested operations worth $9 billion, made new acquisitions totaling $24 billion, and cut its workforce by 100,000 people. Then, during the 1990–2001 period, GE continued to reshuffle its business lineup, acquiring over 600 new companies, including 108 in 1998 and 64 during a 90-day period in 1999. Most of the new acquisitions were in Europe, Asia, and Latin America and were aimed at transforming GE into a truly global enterprise. In 2003, GE’s new CEO, Jeffrey Immelt, began a further restructuring of GE’s business lineup with three initiatives: (1) spending $10 billion to acquire British-based Amersham and extend GE’s Medical Systems business into diagnostic pharmaceuticals and biosciences, thereby creating a $15 billion business designated as GE Healthcare; (2) acquiring the entertainment assets of debt-ridden French media conglomerate Vivendi Universal Entertainment (Universal Studios, five Universal theme parks, USA Network, Sci-Fi Channel, the Trio cable channel, and Spanish-language broadcaster Telemundo) and integrate its operations into GE’s NBC division (the owner of NBC, 29 television stations, and cable networks CNBC, MSNBC, and Bravo), thereby creating a broad-based $13 billion media business positioned to compete against Walt Disney, Time Warner, Fox, and Viacom; and (3) beginning a withdrawal from the insurance business by divesting several companies in its insurance division and preparing to spin off its remaining life and mortgage insurance businesses through an initial public offering of stock for a new company called Genworth Financial.
In a study of the performance of the 200 largest U.S. corporations from 1990 to 2000, McKinsey & Company found that those companies that actively managed their business portfolios through acquisitions and divestitures created substantially more shareholder value than those that kept a fixed lineup of businesses.28

**Multinational Diversification Strategies**

The distinguishing characteristics of a multinational diversification strategy are a *diversity of businesses* and a *diversity of national markets*.29 Such diversity makes multinational diversification a particularly challenging and complex strategy to conceive and execute. Managers have to develop business strategies for each industry (with as many multinational variations as conditions in each country market dictate). Then they have to pursue and manage opportunities for cross-business and cross-country collaboration and strategic coordination in ways calculated to result in competitive advantage and enhanced profitability.

Moreover, the geographic operating scope of individual businesses within a diversified multinational corporation (DMNC) can range from one country only to several countries to many countries to global. Thus, each business unit within a DMNC often competes in a somewhat different combination of geographic markets than the other businesses do—adding another element of strategic complexity, and perhaps an element of opportunity.

Illustration Capsule 9.5 shows the scope of four prominent DMNCs.

**The Appeal of Multinational Diversification: More Opportunities for Sustained Growth and Maximum Competitive Advantage Potential**

Despite their complexity, multinational diversification strategies have great appeal. They contain *two major avenues* for growing revenues and profits: One is to grow by entering additional businesses, and the other is to grow by extending the operations of existing businesses into additional country markets. Moreover, a strategy of multinational diversification also contains six attractive paths to competitive advantage, *all of which can be pursued simultaneously*:

1. **Full capture of economies of scale and experience/learning curve effects.** In some businesses, the volume of sales needed to realize full economies of scale and/or benefit fully from experience/learning curve effects is rather sizable, often exceeding the volume that can be achieved operating within the boundaries of a single country market, especially a small one. *The ability to drive down unit costs by expanding sales to additional country markets is one reason why a diversified multinational may seek to acquire a business and then rapidly expand its operations into more and more foreign markets.*

2. **Opportunities to capitalize on cross-business economies of scope.** Diversifying into related businesses offering economies of scope can drive the development of a low-cost advantage over less diversified rivals. For example, a DMNC that uses mostly the same distributors and retail dealers worldwide can diversify into new businesses using these same worldwide distribution channels at relatively little incremental expense. The cost savings of piggybacking distribution activities can be substantial. Moreover, with more business selling more products in more countries, a DMNC acquires more bargaining leverage in its purchases from suppliers and more bargaining leverage with retailers in securing attractive display space for its products. Consider, for example, the competitive power that Sony derived...
from these very sorts of economies of scope when it decided to diversify into the video game business with its PlayStation product line. Sony had in place capability to go after video game sales in all country markets where it presently did business in other electronics product categories (TVs, computers, DVD players, VCRs, radios, CD players, and camcorders). And it had the marketing clout and brand-name credibility to persuade retailers to give Sony’s PlayStation products prime shelf space and visibility. These strategic-fit benefits helped Sony quickly overtake long-time industry leaders Nintendo and Sega and defend its market leadership against Microsoft’s new Xbox.

### Illustration Capsule 9.5

**The Global Scope of Four Prominent Diversified Multinational Corporations**

<table>
<thead>
<tr>
<th>Company</th>
<th>Global Scope</th>
<th>Businesses into Which the Company Has Diversified</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sony</td>
<td>Operations in more than 100 countries and sales offices in more than 200 countries</td>
<td>• Televisions, VCRs, DVD players, Walkman MP3 players, radios, digital cameras and video equipment, Vaio PCs, and Trinitron computer monitors; PlayStation game consoles and video game software; Columbia, Epic, and Sony Classical pre-recorded music; Columbia TriStar motion pictures; syndicated television programs; entertainment complexes, and insurance</td>
</tr>
<tr>
<td>Nestlé</td>
<td>Operations in 70 countries and sales offices in more than 200 countries</td>
<td>• Beverages (Nescafé and Taster’s Choice coffees, Nestea, Perrier, Arrowhead, &amp; Calistoga mineral and bottled waters); milk products (Carnation, Gloria, Neslac, Coffee Mate, Nestlé ice cream and yogurt); pet foods (Friskies, Alpo, Fancy Feast, Mighty Dog); Contadina, Libby’s, and Stouffer’s food products and prepared dishes; chocolate and confectionery products (Nestlé Crunch, Smarties, Baby Ruth, Butterfinger, KitKat); and pharmaceuticals (Alcon ophthalmic products, Galderma dermatological products)</td>
</tr>
<tr>
<td>Siemens</td>
<td>Operations in 160 countries and sales offices in more than 190 countries</td>
<td>• Electrical power generation, transmission, and distribution equipment and products; manufacturing automation systems; industrial motors, machinery, and tools; plant construction and maintenance; corporate communication networks; telephones; PCs, mainframes, computer network products, consulting services; mass transit and light rail systems, rail cars, locomotives, lighting products (bulbs, lamps, theater and television lighting systems); semiconductors; home appliances; vacuum cleaners; and financial, procurement, and logistics services</td>
</tr>
<tr>
<td>Samsung</td>
<td>Operations in more than 60 countries and sales offices in more than 200 countries</td>
<td>• Notebook computers, hard disk drives, CD/DVD-ROM drives, monitors, printers, and fax machines; televisions (big-screen TVs, plasma-screen TVs, and LCD-screen TVs); DVD and MP3 players; Cell phones and various other telecommunications products; compressors; home appliances; DRAM chips, flash memory chips, and graphics memory chips; and optical fibers, fiber-optic cables, and fiber-optic connectors</td>
</tr>
</tbody>
</table>

*Source: Company annual reports and Web sites.*
3. **Opportunities to transfer competitively valuable resources both from one business to another and from one country to another.** A company pursuing related diversification can gain a competitive edge over less diversified rivals by transferring competitively valuable resources from one business to another; a multinational company can gain competitive advantage over rivals with narrower geographic coverage by transferring competitively valuable resources from one country to another. But a strategy of multinational diversification enables simultaneous pursuit of both sources of competitive advantage.

4. **Ability to leverage use of a well-known and competitively powerful brand name.** Diversified multinational companies whose businesses have brand names that are well known and respected across the world possess a valuable strategic asset with competitive advantage potential. For example, Sony’s well-established global brand-name recognition gives it an important marketing and advertising advantage over rivals with lesser-known brands. When Sony goes into a new marketplace with the stamp of the Sony brand on its product families, it can command prominent display space with retailers. It can expect to win sales and market share simply on the confidence that buyers place in products carrying the Sony name. While Sony may spend money to make consumers aware of the availability of its new products, it does not have to spend nearly as much on achieving brand recognition and market acceptance as would a lesser-known competitor looking at the marketing and advertising costs of entering the same new product/business/country markets and trying to go head-to-head against Sony. Further, if Sony moves into a new country market for the first time and does well selling Sony PlayStations and video games, it is easier to sell consumers in that country Sony TVs, digital cameras, PCs, MP3 players, and so on—plus, the related advertising costs are likely to be less than they would be without having already established the Sony brand strongly in the minds of buyers.

5. **Ability to capitalize on opportunities for cross-business and cross-country collaboration and strategic coordination.** A multinational diversification strategy allows competitively valuable cross-business and cross-country coordination of certain value chain activities. For instance, by channeling corporate resources directly into a combined R&D/technology effort for all related businesses, opposed to letting each business unit fund and direct its own R&D effort however it sees fit, a DMNC can merge its expertise and efforts worldwide to advance core technologies, expedite cross-business and cross-country product improvements, speed the development of new products that complement existing products, and pursue promising technological avenues to create altogether new businesses—all significant contributors to competitive advantage and better corporate performance. Honda has been very successful in building R&D expertise in gasoline engines and transferring the resulting technological advances to its businesses in automobiles, motorcycles, outboard engines, snow blowers, lawn mowers, garden tillers, and portable power generators. Further, a DMNC can reduce costs through cross-business and cross-country coordination of purchasing and procurement from suppliers, from collaborative introduction and shared use of e-commerce technologies and online sales efforts, and from coordinated product introductions and promotional campaigns. Firms that are less diversified and less global in scope have less such cross-business and cross-country collaborative opportunities.
6. **Opportunities to use cross-business or cross-country subsidization to outcompete rivals.** A financially successful DMNC has potentially valuable organizational resources and multiple profit sanctuaries in both certain country markets and certain businesses that it can draw on to wage a market offensive. In comparison, a one-business domestic company has only one profit sanctuary—its home market. A diversified one-country competitor may have profit sanctuaries in several businesses, but all are in the same country market. A one-business multinational company may have profit sanctuaries in several country markets, but all are in the same business. All three are vulnerable to an offensive in their more limited profit sanctuaries by an aggressive DMNC willing to lowball its prices or spend extravagantly on advertising to win market share at their expense. A DMNC’s ability to keep hammering away at competitors with low prices year after year may reflect either a cost advantage growing out of its related diversification strategy or a willingness to accept low profits or even losses in the market being attacked because it has ample earnings from its other profit sanctuaries. For example, Sony’s global-scale diversification strategy gives it unique competitive strengths in outcompeting Nintendo and Sega, neither of which are diversified. If need be, Sony can maintain low prices on its PlayStations or fund high-profile promotions for its latest video game products, using earnings from its other business lines to fund its offensive to wrest market share away from Nintendo and Sega in video games. At the same time, Sony can draw on its considerable resources in R&D, its ability to transfer electronics technology from one electronics product family to another, and its expertise in product innovation to introduce better and better video game players, perhaps players that are multifunctional and do more than just play video games. Such competitive actions not only enhance Sony’s own brand image but also make it very tough for Nintendo and Sega to match Sony’s prices, advertising, and product development efforts and still earn acceptable profits.

**The Combined Effects of These Advantages Is Potent**  A strategy of diversifying into related industries and then competing globally in each of these industries thus has great potential for being a winner in the marketplace because of the long-term growth opportunities it offers and the multiple corporate-level competitive advantage opportunities it contains. Indeed, a strategy of multinational diversification contains more competitive advantage potential (above and beyond what is achievable through a particular business’s own competitive strategy) than any other diversification strategy. The strategic key to maximum competitive advantage is for a DMNC to concentrate its diversification efforts in those industries where there are resource-sharing and resource-transfer opportunities and where there are important economies of scope and brand-name benefits. The more a company’s diversification strategy yields these kinds of strategic-fit benefits, the more powerful a competitor it becomes and the better its profit and growth performance is likely to be.

However, it is important to recognize that while, in theory, a DMNC’s cross-subsidization capabilities are a potent competitive weapon, cross-subsidization can, in actual practice, be used only sparingly. It is one thing to occasionally divert a portion of the profits and cash flows from existing businesses to help fund entry into a new business or country market or wage a competitive offensive against select rivals. It is quite another thing to regularly use cross-subsidization tactics and thereby weaken...
overall company performance. A DMNC is under the same pressures as any other company to demonstrate consistently acceptable profitability across its whole operation. At some juncture, every business and every country market needs to make a profit contribution or become a candidate for abandonment. As a general rule, cross-subsidization tactics are justified only when there is a good prospect that the short-term impairment to corporate profitability will be offset by stronger competitiveness and better overall profitability over the long term.

Key Points

The purpose of diversification is to build shareholder value. Diversification builds shareholder value when a diversified group of businesses can perform better under the auspices of a single corporate parent than they would as independent, stand-alone businesses—the goal is not to achieve just a $1 + 1 = 2$ result, but rather to realize important $1 + 1 = 3$ performance benefits. Whether getting into a new business has potential to enhance shareholder value hinges on whether a company’s entry into that business can pass the attractiveness test, the cost-of-entry test, and the better-off test.

Entry into new businesses can take any of three forms: acquisition, internal start-up, or joint venture/strategic partnership. Each has its pros and cons, but acquisition is the most frequently used; internal start-up takes the longest to produce home-run results, and joint venture/strategic partnership, though used second most frequently, is the least durable.

There are two fundamental approaches to diversification—into related businesses and into unrelated businesses. The rationale for related diversification is strategic: Diversify into businesses with strategic fits along their respective value chains, capitalize on strategic-fit relationships to gain competitive advantage, and then use competitive advantage to achieve the desired $1 + 1 = 3$ impact on shareholder value.

The basic premise of unrelated diversification is that any business that has good profit prospects and can be acquired on good financial terms is a good business to diversify into. Unrelated diversification strategies surrender the competitive advantage potential of strategic fit in return for such advantages as (1) spreading business risk over a variety of industries and (2) providing opportunities for financial gain (if candidate acquisitions have undervalued assets, are bargain priced and have good upside potential given the right management, or need the backing of a financially strong parent to capitalize on attractive opportunities). However, the greater the number of businesses a company has diversified into and the more diverse these businesses are, the harder it is for corporate executives to select capable managers to run each business, know when the major strategic proposals of business units are sound, or decide on a wise course of recovery when a business unit stumbles.

Analyzing how good a company’s diversification strategy is a six-step process:

1. Evaluate the long-term attractiveness of the industries into which the firm has diversified. Industry attractiveness needs to be evaluated from three angles: the attractiveness of each industry on its own, the attractiveness of each industry relative to the others, and the attractiveness of all the industries as a group.

2. Evaluate the relative competitive strength of each of the company’s business units. Again, quantitative ratings of competitive strength are preferable to subjective
judgments. The purpose of rating the competitive strength of each business is to gain clear understanding of which businesses are strong contenders in their industries, which are weak contenders, and the underlying reasons for their strength or weakness. The conclusions about industry attractiveness can be joined with the conclusions about competitive strength by drawing an industry attractiveness–competitive strength matrix that helps identify the prospects of each business and what priority each business should be given in allocating corporate resources and investment capital.

3. **Check for cross-business strategic fits.** A business is more attractive strategically when it has value chain relationships with sister business units that offer potential to (a) realize economies of scope or cost-saving efficiencies; (b) transfer technology, skills, know-how, or other resource capabilities from one business to another; (c) leverage use of a well-known and trusted brand name; and (d) to build new or stronger resource strengths and competitive capabilities via cross-business collaboration. Cross-business strategic fits represent a significant avenue for producing competitive advantage beyond what any one business can achieve on its own.

4. **Check whether the firm’s resource strengths fit the resource requirements of its present business lineup.** Resource fit exists when (a) businesses add to a company’s resource strengths, either financially or strategically; (b) a company has the resources to adequately support the resource requirements of its businesses as a group without spreading itself too thin; and (c) there are close matches between a company’s resources and industry key success factors. One important test of financial resource fit involves determining whether a company has ample cash cows and not too many cash hogs.

5. **Rank the performance prospects of the businesses from best to worst and determine what the corporate parent’s priority should be in allocating resources to its various businesses.** The most important considerations in judging business-unit performance are sales growth, profit growth, contribution to company earnings, and the return on capital invested in the business. Sometimes, cash flow generation is a big consideration. Normally, strong business units in attractive industries have significantly better performance prospects than weak businesses or businesses in unattractive industries. Business subsidiaries with the brightest profit and growth prospects and solid strategic and resource fits generally should head the list for corporate resource support.

6. **Crafting new strategic moves to improve overall corporate performance.** This step entails using the results of the preceding analysis as the basis for devising actions to strengthen existing businesses, make new acquisitions, divest weak-performing and unattractive businesses, restructure the company’s business lineup, expand the scope of the company’s geographic reach multinational or globally, and otherwise steer corporate resources into the areas of greatest opportunity.

Once a company has diversified, corporate management’s task is to manage the collection of businesses for maximum long-term performance. There are four different strategic paths for improving a diversified company’s performance: (1) broadening the firm’s business base by diversifying into additional businesses, (2) retrenching to a narrower diversification base by divesting some of its present businesses, (3) restructuring the company, and (4) diversifying multinationally.
Exercises

1. Consider the business lineup of General Electric (GE) shown in Illustration Capsule 9.2. What problems do you think the top executives at GE encounter in trying to stay on top of all the businesses the company is in? How might they decide the merits of adding new businesses or divesting poorly performing businesses? What types of advice might they be in a position to give to the general managers of each of GE’s business units?

2. The Walt Disney Company is in the following businesses:
   - Theme parks.
   - Disney Cruise Line.
   - Resort properties.
   - Movie, video, and theatrical productions (for both children and adults).
   - Television broadcasting (ABC, Disney Channel, Toon Disney, Classic Sports Network, ESPN and ESPN2, E!, Lifetime, and A&E networks).
   - Radio broadcasting (Disney Radio).
   - Musical recordings and sales of animation art.
   - Anaheim Mighty Ducks NHL franchise.
   - Anaheim Angels major league baseball franchise (25 percent ownership).
   - Books and magazine publishing.
   - Interactive software and Internet sites.
   - The Disney Store retail shops.

Given the above listing, would you say that Walt Disney’s business lineup reflects a strategy of related or unrelated diversification? Explain your answer in terms of the extent to which the value chains of Disney’s different businesses seem to have competitively valuable cross-business relationships.

3. Newell Rubbermaid is in the following businesses:
   - Cleaning and organizations businesses: Rubbermaid storage, organization, and cleaning products; Blue Ice ice substitute; Roughneck storage item; Stain Shield and TakeAlongs food storage containers; and Brute commercial-grade storage and cleaning products (25 percent of annual revenues).
   - Home and family businesses: Calphalon cookware and bakeware, Cookware Europe, Graco strollers, Little Tikes children’s toys and furniture, and Goody hair accessories (20 percent of annual sales).
   - Home fashions: Levolor and Kirsch window blinds, shades, and hardware in the United States; Swish, Gardinia and Harrison Drape home furnishings in Europe (15 percent of annual revenues).
   - Office products businesses: Sharpie markers, Sanford highlighters, Eberhard Faber and Berol ballpoint pens, Paper Mate pens and pencils, Waterman and Parker fine writing instruments, and Liquid Paper (25 percent of annual revenues).

Would you say that Newell Rubbermaid’s strategy is one of related diversification, unrelated diversification or a mixture of both? Explain.
4. Explore the Web sites of the following companies and determine whether the company is pursuing a strategy of related diversification, unrelated diversification, or a mixture of both:
   - Berkshire Hathaway
   - News Corporation
   - Dow Jones & Company
   - Kimberly Clark
When morality comes up against profit, it is seldom profit that loses.
—Shirley Chisholm
Former Congresswoman

But I’d shut my eyes in the sentry box so I didn’t see nothing wrong.
—Rudyard Kipling
Author

Values can’t just be words on a page. To be effective, they must shape action.
—Jeffrey R. Immelt
CEO, General Electric

Leaders must be more than individuals of high character. They must “lead” others to behave ethically.
—Linda K. Treviño
and Michael E. Brown
Professors

Integrity violations are no-brainers. In such cases, you don’t need to hesitate for a moment before firing someone or fret about it either. Just do it, and make sure the organization knows why, so that the consequences of breaking the rules are not lost on anyone.
—Jack Welch
Former CEO, General Electric

There is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say engages in free and open competition, without deception or fraud.
—Milton Friedman
Nobel Prize–winning economist

Corporations are economic entities, to be sure, but they are also social institutions that must justify their existence by their overall contribution to society.
—Henry Mintzberg, Robert Simons, and Kunal Basu
Professors
C
learly, a company has a responsibility to make a profit and grow the business—in capitalistic, or market, economies, management’s fiduciary duty to create value for shareholders is not a matter for serious debate. Just as clearly, a company and its personnel also have a duty to obey the law and play by the rules of fair competition. But does a company have a duty to operate according to the ethical norms of the societies in which it operates—should it be held to some standard of ethical conduct? And does it have a duty or obligation to contribute to the betterment of society independent of the needs and preferences of the customers it serves? Should a company display a social conscience and devote a portion of its resources to bettering society?

The focus of this chapter is to examine what link, if any, there should be between a company’s efforts to craft and execute a winning strategy and its duties to (1) conduct its activities ethically and (2) demonstrate socially responsible behavior by being a committed corporate citizen and directing corporate resources to the betterment of employees, the communities in which it operates, and society as a whole.

WHAT DO WE MEAN BY BUSINESS ETHICS?

Business ethics is the application of ethical principles and standards to business behavior. Business ethics does not really involve a special set of ethical standards applicable only to business situations. Ethical principles in business are not materially different from ethical principles in general. Why? Because business actions have to be judged in the context of society’s standards of right and wrong, not by a special set of rules that businesspeople decide to apply to their own conduct. If dishonesty is considered to be unethical and immoral, then dishonest behavior in business—whether it relates to customers, suppliers, employees or shareholders—qualifies as equally unethical and immoral. If being ethical entails not deliberately harming others, then recalling a defective or unsafe product is ethically necessary and failing to undertake such a recall or correct the problem in future shipments of the product is likewise unethical. If society deems bribery to be unethical, then it is unethical for company personnel to make payoffs to government officials to facilitate business transactions or bestow gifts and other favors on prospective customers to win or retain their business.
Notions of right and wrong, fair and unfair, moral and immoral, ethical and unethical are present in all societies, organizations, and individuals. But there are three schools of thought about the extent to which the ethical standards travel across cultures and whether multinational companies can apply the same set of ethical standards in any and all of the locations where they operate.

The School of Ethical Universalism

According to the school of ethical universalism, some concepts of what is right and what is wrong are universal; that is, they transcend all cultures, societies, and religions. For instance, being truthful (or not lying, or not being deliberately deceitful) is considered right by the peoples of all nations. Likewise, demonstrating integrity of character, not cheating, and treating people with dignity and respect are concepts that resonate with people of most cultures and religions. In most societies, people believe that companies should not pillage or degrade the environment in the course of conducting their operations. In most societies, people would concur that it is unethical to knowingly expose workers to toxic chemicals and hazardous materials or to sell products known to be unsafe or harmful to the users.

To the extent that there is common moral agreement about right and wrong actions and behaviors across multiple cultures and countries, there exists a set of universal ethical standards to which all societies, all companies, and all individuals can be held accountable. These universal ethical principles or norms put limits on what actions and behaviors fall inside the boundaries of what is right and which ones fall outside. They set forth the traits and behaviors that are considered virtuous and that a good person is supposed to believe in and to display.

Many ethicists believe that the most important moral standards travel well across countries and cultures and thus are universal—universal norms include honesty or trustworthiness, respecting the rights of others, practicing the Golden Rule, avoiding unnecessary harm to workers or to the users of the company’s product or service, and respect for the environment. In all such instances where there is cross-cultural agreement as to what actions and behaviors are inside and outside ethical and moral boundaries, adherents of the school of ethical universalism maintain that the conduct of personnel at companies operating in a variety of country markets and cultural circumstances can be judged against the resulting set of common ethical standards.

The strength of ethical universalism is that it draws on the collective views of multiple societies and cultures to put some clear boundaries on what constitutes ethical business behavior and what constitutes unethical business behavior no matter what country market or culture a company or its personnel are operating in. This means that whenever basic moral standards really do not vary significantly according to local cultural beliefs, traditions, religious convictions, or time and circumstance, a multinational company can apply a code of ethics more or less evenly across its worldwide operations. It can avoid the slippery slope that comes from having different ethical standards for different company personnel depending on where in the world they are working.
The School of Ethical Relativism

Apart from select universal basics—honesty, trustworthiness, fairness, a regard for worker safety, and respect for the environment—there are meaningful variations in what societies generally agree to be right and wrong in the conduct of business activities. Divergent religious beliefs, historic traditions, social customs, and prevailing political and economic doctrines (whether a country leans more toward a capitalistic market economy or one heavily dominated by socialistic or communistic principles) frequently produce ethical norms that vary from one country to another. The school of ethical relativism holds that when there are cross-country or cross-cultural differences in what is deemed fair or unfair, what constitutes proper regard for human rights, and what is considered ethical or unethical in business situations, it is appropriate for local moral standards to take precedence over what the ethical standards may be elsewhere—for instance, in a company’s home market. The thesis is that whatever a culture thinks is right or wrong really is right or wrong for that culture. Hence, the school of ethical relativism contends that there are important occasions when cultural norms and the circumstances of the situation determine whether certain actions or behaviors are right or wrong. Consider the following examples.

The Use of Underage Labor

In industrialized nations, the use of underage workers is considered taboo; social activists are adamant that child labor is unethical and that companies should neither employ children under the age of 18 as full-time employees nor source any products from foreign suppliers that employ underage workers. Many countries have passed legislation forbidding the use of underage labor or, at a minimum, regulating the employment of people under the age of 18. However, in India, Bangladesh, Botswana, Sri Lanka, Ghana, Somalia, Turkey, and 100-plus other countries, it is customary to view children as potential, even necessary, workers. Many poverty-stricken families cannot subsist without the income earned by young family members, and sending their children to school instead of having them participate in the workforce is not a realistic option. In 2000, the International Labor Organization estimated that 211 million children ages 5 to 14 were working around the world. If such children are not permitted to work—due to pressures imposed by activist groups in industrialized nations—they may be forced to seek work in lower-wage jobs in “hidden” parts of the economy of their countries, beg on the street, or even traffic in drugs or engage in prostitution. So if all businesses succumb to the protests of activist groups and government organizations that, based on their values and beliefs, loudly proclaim that underage labor is unethical, then have either businesses or the protesting groups really done something good on behalf of society in general?

The Payment of Bribes and Kickbacks

A particularly thorny area facing multinational companies is the degree of cross-country variability in paying bribes. In many countries in Eastern Europe, Africa, Latin America, and Asia, it is customary to pay bribes to government officials in order to win a government contract, obtain a license or permit, or facilitate an administrative ruling. Senior managers in China often use their power to obtain kickbacks and offer bribes when they purchase materials or other products for their companies. In some developing nations, it is difficult for any company, foreign or domestic, to move goods through customs without paying off low-level officials. Likewise, in many countries it is normal to make payments to prospective customers in order to win or retain their business. A Wall Street Journal
article reported that 30 to 60 percent of all business transactions in Eastern Europe involved paying bribes, and the costs of bribe payments averaged 2 to 8 percent of revenues. Three recent annual issues of the Global Corruption Report, sponsored by Berlin-based Transparency International, provide credible evidence that corruption among public officials and in business transactions is widespread across the world. Some people stretch to justify the payment of bribes and kickbacks on grounds that bribing government officials to get goods through customs or giving kickbacks to customers to retain their business or win an order is simply a payment for services rendered, in the same way that people tip for service at restaurants. But this argument rests on moral quicksand, even though it is a clever and pragmatic way to rationalize why such facilitating payments should be viewed as a normal and maybe unavoidable cost of doing business in some countries.

Companies that forbid the payment of bribes and kickbacks in their codes of ethical conduct and that are serious about enforcing this prohibition face a particularly vexing problem in those countries where bribery and kickback payments have been entrenched as a local custom for decades and are not considered unethical by the local population. Refusing to pay bribes or kickbacks (so as to comply with the company’s code of ethical conduct) is very often tantamount to losing business. Frequently, the sales and profits are lost to more unscrupulous companies, with the result that both ethical companies and ethical individuals are penalized. However, winking at the code of ethical conduct and going along with the payment of bribes or kickbacks not only undercuts enforcement of and adherence to the company’s code of ethics but can also risk breaking the law. U.S. companies are prohibited by the Foreign Corrupt Practices Act (FCPA) from paying bribes to government officials, political parties, political candidates, or others in all countries where they do business; the FCPA requires U.S. companies with foreign operations to adopt accounting practices that ensure full disclosure of a company’s transactions so that illegal payments can be detected. The 35 member countries of the Organization for Economic Cooperation and Development (OECD) in 1997 adopted a convention to combat bribery in international business transactions; the Anti-Bribery Convention obligated the countries to criminalize the bribery of foreign public officials, including payments made to political parties and party officials. So far, however, there has been only token enforcement of the OECD convention and the payment of bribes in global business transactions remains a common practice in many countries.

**Ethical Relativism Equates to Multiple Sets of Ethical Standards** The existence of varying ethical norms such as those cited above explains why the adherents of ethical relativism maintain that there are few absolutes when it comes to business ethics and thus few ethical absolutes for consistently judging a company’s conduct in various countries and markets. Indeed, the thesis of ethical relativists is that while there are sometimes general moral prescriptions that apply in most every society and business circumstance there are plenty of situations where ethical norms must be contoured to fit the local customs, traditions, and the notions of fairness shared by the parties involved. They argue that a one-size-fits-all template for judging the ethical appropriateness of business actions and the behaviors of company personnel simply does not exist—in other words, ethical problems in business cannot be fully resolved without appealing to the shared convictions of the parties in question. European and American managers may want to impose standards of business conduct that give heavy weight to such core human rights as personal freedom, individual security, political participation, the ownership of property, and the right to subsistence as well as the obligation to respect the dignity of each human person, adequate health and safety...
standards for all employees, and respect for the environment; managers in China have a much weaker commitment to these kinds of human rights. Japanese managers may prefer ethical standards that show respect for the collective good of society. Muslim managers may wish to apply ethical standards compatible with the teachings of Mohammed. Individual companies may want to give explicit recognition to the importance of company personnel living up to the company’s own espoused values and business principles. Clearly, there is merit in the school of ethical relativism’s view that what is deemed right or wrong, fair or unfair, moral or immoral, ethical or unethical in business situations depends partly on the context of each country’s local customs, religious traditions, and societal norms. Hence, there is a kernel of truth in the argument that businesses need some room to tailor their ethical standards to fit local situations. A company has to be very cautious about exporting its home-country values and ethics to foreign countries where it operates—“photocopying” ethics is disrespectful of other cultures and neglects the important role of moral free space.

**Pushed to Extremes, Ethical Relativism Breaks Down** While the relativistic rule of “When in Rome, do as the Romans do” appears reasonable, it nonetheless presents a big problem—when the envelope starts to be pushed, as will inevitably be the case, it is tantamount to rudderless ethical standards. Consider, for instance, the following example: In 1992, the owners of the SS United States, an aging luxury ocean liner constructed with asbestos in the 1940s, had the liner towed to Turkey, where a contractor had agreed to remove the asbestos for $2 million (versus a far higher cost in the United States, where asbestos removal safety standards were much more stringent).18 When Turkish officials blocked the asbestos removal because of the dangers to workers of contracting cancer, the owners had the liner towed to the Black Sea port of Sevastopol, in the Crimean Republic, where the asbestos removal standards were quite lax and where a contractor had agreed to remove more than 500,000 square feet of carcinogenic asbestos for less than $2 million. There are no moral grounds for arguing that exposing workers to carcinogenic asbestos is ethically correct, irrespective of what a country’s law allows or the value the country places on worker safety.

A company that adopts the principle of ethical relativism and holds company personnel to local ethical standards necessarily assumes that what prevails as local morality is an adequate guide to ethical behavior. This can be ethically dangerous—it leads to the conclusion that if a country’s culture is accepting of bribery or environmental degradation or exposing workers to dangerous conditions (toxic chemicals or bodily harm), then so much the worse for honest people and protection of the environment and safe working conditions. Such a position is morally unacceptable. Even though bribery of government officials in China is a common practice, when Lucent Technologies found that managers in its Chinese operations had bribed government officials, it fired the entire senior management team.19

Moreover, from a global markets perspective, ethical relativism results in a maze of conflicting ethical standards for multinational companies wanting to address the very real issue of what ethical standards to enforce companywide. On the one hand, multinational companies need to educate and motivate their employees worldwide to respect the customs and traditions of other nations, and, on the other hand, they must enforce compliance with the company’s own particular code of ethical behavior. It is a slippery slope indeed to resolve such ethical diversity without any kind of higher-order moral compass. Imagine, for example, that a multinational company in the name of
ethics and integrative social contracts theory

Social contract theory provides a middle position between the opposing views of universalism (that the same set of ethical standards should apply everywhere) and relativism (that ethical standards vary according to local custom). According to **integrative social contracts theory**, the ethical standards a company should try to uphold are governed both by (1) a limited number of universal ethical principles that are widely recognized as putting legitimate ethical boundaries on actions and behavior in all situations and (2) the circumstances of local cultures, traditions, and shared values that further prescribe what constitutes ethically permissible behavior and what does not. However, **universal ethical norms take precedence over local ethical norms**. In other words, universal ethical principles apply in those situations where most all societies—endowed with rationality and moral knowledge—have common moral agreement on what is wrong and thereby put limits on what actions and behaviors fall inside the boundaries of what is right and which ones fall outside. These mostly uniform agreements about what is morally right and wrong form a “social contract” or contract with society that is binding on all individuals, groups, organizations, and businesses in terms of establishing right and wrong and in drawing the line between ethical and unethical behaviors. But these universal ethical principles or norms nonetheless still leave some moral free space for the people in a particular country (or local culture or even a company) to make specific interpretations of what other actions may or may not be permissible within the bounds defined by universal ethical principles. Hence, while firms, industries, professional associations, and other business-relevant groups are contractually obligated to society to observe universal ethical norms, they have the discretion to go beyond these universal norms and specify other behaviors that are out of bounds and place further limitations on what is considered ethical. Both the legal and medical professions have standards regarding what kinds of advertising are ethically permissible and what kinds are not. Food products companies are beginning to establish ethical guidelines for judging what is and is not appropriate advertising for food products that are inherently unhealthy and may cause dietary or obesity problems for people who eat them regularly or consume them in large quantities.

The strength of integrated social contracts theory is that it accommodates the best parts of ethical universalism and ethical relativism. It is indisputable that cultural differences impact how business is conducted in various parts of the world and that these cultural differences sometimes give rise to different ethical norms. But it is just as indisputable that some ethical norms are more authentic or universally applicable than...
others, meaning that, in many instances of cross-country differences, one side may be more “ethically correct” or “more right” than another. In such instances, resolving cross-cultural differences entails applying universal, or first-order, ethical norms and overriding the local, or second-order, ethical norms. A good example is the payment of bribes and kickbacks. Yes, bribes and kickbacks seem to be common in some countries, but does this justify paying them? Just because bribery flourishes in a country does not mean that it is an authentic or legitimate ethical norm. Virtually all of the world’s major religions (Buddhism, Christianity, Confucianism, Hinduism, Islam, Judaism, Sikhism, and Taoism) and all moral schools of thought condemn bribery and corruption. Bribery is commonplace in India but interviews with Indian CEOs whose companies constantly engaged in payoffs indicated disgust for the practice and they expressed no illusions about its impropriety. Therefore, a multinational company might reasonably conclude that the right ethical standard is one of refusing to condone bribery and kickbacks on the part of company personnel no matter what the local custom is and no matter what the sales consequences are.

Granting an automatic preference to local country ethical norms presents vexing problems to multinational company managers when the ethical standards followed in a foreign country are lower than those in its home country or are in conflict with the company’s code of ethics. Sometimes there can be no compromise on what is ethically permissible and what is not. This is precisely what integrated social contracts theory maintains—universal or first-order ethical norms should always take precedence over local or second-order norms. Integrated social contracts theory offers managers in multinational companies clear guidance in resolving cross-country ethical differences: Those parts of the company’s code of ethics that involve universal ethical norms must be enforced worldwide, but within these boundaries there is room for ethical diversity and opportunity for host country cultures to exert some influence in setting their own moral and ethical standards. Such an approach detours the somewhat scary case of a self-righteous multinational company trying to operate as the standard-bearer of moral truth and imposing its interpretation of its code of ethics worldwide no matter what. And it avoids the equally scary case for a company’s ethical conduct to be no higher than local ethical norms in situations where local ethical norms permit practices that are generally considered immoral or when local norms clearly conflict with a company’s code of ethical conduct. But even with the guidance provided by integrated social contracts theory, there are many instances where cross-country differences in ethical norms create gray areas in which it is tough to draw a line in the sand between right and wrong decisions, actions, and business practices.

THE THREE CATEGORIES OF MANAGEMENT MORALITY

Three categories of managers stand out with regard to ethical and moral principles in business affairs:

- **The moral manager**—Moral managers are dedicated to high standards of ethical behavior, both in their own actions and in their expectations of how the company’s business is to be conducted. They see themselves as stewards of ethical behavior and believe it is important to exercise ethical leadership. Moral managers may well be ambitious and have a powerful urge to succeed, but they pursue success in business within the confines of both the letter and the spirit of what is ethical and legal—they typically regard the law as an ethical minimum and have a habit of operating well above what the law requires.
The immoral manager—Immoral managers have no regard for so-called ethical standards in business and pay no attention to ethical principles in making decisions and conducting the company’s business. Their philosophy is that good businesspeople cannot spend time watching out for the interests of others and agonizing over “the right thing to do.” In the minds of immoral managers, nice guys come in second and the competitive nature of business requires that you either trample on others or get trampled yourself. They believe what really matters is single-minded pursuit of their own best interests—they are living examples of capitalistic greed, caring only about their own or their organization’s gains and successes. Immoral managers may even be willing to short-circuit legal and regulatory requirements if they think they can escape detection. And they are always on the lookout for legal loopholes and creative ways to get around rules and regulations that block or constrain actions they deem in their own or their company’s self-interest. Immoral managers are thus the bad guys—they have few scruples, little or no integrity, and are willing to do most anything they believe they can get away with. It doesn’t bother them much to be seen by others as wearing the black hats.

The amoral manager—Amoral managers appear in two forms: the intentionally amoral manager and the unintentionally amoral manager. Intentionally amoral managers are of the strong opinion that business and ethics are not to be mixed. They are not troubled by failing to factor ethical considerations into their decisions and actions because it is perfectly legitimate for businesses to do anything they wish so long as they stay within legal and regulatory bounds—in other words, if particular actions and behaviors are legal and comply with existing regulations, then they qualify as permissible and should not be seen as unethical. Intentionally amoral managers view the observance of high ethical standards (doing more than what is required by law) as too Sunday-schoolish for the tough competitive world of business, even though observing some higher ethical considerations may be appropriate in life outside of business. Their concept of right and wrong tends to be lawyer-driven—how much can we get by with and can we go ahead even if it is borderline? Thus intentionally amoral managers hold firmly to the view that anything goes, so long as actions and behaviors are not clearly ruled out by prevailing legal and regulatory requirements.

Unintentionally amoral managers do not pay much attention to the concept of business ethics either, but for different reasons. They are simply casual about, careless about, or inattentive to the fact that certain kinds of business decisions or company activities are unsavory or may have deleterious effects on others—in short, they go about their jobs as best they can without giving serious thought to the ethical dimension of decisions and business actions. They are ethically unconscious when it comes to business matters, partly or mainly because they have just never stopped to consider whether and to what extent business decisions or company actions sometimes spill over to create adverse impacts on others. Unintentionally amoral managers may even see themselves as people of integrity and as personally ethical. But, like intentionally amoral managers, they are of the firm view that businesses ought to be able to do whatever the current legal and regulatory framework allows them to do without being shackled by ethical considerations.

By some accounts, the population of managers is said to be distributed among all three types in a bell-shaped curve, with immoral managers and moral managers occupying...
the two tails of the curve, and the amoral managers (especially the intentionally amoral managers) occupying the broad middle ground. Furthermore, within the population of managers, there is experiential evidence to support that while the average manager may be amoral most of the time, he or she may slip into a moral or immoral mode on occasion, based on a variety of impinging factors and circumstances.

**Evidence of Managerial Immorality in the Global Business Community**

There is considerable evidence that a sizable majority of managers are either amoral or immoral. The 2005 *Global Corruption Report*, sponsored by Transparency International, found that corruption among public officials and in business transactions is widespread across the world. Table 10.1 shows some of the countries where corruption is believed to be lowest and highest—even in the countries where business practices are deemed to be least corrupt, there is considerable room for improvement in the extent to which managers observe ethical business practices. Table 10.2 presents data showing the perceived likelihood that companies in the 21 largest exporting countries are paying bribes to win business in the markets of 15 emerging-country markets—Argentina, Brazil, Colombia, Hungary, India, Indonesia, Mexico, Morocco, Nigeria, the Philippines, Poland, Russia, South Africa, South Korea, and Thailand.

**Table 10.1  Corruption Perceptions Index, Selected Countries, 2004**

<table>
<thead>
<tr>
<th>Country</th>
<th>2004 CPI Score*</th>
<th>High–Low Range</th>
<th>Number of Surveys Used</th>
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<tr>
<td>Finland</td>
<td>9.7</td>
<td>9.2–10.0</td>
<td>9</td>
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<tr>
<td>New Zealand</td>
<td>9.6</td>
<td>9.2–9.7</td>
<td>9</td>
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<td>Denmark</td>
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<td>8.7–9.8</td>
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<td>Sweden</td>
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<tr>
<td>Switzerland</td>
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<td>8.6–9.4</td>
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<td>6.5–9.4</td>
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<td>Germany</td>
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<td>7.5–9.2</td>
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<td>Israel</td>
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<th>High–Low Range</th>
<th>Number of Surveys Used</th>
</tr>
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<td>South Africa</td>
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<td>Brazil</td>
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<td>3.6</td>
<td>2.5–4.5</td>
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<td>3.4</td>
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<td>Turkey</td>
<td>3.2</td>
<td>1.9–5.4</td>
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</tr>
<tr>
<td>India</td>
<td>2.8</td>
<td>2.2–3.7</td>
<td>15</td>
</tr>
<tr>
<td>Russia</td>
<td>2.8</td>
<td>2.0–5.0</td>
<td>15</td>
</tr>
<tr>
<td>Philippines</td>
<td>2.6</td>
<td>1.4–3.7</td>
<td>14</td>
</tr>
<tr>
<td>Vietnam</td>
<td>2.6</td>
<td>1.6–3.7</td>
<td>11</td>
</tr>
<tr>
<td>Argentina</td>
<td>2.5</td>
<td>1.7–3.7</td>
<td>11</td>
</tr>
<tr>
<td>Venezuela</td>
<td>2.3</td>
<td>2.0–3.0</td>
<td>11</td>
</tr>
<tr>
<td>Pakistan</td>
<td>2.1</td>
<td>1.2–3.3</td>
<td>7</td>
</tr>
<tr>
<td>Nigeria</td>
<td>1.6</td>
<td>0.9–2.1</td>
<td>9</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>1.5</td>
<td>0.3–2.4</td>
<td>5</td>
</tr>
</tbody>
</table>

* The CPI scores range between 10 (highly clean) and 0 (highly corrupt); the data were collected between 2002 and 2004 and reflect a composite of 18 data sources from 12 institutions, as indicated in the number of surveys used. The CPI score represents the perceptions of the degree of corruption as seen by businesspeople, academics, and risk analysts. CPI scores were reported for 146 countries.

Table 10.2 The Degree to Which Companies in Major Exporting Countries Are Perceived to Be Paying Bribes in Doing Business Abroad

<table>
<thead>
<tr>
<th>Rank/Country</th>
<th>Bribe-Payer Index (10 = Low; 0 = High)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>8.5</td>
</tr>
<tr>
<td>Sweden</td>
<td>8.4</td>
</tr>
<tr>
<td>Switzerland</td>
<td>8.4</td>
</tr>
<tr>
<td>Austria</td>
<td>8.2</td>
</tr>
<tr>
<td>Canada</td>
<td>8.1</td>
</tr>
<tr>
<td>Netherlands</td>
<td>7.8</td>
</tr>
<tr>
<td>Belgium</td>
<td>7.8</td>
</tr>
<tr>
<td>Britain</td>
<td>6.9</td>
</tr>
<tr>
<td>Singapore</td>
<td>6.3</td>
</tr>
<tr>
<td>Germany</td>
<td>6.3</td>
</tr>
<tr>
<td>Spain</td>
<td>5.8</td>
</tr>
<tr>
<td>12. France</td>
<td>5.5</td>
</tr>
<tr>
<td>13. United States</td>
<td>5.3</td>
</tr>
<tr>
<td>14. Japan</td>
<td>5.3</td>
</tr>
<tr>
<td>15. Malaysia</td>
<td>4.3</td>
</tr>
<tr>
<td>16. Hong Kong</td>
<td>4.3</td>
</tr>
<tr>
<td>17. Italy</td>
<td>4.1</td>
</tr>
<tr>
<td>18. South Korea</td>
<td>3.9</td>
</tr>
<tr>
<td>19. Taiwan</td>
<td>3.8</td>
</tr>
<tr>
<td>20. China (excluding Hong Kong)</td>
<td>3.5</td>
</tr>
<tr>
<td>21. Russia</td>
<td>3.2</td>
</tr>
</tbody>
</table>

Note: The bribe-payer index is based on a questionnaire developed by Transparency International and a survey of some 835 private-sector leaders in 15 emerging countries accounting for 60 percent of all imports into non-Organization for Economic Cooperation and Development countries—actual polling was conducted by Gallup International.


The 2003 Global Corruption Report cited data indicating that bribery occurred most often in (1) public works contracts and construction, (2) the arms and defense industry, and (3) the oil and gas industry. On a scale of 1 to 10, where 10 indicates negligible bribery, even the “cleanest” industry sectors—agriculture, light manufacturing, and fisheries—only had “passable” scores of 5.9, indicating that bribes are quite likely a common occurrence in these sectors as well (see Table 10.3).

The corruption, of course, extends beyond just bribes and kickbacks. For example, in 2005, four global chip makers (Samsung and Hynix Semiconductor in South Korea, Infineon Technologies in Germany, and Micron Technology in the United States) pleaded guilty to conspiring to fix the prices of dynamic random access memory (DRAM) chips sold to such companies as Dell, Apple Computer, and Hewlett-Packard—DRAM chips generate annual worldwide sales of around $26 billion and are used in computers, electronics products, and motor vehicles. So far, the probe has resulted in fines of $730 million, jail terms for nine executives, and pending criminal charges for three more employees for their role in the global cartel; the guilty companies face hundreds of millions of dollars more in damage claims from customers and from consumer class-action lawsuits.

A global business community that is apparently so populated with unethical business practices and managerial immorality does not bode well for concluding that many companies ground their strategies on exemplary ethical principles or for the vigor with which company managers try to ingrain ethical behavior into company personnel. And, as many business school professors have noted, there are considerable numbers of amoral business students in our classrooms. So efforts to root out shady and corrupt business practices and implant high ethical principles into the managerial process of crafting and executing strategy is unlikely to produce an ethically strong global business climate anytime in the near future, barring major effort to address and correct the ethical laxness of company managers.
Chapter 10  Strategy, Ethics, and Social Responsibility

Table 10.3  Bribery in Different Industries

<table>
<thead>
<tr>
<th>Business Sector</th>
<th>Bribery Score (10 = Low; 0 = High)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>5.9</td>
</tr>
<tr>
<td>Light manufacturing</td>
<td>5.9</td>
</tr>
<tr>
<td>Fisheries</td>
<td>5.9</td>
</tr>
<tr>
<td>Information technology</td>
<td>5.1</td>
</tr>
<tr>
<td>Forestry</td>
<td>5.1</td>
</tr>
<tr>
<td>Civilian aerospace</td>
<td>4.9</td>
</tr>
<tr>
<td>Banking and finance</td>
<td>4.7</td>
</tr>
<tr>
<td>Heavy manufacturing</td>
<td>4.5</td>
</tr>
<tr>
<td>Pharmaceuticals/medical care</td>
<td>4.3</td>
</tr>
<tr>
<td>Transportation/storage</td>
<td>4.3</td>
</tr>
<tr>
<td>Mining</td>
<td>4.0</td>
</tr>
<tr>
<td>Power generation/transmission</td>
<td>3.7</td>
</tr>
<tr>
<td>Telecommunications</td>
<td>3.7</td>
</tr>
<tr>
<td>Real estate/property</td>
<td>3.5</td>
</tr>
<tr>
<td>Oil and gas</td>
<td>2.7</td>
</tr>
<tr>
<td>Arms and defense</td>
<td>1.9</td>
</tr>
<tr>
<td>Public works/construction</td>
<td>1.3</td>
</tr>
</tbody>
</table>

Note: The bribery scores for each industry are based on a questionnaire developed by Transparency International and a survey of some 835 private sector leaders in 15 emerging countries accounting for 60 percent of all imports into non-Organization for Economic Cooperation and Development countries—actual polling was conducted by Gallup International.


DO COMPANY STRATEGIES NEED TO BE ETHICAL?

Company managers may formulate strategies that are ethical in all respects, or they may decide to employ strategies that, for one reason or another, have unethical or at least gray-area components. While most company managers are usually careful to ensure that a company’s strategy is within the bounds of what is legal, the available evidence indicates they are not always so careful to ensure that all elements of their strategies are within the bounds of what is generally deemed ethical. Senior executives with strong ethical convictions are normally proactive in insisting that all aspects of company strategy fall within ethical boundaries. In contrast, senior executives who are either immoral or amoral may use shady strategies and unethical or borderline business practices, especially if they are clever at devising schemes to keep ethically questionable actions hidden from view.

During the past five years, there has been an ongoing series of revelations about managers who have ignored ethical standards, deliberately stepped out of bounds, and been called to account by the media, regulators, and the legal system. Ethical misconduct has occurred at Enron, Tyco International, HealthSouth, Rite Aid, Citicorp, Bristol-Myers Squibb, Adelphia, Royal Dutch/Shell, Parmalat (an Italy-based food products company), Mexican oil giant Pemex, Marsh & McLennan and other insurance brokers, several leading brokerage houses and investment banking firms, and a
host of mutual fund companies. The consequences of crafting strategies that cannot pass the test of moral scrutiny are manifested in the sharp drops in the stock prices of the guilty companies that have cost shareholders billions of dollars; the frequently devastating public relations hits that the accused companies have taken, the sizes of the fines that have been levied (often amounting to several hundred million dollars); the growing legion of criminal indictments and convictions of company executives; and the number of executives who have either been dismissed from their jobs, shoved into early retirement, and/or suffered immense public embarrassment. The fallout from all these scandals has resulted in heightened management attention to legal and ethical considerations in crafting strategy. Illustration Capsule 10.1 details the ethically flawed strategy at the world’s leading insurance broker, and the consequences to those concerned.

What Are the Drivers of Unethical Strategies and Business Behavior?

The apparent pervasiveness of immoral and amoral businesspeople is one obvious reason why ethical principles are an ineffective moral compass in business dealings and why companies may resort to unethical strategic behavior. But apart from thinking that maintains “The business of business is business, not ethics,” three other main drivers of unethical business behavior also stand out:  

- Faulty oversight such that overzealous or obsessive pursuit of personal gain, wealth, and other selfish interests is overlooked by or escapes the attention of higher-ups (most usually the board of directors).  
- Heavy pressures on company managers to meet or beat performance targets.  
- A company culture that puts the profitability and good business performance ahead of ethical behavior.

Overzealous Pursuit of Personal Gain, Wealth, and Selfish Interests

People who are obsessed with wealth accumulation, greed, power, status, and other selfish interests often push ethical principles aside in their quest for self-gain. Driven by their ambitions, they exhibit few qualms in skirting the rules or doing whatever is necessary to achieve their goals. The first and only priority of such corporate bad apples is to look out for their own best interests and if climbing the ladder of success means having few scruples and ignoring the welfare of others, so be it. A general disregard for business ethics can prompt all kinds of unethical strategic maneuvers and behaviors at companies. Top executives, directors, and majority shareholders at cable-TV company Adelphia Communications ripped off the company for amounts totaling well over $1 billion, diverting hundreds of millions of dollars to fund their Buffalo Sabres hockey team, build a private golf course, and buy timber rights—among other things—and driving the company into bankruptcy. Their actions, which represent one of the biggest instances of corporate looting and self-dealing in American business, took place despite the company’s public pontifications about the principles it would observe in trying to care for customers, employees, stockholders, and the local communities where it operated. Andrew Fastow, Enron’s chief financial officer (CFO), set himself up as the manager of one of Enron’s off-the-books partnerships and as the part-owner of another, allegedly earning extra compensation of $30 million for his owner-manager roles in the two partnerships; Enron’s board of directors agreed to suspend the company’s conflict-of-interest rules designed to protect the company from this very kind of executive self-dealing (but directors and perhaps Fastow’s superiors were kept in the dark about how much Fastow was earning on the side).
In October 2004, Wall Street Journal headlines trumpeted that a cartel among insurance brokers had been busted. Among the ringleaders was worldwide industry leader Marsh & McLennan Companies Inc., with 2003 revenues of $11.5 billion and a U.S. market share of close to 20 percent. The gist of the brokers’ plan was to cheat corporate clients by rigging the bids brokers solicited for insurance policies and thereby collecting big fees (called contingent commissions) from major insurance companies for steering business their way. Two family members of Marsh & McLennan CEO Jeffery Greenberg were CEOs of major insurance companies to which Marsh sometimes steered business. Greenberg’s father was CEO of insurance giant AIG (which had total revenues of $81 billion and insurance premium revenues of $28 billion in 2003), and Greenberg’s younger brother was CEO of ACE Ltd., the 24th biggest property-casualty insurer in the United States, with 2003 revenues of $10.7 billion and insurance premium revenues of more than $5 billion worldwide. Prior to joining ACE, Greenberg’s younger brother had been president and chief operating officer of AIG, headed by his father.

Several months prior to the cartel bust, a Marsh subsidiary, Putnam Investments, had paid a $110 million fine for securities fraud and another Marsh subsidiary, Mercer Consulting, was placed under Securities and Exchange Commission (SEC) investigation for engaging in pay-to-play practices that forced investment managers to pay fees in order to secure Mercer’s endorsement of their services when making recommendations to Mercer’s pension fund clients.

The cartel scheme arose from the practice of large corporations to hire the services of such brokers as Marsh & McLennan, Aon Corporation, A. J. Gallaher & Company, Wells Fargo, or BB&T Insurance Services to manage their risks and take out appropriate property and casualty insurance on their behalf. The broker’s job was to solicit bids from several insurers and obtain the best policies at the lowest prices for the client.

Marsh’s insurance brokerage strategy was to solicit artificially high bids from some insurance companies so that it could guarantee that the bid of a preferred insurer on a given deal would win the bid. Marsh brokers called underwriters at various insurers, often including AIG and ACE, and asked for “B” quotes—bids that were deliberately high. Insurers asked for B quotes knew that Marsh wanted another insurer to win the business, but they were willing to participate because on other policy solicitations Marsh could end up steering the business to them via Marsh’s same strategy. Sometimes Marsh even asked underwriters that were providing B quotes to attend a meeting with Marsh’s client and make a presentation regarding their policy to help bolster the credibility of their inflated bid.

Since it was widespread practice among insurers to pay brokers contingent commissions based on the volume or profitability of the business the broker directed to them, Marsh’s B-quote solicitation strategy allowed it to steer business to those insurers paying the largest contingent commissions—these contingent commissions were in addition to the fees the broker earned from the corporate client for services rendered in conducting the bidding process for the client. A substantial fraction of the policies that Marsh unlawfully steered were to two Bermuda-based insurance companies that it helped start up and in which it also had ownership interests (some Marsh executives also indirectly owned shares of stock in one of the companies); indeed, these two insurance companies received 30–40 percent of their total business from policies steered to them by Marsh.

At Marsh, steering business to insurers paying the highest contingent commission was a key component of the company’s overall strategy. Marsh’s contingent commissions generated revenues of close to $1.5 billion over the 2001–2003 period, including $845 million in 2003. Without these commission revenues, Marsh’s $1.5 billion in net profits would have been close to 40 percent lower in 2003.

Within days of headlines about the cartel bust, Marsh’s stock price had fallen by 48 percent (costing shareholders about $11.5 billion in market value) and the company was looking down the barrel of a criminal indictment. To stave off the criminal indictment (something no insurance company had ever survived), board members forced Jeffrey Greenberg to resign as CEO. Another top executive was suspended. Criminal charges against several Marsh executives for their roles in the bid-rigging scheme were filed several weeks thereafter.

In an attempt to lead industry reform, Greenberg’s successor quickly announced a new business model for Marsh that included not accepting any contingent commissions from insurers. Marsh’s new strategy and business model involved charging fees only to its corporate clients for soliciting bids, placing their insurance, and otherwise managing clients’ risks and crises. This eliminated Marsh’s conflict of interest in earning fees from both sides of the transactions it made on behalf of its corporate clients. Marsh also committed to provide up-front disclosure to clients of the fees it would earn on their business (in the past such fees had been murky and incomplete). Even so, there were indications that close to 10 lawsuits, some involving class action, would soon be filed against the company.

Meanwhile, all major commercial property-casualty insurers were scrambling to determine whether their payment of contingent commissions was ethical, since such arrangements clearly gave insurance brokers a financial incentive to place insurance with companies paying the biggest contingent commissions, not those with the best prices or terms. Prosecutors of the cartel had referred to the contingent commissions as kickbacks.

According to a civil complaint filed by the Securities and Exchange Commission, the CEO of Tyco International, a well-known $35.6 billion manufacturing and services company, conspired with the company’s CFO to steal more than $170 million, including a company-paid $2 million birthday party for the CEO’s wife held on Sardinia, an island off the coast of Italy; a $7 million Park Avenue apartment for his wife; and secret low-interest and interest-free loans to fund private businesses and investments and purchase lavish artwork, yachts, estate jewelry, and vacation homes in New Hampshire, Connecticut, Massachusetts, and Utah. The CEO allegedly lived rent-free in a $31 million Fifth Avenue apartment that Tyco purchased in his name, directed millions of dollars of charitable contributions in his own name using Tyco funds, diverted company funds to finance his personal businesses and investments, and sold millions of dollars of Tyco stock back to Tyco itself through Tyco subsidiaries located in offshore bank-secrecy jurisdictions. Tyco’s CEO and CFO were further charged with conspiring to reap more than $430 million from sales of stock, using questionable accounting to hide their actions, and engaging in deceptive accounting practices to distort the company’s financial condition from 1995 to 2002. At the trial on the charges filed by the SEC, the prosecutor told the jury in his opening statement, “This case is about lying, cheating and stealing. These people didn’t win the jackpot—they stole it.” Defense lawyers countered that “every single transaction . . . was set down in detail in Tyco’s books and records” and that the authorized and disclosed multimillion-dollar compensation packages were merited by the company’s financial performance and stock price gains. The two Tyco executives were convicted and sentenced to jail.

Prudential Securities paid a total of about $2 billion in the 1990s to settle misconduct charges relating to practices that misled investors on the risks and rewards of limited-partnership investments. Providian Financial Corporation, despite an otherwise glowing record of social responsibility and corporate citizenship, paid $150 million in 2001 to settle claims that its strategy included systematic attempts to cheat credit card holders. Ten prominent Wall Street securities firms in 2003 paid $1.4 billion to settle charges that they knowingly issued misleading stock research to investors in an effort to prop up the stock prices of client corporations. A host of mutual-fund firms made under-the-table arrangements to regularly buy and sell stock for their accounts at special after-hours trading prices that disadvantaged long-term investors and had to pay nearly $2.0 billion in fines and restitution when their unethical practices were discovered by authorities during 2002–2003. Salomon Smith Barney, Goldman Sachs, Credit Suisse First Boston, and several other financial firms were assessed close to $2 billion in fines and restitution for the unethical manner in which they contributed to the scandals at Enron and WorldCom and for the shady practice of allocating shares of hot initial public offering stocks to a select list of corporate executives who either steered or were in a position to steer investment banking business their way.

### Heavy Pressures on Company Managers to Meet or Beat Earnings Targets

When companies find themselves scrambling to achieve ambitious earnings growth and meet the quarterly and annual performance expectations of Wall Street analysts and investors, managers often feel enormous pressure to do whatever it takes to sustain the company’s reputation for delivering good financial performance. Executives at high-performing companies know that investors will see the slightest sign of a slowdown in earnings growth as a red flag and drive down the company’s stock price. The company’s credit rating could be downgraded if it has used lots of debt to finance its growth. The pressure to watch the scoreboard and never miss a quarter—so as not to upset the expectations of Wall Street analysts and fickle stock market investors—prompts managers to cut costs wherever savings show up immediately,
squeeze extra sales out of early deliveries, and engage in other short-term maneuvers to make the numbers. As the pressure builds to keep performance numbers looking good, company personnel start stretching the rules further and further, until the limits of ethical conduct are overlooked.27 Once ethical boundaries are crossed in efforts to “meet or beat the numbers,” the threshold for making more extreme ethical compromises becomes lower.

Several top executives at WorldCom (the remains of which is now part of Verizon Communications), a company built with scores of acquisitions in exchange for WorldCom stock, allegedly concocted a fraudulent $11 billion accounting scheme to hide costs and inflate revenues and profit over several years; the scheme was said to have helped the company keep its stock price propped up high enough to make additional acquisitions, support its nearly $30 billion debt load, and allow executives to cash in on their lucrative stock options. At Qwest Communications, a company created by the merger of a go-go telecom start-up and U.S. West (one of the regional Bell companies), management was charged with scheming to improperly book $2.4 billion in revenues from a variety of sources and deals, thereby inflating the company’s profits and making it appear that the company’s strategy to create a telecommunications company of the future was on track when, in fact, it was faltering badly behind the scenes. Top-level Qwest executives were dismissed, and in 2004 new management agreed to $250 million in fines for all the misdeeds.

At Bristol-Myers Squibb, the world’s fifth-largest drug maker, management apparently engaged in a series of numbers-game maneuvers to meet earnings targets, including such actions as:

- Offering special end-of-quarter discounts to induce distributors and local pharmacies to stock up on certain prescription drugs—a practice known as channel stuffing.
- Issuing last-minute price increase alerts to spur purchases and beef up operating profits.
- Setting up excessive reserves for restructuring charges and then reversing some of the charges as needed to bolster operating profits.
- Making repeated asset sales small enough that the gains could be reported as additions to operating profit rather than being flagged as one-time gains. (Some accountants have long used a rule of thumb that says a transaction that alters quarterly profits by less than 5 percent is “immaterial” and need not be disclosed in the company’s financial reports.)

Such numbers games were said to be a common “earnings management” practice at Bristol-Myers and, according to one former executive, “sent a huge message across the organization that you make your numbers at all costs.”28

Company executives often feel pressured to hit financial performance targets because their compensation depends heavily on the company’s performance. During the late 1990s, it became fashionable for boards of directors to grant lavish bonuses, stock option awards, and other compensation benefits to executives for meeting specified performance targets. So outlandishly large were these rewards that executives had strong personal incentives to bend the rules and engage in behaviors the allowed the targets to be met. Much of the accounting hocus-pocus at the root of recent corporate scandals has entailed situations in which executives benefited enormously from misleading accounting or other shady activities that allowed them to hit the numbers and receive incentive awards ranging from $10 million to $100 million. At Bristol-Myers Squibb, for example, the pay-for-performance link spawned strong rules-bending incentives. About 94 percent of one top executive’s $18.5 million in total compensation
in 2001 came from stock-option grants, a bonus, and long-term incentive payments linked to corporate performance; about 92 percent of a second executive’s $12.9 million of compensation was incentive-based.\(^{29}\)

The fundamental problem with a “make the numbers and move on” syndrome is that a company doesn’t really serve its customers or its shareholders by going overboard in pursuing bottom-line profitability. In the final analysis, shareholder interests are best served by doing a really good job of serving customers (observing the rule that customers are king) and by improving the company’s competitiveness in the marketplace—these outcomes are the most reliable drivers of higher profits and added shareholder value. Cutting ethical corners or stooping to downright illegal actions in the name of profits first carries exceptionally high risk for shareholders—the steep stock-price decline and tarnished brand image that accompany the discovery of scurrilous behavior leaves shareholders with a company worth much less than before—and the rebuilding task can be arduous, taking both considerable time and resources.

**Company Cultures That Put the Bottom Line Ahead of Ethical Behavior**

When a company’s culture spawns an ethically corrupt or amoral work climate, people have a company-approved license to ignore what’s right and engage in most any behavior or employ most any strategy they think they can get away with. Such cultural norms as “No one expects strict adherence to ethical standards,” “Everyone else does it,” and “It is politic to bend the rules to get the job done” permeate the work environment.\(^{30}\) At such companies, ethically immoral or amoral people play down observance of ethical strategic actions and business conduct. Moreover, the pressures to conform to cultural norms can prompt otherwise honorable people to make ethical mistakes and succumb to the many opportunities around them to engage in unethical practices.

A perfect example of a company culture gone awry on ethics is Enron.\(^{31}\) Enron’s leaders encouraged company personnel to focus on the current bottom line and to be innovative and aggressive in figuring out what could be done to grow current revenues and earnings. Employees were expected to pursue opportunities to the utmost. Enron executives viewed the company as a laboratory for innovation; the company hired the best and brightest people and pushed them to be creative, look at problems and opportunities in new ways, and exhibit a sense of urgency in making things happen. Employees were encouraged to make a difference and do their part in creating an entrepreneurial environment in which creativity flourished, people could achieve their full potential, and everyone had a stake in the outcome. Enron employees got the message—pushing the limits and meeting one’s numbers were viewed as survival skills. Enron’s annual “rank and yank” formal evaluation process, in which the 15 to 20 percent lowest-ranking employees were let go or encouraged to seek other employment, made it abundantly clear that hitting earnings targets and being the mover and shaker in the marketplace were what counted. The name of the game at Enron became devising clever ways to boost revenues and earnings, even if it sometimes meant operating outside established policies and without the knowledge of superiors. In fact, outside-the-lines behavior was celebrated if it generated profitable new business. Enron’s energy contracts and its trading and hedging activities grew increasingly more complex and diverse as employees pursued first this avenue and then another to help keep Enron’s financial performance looking good.

As a consequence of Enron’s well-publicized successes in creating new products and businesses and leveraging the company’s trading and hedging expertise into new market arenas, Enron came to be regarded as exceptionally innovative. It was ranked by its corporate peers as the most innovative U.S. company for three consecutive
years in Fortune magazine’s annual surveys of the most-admired companies. A high-performance/high-rewards climate came to pervade the Enron culture, as the best workers (determined by who produced the best bottom-line results) received impressively large incentives and bonuses (amounting to as much as $1 million for traders and even more for senior executives). On Car Day at Enron, an array of luxury sports cars arrived for presentation to the most successful employees. Understandably, employees wanted to be seen as part of Enron’s star team and partake in the benefits that being one of Enron’s best and smartest employees entailed. The high monetary rewards, the ambitious and hard-driving people that the company hired and promoted, and the competitive, results-oriented culture combined to give Enron a reputation not only for trampling competitors at every opportunity but also for practicing internal ruthlessness. The company’s super-aggressiveness and win-at-all-costs mind-set nurtured a culture that gradually and then more rapidly fostered the erosion of ethical standards, eventually making a mockery of the company’s stated values of integrity and respect. When it became evident in the fall of 2001 that Enron was a house of cards propped up by deceitful accounting and a myriad of unsavory practices, the company imploded in a matter of weeks—the biggest bankruptcy of all time cost investors $64 billion in losses (between August 2000, when the stock price was at its five-year high, and November 2001), and Enron employees lost their retirement assets, which were almost totally invested in Enron stock.

More recently, a team investigating an ethical scandal at oil giant Royal Dutch/Shell Group that resulted in the payment of $150 million in fines found that an ethically flawed culture was a major contributor to why managers made rosy forecasts that they couldn’t meet and why top executives engaged in maneuvers to mislead investors by overstating Shell’s oil and gas reserves by 25 percent (equal to 4.5 billion barrels of oil). The investigation revealed that top Shell executives knew that a variety of internal practices, together with unrealistic and unsupportable estimates submitted by overzealous, bonus-conscious managers in Shell’s exploration and production group, were being used to overstate reserves. An e-mail written by Shell’s top executive for exploration and production (who was caught up in the ethical misdeeds and later forced to resign) said, “I am becoming sick and tired about lying about the extent of our reserves issues and the downward revisions that need to be done because of our far too aggressive/optimistic bookings.”

Illustration Capsule 10.2 describes Philip Morris USA’s new strategy for growing the sales of its leading Marlboro cigarette brand—judge for yourself whether the strategy is ethical or shady in light of the undisputed medical links between smoking and lung cancer.

**Approaches to Managing a Company’s Ethical Conduct**

The stance a company takes in dealing with or managing ethical conduct at any given point can take any of four basic forms:

- The unconcerned, or nonissue, approach.
- The damage control approach.
- The compliance approach.
- The ethical culture approach.

The differences in these four approaches are discussed briefly below and summarized in Table 10.4 on page 335.
Illustration Capsule 10.2

Philip Morris USA’s Strategy for Marlboro Cigarettes: Ethical or Unethical?

In late 2005, Philip Morris USA and its corporate parent, Altria Group Inc., wrapped up a year of promotions and parties to celebrate the 50th year of selling Marlboro cigarettes. Marlboro commanded a 40 percent share of the U.S. market for cigarettes and was also one of the world’s top cigarette brands. Despite sharp advertising restrictions agreed to by cigarette marketers in 1998 and a big jump in state excise taxes on cigarettes since 2002, Marlboro’s sales and market share were climbing, thanks to a new trailblazing marketing strategy.

Marlboro had become a major brand in the 1960s and 1970s via a classic mass-marketing strategy anchored by annual ad budgets in the millions of dollars. The company’s TV, magazine, and billboard ads for Marlboros always featured a rugged cowboy wearing a Stetson, riding a horse in a mountainous area, and smoking a Marlboro—closely connecting the brand with the American West. The Marlboro ad campaign was a gigantic success, making Marlboro one of the world’s best-known and valuable brands.

But following the ad restrictions in 1998, Philip Morris had to shift to a different marketing strategy to grow Marlboro’s sales. It opted for an approach aimed at generating all kinds of marketing buzz for the Marlboro brand and creating a larger cadre of loyal Marlboro smokers (who often felt persecuted by social pressures and antismoking ordinances). Philip Morris directed company field reps to set up promotions at local bars where smokers could sign up for promotional offers like price discounts on Marlboro purchases, a Marlboro Miles program that included cash, trips, and Marlboro apparel; some prizes could be purchased with Marlboro Miles points. It also began to sponsor live concerts and other events to generate additional sign-ups among attendees. A Web site was created to spur Internet chatter among the Marlboro faithful and to encourage still more sign-ups for special deals and contests (some with prizes up to a $1 million)—an online community quickly sprang up around the brand. Via all the sign-ups and calls to an 800 number, Philip Morris created a database of Marlboro smokers that by 2005 had grown to 26 million names. Using direct mail and e-mail, the company sent the members of its database a steady stream of messages and offers, ranging from birthday coupons for free breakfasts to price discounts to chances to attend local concerts, enjoy a day at nearby horse tracks, or win a trip to the company’s ranch in Montana (where winners got gifts, five-course meals, massages, and free drinks and could go snowmobiling, fly fishing, or horseback riding).

Meanwhile, Philip Morris also became considerably more aggressive in retail stores, launching an offensive initiative to give discounts and incentives to retailers who utilized special aisle displays and signage for its cigarette brands. One 22-store retail chain reported that, by agreeing to a deal to give Philip Morris brands about 66 percent of its cigarette shelf space, it ended up paying about $5.50 per carton less for its Marlboro purchases than it paid for cartons of Camels supplied by rival R. J. Reynolds. Some Wal-Mart stores were said to have awarded Philip Morris as much as 80 percent of its cigarette shelf space.

Thus, despite being besieged by the costs of defending lawsuits and paying out billions to governments as compensation for the increased health care costs associated with smoking, Philip Morris and other cigarette makers were making very healthy profits: operating margins of nearly 28 percent in 2005 (up from 26 percent in 2004) and net income of about $11.4 billion on sales of $66.3 billion in the United States and abroad.

However, health care officials were highly critical of Philip Morris’s marketing tactics for Marlboro, and the U.S. Department of Justice had filed a lawsuit claiming, among other things, that the company knowingly marketed Marlboros to underage people in its database, a charge denied by the company.


The Unconcerned, or Nonissue, Approach  The unconcerned approach is prevalent at companies whose executives are immoral and unintentionally amoral. Senior executives at companies using this approach ascribe to the view that notions of right and wrong in matters of business are defined entirely by government via the prevailing laws and regulations. They maintain that trying to enforce ethical standards above and beyond what is legally required is a nonissue because businesses are entitled to conduct their affairs in whatever manner they wish so long as
Chapter 10  Strategy, Ethics, and Social Responsibility

Table 10.4  Four Approaches to Managing Business Ethics

<table>
<thead>
<tr>
<th>Unconcerned, or Nonissue Approach</th>
<th>Damage Control Approach</th>
<th>Compliance Approach</th>
<th>Ethical Culture Approach</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Underlying beliefs</strong></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>• The business of business is business, not ethics.</td>
<td>• The company needs to make a token gesture in the direction of ethical standards (a code of ethics).</td>
<td>• The company must be committed to ethical standards and monitoring ethics performance.</td>
<td>• Ethics is basic to the culture.</td>
</tr>
<tr>
<td>• All that matters is whether an action is legal.</td>
<td>• Unethical behavior must be prevented and punished if discovered.</td>
<td>• Ethics has no place in the conduct of business.</td>
<td>• Behaving ethically must be a deeply held corporate value and become a way of life.</td>
</tr>
<tr>
<td>• Ethics has no place in the conduct of business.</td>
<td>• It is important to have a reputation for high ethical standards.</td>
<td>• Companies should not be morally accountable for their actions.</td>
<td>• Everyone is expected to walk the talk.</td>
</tr>
<tr>
<td>• Companies should not be morally accountable for their actions.</td>
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| Ethics management approaches | | | |
| • There’s no need to make decisions concerning business ethics—if it’s legal, it is okay. | • The company must act to protect against the dangers of unethical strategies and behavior. | • The company must establish a clear, comprehensive code of ethics. | • Ethical behavior is ingrained and reinforced as part of the culture. |
| • No intervention regarding the ethical component of decisions is needed. | • Ignore unethical behavior or allow it to go unpunished unless the situation is extreme and requires action. | • The company must provide ethics training for all personnel. | • Much reliance on co-worker peer pressure—“That’s not how we do things here.” |
| | | • Have formal ethics compliance procedures, an ethics compliance office, and a chief ethics officer. | • Everyone is an ethics watchdog—whistle-blowing is required. |
| | | | • Ethics heroes are celebrated; ethics stories are told. |
| **Challenges** | | | |
| • Financial consequences can become unaffordable. | • Credibility problems with stakeholders can arise. | • Organizational members come to rely on the existing rules for moral guidance—fosters a mentality of what is not forbidden is allowed. | • New employees must go through strong ethics induction program. |
| • Some stakeholders are alienated. | • The company is susceptible to ethical scandal. | • Rules and guidelines proliferate. | • Formal ethics management systems can be underutilized. |
| | • The company has a subpar ethical reputation—executives and company personnel don’t walk the talk. | • The locus of moral control resides in the code and in the ethics compliance system rather than in an individual’s own moral responsibility for ethical behavior. | • Relying on peer pressures and cultural norms to enforce ethical standards can result in eliminating some or many of the compliance trappings and, over time, induce moral laxness. |

they comply with the letter of what is legally required. Hence, there is no need to spend valuable management time trying to prescribe and enforce standards of conduct that go above and beyond legal and regulatory requirements. In companies where senior managers are immoral, the prevailing view may well be that under-the-table dealing can be good business if it can be kept hidden or if it can be justified on grounds that others are doing it too. Companies in this mode usually engage in most any business practices they believe they can get away with, and the strategies they employ may well embrace elements that are either borderline from a legal perspective or ethically shady and unsavory.

The Damage Control Approach  Damage control is favored at companies whose managers are intentionally amoral but who are wary of scandal and adverse public relations fallout that could cost them their jobs or tarnish their careers. Companies using this approach, not wanting to risk tarnishing the reputations of key personnel or the company, usually make some concession to window-dressing ethics, going so far as to adopt a code of ethics—so that their executives can point to it as evidence of good-faith efforts to prevent unethical strategy making or unethical conduct on the part of company personnel. But the code of ethics exists mainly as nice words on paper, and company personnel do not operate within a strong ethical context—there’s a notable gap between talking ethics and walking ethics. Employees quickly get the message that rule bending is tolerated and may even be rewarded if the company benefits from their actions.

Company executives that practice the damage control approach are prone to look the other way when shady or borderline behavior occurs—adopting a kind of “See no evil, hear no evil, speak no evil” stance (except when exposure of the company’s actions put executives under great pressure to redress any wrongs that have been done). They may even condone questionable actions that help the company reach earnings targets or bolster its market standing—such as pressuring customers to stock up on the company’s product (channel stuffing), making under-the-table payments to win new business, stonewalling the recall of products claimed to be unsafe, bad-mouthing the products of rivals, or trying to keep prices low by sourcing goods from disreputable suppliers in low-wage countries that run sweatshop operations or use child labor. But they are usually careful to do such things in a manner that lessens the risks of exposure or damaging consequences. This generally includes making token gestures to police compliance with codes of ethics and relying heavily on spin to help extricate the company or themselves from claims that the company’s strategy has unethical components or that company personnel have engaged in unethical practices.

The Compliance Approach  Anywhere from light to forceful compliance is favored at companies whose managers are intentionally amoral but are highly concerned about having ethically upstanding reputations or (2) are moral and see strong compliance methods as the best way to impose and enforce ethical rules and high ethical standards. Companies that adopt a compliance mode usually do some or all of the following to display their commitment to ethical conduct: make the code of ethics a visible and regular part of communications with employees, implement ethics training programs, appoint a chief ethics officer or ethics ombudsperson, have ethics committees to give guidance on ethics matters, institute formal procedures for
investigating alleged ethics violations, conduct ethics audits to measure and document compliance, give ethics awards to employees for outstanding efforts to create an ethical climate and improve ethical performance, and/or try to deter violations by setting up ethics hotlines for anonymous callers to use in reporting possible violations.

Emphasis here is usually on securing broad compliance and measuring the degree to which ethical standards are upheld and observed. However, violators are disciplined and sometimes subjected to public reprimand and punishment (including dismissal), thereby sending a clear signal to company personnel that complying with ethical standards needs to be taken seriously. The driving force behind the company’s commitment to eradicate unethical behavior normally stems from a desire to avoid the cost and damage associated with unethical conduct or else a quest to gain favor from stakeholders (especially ethically conscious customers, employees, and investors) for having a highly regarded reputation for ethical behavior. One of the weaknesses of the compliance approach is that moral control resides in the company’s code of ethics and in the ethics compliance system rather than in (1) the strong peer pressures for ethical behavior that come from ingraining a highly ethical corporate culture and (2) an individual’s own moral responsibility for ethical behavior.34

The Ethical Culture Approach

At some companies, top executives believe that high ethical principles must be deeply ingrained in the corporate culture and function as guides for “how we do things around here.” A company using the ethical culture approach seeks to gain employee buy-in to the company’s ethical standards, business principles, and corporate values. The ethical principles embraced in the company’s code of ethics and/or in its statement of corporate values are seen as integral to the company’s identity and ways of operating—they are at the core of the company’s soul and are promoted as part of business as usual. The integrity of the ethical culture approach depends heavily on the ethical integrity of the executives who create and nurture the culture—it is incumbent on them to determine how high the bar is to be set and to exemplify ethical standards in their own decisions and behavior. Further, it is essential that the strategy be ethical in all respects and that ethical behavior be ingrained in the means that company personnel employ to execute the strategy. Such insistence on observing ethical standards is what creates an ethical work climate and a workplace where displaying integrity is the norm.

Many of the trappings used in the compliance approach are also manifest in the ethical culture mode, but one other is added—strong peer pressure from co-workers to observe ethical norms. Thus, responsibility for ethics compliance is widely dispersed throughout all levels of management and the rank-and-file. Stories of former and current moral heroes are kept in circulation, and the deeds of company personnel who display ethical values and are dedicated to walking the talk are celebrated at internal company events. The message that ethics matters—and matters a lot—resounds loudly and clearly throughout the organization and in its strategy and decisions. However, one of the challenges to overcome in the ethical culture approach is relying too heavily on peer pressures and cultural norms to enforce ethics compliance rather than on an individual’s own moral responsibility for ethical behavior—absent unrelenting peer pressure or strong internal compliance systems, there is a danger that over time company personnel may become lax about its ethical standards. Compliance procedures need to be an integral part of the ethical culture approach to help send the message that management takes the observance of ethical norms seriously and that behavior that falls outside ethical boundaries will have negative consequences.
Why a Company Can Change Its Ethics Management Approach

Regardless of the approach they have used to managing ethical conduct, a company’s executives may sense that they have exhausted a particular mode’s potential for managing ethics and that they need to become more forceful in their approach to ethics management. Such changes typically occur when the company’s ethical failures have made the headlines and created an embarrassing situation for company officials or when the business climate changes. For example, the recent raft of corporate scandals, coupled with aggressive enforcement of anticorruption legislation such as the Sarbanes-Oxley Act of 2002 (which addresses corporate governance and accounting practices), has prompted numerous executives and boards of directors to clean up their acts in accounting and financial reporting, review their ethical standards, and tighten up ethics compliance procedures. Intentionally amoral managers using the unconcerned approach to ethics management may see less risk in shifting to the damage control approach (or, for appearance’s sake, maybe a “light” compliance mode). Senior managers who have employed the damage control mode may be motivated by bad experiences to mend their ways and shift to a compliance mode. In the wake of so many corporate scandals, companies in the compliance mode may move closer to the ethical culture approach.

WHY SHOULD COMPANY STRATEGIES BE ETHICAL?

There are two reasons why a company’s strategy should be ethical: (1) because a strategy that is unethical in whole or in part is morally wrong and reflects badly on the character of the company personnel involved and (2) because an ethical strategy is good business and in the self-interest of shareholders.

The Moral Case for an Ethical Strategy

Managers do not dispassionately assess what strategic course to steer. Ethical strategy making generally begins with managers who themselves have strong character (i.e., who are honest, have integrity, are ethical, and truly care about how they conduct the company’s business). Managers with high ethical principles and standards are usually advocates of a corporate code of ethics and strong ethics compliance, and they are typically genuinely committed to certain corporate values and business principles. They walk the talk in displaying the company’s stated values and living up to its business principles and ethical standards. They understand that there is a big difference between adopting values statements and codes of ethics that serve merely as window dressing and those that truly paint the white lines for a company’s actual strategy and business conduct. As a consequence, ethically strong managers consciously opt for strategic actions that can pass moral scrutiny—they display no tolerance for strategies with ethically controversial components.

The Business Case for an Ethical Strategy

There are solid business reasons to adopt ethical strategies even if most company managers are not of strong moral character and personally committed to high ethical standards. Pursuing unethical strategies not only damages a company’s reputation but can also have costly, wide-ranging consequences. Some of the costs are readily visible; others are hidden and difficult to track down—as shown in Figure 10.1. The costs of
fines and penalties and any declines in the stock price are easy enough to calculate. The administrative cleanup (or Level 2) costs are usually buried in the general costs of doing business and can be difficult to ascribe to any one ethical misdeed. Level 3 costs can be quite difficult to quantify but can sometimes be the most devastating—the aftermath of the Enron debacle left Arthur Andersen’s reputation in shreds and led to the once-revered accounting firm’s almost immediate demise, and it remains to be seen whether Marsh & McLennan can overcome the problems described in Illustration Capsule 10.1. Merck, once one of the world’s most respected pharmaceutical firms, has been struggling against the revelation that senior management deliberately concealed that its Vioxx painkiller, which the company pulled off the market in September 2004, was tied to much greater risk of heart attack and strokes—some 20 million people in the United States had taken Vioxx over the years, and Merck executives had reason to suspect as early as 2000 (and perhaps earlier) that Vioxx had dangerous side effects.35

Rehabilitating a company’s shattered reputation is time-consuming and costly. Customers shun companies known for their shady behavior. Companies with reputations for unethical conduct have considerable difficulty in recruiting and retaining talented employees. Most hardworking, ethically upstanding people are repulsed by a work environment where unethical behavior is condoned; they don’t want to get entrapped in a

Conducting business in an ethical fashion is in a company’s enlightened self-interest.
Illustration Capsule 10.3
A Test of Your Business Ethics

As a gauge of your own ethical and moral standards, take the following quiz and see how you stack up against other members of your class. For the test to be valid, you need to answer the questions candidly, not on the basis of what you think the ethically correct answer is.

1. Do you think that it would be unethical for you to give two Super Bowl tickets to an important customer? Would your answer be different if the customer is likely to place a large order that would qualify you for a large year-end sales bonus?
   - Yes
   - No
   - Unsure (it depends)
   - Need more information

2. Would it be wrong to accept a case of fine wine from an important customer? Would your answer be different if you have just convinced your superiors to authorize a special price discount on a big order that the customer has just placed?
   - Yes
   - No
   - Unsure (it depends)
   - Need more information

3. Is it unethical for a high school or college coach to accept a “talent fee” or similar type of payment from a maker of sports apparel or sports equipment when the coach has authority to determine which brand of apparel or equipment to use for his or her team and subsequently chooses the brand of the company making the payment? Is it unethical for the maker of the sports apparel or equipment to make such payments in expectation that the coach will reciprocate by selecting the company’s brand? (Would you answer be different if everybody else is doing it?)
   - Yes
   - No
   - Unsure (it depends)
   - Need more information

4. Is it unethical to accept an invitation from a supplier to spend a holiday weekend skiing at the supplier company’s resort home in Colorado? (Would your answer be different if you were presently considering a proposal from that supplier to purchase $1 million worth of components?)
   - Yes
   - No
   - Unsure (it depends)
   - Need more information

5. Is it unethical for a food products company to incorporate ingredients that have trans fats in its products, given that trans fats are known to be very unhealthy for consumers and that alternative ingredients (which might be somewhat more expensive) can be used in producing the product?
   - Yes
   - No
   - Unsure (it depends)
   - Need more information

6. Would it be wrong to keep quiet if you, as a junior financial analyst, had just calculated that the projected return on a possible project was 18 percent and your boss (a) informed you that no project could be approved without the prospect of a 25 percent return and (b) told you to go back and redo the numbers and “get them right”?
   - Yes
   - No
   - Unsure (it depends)
   - Need more information

7. Would it be unethical to allow your supervisor to believe that you were chiefly responsible for the success of a new company initiative if it actually resulted from a team effort or major contributions by a co-worker?
   - Yes
   - No
   - Unsure (it depends)
   - Need more information

8. Would it be unethical for you, as the chief company official in India to (a) authorize a $25,000 payment to a local government official to facilitate governmental approval to construct a $200 million petrochemical plant and (b) disguise this payment by instructing accounting personnel to classify the payment as part of the cost of obtaining a building permit? (As you can see from Table 10.1, corruption is the norm in India, and bribes and kickbacks are often a “necessary” cost of doing business there.)
   - Yes
   - No
   - Unsure (it depends)
   - Need more information

9. Is it unethical for a motor vehicle manufacturer to resist recalling some of its vehicles when governmental authorities present it with credible evidence that the vehicles have safety defects?
   - Yes
   - No
   - Unsure (it depends)
   - Need more information

10. Is it unethical for a credit card company to aggressively try to sign up new accounts when, after an introductory period of interest-free or low-interest charges on unpaid monthly balances, the interest rate on unpaid balances jumps to 1.5 percent or more monthly (even though such high rates of 18 percent or more annually are disclosed in fine print)?
    - Yes
    - No
    - Unsure (it depends)
    - Need more information

11. Is it unethical to bolster your résumé with exaggerated claims of your credentials and prior job accomplishments in hopes of improving your chances of gaining employment at another company?
    - Yes
    - No
    - Unsure (it depends)
    - Need more information

12. Is it unethical for a company to spend as little as possible on pollution control when, with some extra effort and expenditures, it could substantially reduce the amount of pollution caused by its operations?
    - Yes
    - No
    - Unsure (it depends)
    - Need more information

Answers: The answers to questions 1, 2, and 4 probably shift from no/unsure to a definite yes when the second part of the circumstance comes into play. We think a strong case can be made that the answers to the remaining 9 questions are yes, although it can be argued that more information about the circumstances might be needed in responding to questions 5, 7, 9, and 12.
compromising situation, nor do they want their personal reputations tarnished by the actions of an unsavory employer. A 1997 survey revealed that 42 percent of the respondents took into account a company’s ethics when deciding whether to accept a job.36 Creditors are usually unnerved by the unethical actions of a borrower because of the potential business fallout and subsequent risk of default on any loans. To some significant degree, therefore, companies recognize that ethical strategies and ethical conduct are good business. Most companies have strategies that pass the test of being ethical, and most companies are aware that both their reputations and their long-term well-being are tied to conducting their business in a manner that wins the approval of suppliers, employees, investors, and society at large.

As a test your own business ethics and where you stand on the importance of companies having an ethical strategy, take the test on page 340.

**LINKING A COMPANY’S STRATEGY TO ITS ETHICAL PRINCIPLES AND CORE VALUES**

Many companies have officially adopted a code of ethical conduct and a statement of company values—in the United States, the Sarbanes-Oxley Act, passed in 2002, requires that companies whose stock is publicly traded have a code of ethics or else explain in writing to the Securities and Exchange Commission why they do not. But there’s a big difference between having a code of ethics and a values statement that serve merely as a public window dressing and having ethical standards and corporate values that truly paint the white lines for a company’s actual strategy and business conduct. If ethical standards and statements of core values are to have more than a cosmetic role, boards of directors and top executives must work diligently to see that they are scrupulously observed in crafting the company’s strategy and conducting every facet of the company’s business. In other words, living up to the ethical principles and displaying the core values in actions and decisions must become a way of life at the company.

Indeed, the litmus test of whether a company’s code of ethics and statement of core values are cosmetic is the extent to which they are embraced in crafting strategy and in operating the business day to day. It is up to senior executives to walk the talk and make a point of considering two sets of questions whenever a new strategic initiative is under review:

- Is what we are proposing to do fully compliant with our code of ethical conduct? Is there anything here that could be considered ethically objectionable?
- Is it apparent that this proposed action is in harmony with our core values? Are any conflicts or concerns evident?

Unless questions of this nature are posed—either in open discussion or by force of habit in the minds of strategy makers, then there’s room for strategic initiatives to become disconnected from the company’s code of ethics and stated core values. If a company’s executives are ethically principled and believe strongly in living up to the company’s stated core values, there’s a good chance they will pose these types of questions and reject strategic initiatives that don’t measure up. There’s also a good chance that strategic actions will be scrutinized for their compatibility with ethical standards and core values when the latter are so deeply ingrained in a company’s culture and in the

**Core Concept**

More attention is paid to linking strategy with ethical principles and core values in companies headed by moral executives and in companies where ethical principles and core values are a way of life.
everyday conduct of company personnel that they are automatically taken into account in all that the company does. However, in companies with window-dressing ethics and core values or in companies headed by immoral or amoral managers, any strategy-ethics-values link stems mainly from a desire to avoid the risk of embarrassment, scandal, and possible disciplinary action should strategy makers get called on the carpet and held accountable for approving an unethical strategic initiative.

**STRATEGY AND SOCIAL RESPONSIBILITY**

The idea that businesses have an obligation to foster social betterment, a much-debated topic in the past 40 years, took root in the 19th century when progressive companies in the aftermath of the industrial revolution began to provide workers with housing and other amenities. The notion that corporate executives should balance the interests of all stakeholders—shareholders, employees, customers, suppliers, the communities in which they operated, and society at large—began to blossom in the 1960s. A group of chief executives of America’s 200 largest corporations, calling themselves the Business Roundtable, promoted the concept of corporate social responsibility. In 1981, the Roundtable’s “Statement on Corporate Responsibility” said:

> Balancing the shareholder’s expectations of maximum return against other priorities is one of the fundamental problems confronting corporate management. The shareholder must receive a good return but the legitimate concerns of other constituencies (customers, employees, communities, suppliers and society at large) also must have the appropriate attention . . . [Leading managers] believe that by giving enlightened consideration to balancing the legitimate claims of all its constituents, a corporation will best serve the interest of its shareholders.

Today, corporate social responsibility is a concept that resonates in Western Europe, the United States, Canada, and such developing nations as Brazil and India.

**What Do We Mean by Social Responsibility?**

The essence of socially responsible business behavior is that a company should balance strategic actions to benefit shareholders against the **duty** to be a good corporate citizen. The thesis is that company managers are obligated to display a **social conscience** in operating the business and specifically take into account how management decisions and company actions affect the well-being of employees, local communities, the environment, and society at large. Acting in a socially responsible manner thus encompasses more than just participating in community service projects and donating money to charities and other worthy social causes. Demonstrating social responsibility also entails undertaking actions that earn trust and respect from all stakeholders—operating in an honorable and ethical manner, striving to make the company a great place to work, demonstrating genuine respect for the environment, and trying to make a difference in bettering society. As depicted in Figure 10.2, the menu for demonstrating a social conscience and choosing specific ways to exercise social responsibility includes:

- **Efforts to employ an ethical strategy and observe ethical principles in operating the business**—A sincere commitment to observing ethical principles is
necessary here simply because unethical strategies and conduct are incompatible with the concept of good corporate citizenship and socially responsible business behavior.

- **Making charitable contributions**, donating money and the time of company personnel to community service endeavors, supporting various worthy organizational causes, and reaching out to make a difference in the lives of the disadvantaged—Some companies fulfill their corporate citizenship and community outreach obligations by spreading their efforts over a multitude of charitable and community activities; for instance, Microsoft and Johnson & Johnson support a broad variety of community art, social welfare, and environmental programs. Others prefer to focus their energies more narrowly. McDonald’s, for example, concentrates on sponsoring the Ronald McDonald House program (which provides a home away from home for the families of seriously ill children receiving treatment at nearby hospitals), preventing child
abuse and neglect, and participating in local community service activities; in 2004, there were 240 Ronald McDonald Houses in 25 countries and more than 6,000 bedrooms available nightly. British Telecom gives 1 percent of its profits directly to communities, largely for education—teacher training, in-school workshops, and digital technology. Leading prescription drug maker GlaxoSmithKline and other pharmaceutical companies either donate or heavily discount medicines for distribution in the least-developed nations. Numerous health-related businesses take a leading role in community activities that promote effective health care. Many companies work closely with community officials to minimize the impact of hiring large numbers of new employees (which could put a strain on local schools and utility services) and to provide outplacement services for laid-off workers. Companies frequently reinforce their philanthropic efforts by encouraging employees to support charitable causes and participate in community affairs, often through programs to match employee contributions.

- **Actions to protect or enhance the environment and, in particular, to minimize or eliminate any adverse impact on the environment stemming from the company’s own business activities**—Social responsibility as it applies to environmental protection means doing more than what is legally required. From a social responsibility perspective, companies have an obligation to be stewards of the environment. This means using the best available science and technology to achieve higher-than-required environmental standards. Even more ideally, it means putting time and money into improving the environment in ways that extend past a company’s own industry boundaries—such as participating in recycling projects, adopting energy conservation practices, and supporting efforts to clean up local water supplies. Retailers such as Home Depot in the United States and B&Q in the United Kingdom have pressured their suppliers to adopt stronger environmental protection practices.38

- **Actions to create a work environment that enhances the quality of life for employees and makes the company a great place to work**—Numerous companies go beyond providing the ordinary kinds of compensation and exert extra efforts to enhance the quality of life for their employees, both at work and at home. This can include varied and engaging job assignments, career development programs and mentoring, rapid career advancement, appealing compensation incentives, ongoing training to ensure future employability, added decision-making authority, onsite day care, flexible work schedules for single parents, workplace exercise facilities, special leaves to care for sick family members, work-at-home opportunities, gender pay equity, showcase plants and offices, special safety programs, and the like.

- **Actions to build a workforce that is diverse with respect to gender, race, national origin, and perhaps other aspects that different people bring to the workplace**—Most large companies in the United States have established workforce diversity programs, and some go the extra mile to ensure that their workplaces are attractive to ethnic minorities and inclusive of all groups and perspectives. The pursuit of workforce diversity can be good business—Johnson & Johnson, Pfizer, and Coca-Cola believe that a reputation for workforce diversity makes recruiting employees easier (talented employees from diverse backgrounds often seek out such companies). And at Coca-Cola, where strategic success depends on getting people all over the world to become loyal consumers of the company’s beverages, efforts to build a public persona of inclusiveness for people of all races, religions, nationalities, interests, and talents has considerable strategic
value. Multinational companies are particularly inclined to make workforce diversity a visible strategic component; they recognize that respecting individual differences and promoting inclusiveness resonate well with people all around the world. At a few companies the diversity initiative extends to suppliers—sourcing items from small businesses owned by women or ethnic minorities.

**Crafting a Social Responsibility Strategy: The Starting Point for Demonstrating a Social Conscience**

While striving to be socially responsible entails choosing from the menu outlined in the preceding section, there’s plenty of room for every company to make its own statement about what charitable contributions to make, what kinds of community service projects to emphasize, what environmental actions to support, how to make the company a good place to work, where and how workforce diversity fits into the picture, and what else it will do to support worthy causes and projects that benefit society. The particular combination of socially responsible endeavors a company elects to pursue defines its social responsibility strategy.

However, unless a company’s social responsibility initiatives become part of the way it operates its business every day, the initiatives are unlikely to catch fire and be fully effective. As an executive at Royal Dutch/Shell put it, corporate social responsibility “is not a cosmetic; it must be rooted in our values. It must make a difference to the way we do business.” Thus some companies are integrating social responsibility objectives into their missions and overall performance targets—they see social performance and environmental metrics as an essential component of judging the company’s overall future performance. Some 2,500 companies around the world are not only articulating their social responsibility strategies and commitments but they are also issuing annual social responsibility reports (much like an annual report) that set forth their commitments and the progress they are making for all the world to see and evaluate.

At Starbucks, the commitment to social responsibility is linked to the company’s strategy and operating practices via the tag line “Giving back to our communities is the way we do business”; top management makes the theme come alive via the company’s extensive community-building activities, efforts to protect the welfare of coffee growers and their families (in particular, making sure they receive a fair price), a variety of recycling and environmental conservation practices, and the financial support it provides to charities and the disadvantaged through the Starbucks Foundation. At Green Mountain Coffee Roasters, social responsibility includes fair dealing with suppliers and trying to do something about the poverty of small coffee growers; in its dealings with suppliers at small farmer cooperatives in Peru, Mexico, and Sumatra, Green Mountain pays “fair trade” prices for coffee beans (in 2002, the fair trade prices were a minimum of $1.26 per pound for conventional coffee and $1.41 for organically grown versus market prices of 24 to 50 cents per pound). Green Mountain also purchases about 25 percent of its coffee direct from farmers so as to cut out intermediaries and see that farmers realize a higher price for their efforts—coffee is the world’s second most heavily traded commodity after oil, requiring the labor of some 20 million people, most of whom live at the poverty level.

At Whole Foods Market, a $5 billion supermarket chain specializing in organic and natural foods, the social responsibility emphasis is on supporting organic farming and
sustainable agriculture, recycling, sustainable seafood practices, giving employees paid time off to participate in worthy community service endeavors, and donating 5 percent of after-tax profits in cash or products to charitable causes. At General Mills the social responsibility focus is on service to the community and bettering the employment opportunities for minorities and women. Stonyfield Farm, a producer of yogurt and ice cream products, employs a social responsibility strategy focused on wellness, good nutrition, and earth-friendly actions (10 percent of profits are donated to help protect and restore the earth, and yogurt lids are used as miniature billboards to help educate people about environmental issues); in addition, it is stressing the development of an environmentally friendly supply chain, sourcing from farmers that grow organic products and refrain from using artificial hormones in milk production. Chick-Fil-A, an Atlanta-based fast-food chain with over 1,200 outlets in 38 states, has a charitable foundation; supports 14 foster homes and a summer camp (for some 1,600 campers from 22 states and several foreign countries); funds two scholarship programs (including one for employees that has awarded more than $20 million in scholarships); and maintains a closed-on-Sunday policy to ensure that every Chick-Fil-A employee and restaurant operator has an opportunity to worship, spend time with family and friends, or just plain rest from the workweek.42 Toys “R” Us supports initiatives addressing the issues of child labor and fair labor practices around the world. Community Pride Food Stores is assisting in revitalizing the inner city of Richmond, Virginia, where the company is based.

It is common for companies engaged in natural resource extraction, electric power production, forestry and paper products, motor vehicles, and chemicals production to place more emphasis on addressing environmental concerns than, say, software and electronics firms or apparel manufacturers. Companies whose business success is heavily dependent on high employee morale or attracting and retaining the best and brightest employees are somewhat more prone to stress the well-being of their employees and foster a positive, high-energy workplace environment that elicits the dedication and enthusiastic commitment of employees, thus putting real meaning behind the claim “Our people are our greatest asset.” Ernst & Young, one of the four largest global accounting firms, stresses its “People First” workforce diversity strategy, which focuses on respecting differences, fostering individuality, and promoting inclusiveness so that its 105,000 employees in 140 countries can feel valued, engaged, and empowered in developing creative ways to serve the firm’s clients.

Thus, while the strategies and actions of all socially responsible companies have a sameness in the sense of drawing on the five categories of socially responsible behavior shown in Figure 10.2, each company’s version of being socially responsible is unique.

**The Moral Case for Corporate Social Responsibility**

The moral case for why businesses should actively promote the betterment of society and act in a manner that benefits all of the company’s stakeholders—not just the interests of shareholders—boils down to the fact that it’s the right thing to do. Ordinary decency, civic-mindedness, and contributing to the well-being of society should be expected of any business. In today’s social and political climate, most business leaders can be expected to acknowledge that socially responsible actions are important and that businesses have a duty to be good corporate citizens. But there is a complementary school of thought that business operates on the basis of an implied social contract with the members of society. According to this contract, society grants a business the right to conduct its business
affairs and agrees not to unreasonably restrain its pursuit of a fair profit for the goods or services it sells; in return for this “license to operate,” a business is obligated to act as a responsible citizen and do its fair share to promote the general welfare. Such a view clearly puts a moral burden on a company to take corporate citizenship into consideration and to do what’s best for shareholders within the confines of discharging its duties to operate honorably, provide good working conditions to employees, be a good environmental steward, and display good corporate citizenship.

The Business Case for Socially Responsible Behavior

Whatever the merits of the moral case for socially responsible business behavior, it has long been recognized that it is in the enlightened self-interest of companies to be good citizens and devote some of their energies and resources to the betterment of employees, the communities in which they operate, and society in general. In short, there are several reasons why the exercise of social responsibility is good business:

- **It generates internal benefits (particularly as concerns employee recruiting, workforce retention, and training costs)**—Companies with deservedly good reputations for contributing time and money to the betterment of society are better able to attract and retain employees compared to companies with tarnished reputations. Some employees just feel better about working for a company committed to improving society. This can contribute to lower turnover and better worker productivity. Other direct and indirect economic benefits include lower costs for staff recruitment and training. For example, Starbucks is said to enjoy much lower rates of employee turnover because of its full benefits package for both full-time and part-time employees, management efforts to make Starbucks a great place to work, and the company’s socially responsible practices. When a U.S. manufacturer of recycled paper, taking eco-efficiency to heart, discovered how to increase its fiber recovery rate, it saved the equivalent of 20,000 tons of waste paper—a factor that helped the company become the industry’s lowest-cost producer. Various benchmarking and measurement mechanisms have shown that workforce diversity initiatives promote the success of companies that stay behind them. Making a company a great place to work pays dividends in recruiting talented workers, more creativity and energy on the part of workers, higher worker productivity, and greater employee commitment to the company’s business mission/vision and success in the marketplace.

- **It reduces the risk of reputation-damaging incidents and can lead to increased buyer patronage**—Firms may well be penalized by employees, consumers, and shareholders for actions that are not considered socially responsible. When a major oil company suffered damage to its reputation on environmental and social grounds, the CEO repeatedly said that the most negative impact the company suffered—and the one that made him fear for the future of the company—was that bright young graduates were no longer attracted to work for the company. Consumer, environmental, and human rights activist groups are quick to criticize businesses whose behavior they consider to be out of line, and they are adept at getting their message into the media and onto the Internet. Pressure groups can generate widespread adverse publicity, promote boycotts, and influence like-minded or sympathetic buyers to avoid an offender’s products.
Research has shown that product boycott announcements are associated with a decline in a company’s stock price. Outspoken criticism of Royal Dutch/Shell by environmental and human rights groups and associated boycotts were said to be major factors in the company’s decision to tune in to its social responsibilities. For many years, Nike received stinging criticism for not policing sweatshop conditions in the Asian factories of its contractors, causing Nike CEO Phil Knight to observe that “Nike has become synonymous with slave wages, forced overtime, and arbitrary abuse.” In 1997, Nike began an extensive effort to monitor conditions in the 800 overseas factories to which it outsourced its shoes; Knight said, “Good shoes come from good factories, and good factories have good labor relations.” Nonetheless, Nike has continually been plagued by complaints from human rights activists that its monitoring procedures are flawed and that it is not doing enough to correct the plight of factory workers. In contrast, to the extent that a company’s socially responsible behavior wins applause from consumers and fortifies its reputation, the company may win additional patronage; Ben & Jerry’s, Whole Foods Market, Stonyfield Farm, and the Body Shop have definitely expanded their customer bases because of their visible and well-publicized activities as socially conscious companies. More and more companies are recognizing the strategic value of social responsibility strategies that reach out to people of all cultures and demographics—in the United States, women are said to having buying power of $3.7 trillion, retired and disabled people close to $4.1 trillion, Hispanics nearly $600 billion, African Americans some $500 billion, and Asian Americans about $255 billion. So reaching out in ways that appeal to such groups can pay off at the cash register. Some observers and executives are convinced that a strong, visible social responsibility strategy gives a company an edge in differentiating itself from rivals and in appealing to those consumers who prefer to do business with companies that are solid corporate citizens. Yet there is only limited evidence that consumers go out of their way to patronize socially responsible companies if it means paying a higher price or purchasing an inferior product.

- **It is in the best interest of shareholders**—Well-conceived social responsibility strategies work to the advantage of shareholders in several ways. Socially responsible business behavior helps avoid or preempt legal and regulatory actions that could prove costly and otherwise burdensome. Increasing numbers of mutual funds and pension benefit managers are restricting their stock purchases to companies that meet social responsibility criteria. According to one survey, one out of every eight dollars under professional management in the United States involved socially responsible investing. Moreover, the growth in socially responsible investing and identifying socially responsible companies has led to a substantial increase in the number of companies that publish formal reports on their social and environmental activities. The stock prices of companies that rate high on social and environmental performance criteria have been found to perform 35 to 45 percent better than the average of the 2,500 companies comprising the Dow Jones Global Index. A two-year study of leading companies found that improving environmental compliance and developing environmentally friendly products can enhance earnings per share, profitability, and the likelihood of winning contracts. Nearly 100 studies have examined the relationship between corporate citizenship and corporate financial performance over the past 30 years; the majority point to a positive relationship. Of the 80 studies that examined whether a company’s social performance is a good predictor of its financial performance, 42 concluded yes, 4 concluded
no, and the remainder reported mixed or inconclusive findings. To the extent that socially responsible behavior is good business, then, a social responsibility strategy that packs some punch and is more than rhetorical flourish turns out to be in the best interest of shareholders.

In sum, companies that take social responsibility seriously can improve their business reputations and operational efficiency while also reducing their risk exposure and encouraging loyalty and innovation. Overall, companies that take special pains to protect the environment (beyond what is required by law), are active in community affairs, and are generous supporters of charitable causes and projects that benefit society are more likely to be seen as good investments and as good companies to work for or do business with. Shareholders are likely to view the business case for social responsibility as a strong one, even though they certainly have a right to be concerned whether the time and money their company spends to carry out its social responsibility strategy outweighs the benefits and reduces the bottom line by an unjustified amount.

Companies are, of course, sometimes rewarded for bad behavior—a company that is able to shift environmental and other social costs associated with its activities onto society as a whole can reap large short-term profits. The major cigarette producers for many years were able to earn greatly inflated profits by shifting the health-related costs of smoking onto others and escaping any responsibility for the harm their products caused to consumers and the general public. Most companies will, of course, try to evade paying for the social harms of their operations for as long as they can. Calling a halt to such actions usually hinges upon (1) the effectiveness of activist social groups in publicizing the adverse consequences of a company’s social irresponsibility and marshaling public opinion for something to be done, (2) the enactment of legislation or regulations to correct the inequity, and (3) widespread actions on the part of socially conscious buyers to take their business elsewhere.

The Well-Intentioned Efforts of Do-Good Executives Can Be Controversial

While there is substantial agreement that businesses have obligations to non-owner stakeholders and to society at large, and that these must be factored into a company’s overall strategy and into the conduct of its business operations, there is much less agreement about the extent to which “do-good” executives should pursue their personal vision of a better world using company funds. One view holds that any money executives authorize for so-called social responsibility initiatives is effectively theft from a company’s shareholders who can, after all, decide for themselves what and how much to give to charity and other causes they deem worthy. A related school of thought says that companies should be wary of taking on an assortment of societal obligations because doing so diverts valuable resources and weakens a company’s competitiveness. Many academics and businesspeople believe that businesses best satisfy their social responsibilities through conventional business activities, primarily producing needed goods and services at prices that people can afford. They further argue that spending shareholders’ or customers’ money for social causes not only muddies decision making by diluting the focus on the company’s business mission but also thrusts business executives into the role of social engineers—a role more appropriately performed by charitable and nonprofit organizations and duly elected government officials. Do we really want corporate executives deciding how to best balance the different interests of stakeholders and functioning as social engineers? Are they competent to make such judgments?
Take the case of Coca-Cola and Pepsi bottlers. Local bottlers of both brands have signed contracts with public school districts that provide millions of dollars of support for local schools in exchange for vending-machine distribution rights in the schools. \(^{55}\) While such contracts would seem to be a win–win proposition, protests from parents concerned about children’s sugar-laden diets and commercialism in the schools make such contracts questionable. Opponents of these contracts claim that it is the role of government to provide adequate school funding and that the learning environment in local schools should be free of commercialism and the self-serving efforts of businesses to hide behind providing support for education.

In September 1997, the Business Roundtable changed its stance from one of support for social responsibility and balanced consideration of stakeholder interests to one of skepticism with regard to such actions:

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The notion that the board must somehow balance the interests of stockholders against the interests of other stakeholders fundamentally misconstrues the role of directors. It is, moreover, an unworkable notion because it would leave the board with no criteria for resolving conflicts between the interest of stockholders and of other stakeholders or among different groups of stakeholders. \(^{56}\)
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The new Business Roundtable view implied that the paramount duty of management and of boards of directors is to the corporation’s stockholders. Customers may be “king,” and employees may be the corporation’s “greatest asset” (at least in the rhetoric), but the interests of shareholders rule. \(^{57}\)

However, there are real problems with disconnecting business behavior from the well-being of non-owner stakeholders and the well-being of society at large. \(^{58}\) Isolating business from the rest of society when the two are inextricably intertwined is unrealistic. Many business decisions spill over to impact non-owner stakeholders and society. Furthermore, the notion that businesses must be managed solely to serve the interests of shareholders is something of a stretch. Clearly, a business’s first priority must be to deliver value to customers. Unless a company does a creditable job of satisfying buyer needs and expectations of reliable and attractively priced goods and services, it cannot survive. While shareholders provide capital and are certainly entitled to a return on their investment, fewer and fewer shareholders are truly committed to the companies whose stock they own. Shareholders can dispose of their holdings in a moment’s whim or at the first sign of a downturn in the stock price. Mutual funds buy and sell shares daily, adding and dropping companies whenever they see fit. Day traders buy and sell within hours. Such buying and selling of shares is nothing more than a financial transaction and results in no capital being provided to the company to fund operations except when it entails the purchase of newly issued shares of stock. So why should shareholders—a group distant from the company’s operations and adding little to its operations except when new shares of stock are purchased—lay such a large claim on how a company should be managed? Are most shareholders really interested in or knowledgeable about the companies they own? Or do they just own a stock for whatever financial returns it is expected to provide?

While there is legitimate concern about the use of company resources for do-good purposes and the motives and competencies of business executives in functioning as social engineers, it is tough to argue that businesses have no obligations to nonowner stakeholders or to society at large. If one looks at the category of activities that fall under the umbrella of socially responsible behavior (Figure 10.2), there’s really very little for shareholders or others concerned about the do-good attempts of executives to object to in principle. Certainly, it is legitimate for companies to minimize or eliminate any adverse impacts of their operations on the environment. It is hard to argue
against efforts to make the company a great place to work or to promote workforce diversity. And with regard to charitable contributions, community service projects, and the like, it would be hard to find a company where spending on such activities is so out of control that shareholders might rightfully complain or that the company’s competitiveness is being eroded. What is likely to prove most objectionable in the social responsibility arena are the specific activities a company elects to engage in and/or the manner in which a company carries out its attempts to behave in a socially responsible manner.

How Much Attention to Social Responsibility Is Enough?

What is an appropriate balance between the imperative to create value for shareholders and the obligation to proactively contribute to the larger social good? What fraction of a company’s resources ought to be aimed at addressing social concerns and bettering the well-being of society and the environment? A few companies have a policy of setting aside a specified percentage of their profits (typically 5 percent or maybe 10 percent) to fund their social responsibility strategy; they view such percentages as a fair amount to return to the community as a kind of thank-you or a tithe to the betterment of society. Other companies shy away from a specified percentage of profits or revenues because it entails upping the commitment in good times and cutting back on social responsibility initiatives in hard times (even cutting out social responsibility initiatives entirely if profits temporarily turn into losses). If social responsibility is an ongoing commitment rooted in the corporate culture and enlists broad participation on the part of company personnel, then a sizable portion of the funding for the company’s social responsibility strategy has to be viewed as simply a regular and ongoing cost of doing business.

But judging how far a particular company should go in pursuing particular social causes is a tough issue. Consider, for example, Nike’s commitment to monitoring the workplace conditions of its contract suppliers. The scale of this monitoring task is significant: in 2005, Nike had over 800 contract suppliers employing over 600,000 people in 50 countries. How frequently should sites be monitored? How should it respond to the use of underage labor? If only children above a set age are to be employed by suppliers, should suppliers still be required to provide schooling opportunities? At last count, Nike had some 80 people engaged in site monitoring. Should Nike’s monitoring budget be $2 million, $5 million, $10 million, or whatever it takes?

Consider another example: If pharmaceutical manufacturers donate or discount their drugs for distribution to low-income people in less-developed nations, what safeguards should they put in place to see that the drugs reach the intended recipients and are not diverted by corrupt local officials for reexport to markets in other countries? Should drug manufacturers also assist in drug distribution and administration in these less-developed countries? How much should a drug company invest in R&D to develop medicines for tropical diseases commonly occurring in less-developed countries when it is unlikely to recover its costs in the foreseeable future?

And how much should a company allocate to charitable contributions? Is it falling short of its responsibilities if its donations are less than 1 percent of profits? Is a company going too far if it allocates 5 percent or even 10 percent of its profits to worthy causes of one kind or another? The point here is that there is no simple or widely accepted standard for judging when a company has or has not gone far enough in fulfilling its citizenship responsibilities.
Linking Social Performance Targets to Executive Compensation

Perhaps the most surefire way to enlist a genuine commitment to corporate social responsibility initiatives is to link the achievement of social performance targets to executive compensation. If a company’s board of directors is serious about corporate citizenship, then it will incorporate measures of the company’s social and environmental performance into its evaluation of top executives, especially the CEO. And if the CEO uses compensation incentives to further enlist the support of down-the-line company personnel in effectively crafting and executing a social responsibility strategy, the company will over time build a culture rooted in socially responsible and ethical behavior. According to one survey, 80 percent of surveyed CEOs believe that environmental and social performance metrics are a valid part of measuring a company’s overall performance. At Verizon Communications, 10 percent of the annual bonus of the company’s top 2,500 managers is tied directly to the achievement of social responsibility targets; for the rest of the staff, there are corporate recognition awards in the form of cash for employees who have made big contributions towards social causes. The corporate social responsibility reports being issued annually by 2,500 companies across the world that detail social responsibility initiatives and the results achieved are a good basis for compensating executives and judging the effectiveness of their commitment to social responsibility.

Key Points

Ethics involves concepts of right and wrong, fair and unfair, moral and immoral. Beliefs about what is ethical serve as a moral compass in guiding the actions and behaviors of individuals and organizations. Ethical principles in business are not materially different from ethical principles in general.

There are three schools of thought about ethical standards:

1. According to the school of ethical universalism, the same standards of what’s ethical and what’s unethical resonate with peoples of most societies regardless of local traditions and cultural norms; hence, common ethical standards can be used to judge the conduct of personnel at companies operating in a variety of country markets and cultural circumstances.

2. According to the school of ethical relativism different societal cultures and customs have divergent values and standards of right and wrong—thus, what is ethical or unethical must be judged in the light of local customs and social mores and can vary from one culture or nation to another.

3. According to integrated social contracts theory, universal ethical principles or norms based on the collective views of multiple cultures and societies combine to form a “social contract” that all individuals in all situations have a duty to observe. Within the boundaries of this social contract, local cultures can specify other impermissible actions; however, universal ethical norms always take precedence over local ethical norms.

Three categories of managers stand out as concerns their prevailing beliefs in and commitments to ethical and moral principles in business affairs: the moral manager; the immoral manager, and the amoral manager. By some accounts, the population of managers is said to be distributed among all three types in a bell-shaped curve, with
immoral managers and moral managers occupying the two tails of the curve, and the amoral managers, especially the intentionally amoral managers, occupying the broad middle ground.

The apparently large numbers of immoral and amoral businesspeople are one obvious reason why some companies resort to unethical strategic behavior. Three other main drivers of unethical business behavior also stand out:

1. Overzealous or obsessive pursuit of personal gain, wealth, and other selfish interests.
2. Heavy pressures on company managers to meet or beat earnings targets.
3. A company culture that puts the profitability and good business performance ahead of ethical behavior.

The stance a company takes in dealing with or managing ethical conduct at any given time can take any of four basic forms:

1. The unconcerned, or nonissue, approach.
2. The damage control approach.
3. The compliance approach.
4. The ethical culture approach.

There are two reasons why a company’s strategy should be ethical: (1) because a strategy that is unethical in whole or in part is morally wrong and reflects badly on the character of the company personnel involved, and (2) because an ethical strategy is good business and in the self-interest of shareholders.

The term corporate social responsibility concerns a company’s duty to operate in an honorable manner, provide good working conditions for employees, be a good steward of the environment, and actively work to better the quality of life in the local communities where it operates and in society at large. The menu of actions and behavior for demonstrating social responsibility includes:

1. Employing an ethical strategy and observing ethical principles in operating the business.
2. Making charitable contributions, donating money and the time of company personnel to community service endeavors, supporting various worthy organizational causes, and making a difference in the lives of the disadvantaged. Corporate commitments are further reinforced by encouraging employees to support charitable and community activities.
3. Protecting or enhancing the environment and, in particular, striving to minimize or eliminate any adverse impact on the environment stemming from the company’s own business activities.
4. Creating a work environment that makes the company a great place to work.
5. Employing a workforce that is diverse with respect to gender, race, national origin, and perhaps other aspects that different people bring to the workplace.

There is ample room for every company to tailor its social responsibility strategy to fit its core values and business mission, thereby making their own statement about “how we do business and how we intend to fulfill our duties to all stakeholders and society at large.”

The moral case for social responsibility boils down to a simple concept: It’s the right thing to do. The business case for social responsibility holds that it is in the
enlightened self-interest of companies to be good citizens and devote some of their energies and resources to the betterment of such stakeholders as employees, the communities in which it operates, and society in general.

**Exercises**

1. Given the description of Marsh & McLennan’s strategy presented in Illustration Capsule 10.1, would it be fair to characterize the payment of contingent commissions by property-casualty insurers as nothing more than thinly disguised kickbacks? Why or why not? If you were the manager of a company that hired Marsh & McLennan to provide risk management services, would you see that Marsh had a conflict of interest in steering your company’s insurance policies to insurers in which it has an ownership interest? Given Marsh’s unethical and illegal foray into rigging the bids on insurance policies for its corporate clients, what sort of fines and penalties would you impose on the company for its misdeeds (assuming you were asked to recommend appropriate penalties by the prosecuting authorities). In arriving at a figure, bear in mind that Prudential Securities paid a total of about $2 billion in the 1990s to settle civil regulatory charges and private lawsuits alleging that it misled investors on the risks and rewards of limited-partnership investments. Ten Wall Street securities firms in 2003 paid $1.4 billion to settle civil charges for issuing misleading stock research to investors. Prominent mutual-fund firms were assessed nearly $2 billion in fines and restitution for engaging in after-hours stock trading at prearranged prices that were contrary to the interests of long-term shareholders. And several well-known financial institutions, including Citigroup, Merrill Lynch, Goldmans Sachs, and Credit Suisse First Boston agreed to pay several billion dollars in fines and restitution for their role in scandals at Enron and WorldCom and for improperly allocating initial public offerings of stock. Using Internet research tools, determine what Marsh & McLennan ended up paying in fines and restitution for its unethical and illegal strategic behavior and assess the extent to which the conduct of company personnel damaged shareholders.

2. Consider the following portrayal of strategies employed by major recording studios:

Some recording artists and the Recording Artists’ Coalition claim that the world’s five major music recording studios—Universal, Sony, Time Warner, EMI/Virgin, and Bertelsmann—deliberately employ strategies calculated to take advantage of musicians who record for them. One practice to which they strenuously object is that the major-label record companies frequently require artists to sign contracts committing them to do six to eight albums, an obligation that some artists say can entail an indefinite term of indentured servitude. Further, it is claimed that audits routinely detect unpaid royalties to musicians under contract; according to one music industry attorney, record companies misreport and underpay artist royalties by 10 to 40 percent and are “intentionally fraudulent.” One music writer was recently quoted as saying the process was “an entrenched system whose prowess and conniving makes Enron look like amateur hour.” Royalty calculations are based on complex formulas that are paid only after artists pay for recording costs and other expenses and after any advances are covered by royalty earnings.

A *Baffler* magazine article outlined a hypothetical but typical record deal in which a promising young band is given a $250,000 royalty advance on a new album. The album subsequently sells 250,000 copies, earning $710,000 for the
record company; but the band, after repaying the record company for $264,000 in expenses ranging from recording fees and video budgets to catering, wardrobe, and bus tour costs for promotional events related to the album, ends up $14,000 in the hole, owes the record company money, and is thus paid no royalties on any of the $710,000 in revenues the recording company receives from the sale of the band’s music. It is also standard practice in the music industry for recording studios to sidestep payola laws by hiring independent promoters to lobby and compensate radio stations for playing certain records. Record companies are often entitled to damages for undelivered albums if an artist leaves a recording studio for another label after seven years. Record companies also retain the copyrights in perpetuity on all music recorded under contract, a practice that artists claim is unfair. The Dixie Chicks, after a year-long feud with Sony over contract terms, ended up refusing to do another album; Sony sued for breach of contract, prompting a countersuit by the Dixie Chicks charging “systematic thievery” to cheat them out of royalties. The suits were settled out of court. One artist said, “The record companies are like cartels.”

Recording studios defend their strategic practices by pointing out that fewer than 5 percent of the signed artists ever deliver a hit and that they lose money on albums that sell poorly. According to one study, only 1 of 244 contracts signed during 1994–1996 was negotiated without the artists being represented by legal counsel, and virtually all contracts renegotiated after a hit album added terms more favorable to the artist.

a. If you were a recording artist, would you be happy with some of the strategic practices of the recording studios? Would you feel comfortable signing a recording contract with studios engaging in any of the practices?

b. Which, if any, of the practices of the recording studios do you view as unethical?

3. Recently, it came to light that three of the world’s four biggest public accounting firms may have overbilled clients for travel-related expenses. Pricewaterhouse Coopers, KPMG, and Ernst & Young were sued for systematically charging their clients full price for airline tickets, hotel rooms and car-rental expenses, even though they received volume discounts and rebates of up to 40 percent under their contracts with various travel companies. Large accounting firms, law firms, and medical practices have in recent years used their size and purchasing volumes to negotiate sizable discounts and rebates on up-front travel costs; some of these contracts apparently required that the discounts not be disclosed to other parties, which seemingly included clients.

However, it has long been the custom for accounting and law firms to bill their clients for actual out-of-pocket expenses. The three accounting firms, so the lawsuit alleges, billed clients for the so-called full prices of the airline tickets, hotel rooms, and car-rental expenses rather than for the out-of-pocket discounted amounts. They pocketed the differences to the tune of several million dollars annually in additional profits. Several clients, upon learning of the full-price billing practices, claimed fraud and sued.

Do you consider the accounting firms’ billing practice to be unethical? Why or why not?

4. Suppose you found yourself in the following situation: In preparing a bid for a multimillion-dollar contract in a foreign country, you are introduced to a “consultant” who offers to help you in submitting the bid and negotiating with the customer company. You learn in conversing with the consultant that she is well connected in local government and business circles and knows key personnel in the customer company extremely well. The consultant quotes you a six-figure fee.
Later, your local co-workers tell you that the use of such consultants is normal in this country—and that a large fraction of the fee will go directly to people working for the customer company. They further inform you that bidders who reject the help of such consultants have lost contracts to competitors who employed them. What would you do, assuming your company’s code of ethics expressly forbids the payments of bribes or kickbacks in any form?

5. Assume that you are the sales manager at a European company that makes sleepwear products for children. Company personnel discover that the chemicals used to flameproof the company’s line of children’s pajamas might cause cancer if absorbed through the skin. Following this discovery, the pajamas are then banned from sale in the European Union and the United States, but senior executives of your company learn that the children’s pajamas in inventory and the remaining flameproof material can be sold to sleepwear distributors in certain East European countries where there are no restrictions against the material’s use. Your superiors instruct you to make the necessary arrangements to sell the inventories of banned pajamas and flameproof materials to East European distributors. Would you comply if you felt that your job would be in jeopardy if you didn’t?

6. At Salomon Smith Barney (a subsidiary of Citigroup), Credit Suisse First Boston (CSFB), and Goldman Sachs (three of the world’s most prominent investment banking companies), part of the strategy for securing the investment banking business of large corporate clients (to handle the sale of new stock issues or new bond issues or advise on mergers and acquisitions) involved (a) hyping the stocks of companies that were actual or prospective customers of their investment banking services, and (b) allocating hard-to-get shares of hot new initial public offerings (IPOs) to select executives and directors of existing and potential client companies, who then made millions of dollars in profits when the stocks went up once public trading began. Former WorldCom CEO Bernard Ebbers reportedly made more than $11 million in trading profits over a four-year period on shares of IPOs received from Salomon Smith Barney; Salomon served as WorldCom’s investment banker on a variety of deals during this period. Jack Grubman, Salomon’s top-paid research analyst at the time, enthusiastically touted WorldCom stock and was regarded as the company’s biggest cheerleader on Wall Street.

To help draw in business from new or existing corporate clients, CSFB established brokerage accounts for corporate executives who steered their company’s investment banking business to CSFB. Apparently, CSFB’s strategy for acquiring more business involved promising the CEO and/or CFO of companies about to go public for the first time or needing to issue new long-term bonds that if CSFB was chosen to handle their company’s IPO of common stock or a new bond issue, then CSFB would ensure they would be allocated shares at the initial offering price of all subsequent IPOs in which CSFB was a participant. During 1999–2000, it was common for the stock of a hot new IPO to rise 100 to 500 percent above the initial offering price; the shares allocated to these executives were then sold for a tidy profit over the initial offering price. According to investigative sources, CSFB increased the number of companies whose executives were allowed to participate in its IPO offerings from 26 companies in January 1999 to 160 companies in early 2000; executives received anywhere from 200 to 1,000 shares each of every IPO in which CSFB was a participant in 2000. CSFB’s accounts for these executives reportedly generated profits of about $80 million for the participants. Apparently, it was CSFB’s practice to curtail
access to IPOs for some executives if their companies didn’t come through with additional securities business for CSFB or if CSFB concluded that other securities offerings by these companies would be unlikely.

Goldman Sachs also used an IPO-allocation scheme to attract investment banking business, giving shares to executives at 21 companies—among the participants were the CEOs of eBay, Yahoo, and Ford Motor Company. eBay’s CEO was a participant in over 100 IPOs managed by Goldman during the 1996–2000 period and was on Goldman’s board of directors part of this time; eBay paid Goldman Sachs $8 million in fees for services during the 1996–2001 period.

a. If you were a top executive at Salomon Smith Barney, CSFB, or Goldman Sachs, would you be proud to defend your company’s actions?

b. Would you want to step forward and take credit for having been a part of the group who designed or approved of the strategy for gaining new business at any of these three firms?

c. Is it accurate to characterize the allocations of IPO shares to “favored” corporate executives as bribes or kickbacks?
Building an Organization Capable of Good Strategy Execution

The best game plan in the world never blocked or tackled anybody.
—Vince Lombardi
Hall of Fame football coach

Strategies most often fail because they aren’t executed well.
—Larry Bossidy and Ram Charan
CEO Honeywell International; author and consultant

A second-rate strategy perfectly executed will beat a first-rate strategy poorly executed every time.
—Richard M. Kovacevich
Chairman and CEO, Wells Fargo

Any strategy, however brilliant, needs to be implemented properly if it is to deliver the desired results.
—Costas Markides
Professor

People are not your most important asset. The right people are.
—Jim Collins
Professor and author

Organizing is what you do before you do something, so that when you do it, it is not all mixed up.
—A. A. Milne
Author
Once managers have decided on a strategy, the emphasis turns to converting it into actions and good results. Putting the strategy into place and getting the organization to execute it well call for different sets of managerial skills. Whereas crafting strategy is largely a market-driven activity, implementing and executing strategy is primarily an operations-driven activity revolving around the management of people and business processes. Whereas successful strategy making depends on business vision, solid industry and competitive analysis, and shrewd market positioning, successful strategy execution depends on doing a good job of working with and through others, building and strengthening competitive capabilities, motivating and rewarding people in a strategy-supportive manner, and instilling a discipline of getting things done. Executing strategy is an action-oriented, make-things-happen task that tests a manager’s ability to direct organizational change, achieve continuous improvement in operations and business processes, create and nurture a strategy-supportive culture, and consistently meet or beat performance targets.

Experienced managers are emphatic in declaring that it is a whole lot easier to develop a sound strategic plan than it is to execute the plan and achieve the desired outcomes. According to one executive, “It’s been rather easy for us to decide where we wanted to go. The hard part is to get the organization to act on the new priorities.”\(^1\) Just because senior managers announce a new strategy doesn’t mean that organizational members will agree with it or enthusiastically move forward in implementing it. Senior executives cannot simply direct immediate subordinates to abandon old ways and take up new ways, and they certainly cannot expect the needed actions and changes to occur in rapid-fire fashion and lead to the desired outcomes. Some managers and employees may be skeptical about the merits of the strategy, seeing it as contrary to the organization’s best interests, unlikely to succeed, or threatening to their departments or careers. Moreover, different employees may interpret the new strategy differently or have different ideas about what internal changes are needed to execute it. Long-standing attitudes, vested interests, inertia, and ingrained organizational practices don’t melt away when managers decide on a new strategy and begin efforts to implement it—especially when only comparatively few people have been involved in crafting the strategy and when the rationale for strategic change has to be sold to enough organizational members to root out the status quo.
It takes adept managerial leadership to convincingly communicate the new strategy and the reasons for it, overcome pockets of doubt and disagreement, secure the commitment and enthusiasm of concerned parties, identify and build consensus on all the hows of implementation and execution, and move forward to get all the pieces into place. Company personnel have to understand—in their heads and in their hearts—why a new strategic direction is necessary and where the new strategy is taking them.\(^2\) Instituting change is, of course, easier when the problems with the old strategy have become obvious and/or the company has spiraled into a financial crisis.

But the challenge of successfully implementing new strategic initiatives goes well beyond managerial adeptness in overcoming resistance to change. What really makes executing strategy a tougher, more time-consuming management challenge than crafting strategy are the wide array of managerial activities that have to be attended to, the many ways that managers can proceed, and the number of bedeviling issues that must be worked out. It takes first-rate “managerial smarts” to zero in on what exactly needs to be done to put new strategic initiatives in place and, further, how best to get these things done in a timely fashion and in a manner that yields good results. Demanding people-management skills are required. Plus, it takes follow-through and perseverance to get a variety of initiatives launched and moving and to integrate the efforts of many different work groups into a smoothly functioning whole. Depending on how much consensus building and organizational change is involved, the process of implementing strategy changes can take several months to several years. And it takes still longer to achieve real proficiency in executing the strategy.

Like crafting strategy, executing strategy is a job for the whole management team, not just a few senior managers. While an organization’s chief executive officer and the heads of major units (business divisions, functional departments, and key operating units) are ultimately responsible for seeing that strategy is executed successfully, the process typically affects every part of the firm, from the biggest operating unit to the smallest frontline work group. Top-level managers have to rely on the active support and cooperation of middle and lower managers to push strategy changes into functional areas and operating units and to see that the organization actually operates in accordance with the strategy on a daily basis. Middle and lower-level managers not only are responsible for initiating and supervising the execution process in their areas of authority but also are instrumental in getting subordinates to continuously improve on how strategy-critical value chain activities are being performed and in producing the operating results that allow company performance targets to be met—their role on the company’s strategy execution team is by no means minimal.

**Core Concept**

Good strategy execution requires a team effort. All managers have strategy-executing responsibility in their areas of authority, and all employees are participants in the strategy execution process.
A FRAMEWORK FOR EXECUTING STRATEGY

Implementing and executing strategy entails figuring out all the hows—the specific techniques, actions, and behaviors that are needed for a smooth strategy-supportive operation—and then following through to get things done and deliver results. The idea is to make things happen and make them happen right. The first step in implementing strategic changes is for management to communicate the case for organizational change so clearly and persuasively to organizational members that a determined commitment takes hold throughout the ranks to find ways to put the strategy into place, make it work, and meet performance targets. The ideal condition is for managers to arouse enough enthusiasm for the strategy to turn the implementation process into a companywide crusade. Management’s handling of the strategy implementation process can be considered successful if and when the company achieves the targeted strategic and financial performance and shows good progress in making its strategic vision a reality.

The specific hows of executing a strategy—the exact items that need to be placed on management’s action agenda—always have to be customized to fit the particulars of a company’s situation. Making minor changes in an existing strategy differs from implementing radical strategy changes. The hot buttons for successfully executing a low-cost provider strategy are different from those in executing a high-end differentiation strategy. Implementing and executing a new strategy for a struggling company in the midst of a financial crisis is a different job from that of improving strategy execution in a company where the execution is already pretty good. Moreover, some managers are more adept than others at using this or that approach to achieving the desired kinds of organizational changes. Hence, there’s no definitive managerial recipe for successful strategy execution that cuts across all company situations and all types of strategies or that works for all types of managers. Rather, the specific hows of implementing and executing a strategy—the to-do list that constitutes management’s agenda for action—must always be custom-tailored to fit an individual company’s own circumstances and represents management’s judgment about how best to proceed.

THE PRINCIPAL MANAGERIAL COMPONENTS OF THE STRATEGY EXECUTION PROCESS

Despite the need to tailor a company’s strategy-executing approaches to the particulars of its situation, certain managerial bases have to be covered no matter what the circumstances. Eight managerial tasks crop up repeatedly in company efforts to execute strategy (see Figure 11.1):

1. Building an organization with the competencies, capabilities, and resource strengths to execute strategy successfully.
2. Marshaling sufficient money and people behind the drive for strategy execution.
3. Instituting policies and procedures that facilitate rather than impede strategy execution.
4. Adopting best practices and pushing for continuous improvement in how value chain activities are performed.
5. Installing information and operating systems that enable company personnel to carry out their strategic roles proficiently.
6. Tying rewards directly to the achievement of strategic and financial targets and to good strategy execution.
7. Instilling a corporate culture that promotes good strategy execution.
8. Exercising strong leadership to drive execution forward, keep improving on the details of execution, and achieve operating excellence as rapidly as feasible.

How well managers perform these eight tasks has a decisive impact on whether the outcome is a spectacular success, a colossal failure, or something in between.

In devising an action agenda for implementing and executing strategy, the place for managers to start is with a probing assessment of what the organization must do differently and better to carry out the strategy successfully. They should then consider precisely how to make the necessary internal changes as rapidly as possible. Successful strategy implementers have a knack for diagnosing what their organizations need to do to execute the chosen strategy well and figuring out how to get things done—they are
masters in promoting results-oriented behaviors on the part of company personnel and following through on making the right things happen in a timely fashion.\(^3\)

In big organizations with geographically scattered operating units, the action agenda of senior executives mostly involves communicating the case for change to others, building consensus for how to proceed, installing strong allies in positions where they can push implementation along in key organizational units, urging and empowering subordinates to keep the process moving, establishing measures of progress and deadlines, recognizing and rewarding those who achieve implementation milestones, directing resources to the right places, and personally leading the strategic change process. Thus, the bigger the organization, the more successful strategy execution depends on the cooperation and implementing skills of operating managers who can push needed changes at the lowest organizational levels and deliver results. In small organizations, top managers can deal directly with frontline managers and employees, personally orchestrating the action steps and implementation sequence, observing firsthand how implementation is progressing, and deciding how hard and how fast to push the process along. Regardless of the organization’s size and whether implementation involves sweeping or minor changes, the most important leadership traits are a strong, confident sense of what to do and how to do it. Having a strong grip on these two things comes from understanding the circumstances of the organization and the requirements for effective strategy execution. Then it remains for those managers and company personnel in strategy-critical areas to step up to the plate and produce the desired results.

**What’s Covered in Chapters 11, 12, and 13**  In the remainder of this chapter and the next two chapters, we will discuss what is involved in performing the eight key managerial tasks (shown in Figure 11.1) that shape the process of implementing and executing strategy. This chapter explores building an organization with the competencies, capabilities, and resource strengths to execute the strategy successfully. Chapter 12 looks at marshaling resources, instituting strategy-facilitating policies and procedures, adopting best practices, installing operating systems, and tying rewards to the achievement of good results. Chapter 13 deals with creating a strategy-supportive corporate culture and exercising the leadership needed to drive the execution process forward.

**BUILDING AN ORGANIZATION CAPABLE OF GOOD STRATEGY EXECUTION**

Proficient strategy execution depends heavily on competent personnel, better-than-adequate competitive capabilities, and effective internal organization. Building a capable organization is thus always a top priority in strategy execution. As shown in Figure 11.2, three types of organization-building actions are paramount:

1. **Staffing the organization**—putting together a strong management team, and recruiting and retaining employees with the needed experience, technical skills, and intellectual capital.

2. **Building core competencies and competitive capabilities**—developing proficiencies in performing strategy-critical value chain activities and updating them to match changing market conditions and customer expectations.

3. **Structuring the organization and work effort**—organizing value chain activities and business processes and deciding how much decision-making authority to push down to lower-level managers and frontline employees.
Figure 11.2  The Three Components of Building an Organization Capable of Proficient Strategy Execution

<table>
<thead>
<tr>
<th>STAFFING THE ORGANIZATION</th>
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<tbody>
<tr>
<td>No company can hope to perform the activities required for successful strategy execution without attracting and retaining talented managers and employees with suitable skills and intellectual capital.</td>
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<th>Putting Together a Strong Management Team</th>
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| Assembling a capable management team is a cornerstone of the organization-building task. While different strategies and company circumstances sometimes call for different mixes of backgrounds, experiences, values, beliefs, management styles, and know-how, the most important consideration is to fill key managerial slots with smart people who are clear thinkers, good at figuring out what needs to be done, and skilled in “making it happen” and delivering good results. The task of implementing and executing challenging strategic initiatives must be assigned to executives who have the skills and talents to handle them and who can be counted on to turn their decisions and actions into results that meet or beat the established performance targets. It helps enormously when a company’s top management team has several people who are particularly good change agents—true believers who champion change, know how to make it happen, and love every second of the process. Without a smart, capable, results-oriented management team, the implementation-execution process ends up being hampered by missed deadlines, misdirected or wasteful efforts, and/or managerial ineptness. Weak executives are serious impediments to getting }
optimal results because they are unable to differentiate between ideas and approaches that have merit and those that are misguided—the caliber of work done under their supervision suffers. In contrast, managers with strong strategy-implementing capabilities have a talent for asking tough, incisive questions. They know enough about the details of the business to be able to challenge and ensure the soundness of the approaches and decisions of the people around them, and they can discern whether the resources people are asking for to put the strategy in place make sense. They are good at getting things done through others, typically by making sure they have the right people under them and that these people are put in the right jobs. They consistently follow through on issues, monitor progress carefully, make adjustments when needed, and not let important details slip through the cracks. In short, they understand how to drive organizational change, and they have the managerial discipline requisite for first-rate strategy execution.

Sometimes a company’s existing management team is suitable; at other times it may need to be strengthened or expanded by promoting qualified people from within or by bringing in outsiders whose experiences, talents, and leadership styles better suit the situation. In turnaround and rapid-growth situations, and in instances when a company doesn’t have insiders with the requisite know-how, filling key management slots from the outside is a fairly standard organization-building approach. In addition, it is important to ferret out and replace managers who, for whatever reasons, prefer the status quo and who either do not buy into the case for making organizational changes or do not see ways to make things better. For a top management team to be truly effective, it has got to consist of “true believers” who recognize that organizational changes are needed and are ready to get on with the process. Weak executives and die-hard resisters have to be replaced or sidelined (by shifting them to positions of lesser influence where they cannot hamper or derail new strategy execution initiatives).

The overriding aim in building a management team should be to assemble a critical mass of talented managers who can function as agents of change and further the cause of first-rate strategy execution—every manager’s success is enhanced (or limited) by the quality of their managerial colleagues and the degree to which they freely exchange ideas, debate how to improve approaches that have merit, and join forces to tackle issues and solve problems. When a first-rate manager enjoys the help and support of other first-rate managers, it’s possible to create a managerial whole that is greater than the sum of individual efforts—talented managers who work well together as a team can produce organizational results that are dramatically better than what one or two star managers acting individually can achieve. The chief lesson here is that a company needs to get the right executives on the bus—and the wrong executives off the bus—before trying to drive the bus in the desired direction.

Illustration Capsule 11.1 describes General Electric’s widely acclaimed approach to developing a top-caliber management team.

**Recruiting and Retaining Capable Employees**

Assembling a capable management team is not enough. Staffing the organization with the right kinds of people must go much deeper than managerial jobs in order for value chain activities to be performed competently. The quality of an organization’s people is always an essential ingredient of successful strategy execution—knowledgeable, engaged employees are a company’s best source of creative ideas for the nuts-and-bolts operating improvements that lead to operating excellence. Companies in many industries, adding to a company’s talent base and building intellectual capital is more important to good strategy execution than additional investments in plants, equipment, and capital projects.
General Electric (GE) is widely considered to be one of the best-managed companies in the world, partly because of its concerted effort to develop outstanding managers. For starters, GE strives to hire talented people with high potential for executive leadership; it then goes to great lengths to expand the leadership, business, and decision-making capabilities of all its managers. Four key elements undergird GE’s efforts to build a talent-rich stable of managers:

- GE makes a practice of transferring managers across divisional, business, or functional lines for sustained periods of time. Such transfers allow managers to develop relationships with colleagues in other parts of the company, help break down insular thinking in business “silos,” and promote the sharing of cross-business ideas and best practices. There is an enormous emphasis at GE on transferring ideas and best practices from business to business and making GE a “boundaryless” company.

- In selecting executives for key positions, GE is strongly disposed to candidates who exhibit what are called the four E’s—enormous personal energy, the ability to motivate and energize others, edge (a GE code word for instinctive competitiveness and the ability to make tough decisions in a timely fashion, saying yes or no, and not maybe), and execution (the ability to carry things through to fruition). Considerable attention is also paid to problem-solving ability, experience in multiple functions or businesses, and experience in driving business growth (as indicated by good market instincts, in-depth knowledge of particular markets, customer touch, and technical understanding).

- All managers are expected to be proficient at what GE calls workout—a process in which managers and employees come together to confront issues as soon as they come up, pinpoint the root cause of the issues, and bring about quick resolutions so the business can move forward. Workout is GE’s way of training its managers to diagnose what to do and how to do it.

- Each year GE sends about 10,000 newly hired and long-time managers to its Leadership Development Center (generally regarded as one of the best corporate training centers in the world), for a three-week course on the company’s Six Sigma quality initiative. Close to 10,000 “master black belt” and “black belt” Six Sigma experts have graduated from the program to drive forward thousands of quality initiatives throughout GE. Six Sigma training is an ironclad requirement for promotion to any professional and managerial position and any stock option award. GE’s Leadership Development Center also offers advanced courses for senior managers that may focus on a single management topic for a month. All classes involve managers from different GE businesses and different parts of the world. Some of the most valuable learning comes in between formal class sessions when GE managers from different businesses trade ideas about how to improve processes and better serve the customer. This knowledge sharing not only spreads best practices throughout the organization but also improves each GE manager’s knowledge.

All of GE’s 85,000 managers and professionals are graded in an annual process that divides them into five tiers: the top 10 percent, the next 15 percent, the middle 50 percent, the next 15 percent, and the bottom 10 percent. Everyone in the top tier gets stock awards, nobody in the fourth tier gets shares of stock, and most of those in the fifth tier become candidates for being weeded out. Business heads are pressured to wean out “C” players. GE’s CEO personally reviews the performance of the top 3,000 managers. Senior executive compensation is heavily weighted toward Six Sigma commitment and successful business results.

According to Jack Welch, GE’s CEO from 1980 to 2001, “The reality is, we simply cannot afford to field anything but teams of ‘A’ players.”

their business. Microsoft makes a point of hiring the very brightest and most talented programmers it can find and motivating them with both good monetary incentives and the challenge of working on cutting-edge software design projects. McKinsey & Company, one of the world’s premier management consulting companies, recruits only cream-of-the-crop MBAs at the nation’s top 10 business schools; such talent is essential to McKinsey’s strategy of performing high-level consulting for the world’s top corporations. The leading global accounting firms screen candidates not only on the basis of their accounting expertise but also on whether they possess the people skills needed to relate well with clients and colleagues. Southwest Airlines goes to considerable lengths to hire people who can have fun and be fun on the job; it uses special interviewing and screening methods to gauge whether applicants for customer-contact jobs have outgoing personality traits that match its strategy of creating a high-spirited, fun-loving, in-flight atmosphere for passengers; it is so selective that only about 3 percent of the people who apply are offered jobs.

In high-tech companies, the challenge is to staff work groups with gifted, imaginative, and energetic people who can bring life to new ideas quickly and inject into the organization what one Dell Inc. executive calls “hum.” The saying “People are our most important asset” may seem hollow, but it fits high-technology companies dead-on. Besides checking closely for functional and technical skills, Dell tests applicants for their tolerance of ambiguity and change, their capacity to work in teams, and their ability to learn on the fly. Companies like Amazon.com, Google, Yahoo, and Cisco Systems have broken new ground in recruiting, hiring, cultivating, developing, and retaining talented employees—most of whom are in their 20s and 30s. Cisco goes after the top 10 percent, raiding other companies and endeavoring to retain key people at the companies it acquires so as to maintain a cadre of star engineers, programmers, managers, salespeople, and support personnel in executing its strategy to remain the world’s leading provider of Internet infrastructure products and technology.

In instances where intellectual capital greatly aids good strategy execution, companies have instituted a number of practices aimed at staffing jobs with the best people they can find:

1. Spending considerable effort in screening and evaluating job applicants, selecting only those with suitable skill sets, energy, initiative, judgment, and aptitudes for learning and adaptability to the company’s work environment and culture.
2. Putting employees through training programs that continue throughout their careers.
3. Providing promising employees with challenging, interesting, and skill-stretching assignments.
4. Rotating people through jobs that not only have great content but also span functional and geographic boundaries. Providing people with opportunities to gain experience in a variety of international settings is increasingly considered an essential part of career development in multinational or global companies.
5. Encouraging employees to challenge existing ways of doing things, to be creative and innovative in proposing better ways of operating, and to push their ideas for new products or businesses. Progressive companies work hard at creating an environment in which ideas and suggestions bubble up from below and employees are made to feel that their views and suggestions count.
6. Making the work environment stimulating and engaging such that employees will consider the company a great place to work.
7. Striving to retain talented, high-performing employees via promotions, salary increases, performance bonuses, stock options and equity ownership, fringe benefit packages, and other perks.

The best companies make a point of recruiting and retaining talented employees—the objective is to make the company’s entire workforce (managers and rank-and-file employees) a genuine resource strength.
8. Coaching average performers to improve their skills and capabilities, while weeding out underperformers and benchwarmers.

It is very difficult for a company to competently execute its strategy and achieve operating excellence without a large band of capable employees who are actively engaged in the process of making ongoing operating improvements.

BUILDING CORE COMPETENCIES AND COMPETITIVE CAPABILITIES

High among the organization-building priorities in the strategy implementing/executing process is the need to build and strengthen competitively valuable core competencies and organizational capabilities. Whereas managers identify the desired competencies and capabilities in the course of crafting strategy, good strategy execution requires putting the desired competencies and capabilities in place, upgrading them as needed, and then modifying them as market conditions evolve. Sometimes a company already has some semblance of the needed competencies and capabilities, in which case managers can concentrate on strengthening and nurturing them to promote better strategy execution. More usually, however, company managers have to significantly broaden or deepen certain capabilities or even add entirely new competencies in order to put strategic initiatives in place and execute them proficiently.

A number of prominent companies have succeeded in establishing core competencies and capabilities that have been instrumental in making them winners in the marketplace. Intel’s core competence is in the design and mass production of complex chips for personal computers, servers, and other electronic products. Procter & Gamble’s core competencies reside in its superb marketing/distribution skills and its R&D capabilities in five core technologies—fats, oils, skin chemistry, surfactants, and emulsifiers. Ciba Specialty Chemicals has technology-based competencies that allow it to quickly manufacture products for customers wanting customized products relating to coloration, brightening and whitening, water treatment and paper processing, freshness, and cleaning. General Electric has a core competence in developing professional managers with broad problem-solving skills and proven ability to grow global businesses. Disney has core competencies in theme park operation and family entertainment. Dell Inc. has the capabilities to deliver state-of-the-art products to its customers within days of next-generation components coming available—and to do so at attractively low costs (it has leveraged its collection of competencies and capabilities into being the global low-cost leader in PCs). Toyota’s success in motor vehicles is due, in large part, to its legendary “production system,” which it has honed and perfected and which gives it the capability to produce high-quality vehicles at relatively low costs.

The Three-Stage Process of Developing and Strengthening Competencies and Capabilities

Building core competencies and competitive capabilities is a time-consuming, managerially challenging exercise. While some organization-building assist can be gotten from discovering how best-in-industry or best-in-world companies perform a particular activity, trying to replicate and then improve on the competencies and capabilities of others is, however, much easier said than done—for the same reasons that one is unlikely to ever become a good golfer just by studying what Tiger Woods
does. Putting a new capability in place is more complicated than just forming a new team or department and charging it with becoming highly competent in performing the desired activity, using whatever it can learn from other companies having similar competencies or capabilities. Rather, it takes a series of deliberate and well orchestrated organizational steps to achieve mounting proficiency in performing an activity. The capability-building process has three stages:

Stage 1—First, the organization must develop the ability to do something, however imperfectly or inefficiently. This entails selecting people with the requisite skills and experience, upgrading or expanding individual abilities as needed, and then molding the efforts and work products of individuals into a collaborative effort to create organizational ability.

Stage 2—As experience grows and company personnel learn how to perform the activity consistently well and at an acceptable cost, the ability evolves into a tried-and-true competence or capability.

Stage 3—Should company personnel continue to polish and refine their know-how and otherwise sharpen their performance of an activity such that the company eventually becomes better than rivals at performing the activity, the core competence rises to the rank of a distinctive competence (or the capability becomes a competitively superior capability), thus providing a path to competitive advantage.

Many companies are able to get through stages 1 and 2 in performing a strategy-critical activity, but comparatively few achieve sufficient proficiency in performing strategy-critical activities to qualify for the third stage.

Managing the Process Four traits concerning core competencies and competitive capabilities are important in successfully managing the organization-building process:14

1. Core competencies and competitive capabilities are bundles of skills and know-how that most often grow out of the combined efforts of cross-functional work groups and departments performing complementary activities at different locations in the firm’s value chain. Rarely does a core competence or capability consist of narrow skills attached to the work efforts of a single department. For instance, a core competence in speeding new products to market involves the collaborative efforts of personnel in research and development (R&D), engineering and design, purchasing, production, marketing, and distribution. Similarly, the capability to provide superior customer service is a team effort among people in customer call centers (where orders are taken and inquiries are answered), shipping and delivery, billing and accounts receivable, and after-sale support. Complex activities (like designing and manufacturing a sports-utility vehicle or creating the capability for secure credit card transactions over the Internet) usually involve a number of component skills, technological disciplines, competencies, and capabilities—some performed in-house and some provided by suppliers/allies. An important part of the organization-building function is to think about which activities of which groups need to be linked and made mutually reinforcing and then to forge the necessary collaboration both internally and with outside resource providers.

2. Normally, a core competence or capability emerges incrementally out of company efforts either to bolster skills that contributed to earlier successes or to respond to customer problems, new technological and market opportunities, and the
competitive maneuverings of rivals. Migrating from the one-time ability to do something up the ladder to a core competence or competitively valuable capability is usually an organization-building process that takes months and often years to accomplish—it is definitely not an overnight event.

3. **The key to leveraging a core competence into a distinctive competence (or a capability into a competitively superior capability) is concentrating more effort and more talent than rivals on deepening and strengthening the competence or capability, so as to achieve the dominance needed for competitive advantage.** This does not necessarily mean spending more money on such activities than competitors, but it does mean consciously focusing more talent on them and striving for best-in-industry, if not best-in-world, status. To achieve dominance on lean financial resources, companies like Cray in large computers and Honda in gasoline engines have leveraged the expertise of their talent pool by frequently re-forming high-intensity teams and reusing key people on special projects. The experiences of these and other companies indicate that the usual keys to successfully building core competencies and valuable capabilities are superior employee selection, thorough training and retraining, powerful cultural influences, effective cross-functional collaboration, empowerment, motivating incentives, short deadlines, and good databases—not big operating budgets.

4. **Evolving changes in customers’ needs and competitive conditions often require tweaking and adjusting a company’s portfolio of competencies and intellectual capital to keep its capabilities freshly honed and on the cutting edge.** This is particularly important in high-tech industries and fast-paced markets where important developments occur weekly. As a consequence, wise company managers work at anticipating changes in customer-market requirements and staying ahead of the curve in proactively building a package of competencies and capabilities that can win out over rivals.

Managerial actions to develop core competencies and competitive capabilities generally take one of two forms: either strengthening the company’s base of skills, knowledge, and intellect, or coordinating and networking the efforts of the various work groups and departments. Actions of the first sort can be undertaken at all managerial levels, but actions of the second sort are best orchestrated by senior managers who not only appreciate the strategy-executing significance of strong competencies/capabilities but also have the clout to enforce the necessary networking and cooperation among individuals, groups, departments, and external allies.

One organization-building question is whether to develop the desired competencies and capabilities internally or to outsource them by partnering with key suppliers or forming strategic alliances. The answer depends on what can be safely delegated to outside suppliers or allies versus what internal capabilities are key to the company’s long-term success. Either way, though, calls for action. Outsourcing means launching initiatives to identify the most attractive providers and to establish collaborative relationships. Developing the capabilities in-house means marshaling personnel with relevant skills and experience, collaboratively networking the individual skills and related cross-functional activities to form organizational capability, and building the desired levels of proficiency through repetition (practice makes perfect).15

Sometimes the tediousness of internal organization building can be shortcut by buying a company that has the requisite capability and integrating its competencies into the firm’s value chain. Indeed, a pressing need to acquire certain capabilities quickly is one reason to acquire another company—an acquisition aimed at building
greater capability can be every bit as competitively valuable as an acquisition aimed at adding new products or services to the company’s business lineup. Capabilities-motivated acquisitions are essential (1) when a market opportunity can slip by faster than a needed capability can be created internally, and (2) when industry conditions, technology, or competitors are moving at such a rapid clip that time is of the essence. But usually there’s no good substitute for ongoing internal efforts to build and strengthen the company’s competencies and capabilities in performing strategy-critical value chain activities.

**Updating and Remodeling Competencies and Capabilities as External Conditions and Company Strategy Change** Even after core competencies and competitive capabilities are in place and functioning, company managers can’t relax. Competencies and capabilities that grow stale can impair competitiveness unless they are refreshed, modified, or even phased out and replaced in response to ongoing market changes and shifts in company strategy. Indeed, the buildup of knowledge and experience over time, coupled with the imperatives of keeping capabilities in step with ongoing strategy and market changes, makes it appropriate to view a company as a bundle of evolving competencies and capabilities. Management’s organization-building challenge is one of deciding when and how to recalibrate existing competencies and capabilities, and when and how to develop new ones. Although the task is formidable, ideally it produces a dynamic organization with “hum” and momentum as well as a distinctive competence. Toyota, aspiring to overtake General Motors as the global leader in motor vehicles, has been aggressively upgrading its capabilities in fuel-efficient hybrid engine technology and is constantly fine-tuning its famed Toyota Production System to enhance its already proficient capabilities in manufacturing top-quality vehicles at relatively low costs—see Illustration Capsule 11.2. Likewise, Honda, which has long had a core competence in gasoline engine technology and small engine design, has accelerated its efforts to broaden its expertise and capabilities in hybrid engines so as to stay close behind Toyota. TV broadcasters are upgrading their capabilities in digital broadcasting technology in readiness for the upcoming switchover from analog to digital signal transmission. Microsoft has totally retooled the manner in which its programmers attack the task of writing code for its new operating systems for PCs and servers (the first wave of which was due out in 2006).

**The Strategic Role of Employee Training**

Training and retraining are important when a company shifts to a strategy requiring different skills, competitive capabilities, managerial approaches, and operating methods. Training is also strategically important in organizational efforts to build skills-based competencies. And it is a key activity in businesses where technical know-how is changing so rapidly that a company loses its ability to compete unless its skilled people have cutting-edge knowledge and expertise. Successful strategy implementers see to it that the training function is both adequately funded and effective. If the chosen strategy calls for new skills, deeper technological capability, or building and using new capabilities, training should be placed near the top of the action agenda.

The strategic importance of training has not gone unnoticed. Over 600 companies have established internal “universities” to lead the training effort, facilitate continuous organizational learning, and help upgrade company competencies and capabilities. Many companies conduct orientation sessions for new employees, fund an assortment
Illustration Capsule 11.2

Toyota’s Legendary Production System: A Capability That Translates into Competitive Advantage

The heart of Toyota’s strategy in motor vehicles is to outcompete rivals by manufacturing world-class, quality vehicles at lower costs and selling them at competitive price levels. Executing this strategy requires top-notch manufacturing capability and super-efficient management of people, equipment, and materials. Toyota began conscious efforts to improve its manufacturing competence more than 50 years ago. Through tireless trial and error, the company gradually took what started as a loose collection of techniques and practices and integrated them into a full-fledged process that has come to be known as the Toyota Production System (TPS). The TPS drives all plant operations and the company’s supply chain management practices. TPS is grounded in the following principles, practices, and techniques:

- **Deliver parts and components just-in-time to the point of vehicle assembly.** The idea here is to cut out all the bits and pieces of transferring materials from place to place and to discontinue all activities on the part of workers that don’t add value (particularly activities where nothing ends up being made or assembled).

- **Develop people who can come up with unique ideas for production improvements.**

- **Emphasize continuous improvement.** Workers are expected to use their heads and develop better ways of doing things, rather than mechanically follow instructions. Toyota managers tell workers that the T in TPS also stands for “Thinking.” The thesis is that a work environment where people have to think generates the wisdom to spot opportunities for making tasks simpler and easier to perform, increasing the speed and efficiency with which activities are performed, and constantly improving product quality.

- **Empower workers to stop the assembly line when there’s a problem or a defect is spotted.** Toyota views worker efforts to purge defects and sort out the problem immediately as critical to the whole concept of building quality into the production process. According to TPS, “If the line doesn’t stop, useless defective items will move on to the next stage. If you don’t know where the problem occurred, you can’t do anything to fix it.” The tool for halting the assembly line is the andon electric light board, which is visible to everyone on the production floor.

  - **Deal with defects only when they occur.** TPS philosophy holds that when things are running smoothly, they should not be subject to control; if attention is directed to fixing problems that are found, quality control along the assembly line can be handled with fewer personnel.

  - **Ask yourself “Why?” five times.** While errors need to be fixed whenever they occur, the value of asking “Why?” five times enables identifying the root cause of the error and correcting it so that the error won’t recur.

  - **Organize all jobs around human motion to create a production/assembly system with no wasted effort.** Work organized in this fashion is called standardized work, and people are trained to observe standardized work procedures (which include supplying parts to each process on the assembly line at the proper time, sequencing the work in an optimal manner, and allowing workers to do their jobs continuously in a set sequence of subprocesses).

  - **Find where a part is made cheaply and use that price as a benchmark.**

The TPS uses unique terms (such as kanban, takt time, jikoda, kaizen, heijunka, monozukuri, poka yoke, and muda) that facilitate precise discussion of specific TPS elements. In 2003, Toyota established a Global Production Center to efficiently train large numbers of shop-floor experts in the latest TPS methods and better operate an increasing number of production sites worldwide. There’s widespread agreement that Toyota’s ongoing effort to refine and improve on its renowned TPS gives it important manufacturing capabilities that are the envy of other motor vehicle manufacturers.

take an active role in their own professional development, assuming responsibility for keeping their skills and expertise up-to-date and in sync with the company’s needs.

**From Competencies and Capabilities to Competitive Advantage**

While strong core competencies and competitive capabilities are a major assist in executing strategy, they are an equally important avenue for securing a competitive edge over rivals in situations where it is relatively easy for rivals to copy smart strategies. Any time rivals can readily duplicate successful strategy features, making it difficult or impossible to outstrategize rivals and beat them in the marketplace with a superior strategy, the chief way to achieve lasting competitive advantage is to outexecute them (beat them by performing certain value chain activities in a superior fashion). Building core competencies and competitive capabilities that are very difficult or costly for rivals to emulate and that push a company closer to true operating excellence promotes very proficient strategy execution. Moreover, because cutting-edge core competencies and competitive capabilities represent resource strengths that are often time-consuming and expensive for rivals to match or trump, any competitive edge they produce tends to be sustainable and pave the way for above-average company performance.

It is easy to cite instances where companies have gained a competitive edge based on superior competencies and capabilities. Toyota’s production capabilities (see Illustration Capsule 11.2) have given it a decided market edge over such rivals as General Motors, Ford, DaimlerChrysler, and Volkswagen. Dell’s competitors have spent years and millions of dollars in what so far is a futile effort to match Dell’s cost-efficient supply chain management capabilities. FedEx has unmatched capabilities in reliable overnight delivery of documents and small parcels. Various business news media have been unable to match the competence of Dow-Jones in gathering and reporting business news via *The Wall Street Journal*.

**EXECUTION-RELATED ASPECTS OF ORGANIZING THE WORK EFFORT**

There are few hard-and-fast rules for organizing the work effort to support good strategy execution. Every firm’s organization chart is partly a product of its particular situation, reflecting prior organizational patterns, varying internal circumstances, executive judgments about reporting relationships, and the politics of who gets which assignments. Moreover, every strategy is grounded in its own set of key success factors and value chain activities. But some organizational considerations are common to all companies. These are summarized in Figure 11.3 and discussed in turn in the following sections.

**Deciding Which Value Chain Activities to Perform Internally and Which to Outsource**

The advantages of a company having an outsourcing component in its strategy were discussed in Chapter 6 (pp. 160–193), but there is also a need to consider the role of outsourcing in executing the strategy. Aside from the fact than an outsider, because of
its expertise and specialized know-how, may be able to perform certain value chain activities better or cheaper than a company can perform them internally, outsourcing can also have several organization-related benefits. Managers too often spend inordinate amounts of time, mental energy, and resources haggling with functional support groups and other internal bureaucracies over needed services, leaving less time for them to devote to performing strategy-critical activities in the most proficient manner. One way to reduce such distractions is to outsource the performance of assorted administrative support functions and perhaps even selected core or primary value chain activities to outside vendors, thereby enabling the company to **heighten its strategic focus and concentrate its full energies and resources on even more competently performing those value chain activities that are at the core of its strategy and for which it can create unique value.** For example, E. & J. Gallo Winery outsources 95 percent of its grape production, letting farmers take on the weather and other grape-growing risks while it concentrates its full energies on wine production and sales. A number of personal computer (PC) makers outsource the mundane and highly specialized task of PC assembly, concentrating their energies instead on product design, sales and marketing, and distribution.

When a company uses outsourcing to zero in on ever better performance of those truly strategy-critical activities where its expertise is most needed, then it may be able to realize three very positive benefits:

1. The company improves its chances for outclassing rivals in the performance of strategy-critical activities and turning a core competence into a distinctive competence. At the very least, the heightened focus on performing a select few
value chain activities should meaningfully strengthen the company’s existing core competences and promote more innovative performance of those activities—either of which could lower costs or materially improve competitive capabilities. Eastman Kodak, Ford, Exxon Mobil, Merrill Lynch, and Chevron have outsourced their data processing activities to computer service firms, believing that outside specialists can perform the needed services at lower costs and equal or better quality. A relatively large number of companies outsource the operation of their Web sites to Web design and hosting enterprises. Many business that get a lot of inquiries from customers or that have to provide 24/7 technical support to users of their products across the world have found that it is considerably less expensive to outsource these functions to specialists (often located in foreign countries where skilled personnel are readily available and worker compensation costs are much lower) than to operate their own call centers.

2. The streamlining of internal operations that flows from outsourcing often acts to decrease internal bureaucracies, flatten the organization structure, speed internal decision making, and shorten the time it takes to respond to changing market conditions. In consumer electronics, where advancing technology drives new product innovation, organizing the work effort in a manner that expedites getting next-generation products to market ahead of rivals is a critical competitive capability. Motor vehicle manufacturers have found that they can shorten the cycle time for new models, improve the quality and performance of those models, and lower overall production costs by outsourcing the big majority of their parts and components from independent suppliers and then working closely with their vendors to advance the design and functioning of the items being supplied, to swiftly incorporate new technology, and to better integrate individual parts and components to form engine cooling systems, transmission systems, and electrical systems.

3. Outsourcing the performance of certain value chain activities to able suppliers can add to a company’s arsenal of capabilities and contribute to better strategy execution. By building, continually improving, and then leveraging its partnerships with able suppliers, a company enhances its overall organizational capabilities and builds resource strengths—strengths that deliver value to customers and consequently pave the way for competitive success. Soft-drink and beer manufacturers all cultivate their relationships with their bottlers and distributors to strengthen access to local markets and build the loyalty, support, and commitment for corporate marketing programs, without which their own sales and growth are weakened. Similarly, fast-food enterprises like McDonald’s and Taco Bell find it essential to work hand-in-hand with franchisees on outlet cleanliness, consistency of product quality, in-store ambience, courtesy and friendliness of store personnel, and other aspects of store operations. Unless franchisees continuously deliver sufficient customer satisfaction to attract repeat business, a fast-food chain’s sales and competitive standing will suffer quickly. Companies like Boeing, Aerospatiale, Verizon Communications, and Dell have learned that their central R&D groups cannot begin to match the innovative capabilities of a well-managed network of supply chain partners having the ability to advance the technology, lead the development of next-generation parts and components, and supply them at a relatively low price.

As a general rule, companies refrain from outsourcing those value chain activities over which they need direct strategic and operating control in order to build core competencies, achieve competitive advantage, and effectively manage key customer–supplier–distributor relationships. It is the strategically less important activities—like handling customer inquiries and providing technical support, doing the payroll,
administering employee benefit programs, providing corporate security, managing stockholder relations, maintaining fleet vehicles, operating the company’s Web site, conducting employee training, and managing an assortment of information and data processing functions—where outsourcing is most used.

Even so, a number of companies have found ways to successfully rely on outside vendors to perform strategically significant value chain activities. Broadcom, a global leader in chips for broadband communications systems, outsources the manufacture of its chips to Taiwan Semiconductor, thus freeing company personnel to focus their full energies on R&D, new chip design, and marketing. For years Polaroid Corporation bought its film from Eastman Kodak, its electronics from Texas Instruments, and its cameras from Timex and others, while it concentrated on producing its unique self-developing film packets and designing its next-generation cameras and films. Nike concentrates on design, marketing, and distribution to retailers, while outsourcing virtually all production of its shoes and sporting apparel. Cisco Systems outsources virtually all manufacturing of its routers, switches, and other Internet gear, yet it protects its market position by retaining tight internal control over product design and closely monitors the daily operations of its manufacturing vendors. Large numbers of electronics companies outsource the design, engineering, manufacturing, and shipping of their products to such companies as Flextronics and Solectron, both of which have built huge businesses as providers of such services to companies worldwide. So while performing core value chain activities in-house normally makes good sense, there can be times when outsourcing some of them works to good advantage.

The Dangers of Excessive Outsourcing Critics contend that a company can go overboard on outsourcing and so hollow out its knowledge base and capabilities as to leave itself at the mercy of outside suppliers and short of the resource strengths to be a master of its own destiny. The point is well taken, but most companies appear alert to the danger of taking outsourcing to an extreme or failing to maintain control of the work performed by specialist vendors or offshore suppliers. Many companies refuse to source key components from a single supplier, opting to use two or three suppliers as a way of avoiding single supplier dependence or giving one supplier too much bargaining power. Moreover, they regularly evaluate their suppliers, looking not only at the supplier’s overall performance but also at whether they should switch to another supplier or even bring the activity back in-house. To avoid loss of control, companies typically work closely with key suppliers, meeting often and setting up online systems to share data and information, collaborate on work in progress, monitor performance, and otherwise document that suppliers’ activities are closely integrated with their own requirements and expectations. Indeed, sophisticated online systems permit companies to work in “real time” with suppliers 10,000 miles away, making rapid response possible whenever concerns or problems arise. Hence the real debate surrounding outsourcing is not about whether too much outsourcing risks loss of control, but about how to use outsourcing in a manner that produces greater competitiveness.

Making Strategy-Critical Activities the Main Building Blocks of the Organization Structure

In any business, some activities in the value chain are always more critical to strategic success and competitive advantage than others. For instance, hotel/motel enterprises

Core Concept
Wisely choosing which activities to perform internally and which to outsource can lead to several strategy-executing advantages—lower costs, heightened strategic focus, less internal bureaucracy, speedier decision making, and a better arsenal of competencies and capabilities.
have to be good at fast check-in/check-out, housekeeping and facilities maintenance, food service, and the creation of a pleasant ambience. For a manufacturer of chocolate bars, buying quality cocoa beans at low prices is vital and reducing production costs by a fraction of a cent per bar can mean a seven-figure improvement in the bottom line. In discount stock brokerage, the strategy-critical activities are fast access to information, accurate order execution, efficient record keeping and transactions processing, and good customer service. In specialty chemicals, the critical activities are R&D, product innovation, getting new products onto the market quickly, effective marketing, and expertise in assisting customers. Where such is the case, it is important for management to build its organization structure around proficient performance of these activities, making them the centerpieces or main building blocks on the organization chart.

The rationale for making strategy-critical activities the main building blocks in structuring a business is compelling: If activities crucial to strategic success are to have the resources, decision-making influence, and organizational impact they need, they have to be centerpieces in the organizational scheme. Plainly, implementing a new or changed strategy is likely to entail new or different key activities, competencies, or capabilities and therefore to require new or different organizational arrangements. If workable organizational adjustments are not forthcoming, the resulting mismatch between strategy and structure can open the door to execution and performance problems. Hence, attempting to carry out a new strategy with an old organization structure is usually unwise.

What Types of Organization Structures Fit Which Strategies? It is generally agreed that some type of functional structure is the best organizational arrangement when a company is in just one particular business (irrespective of which of the five competitive strategies it opts to pursue). The primary organizational building blocks within a business are usually traditional functional departments (R&D, engineering and design, production and operations, sales and marketing, information technology, finance and accounting, and human resources) and process departments (where people in a single work unit have responsibility for all the aspects of a certain process like supply chain management, new product development, customer service, quality control, or selling direct to customers via the company’s Web site). For instance, a technical instruments manufacturer may be organized around research and development, engineering, supply chain management, assembly, quality control, marketing, technical services, and corporate administration. A hotel may have a functional organization based on front-desk operations, housekeeping, building maintenance, food service, convention services and special events, guest services, personnel and training, and accounting. A discount retailer may organize around such functional units as purchasing, warehousing and distribution, store operations, advertising, merchandising and promotion, customer service, and corporate administrative services.

In enterprises with operations in various countries around the world (or with geographically scattered organizational units within a country), the basic building blocks may also include geographic organizational units, each of which has profit/loss responsibility for its assigned geographic area. In vertically integrated firms, the major building blocks are divisional units performing one or more of the major processing steps along the value chain (raw materials production, components manufacture, assembly, wholesale distribution, retail store operations); each division in the value chain may operate as a profit center for performance measurement purposes. The typical building blocks of a diversified company are its individual businesses, with each business unit usually operating as an independent profit center and with corporate
headquarters performing assorted support functions for all of its business units. But a divisional business-unit structure can present problems to a company pursuing related diversification.

**Determining the Degree of Authority and Independence to Give Each Unit and Each Employee**

In executing the strategy and conducting daily operations, companies must decide how much authority to delegate to the managers of each organization unit—especially the heads of business subsidiaries; functional and process departments; and plants, sales offices, distribution centers, and other operating units—and how much decision-making latitude to give individual employees in performing their jobs. The two extremes are to centralize decision making at the top (the CEO and a few close lieutenants) or to decentralize decision making by giving managers and employees considerable decision-making latitude in their areas of responsibility. As shown in Table 11.1, the two approaches are based on sharply different underlying principles and beliefs, with each having its pros and cons.

**Centralized Decision Making: Pros and Cons**  In a highly centralized organization structure, top executives retain authority for most strategic and operating decisions and keep a tight rein on business-unit heads, department heads, and the

**Table 11.1 Advantages and Disadvantages of Centralized versus Decentralized Decision Making**

<table>
<thead>
<tr>
<th>Centralized Organizational Structures</th>
<th>Decentralized Organizational Structures</th>
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<tr>
<td><strong>Basic tenets</strong></td>
<td><strong>Basic tenets</strong></td>
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<tr>
<td>• Decisions on most matters of importance should be pushed to managers up the line who have the experience, expertise, and judgment to decide what is the wisest or best course of action.</td>
<td>• Decision-making authority should be put in the hands of the people closest to and most familiar with the situation and these people should be trained to exercise good judgment.</td>
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<td>• Frontline supervisors and rank-and-file employees can’t be relied on to make the right decisions—because they seldom know what is best for the organization and because they do not have the time or the inclination to properly manage the tasks they are performing (letting them decide “what to do” is thus risky).</td>
<td>• A company that draws on the combined intellectual capital of all its employees can outperform a command-and-control company.</td>
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<td><strong>Chief advantage</strong></td>
<td><strong>Chief advantages</strong></td>
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<td>• Fixes accountability.</td>
<td>• Encourages lower level managers and rank-and-file employees to exercise initiative and act responsibly.</td>
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<td><strong>Primary disadvantages</strong></td>
<td>• Promotes greater motivation and involvement in the business on the part of more company personnel.</td>
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<td>• Lengthens response times because management bureaucracy must decide on a course of action.</td>
<td>• Spurs new ideas and creative thinking.</td>
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<tr>
<td>• Does not encourage responsibility among lower level managers and rank-and-file employees.</td>
<td>• Allows fast response times.</td>
</tr>
<tr>
<td>• Discourages lower level managers and rank-and-file employees from exercising any initiative—they are expected to wait to be told what to do.</td>
<td>• Entails fewer layers of management.</td>
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<td></td>
<td><strong>Primary disadvantages</strong></td>
</tr>
<tr>
<td>• Puts the organization at risk if many bad decisions are made at lower levels—top management lacks full control.</td>
<td>• Impedes cross-business coordination and capture of strategic fits in diversified companies.</td>
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managers of key operating units; comparatively little discretionary authority is granted to frontline supervisors and rank-and-file employees. The command-and-control paradigm of centralized structures is based on the underlying assumption that frontline personnel have neither the time nor the inclination to direct and properly control the work they are performing, and that they lack the knowledge and judgment to make wise decisions about how best to do it—hence the need for managerially prescribed policies and procedures, close supervision, and tight control. The thesis underlying authoritarian structures is that strict enforcement of detailed procedures backed by rigorous managerial oversight is the most reliable way to keep the daily execution of strategy on track.

The big advantage of an authoritarian structure is tight control by the manager in charge—it is easy to know who is accountable when things do not go well. But there are some serious disadvantages. Hierarchical command-and-control structures make an organization sluggish in responding to changing conditions because of the time it takes for the review/approval process to run up all the layers of the management bureaucracy. Furthermore, to work well, centralized decision making requires top-level managers to gather and process whatever information is relevant to the decision. When the relevant knowledge resides at lower organizational levels (or is technical, detailed, or hard to express in words), it is difficult and time-consuming to get all of the facts and nuances in front of a high-level executive located far from the scene of the action—full understanding of the situation cannot be readily copied from one mind to another. Hence, centralized decision making is often impractical—the larger the company and the more scattered its operations, the more that decision-making authority has to be delegated to managers closer to the scene of the action.

Decentralized Decision Making: Pros and Cons

In a highly decentralized organization, decision-making authority is pushed down to the lowest organizational level capable of making timely, informed, competent decisions. The objective is to put adequate decision-making authority in the hands of the people closest to and most familiar with the situation and train them to weigh all the factors and exercise good judgment. Decentralized decision making means that the managers of each organizational unit are delegated lead responsibility for deciding how best to execute strategy (as well as some role in shaping the strategy for the units they head). Decentralization thus requires selecting strong managers to head each organizational unit and holding them accountable for crafting and executing appropriate strategies for their units. Managers who consistently produce unsatisfactory results have to be weeded out.

The case for empowering down-the-line managers and employees to make decisions related to daily operations and executing the strategy is based on the belief that a company that draws on the combined intellectual capital of all its employees can outperform a command-and-control company. Decentralized decision making means, for example, that in a diversified company the various business-unit heads have broad authority to execute the agreed-on business strategy with comparatively little interference from corporate headquarters; moreover, the business-unit heads delegate considerable decision-making latitude to functional and process department heads and the heads of the various operating units (plants, distribution centers, sales offices) in implementing and executing their pieces of the strategy. In turn, work teams may be empowered to manage and improve their assigned value chain activity, and employees with customer contact may be empowered to do what it takes to please customers.
At Starbucks, for example, employees are encouraged to exercise initiative in promoting customer satisfaction—there’s the story of a store employee who, when the computerized cash register system went offline, enthusiastically offered free coffee to waiting customers. With decentralized decision making, top management maintains control by limiting empowered managers’ and employees’ discretionary authority and holding people accountable for the decisions they make.

Decentralized organization structures have much to recommend them. Delegating greater authority to subordinate managers and employees creates a more horizontal organization structure with fewer management layers. Whereas in a centralized vertical structure managers and workers have to go up the ladder of authority for an answer, in a decentralized horizontal structure they develop their own answers and action plans—making decisions in their areas of responsibility and being accountable for results is an integral part of their job. Pushing decision-making authority down to middle and lower-level managers and then further on to work teams and individual employees shortens organizational response times and spurs new ideas, creative thinking, innovation, and greater involvement on the part of subordinate managers and employees. In worker-empowered structures, jobs can be defined more broadly, several tasks can be integrated into a single job, and people can direct their own work. Fewer managers are needed because deciding how to do things becomes part of each person’s or team’s job. Further, today’s online communication systems make it easy and relatively inexpensive for people at all organizational levels to have direct access to data, other employees, managers, suppliers, and customers. They can access information quickly (via the Internet or company intranet), readily check with superiors or co-workers as needed, and take responsible action. Typically, there are gains in morale and productivity when people are provided with the tools and information they need to operate in a self-directed way. Decentralized decision making not only can shorten organizational response times but also can spur new ideas, creative thinking, innovation, and greater involvement on the part of subordinate managers and employees.

The past decade has seen a growing shift from authoritarian, multilayered hierarchical structures to flatter, more decentralized structures that stress employee empowerment. There’s strong and growing consensus that authoritarian, hierarchical organization structures are not well suited to implementing and executing strategies in an era when extensive information and instant communication are the norm and when a big fraction of the organization’s most valuable assets consists of intellectual capital and resides in the knowledge and capabilities of its employees. Many companies have therefore begun empowering lower-level managers and employees throughout their organizations, giving them greater discretionary authority to make strategic adjustments in their areas of responsibility and to decide what needs to be done to put new strategic initiatives into place and execute them proficiently.

**Maintaining Control in a Decentralized Organization Structure**

Pushing decision-making authority deep down into the organization structure and empowering employees presents its own organizing challenge: *how to exercise adequate control over the actions of empowered employees so that the business is not put at risk at the same time that the benefits of empowerment are realized.* Maintaining adequate organizational control over empowered employees is generally accomplished by placing limits on the authority that empowered personnel can exercise, holding people accountable for their decisions, instituting compensation incentives that reward
people for doing their jobs in a manner that contributes to good company performance, and creating a corporate culture where there’s strong peer pressure on individuals to act responsibly.

**Capturing Strategic Fits in a Decentralized Structure**  Diversified companies striving to capture cross-business strategic fits have to beware of giving business heads full rein to operate independently when cross-business collaboration is essential in order to gain strategic fit benefits. Cross-business strategic fits typically have to be captured either by enforcing close cross-business collaboration or by centralizing performance of functions having strategic fits at the corporate level.25 For example, if businesses with overlapping process and product technologies have their own independent R&D departments—each pursuing their own priorities, projects, and strategic agendas—it’s hard for the corporate parent to prevent duplication of effort, capture either economies of scale or economies of scope, or broaden the company’s R&D efforts to embrace new technological paths, product families, end-use applications, and customer groups. Where cross-business R&D fits exist, the best solution is usually to centralize the R&D function and have a coordinated corporate R&D effort that serves both the interests of individual businesses and the company as a whole. Likewise, centralizing the related activities of separate businesses makes sense when there are opportunities to share a common sales force, use common distribution channels, rely on a common field service organization to handle customer requests or provide maintenance and repair services, use common e-commerce systems and approaches, and so on.

The point here is that efforts to decentralize decision making and give organizational units leeway in conducting operations have to be tempered with the need to maintain adequate control and cross-unit coordination—decentralization doesn’t mean delegating authority in ways that allow organization units and individuals to do their own thing. There are numerous instances when decision-making authority must be retained at high levels in the organization and ample cross-unit coordination strictly enforced.

**Providing for Internal Cross-Unit Coordination**

The classic way to coordinate the activities of organizational units is to position them in the hierarchy so that the most closely related ones report to a single person (a functional department head, a process manager, a geographic area head, a senior executive). Managers higher up in the ranks generally have the clout to coordinate, integrate, and arrange for the cooperation of units under their supervision. In such structures, the chief executive officer, chief operating officer, and business-level managers end up as central points of coordination because of their positions of authority over the whole unit. When a firm is pursuing a related diversification strategy, coordinating the related activities of independent business units often requires the centralizing authority of a single corporate-level officer. Also, diversified companies commonly centralize such staff support functions as public relations, finance and accounting, employee benefits, and information technology at the corporate level both to contain the costs of support activities and to facilitate uniform and coordinated performance of such functions within each business unit.

However, close cross-unit collaboration is usually needed to build core competencies and competitive capabilities in strategically important activities—such as speeding new products to market and providing superior customer service—that involve
employees scattered across several internal organization units (and perhaps the employees of outside strategic partners or specialty vendors). A big weakness of traditional functionally organized structures is that pieces of strategically relevant activities and capabilities often end up scattered across many departments, with the result that no one group or manager is accountable. Consider, for example, how the following strategy-critical activities cut across different functions:

- **Filling customer orders accurately and promptly**—a process that involves personnel from sales (which wins the order), finance (which may have to check credit terms or approve special financing), production (which must produce the goods and replenish warehouse inventories as needed), warehousing (which has to verify whether the items are in stock, pick the order from the warehouse, and package it for shipping), and shipping (which has to choose a carrier to deliver the goods and release the goods to the carrier).26

- **Fast, ongoing introduction of new products**—a cross-functional process involving personnel in R&D, design and engineering, purchasing, manufacturing, and sales and marketing.

- **Improving product quality**—a process that entails the collaboration of personnel in R&D, design and engineering, purchasing, in-house components production, manufacturing, and assembly.

- **Supply chain management**—a collaborative process that cuts across such functional areas as purchasing, inventory management, manufacturing and assembly, and warehousing and shipping.

- **Building the capability to conduct business via the Internet**—a process that involves personnel in information technology, supply chain management, production, sales and marketing, warehousing and shipping, customer service, finance, and accounting.

- **Obtaining feedback from customers and making product modifications to meet their needs**—a process that involves personnel in customer service and after-sale support, R&D, design and engineering, purchasing, manufacturing and assembly, and marketing research.

Handoffs from one department to another lengthen completion time and frequently drive up administrative costs, since coordinating the fragmented pieces can soak up hours of effort on the parts of many people.27 This is not a fatal flaw of functional organization—organizing around specific functions normally works to good advantage in support activities like finance and accounting, human resource management, and engineering, and in such primary activities as R&D, manufacturing, and marketing. But the tendency for pieces of a strategy-critical activity to be scattered across several functional departments is an important weakness of functional organization and accounts for why a company’s competencies and capabilities are typically cross-functional.

Many companies have found that rather than continuing to scatter related pieces of a strategy-critical business process across several functional departments and scrambling to integrate their efforts, it is better to reengineer the work effort and pull the people who performed the pieces in functional departments into a group that works together to perform the whole process, thus creating **process departments** (like customer service or new product development or supply chain management). And sometimes the coordinating mechanisms involve the use of cross-functional task forces, dual reporting relationships, informal organizational networking, voluntary
cooperation, incentive compensation tied to measures of group performance, and strong executive-level insistence on teamwork and cross-department cooperation (including removal of recalcitrant managers who stonewall collaborative efforts). At one European-based company, a top executive promptly replaced the managers of several plants who were not fully committed to collaborating closely on eliminating duplication in product development and production efforts among plants in several different countries. Earlier, the executive, noting that negotiations among the managers had stalled on which labs and plants to close, had met with all the managers, asked them to cooperate to find a solution, discussed with them which options were unacceptable, and given them a deadline to find a solution. When the asked-for teamwork wasn’t forthcoming, several managers were replaced.

Providing for Collaboration with Outside Suppliers and Strategic Allies

Someone or some group must be authorized to collaborate as needed with each major outside constituency involved in strategy execution. Forming alliances and cooperative relationships presents immediate opportunities and opens the door to future possibilities, but nothing valuable is realized until the relationship grows, develops, and blossoms. Unless top management sees that constructive organizational bridge building with strategic partners occurs and that productive working relationships emerge, the value of alliances is lost and the company’s power to execute its strategy is weakened. If close working relationships with suppliers are crucial, then supply chain management must be given formal status on the company’s organization chart and a significant position in the pecking order. If distributor/dealer/franchisee relationships are important, someone must be assigned the task of nurturing the relationships with forward channel allies. If working in parallel with providers of complementary products and services contributes to enhanced organizational capability, then cooperative organizational arrangements have to be put in place and managed to good effect.

Building organizational bridges with external allies can be accomplished by appointing “relationship managers” with responsibility for making particular strategic partnerships or alliances generate the intended benefits. Relationship managers have many roles and functions: getting the right people together, promoting good rapport, seeing that plans for specific activities are developed and carried out, helping adjust internal organizational procedures and communication systems, ironing out operating dissimilarities, and nurturing interpersonal cooperation. Multiple cross-organization ties have to be established and kept open to ensure proper communication and coordination.28 There has to be enough information sharing to make the relationship work and periodic frank discussions of conflicts, trouble spots, and changing situations.29

CURRENT ORGANIZATIONAL TRENDS

Many of today’s companies are winding up the task of remodeling their traditional hierarchical structures once built around functional specialization and centralized authority. Much of the corporate downsizing movement in the late 1980s and early 1990s was aimed at recasting authoritarian, pyramidal organizational structures into flatter, decentralized structures. The change was driven by growing realization that command-and-control hierarchies were proving a liability in businesses where
customer preferences were shifting from standardized products to custom orders and special features, product life cycles were growing shorter, custom mass-production methods were replacing standardized mass-production techniques, customers wanted to be treated as individuals, technological change was ongoing, and market conditions were fluid. Layered management hierarchies with lots of checks and controls that required people to look upward in the organizational structure for answers and approval were failing to deliver responsive customer service and timely adaptations to changing conditions.

The organizational adjustments and downsizing of companies in 2001–2005 brought further refinements and changes to streamline organizational activities and shake out inefficiencies. The goals have been to make companies leaner, flatter, and more responsive to change. Many companies are drawing on five tools of organizational design: (1) managers and workers empowered to act on their own judgments, (2) work process redesign (to achieve greater streamlining and tighter cohesion), (3) self-directed work teams, (4) rapid incorporation of Internet technology applications, and (5) networking with outsiders to improve existing organization capabilities and create new ones. Considerable management attention is being devoted to building a company capable of outcompeting rivals on the basis of superior resource strengths and competitive capabilities—capabilities that are increasingly based on intellectual capital and cross-unit collaboration.

Several other organizational characteristics are emerging:

- Extensive use of Internet technology and e-commerce business practices—real-time data and information systems; greater reliance on online systems for transacting business with suppliers and customers; and Internet-based communication and collaboration with suppliers, customers, and strategic partners.
- Fewer barriers between different vertical ranks, between functions and disciplines, between units in different geographic locations, and between the company and its suppliers, distributors/dealers, strategic allies, and customers—an outcome partly due to pervasive use of online systems.
- Rapid dissemination of information, rapid learning, and rapid response times—also an outcome partly due to pervasive use of online systems.
- Collaborative efforts among people in different functional specialties and geographic locations—essential to create organization competencies and capabilities.

**Key Points**

Implementing and executing strategy is an operation-driven activity revolving around the management of people and business processes. The managerial emphasis is on converting strategic plans into actions and good results. *Management's handling of the process of implementing and executing the chosen strategy can be considered successful if and when the company achieves the targeted strategic and financial performance and shows good progress in making its strategic vision a reality.* Shortfalls in performance signal weak strategy, weak execution, or both.

The place for managers to start in implementing and executing a new or different strategy is with a probing assessment of what the organization must do differently and
better to carry out the strategy successfully. They should then consider precisely how to make the necessary internal changes as rapidly as possible.

Like crafting strategy, executing strategy is a job for a company’s whole management team, not just a few senior managers. Top-level managers have to rely on the active support and cooperation of middle and lower managers to push strategy changes into functional areas and operating units and to see that the organization actually operates in accordance with the strategy on a daily basis.

Eight managerial tasks crop up repeatedly in company efforts to execute strategy:

1. Building an organization with the competencies, capabilities, and resource strengths to execute strategy successfully.
2. Marshaling sufficient money and people behind the drive for strategy execution.
3. Instituting policies and procedures that facilitate rather than impede strategy execution.
4. Adopting best practices and pushing for continuous improvement in how value chain activities are performed.
5. Installing information and operating systems that enable company personnel to carry out their strategic roles proficiently.
6. Tying rewards directly to the achievement of strategic and financial targets and to good strategy execution.
7. Shaping the work environment and corporate culture to fit the strategy.
8. Exercising strong leadership to drive execution forward, keep improving on the details of execution, and achieve operating excellence as rapidly as feasible.

Building an organization capable of good strategy execution entails three types of organization-building actions: (1) staffing the organization—assembling a talented, can-do management team, and recruiting and retaining employees with the needed experience, technical skills, and intellectual capital; (2) building core competencies and competitive capabilities that will enable good strategy execution and updating them as strategy and external conditions change; and (3) structuring the organization and work effort—organizing value chain activities and business processes and deciding how much decision-making authority to push down to lower-level managers and frontline employees.

Building core competencies and competitive capabilities is a time-consuming, managerially challenging exercise that involves three stages: (1) developing the ability to do something, however imperfectly or inefficiently, by selecting people with the requisite skills and experience, upgrading or expanding individual abilities as needed, and then molding the efforts and work products of individuals into a collaborative group effort; (2) coordinating group efforts to learn how to perform the activity consistently well and at an acceptable cost, thereby transforming the ability into a tried-and-true competence or capability; and (3) continuing to polish and refine the organization’s know-how and otherwise sharpen performance such that it becomes better than rivals at performing the activity, thus raising the core competence (or capability) to the rank of a distinctive competence (or competitively superior capability) and opening an avenue to competitive advantage. Many companies manage to get through stages 1 and 2 in performing a strategy-critical activity but comparatively few achieve sufficient proficiency in performing strategy-critical activities to qualify for the third stage.
Strong core competencies and competitive capabilities are an important avenue for securing a competitive edge over rivals in situations where it is relatively easy for rivals to copy smart strategies. Any time rivals can readily duplicate successful strategy features, making it difficult or impossible to *outstrategize* rivals and beat them in the marketplace with a superior strategy, the chief way to achieve lasting competitive advantage is to *outexecute* them (beat them by performing certain value chain activities in superior fashion). *Building core competencies and competitive capabilities that are very difficult or costly for rivals to emulate and that push a company closer to true operating excellence is one of the best and most reliable ways to achieve a durable competitive edge.*

Structuring the organization and organizing the work effort in a strategy-supportive fashion has five aspects: (1) deciding which value chain activities to perform internally and which ones to outsource; (2) making internally performed strategy-critical activities the main building blocks in the organization structure; (3) deciding how much authority to centralize at the top and how much to delegate to down-the-line managers and employees; (4) providing for internal cross-unit coordination and collaboration to build and strengthen internal competencies/capabilities; and (5) providing for the necessary collaboration and coordination with suppliers and strategic allies.

### Exercises

1. As the new owner of a local ice cream store located in a strip mall adjacent to a university campus, you are contemplating how to organize your business—whether to make your ice cream in-house or outsource its production to a nearby ice cream manufacturer whose brand is in most of the local supermarkets, and how much authority to delegate to the two assistant store managers and to employees working the counter and the cash register. You plan to sell 20 flavors of ice cream.
   - What are the pros and cons of contracting with the local company to custom-produce your product line?
   - Since you do not plan to be in the store during all of the hours it is open, what specific decision-making authority would you delegate to the two assistant store managers?
   - To what extent, if any, should store employees—many of whom will be university students working part-time—be empowered to make decisions relating to store operations (opening and closing, keeping the premises clean and attractive, keeping the work area behind the counter stocked with adequate supplies of cups, cones, napkins, and so on)?
   - Should you create a policies and procedures manual for the assistant managers and employees, or should you just give oral instructions and have them learn their duties and responsibilities on the job?
   - How can you maintain control during the times you are not in the store?
2. Go to Home Depot’s corporate home page (www.homedepot.com/corporate) and review the information under the headings About The Home Depot, Investor Relations, and Careers. How does Home Depot go about building core competencies and competitive capabilities? Would any of Home Depot’s competencies qualify as a distinctive competence? Please use the chapter’s discussion of building core competencies and competitive capabilities as a guide for preparing your answer.

3. Using Google Scholar or your access to EBSCO, InfoTrac, or other online database of journal articles and research in your university’s library, do a search for recent writings on self-directed or empowered work teams. According to the articles you found in the various management journals, what are the conditions for the effective use of such teams? Also, how should such teams be organized or structured to better ensure their success?
Managing Internal Operations
Actions That Promote Good Strategy Execution

Winning companies know how to do their work better.
—Michael Hammer and James Champy

Companies that make best practices a priority are thriving, thirsty, learning organizations. They believe that everyone should always be searching for a better way. Those kinds of companies are filled with energy and curiosity and a spirit of can-do.
—Jack Welch
Former CEO, General Electric

If you want people motivated to do a good job, give them a good job to do.
—Frederick Herzberg

You ought to pay big bonuses for premier performance. . . . Be a top payer, not in the middle or low end of the pack.
—Lawrence Bossidy
CEO, Honeywell International
In Chapter 11 we emphasized the importance of building organization capabilities and structuring the work effort so as to perform strategy-critical activities in a coordinated and highly competent manner. In this chapter we discuss five additional managerial actions that promote the success of a company’s strategy execution efforts:

1. Marshaling resources behind the drive for good strategy execution.
2. Instituting policies and procedures that facilitate strategy execution.
3. Adopting best practices and striving for continuous improvement in how value chain activities are performed.
4. Installing information and operating systems that enable company personnel to carry out their strategic roles proficiently.
5. Tying rewards and incentives directly to the achievement of strategic and financial targets and to good strategy execution.

MARSHALING RESOURCES BEHIND THE DRIVE FOR GOOD STRATEGY EXECUTION

Early in the process of implementing and executing a new or different strategy, managers need to determine what resources will be needed and then consider whether the current budgets of organizational units are suitable. Plainly, organizational units must have the budgets and resources for executing their parts of the strategic plan effectively and efficiently. Developing a strategy-driven budget requires top management to determine what funding is needed to execute new strategic initiatives and to strengthen or modify the company’s competencies and capabilities. This includes careful screening of requests for more people and more or better facilities and equipment, approving those that hold promise for making a cost-justified contribution to strategy execution, and turning down those that don’t. Should internal cash flows prove insufficient to fund the planned strategic initiatives, then management must raise additional funds through borrowing or selling additional shares of stock to willing investors.

A company’s ability to marshal the resources needed to support new strategic initiatives and steer them to the appropriate organizational units has a major impact on the strategy execution process. Too little funding (stemming either from constrained financial resources or from sluggish management action to adequately increase the budgets of strategy-critical organizational units) slows progress and impedes the efforts of organizational units to execute their pieces of the strategic plan proficiently. Too much funding wastes organizational resources and reduces financial performance. Both outcomes argue for managers to be deeply involved in reviewing budget proposals and directing the proper kinds and amounts of resources to strategy-critical organization units.
A change in strategy nearly always calls for budget reallocations and resource shifting. Units important in the prior strategy but having a lesser role in the new strategy may need downsizing. Units that now have a bigger and more critical strategic role may need more people, new equipment, additional facilities, and above-average increases in their operating budgets. More resources may have to be devoted to quality control or to adding new product features or to building a better brand image or to cutting costs or to employee retraining. Strategy implementers need to be active and forceful in shifting resources, downsizing some functions and upsizing others, not only to amply fund activities with a critical role in the new strategy but also to avoid inefficiency and achieve profit projections. They have to exercise their power to put enough resources behind new strategic initiatives to make things happen, and they have to make the tough decisions to kill projects and activities that are no longer justified.

Visible actions to reallocate operating funds and move people into new organizational units signal a determined commitment to strategic change and frequently are needed to catalyze the implementation process and give it credibility. Microsoft has made a practice of regularly shifting hundreds of programmers to new high-priority programming initiatives within a matter of weeks or even days. At Harris Corporation, where the strategy was to diffuse research ideas into areas that were commercially viable, top management regularly shifted groups of engineers out of government projects and into new commercial venture divisions. Fast-moving developments in many markets are prompting companies to abandon traditional annual or semiannual budgeting and resource allocation cycles in favor of cycles that match the strategy changes a company makes in response to newly developing events.

The bigger the change in strategy (or the more obstacles that lie in the path of good strategy execution), the bigger the resource shifts that will likely be required. Merely fine-tuning the execution of a company’s existing strategy seldom requires big movements of people and money from one area to another. The desired improvements can usually be accomplished through above-average budget increases to organizational units launching new initiatives and below-average increases (or even small cuts) for the remaining organizational units. The chief exception occurs where all the strategy changes or new execution initiatives need to be made without adding to total expenses. Then managers have to work their way through the existing budget line-by-line and activity-by-activity, looking for ways to trim costs in some areas and shift the resources to higher priority activities where new execution initiatives are needed.

INSTITUTING POLICIES AND PROCEDURES THAT FACILITATE GOOD STRATEGY EXECUTION

A company’s policies and procedures can either assist the cause of good strategy execution or be a barrier. Any time a company moves to put new strategy elements in place or improve its strategy execution capabilities, managers are well advised to undertake a careful review of existing policies and procedures, proactively revising or discarding those that are out of sync. A change in strategy or a push for better strategy execution generally requires some changes in work practices and the behavior of company personnel. One way of promoting such changes is by instituting a select set of new policies and procedures deliberately aimed at steering the actions and behavior of company personnel in a direction more conducive to good strategy execution and operating excellence.
As shown in Figure 12.1, prescribing new policies and operating procedures acts to facilitate strategy execution in three ways:

1. **Instituting new policies and procedures provides top-down guidance regarding how certain things now need to be done.** Asking people to alter established habits and procedures, of course, always upsets the internal order of things. It is normal for pockets of resistance to develop and for people to exhibit some degree of stress and anxiety about how the changes will affect them, especially when the changes may eliminate jobs. But when existing ways of doing things pose a barrier to improving strategy execution, actions and behaviors have to be changed. The managerial role of establishing and enforcing new policies and operating practices is to paint a different set of white lines, place limits on independent behavior, and channel individual and group efforts along a path more conducive to executing the strategy. Policies are a particularly useful way to counteract tendencies for some people to resist change—most people refrain from violating company policy or going against recommended practices and procedures without first gaining clearance or having strong justification.

2. **Policies and procedures help enforce needed consistency in how particular strategy-critical activities are performed in geographically scattered operating units.** Standardization and strict conformity are sometimes desirable components of good strategy execution. Eliminating significant differences in the operating practices of different plants, sales regions, customer service centers, or the individual outlets in a chain operation helps a company deliver consistent product quality and service to customers. Good strategy execution nearly always entails an ability to replicate product quality and the caliber of customer service at every location where the company does business—anything less blurs the company’s image and fails to meet customer expectations.
Illustration Capsule 12.1

Granite Construction’s Short-Pay Policy:
An Innovative Way to Drive Better Strategy Execution

In 1987, the owners of Granite Construction, a 100-plus-year-old supplier of crushed gravel, sand, concrete, and asphalt in Watsonville, California, decided to pursue two strategic targets: total customer satisfaction and a reputation for superior service. To drive the internal efforts to achieve these two objectives and signal both employees and customers that it was deadly serious about these two strategic commitments, top management instituted a short-pay policy that appeared on the bottom of every Granite Construction invoice:

If you are not satisfied for any reason, don’t pay us for it. Simply scratch out the line item, write a brief note about the problem, and return a copy of this invoice along with your check for the balance.

Customers did not have to call and complain and were not expected to return the product. They were given complete discretionary power to decide whether and how much to pay based on their satisfaction level. Management believed that empowering customers not to pay for items or service they found lacking would provide unmistakable feedback and spur company personnel to correct any problems quickly in order to avoid repeated short payments.

The short-pay policy had the desired impact, focusing the attention of company personnel on avoiding short payments by customers and boosting customer satisfaction significantly. Granite has enjoyed compound annual sales gains of 12.2 percent since 2000, while charging a 6 percent price premium for its commodity products in competition against larger rivals.

In addition to its short-pay policy, Granite employs two other policies to help induce company personnel to do their very best to satisfy the company’s customers. It has a no-layoff policy (no employees have been laid off in over 80 years), and it sends positive customer comments about employees home for families to read. To make sure its workforce force is properly trained, company employees go through training programs averaging 43 hours per employee annually. And compensation is attractive: Entry-level employees, called job owners, start at $16 an hour and progress to such positions as “accomplished job owner” and “improvement champion” (base pay of $26 an hour); all employees are entitled to 12 company-paid massages annually.

Granite won the prestigious Malcolm Baldrige National Quality Award in 1992, about five years after instituting the short-pay policy. Fortune rated Granite as one of the 100 best companies to work for in America in eight of the nine years from 1998 to 2006 (its highest ranking was 16th in 2002, and its lowest was 90th in 2004). The company was on Fortune’s “Most Admired Companies” list in 2005 and 2006.


3. Well-conceived policies and procedures promote the creation of a work climate that facilitates good strategy execution. Because discarding old policies and procedures in favor of new ones invariably alters the internal work climate, managers can use the policy-changing process as a powerful lever for changing the corporate culture in ways that produce a stronger fit with the new strategy. The trick here, obviously, is to hit upon a new policy that will catch the immediate attention of the whole organization, quickly shift their actions and behavior, and then become embedded in how things are done—as with Granite Construction’s short-pay policy discussed in Illustration Capsule 12.1.

In an attempt to steer “crew members” into stronger quality and service behavior patterns, McDonald’s policy manual spells out detailed procedures that personnel in each McDonald’s unit are expected to observe; for example, “Cooks must turn, never flip, hamburgers,” “If they haven’t been purchased, Big Macs must be discarded in 10 minutes after being cooked and French fries in 7 minutes,” and “Cashiers must make eye contact with and smile at every customer.”
Nordstrom’s strategic objective is to make sure that each customer has a pleasing shopping experience in its department stores and returns time and again; to get store personnel to dedicate themselves to outstanding customer service, Nordstrom has a policy of promoting only those people whose personnel records contain evidence of “heroic acts” to please customers—especially customers who may have made “unreasonable requests” that require special efforts. To keep its R&D activities responsive to customer needs and expectations, Hewlett-Packard (HP) requires R&D people to make regular visits to customers to learn about their problems and learn their reactions to HP’s latest new products.

One of the big policymaking issues concerns what activities need to be rigidly prescribed and what activities ought to allow room for independent action on the part of empowered personnel. Few companies need thick policy manuals to direct the strategy execution process or prescribe exactly how daily operations are to be conducted. Too much policy can erect as many obstacles as wrong policy or be as confusing as no policy. There is wisdom in a middle approach: *Prescribe enough policies to give organization members clear direction in implementing strategy and to place desirable boundaries on their actions; then empower them to act within these boundaries however they think makes sense.* Allowing company personnel to act anywhere between the “white lines” is especially appropriate when individual creativity and initiative are more essential to good strategy execution than standardization and strict conformity. Instituting strategy-facilitating policies can therefore mean more policies, fewer policies, or different policies. It can mean policies that require things to be done a certain way or policies that give employees leeway to do activities the way they think best.

### ADOPTING BEST PRACTICES AND STRIVING FOR CONTINUOUS IMPROVEMENT

Company managers can significantly advance the cause of competent strategy execution by pushing organization units and company personnel to identify and adopt the best practices for performing value chain activities and, further, insisting on continuous improvement in how internal operations are conducted. One of the most widely used and effective tools for gauging how well a company is executing pieces of its strategy entails benchmarking the company’s performance of particular activities and business processes against best-in-industry and best-in-world performers. It can also be useful to look at best-in-company performers of an activity if a company has a number of different organizational units performing much the same function at different locations. Identifying, analyzing, and understanding how top companies or individuals perform particular value chain activities and business processes provides useful yardsticks for judging the effectiveness and efficiency of internal operations and setting performance standards for organization units to meet or beat.

### How the Process of Identifying and Incorporating Best Practices Works

A best practice is a technique for performing an activity or business process that at least one company has demonstrated works particularly well. To qualify as a legitimate best practice, the technique must have a proven record in significantly lowering costs, improving quality or performance, shortening time requirements, enhancing safety, or...
delivering some other highly positive operating outcome. Best practices thus identify a path to operating excellence. For a best practice to be valuable and transferable, it must demonstrate success over time, deliver quantifiable and highly positive results, and be repeatable.

Benchmarking is the backbone of the process of identifying, studying, and implementing outstanding practices. A company’s benchmarking effort looks outward to find best practices and then proceeds to develop the data for measuring how well a company’s own performance of an activity stacks up against the best-practice standard. Informally, benchmarking involves being humble enough to admit that others have come up with world-class ways to perform particular activities yet wise enough to try to learn how to match, and even surpass, them. But, as shown in Figure 12.2, the payoff of benchmarking comes from adapting the top-notch approaches pioneered by other companies in the company’s own operation and thereby boosting, perhaps dramatically, the proficiency with which value chain tasks are performed.

However, benchmarking is more complicated than simply identifying which companies are the best performers of an activity and then trying to imitate their approaches—especially if these companies are in other industries. Normally, the outstanding practices of other organizations have to be adapted to fit the specific circumstances of a company’s own business and operating requirements. Since most companies believe their work is unique, the telling part of any best-practice initiative is how well the company puts its own version of the best practice into place and makes it work.

Indeed, a best practice remains little more than another company’s interesting success story unless company personnel buy into the task of translating what can be learned from other companies into real action and results. The agents of change must be frontline employees who are convinced of the need to abandon the old ways of doing things and switch to a best-practice mind-set. The more that organizational units use best practices in performing their work, the closer a company moves toward performing its value chain activities as effectively and efficiently as possible. This is what operational excellence is all about.

Legions of companies across the world now engage in benchmarking to improve their strategy execution efforts and, ideally, gain a strategic, operational, and financial advantage over rivals. Scores of trade associations and special interest organizations have undertaken efforts to collect best-practice data relevant to a particular industry or business function and make their databases available online to members—good
examples include The Benchmarking Exchange’s BenchNet (www.benchnet.com), Best Practices LLC (www.best-in-class.com), and the American Productivity and Quality Center (www.apqc.org). Benchmarking and best-practice implementation have clearly emerged as legitimate and valuable managerial tools for promoting operational excellence.

**Business Process Reengineering, Six Sigma Quality Programs, and TQM: Tools for Promoting Operating Excellence**

In striving for operating excellence, many companies have also come to rely on three other potent management tools: business process reengineering, Six Sigma quality control techniques, and total quality management (TQM) programs. Indeed, these three tools have become globally pervasive techniques for implementing strategies keyed to cost reduction, defect-free manufacture, superior product quality, superior customer service, and total customer satisfaction. The following sections describe how business process reengineering, Six Sigma, and TQM can contribute to operating excellence and better strategy execution.

**Business Process Reengineering**

Companies scouring for ways to improve their operations have sometimes discovered that the execution of strategy-critical activities is hindered by an organizational arrangement where pieces of the activity are performed in several different functional departments, with no one manager or group being accountable for optimum performance of the entire activity. This can easily occur in such inherently cross-functional activities as customer service (which can involve personnel in order filling, warehousing and shipping, invoicing, accounts receivable, after-sale repair, and technical support), new product development (which can typically involve personnel in R&D, design and engineering, purchasing, manufacturing, and sales and marketing), and supply chain management (which cuts across such areas as purchasing, inventory management, manufacturing and assembly, warehousing, and shipping). Even if personnel in all the different departments and functional areas are inclined to collaborate closely, the activity may not end up being performed optimally or cost-efficiently, such that performance is adversely affected.

To address such shortcomings in strategy execution, many companies during the past decade have opted to reengineer the work effort by pulling the pieces of strategy-critical activities out of different departments and unifying their performance in a single department or cross-functional work group. Reorganizing the people who performed the pieces in functional departments into a close-knit group that has charge over the whole process and that can be held accountable for performing the activity in a cheaper, better, and/or more strategy-supportive fashion is called business process reengineering.²

When done properly, business process reengineering can produce dramatic operating benefits. In the order-processing section of General Electric’s circuit breaker division, elapsed time from order receipt to delivery was cut from three weeks to three days by consolidating six production units into one, reducing a variety of former inventory and handling steps, automating the design system to replace a human custom-design process, and cutting the organizational layers between managers and workers from three to one. Productivity rose 20 percent in one year, and unit manufacturing costs dropped 30 percent. Northwest Water, a British utility, used business process reengineering to eliminate 45 work depots that served as home bases to crews who installed and
repaired water and sewage lines and equipment. Now crews work directly from their vehicles, receiving assignments and reporting work completion from computer terminals in their trucks. Crew members are no longer employees but rather contractors to Northwest Water. These reengineering efforts not only eliminated the need for the work depots but also allowed Northwest Water to eliminate a big percentage of the bureaucratic personnel and supervisory organization that managed the crews.3

Since the early 1990s, reengineering of value chain activities has been undertaken at many companies in many industries all over the world, with excellent results being achieved at some companies.4 While reengineering has produced only modest results in some instances, usually because of ineptness or lack of wholehearted commitment, reengineering has nonetheless proved itself as a useful tool for streamlining a company’s work effort and moving closer to operational excellence.

**Total Quality Management Programs**

Total quality management (TQM) is a philosophy of managing a set of business practices that emphasizes continuous improvement in all phases of operations, 100 percent accuracy in performing tasks, involvement and empowerment of employees at all levels, team-based work design, benchmarking, and total customer satisfaction.5 While TQM concentrates on the production of quality goods and fully satisfying customer expectations, it achieves its biggest successes when it is also extended to employee efforts in all departments—human resources, billing, R&D, engineering, accounting and records, and information systems—that may lack pressing, customer-driven incentives to improve. It involves reforming the corporate culture and shifting to a total quality/continuous improvement business philosophy that permeates every facet of the organization.6 TQM aims at instilling enthusiasm and commitment to doing things right from the top to the bottom of the organization. Management’s job is to kindle an company-wide search for ways to improve, a search that involves all company personnel exercising initiative and using their ingenuity. TQM doctrine preaches that there’s no such thing as “good enough” and that everyone has a responsibility to participate in continuous improvement. TQM is thus a race without a finish. Success comes from making little steps forward each day, a process that the Japanese call *kaizen*.

TQM takes a fairly long time to show significant results—very little benefit emerges within the first six months. The long-term payoff of TQM, if it comes, depends heavily on management’s success in implanting a culture within which TQM philosophies and practices can thrive. TQM is a managerial tool that has attracted numerous users and advocates over several decades, and it can deliver good results when used properly.

**Six Sigma Quality Control**

Six Sigma quality control consists of a disciplined, statistics-based system aimed at producing not more than 3.4 defects per million iterations for any business process—from manufacturing to customer transactions.7 The Six Sigma process of define, measure, analyze, improve, and control (DMAIC) is an improvement system for existing processes falling below specification and needing incremental improvement. The Six Sigma process of define, measure, analyze, design, and verify (DMADV) is used to develop new processes or products at Six Sigma quality levels. Both Six Sigma processes are executed by personnel who have earned Six Sigma “green belts” and Six Sigma “black belts,” and are overseen by personnel who have completed Six Sigma “master black belt” training. According to the Six Sigma Academy, personnel with black belts can save companies approximately $230,000 per project and can complete four to six projects a year.8
The statistical thinking underlying Six Sigma is based on the following three principles: All work is a process, all processes have variability, and all processes create data that explains variability. To illustrate how these three principles drive the metrics of DMAIC, consider the case of a janitorial company that wants to improve the caliber of work done by its cleaning crews and thereby boost customer satisfaction. The janitorial company’s Six Sigma team can pursue quality enhancement and continuous improvement via the DMAIC process as follows:

- **Define.** Because Six Sigma is aimed at reducing defects, the first step is to define what constitutes a defect. Six Sigma team members might decide that leaving streaks on windows is a defect because it is a source of customer dissatisfaction.
- **Measure.** The next step is to collect data to find out why, how, and how often this defect occurs. This might include a process flow map of the specific ways that cleaning crews go about the task of cleaning a commercial customer’s windows. Other metrics may include recording what tools and cleaning products the crews use to clean windows.
- **Analyze.** After the data are gathered and the statistics analyzed, the company’s Six Sigma team discovers that the tools and window-cleaning techniques of certain employees are better than those of other employees because their tools and procedures leave no streaked windows—a “best practice” for avoiding window streaking is thus identified and documented.
- **Improve.** The Six Sigma team implements the documented best practice as a standard way of cleaning windows.
- **Control.** The company teaches new and existing employees the best practice technique for window cleaning. Over time, there’s significant improvement in customer satisfaction and increased business.

Six Sigma’s DMAIC process is a particularly good vehicle for improving performance when there are wide variations in how well an activity is performed. For instance, airlines striving to improve the on-time performance of their flights have more to gain from actions to curtail the number of flights that are late by more than 30 minutes than from actions to reduce the number of flights that are late by less than 5 minutes. Likewise, an overnight delivery service might have a 16-hour average delivery time, but if the actual delivery time varies around the 16-hour average from a low of 12 hours to a high of 26 hours such that 10 percent of its packages are delivered more than 6 hours late, then the company has a huge reliability problem.

Since the mid-1990s, thousands of companies and nonprofit organizations around the world have begun using Six Sigma programs to promote operating excellence. Such manufacturers as Motorola, Allied Signal, Caterpillar, DuPont, Xerox, Alcan Aluminum, BMW, Volkswagen, Nokia, Owens Corning, and Emerson Electric have employed Six Sigma techniques to good advantage in improving production quality. General Electric (GE), one of the most successful companies implementing Six Sigma training and pursuing Six Sigma perfection, estimated benefits on the order of $10 billion during the first five years of implementation. GE first began Six Sigma in 1995 after Motorola and Allied Signal blazed the Six Sigma trail. One of GE’s successes was in its Lighting division, where Six Sigma was used to cut invoice defects and disputes by 98 percent, a particular benefit to Wal-Mart, the division’s largest customer. GE Capital Mortgage improved the chances of a caller reaching a “live” GE person from 76 to 99 percent. Illustration Capsule 12.2 describes Whirlpool’s use of Six Sigma in its appliance business.
Illustration Capsule 12.2

Whirlpool’s Use of Six Sigma to Promote Operating Excellence

Top management at Whirlpool Corporation, the leading global manufacturer and marketer of home appliances in 2005 with 50 manufacturing and technology centers around the globe and sales in some 170 countries, has a vision of Whirlpool appliances in “Every Home, Everywhere.” One of management’s chief objectives in pursuing this vision is to build unmatched customer loyalty to the Whirlpool brand. Whirlpool’s strategy to win the hearts and minds of appliance buyers the world over has been to produce and market appliances with top-notch quality and innovative features that users will find appealing. In addition, Whirlpool’s strategy has been to offer a wide selection of models (recognizing that buyer tastes and needs differ) and to strive for low-cost production efficiency, thereby enabling Whirlpool to price its products competitively. Executing this strategy at Whirlpool’s operations in North America (where it is the market leader), Latin America (where it is also the market leader), Europe (where it ranks third), and Asia (where it number one in India and has a foothold with huge growth opportunities elsewhere) has involved a strong focus on continuous improvement, lean manufacturing capabilities, and a drive for operating excellence. To marshal the efforts of Whirlpool’s 68,000 employees in executing the strategy successfully, management developed a comprehensive Operational Excellence program with Six Sigma as one of the centerpieces.

The Operational Excellence initiative, which began in the 1990s, incorporated Six Sigma techniques to improve the quality of Whirlpool products, while at the same time lowering costs and trimming the time it took to get product innovations into the marketplace. The Six Sigma program helped Whirlpool save $175 million in manufacturing costs in its first three years.

To sustain the productivity gains and cost savings, Whirlpool embedded Six Sigma practices within each of its manufacturing facilities worldwide and instilled a culture based on Six Sigma and lean manufacturing skills and capabilities. Beginning in 2002, each of Whirlpool’s operating units began taking the Six Sigma initiative to a higher level by first placing the needs of the customer at the center of every function—R&D, technology, manufacturing, marketing, and administrative support—and then striving to consistently improve quality levels while eliminating all unnecessary costs. The company systematically went through every aspect of its business with the view that company personnel should perform every activity at every level in a manner that delivers value to the customer and that leads to continuous improvement on how things are done.

Whirlpool management believes that the company’s Operational Excellence process has been a major contributor in sustaining the company’s global leadership in appliances.


Six Sigma is, however, not just a quality-enhancing tool for manufacturers. At one company, product sales personnel typically wined and dined customers to close their deals. But the costs of such entertaining were viewed as excessively high in many instances. A Six Sigma project that examined sales data found that although face time with customers was important, wining, dining, and other types of entertainment were not. The data showed that regular face time helped close sales, but that time could be spent over a cup of coffee instead of golfing at a resort or taking clients to expensive restaurants. In addition, analysis showed that too much face time with customers was counterproductive. A regularly scheduled customer picnic was found to be detrimental to closing sales because it was held at a busy time of year, when customers preferred not to be away from their offices. Changing the manner in which prospective customers were wooed resulted in a 10 percent increase in sales.

A Milwaukee hospital used Six Sigma to map the process as prescriptions originated with a doctor’s writeup, were filled by the hospital pharmacy, and then administered by nurses. DMAIC analysis revealed that most mistakes came from misreading the doctor’s handwriting. The hospital implemented a program requiring doctors to type the prescription into a computer, which slashed the number of errors dramatically.

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A problem tailor-made for Six Sigma occurs in the insurance industry, where it is common for top agents to outsell poor agents by a factor of 10 to 1 or more. If insurance executives offer a trip to Hawaii in a monthly contest to motivate low-performing agents, the typical result is to motivate top agents to be even more productive and make the performance gap even wider. A DMAIC Six Sigma project to reduce the variation in the performance of agents and correct the problem of so many low-performing agents would begin by measuring the performance of all agents, perhaps discovering that the top 20 percent sell 7 times more policies than the bottom 40 percent. Six Sigma analysis would then consider such steps as mapping how top agents spend their day, investigating the factors that distinguish top performers from low performers, learning what techniques training specialists have employed in converting low-performing agents into high performers, and examining how the hiring process could be improved to avoid hiring underperformers in the first place. The next step would be to test proposed solutions—better training methods or psychological profiling to identify and weed out candidates likely to be poor performers—to identify and measure which alternative solutions really work, which don’t, and why. Only those actions that prove statistically beneficial are then introduced on a wide scale. The DMAIC method thus entails empirical analysis to diagnose the problem (design, measure), test alternative solutions (improve) and then control the variability in how well the activity is performed by implementing actions shown to truly fix the problem.

A company that systematically applies Six Sigma methods to its value chain, activity by activity, can make major strides in improving the proficiency with which its strategy is executed. As is the case with TQM, obtaining managerial commitment, establishing a quality culture, and fully involving employees are the three most intractable challenges encountered in the implementation of Six Sigma quality programs.14

The Difference between Business Process Reengineering and Continuous Improvement Programs Like Six Sigma and TQM

Business process reengineering and continuous improvement efforts like TQM and Six Sigma both aim at improved efficiency and reduced costs, better product quality, and greater customer satisfaction. The essential difference between business process reengineering and continuous improvement programs is that reengineering aims at quantum gains on the order of 30 to 50 percent or more whereas total quality programs stress incremental progress, striving for inch-by-inch gains again and again in a never-ending stream. The two approaches to improved performance of value chain activities and operating excellence are not mutually exclusive; it makes sense to use them in tandem. Reengineering can be used first to produce a good basic design that yields quick, dramatic improvements in performing a business process. Total quality programs can then be used as a follow-on to reengineering and/or best-practice implementation, delivering gradual improvements. Such a two-pronged approach to implementing operational excellence is like a marathon race in which you run the first four miles as fast as you can, then gradually pick up speed the remainder of the way.

Capturing the Benefits of Initiatives to Improve Operations

Usually, the biggest beneficiaries of benchmarking and best-practice initiatives, reengineering, TQM, and Six Sigma are companies that view such programs not as ends in themselves but as tools for implementing and executing company strategy more effectively. The skimpiest payoffs occur when company managers seize them as
something worth trying—novel ideas that could improve things. In most such instances, they result in strategy-blind efforts to simply manage better. There’s an important lesson here. Best practices, TQM, Six Sigma quality, and reengineering all need to be seen and used as part of a bigger-picture effort to execute strategy proficiently. Only strategy can point to which value chain activities matter and what performance targets make the most sense. Absent a strategic framework, managers lack the context in which to fix things that really matter to business-unit performance and competitive success.

To get the most from initiatives to better execute strategy, managers must have a clear idea of what specific outcomes really matter. Is it a Six Sigma or lower defect rate, high on-time delivery percentages, low overall costs relative to rivals, high percentages of pleased customers and few customer complaints, shorter cycle times, a higher percentage of revenues coming from recently introduced products, or what? Benchmarking best-in-industry and best-in-world performance of most or all value chain activities provides a realistic basis for setting internal performance milestones and longer-range targets.

Then comes the managerial task of building a total quality culture genuinely committed to achieving the performance outcomes that strategic success requires. Managers can take the following action steps to realize full value from TQM or Six Sigma initiatives:

1. Visible, unequivocal, and unyielding commitment to total quality and continuous improvement, including a quality vision and specific, measurable objectives for boosting quality and making continuous improvement.
2. Nudging people toward quality-supportive behaviors by:
   a. Screening job applicants rigorously and hiring only those with attitudes and aptitudes right for quality-based performance.
   b. Providing quality training for most employees.
   c. Using teams and team-building exercises to reinforce and nurture individual effort (the creation of a quality culture is facilitated when teams become more cross-functional, multitask-oriented, and increasingly self-managed).
   d. Recognizing and rewarding individual and team efforts regularly and systematically.
   e. Stressing prevention (doing it right the first time), not inspection (instituting ways to correct mistakes).
3. Empowering employees so that authority for delivering great service or improving products is in the hands of the doers rather than the overseers—improving quality has to be seen as part of everyone’s job.
4. Using online systems to provide all relevant parties with the latest best practices and actual experiences with them, thereby speeding the diffusion and adoption of best practices throughout the organization and also allowing them to exchange data and opinions about how to upgrade the prevailing best practices.
5. Preaching that performance can, and must, be improved because competitors are not resting on their laurels and customers are always looking for something better.

If the targeted performance measures are appropriate to the strategy and if all organizational members (top executives, middle managers, professional staff, and line employees) buy into a culture of operating excellence, then a company’s work climate becomes decidedly more conducive to proficient strategy execution. Benchmarking,
best-practice implementation, reengineering, TQM, and Six Sigma initiatives can greatly enhance a company’s product design, cycle time, production costs, product quality, service, customer satisfaction, and other operating capabilities—and they can even deliver competitive advantage. Not only do improvements from such initiatives add up over time and strengthen organizational capabilities, but the benefits they produce have hard-to-imitate aspects. While it is relatively easy for rivals to undertake benchmarking, process improvement, and quality training, it is much more difficult and time-consuming for them to instill a deeply ingrained culture of operating excellence (as occurs when such techniques are religiously employed) and top management exhibits lasting commitment to operational excellence throughout the organization.

INSTALLING INFORMATION AND OPERATING SYSTEMS

Company strategies can’t be executed well without a number of internal systems for business operations. Southwest, American, Northwest, Delta, and other major airlines cannot hope to provide passenger-pleasing service without a user-friendly online reservation system, an accurate and speedy baggage handling system, and a strict aircraft maintenance program that minimizes equipment failures requiring at-the-gate service and delaying plane departures. FedEx has internal communication systems that allow it to coordinate its over 70,000 vehicles in handling an average of 5.5 million packages a day. Its leading-edge flight operations systems allow a single controller to direct as many as 200 of FedEx’s 650 aircraft simultaneously, overriding their flight plans should weather or other special emergencies arise. In addition, FedEx has created a series of e-business tools for customers that allow them to ship and track packages online (either at FedEx’s Web site or on their own company intranets or Web sites), create address books, review shipping history, generate custom reports, simplify customer billing, reduce internal warehousing and inventory management costs, purchase goods and services from suppliers, and respond quickly to changing customer demands. All of FedEx’s systems support the company’s strategy of providing businesses and individuals with a broad array of package delivery services (from premium next-day to economical five-day deliveries) and boosting its competitiveness against United Parcel Service, Airborne Express, and the U.S. Postal Service.

Otis Elevator, the world’s largest manufacturer of elevators, has 24-hour communications service centers for customers called OtisLine to coordinate its maintenance efforts for some 1.5 million elevators and escalators it has installed worldwide. Electronic monitors installed on each user’s site can detect when an elevator or escalator has any of 325 problems and will automatically place a service call to the nearest service center location. Trained operators take all trouble calls, input critical information on a computer screen, and can dispatch trained mechanics from 325 locations across the world to the local trouble spot when needed. All customers have online access to performance data on each of their Otis elevators. More than 80 percent of mechanics in North America carry Web-enabled phones connected to e*Service that transport needed information quickly and allow mechanics to update data in Otis computers for future reference. The OtisLine system helps keep outage times to less than two and a half hours. All the trouble-call data is relayed to design and manufacturing personnel, allowing them to quickly alter design specifications or manufacturing procedures when needed to correct recurring problems.

Amazon.com ships customer orders from fully computerized, 1,300-by-600-foot warehouses containing about 3 million books, CDs, toys, and houseware items. The
warehouses are so technologically sophisticated that they require about as many lines of code to run as Amazon’s Web site does. Using complex picking algorithms, computers initiate the order-picking process by sending signals to workers’ wireless receivers, telling them which items to pick off the shelves in which order. Computers also generate data on misboxed items, chute backup times, line speed, worker productivity, and shipping weights on orders. Systems are upgraded regularly, and productivity improvements are aggressively pursued. In 2003 Amazon’s six warehouses were able to handle three times the volume handled in 1999 at costs averaging 10 percent of revenues (versus 20 percent in 1999); in addition, they turned their inventory over 20 times annually in an industry whose average was 15 turns. Amazon’s warehouse efficiency and cost per order filled was so low that one of the fastest-growing and most profitable parts of Amazon’s business was using its warehouses to run the e-commerce operations of Toys “R” Us and Target.

Most telephone companies, electric utilities, and TV broadcasting systems have online monitoring systems to spot transmission problems within seconds and increase the reliability of their services. At eBay, there are systems for real-time monitoring of new listings, bidding activity, Web site traffic, and page views. Kaiser Permanente spent $3 billion to digitize the medical records of its 8.2 million members so that it could manage patient care more efficiently. IBM has created a database of 36,000 employee profiles that enable it to better assign the most qualified IBM consultant to the projects it is doing for clients. In businesses such as public accounting and management consulting, where large numbers of professional staff need cutting-edge technical know-how, companies have developed systems that identify when it is time for certain employees to attend training programs to update their skills and know-how. Many companies have cataloged best-practice information on their intranets to promote faster transfer and implementation throughout the organization.

Well-conceived, state-of-the-art operating systems not only enable better strategy execution but also strengthen organizational capabilities—perhaps enough to provide a competitive edge over rivals. For example, a company with a differentiation strategy based on superior quality has added capability if it has systems for training personnel in quality techniques, tracking product quality at each production step, and ensuring that all goods shipped meet quality standards. A company striving to be a low-cost provider is competitively stronger if it has a benchmarking system that identifies opportunities to implement best practices and drive costs out of the business. Fast-growing companies get an important assist from having capabilities in place to recruit and train new employees in large numbers and from investing in infrastructure that gives them the capability to handle rapid growth as it occurs. It is nearly always better to put infrastructure and support systems in place before they are actually needed than to have to scramble to catch up to customer demand.

**Instituting Adequate Information Systems, Performance Tracking, and Controls**

Accurate and timely information about daily operations is essential if managers are to gauge how well the strategy execution process is proceeding. Information systems need to cover five broad areas: (1) customer data, (2) operations data, (3) employee data, (4) supplier/partner/collaborative ally data, and (5) financial performance data. All key strategic performance indicators have to be tracked and reported as often as practical. Monthly profit-and-loss statements and monthly statistical summaries, long the norm, are fast being replaced by daily statistical updates and even up-to-the-minute
performance monitoring that online technology makes possible. Many retail companies have automated online systems that generate daily sales reports for each store and maintain up-to-the-minute inventory and sales records on each item. Manufacturing plants typically generate daily production reports and track labor productivity on every shift. Many retailers and manufacturers have online data systems connecting them with their suppliers that monitor the status of inventories, track shipments and deliveries, and measure defect rates.

Real-time information systems permit company managers to stay on top of implementation initiatives and daily operations, and to intervene if things seem to be drifting off course. Tracking key performance indicators, gathering information from operating personnel, quickly identifying and diagnosing problems, and taking corrective actions are all integral pieces of the process of managing strategy implementation and execution and exercising adequate organization control. A number of companies have recently begun creating “electronic scorecards” for senior managers that gather daily or weekly statistics from different databases about inventory, sales, costs, and sales trends; such information enables these managers to easily stay abreast of what’s happening and make better decisions on a real-time basis. Telephone companies have elaborate information systems to measure signal quality, connection times, interrupts, wrong connections, billing errors, and other measures of reliability that affect customer service and satisfaction. To track and manage the quality of passenger service, airlines have information systems to monitor gate delays, on-time departures and arrivals, baggage handling times, lost baggage complaints, stockouts on meals and drinks, overbookings, and maintenance delays and failures. Continental Airlines has an online system that alerts the company when planes arrive late and assesses whether connecting flights need to be delayed slightly for late-arriving passengers and carts sent to the gate to shorten the time it will take for passengers to reach their connecting flight. British Petroleum (BP) has outfitted rail cars carrying hazardous materials with sensors and global positioning system (GPS) devices so that it can track the status, location, and other information about these shipments via satellite and relay the data to its corporate intranet. Companies that rely on empowered customer-contact personnel to act promptly and creatively in pleasing customers have installed online information systems that put essential customer data on their computer monitors with a few keystrokes so that they can respond effectively to customer inquiries and deliver personalized customer service.

Statistical information gives managers a feel for the numbers, briefings and meetings provide a feel for the latest developments and emerging issues, and personal contacts add a feel for the people dimension. All are good barometers.

Managers have to identify problem areas and deviations from plan before they can take actions to get the organization back on course, by either improving the approaches to strategy execution or fine-tuning the strategy. Jeff Bezos, Amazon’s CEO, is an ardent proponent of managing by the numbers—as he puts it, “Math-based decisions always trump opinion and judgment. The trouble with most corporations is that they make judgment-based decisions when data-based decisions could be made.”

**Exercising Adequate Controls over Empowered Employees**

Another important aspect of effectively managing and controlling the strategy execution process is monitoring the performance of empowered workers to see that they are acting within the specified limits. Leaving empowered employees to their own devices in meeting performance standards without appropriate checks and balances can

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**Core Concept**

Having good information systems and operating data are integral to competent strategy execution and operating excellence.
Instances abound of employees’ decisions or behavior having gone awry, sometimes costing a company huge sums or producing lawsuits aside from just generating embarrassing publicity. Managers shouldn’t have to devote big chunks of their time to making sure that the decisions and behavior of empowered employees stay between the white lines—this would defeat the major purpose of empowerment and, in effect, lead to the reinstatement of a managerial bureaucracy engaged in constant over-the-shoulder supervision. Yet managers have a clear responsibility to exercise sufficient control over empowered employees to protect the company against out-of-bounds behavior and unwelcome surprises. Scrutinizing daily and weekly operating statistics is one of the important ways in which managers can monitor the results that flow from the actions of empowered subordinates—if the operating results flowing from the actions of empowered employees look good, then it is reasonable to assume that empowerment is working.

But close monitoring of real-time or daily operating performance is only one of the control tools at management’s disposal. Another valuable lever of control in companies that rely on empowered employees, especially in those that use self-managed work groups or other such teams, is peer-based control. Most team members feel responsible for the success of the whole team and tend to be relatively intolerant of any team member’s behavior that weakens team performance or puts team accomplishments at risk (especially when team performance has a big impact on each team member’s compensation). Because peer evaluation is such a powerful control device, companies organized into teams can remove some layers of the management hierarchy and rely on strong peer pressure to keep team members operating between the white lines. This is especially true when a company has the information systems capability to monitor team performance daily or in real time.

**TYING REWARDS AND INCENTIVES TO GOOD STRATEGY EXECUTION**

It is important for both organization units and individuals to be enthusiastically committed to executing strategy and achieving performance targets. Managers typically use an assortment of motivational techniques and rewards to enlist companywide commitment to executing the strategic plan. A manager has to do more than just talk to everyone about how important new strategic practices and performance targets are to the organization’s well-being. No matter how inspiring, talk seldom commands people’s best efforts for long. To get employees’ sustained, energetic commitment, management has to be resourceful in designing and using motivational incentives—both monetary and nonmonetary. The more a manager understands what motivates subordinates and the more he or she relies on motivational incentives as a tool for achieving the targeted strategic and financial results, the greater will be employees’ commitment to good day-in, day-out strategy execution and achievement of performance targets.

**Strategy-Facilitating Motivational Practices**

Financial incentives generally head the list of motivating tools for trying to gain whole-hearted employee commitment to good strategy execution and operating excellence. Monetary rewards generally include some combination of base pay increases, performance bonuses, profit-sharing plans, stock awards, company contributions to employee
• Providing attractive perks and fringe benefits—The various options here include full coverage of health insurance premiums; full tuition reimbursement for work on college degrees; paid vacation time of three or four weeks; on-site child care at major facilities; on-site gym facilities and massage therapists; getaway opportunities at company-owned recreational facilities (beach houses, ranches, resort condos); personal concierge services; subsidized cafeterias and free lunches; casual dress every day; personal travel services; paid sabbaticals; maternity leaves; paid leaves to care for ill family members; telecommuting; compressed workweeks (four 10-hour days instead of five 8-hour days); reduced summer hours; college scholarships for children; on-the-spot bonuses for exceptional performance; and relocation services.

• Relying on promotion from within whenever possible—This practice helps bind workers to their employer and employers to their workers; plus, it is an incentive for good performance. Promotion from within also helps ensure that people in positions of responsibility actually know something about the business, technology, and operations they are managing.

• Making sure that the ideas and suggestions of employees are valued and that those with merit are promptly acted on—Many companies find that their best ideas for nuts-and-bolts operating improvements come from the suggestions of employees. Moreover, research indicates that the moves of many companies to push decision making down the line and empower employees increases employee motivation and satisfaction, as well as boosting their productivity. The use of self-managed teams has much the same effect.

• Creating a work atmosphere in which there is genuine sincerity, caring, and mutual respect among workers and between management and employees—A “family” work environment in which people are on a first-name basis and there is strong camaraderie promotes teamwork and cross-unit collaboration.

• Stating the strategic vision in inspirational terms that make employees feel they are a part of doing something very worthwhile in a larger social sense—There’s strong motivating power associated with giving people a chance to be part of something exciting and personally satisfying. Jobs with noble purpose tend to turn employees on. At Pfizer, Merck, and most other pharmaceutical companies, it is the notion of helping sick people get well and restoring patients to full life. At Whole Foods Market (a natural foods grocery chain), it is helping customers discover good eating habits and thus improving human health and nutrition.

• Sharing information with employees about financial performance, strategy, operational measures, market conditions, and competitors’ actions—Broad disclosure and prompt communication send the message that managers trust
their workers. Keeping employees in the dark denies them information useful to performing their job, prevents them from being “students of the business,” and usually turns them off.

- **Having knockout facilities**—A workplace with appealing features and amenities usually has decidedly positive effects on employee morale and productivity.
- **Being flexible in how the company approaches people management (motivation, compensation, recognition, recruitment) in multinational, multicultural environments**—There is usually some merit in giving local managers in foreign operations to adapt their motivation, compensation, recognition, and recruitment practices to fit local customs, habits, values, and business practices rather than insisting on consistent people-management practices worldwide. But the one area where consistency is essential is conveying the message that the organization values people of all races and cultural backgrounds and that discrimination of any sort will not be tolerated.

For specific examples of the motivational tactics employed by several prominent companies (many of which appear on Fortune’s list of “The 100 Best Companies to Work for in America”), see Illustration Capsule 12.3.

**Striking the Right Balance between Rewards and Punishment**

While most approaches to motivation, compensation, and people management accentuate the positive, companies also embellish positive rewards with the risk of punishment. At General Electric, McKinsey & Company, several global public accounting firms, and other companies that look for and expect top-notch individual performance, there’s an “up-or-out” policy—managers and professionals whose performance is not good enough to warrant promotion are first denied bonuses and stock awards and eventually weeded out. A number of companies deliberately give employees heavy workloads and tight deadlines—personnel are pushed hard to achieve “stretch” objectives and expected to put in long hours (nights and weekends if need be). At most companies, senior executives and key personnel in underperforming units are pressured to outperform their job, prevent turnover, and expected to put in long hours (nights and weekends if need be). At most companies, senior executives and key personnel in underperforming units are pressured to

As a general rule, it is unwise to take off the pressure for good individual and group performance or play down the stress, anxiety, and adverse consequences of shortfalls in performance. There is no evidence that a no-pressure/no-adverse-consequences work environment leads to superior strategy execution or operating excellence. As the CEO of a major bank put it, “There’s a deliberate policy here to create a level of anxiety. Winners usually play like they’re one touchdown behind.”

High-performing organizations nearly always have a cadre of ambitious people who relish the opportunity to climb the ladder of success, love a challenge, thrive in a performance-oriented environment, and find some competition and pressure useful to satisfy their own drives for personal recognition, accomplishment, and self-satisfaction.

However, if an organization’s motivational approaches and reward structure induce too much stress, internal competitiveness, job insecurity, and unpleasant consequences, the impact on workforce morale and strategy execution can be counterproductive. Evidence shows that managerial initiatives to improve strategy execution should incorporate more positive than negative motivational elements because when cooperation is
Illustration Capsule 12.3

What Companies Do to Motivate and Reward Employees

Companies have come up with an impressive variety of motivational and reward practices to help create a work environment that energizes employees and promotes better strategy execution. Here’s a sampling of what companies are doing:

- Google has a sprawling four-building complex known as the Googleplex where the company’s roughly 1,000 employees are provided with free food, unlimited ice cream, pool and Ping-Pong tables, and complimentary massages—management built the Googleplex to be “a dream environment.” Moreover, the company gives its employees the ability to spend 20 percent of their work time on any outside activity.

- Lincoln Electric, widely known for its piecework pay scheme and incentive bonus plan, rewards individual productivity by paying workers for each nondefective piece produced. Workers have to correct quality problems on their own time—defects in products used by customers can be traced back to the worker who caused them. Lincoln’s piecework plan motivates workers to pay attention to both quality and volume produced. In addition, the company sets aside a substantial portion of its profits above a specified base for worker bonuses. To determine bonus size, Lincoln Electric rates each worker on four equally important performance measures: dependability, quality, output, and ideas and cooperation. The higher a worker’s merit rating, the higher the incentive bonus earned; the most highly rated workers in good profit years receive bonuses of as much as 110 percent of their piecework compensation.

- At JM Family Enterprises, a Toyota distributor in Florida, employees get a great lease on new Toyotas and are flown to the Bahamas for cruises on the 172-foot company yacht. The company’s office facility has such amenities as a heated lap pool, a fitness center, and a free nail salon. Employees get free prescriptions delivered by a “pharmacy concierge” and professionally made take-home dinners.

- Amazon.com hands out Just Do It awards to employees who do something they think will help Amazon without getting their boss’s permission. The action has to be well thought through but doesn’t have to succeed.

- Nordstrom, widely regarded for its superior in-house customer service experience, typically pays its retail salespeople an hourly wage higher than the prevailing rates paid by other department store chains plus a commission on each sale. Spurred by a culture that encourages salespeople to go all out to satisfy customers and to seek out and promote new fashion ideas, Nordstrom salespeople often earn twice the average incomes of sales employees at competing stores. Nordstrom’s rules for employees are simple: “Rule #1: Use your good judgment in all situations. There will be no additional rules.”

- At W. L. Gore (the maker of Gore-Tex), employees get to choose what project/team they work on and each team member’s compensation is based on other team members’ rankings of his or her contribution to the enterprise.

- At Ukrop’s Super Markets, a family-owned chain, stores stay closed on Sunday; the company pays out 20 percent of pretax profits to employees in the form of quarterly bonuses; and the company picks up the membership tab for employees if they visit their health club 30 times a quarter.

- At biotech leader Amgen, employees get 16 paid holidays, generous vacation time, tuition reimbursements up to $10,000, on-site massages, a discounted car wash, and the convenience of shopping at on-site farmers’ markets.

- At Synovus, a financial services and credit card company, the company adds as much as 20 percent annually to each employee’s compensation via a “wealth-building” program that includes a 401(k) and profit sharing; plus, it holds an annual bass fishing tournament.

- At specialty chipmaker Xilinx, new hires receive stock option grants; the CEO responds promptly to employee e-mails, and during hard times management takes a 20 percent pay cut instead of laying off employees.

positively enlisted and rewarded, rather than strong-armed by orders and threats (implicit or explicit), people tend to respond with more enthusiasm, dedication, creativity, and initiative. Something of a middle ground is generally optimal—not only handing out decidedly positive rewards for meeting or beating performance targets but also imposing sufficiently negative consequences (if only withholding rewards) when actual performance falls short of the target. But the negative consequences of underachievement should never be so severe or demoralizing as to impede a renewed and determined effort to overcome existing obstacles and hit the targets in upcoming periods.

**Linking the Reward System to Strategically Relevant Performance Outcomes**

The most dependable way to keep people focused on strategy execution and the achievement of performance targets is to generously reward and recognize individuals and groups who meet or beat performance targets and deny rewards and recognition to those who don’t. The use of incentives and rewards is the single most powerful tool management has to win strong employee commitment to diligent, competent strategy execution and operating excellence. Decisions on salary increases, incentive compensation, promotions, key assignments, and the ways and means of awarding praise and recognition are potent attention-getting, commitment-generating devices. Such decisions seldom escape the closest employee scrutiny, saying more about what is expected and who is considered to be doing a good job than about any other factor. Hence, when meeting or beating strategic and financial targets become the dominating basis for designing incentives, evaluating individual and group efforts, and handing out rewards, company personnel quickly grasp that it is in their own self-interest to do their best in executing the strategy competently and achieving key performance targets. Indeed, it is usually through the company’s system of incentives and rewards that workforce members emotionally ratify their commitment to the company’s strategy execution effort.

Ideally, performance targets should be set for every organization unit, every manager, every team or work group, and perhaps every employee—targets that measure whether strategy execution is progressing satisfactorily. If the company’s strategy is to be a low-cost provider, the incentive system must reward actions and achievements that result in lower costs. If the company has a differentiation strategy predicated on superior quality and service, the incentive system must reward such outcomes as Six Sigma defect rates, infrequent need for product repair, low numbers of customer complaints, speedy order processing and delivery, and high levels of customer satisfaction. If a company’s growth is predicated on a strategy of new product innovation, incentives should be tied to factors such as the percentages of revenues and profits coming from newly introduced products.

Illustration Capsule 12.4 provides two vivid examples of how companies have designed incentives linked directly to outcomes reflecting good strategy execution.

**The Importance of Basing Incentives on Achieving Results, Not on Performing Assigned Duties** To create a strategy-supportive system of rewards and incentives, a company must emphasize rewarding people for accomplishing results, not for just dutifully performing assigned tasks. Focusing jobholders’ attention and energy on what to achieve as opposed to what to do makes the work...
Illustration Capsule 12.4

Nucor and Bank One: Two Companies that Tie Incentives Directly to Strategy Execution

The strategy at Nucor Corporation, now the biggest steel producer in the United States, is to be the low-cost producer of steel products. Because labor costs are a significant fraction of total cost in the steel business, successful implementation of Nucor’s low-cost leadership strategy entails achieving lower labor costs per ton of steel than competitors’ costs. Nucor management uses an incentive system to promote high worker productivity and drive labor costs per ton below rivals. Each plant’s workforce is organized into production teams (each assigned to perform particular functions), and weekly production targets are established for each team. Base pay scales are set at levels comparable to wages for similar manufacturing jobs in the local areas where Nucor has plants, but workers can earn a 1 percent bonus for each 1 percent that their output exceeds target levels. If a production team exceeds its weekly production target by 10 percent, team members receive a 10 percent bonus in their next paycheck; if a team exceeds its quota by 20 percent, team members earn a 20 percent bonus. Bonuses, paid every two weeks, are based on the prior two weeks’ actual production levels measured against the targets.

Nucor’s piece-rate incentive plan has produced impressive results. The production teams put forth exceptional effort; it is not uncommon for most teams to beat their weekly production targets anywhere from 20 to 50 percent. When added to their base pay, the bonuses earned by Nucor workers make Nucor’s workforce among the highest-paid in the U.S. steel industry. From a management perspective, the incentive system has resulted in Nucor having labor productivity levels 10 to 20 percent above the average of the unionized workforces at several of its largest rivals, which in turn has given Nucor a significant labor cost advantage over most rivals.

At Bank One (recently acquired by JP Morgan Chase), management believed it was strategically important to boost its customer satisfaction ratings in order to enhance its competitiveness vis-à-vis rivals. Targets were set for customer satisfaction and monitoring systems for measuring customer satisfaction at each branch office were put in place. Then, to motivate branch office personnel to be more attentive in trying to please customers and also to signal that top management was truly committed to achieving higher levels of overall customer satisfaction, top management opted to tie pay scales in each branch office to that branch’s customer satisfaction rating—the higher the branch’s ratings, the higher that branch’s pay scales. Management believed its shift from a theme of equal pay for equal work to one of equal pay for equal performance contributed significantly to its customer satisfaction priority.

It is folly to reward one outcome in hopes of getting another outcome.
the number and extent of work stoppages due to labor disagreements and equipment breakdowns, and so on. In sales and marketing, there may be incentives for achieving dollar sales or unit volume targets, market share, sales penetration of each target customer group, the fate of newly introduced products, the frequency of customer complaints, the number of new accounts acquired, and customer satisfaction. Which performance measures to base incentive compensation on depends on the situation—the priority placed on various financial and strategic objectives, the requirements for strategic and competitive success, and what specific results are needed in different facets of the business to keep strategy execution on track.

**Guidelines for Designing Incentive Compensation Systems** The concepts and company experiences discussed above yield the following prescriptive guidelines for creating an incentive compensation system to help drive successful strategy execution:

1. **Make the performance payoff a major, not minor, piece of the total compensation package.** Payoffs must be at least 10 to 12 percent of base salary to have much impact. Incentives that amount to 20 percent or more of total compensation are big attention-getters, likely to really drive individual or team effort; incentives amounting to less than 5 percent of total compensation have comparatively weak motivational impact. Moreover, the payoff for high-performing individuals and teams must be meaningfully greater than the payoff for average performers, and the payoff for average performers meaningfully bigger than for below-average performers.

2. **Have incentives that extend to all managers and all workers, not just top management.** It is a gross miscalculation to expect that lower-level managers and employees will work their hardest to hit performance targets just so a few senior executives can get lucrative rewards.

3. **Administer the reward system with scrupulous objectivity and fairness.** If performance standards are set unrealistically high or if individual/group performance evaluations are not accurate and well documented, dissatisfaction with the system will overcome any positive benefits.

4. **Tie incentives to performance outcomes directly linked to good strategy execution and financial performance.** Incentives should never be paid just because people are thought to be “doing a good job” or because they “work hard.” Performance evaluation based on factors not tightly related to good strategy execution signal that either the strategic plan is incomplete (because important performance targets were left out) or management’s real agenda is something other than the stated strategic and financial objectives.

5. **Make sure that the performance targets each individual or team is expected to achieve involve outcomes that the individual or team can personally affect.** The role of incentives is to enhance individual commitment and channel behavior in beneficial directions. This role is not well served when the performance measures by which company personnel are judged are outside their arena of influence.

6. **Keep the time between achieving the target performance outcome and the payment of the reward as short as possible.** Companies like Nucor and Continental Airlines have discovered that weekly or monthly payments for good performance work much better than annual payments. Nucor pays weekly bonuses based on
prior-week production levels; Continental awards employees a monthly bonus for each month that on-time flight performance meets or beats a specified percentage companywide. Annual bonus payouts work best for higher-level managers and for situations where target outcome relates to overall company profitability or stock price performance.

7. **Make liberal use of nonmonetary rewards; don’t rely solely on monetary rewards.** When used properly, money is a great motivator, but there are also potent advantages to be gained from praise, special recognition, handing out plum assignments, and so on.

8. **Absolutely avoid skirting the system to find ways to reward effort rather than results.** Whenever actual performance falls short of targeted performance, there’s merit in determining whether the causes are attributable to subpar individual/group performance or to circumstances beyond the control of those responsible. An argument can be made that exceptions should be made in giving rewards to people who’ve tried hard, gone the extra mile, yet still come up short because of circumstances beyond their control. The problem with making exceptions for unknowable, uncontrollable, or unforeseeable circumstances is that once good excuses start to creep into justifying rewards for subpar results, the door is open for all kinds of reasons why actual performance failed to match targeted performance. A “no excuses” standard is more evenhanded and certainly easier to administer.

Once the incentives are designed, they have to be communicated and explained. Everybody needs to understand how their incentive compensation is calculated and how individual/group performance targets contribute to organizational performance targets. The pressure to achieve the targeted strategic and financial performance and continuously improve on strategy execution should be unrelenting, with few (if any) loopholes for rewarding shortfalls in performance. People at all levels have to be held accountable for carrying out their assigned parts of the strategic plan, and they have to understand their rewards are based on the caliber of results that are achieved. But with the pressure to perform should come meaningful rewards. Without an ample payoff, the system breaks down, and managers are left with the less workable options of barking orders, trying to enforce compliance, and depending on the goodwill of employees.

**Performance-Based Incentives and Rewards in Multinational Enterprises** In some foreign countries, incentive pay runs counter to local customs and cultural norms. Professor Steven Kerr cites the time he lectured an executive education class on the need for more performance-based pay and a Japanese manager protested, “You shouldn’t bribe your children to do their homework, you shouldn’t bribe your wife to prepare dinner, and you shouldn’t bribe your employees to work for the company.”

Singling out individuals and commending them for unusually good effort can also be a problem; Japanese culture considers public praise of an individual an affront to the harmony of the group. In some countries, employees have a preference for nonmonetary rewards—more leisure time, important titles, access to vacation villages, and nontaxable perks. Thus, multinational companies have to build some degree of flexibility into the design of incentives and rewards in order to accommodate cross-cultural traditions and preferences.
Managers implementing and executing a new or different strategy must identify the resource requirements of each new strategic initiative and then consider whether the current pattern of resource allocation and the budgets of the various subunits are suitable.

Anytime a company alters its strategy, managers should review existing policies and operating procedures, proactively revise or discard those that are out of sync, and formulate new ones to facilitate execution of new strategic initiatives. Prescribing new or freshly revised policies and operating procedures aids the task of strategy execution (1) by providing top-down guidance to operating managers, supervisory personnel, and employees regarding how certain things need to be done and what the boundaries are on independent actions and decisions; (2) by enforcing consistency in how particular strategy-critical activities are performed in geographically scattered operating units; and (3) by promoting the creation of a work climate and corporate culture that promotes good strategy execution.

Competent strategy execution entails visible, unyielding managerial commitment to best practices and continuous improvement. Benchmarking, the discovery and adoption of best practices, reengineering core business processes, and continuous improvement initiatives like total quality management (TQM) or Six Sigma programs, all aim at improved efficiency, lower costs, better product quality, and greater customer satisfaction. These initiatives are important tools for learning how to execute a strategy more proficiently.

Company strategies can’t be implemented or executed well without a number of support systems to carry on business operations. Well-conceived state-of-the-art support systems not only facilitate better strategy execution but also strengthen organizational capabilities enough to provide a competitive edge over rivals. Real-time information and control systems further aid the cause of good strategy execution.

Strategy-supportive motivational practices and reward systems are powerful management tools for gaining employee commitment. The key to creating a reward system that promotes good strategy execution is to make strategically relevant measures of performance the dominating basis for designing incentives, evaluating individual and group efforts, and handing out rewards. Positive motivational practices generally work better than negative ones, but there is a place for both. There’s also a place for both monetary and nonmonetary incentives.

For an incentive compensation system to work well (1) the monetary payoff should be a major percentage of the compensation package, (2) the use of incentives should extend to all managers and workers, (3) the system should be administered with care and fairness, (4) the incentives should be linked to performance targets spelled out in the strategic plan, (5) each individual’s performance targets should involve outcomes the person can personally affect, (6) rewards should promptly follow the determination of good performance, (7) monetary rewards should be supplemented with liberal use of nonmonetary rewards, and (8) skirting the system to reward nonperformers or subpar results should be scrupulously avoided. Companies with operations in multiple countries often have to build some degree of flexibility into the design of incentives and rewards in order to accommodate cross-cultural traditions and preferences.
Exercises

1. Go to Google or another Internet search engine and, using the advanced search feature, enter “best practices.” Browse through the search results to identify at least five organizations that have gathered a set of best practices and are making the best-practice library they have assembled available to members. Explore at least one of the sites to get an idea of the kind of best-practice information that is available.

2. Do an Internet search on “Six Sigma” quality programs. Browse through the search results and (a) identify at least three companies that offer Six Sigma training and (b) find lists of companies that have implemented Six Sigma programs in their pursuit of operational excellence—you should be able to cite at least 25 companies that are Six Sigma users. Prepare a one-page report to your instructor detailing the experiences and benefits that one company has realized from employing Six Sigma methods in its operations. To learn more about how Six Sigma works, go to www.isixsigma.com and explore the Q&A menu option.

3. Do an Internet search on “total quality management.” Browse through the search results and (a) identify 10 companies that offer TQM training, (b) identify 5 books on TQM programs, and (c) find lists of companies that have implemented TQM programs in their pursuit of operational excellence—you should be able to name at least 20 companies that are TQM users.

4. Consult the latest issue of Fortune containing the annual “100 Best Companies to Work For” (usually a late-January or early-February issue, or else use a search engine to locate the list online) and identify at least five compensation incentives and work practices that these companies use to enhance employee motivation and reward them for good strategic and financial performance. Choose compensation methods and work practices that are different from those cited in Illustration Capsule 12.3.

5. Review the profiles and applications of the latest Malcolm Baldrige National Quality Award recipients at www.quality.nist.gov. What are the standout features of the companies’ approaches to managing operations? What do you find impressive about the companies’ policies and procedures, use of best practices, emphasis on continuous improvement, and use of rewards and incentives?

6. Using Google Scholar or your access to online business periodicals in your university’s library, search for the term “incentive compensation” and prepare a report of one to two pages to your instructor discussing the successful (or unsuccessful) use of incentive compensation plans by various companies. According to your research, what factors seem to determine whether incentive compensation plans succeed or fail?
The biggest levers you’ve got to change a company are strategy, structure, and culture. If I could pick two, I’d pick strategy and culture.

—Wayne Leonard
CEO, Entergy

An organization’s capacity to execute its strategy depends on its “hard” infrastructure—its organizational structure and systems—and on its “soft” infrastructure—its culture and norms.

—Amar Bhide

Weak leadership can wreck the soundest strategy; forceful execution of even a poor plan can often bring victory.

—Sun Zi

Leadership is accomplishing something through other people that wouldn’t have happened if you weren’t there. . . . Leadership is being able to mobilize ideas and values that energize other people. . . . Leaders develop a story line that engages other people.

—Noel Tichy

Seeing people in person is a big part of how you drive any change process. You have to show people a positive view of the future and say “we can do it.”

—Jeffrey R. Immelt
CEO, General Electric
In the previous two chapters we examined six of the managerial tasks important to good strategy execution and operating excellence—building a capable organization, marshaling the needed resources and steering them to strategy-critical operating units, establishing policies and procedures that facilitate good strategy execution, adopting best practices and pushing for continuous improvement in how value chain activities are performed, creating internal operating systems that enable better execution, and employing motivational practices and compensation incentives that gain wholehearted employee commitment to the strategy execution process. In this chapter we explore the two remaining managerial tasks that shape the outcome of efforts to execute a company’s strategy: creating a strategy-supportive corporate culture and exerting the internal leadership needed to drive the implementation of strategic initiatives forward and achieve higher plateaus of operating excellence.

INSTILLING A CORPORATE CULTURE THAT PROMOTES GOOD STRATEGY EXECUTION

Every company has its own unique culture. The character of a company’s culture or work climate is a product of the core values and business principles that executives espouse, the standards of what is ethically acceptable and what is not, the work practices and behaviors that define “how we do things around here,” the approach to people management and style of operating, the “chemistry” and the “personality” that permeates the work environment, and the stories that get told over and over to illustrate and reinforce the company’s values, business practices, and traditions. The meshing together of stated beliefs, business principles, styles of operating, ingrained behaviors and attitudes, and work climate define a company’s corporate culture. A company’s culture is important because it influences the organization’s actions and approaches to conducting business—in a very real sense, the culture is the company’s “operating system” or organizational DNA.

The psyche of corporate cultures varies widely. For instance, the bedrock of Wal-Mart’s culture is dedication to customer satisfaction, zealous pursuit of low costs and frugal operating practices, a strong work ethic, ritualistic Saturday-morning head quarters meetings to exchange ideas and review problems, and company executives’ commitment to visiting stores, listening to customers, and soliciting suggestions from customers.
employees. General Electric’s culture is founded on a hard-driving, results-oriented atmosphere (where all of the company’s business divisions are held to a standard of being number one or two in their industries as well as achieving good business results); extensive cross-business sharing of ideas, best practices, and learning; the reliance on “workout sessions” to identify, debate, and resolve burning issues; a commitment to Six Sigma quality; and globalization of the company. At Occidental Petroleum, the culture is grounded in entrepreneurship on the part of employees; the company’s empowered employees are encouraged to be innovative, excel in their fields of specialization, respond quickly to strategic opportunities, and creatively apply state-of-the-art technology in a manner that promotes operating excellence and sets Occidental apart from its competitors. At Nordstrom, the corporate culture is centered on delivering exceptional service to customers; the company’s motto is “Respond to unreasonable customer requests”—each out-of-the-ordinary request is seen as an opportunity for a “heroic” act by an employee that can further the company’s reputation for a customer-pleasing shopping environment. Nordstrom makes a point of promoting employees noted for their heroic acts and dedication to outstanding service; the company motivates its salespeople with a commission-based compensation system that enables Nordstrom’s best salespeople to earn more than double what other department stores pay.

Illustration Capsule 13.1 relates how Google and Alberto-Culver describe their corporate cultures.

**Identifying the Key Features of a Company’s Corporate Culture**

A company’s corporate culture is mirrored in the character or “personality” of its work environment—the factors that underlie how the company tries to conduct its business and the behaviors that are held in high esteem. The chief things to look for include the following:

- **The values, business principles, and ethical standards that management preaches and practices.** Actions speak much louder than words here.
- **The company’s approach to people management** and the official policies, procedures, and operating practices that paint the white lines for the behavior of company personnel.
- **The spirit and character that pervade the work climate.** Is the workplace vibrant and fun, methodical and all-business, tense and harried, or highly competitive and politicized? Are people excited about their work and emotionally connected to the company’s business or are they just there to draw a paycheck? Is there an emphasis on empowered worker creativity or do people have little discretion in how jobs are done?
- **How managers and employees interact and relate to each other.** How much reliance is there on teamwork and open communication? To what extent is there good camaraderie? Are people called by their first names? Do co-workers spend little or lots of time together outside the workplace? What are the dress codes (the accepted styles of attire and whether there are casual days)?
- **The strength of peer pressure to do things in particular ways and conform to expected norms.** What actions and behaviors are approved (and rewarded by management in the form of compensation and promotion) and which ones are frowned on?
Chapter 13  Corporate Culture and Leadership

Illustration Capsule 13.1

The Corporate Cultures at Google and Alberto-Culver

GOOGLE

Founded in 1998 by Larry Page and Sergey Brin, two Ph.D. students in computer science at Stanford University, Google has become world-renowned for its search engine technology. Google.com is one of the five most popular sites on the Internet, attracting over 380 million unique visitors monthly from around the world. Google has some unique ways of operating, and its culture is rather quirky. The company describes its culture as follows:

Though growing rapidly, Google still maintains a small company feel. At the Googleplex headquarters almost everyone eats in the Google cafe (known as “Charlie’s Place”), sitting at whatever table has an opening and enjoying conversations with Googlers from all different departments. Topics range from the trivial to the technical, and whether the discussion is about computer games or encryption or ad serving software, it’s not surprising to hear someone say, “That’s a product I helped develop before I came to Google.”

Google’s emphasis on innovation and commitment to cost containment means each employee is a hands-on contributor. There’s little in the way of corporate hierarchy and everyone wears several hats. The international webmaster who creates Google’s holiday logos spent a week translating the entire site into Korean. The chief operations engineer is also a licensed neurosurgeon. Because everyone realizes they are an equally important part of Google’s success, no one hesitates to skate over a corporate officer during roller hockey.

Google’s hiring policy is aggressively non-discriminatory and favors ability over experience. The result is a staff that reflects the global audience the search engine serves. Google has offices around the globe and Google engineering centers are recruiting local talent in locations from Zurich to Bangalore. Dozens of languages are spoken by Google staffers, from Turkish to Telugu. When not at work, Googlers pursue interests from cross-country cycling to wine tasting, from flying to Frisbee. As Google expands its development team, it continues to look for those who share an obsessive commitment to creating search perfection and having a great time doing it.

ALBERTO-CULVER

The Alberto-Culver Company, with fiscal 2005 revenues of about $3.5 billion, is the producer and marketer of Alberto VO5, TRESemmé, Consort, and Just for Me hair care products; St. Ives skin care, hair care, and facial care products; and such brands as Molly McButter, Mrs. Dash, Sugar Twin, and Static Guard. Alberto-Culver brands are sold in 120 countries. Its Sally Beauty Company, with over 3,250 stores and 1,250 professional sales consultants, is the largest marketer of professional beauty care products in the world.

At the careers section of its Web site, the company described its culture in the following words:

Building careers is as important to us as building brands. We believe that passionate people create powerful growth. We believe in a workplace built on values and believe our best people display those same values in their families and their communities. We believe in recognizing and rewarding accomplishment and celebrating our victories.

We believe the best ideas work their way—quickly—up an organization, not down. We believe that we should take advantage of every ounce of your talent on teams and cross-functional activities, not just assign you to a box.

We believe in open communication. We believe that you can improve what you measure, so we survey and spot check all the time. For that same reason, everyone has specific goals so that their expectations are in line with their managers’ and the company’s.

We believe that victory is a team accomplishment. We believe in personal development. We believe if you talk with us you will catch our enthusiasm and want to be a part of the Alberto-Culver team.


- The company’s revered traditions and oft-repeated stories. Do people talk a lot about “heroic acts” and “how we do things around here”?
- The manner in which the company deals with external stakeholders (particularly vendors and local communities where it has operations). Does it treat
suppliers as business partners or does it prefer hardnosed, arm’s-length business arrangements? How strong and genuine is its commitment to corporate citizenship?

Some of these sociological forces are readily apparent, and others operate quite subtly. The values, beliefs, and practices that undergird a company’s culture can come from anywhere in the organization hierarchy, most often representing the business philosophy and managerial style of influential executives but also resulting from exemplary actions on the part of company personnel and consensus agreement about “how we ought to do things around here.” Typically, key elements of the culture originate with a founder or certain strong leaders who articulated them as a set of business principles, company policies, operating approaches, and ways of dealing with employees, customers, vendors, shareholders, and local communities where the company has operations. Over time, these cultural underpinnings take root, become embedded in how the company conducts its business, come to be accepted by company managers and employees alike, and then persist as new employees are encouraged to adopt and follow the professed values, behaviors, and work practices.

The Role of Stories

Frequently, a significant part of a company’s culture is captured in the stories that get told over and over again to illustrate to newcomers the importance of certain values and the depth of commitment that various company personnel have displayed. One of the folktales at FedEx, world renowned for the reliability of its next-day package delivery guarantee, is about a deliveryman who had been given the wrong key to a FedEx drop box. Rather than leave the packages in the drop box until the next day when the right key was available, the deliveryman unbolted the drop box from its base, loaded it into the truck, and took it back to the station. There, the box was pried open and the contents removed and sped on their way to their destination the next day. Nordstrom keeps a scrapbook commemorating the heroic acts of its employees and uses it as a regular reminder of the beyond-the-call-of-duty behaviors that employees are encouraged to display. At Frito-Lay, there are dozens of stories about truck drivers who went to extraordinary lengths in overcoming adverse weather conditions in order to make scheduled deliveries to retail customers and keep store shelves stocked with Frito-Lay products. At Microsoft, there are stories of the long hours programmers put in, the emotional peaks and valleys in encountering and overcoming coding problems, the exhilaration of completing a complex program on schedule, the satisfaction of working on cutting-edge projects, the rewards of being part of a team responsible for a popular new software program, and the tradition of competing aggressively. Such stories serve the valuable purpose of illustrating the kinds of behavior the company encourages and reveres. Moreover, each retelling of a legendary story puts a bit more peer pressure on company personnel to display core values and do their part in keeping the company’s traditions alive.

Perpetuating the Culture

Once established, company cultures are perpetuated in six important ways: (1) by screening and selecting new employees that will mesh well with the culture, (2) by systematic indoctrination of new members in the culture’s fundamentals, (3) by the efforts of senior group members to reiterate core values in daily conversations and pronouncements, (4) by the telling and retelling of company legends, (5) by regular ceremonies honoring members who display desired cultural behaviors, and (6) by visibly rewarding those who display cultural norms and penalizing those who don’t. The more new employees a company is hiring, the more important it becomes to screen job applicants every bit as much for how well their values, beliefs, and personalities match up with the culture as for their technical skills and experience.
For example, a company that stresses operating with integrity and fairness has to hire people who themselves have integrity and place a high value on fair play. A company whose culture revolves around creativity, product innovation, and leading change has to screen new hires for their ability to think outside the box, generate new ideas, and thrive in a climate of rapid change and ambiguity. Southwest Airlines—whose two core values, “LUV” and fun, permeate the work environment and whose objective is to ensure that passengers have a positive and enjoyable flying experience—goes to considerable lengths to hire flight attendants and gate personnel who are witty, cheery, and outgoing and who display whistle-while-you-work attitudes. Fast-growing companies risk creating a culture by chance rather than by design if they rush to hire employees mainly for their talents and credentials and neglect to screen out candidates whose values, philosophies, and personalities aren’t a good fit with the organizational character, vision, and strategy being articulated by the company’s senior executives.

As a rule, companies are attentive to the task of hiring people who will fit in and who will embrace the prevailing culture. And, usually, job seekers lean toward accepting jobs at companies where they feel comfortable with the atmosphere and the people they will be working with. Employees who don’t hit it off at a company tend to leave quickly, while employees who thrive and are pleased with the work environment stay on, eventually moving up the ranks to positions of greater responsibility. The longer people stay at an organization, the more they come to embrace and mirror the corporate culture—their values and beliefs tend to be molded by mentors, fellow workers, company training programs, and the reward structure. Normally, employees who have worked at a company for a long time play a major role in indoctrinating new employees into the culture.

**Forces That Cause a Company’s Culture to Evolve**

However, even stable cultures aren’t static; just like strategy and organization structure, they evolve. New challenges in the marketplace, revolutionary technologies, and shifting internal conditions—especially eroding business prospects, an internal crisis, or top executive turnover—tend to breed new ways of doing things and, in turn, cultural evolution. An incoming CEO who decides to shake up the existing business and take it in new directions often triggers a cultural shift, perhaps one of major proportions. Likewise, diversification into new businesses, expansion into foreign countries, rapid growth, an influx of new employees, and merger with or acquisition of another company can all precipitate cultural changes of one kind or another.

**Company Subcultures: The Problems Posed by New Acquisitions and Multinational Operations**

Although it is common to speak about corporate culture in the singular, it is not uncommon for companies to have multiple cultures (or subcultures).4 Values, beliefs, and practices within a company sometimes vary significantly by department, geographic location, division, or business unit. A company’s subcultures can clash, or at least not mesh well, if they embrace conflicting business philosophies or operating approaches, if key executives employ different approaches to people management, or if important differences between a company’s culture and those of recently acquired companies have not yet been ironed out. Global and multinational companies tend to be at least partly multicultural because cross-country organization units have different operating histories and work climates, as well as members who have grown up under different social customs and traditions and who have different sets of values and beliefs. The human resources manager of a global pharmaceutical company who took on an assignment in the Far East discovered, to his surprise, that one of his biggest challenges was to persuade his company’s managers in China,
Korea, Malaysia, and Taiwan to accept promotions—their cultural values were such that they did not believe in competing with their peers for career rewards or personal gain, nor did they relish breaking ties to their local communities to assume cross-national responsibilities. Many companies that have merged with or acquired foreign companies have to deal with language- and custom-based cultural differences. Nonetheless, the existence of subcultures does not preclude important areas of commonality and compatibility. For example, General Electric’s cultural traits of boundarylessness, workout, and Six Sigma quality can be implanted and practiced successfully in different countries. AES, a global power company with operations in over 25 countries, has found that the four core values of integrity, fairness, fun, and social responsibility underlying its culture are readily embraced by people in most countries. Moreover, AES tries to define and practice its cultural values the same way in all of its locations while still being sensitive to differences that exist among various people groups across the world; top managers at AES express the views that people across the world are more similar than different and that the company’s culture is as meaningful in Buenos Aires or Kazakhstan as in Virginia.

In today’s globalizing world, multinational companies are learning how to make strategy-critical cultural traits travel across country boundaries and create a workably uniform culture worldwide. Likewise, company managements are quite alert to the importance of cultural compatibility in making acquisitions and the need to address how to merge and integrate the cultures of newly acquired companies—cultural due diligence is often as important as financial due diligence in deciding whether to go forward on an acquisition or merger. On a number of occasions, companies have decided to pass on acquiring particular companies because of culture conflicts that they believed would be hard to resolve.

**Strong versus Weak Cultures**

Company cultures vary widely in strength and influence. Some are strongly embedded and have a big impact on a company’s practices and behavioral norms. Others are weak and have comparatively little influence on company operations.

**Strong-Culture Companies** The hallmark of a strong-culture company is the dominating presence of certain deeply rooted values and operating approaches that “regulate” the conduct of a company’s business and the climate of its workplace. Strong cultures emerge over a period of years (sometimes decades) and are never an overnight phenomenon. In strong culture companies, senior managers make a point of reiterating these principles and values to organization members and explaining how they relate to its business environment. But, more important, they make a conscious effort to display these principles in their own actions and behavior—they walk the talk, and they insist that company values and business principles be reflected in the decisions and actions taken by all company personnel. An unequivocal expectation that company personnel will act and behave in accordance with the adopted values and ways of doing business leads to two important outcomes: (1) Over time, the values come to be widely shared by rank-and-file employees—people who dislike the culture tend to leave—and (2) individuals encounter strong peer pressure from co-workers to observe the culturally approved norms and behaviors. Hence, a strongly implanted corporate culture ends up having a powerful influence on “how we...
do things around here” because so many company personnel are accepting of cultural traditions and because this acceptance is reinforced both by management expectations and co-worker peer pressure to conform to cultural norms. Since cultural traditions and norms have such a dominating influence in strong-culture companies, the character of the culture becomes the company’s soul or psyche.

Three factors contribute to the development of strong cultures: (1) a founder or strong leader who establishes values, principles, and practices that are consistent and sensible in light of customer needs, competitive conditions, and strategic requirements; (2) a sincere, long-standing company commitment to operating the business according to these established traditions, thereby creating an internal environment that supports decision making and strategies based on cultural norms; and (3) a genuine concern for the well-being of the organization’s three biggest constituencies—customers, employees, and shareholders. Continuity of leadership, small group size, stable group membership, geographic concentration, and considerable organizational success all contribute to the emergence and sustainability of a strong culture.7

During the time a strong culture is being implanted, there’s nearly always a good strategy–culture fit (which partially accounts for the organization’s success). Mismatches between strategy and culture in a strong-culture company tend to occur when a company’s business environment undergoes significant change, prompting a drastic strategy revision that clashes with the entrenched culture. A strategy–culture clash can also occur in a strong-culture company whose business has gradually eroded; when a new leader is brought in to revitalize the company’s operations, he or she may push the company in a strategic direction that requires substantially different cultural and behavioral norms. In such cases, a major culture-changing effort has to be launched.

In strong-culture companies, values and behavioral norms are so ingrained that they can endure leadership changes at the top—although their strength can erode over time if new CEOs cease to nurture them or move aggressively to institute cultural adjustments. And the cultural norms in a strong-culture company may not change much as strategy evolves and the organization acts to make strategy adjustments, either because the new strategies are compatible with the present culture or because the dominant traits of the culture are somewhat strategy-neutral and compatible with evolving versions of the company’s strategy.

Weak-Culture Companies In direct contrast to strong-culture companies, weak-culture companies lack values and principles that are consistently preached or widely shared (usually because the company has had a series of CEOs with differing values and differing views about how the company’s business ought to be conducted). As a consequence, the company has few widely revered traditions and few culture-induced norms are evident in operating practices. Because top executives at a weak-culture company don’t repeatedly espouse any particular business philosophy, exhibit long-standing commitment to particular values, or extol particular operating practices and behavioral norms, individuals encounter little co-worker peer pressure to do things in particular ways. Moreover, a weak company culture breeds no strong employee allegiance to what the company stands for or to operating the business in well-defined ways. While individual employees may well have some bonds of identification with and loyalty toward their department, their colleagues, their union, or their boss, there is neither passion about the company nor emotional commitment to what it is trying to accomplish—a condition that often results in many employees viewing
their company as just a place to work and their job as just a way to make a living. Very often, cultural weakness stems from moderately entrenched subcultures that block the emergence of a well-defined companywide work climate.

As a consequence, weak cultures provide little or no assistance in executing strategy because there are no traditions, beliefs, values, common bonds, or behavioral norms that management can use as levers to mobilize commitment to executing the chosen strategy. The only plus of a weak culture is that it does not usually pose a strong barrier to strategy execution, but the negative of not providing any support means that culture-building has to be high on management’s action agenda. Absent a work climate that channels organizational energy in the direction of good strategy execution, managers are left with the options of either using compensation incentives and other motivational devices to mobilize employee commitment or trying to establish cultural roots that will in time start to nurture the strategy execution process.

**Unhealthy Cultures**

The distinctive characteristic of an unhealthy corporate culture is the presence of counterproductive cultural traits that adversely impact the work climate and company performance. The following four traits are particularly unhealthy:

1. A highly politicized internal environment in which many issues get resolved and decisions made on the basis of which individuals or groups have the most political clout to carry the day.

2. Hostility to change and a general wariness of people who champion new ways of doing things.

3. An insular “not-invented-here” mind-set that makes company personnel averse to looking outside the company for best practices, new managerial approaches, and innovative ideas.

4. A disregard for high ethical standards and overzealous pursuit of wealth and status on the part of key executives.

**Politicized Cultures** What makes a politicized internal environment so unhealthy is that political infighting consumes a great deal of organizational energy, often with the result that what’s best for the company takes a backseat to political maneuvering. In companies where internal politics pervades the work climate, empire-building managers jealously guard their decision-making prerogatives. They have their own agendas and operate the work units under their supervision as autonomous “fiefdoms,” and the positions they take on issues is usually aimed at protecting or expanding their turf. Collaboration with other organizational units is viewed with suspicion (What are “they” up to? How can “we” protect “our” flanks?), and cross-unit cooperation occurs grudgingly. When an important proposal moves to the front burner, advocates try to ram it through and opponents try to alter it in significant ways or else kill it altogether. The support or opposition of politically influential executives and/or coalitions among departments with vested interests in a particular outcome typically weigh heavily in deciding what actions the company takes. All this maneuvering takes away from efforts to execute strategy with real proficiency and frustrates company personnel who are less political and more inclined to do what is in the company’s best interests.

**Change-Resistant Cultures** In less-adaptive cultures where skepticism about the importance of new developments and resistance to change are the norm, managers
prefer waiting until the fog of uncertainty clears before steering a new course, making fundamental adjustments to their product line, or embracing a major new technology. They believe in moving cautiously and conservatively, preferring to follow others rather than taking decisive action to be in the forefront of change. Change-resistant cultures place a premium on not making mistakes, prompting managers to lean toward safe, don’t-rock-the-boat options that will have only a ripple effect on the status quo, protect or advance their own careers, and guard the interests of their immediate work groups.

Change-resistant cultures encourage a number of undesirable or unhealthy behaviors—avoiding risks, not making bold proposals to pursue emerging opportunities, a lax approach to both product innovation and continuous improvement in performing value chain activities, and following rather than leading market change. In change-resistant cultures, word quickly gets around that proposals to do things differently face an uphill battle and that people who champion them may be seen as either something of a nuisance or a troublemaker. Executives who don’t value managers or employees with initiative and new ideas put a damper on product innovation, experimentation, and efforts to improve. At the same time, change-resistant companies have little appetite for being first-movers or fast-followers, believing that being in the forefront of change is too risky and that acting too quickly increases vulnerability to costly mistakes. They are more inclined to adopt a wait-and-see posture, carefully analyze several alternative responses, learn from the missteps of early movers, and then move forward cautiously and conservatively with initiatives that are deemed safe. Hostility to change is most often found in companies with multilayered management bureaucracies that have enjoyed considerable market success in years past and that are wedded to the “We have done it this way for years” syndrome.

When such companies encounter business environments with accelerating change, going slow on altering traditional ways of doing things can become a liability rather than an asset. General Motors, IBM, Sears, and Eastman Kodak are classic examples of companies whose change-resistant bureaucracies were slow to respond to fundamental changes in their markets; clinging to the cultures and traditions that made them successful, they were reluctant to alter operating practices and modify their business approaches. As strategies of gradual change won out over bold innovation and being an early mover, all four lost market share to rivals that quickly moved to institute changes more in tune with evolving market conditions and buyer preferences. These companies are now struggling to recoup lost ground with cultures and behaviors more suited to market success—the kinds of fit that caused them to succeed in the first place.

Insular, Inwardly Focused Cultures Sometimes a company reigns as an industry leader or enjoys great market success for so long that its personnel start to believe they have all the answers or can develop them on their own. There is a strong tendency to neglect what customers are saying and how their needs and expectations are changing. Such confidence in the correctness of how it does things and in the company’s skills and capabilities breeds arrogance—company personnel discount the merits of what outsiders are doing and what can be learned by studying best-in-class performers. Benchmarking and a search for the best practices of outsiders are seen as offering little payoff. Any market share gains on the part of up-and-coming rivals are regarded as temporary setbacks, soon to be reversed by the company’s own forthcoming initiatives (which, it is confidently predicted, will be an instant market hit with customers).

Insular thinking, internally driven solutions, and a must-be-invented-here mindset come to permeate the corporate culture. An inwardly focused corporate culture
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gives rise to managerial inbreeding and a failure to recruit people who can offer fresh thinking and outside perspectives. The big risk of insular cultural thinking is that the company can underestimate the competencies and accomplishments of rival companies and overestimate its own progress—with a resulting loss of competitive advantage over time.

Unethical and Greed-Driven Cultures Companies that have little regard for ethical standards or that are run by executives driven by greed and ego gratification are scandals waiting to happen. Enron’s collapse in 2001 was largely the product of an ethically dysfunctional corporate culture—while the culture embraced the positives of product innovation, aggressive risk taking, and a driving ambition to lead global change in the energy business, its executives exuded the negatives of arrogance, ego, greed, and an ends-justify-the-means mentality in pursuing stretched revenue and profitability targets. A number of Enron’s senior managers were all too willing to wink at unethical behavior, to cross over the line to unethical (and sometimes criminal) behavior themselves, and to deliberately stretch generally accepted accounting principles to make Enron’s financial performance look far better than it really was. In the end, Enron came unglued because a few top executives chose unethical and illegal paths to pursue corporate revenue and profitability targets—in a company that publicly preached integrity and other notable corporate values but was lax in making sure that key executives walked the talk. Unethical cultures and executive greed have also produced scandals at WorldCom, Qwest, HealthSouth, Adelphia, Tyco, McWane, Parmalat, Rite Aid, Hollinger International, Refco, and Marsh & McLennan, with executives being indicted and/or convicted of criminal behavior. The U.S. Attorney’s office elected not to prosecute the accounting firm KPMG with “systematic” criminal acts to market illegal tax shelters to wealthy clients (which KPMG tried mightily to cover up) because a criminal indictment would have resulted in the immediate collapse of KPMG and cut the number of global public accounting firms from four to just three; instead, criminal charges were filed against the company officials deemed most responsible. In 2005, U.S. prosecutors elected not to press criminal charges against Royal Dutch Petroleum (Shell Oil) for repeatedly and knowingly reporting inflated oil reserves to the U.S. Securities and Exchange Commission and not to indict Tommy Hilfiger USA for multiple tax law violations—but both companies agreed to sign nonprosecution agreements, the terms of which were not made public but which almost certainly involved fines and a long-term company commitment to cease and desist.

High-Performance Cultures

Some companies have high-performance cultures, in which the standout cultural traits are a can-do spirit, pride in doing things right, no-excuses accountability, and a pervasive results-oriented work climate in which people go the extra mile to meet or beat stretch objectives. In high-performance cultures, there is a strong sense of involvement on the part of company personnel and emphasis on individual initiative and creativity. Performance expectations are clearly delineated for the company as a whole, for each organizational unit, and for each individual. Issues and problems are promptly addressed—a strong bias exists for being proactive instead of reactive. There is a razor-sharp focus on what needs to be done. The clear and unyielding expectation is that all company personnel, from senior executives to frontline employees will display high-performance behaviors and a passion for making the company successful. There is respect for the contributions of individuals and groups.
A high-performance culture is a valuable contributor to good strategy execution and operating excellence. High performance, results-oriented cultures are permeated with a spirit of achievement and have a good track record in meeting or beating performance targets.

The challenge in creating a high-performance culture is to inspire high loyalty and dedication on the part of employees, such that they are both energized and preoccupied with putting forth their very best efforts to do things right and be unusually productive. Managers have to reinforce constructive behavior, reward top performers, and purge habits and behaviors that stand in the way of high productivity and good results. They must work at knowing the strengths and weaknesses of their subordinates, so as to better match talent with task and enable people to make meaningful contributions by doing what they do best. They have to stress correcting and learning from mistakes, and they must put an unrelenting emphasis on moving forward and making good progress—in effect, there has to be a disciplined, performance-focused approach to managing the organization.

Adaptive Cultures

The hallmark of adaptive corporate cultures is willingness on the part of organizational members to accept change and take on the challenge of introducing and executing new strategies. Company personnel share a feeling of confidence that the organization can deal with whatever threats and opportunities come down the pike; they are receptive to risk taking, experimentation, and innovation. In direct contrast to change-resistant cultures, adaptive cultures are very supportive of managers and employees at all ranks who propose or help initiate useful change. Internal entrepreneurship on the part of individuals and groups is encouraged and rewarded. Senior executives seek out, support, and promote individuals who exercise initiative, spot opportunities for improvement, and display the skills to implement them. Managers openly evaluate ideas and suggestions, fund initiatives to develop new or better products, and take prudent risks to pursue emerging market opportunities. As in high-performance cultures, the adaptive company exhibits a proactive approach to identifying issues, evaluating the implications and options, and quickly moving ahead with workable solutions. Strategies and traditional operating practices are modified as needed to adjust to or take advantage of changes in the business environment.

But why is change so willingly embraced in an adaptive culture? Why are organization members not fearful of how change will affect them? Why does an adaptive culture not become unglued with ongoing changes in strategy, operating practices, and behavioral norms? The answers lie in two distinctive and dominant traits of an adaptive culture: (1) Any changes in operating practices and behaviors must not compromise core values and long-standing business principles, and (2) the changes that are instituted must satisfy the legitimate interests of stakeholders—customers, employees, shareowners, suppliers, and the communities in which the company operates. In other words, what sustains an adaptive culture is that organization members perceive the changes that management is trying to institute as legitimate and in keeping with the core values and business principles underpinning the culture.

Thus, for an adaptive culture to remain intact over time, top management must orchestrate organizational changes in a manner that (1) demonstrates genuine care for the well-being of all key constituencies and (2) tries to satisfy all their legitimate interests simultaneously. Unless fairness to all constituencies is a decision-making principle and
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a commitment to doing the right thing is evident to organization members, the changes are not likely to be seen as legitimate and thus be readily accepted and implemented wholeheartedly. Making changes that will please customers and that protect, if not enhance, the company’s long-term well-being are generally seen as legitimate and are often seen as the best way of looking out for the interests of employees, stockholders, suppliers, and communities where the company operates. At companies with adaptive cultures, management concern for the well-being of employees is nearly always a big factor in gaining employee support for change—company personnel are usually receptive to change as long as employees understand that changes in their job assignments are part of the process of adapting to new conditions and that their employment security will not be threatened unless the company’s business unexpectedly reverses direction. In cases where workforce downsizing becomes necessary, management concern for employees dictates that separation be handled humanely, making employee departure as painless as possible. Management efforts to make the process of adapting to change fair and equitable for customers, employees, stockholders, suppliers, and communities where the company operates, keeping adverse impacts to a minimum insofar as possible, breeds acceptance of and support for change among all organization stakeholders.

Technology companies, software companies, and today’s dot-com companies are good illustrations of organizations with adaptive cultures. Such companies thrive on change—driving it, leading it, and capitalizing on it (but sometimes also succumbing to change when they make the wrong move or are swamped by better technologies or the superior business models of rivals). Companies like Google, Intel, Cisco Systems, eBay, Nokia, Amazon.com, and Dell cultivate the capability to act and react rapidly. They are avid practitioners of entrepreneurship and innovation, with a demonstrated willingness to take bold risks to create altogether new products, new businesses, and new industries. To create and nurture a culture that can adapt rapidly to changing to shifting business conditions, they make a point of staffing their organizations with people who are proactive, who rise to the challenge of change, and who have an aptitude for adapting.

In fast-changing business environments, a corporate culture that is receptive to altering organizational practices and behaviors is a virtual necessity. However, adaptive cultures work to the advantage of all companies, not just those in rapid-change environments. Every company operates in a market and business climate that is changing to one degree or another and that, in turn, requires internal operating responses and new behaviors on the part of organization members. As a company’s strategy evolves, an adaptive culture is a definite ally in the strategy-implementing, strategy-executing process as compared to cultures that have to be coaxed and cajoled to change.

Culture: Ally or Obstacle to Strategy Execution?

A company’s present culture and work climate may or may not be compatible with what is needed for effective implementation and execution of the chosen strategy. When a company’s present work climate promotes attitudes and behaviors that are well suited to first-rate strategy execution, its culture functions as a valuable ally in the strategy execution process. When the culture is in conflict with some aspect of the company’s direction, performance targets, or strategy, the culture becomes a stumbling block.

How a Company’s Culture Can Promote Better Strategy Execution  A culture grounded in strategy-supportive values, practices, and behavioral norms adds significantly to the power and effectiveness of a company’s strategy execution effort.
For example, a culture where frugality and thrift are values widely shared by organizational members nurtures employee actions to identify cost-saving opportunities—the very behavior needed for successful execution of a low-cost leadership strategy. A culture built around such business principles as pleasing customers, fair treatment, operating excellence, and employee empowerment promotes employee behaviors and an esprit de corps that facilitate execution of strategies keyed to high product quality and superior customer service. A culture in which taking initiative, challenging the status quo, exhibiting creativity, embracing change, and collaborating with team members pervade the work climate promotes a company’s drive to lead market change—outcomes that are conducive to successful execution of product innovation and technological leadership strategies. Good alignment between ingrained cultural norms and the behaviors needed for good strategy execution makes the culture a valuable ally in the strategy-execution process. In a company where strategy and culture are misaligned, some of the very behaviors needed to execute strategy successfully run contrary to the behaviors and values imbedded in the prevailing culture. Such a clash nearly always produces a roadblock from employees whose actions and behaviors are strongly linked to the present culture. Culture-bred resistance to the actions and behaviors needed for good execution, if strong and widespread, poses a formidable hurdle that has to be cleared for strategy execution to get very far.

A tight culture–strategy matchup furthers a company’s strategy execution effort in three ways:

1. A culture that encourages actions, behaviors, and work practices supportive of good strategy execution not only provides company personnel with clear guidance regarding “how we do things around here” but also produces significant peer pressure from co-workers to conform to culturally acceptable norms. The stronger the admonishments from top executives about “how we need to do things around here” and the stronger the peer pressure from co-workers, the more the culture influences people to display behaviors and observe operating practices that support good strategy execution.

2. A deeply embedded culture tightly matched to the strategy aids the cause of competent strategy execution by steering company personnel to culturally approved behaviors and work practices and thus makes it far simpler to root out any operating practice that is a misfit. This is why it is very much in management’s best interests to build and nurture a deeply rooted culture where ingrained behaviors and operating practices marshal organizational energy behind the drive for good strategy execution.

3. A culture imbedded with values and behaviors that facilitate strategy execution promotes strong employee identification with and commitment to the company’s vision, performance targets, and strategy. When a company’s culture is grounded in many of the needed strategy-executing behaviors, employees feel genuinely better about their jobs, the company they work for, and the merits of what the company is trying to accomplish. As a consequence, greater numbers of company personnel exhibit some passion about their work and exert their best efforts to execute the strategy and achieve performance targets. All this helps move the company closer to realizing its strategic vision and, from employees’ standpoint, makes the company a more engaging place to work.

These aspects of culture–strategy alignment say something important about the task of managing the strategy executing process: Closely aligning corporate culture with the requirements for proficient strategy execution merits the full attention of senior
Core Concept
It is in management’s best interest to dedicate considerable effort to embedding a corporate culture that encourages behaviors and work practices conducive to good strategy execution—a tight strategy–culture fit automatically nurtures culturally-approved behaviors and squashes culturally-disapproved behaviors.

executives. The culture-building objective is to create a work climate and style of operating that mobilize the energy and behavior of company personnel squarely behind efforts to execute strategy competently. The more deeply that management can embed strategy-supportive ways of doing things, the more that management can rely on the culture to automatically steer company personnel toward behaviors and work practices that aid good strategy execution and away from ways of doing things that impede it.

Furthermore, culturally astute managers understand that nourishing the right cultural environment not only adds power to their push for proficient strategy execution but also promotes strong employee identification with and commitment to the company’s vision, performance targets, and strategy. A culture–strategy fit prompts employees with emotional allegiance to the culture to feel genuinely better about their jobs, the company they work for, and the merits of what the company is trying to accomplish. As a consequence, their morale is higher and their productivity is higher. In addition, greater numbers of company personnel exhibit passion for their work and exert their best efforts to make the strategy succeed and achieve performance targets. All this helps move the company closer to realizing its strategic vision and, from the employees’ standpoint, makes the company a more engaging place to work.

The Perils of Strategy–Culture Conflict
Conflicts between behaviors approved by the culture and behaviors needed for good strategy execution pose a real dilemma for company personnel. Should they be loyal to the culture and company traditions (to which they are likely to be emotionally attached) and thus resist or be indifferent to actions and behaviors that will promote better strategy execution—a choice that will certainly weaken the drive for good strategy execution? Or should they go along with the strategy execution effort and engage in actions and behaviors that run counter to the culture—a choice that will likely impair morale and lead to less-than-wholehearted commitment to management’s strategy execution efforts? Neither choice leads to desirable outcomes, and the solution is obvious: eliminate the conflict.

When a company’s culture is out of sync with the actions and behaviors needed to execute the strategy successfully, the culture has to be changed as rapidly as can be managed—this, of course, presumes that it is one or more aspects of the culture that are out of whack rather than the strategy execution approaches management wishes to institute. While correcting a strategy–culture conflict can occasionally mean revamping a company’s approach to executing the strategy to produce good cultural fit, more usually it means altering aspects of the mismatched culture to ingrain new behaviors and work practices that will enable first-rate strategy execution. The more entrenched the mismatched aspects of the culture, the greater the difficulty of implementing and executing new or different strategies until better strategy–culture alignment emerges. A sizable and prolonged strategy–culture conflict weakens and may even defeat managerial efforts to make the strategy work.

Changing a Problem Culture
Changing a company culture that impedes proficient strategy execution is among the toughest management tasks because of the heavy anchor of ingrained behaviors and ways of doing things. It is natural for company personnel to cling to familiar practices and to be wary, if not hostile, to new approaches of how things are to be done. Consequently, it takes concerted
management action over a period of time to root out certain unwanted behaviors and replace an out-of-sync culture with different behaviors and ways of doing things deemed more conducive to executing the strategy. The single most visible factor that distinguishes successful culture-change efforts from failed attempts is competent leadership at the top. Great power is needed to force major cultural change and overcome the springback resistance of entrenched cultures—and great power is possessed only by the most senior executives, especially the CEO. However, while top management must be out front leading the effort, marshaling support for a new culture and, more important, instilling new cultural behaviors are tasks for the whole management team. Middle managers and frontline supervisors play a key role in implementing the new work practices and operating approaches, helping win rank-and-file acceptance of and support for the changes, and instilling the desired behavioral norms.

As shown in Figure 13.1, the first step in fixing a problem culture is for top management to identify those facets of the present culture that are dysfunctional and pose obstacles to executing new strategic initiatives and meeting or beating company performance targets. Second, managers have to clearly define the desired new behaviors and features of the culture they want to create. Third, managers have to convince company personnel why the present culture poses problems and why and how new behaviors and operating approaches will improve company performance—the case for cultural change and the benefits of a reformed culture have to be persuasive. Finally, and most important, all the talk about remodeling the present culture has to be followed swiftly by visible, forceful actions to promote the desired new behaviors and work practices—actions that company personnel will interpret as a determined top management commitment to alter the culture and instill a different work climate and different ways of operating.

Making a Compelling Case for Culture Change  The place for management to begin a major remodeling of the corporate culture is by selling company personnel on

**Figure 13.1  Changing a Problem Culture**

1. **Step 1**
   - Identity facets of present culture that are conducive to strategy execution and operating excellence and those that are not.

2. **Step 2**
   - Specify what new actions, behaviors, and work practices should be prominent in the “new” culture.

3. **Step 3**
   - Talk openly about problems of present culture and how new behaviors will improve performance.

4. **Step 4**
   - Follow with visible, forceful actions—both substantive and symbolic—to ingrain a new set of behaviors, practices, and cultural norms.
the need for new-style behaviors and work practices. This means making a compelling case for why the company’s new strategic direction and culture-remodeling efforts are in the organization’s best interests and why company personnel should wholeheartedly join the effort to doing things somewhat differently. Skeptics and opinion leaders have to be convinced that all is not well with the status quo. This can be done by:

- Citing reasons why the current strategy has to be modified and why new strategic initiatives that are being undertaken will bolster the company’s competitiveness and performance. The case for altering the old strategy usually needs to be predicated on its shortcomings—why sales are growing slowly, why rivals are doing so much better, why too many customers are opting to go with the products of rivals, why costs are too high, why the company’s price has to be lowered, and so on. There may be merit in holding events where managers and other key personnel are forced to listen to dissatisfied customers, the complaints of strategic allies, alienated employees, or disenchanted stockholders

- Citing why and how certain behavioral norms and work practices in the current culture pose obstacles to good execution of new strategic initiatives.

- Explaining how certain new behaviors and work practices that are to be introduced and have important roles in the new culture will be more advantageous and produce better results.

It is essential for the CEO and other top executives to personally talk to company personnel all across the company about the reasons for modifying work practices and culture-related behaviors. Senior officers and department heads have to play the lead role in explaining the behaviors, practices, and operating approaches that are to be introduced and why they are beneficial—and the explanations will likely have to be repeated many times. For the culture-change effort to be successful, frontline supervisors and employee opinion leaders must be won over to the cause, which means convincing them of the merits of practicing and enforcing cultural norms at the lowest levels in the organization. Until a big majority of employees accept the need for a new culture and agree that different work practices and behaviors are called for, there’s more work to be done in selling company personnel on the whys and wherefores of culture change. Building widespread organizational support requires taking every opportunity to repeat the messages of why the new work practices, operating approaches, and behaviors are good for company stakeholders (particularly customers, employees, and shareholders). Effective culture-change leaders are good at telling stories to describe the new values and desired behaviors and connect them to everyday practices.

Management’s efforts to make a persuasive case for changing what is deemed to be a problem culture must be quickly followed by forceful, high-profile actions across several fronts. The actions to implant the new culture must be both substantive and symbolic.

**Substantive Culture-Changing Actions** No culture change effort can get very far with just talk about the need for different actions, behaviors, and work practices. Company executives have to give the culture-change effort some teeth by initiating a series of actions that company personnel will see as credible and unmistakably indicative of the seriousness of management’s commitment to new strategic initiatives and the associated cultural changes. The strongest signs that management is truly committed to instilling a new culture include:

1. Replacing key executives who are strongly associated with the old culture and are stonewalling needed organizational and cultural changes.
2. Promoting individuals who are known to possess the desired cultural traits, who have stepped forward to advocate the shift to a different culture, and who can serve as role models for the desired cultural behavior.

3. Appointing outsiders with the desired cultural attributes to high-profile positions—bringing in new-breed managers to serve as role models and help drive the culture-change movement sends an unmistakable message that a new era is dawning and acts to reinforce company personnel who have already gotten on board the culture-change effort.

4. Screening all candidates for new positions carefully, hiring only those who appear to fit in with the new culture—this helps build a critical mass of people to help turn the tide in favor of the new culture.

5. Mandating that all company personnel attend culture-training programs to learn more about the new work practices and operating approaches and to better understand the culture-related actions and behaviors that are expected.

6. Pushing hard to implement new-style work practices and operating procedures.

7. Designing compensation incentives that boost the pay of teams and individuals who display the desired cultural behaviors and hit change resisters in the pocketbook—company personnel are much more inclined to exhibit the desired kinds of actions and behaviors when it is in their financial best interest to do so.

8. Granting generous pay raises to individuals who step out front, lead the adoption of the desired work practices, display the new-style behaviors, and achieve pace-setting results.

9. Revising policies and procedures in ways that will help drive cultural change.

Executives must take care to launch enough companywide culture-change actions at the outset to leave no room for doubt that management is dead serious about changing the present culture and that a cultural transformation is inevitable. To convince doubters and skeptics that they cannot just wait in hopes the culture-change initiative will soon die out, the series of actions initiated by top management must create lots of hallway talk across the whole company, get the change process off to a fast start, and be followed by unrelenting efforts to firmly establish the new work practices and style of operating as standard.

Symbolic Culture-Changing Actions Symbolic managerial actions are necessary to alter a problem culture and tighten the strategy–culture fit. The most important symbolic actions are those that top executives take to lead by example. For instance, if the organization’s strategy involves a drive to become the industry’s low-cost producer, senior managers must display frugality in their own actions and decisions: inexpensive decorations in the executive suite, conservative expense accounts and entertainment allowances, a lean staff in the corporate office, scrutiny of budget requests, few executive perks, and so on. At Wal-Mart, all the executive offices are simply decorated; executives are habitually frugal in their own actions, and they are zealous in their own efforts to control costs and promote greater efficiency. At Nucor, one of the world’s low-cost producers of steel products, executives fly coach class and use taxis at airports rather than limousines. If the culture change imperative is to be more responsive to customers’ needs and to pleasing customers, the CEO can instill greater customer awareness by requiring all officers and executives to spend a significant portion of each week talking with customers about their needs. Top executives must be alert to the fact that company personnel will be watching their actions and decisions to see if they are walking the talk. Hence, they need to make sure that
their current decisions will be construed as consistent with new-culture values and behaviors.\(^{17}\)

Another category of symbolic actions includes holding ceremonial events to single out and honor people whose actions and performance exemplify what is called for in the new culture. A point is made of holding events to celebrate each culture-change success (and any other outcome that management would like to see happen again). Executives sensitive to their role in promoting strategy–culture fits make a habit of appearing at ceremonial functions to praise individuals and groups that get with the program. They show up at employee training programs to stress strategic priorities, values, ethical principles, and cultural norms. Every group gathering is seen as an opportunity to repeat and ingrain values, praise good deeds, expound on the merits of the new culture, and cite instances of how the new work practices and operating approaches have worked to good advantage.

The use of symbols in culture building is widespread. Many universities give outstanding teacher awards each year to symbolize their commitment to good teaching and their esteem for instructors who display exceptional classroom talents. Numerous businesses have employee-of-the-month awards. The military has a long-standing custom of awarding ribbons and medals for exemplary actions. Mary Kay Cosmetics awards an array of prizes—from ribbons to pink automobiles—to its beauty consultants for reaching various sales plateaus.

How Long Does It Take to Change a Problem Culture? Planting and growing the seeds of a new culture require a determined effort by the chief executive and other senior managers. Neither charisma nor personal magnetism is essential. But a sustained and persistent effort to reinforce the culture at every opportunity through both word and deed is very definitely required. Changing a problem culture is never a short-term exercise. It takes time for a new culture to emerge and prevail. Overnight transformations simply don’t occur. And it takes even longer for a new culture to become deeply embedded. The bigger the organization and the greater the cultural shift needed to produce a strategy–culture fit, the longer it takes. In large companies, fixing a problem culture and instilling a new set of attitudes and behaviors can take two to five years. In fact, it is usually tougher to reform an entrenched problematic culture than it is to instill a strategy-supportive culture from scratch in a brand-new organization. Sometimes executives succeed in changing the values and behaviors of small groups of managers and even whole departments or divisions, only to find the changes eroded over time by the actions of the rest of the organization—what is communicated, praised, supported, and penalized by an entrenched majority undermines the new emergent culture and halts its progress. Executives, despite a series of well-intended actions to reform a problem culture, are likely to fail at weeding out embedded cultural traits when widespread employee skepticism about the company’s new directions and culture-change effort spawns covert resistance to the cultural behaviors and operating practices advocated by top management. This is why management must take every opportunity to convince employees of the need for culture change and communicate to them how new attitudes, behaviors, and operating practices will benefit the interests of organizational stakeholders.

A company that succeeded in fixing a problem culture is Alberto-Culver—see Illustration Capsule 13.2.
Illustration Capsule 13.2
Changing the Culture in Alberto-Culver’s North American Division

In 1993, Carol Bernick—vice chairperson of Alberto-Culver, president of its North American division, and daughter of the company’s founders—concluded that her division’s existing culture had four problems: Employees dutifully waited for marching orders from their bosses, workers put pleasing their bosses ahead of pleasing customers, some company policies were not family-friendly, and there was too much bureaucracy and paperwork. What was needed, in Bernick’s opinion, was a culture in which company employees had a sense of ownership and an urgency to get things done, welcomed innovation, and were willing to take risks.

Alberto-Culver’s management undertook a series of actions to introduce and ingrain the desired cultural attributes:

- In 1993, a new position, called growth development leader (GDL), was created to help orchestrate the task of fixing the culture deep in the ranks (there were 70 GDls in Alberto-Culver’s North American division). GDls came from all ranks of the company’s managerial ladder and were handpicked for such qualities as empathy, communication skills, positive attitude, and ability to let their hair down and have fun. GDls performed their regular jobs in addition to taking on the GDL roles; it was considered an honor to be chosen. Each GDL mentored about 12 people from both a career and a family standpoint. GDls met with senior executives weekly, bringing forward people’s questions and issues and then, afterward, sharing with their groups the topics and solutions that were discussed. GDls brought a group member as a guest to each meeting. One meeting each year is devoted to identifying “macros and irritations”—attendees are divided into four subgroups and given 15 minutes to identify the company’s four biggest challenges (the macros) and the four most annoying aspects of life at the company (the irritations); the whole group votes on which four deserve the company’s attention. Those selected are then addressed, and assignments made for follow-up and results.
- Changing the culture was made an issue across the company, starting in 1995 with a two-hour State of the Company presentation to employees covering where the company was and where it wanted to be. The State of the Company address then became an annual event.
- Management created ways to measure the gains in changing the culture. One involved an annual all-employee survey to assess progress against cultural goals and to get 360-degree feedback—the 2000 survey had 180 questions, including 33 relating to the performance of each respondent’s GDL. A bonfire celebration was held in the company parking lot to announce that paperwork would be cut by 30 percent.
- A list of 10 cultural imperatives was formalized in 1998—honesty, ownership, trust, customer orientation, commitment, fun, innovation, risk taking, speed and urgency, and teamwork. These imperatives came to be known internally as HOT CC FIRST.
- Numerous celebrations and awards programs were instituted. Most celebrations are scheduled, but some are spontaneous (an impromptu thank-you party for a good fiscal year). Business Builder Awards (initiated in 1997) are given to individuals and teams that make a significant impact on the company’s growth and profitability. The best-scoring GDls on the annual employee surveys are awarded shares of company stock. The company notes all work anniversaries and personal milestones with “Alberto-appropriate” gifts; appreciative company employees sometimes give thank-you gifts to their GDls. According to Carol Bernick, “If you want something to grow, pour champagne on it. We’ve made a huge effort—maybe even an over-the-top effort—to celebrate our successes and, indeed, just about everything we’d like to see happen again.”

The culture change effort at Alberto-Culver North America was viewed as a major contributor to improved performance. From 1993 (when the effort first began) to 2001, the division’s sales increased from just under $350 million to over $600 million and pretax profits rose from $20 million to almost $50 million. Carol Bernick was elevated to chairman of Alberto-Culver’s board of directors in 2004.

Part 1  Concepts and Techniques for Crafting and Executing Strategy

**Grounding the Culture in Core Values and Ethics**

The foundation of a company’s corporate culture nearly always resides in its dedication to certain core values and the bar it sets for ethical behavior. The culture-shaping significance of core values and ethical behaviors accounts for why so many companies have developed a formal values statement and a code of ethics—see Table 13.1 for representative core values and the ground usually covered in codes of ethics. Many companies today convey their values and codes of ethics to stakeholders and interested parties in their annual reports and on their Web sites. The trend of making stakeholders aware of a company’s commitment to core values and ethical business conduct is attributable to three factors: (1) greater management understanding of the role these statements play in culture building, (2) a renewed focus on ethical standards stemming from the numerous corporate scandals that hit the headlines during 2001–2005, and (3) the sizable fraction of consumers and suppliers who prefer doing business with ethical companies.

At Darden Restaurants—the world’s largest casual dining company, which employs more than 150,000 people and serves 300 million meals annually at 1,400 Red Lobster, Olive Garden, Bahama Breeze, Smokey Bones Barbeque & Grill, and Seasons 52 restaurants in North America—the core values are operating with integrity and fairness, caring and respect, being of service, teamwork, excellence, always learning and teaching, and welcoming and celebrating workforce diversity. Top executives at

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**Table 13.1  Representative Content of Company Values Statements and Codes of Ethics**

<table>
<thead>
<tr>
<th>Typical Core Values</th>
<th>Areas Covered by Codes of Ethics</th>
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<tbody>
<tr>
<td>• Satisfying and delighting customers</td>
<td>• Expecting all company personnel to display honesty and integrity in their actions and avoid conflicts of interest</td>
</tr>
<tr>
<td>• Dedication to superior customer service, top-notch quality, product innovation, and/or technological leadership</td>
<td>• Mandating full compliance with all laws and regulations, specifically:</td>
</tr>
<tr>
<td>• A commitment to excellence and results</td>
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<tr>
<td>• Exhibiting such qualities as integrity, fairness, trustworthiness, pride of workmanship, Golden Rule behavior, respect for co-workers, and ethical behavior</td>
<td></td>
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<tr>
<td>• Creativity, exercising initiative, and accepting responsibility</td>
<td></td>
</tr>
<tr>
<td>• Teamwork and cooperative attitudes</td>
<td></td>
</tr>
<tr>
<td>• Fair treatment of suppliers</td>
<td></td>
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<tr>
<td>• Making the company a great place to work</td>
<td></td>
</tr>
<tr>
<td>• A commitment to having fun and creating a fun work environment</td>
<td>• Prohibiting giving or accepting bribes, kickbacks, or gifts</td>
</tr>
<tr>
<td>• Being stewards of shareholders’ investments and remaining committed to profits and growth</td>
<td>• Engaging in fair selling and marketing practices</td>
</tr>
<tr>
<td>• Exercising social responsibility and being a good community citizen</td>
<td>• Not dealing with suppliers that employ child labor or engage in other unsavory practices</td>
</tr>
<tr>
<td>• Caring about protecting the environment</td>
<td>• Being above-board in acquiring and using competitively sensitive information about rivals and others</td>
</tr>
<tr>
<td>• Having a diverse workforce</td>
<td>• Avoiding use of company assets, resources, and property for personal or other inappropriate purposes</td>
</tr>
<tr>
<td></td>
<td>• Responsibility to protect proprietary information and not divulge trade secrets</td>
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</tbody>
</table>
Darden believe the company’s practice of these values has been instrumental in creating a culture characterized by trust, exciting jobs and career opportunities for employees, and a passion to provide “a terrific dining experience to every guest, every time, in every one of our restaurants.”

Of course, sometimes a company’s stated core values and codes of ethics are cosmetic, existing mainly to impress outsiders and help create a positive company image. But more usually they have been developed to shape the culture. Many executives want the work climate at their companies to mirror certain values and ethical standards, partly because they are personally committed to these values and ethical standards but mainly because they are convinced that adherence to such values and ethical principles will make the company a much better performer and improve its image. As discussed earlier, values-related cultural norms promote better strategy execution and mobilize company personnel behind the drive to achieve stretch objectives and the company’s strategic vision. Hence, a corporate culture grounded in well-chosen core values and high ethical standards contributes mightily to a company’s long-term strategic success. And, not incidentally, strongly ingrained values and ethical standards reduce the likelihood of lapses in ethical and socially-approved behavior that mar a company’s reputation and put its financial performance and market standing at risk.

The Culture-Building Role of Values and Codes of Ethics  At companies where executives believe in the merits of practicing the values and ethical standards that have been espoused, the stated core values and ethical principles are the cornerstones of the corporate culture. As depicted in Figure 13.2, a company’s stated core values and ethical principles have two roles in the culture-building process. One, a company that works hard at putting its stated core values and ethical principles into practice fosters a work climate where company personnel share common and strongly held convictions about how the company’s business is to be conducted. Second, the stated values and ethical principles provide company personnel with guidance about the manner in which...
they are to do their jobs—which behaviors and ways of doing things are approved (and expected) and which are out-of-bounds.

**Transforming Core Values and Ethical Standards into Cultural Norms**

Once values and ethical standards have been formally adopted, they must be institutionalized in the company’s policies and practices and embedded in the conduct of company personnel. This can be done in a number of different ways.20 Tradition-steeped companies with a rich folklore rely heavily on word-of-mouth indoctrination and the power of tradition to instill values and enforce ethical conduct. But most companies employ a variety of techniques to hammer in core values and ethical standards, using some or all of the following:

1. Giving explicit attention to values and ethics in recruiting and hiring to screen out applicants who do not exhibit compatible character traits.
2. Incorporating the statement of values and the code of ethics into orientation programs for new employees and training courses for managers and employees.
3. Having senior executives frequently reiterate the importance and role of company values and ethical principles at company events and internal communications to employees.
4. Using values statements and codes of ethical conduct as benchmarks for judging the appropriateness of company policies and operating practices.
5. Making the display of core values and ethical principles a big factor in evaluating each person’s job performance—there’s no better way to win the attention and commitment of company personnel than by using the degree to which individuals observe core values and ethical standards as a basis for compensation increases and promotion.
6. Making sure that managers, from the CEO down to frontline supervisors, are diligent in stressing the importance of ethical conduct and observance of core values. Line managers at all levels must give serious and continuous attention to the task of explaining how the values and ethical code apply in their areas.
7. Encouraging everyone to use their influence in helping enforce observance of core values and ethical standards—strong peer pressures to exhibit core values and ethical standards are a deterrent to outside-the-lines behavior.
8. Periodically having ceremonial occasions to recognize individuals and groups who display the values and ethical principles.
9. Instituting ethics enforcement procedures.

To deeply ingrain the stated core values and to high ethical standards, companies must turn them into *strictly enforced cultural norms*. They must put a stake in the ground, making it unequivocally clear that living up to the company’s values and ethical standards has to be a way of life at the company and that there will be little toleration of outside-the-lines behavior.

**The Benefits of Cultural Norms Grounded in Core Values and Ethical Principles**

The more that managers succeed in making the espoused values and ethical principles the main drivers of “how we do things around here,” the more that the values and ethical principles function as cultural norms. Over time, a strong culture grounded in the display of core values and ethics may emerge. As shown in Figure 13.3, *cultural norms* rooted in core values and ethical behavior are highly beneficial in three respects.21 One, the advocated core values and ethical standards accurately
communicate the company’s good intentions and validate the integrity and above-board character of its business principles and operating methods. There’s nothing cosmetic or fake about the company’s values statement and code of ethics—company personnel actually strive to practice what is being preached. Second, the values-based and ethics-based cultural norms steer company personnel toward both doing things right and doing the right thing. Third, they establish a “corporate conscience” and provide yardsticks for gauging the appropriateness of particular actions, decisions, and policies.

**Establishing a Strategy–Culture Fit in Multinational and Global Companies**

In multinational and global companies, establishing a tight strategy–culture fit is complicated by the diverse societal circumstances surrounding the company’s operations in different countries. The nature of the local economies, living conditions, per capita incomes, and lifestyles can give rise to considerable cross-border diversity in a company’s workforce and to subcultures within the corporate culture. Leading cross-border culture-change initiatives requires sensitivity to prevailing differences in local circumstances; company managers must discern when local subcultures have to be accommodated and when cross-border differences in the company’s corporate culture can be and should be narrowed.\(^{22}\) Cross-border diversity in a multinational enterprise’s corporate culture is more tolerable if the company is pursuing a multicountry strategy and if the company’s culture in each country is well aligned with its strategy in that country. But significant cross-country differences in a company’s culture are likely to impede execution of a global strategy and have to be addressed.

As discussed earlier in this chapter, the trick to establishing a workable strategy–culture fit in multinational companies is to ground the culture in strategy-supportive values and operating practices that travel well across country borders and strike a
chord with managers and workers in many different areas of the world, despite varying local customs and traditions. A multinational enterprise with a misfit between its strategy and culture in certain countries where it operates can attack the problem by rewording its values statement so as to express core values in ways that have universal appeal. The alternative is to allow some leeway for certain core values to be reinterpreted or de-emphasized or applied somewhat differently from country to country whenever local customs and traditions in a few countries really need to be accommodated. But such accommodation needs to be done in ways that do not impede good strategy execution. Sometimes certain offending operating styles can be modified to good advantage in all locations where the company operates.

Aside from trying to build the corporate culture around a set of core values that have universal appeal, management can seek to minimize the existence of subcultures and promote greater cross-country cultural uniformity by:

- **Instituting culture training in each country.** The goals of this training should be to (1) communicate the meaning of core values in language that resonates with company personnel in that country and (2) explain the case for common operating approaches and work practices. The use of uniform work practices becomes particularly important when the company’s work practices are efficient and aid good strategy execution—in such instances, local managers have to find ways to skirt local preferences and win support for “how we do things around here.”

- **Creating a cultural climate where the norm is to adopt best practices, use common work procedures, and pursue operating excellence.** Companies may find that a values-based corporate culture is less crucial to good strategy execution that an operations-based, results-oriented culture in which the dominant cultural norm is an all-out effort to do things in the best possible manner, achieve continuous improvement, and meet or beat performance targets. A results-oriented culture keyed to operating excellence and meeting stretch objectives sidesteps many of the problems with trying to get people from different societies and traditions to embrace common values.

- **Giving local managers the flexibility to modify people management approaches or operating styles.** In some situations, adherence to companywide cultural traditions simply doesn’t work well. However, local modifications have to be infrequent and done in a manner that doesn’t undermine the establishment of a mostly uniform corporate culture.

- **Giving local managers discretionary authority to use somewhat different motivational and compensation incentives to induce local personnel to adopt and practice the desired cultural behaviors.** Personnel in different countries may respond better to some compensation structures and reward systems than to others.

Generally, a high degree of cross-country homogeneity in a multinational company’s corporate culture is desirable and has to be pursued, particularly when it comes to ingraining universal core values and companywide enforcement of such ethical standards as the payment of bribes and kickbacks, the use of underage labor, and environmental stewardship. Having too much variation in the culture from country to country not only makes it difficult to use the culture in helping drive the strategy execution process but also works against the establishment of a one-company mind-set and a consistent corporate identity.
LEADING THE STRATEGY EXECUTION PROCESS

The litany of managing the strategy process is simple enough: Craft a sound strategic plan, implement it, execute it to the fullest, adjust it as needed, and win! But the leadership challenges are significant and diverse. Exerting take-charge leadership, being a “spark plug,” ramrodding things through, and achieving results thrusts a manager into a variety of leadership roles in managing the strategy execution process: resource acquirer and allocator, capabilities builder, motivator, policymaker, policy enforcer, head cheerleader, crisis solver, decision maker, and taskmaster, to mention a few. There are times when leading the strategy execution process entails being hard-nosed and authoritarian, times when it is best to be a perceptive listener and a compromising decision maker, times when matters are best delegated to people closest to the scene of the action, and times when mentoring or coaching is appropriate. Many occasions call for the manager in charge to assume a highly visible role and put in long hours guiding the process, while others entail only a brief ceremonial performance with the details delegated to subordinates.

For the most part, leading the strategy execution process is a top-down responsibility driven by mandates to get things on the right track and show good results. It must start with a perceptive diagnosis of the requirements for good strategy execution, given the company’s circumstances. Then comes diagnosis of the organization’s capabilities and preparedness to execute the necessary strategic initiatives and decisions as to which of several ways to proceed to get things done and achieve the targeted results. In general, leading the drive for good strategy execution and operating excellence calls for five actions on the part of the manager-in-charge:

1. Staying on top of what is happening, closely monitoring progress, ferreting out issues, and learning what obstacles lie in the path of good execution.
2. Putting constructive pressure on the organization to achieve good results and operating excellence.
3. Leading the development of stronger core competencies and competitive capabilities.
4. Displaying ethical integrity and leading social responsibility initiatives.
5. Pushing corrective actions to improve strategy execution and achieve the targeted results.

Staying on Top of How Well Things Are Going

To stay on top of how well the strategy execution process is going, a manager needs to develop a broad network of contacts and sources of information, both formal and informal. The regular channels include talking with key subordinates, attending meetings and quizzes the presenters, reading reviews of the latest operating results, talking to customers, watching the competitive reactions of rival firms, exchanging e-mail and holding telephone conversations with people in outlying locations, making on-site visits, and listening to rank-and-file employees. However, some information is more trustworthy than the rest, and the views and perspectives offered by different people can vary widely. Presentations and briefings by subordinates may be colored by wishful thinking or shoddy analysis rather than representing the unvarnished truth. Bad news is sometimes filtered, minimized, or distorted by people pursuing their own agendas, and in some cases not reported at all as subordinates delay conveying failures and problems in hopes that they can turn things around in time. Hence, managers have
to decide which information is trustworthy and get an accurate feel for the existing situation. They have to confirm whether things are on track, identify problems, learn what obstacles lie in the path of good strategy execution, ruthlessly assess whether the organization has the talent and attitude needed to drive the required changes, and develop a basis for determining what, if anything, they can personally do to move the process along.24

One of the best ways for executives to stay on top of the strategy execution process is by making regular visits to the field and talking with many different people at many different levels—a technique often labeled managing by walking around (MBWA).

Wal-Mart executives have had a long-standing practice of spending two to three days every week visiting Wal-Mart’s stores and talking with store managers and employees. Sam Walton, Wal-Mart’s founder, insisted, “The key is to get out into the store and listen to what the associates have to say.” Jack Welch, the highly effective CEO of General Electric (GE) from 1980 to 2001, not only spent several days each month personally visiting GE operations and talking with major customers but also arranged his schedule so that he could spend time exchanging information and ideas with GE managers from all over the world who were attending classes at the company’s leadership development center near GE’s headquarters.

Often, customers and suppliers can provide valuable perspectives on how well a company’s strategy execution process is going. Joe Tucci, chief operating officer at data-storage leader EMC, when confronted with an unexpected dropoff in EMC’s sales in 2001 and not sure whether the downturn represented a temporary slump or a structural market change went straight to the source for hard information: the chief executive officers and chief financial officers to whom chief information officers at customer companies reported and to the consultants who advised them. The information he got was eye-opening—fundamental market shifts were occurring, and the rules of market engagement now called for major strategy changes at EMC followed by quick implementation.

To keep their fingers on the company’s pulse, managers at some companies host weekly get-togethers (often on Friday afternoons) to create a regular opportunity for tidbits of information to flow freely between down-the-line employees and executives. Many manufacturing executives make a point of strolling the factory floor to talk with workers and meeting regularly with union officials. Some managers operate out of open cubicles in big spaces so that they can interact easily and frequently with co-workers. Jeff Bezos, Amazon.com’s CEO, is noted for his practice of MBWA, firing off a battery of questions when he tours facilities and insisting that Amazon managers spend time in the trenches with their people to avoid abstract thinking and getting disconnected from the reality of what’s happening.25

Most managers practice MBWA, attaching great importance to spending time with people at various company facilities and gathering information and opinions firsthand from diverse sources about how well various aspects of the strategy execution process are going. They believe facilities visits and face-to-face contacts give them a good feel for what progress is being made, what problems are being encountered, and whether additional resources or different approaches may be needed. Just as important, MBWA provides opportunities to talk informally to many different people at different organizational levels, give encouragement, lift spirits, shift attention from the old to the new priorities, and create some excitement—all of which generate positive energy and help mobilize organizational efforts behind strategy execution.
Putting Constructive Pressure on the Organization to Achieve Good Results and Operating Excellence

Managers have to be out front in mobilizing organizational energy behind the drive for good strategy execution and operating excellence. Part of the leadership requirement here entails nurturing a results-oriented work climate, where performance standards are high and a spirit of achievement is pervasive. The intended outcome is an organization with a good track record in meeting or beating stretch performance targets. A high-performance culture in which there is constructive pressure to achieve good results is a valuable contributor to good strategy execution and operating excellence. If management wants to drive the strategy execution effort by instilling a results-oriented work climate, then senior executives have to take the lead in promoting certain enabling cultural drivers: a strong sense of involvement on the part of company personnel, emphasis on individual initiative and creativity, respect for the contribution of individuals and groups, and pride in doing things right.

Organizational leaders who succeed in creating a results-oriented work climate typically are intensely people-oriented, and they are skilled users of people-management practices that win the emotional commitment of company personnel and inspire them to do their best. They understand that treating employees well generally leads to increased teamwork, higher morale, greater loyalty, and increased employee commitment to making a contribution. All of these foster an esprit de corps that energizes organizational members to contribute to the drive for operating excellence and proficient strategy execution.

Successfully leading the effort to instill a spirit of high achievement into the culture generally entails such leadership actions and managerial practices as:

- **Treating employees with dignity and respect.** This often includes a strong company commitment to training each employee thoroughly, providing attractive career opportunities, emphasizing promotion from within, and providing a high degree of job security. Some companies symbolize the value of individual employees and the importance of their contributions by referring to them as cast members (Disney), crew members (McDonald’s), co-workers (Kinko’s and CDW Computer Centers), job owners (Granite Construction), partners (Starbucks), or associates (Wal-Mart, Lenscrafters, W. L. Gore, Edward Jones, Publix Supermarkets, and Marriott International). At a number of companies, managers at every level are held responsible for developing the people who report to them.

- **Making champions out of the people who turn in winning performances.** This must be done in ways that promote teamwork and cross-unit collaboration as opposed to spurring an unhealthy footrace among employees to best one another. Would-be champions who advocate radical or different ideas must not be looked on as disruptive or troublesome. The best champions and change agents are persistent, competitive, tenacious, committed, and fanatic about seeing their idea through to success. It is particularly important that people who champion an unsuccessful idea not be punished or sidelined but rather encouraged to try again—encouraging lots of “tries” is important since many ideas won’t pan out.

- **Encouraging employees to use initiative and creativity in performing their work.** Operating excellence requires that everybody be expected to contribute
ideas, exercise initiative, and pursue continuous improvement. The leadership trick is to keep a sense of urgency alive in the business so that people see change and innovation as necessities. Moreover, people with maverick ideas or out-of-the-ordinary proposals have to be tolerated and given room to operate; anything less tends to squelch creativity and initiative.

- **Setting stretch objectives.** Managers must clearly communicate an expectation that company personnel are to give their best in achieving performance targets.

- **Using the tools of benchmarking, best practices, business process reengineering, TQM, and Six Sigma quality to focus attention on operating excellence.** These are proven approaches to getting better operating results and facilitating better strategy execution.

- **Using the full range of motivational techniques and compensation incentives to inspire company personnel, nurture a results-oriented work climate, and enforce high-performance standards.** Managers cannot mandate innovative improvements by simply exhorting people to “be creative,” nor can they make continuous progress toward operating excellence with directives to “try harder.” Rather, they have to foster a culture where innovative ideas and experimentation with new ways of doing things can blossom and thrive. Individuals and groups need to be strongly encouraged to brainstorm, let their imaginations fly in all directions, and come up with proposals for improving how things are done. This means giving company personnel enough autonomy to stand out, excel, and contribute. And it means that the rewards for successful champions of new ideas and operating improvements should be large and visible.

- **Celebrating individual, group, and company successes.** Top management should miss no opportunity to express respect for individual employees and their appreciation of extraordinary individual and group effort. Companies like Mary Kay Cosmetics, Tupperware, and McDonald’s actively seek out reasons and opportunities to give pins, buttons, badges, and medals for good showings by average performers—the idea being to express appreciation and give a motivational boost to people who stand out in doing ordinary jobs. General Electric and 3M Corporation make a point of ceremoniously honoring individuals who believe so strongly in their ideas that they take it on themselves to hurdle the bureaucracy, maneuver their projects through the system, and turn them into improved services, new products, or even new businesses.

While leadership efforts to instill a results-oriented, high performance culture usually accentuate the positive, there are negative reinforcers too. Managers whose units consistently perform poorly have to be replaced. Low-performing workers and people who reject the results-oriented cultural emphasis have to be weeded out or at least moved to out-of-the-way positions. Average performers have to be candidly counseled that they have limited career potential unless they show more progress in the form of additional effort, better skills, and improved ability to deliver good results.

**Leading the Development of Better Competencies and Capabilities**

A third avenue to better strategy execution and operating excellence is proactively strengthening core competencies and competitive capabilities to better perform value chain activities and pave the way for better bottom-line results. This often requires top management intervention for two reasons. One, senior managers are more likely to
recognize and appreciate the strategy-executing significance of stronger capabilities; this is especially true in multinational companies where it is top executives are in the best position to spot opportunities to leverage existing competencies and competitive capabilities across geographical borders. Two, senior managers usually have to lead the strengthening effort because core competencies and competitive capabilities typically reside in the combined efforts of different work groups, departments, and strategic allies and only senior managers have the organizational clout to enforce the necessary networking and collaboration.

Aside from leading efforts to strengthen existing competencies and capabilities, effective strategy leaders try to anticipate changes in customer-market requirements and proactively build new competencies and capabilities that offer a competitive edge over rivals. Again, senior managers are in the best position to see the need and potential of new capabilities and then to play a lead role in the capability-building, resource-enhancing process. Proactively building new competencies and capabilities ahead of rivals to gain a competitive edge is strategic leadership of the best kind, but strengthening the company’s resource base in reaction to newly developed capabilities of pioneering rivals occurs more frequently.

Displaying Ethical Integrity and Leading Social Responsibility Initiatives

For an organization to avoid the pitfalls of scandal and disgrace and consistently display the intent to conduct its business in a principled manner, the CEO and those around the CEO must be openly and unswervingly committed to ethical conduct and socially redeeming business principles and core values. Leading the effort to operate the company’s business in an ethically principled fashion has three pieces. First and foremost, the CEO and other senior executives must set an excellent example in their own ethical behavior, demonstrating character and personal integrity in their actions and decisions. The behavior of senior executives sends a clear message to company personnel regarding what the “real” standards of personal conduct are. Moreover, the company’s strategy and operating decisions have to be seen as ethical—actions always speak far louder than the words in a company’s code of ethics. Second, top management must declare unequivocal support of the company’s ethical code and take an uncompromising stand on expecting all company personnel to conduct themselves in an ethical fashion at all times. This means iterating and reiterating to employees that it is their duty to observe the company’s ethical codes. Third, top management must be prepared to act as the final arbiter on hard calls; this means removing people from key positions or terminating them when they are guilty of a violation. It also means reprimanding those who have been lax in monitoring and enforcing ethical compliance. Failure to act swiftly and decisively in punishing ethical misconduct is interpreted as a lack of real commitment.

Establishing an Effective Ethics Compliance and Enforcement Process

If a company’s executives truly aspire for company personnel to behave ethically, they must personally see to it that strong and effective procedures for enforcing ethical standards and handling potential violations are put in place. Even in an ethically strong company, there can be bad apples—and some of the bad apples may be executives. So it is rarely enough to rely on either the exhortations of senior executives or an ethically principled culture to produce ethics compliance.

Executive action to institute formal ethics compliance and enforcement mechanisms can entail forming an ethics committee to give guidance on ethics matters,
appointing an ethics officer to head the compliance effort, establishing an ethics hotline or Web site that employees can use to either anonymously report a possible violation or get confidential advice on a troubling ethics-related situation, and having an annual ethics audit to measure the extent of ethical behavior and identify problem areas. If senior executives are really serious about enforcing ethical behavior, they probably need to do five things:28

1. Have mandatory ethics training programs for employees. Company personnel have to be educated about what is ethical and what is not and given guidance about the gray areas. Special training programs probably are needed for personnel in such ethically vulnerable areas as procurement, sales, and lobbying. Company personnel assigned to subsidiaries in foreign countries can find themselves trapped in ethical dilemmas if bribery and corruption of public officials are common practices or if suppliers or customers are accustomed to kickbacks of one kind or another.

2. Openly encourage company personnel to report possible infractions via anonymous calls to a hotline or e-mails sent to a designated address. Ideally, the company’s culture will be sufficiently ethically principled that most company personnel will feel it is their obligation and duty to report possible ethical violations (not so much to get someone in trouble but to prevent further damage and help the company avoid the dire consequences of a debilitating scandal. Furthermore, everyone must be encouraged to raise issues about ethically gray areas and to get confidential advice from the company’s ethics specialists.

3. Conduct an annual audit of each manager’s efforts to uphold ethical standards and require formal reports on the actions taken by managers to remedy deficient conduct.

4. Require all employees to sign a statement annually certifying that they have complied with the company’s code of ethics.

5. Make sure that ethical violations carry appropriate punishment, including dismissal if the violation is sufficiently egregious.

While these actions may seem extreme, they leave little room to doubt the seriousness of executive commitment to ethics compliance. Openly encouraging people to report possible ethical violations heightens awareness of operating within ethical bounds. And while violators have to be disciplined, the main purpose of the various means of enforcement is to encourage compliance rather than administer punishment. Most company personnel will think twice about knowingly engaging in unethical conduct when their actions could be reported by watchful co-workers. The same is true when they know their actions will be audited and/or when they have to sign statements certifying compliance with the company’s code of ethics.

Top executives in multinational companies face big challenges in enforcing strict ethical standards companywide because what is considered ethical often varies substantially or subtly from country to country. There are shades and variations in what societies generally agree to be right and wrong based on the prevailing circumstances, local customs, and predominant religious convictions. And certainly there are cross-country variations in the degree to which certain behaviors are considered unethical.29 Thus, transnational companies have to make a fundamental decision regarding whether to try to enforce common ethical standards across their operations in all countries or whether to allow some rules to be bent in some cases.
Chapter 13  Corporate Culture and Leadership

Leading Social Responsibility Initiatives  The exercise of social responsibility, just as with observance of ethical principles, requires top executive leadership. What separates companies that make a sincere effort to carry their weight in being good corporate citizens from companies that are content to do only what is legally required of them are company leaders who believe strongly that just making a profit is not good enough. Such leaders are committed to a higher standard of performance that includes social and environmental metrics as well as financial and strategic metrics. Thus, it is up to the CEO and other senior executives to insist that the company go past the rhetoric and cosmetics of corporate citizenship and implement social responsibility initiatives.

Among the leadership responsibilities of the CEO and other senior managers, therefore, are to step out front, to wave the flag of socially responsible behavior for all to see, to marshal the support of company personnel, and to make social responsibility initiatives an everyday part of how the company conducts its business affairs. Top executives have to use social and environmental metrics in evaluating performance and, ideally, the company’s board of directors will elect to tie the company’s social and environmental performance to executive compensation—a surefire way to make sure that social responsibility efforts are more than window dressing. To help ensure that it has commitment from senior managers, Verizon Communications ties 10 percent of the annual bonus of the company’s top 2,500 managers directly to the achievement of social responsibility targets. One survey found over 60 percent of senior managers believed that a portion of executive compensation should be linked to a company’s performance on social and environmental measures. The strength of the commitment from the top—typically a company’s CEO and board of directors—ultimately determines whether a company will implement and execute a full-fledged strategy of social responsibility that embraces some customized combination of actions to protect the environment (beyond what is required by law), actively participate in community affairs, be a generous supporter of charitable causes and projects that benefit society, and have a positive impact on workforce diversity and the overall well-being of employees.

One of the most reliable signs that company executives are leading an authentic effort to carry out fruitful social responsibility initiatives is whether the company issues an annual report on its social responsibility efforts that cites quantitative and qualitative evidence of the company accomplishments.

Leading the Process of Making Corrective Adjustments

The leadership challenge of making corrective adjustments is twofold: deciding when adjustments are needed and deciding what adjustments to make. Both decisions are a normal and necessary part of managing the strategy execution process, since no scheme for implementing and executing strategy can foresee all the events and problems that will arise. There comes a time at every company when managers have to fine-tune or overhaul the approaches to strategy execution and push for better results. Clearly, when a company’s strategy execution effort is not delivering good results and making measurable progress toward operating excellence, it is the leader’s responsibility to step forward and push corrective actions.
The process of making corrective adjustments varies according to the situation. In a crisis, it is typical for leaders to have key subordinates gather information, identify and evaluate options (crunching whatever numbers may be appropriate), and perhaps prepare a preliminary set of recommended actions for consideration. The organizational leader then usually meets with key subordinates and personally presides over extended discussions of the proposed responses, trying to build a quick consensus among members of the executive inner circle. If no consensus emerges and action is required immediately, the burden falls on the manager in charge to choose the response and urge its support.

When the situation allows managers to proceed more deliberately in deciding when to make changes and what changes to make, most managers seem to prefer a process of incrementally solidifying commitment to a particular course of action. The process that managers go through in deciding on corrective adjustments is essentially the same for both proactive and reactive changes: They sense needs, gather information, broaden and deepen their understanding of the situation, develop options and explore their pros and cons, put forth action proposals, generate partial (comfort-level) solutions, strive for a consensus, and finally formally adopt an agreed-on course of action. Deciding what corrective changes to initiate can take a few hours, a few days, a few weeks, or even a few months if the situation is particularly complicated.

Success in initiating corrective actions usually hinges on thorough analysis of the situation, the exercise of good business judgment in deciding what actions to take, and good implementation of the corrective actions that are initiated. Successful managers are skilled in getting an organization back on track rather quickly; they (and their staffs) are good at discerning what actions to take and in ramrodding them through to a successful conclusion. Managers that struggle to show measurable progress in generating good results and improving the performance of strategy-critical value chain activities are candidates for being replaced.

The challenges of leading a successful strategy execution effort are, without question, substantial. But the job is definitely doable. Because each instance of executing strategy occurs under different organizational circumstances, the managerial agenda for executing strategy always needs to be situation-specific—there’s no neat generic procedure to follow. And, as we said at the beginning of Chapter 11, executing strategy is an action-oriented, make-the-right-things-happen task that challenges a manager’s ability to lead and direct organizational change, create or reinvent business processes, manage and motivate people, and achieve performance targets. If you now better understand what the challenges are, what approaches are available, which issues need to be considered, and why the action agenda for implementing and executing strategy sweeps across so many aspects of administrative and managerial work, then we will look on our discussion in Chapters 11, 12, and 13 as a success.

A Final Word on Managing the Process of Crafting and Executing Strategy  In practice, it is hard to separate the leadership requirements of executing strategy from the other pieces of the strategy process. As we emphasized in Chapter 1, the job of crafting, implementing, and executing strategy is a five-phase process with much looping and recycling to fine-tune and adjust strategic visions, objectives, strategies, capabilities, implementation approaches, and cultures to fit one another and to fit changing circumstances. The process is continuous, and the conceptually separate acts of crafting and executing strategy blur together in real-world situations. The best tests of good strategic leadership are whether the company has a
good strategy and whether the strategy execution effort is delivering the hoped-for results. If these two conditions exist, the chances are excellent that the company has good strategic leadership.

**Key Points**

The character of a company’s culture is a product of the core values and business principles that executives espouse, the standards of what is ethically acceptable and what is not, the work practices and behaviors that define “how we do things around here,” its approach to people management and style of operating, the “chemistry” and the “personality” that permeates its work environment, and the stories that get told over and over to illustrate and reinforce the company’s values, business practices, and traditions. A company’s culture is important because it influences the organization’s actions and approaches to conducting business—in a very real sense, the culture is the company’s “operating system” or organizational DNA. The psyche of corporate cultures varies widely. Moreover, company cultures vary widely in strength and influence. Some are strongly embedded and have a big impact on a company’s practices and behavioral norms. Others are weak and have comparatively little influence on company operations. There are four types of unhealthy cultures: (1) those that are highly political and characterized by empire building, (2) those that are change resistant, (3) those that are insular and inwardly focused, and (4) those that are ethically unprincipled and are driven by greed. High-performance cultures and adaptive cultures both have positive features that are conducive to good strategy execution.

A culture grounded in values, practices, and behavioral norms that match what is needed for good strategy execution helps energize people throughout the company to do their jobs in a strategy-supportive manner, adding significantly to the power of a company’s strategy execution effort and the chances of achieving the targeted results. But when the culture is in conflict with some aspect of the company’s direction, performance targets, or strategy, the culture becomes a stumbling block. Thus, an important part of the managing the strategy execution process is establishing and nurturing a good fit between culture and strategy.

A company’s present culture and work climate may or may not be compatible with what is needed for effective implementation and execution of the chosen strategy. When a company’s present work climate promotes attitudes and behaviors that are well suited to first-rate strategy execution, its culture functions as a valuable ally in the strategy execution process. When the culture is in conflict with some aspect of the company’s direction, performance targets, or strategy, the culture becomes a stumbling block. Changing a company’s culture, especially a strong one with traits that don’t fit a new strategy’s requirements, is a tough and often time-consuming challenge. Changing a culture requires competent leadership at the top. It requires symbolic actions and substantive actions that unmistakably indicate serious commitment on the part of top management. The more that culture-driven actions and behaviors fit what’s needed for good strategy execution, the less managers have to depend on policies, rules, procedures, and supervision to enforce what people should and should not do.

The taproot of a company’s corporate culture nearly always is its dedication to certain core values and the bar it sets for ethical behavior. Of course, sometimes a company’s stated core values and codes of ethics are cosmetic, existing mainly to impress outsiders and help create a positive company image. But more usually they have been
developed to shape the culture. If management practices what it preaches, a company’s core values and ethical standards nurture the corporate culture in three highly positive ways: (1) They communicate the company’s good intentions and validate the integrity and above-board character of its business principles and operating methods; (2) they steer company personnel toward both doing the right thing and doing things right; and (3) they establish a corporate conscience that gauges the appropriateness of particular actions, decisions, and policies. Companies that really care about how they conduct their business put a stake in the ground, making it unequivocally clear that company personnel are expected to live up to the company’s values and ethical standards—how well individuals display core values and adhere to ethical standards is often part of the job performance evaluations. Peer pressures to conform to cultural norms are quite strong, acting as an important deterrent to outside-the-lines behavior.

Leading the drive for good strategy execution and operating excellence calls for five actions on the part of the manager-in-charge:

1. Staying on top of what is happening, closely monitoring progress, ferreting out issues, and learning what obstacles lie in the path of good execution.
2. Putting constructive pressure on the organization to achieve good results and operating excellence.
3. Leading the development of stronger core competencies and competitive capabilities.
4. Displaying ethical integrity and leading social responsibility initiatives.
5. Pushing corrective actions to improve strategy execution and achieve the targeted results.

Exercises

1. Go to Herman Miller’s Web site (www.hermanmiller.com) and read what the company has to say about its corporate culture in its careers sections. Do you think this statement is just public relations, or, based on what else you can learn about the Herman Miller Company from browsing this Web site, is there reason to believe that management has truly built a culture that makes the stated values and principles come alive?

2. Go to the careers section at Qualcomm’s Web site (www.qualcomm.com) and see what this company, one of the most prominent companies in mobile communications technology, has to say about life at Qualcomm. Is what’s on this Web site just recruiting propaganda, or does it convey the type of work climate that management is actually trying to create? If you were a senior executive at Qualcomm, would you see merit in building and nurturing a culture like what is described in the section “Life at Qualcomm”? Would such a culture represent a tight fit with Qualcomm’s high-tech business and strategy? (You can get an overview of the Qualcomm’s strategy by exploring the section for investors and some of the recent press releases.) Is your answer consistent with what is presented in the “Awards and Honors” menu selection in the “About Qualcomm” portion of the Web site?

3. Go to the Web site of Johnson & Johnson (www.jnj.com) and read the “J&J Credo,” which sets forth the company’s responsibilities to customers, employees, the community, and shareholders. Then read the “Our Company” section. Why do you think the credo has resulted in numerous awards and accolades that recognize the company as a good corporate citizen?
4. Do an Internet search or use the resources of your university’s library to identify at least five companies that have experienced a failure of strategic leadership on the part of the CEO since 2000. Three candidate companies you might want to research are Adelphia Communications, AIG, and HealthSouth. Then determine which, if any, of the five factors discussed in this chapter’s section titled “Leading the Strategy Execution Process” came into play in the CEOs’ failure.

5. Dell Inc. has been listed as one of *Fortune*’s most admired companies for several years. Click on the “About Dell” link at [www.dell.com](http://www.dell.com). What is your assessment of the company’s extensive discussion of accountability, concern for the environment, and community involvement? Does it appear these programs have the support of upper-level management? Is there evidence that this is more than a public relations initiative?

6. Review the material in Illustration Capsule 13.1 on Google’s corporate culture; then go to the company’s Web site, click on the “About Google” link, then on the “Corporate Info” link and read the “Ten things Google has found to be true” in the “Our Philosophy” section. What relationships do you see between these 10 things and Google’s description of its culture? Are the two closely connected? Why or why not? Explain.
It was in the spring of the second year of his insurrection against the High Sheriff of Nottingham that Robin Hood took a walk in Sherwood Forest. As he walked he pondered the progress of the campaign, the disposition of his forces, the Sheriff’s recent moves, and the options that confronted him.

The revolt against the Sheriff had begun as a personal crusade. It erupted out of Robin’s conflict with the Sheriff and his administration. However, alone Robin Hood could do little. He therefore sought allies, men with grievances and a deep sense of justice. Later he welcomed all who came, asking few questions and demanding only a willingness to serve. Strength, he believed, lay in numbers.

He spent the first year forging the group into a disciplined band, united in enmity against the Sheriff and willing to live outside the law. The band’s organization was simple. Robin ruled supreme, making all important decisions. He delegated specific tasks to his lieutenants. Will Scarlett was in charge of intelligence and scouting. His main job was to shadow the Sheriff and his men, always alert to their next move. He also collected information on the travel plans of rich merchants and tax collectors. Little John kept discipline among the men and saw to it that their archery was at the high peak that their profession demanded. Scarlock took care of the finances, converting loot to cash, paying shares of the take, and finding suitable hiding places for the surplus. Finally, Much the Miller’s son had the difficult task of provisioning the ever-increasing band of Merrymen.

The increasing size of the band was a source of satisfaction for Robin, but also a source of concern. The fame of his Merrymen was spreading, and new recruits were pouring in from every corner of England. As the band grew larger, their small bivouac became a major encampment. Between raids the men milled about, talking and playing games. Vigilance was in decline, and discipline was becoming harder to enforce. “Why,” Robin reflected, “I don’t know half the men I run into these days.”

The growing band was also beginning to exceed the food capacity of the forest. Game was becoming scarce, and supplies had to be obtained from outlying villages. The cost of buying food was beginning to drain the band’s financial reserves at the very moment when revenues were in decline. Travelers, especially those with the most to lose, were now giving the forest a wide berth. This was costly and inconvenient to them, but it was preferable to having all their goods confiscated.

Robin believed that the time had come for the Merrymen to change their policy of outright confiscation of goods to one of a fixed transit tax. His lieutenants strongly resisted this idea. They were proud of the Merrymen’s famous motto: “Rob the rich and give to the poor.” “The farmers and the townspeople,” they argued, “are our most important allies. How can we tax them, and still hope for their help in our fight against the Sheriff?”

Robin wondered how long the Merrymen could keep to the ways and methods of their early days. The Sheriff was growing stronger and becoming better organized. He now had the money and the men and was beginning to harass the band, probing for its weaknesses. The tide of events was beginning to turn against the Merrymen. Robin felt that the campaign must be decisively concluded before the Sheriff had a
chance to deliver a mortal blow. “But how,” he wondered, “could this be done?”

Robin had often entertained the possibility of killing the Sheriff, but the chances for this seemed increasingly remote. Besides, killing the Sheriff might satisfy his personal thirst for revenge, but it would not improve the situation. Robin had hoped that the perpetual state of unrest, and the Sheriff’s failure to collect taxes, would lead to his removal from office. Instead, the Sheriff used his political connections to obtain reinforcement. He had powerful friends at court and was well regarded by the regent, Prince John.

Prince John was vicious and volatile. He was consumed by his unpopularity among the people, who wanted the imprisoned King Richard back. He also lived in constant fear of the barons, who had first given him the regency but were now beginning to dispute his claim to the throne. Several of these barons had set out to collect the ransom that would release King Richard the Lionheart from his jail in Austria. Robin was invited to join the conspiracy in return for future amnesty. It was a dangerous proposition. Provincial banditry was one thing, court intrigue another. Prince John had spies everywhere, and he was known for his vindictiveness. If the conspirators’ plan failed, the pursuit would be relentless, and retributions swift.

The sound of the supper horn startled Robin from his thoughts. There was the smell of roasting venison in the air. Nothing was resolved or settled. Robin headed for camp promising himself that he would give these problems his utmost attention after tomorrow’s raid.
With global revenues exceeding $62 billion in 2005, bottled water was among the world’s most attractive beverage categories. Industry revenues were forecast to grow by an additional 30 percent between 2005 and 2010, to reach approximately $82 billion. Bottled water had long been a widely consumed product in Western Europe and Mexico, where annual per capita consumption approached or exceeded 40 gallons in 2005, but until the mid-1990s bottled water had been somewhat of a novelty or prestige product in the United States. In 1990, approximately 2.2 billion gallons of bottled water were consumed in the United States and per capita consumption approximated 9 gallons. U.S. per capita consumption had grown to more than 25 gallons by 2005. The rising popularity of bottled water in the United States during the late 1990s and early 2000s had allowed the United States to become the world’s largest market for bottled water, with annual volume sales of nearly 7.5 billion gallons in 2005. In 2006, emerging-country markets in Asia and South America seemed to be replicating the impressive growth of bottled water in the United States, with annual growth rates exceeding 20 percent. Exhibit 1 presents bottled water statistics for the 10 largest country markets for bottled water in 2004.

The growing popularity of bottled water in the United States was attributable to concerns over the safety of municipal drinking water, an increased focus on fitness and health, and the hectic on-the-go lifestyles of American consumers. Bottled water’s convenience, purity, and portability made it the natural solution to consumers’ dissatisfaction with tap water and carbonated beverages. The U.S. bottled water market, like most markets outside the United States, was characterized by fierce competitive rivalry as the world’s bottled water sellers jockeyed for market share and volume gains. Both the global and U.S. bottled water markets had become dominated by a few international food and beverage producers—such as Coca-Cola, PepsiCo, and Nestlé—but they also included many small regional sellers who were required to either develop low-cost production and distribution capabilities or use differentiation strategies keyed to some unique product attributes. In 2006, competitive rivalry continued to ratchet upward as sellers launched innovative product variations, lowered prices in developed markets, used strategic agreements to strengthen positions in established markets, and acquired smaller sellers to gain footholds in rapidly growing emerging markets.

Industry analysts and observers believed the recent moves undertaken by the world’s largest sellers of bottled water would alter the competitive dynamics of the bottled water industry and would mandate that certain players modify their current strategic approaches to competition in the industry.

INDUSTRY CONDITIONS IN 2006

Even though it was the world’s largest market for bottled water, the United States remained among the faster-growing markets for bottled water since per capita consumption rates of bottled water fell substantially below those in Western Europe, the Middle
Case 4  Competition in the Bottled Water Industry in 2006

Exhibit 1  Leading Country Markets for Bottled Water, 1999, 2004 (in millions of gallons)

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>1</td>
<td>United States</td>
<td>4,579.9</td>
<td>6,806.7</td>
<td>8.2%</td>
</tr>
<tr>
<td>2</td>
<td>Mexico</td>
<td>3,056.9</td>
<td>4,668.3</td>
<td>8.8</td>
</tr>
<tr>
<td>3</td>
<td>China</td>
<td>1,217.0</td>
<td>3,140.1</td>
<td>20.9</td>
</tr>
<tr>
<td>4</td>
<td>Brazil</td>
<td>1,493.8</td>
<td>3,062.0</td>
<td>15.4</td>
</tr>
<tr>
<td>5</td>
<td>Italy</td>
<td>2,356.1</td>
<td>2,814.4</td>
<td>3.6</td>
</tr>
<tr>
<td>6</td>
<td>Germany</td>
<td>2,194.6</td>
<td>2,722.6</td>
<td>4.4</td>
</tr>
<tr>
<td>7</td>
<td>France</td>
<td>1,834.1</td>
<td>2,257.3</td>
<td>4.2</td>
</tr>
<tr>
<td>8</td>
<td>Indonesia</td>
<td>907.1</td>
<td>1,943.5</td>
<td>16.5</td>
</tr>
<tr>
<td>9</td>
<td>Spain</td>
<td>1,076.4</td>
<td>1,453.5</td>
<td>6.2</td>
</tr>
<tr>
<td>10</td>
<td>India</td>
<td>444.0</td>
<td>1,353.3</td>
<td>25.0</td>
</tr>
<tr>
<td></td>
<td>All others</td>
<td>6,833.5</td>
<td>10,535.0</td>
<td>9.0</td>
</tr>
<tr>
<td></td>
<td>Worldwide total</td>
<td>25,993.4</td>
<td>40,756.7</td>
<td>9.4 (Avg. CARG)</td>
</tr>
</tbody>
</table>

* CAGR=Compound annual growth rate

Source: Beverage Marketing Corporation as reported by the International Bottled Water Association, 2006.

East, and Mexico. Bottled water consumption in the United States also lagged per capita consumption of soft drinks by more than a 2:1 margin, but in 2003 bottled water surpassed coffee, tea, milk, and beer to become the second largest beverage category in the United States. In 2005, more than 15.3 million gallons of carbonated soft drinks were consumed in the United States, but concerns about sugar consumption and other nutrition and fitness issues had encouraged many consumers to transition from soft drinks to bottled water. Whereas the bottled water market in the United States grew by 10.7 percent between 2004 and 2005 to reach 7.5 billion gallons, the U.S. carbonated soft drink market declined by 0.6 percent. Industry analysts expected the carbonated soft drink industry to decline by 1.5 percent annually for the foreseeable future as bottled water, energy drinks, and sports drinks gained a larger “share of the stomach.” Exhibits 2, 3, and 4 illustrate the growing popularity of bottled water among U.S. consumers during the 1990s and through 2004.

Almost one-half of bottled water consumed in the United States in 1990 was delivered to homes and offices in returnable five-gallon containers and dispensed through coolers. At that time, only 186 million gallons of water was sold in one-liter or smaller single-serving polyethylene terephthalate (PET) bottles. Beginning in the late 1990s, consumers began to appreciate the convenience and portability of water bottled in single-serving PET containers that could be purchased chilled from a convenience store and drunk immediately. By 2005, bottled water sold in two-liter or smaller PET containers accounted for 60.8 percent of industry volume. The unit sales of bottled water packaged in PET containers grew by 22.5 percent between 2004 and 2005. Water sold in five-gallon containers used in the home and office delivery (HOD) market accounted for only 17.8 percent of industry volume in 2005 and grew by only 0.2 percent between 2004 and 2005. Similarly, water sold in 1- or 2.5-gallon high-density polyethylene (HDPE) containers accounted for just 16.5 percent of industry volume in 2005 and grew by only 1.0 percent between 2004 and 2005.

Convenience and portability were two of a variety of reasons U.S. consumers were increasingly attracted to bottled water. A heightened emphasis on healthy lifestyles and improved consumer awareness of the need for proper hydration led many consumers to shift traditional beverage preferences toward bottled water. Bottled water consumers frequently claimed that drinking more water improved the appearance of their skin and gave them more energy. Bottled water analysts also believed that many health-conscious consumers drank bottled water because it was a symbol to others that they were interested in their health.

A certain amount of industry growth was attributable to increased concerns over the quality of tap water provided by municipal water sources.
### Exhibit 2 Per Capita Consumption of Bottled Water by Country Market, 1999, 2004

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>1</td>
<td>Italy</td>
<td>40.9 48.5</td>
<td>3.5%</td>
</tr>
<tr>
<td>2</td>
<td>Mexico</td>
<td>30.9 44.5</td>
<td>7.6%</td>
</tr>
<tr>
<td>3</td>
<td>United Arab Emirates</td>
<td>29 43.2</td>
<td>8.3%</td>
</tr>
<tr>
<td>4</td>
<td>Belgium-Luxembourg</td>
<td>32.2 39.1</td>
<td>4.0%</td>
</tr>
<tr>
<td>5</td>
<td>France</td>
<td>31 37.4</td>
<td>3.8%</td>
</tr>
<tr>
<td>6</td>
<td>Spain</td>
<td>26.9 36.1</td>
<td>6.1%</td>
</tr>
<tr>
<td>7</td>
<td>Germany</td>
<td>26.6 33</td>
<td>4.4%</td>
</tr>
<tr>
<td>8</td>
<td>Lebanon</td>
<td>17.9 26.8</td>
<td>8.4%</td>
</tr>
<tr>
<td>9</td>
<td>Switzerland</td>
<td>23.8 26.3</td>
<td>2.0%</td>
</tr>
<tr>
<td>10</td>
<td>Cyprus</td>
<td>17.8 24.3</td>
<td>6.4%</td>
</tr>
<tr>
<td>11</td>
<td>United States</td>
<td>16.8 23.9</td>
<td>7.3%</td>
</tr>
<tr>
<td>12</td>
<td>Saudi Arabia</td>
<td>19.9 23.2</td>
<td>3.1%</td>
</tr>
<tr>
<td>13</td>
<td>Czech Republic</td>
<td>16.4 23</td>
<td>7.0%</td>
</tr>
<tr>
<td>14</td>
<td>Austria</td>
<td>19.7 21.7</td>
<td>2.0%</td>
</tr>
<tr>
<td>15</td>
<td>Portugal</td>
<td>18.6 21.2</td>
<td>2.7%</td>
</tr>
<tr>
<td></td>
<td>Global Average</td>
<td>4.3 6.4</td>
<td>8.3%</td>
</tr>
</tbody>
</table>

* CAGR = compound annual growth rate

Source: Beverage Marketing Corporation as reported by the International Bottled Water Association, 2006.


<table>
<thead>
<tr>
<th>Year</th>
<th>Volume Sales (in billions of liters)</th>
<th>Annual Change</th>
<th>Industry Revenues ($ in billions)</th>
<th>Annual Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>92.8</td>
<td></td>
<td>$47.3</td>
<td></td>
</tr>
<tr>
<td>2002</td>
<td>99.5</td>
<td>7.2%</td>
<td>51.3</td>
<td>8.5%</td>
</tr>
<tr>
<td>2003</td>
<td>107.9</td>
<td>8.4%</td>
<td>56.1</td>
<td>9.4</td>
</tr>
<tr>
<td>2004</td>
<td>113.3</td>
<td>5.0%</td>
<td>59.1</td>
<td>5.3</td>
</tr>
<tr>
<td>2005(e)</td>
<td>119.7</td>
<td>5.6%</td>
<td>62.9</td>
<td>6.4</td>
</tr>
<tr>
<td>2006(f)</td>
<td>125.9</td>
<td>5.2%</td>
<td>66.4</td>
<td>5.6</td>
</tr>
<tr>
<td>2007(f)</td>
<td>132.9</td>
<td>5.6%</td>
<td>70.4</td>
<td>6.0</td>
</tr>
<tr>
<td>2008(f)</td>
<td>139.5</td>
<td>5.0%</td>
<td>74.5</td>
<td>5.8</td>
</tr>
<tr>
<td>2009(f)</td>
<td>146.4</td>
<td>4.9%</td>
<td>78.5</td>
<td>5.4</td>
</tr>
<tr>
<td>2010(f)</td>
<td>153.4</td>
<td>4.8%</td>
<td>81.9</td>
<td>4.3</td>
</tr>
</tbody>
</table>

(e) = estimated
(f) = forecast


Consumers in parts of the world with inadequate water treatment facilities relied on bottled water to provide daily hydration needs, but tap water in the United States was very pure by global standards. (Municipal water systems were regulated by the U.S. Environmental Protection Agency and were required...
to comply with the provisions of the Safe Drinking Water Act Amendments of 2001.) Consumer concerns over the quality of drinking water in the United States emerged in 1993 when 400,000 residents of Milwaukee, Wisconsin, became ill with flu-like symptoms and almost 100 immune-impaired residents died from waterborne bacterial infections. Throughout the 1990s and into the early 2000s, the media sporadically reported cases of municipal water contamination, such as in 2000 when residents of Washington, D.C., became ill after the city’s water filtration process caused elevated levels of suspended materials in the water.

Even though some consumers were concerned about the purity of municipal water, most consumers’ complaints with tap water centered on the chemical taste of tap water that resulted from treatment processes that included the use of chlorine and other chemicals such as fluoride. In a tap-water tasting in Atlanta hosted by Southpoint Magazine, judges rated municipal water on taste and found some cities’ waters very palatable. Water obtained from the municipal source in Memphis was said to have “a refreshing texture.” However, other municipal systems did not fare as well with the judges—some of whom suggested Houston’s water tasted “like a chemistry lab,” while others said Atlanta’s municipal water was akin to “a gulp of swimming pool water.” However, there were positive attributes to the chemicals added to tap water, as chlorine was necessary to kill any bacteria in the water and fluoride had contributed greatly to improved dental health in the United States. In addition, tap water had been shown to be no less healthy than bottled water in a number of independent studies, including a study publicized in Europe that was commissioned by the World Wide Fund for Nature and conducted by researchers at the University of Geneva.

Bottled water producers in the United States were required to meet the standards of both the Environmental Protection Agency (EPA) and the U.S. Food and Drug Administration (FDA). Like all other food and beverage products sold in the United States, bottled water was subject to such food safety and labeling requirements as nutritional labeling provisions and general good manufacturing practices (GMPs). Bottled water GMPs were mandated under the 1962 Kefauver-Harris Drug Amendments to the Federal Food, Drug and Cosmetic Act of 1938 and established specifications for plant construction and design, sanitation, equipment design and construction, production and process controls, and record keeping. The FDA required bottled water producers to test at least weekly for the presence of bacteria and to test annually for inorganic contaminants, trace metals, minerals, pesticides, herbicides, and organic compounds. Bottled water was also regulated by state agencies that conducted inspections of bottling facilities and certification of testing facilities to ensure that bottled water was bottled under federal GMPs and was safe to drink.

Bottled water producers were also required to comply with the FDA’s Standard of Identity, which required bottlers to include source water information on their products’ labels. Water labeled as “spring water” must have been captured from a borehole or natural orifice of a spring that naturally flows to the surface. “Artesian water” could be extracted from a confined aquifer (a water-bearing underground layer of rock or sand) where the water level stood above the top of the aquifer. “Sparkling water” was required to have natural carbonation as it emerged from the source, although carbonation could be added to

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**Exhibit 4** U.S. Per Capita Consumption of Bottled Water, 1991–2005

<table>
<thead>
<tr>
<th>Year</th>
<th>Per Capita Consumption (in gallons)</th>
<th>Annual Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>9.3</td>
<td>—</td>
</tr>
<tr>
<td>1992</td>
<td>9.8</td>
<td>5.4%</td>
</tr>
<tr>
<td>1993</td>
<td>10.5</td>
<td>7.1</td>
</tr>
<tr>
<td>1994</td>
<td>11.5</td>
<td>9.5</td>
</tr>
<tr>
<td>1995</td>
<td>12.2</td>
<td>6.1</td>
</tr>
<tr>
<td>1996</td>
<td>13.1</td>
<td>7.4</td>
</tr>
<tr>
<td>1997</td>
<td>14.1</td>
<td>7.6</td>
</tr>
<tr>
<td>1998</td>
<td>15.3</td>
<td>8.5</td>
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<tr>
<td>1999</td>
<td>16.8</td>
<td>9.8</td>
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<tr>
<td>2000</td>
<td>17.8</td>
<td>6.0</td>
</tr>
<tr>
<td>2001</td>
<td>19.3</td>
<td>8.4</td>
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<tr>
<td>2002</td>
<td>21.2</td>
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<tr>
<td>2003</td>
<td>22.6</td>
<td>6.6</td>
</tr>
<tr>
<td>2004</td>
<td>24</td>
<td>6.2</td>
</tr>
<tr>
<td>2005(p)</td>
<td>25.7</td>
<td>7.1</td>
</tr>
</tbody>
</table>

*(p) = preliminary

*Source:* Beverage Marketing Corporation as reported by the International Bottled Water Association, 2006.
return the carbon dioxide level to what was evident as the water emerged from the source. Even though sparkling water was very popular throughout most of Europe, where it accounted for approximately 54 percent of industry sales, it made up only 8 percent of the bottled water market in the United States.

The FDA’s definition of “mineral water” stated that such water must have at least 250 parts per million of total dissolved solids, and its standards required water labeled as “purified” to have undergone distillation, deionization, or reverse osmosis to remove chemicals such as chlorine and fluoride. “Drinking water” required no additional processing beyond what was required for tap water but could not include flavoring or other additives that account for more than 1 percent of the product’s total weight. Both “drinking water” and “purified water” had to clearly state that the water originated “from a community water system” or “from a municipal source.”

Bottled water producers could also voluntarily become members of the International Bottled Water Association (IBWA) and agree to comply with its Model Code, which went beyond the standards of the EPA, FDA, or state agencies. The Model Code allowed fewer parts per million of certain organic and inorganic chemicals and microbiological contaminants than FDA, EPA, or state regulations and imposed a chlorine limitation on bottled water. Neither the FDA nor the EPA limited chlorine content. IBWA members were monitored for compliance through annual, unannounced inspections administered by an independent third-party organization.

**Distribution and Sale of Bottled Water**

Consumers could purchase bottled water in nearly any location in the United States where food was also sold. The distribution of bottled water varied depending on the producer and the distribution channel. Typically, bottled water was distributed to large grocers and wholesale clubs directly by the bottled water producer, whereas most producers used third parties like beer and wine distributors or food distributors to make sales and deliveries to convenience stores, restaurants, and delis.

Because of the difficulty for food service distributors to restock vending machines and provide bottled water to special events, Coca-Cola and PepsiCo were able to dominate such channels since they could make deliveries of bottled water along with their deliveries of other beverages. Coca-Cola’s and PepsiCo’s vast beverage distribution systems made it easy for the two companies to make Dasani and Aquafina available anywhere Coke or Pepsi could be purchased. In addition, the two cola giants almost always negotiated contracts with sports stadiums, universities, and school systems that made one of them the exclusive supplier of all types of nonalcoholic beverages sold in the venue for a specified period. Under such circumstances, it was nearly impossible for other brands of bottled water to gain access to the account.

PepsiCo and Coca-Cola’s soft drink businesses had allowed vending machine sales to account for 8 percent of industry sales volume in 2005 and had also aided the two companies in making Aquafina and Dasani available in supermarkets, supercenters, wholesale clubs, and convenience stores. Soft drink sales were important to all types of food stores since soft drinks made up a sizable percentage of the store’s sales and since food retailers frequently relied on soft drink promotions to generate store traffic. Coca-Cola and PepsiCo were able to encourage their customers to purchase items across their product lines to ensure prompt and complete shipment of key soft drink products. As a diversified food products company, PepsiCo had exploited the popularity of its soft drinks, Gatorade sports drinks, Frito-Lay snack foods, and Tropicana orange juice in persuading grocery accounts to purchase not only Aquafina but also other non–soft drink brands such as FruitWorks, SoBe, Lipton’s Iced Tea, and Starbucks Frappuccino.

Since most supermarkets, supercenters, and food stores usually carried fewer than seven branded bottled waters plus a private-label brand, bottled water producers other than Coke and Pepsi were required to compete aggressively on price to gain access to shelf space. Supermarkets and discount stores accounted for 43.5 percent of U.S. industry sales in 2005 and were able to require bottled water suppliers to pay slotting fees in addition to offering low prices to gain shelf space. Natural foods stores could also require annual contracts and slotting fees but were much more willing than traditional supermarkets to pay higher wholesale prices for products that could contribute to the store’s overall level of differentiation. In fact, most natural foods stores would not carry brands found in traditional supermarkets.
Convenience stores were also aggressive in pressing bottled water producers and food distributors for low prices and slotting fees. Most convenience stores carried only two to four brands of bottled water beyond what was distributed by Coca-Cola and Pepsi and required bottlers to pay annual slotting fees of $300 to $400 per store in return for providing 5 to 10 bottle facings on a cooler shelf. Some bottlers offered to provide retailers with rebates of approximately 25 cents per case to help secure distributors for their brand of bottled water. Food and beverage distributors usually allowed bottled water producers to negotiate slotting fees and rebates directly with convenience store buyers.

There was not as much competition among bottled water producers to gain shelf space in delis and restaurants since that channel accounted for only 6.5 percent of U.S. industry sales in 2005. PepsiCo and Coca-Cola were among the better-suited bottled water producers to economically distribute water to restaurants since they likely provided fountain drinks to such establishments.

**Suppliers to the Industry**

The suppliers to the bottled water industry included municipal water systems; spring operators; bottling equipment manufacturers; deionization, reverse osmosis, and filtration equipment manufacturers; manufacturers of PET and HDPE bottles and plastic caps; label printers; and secondary packaging suppliers. Most packaging supplies needed for the production of bottled water were readily available from a large number of suppliers. Large bottlers able to commit to annual purchases of more than 5 million PET bottles could purchase bottles for as little as 5 cents per bottle, whereas regional bottlers purchasing smaller quantities of bottles or making only one-time purchases of bottles could expect to pay a much as 15 cents per bottle. Suppliers of secondary packaging like cardboard boxes, shrink-wrap, and six-pack rings and suppliers of printed film or paper labels were numerous and aggressively competed for the business of large bottled water producers.

Bottling equipment used for water purification and filling bottles was manufactured and marketed by about 50 different companies in the United States. A basic bottle-filling line could be purchased for about $125,000, whereas a large state-of-the-art bottling facility could require a capital investment of more than $100 million. Bottlers choosing to sell spring water could expect to invest about $300,000 for source certification, road grading, and installation of pumping equipment, fencing, holding tanks, and disinfecting equipment. Bottlers that did not own springs were also required to enter into lease agreements with spring owners that typically ranged from $20,000 to $30,000 per year. Companies selling purified water merely purchased tap water from municipal water systems at industrial rates prior to purifying and bottling the water for sale to consumers. Sellers of purified water were able not only to pay less for water they bottled, but also to avoid spring water’s inbound shipping costs of 5 to 15 cents per gallon since water arrived at the bottling facility by pipe rather than by truck.

**Key Competitive Capabilities in the Bottled Water Industry**

Bottled water did not enjoy the brand loyalty of soft drinks, beer, or many other food and beverage products but was experiencing some increased brand loyalty, with 10 to 25 percent of consumers looking for a specific brand and an additional two-thirds considering only a few brands acceptable. Because of the growing importance of brand recognition, successful sellers of bottled water were required to possess well-developed brand-building skills. Most of the industry’s major sellers were global food companies that had built respected brands in soft drinks, dairy products, chocolates, and breakfast cereals prior to entering the bottled water industry.

Bottled water sellers also needed to have efficient distribution systems to supermarket, wholesale club, and convenience store channels to be successful in the industry. It was imperative for bottled water distributors (whether direct store delivery by bottlers or delivery by third parties) to maximize the number of deliveries per driver since distribution included high fixed costs for warehouses, trucks, handheld inventory tracking devices, and labor. It was also critical for distributors and bottlers to provide on-time deliveries and offer responsive customer service to large customers in the highly price-competitive market. Price competition also mandated high utilization of large-scale plants to achieve low production costs. Volume and market share were also key factors in keeping marketing expenses at an acceptable per-unit level.
Recent Trends in the Bottled Water Industry

As the annual growth rate of bottled water sales in the United States slowed from double-digit rates, signs had begun to appear that price competition in the bottled water industry might mirror that of the carbonated soft drink industry. Fierce price competition could be expected to bring volume gains but result in flat or declining revenues for the bottled water industry. Coca-Cola, Nestlé, and PepsiCo had avoided strong price competition through 2004, but during the first six months of 2005 all three of the industry’s largest sellers began to offer considerable discounts on 12- and 24-bottle multipacks to boost unit volume. Exhibit 5 presents average U.S. retail prices for 24-bottle multipacks marketed by Nestlé Waters, Coca-Cola, and PepsiCo between 2003 and the first six months of 2005.

The world’s largest sellers of bottled water appeared to be positioning for industry maturity by purchasing smaller regional brands. Nestlé had acquired bottled water producers and entered into joint ventures in Poland, Hungary, Russia, Greece, France, Turkey, Algeria, South Korea, Indonesia, and Saudi Arabia between 2000 and 2006. Danone Waters also made a number of acquisitions and entered into strategic alliances and joint ventures during the early 2000s to increase penetration of selected emerging and developed markets.

Danone and Nestlé had long competed against each other in most country markets, but PepsiCo and Coca-Cola were also becoming global sellers of bottled water. Coca-Cola had used a joint venture with Danone Waters to increase its bottled water product line in the United States beyond Dasani and acquired established brands in Europe and Australia to build strength in markets outside the United States. PepsiCo expanded into international markets for bottled water by allowing foreign bottling franchisees to license the Aquafina brand. The strategic maneuvering had created a more globally competitive environment in which the top sellers met each other in almost all of the world’s markets and made it difficult for regional sellers to survive. California-based Palomar Mountain Spring Water was one of many casualties of intensifying competitive rivalry. Like many other independent bottled water companies launched in the 1990s, Palomar was forced into bankruptcy in 2003 after losing key supermarket and discount store contracts. After Palomar lost much of its distribution in California supermarkets and discount stores to Nestlé, its 2003 revenues fell to $7 million from $30 million just two years earlier. Exhibit 6 illustrates the extent to which the U.S. bottled water market had consolidated by 2003 and 2004.

The introduction of enhanced waters or functional waters was the most important product innovation since bottled water gained widespread acceptance in the United States, with most sellers in 2006 having introduced variations of their products that included flavoring, vitamins, carbohydrates, electrolytes, and other supplements. The innovation seemed to be a hit with U.S. consumers, as the market for enhanced bottled waters expanded from $20 million...
in 2000 to approximately $1 billion in 2006. Most sellers of bottled water had yet to make functional waters widely available outside the United States. Energy Brands helped create the enhanced water segment in the United States with its 2000 launch of Glacéau Vitamin Water, which contained a variety of vitamins promoting mental stimulation, physical rejuvenation, and overall improved health. Glacéau was the best-selling brand of enhanced water in 2000 and 2001, but it fell to the number two position in the segment upon PepsiCo’s launch of Propel Fitness Water. Propel Fitness Water remained the market leader in the U.S. enhanced water segment in 2006. Energy Brands had achieved a compounded annual growth rate of more than 200 percent between 2000 and 2005, to record estimated sales of $350 million and maintain its number two position in the U.S. functional water category.

Coca-Cola, Nestlé, and Danone Waters had begun testing vitamin-enhanced waters in as early as 2002, but all three had changed their approaches to functional waters by 2006. Coke had given up on vitamin-enhanced waters in favor of flavored water, while Nestlé Waters and Danone Waters retained only a fluoride-enhanced water. Like those at Coca-Cola, managers at Nestlé and Danone believed that flavored waters offered substantial growth opportunities in most country markets. The Tata Group, an Indian beverage producer, showed greater confidence in the vitamin-enhanced bottled water market with its purchase of a 30 percent stake in Energy Brands in 2006 for $677 million. The Tata Group’s chairman believed that Energy Brands had the potential to become a $3 billion company within 10 years.

**PROFILES OF THE LEADING BOTTLED WATER PRODUCERS**

**Nestlé Waters**

Nestlé was the world’s leading seller of bottled water, with a worldwide market share of 18.3 percent in 2006. It was also the world’s largest food company, with 2005 sales of 91 billion Swiss francs (approximately $71 billion). The company was broadly diversified into 10 food and beverage categories that were sold in almost every country in the world under such recognizable brand names as Nescafé, Taster’s Choice, Perrier, Vittel, Carnation, PowerBar, Friskies, Alpo, Nestea, Libby’s, Stouffer’s, and of course, Nestlé. The company produced bottled water as early as 1843, but its 1992 acquisition of Perrier created the foundation of what has made Nestlé Waters the world’s largest seller of bottled water, with 75 brands in 130 countries. In 2005, Nestlé recorded bottled water sales of 8.8 billion Swiss francs (approximately $6.9 billion) and was the global leader in the bottled water industry, with an 18.3 percent worldwide market share in 2005. Nestlé Waters was the number one seller of bottled water in the United States with a 42.1 percent market share in 2004 and the number one seller in Europe with a 20 percent market share. Nestlé was also the number one seller in Africa and the Middle East and was aggressive in its attempts to build market-leading positions in emerging markets Asia and Latin America through the introduction
of global Nestlé products and the acquisition of established local brands. The company acquired nearly 20 bottled water producers between 2001 and 2003. In 2006, Nestlé Waters was the number one brand of bottled water in Pakistan, Vietnam, and Cuba; the number two brand in Indonesia and Argentina; and the number three brand in Thailand.

The company’s bottled water portfolio in 2006 included two global brands (Nestlé Pure Life and Nestlé Aquarel), five international premium brands (Perrier, Vittel, Contrex, Acqua Panna, and S. Pellegrino), and 68 local brands. Nestlé Pure Life was a purified water product developed in 1998 for emerging markets and other markets in which spring water was not an important differentiating feature of bottled water. Nestlé Aquarel was developed in 2000 for the European market and markets that preferred still spring water over purified water or sparkling spring water. Nestlé’s other waters marketed in Europe were either spring water with a higher mineral content or sparkling waters such as Perrier and S. Pellegrino. Almost all brands marketed outside of Europe were either spring water or mineral water with no carbonation. Its brands in the United States included Pure Life, Arrowhead, Ice Mountain, Calistoga, Deer Park, Zephyrhills, Ozarka, and Poland Spring.

During the early 2000s, Nestlé Waters management believed that its broad portfolio of local water brands was among the company’s key resource strengths. However, the notable success of Nestlé’s two global brands had caused management to reorganize the division in 2006. Pure Life and Aquarel had grown from just 2.5 percent of the division’s sales in 2002 to 12.0 percent of the division’s 2005 sales. Consumers in the United States seemed to accept the Pure Life brand as well as long-established local brands, with sales of Nestlé Pure Life in the United States increasing by 50 percent between 2004 and 2005. Flavored varieties of Pure Life had also achieved notable success in Canada by capturing a 70 percent share of the flavored water market within the first six months on the market. Nestlé’s 68 local brands had accounted for as much as 75.7 percent of division sales in 2002, but local brands had declined to 64.8 percent of sales in 2005. The company’s five premium international brands accounted for an additional 23.2 percent of 2005 sales.

Nestlé had test-marketed functional waters fortified with vitamins and plant extracts between 2003 and 2004, but offered only fruit-flavored enhanced waters in 2006. Contrex Lemon Meringue and Strawberry Melba were two innovative calorie-free flavors introduced in 2006. The company had also used packaging innovations to differentiate its bottled water brands, including a spill-proof cap for child-sized bottles of Poland Spring, Deer Park, and Arrowhead. Nestlé Waters also developed a bubble-shaped bottle that was designed to appeal to children. Perrier’s new PET container was part of a strategy to revitalize the prestigious brand, which had experienced annual sales declines since the mid-1990s. The new plastic bottle was intended to better match the on-the-go lifestyles of young consumers than Perrier’s heavy one-liter glass containers. Nestlé would still package Perrier in glass bottles for consumers who preferred the brand’s traditional packaging for dinner parties and other formal settings.

Home and office delivery (HOD) was also an important component of Nestlé’s strategy—especially in North America, Europe, and the Middle East. HOD made up nearly 30 percent of Nestlé Waters’ sales volume in the United States and was recording double-digit growth in most other country markets in 2005. In 2005, Nestlé competed in the HOD market for bottled water in 30 countries. Between 2000 and 2004, the company had made 8 acquisitions in the European HOD segment to grow from no presence to the leading position, with 32 percent market share. Nestlé had also made acquisitions and entered into joint ventures to develop market leading positions in countries located in the Middle East, Northern Africa, and the Far East. Nestlé’s market leading positions in Europe and the United States in HOD and PET channels allowed it to earn the status of low-cost leader in the United States. Exhibit 7 illustrates Nestlé Waters’ cost and wholesale pricing advantages relative to Coca-Cola and PepsiCo in U.S. markets. Nestlé Waters’ management stated in mid-2002 that it expected to double the division’s revenues by 2010.

**Groupe Danone**

Groupe Danone was established through the 1966 merger of two of France’s leading glass makers, who foresaw the oncoming acceptability of plastic as a substitute to glass containers. The management of the newly merged company believed that, rather
than shifting its focus to the manufacture of plastic containers, the company should enter markets for products typically sold in glass containers. Groupe Danone’s diversification outside of glass containers began in 1969 when the company acquired Evian—France’s leading brand of bottled water. Throughout the 1970s and 1980s, Groupe Danone acquired additional food and beverage companies that produced beer, pasta, baby food, cereals, sauces, confectionery, dairy products, and baked goods. In 1997, the company slimmed its portfolio of businesses to dairy products, bottled water, and a baked goods division producing cereal, cookies, and snacks. In 2005, Groupe Danone was a leading global food company, with annual sales of €13 billion and was the world’s largest producer of dairy products, the number two producer of cereal, cookies, and baked snacks, and the second largest seller of bottled water. The company had been the largest seller of bottled water by volume in 2005 but was displaced by Nestlé in both terms of volume and dollar sales during 2006.

Danone recorded worldwide bottled water sales of €3.4 billion in 2005. Among Groupe Danone’s most important beverage brands were Evian, the world’s leading brand of spring water, and Wahaha, the leading brand of bottled water in China. Each brand accounted for more than €1 billion in sales during 2005. During that year, 40 percent of Danone’s bottled water sales originated in Europe, 47 percent were in China, and 13 percent were in emerging markets outside of Asia. Danone’s local and regional brands held number one shares in many country markets such as Denmark, Germany, Spain, the United Kingdom, Poland, Indonesia, Mexico, and Morocco.

Like Nestlé, Danone had made a number of acquisitions of regional bottled water producers during the late 1990s and early 2000s. During 2002,
Danone acquired a controlling interest in Poland’s leading brand of bottled water for an undisclosed amount and purchased Canada’s Sparkling Spring brand of waters for an estimated $300–$400 million. The company also entered into a joint venture with Kirin Beverage Company to strengthen its distribution network in Japan and embarked on a partnership with the Rachid Group, an Egyptian firm, to accelerate its development of market opportunities in North Africa and the Near and Middle East. During 2003 and 2004, Groupe Danone acquired three HOD bottled water sellers in Mexico. Danone acquired the leading brand of bottled water in Serbia and an HOD seller in Spain in 2004. In 2006, the company acquired a 49 percent stake in Denmark’s leading seller of bottled water.

Danone Waters’ revenues had declined by nearly 20 percent between 2000 and 2005 as its U.S. distribution agreement with Coca-Cola began to suffer. Prior to Coca-Cola’s launch of Dasani, its bottlers distributed Evian and other non-Coke bottled water brands. Before the introduction of Dasani, about 60 percent of Evian’s U.S. distribution was handled by Coca-Cola bottlers. With Coca-Cola bottler’s attention directed toward the sale of Dasani, Evian lost shelf space in many convenience stores, supermarkets, delis, restaurants, and wholesale clubs.

Danone Waters and Coca-Cola entered into a joint venture in 2002 that allowed Evian and Dannon bottled water brands to be distributed along with Dasani to convenience stores, supermarkets, and other retail locations serviced by Coca-Cola’s bottling operations. In addition, the agreement made Coke responsible for the production, marketing and distribution of Dannon in the United States. Coca-Cola provided Danone an up-front cash payment in return for 51 percent ownership of the joint venture. Danone contributed its five plants and other bottled water assets located in the United States to the joint venture. However, Evian and Dannon continued to suffer under the new distribution arrangement as Coca-Cola continued to put most of its marketing muscle behind Dasani. Danone sold its 49 percent interest in the North American bottled water joint venture to Coca-Cola in 2005.

Danone’s home and office delivery businesses were not included in the agreement with Coca-Cola and were combined with Suntory Water Group’s assets to form DS Waters in 2003. The combination of Danone Waters’ and Suntory Waters assets made the joint venture the largest HOD distributor in the United States, with sales of approximately $800 million. Brands marketed by DS Waters included Alhambra, Crystal Springs, Sierra Springs, Hinckley Springs, Kentwood Springs, Belmont Springs, and Sparkletts. Groupe Danone and Suntory sold 100 percent of DS Waters to a private investment fund in 2005 for an undisclosed sum. The sale resulted in a €315 million loss for Groupe Danone and completed Groupe Danone’s exit from the North American bottled water market. Danone’s HOD business remained the worldwide leader in the category with number one rankings in Asia, Argentina, and Canada. Groupe Danone was the second largest HOD provider in Europe in 2005 through a joint venture with Swiss-based Eden Springs.

Groupe Danone had made functional and flavored waters a strategic priority for its beverage business. The company introduced flavored and vitamin-rich versions of Volvic in Europe during 2003 and 2004, and by 2005 it was selling flavored and functional waters in most of its markets. The company held a number one ranking in functional beverage categories in New Zealand and Argentina. Functional and flavored waters accounted for 25 percent of the group’s beverage sales in 2005.

The Coca-Cola Company

With 300 brands worldwide, the Coca-Cola Company was the world’s leading manufacturer, marketer, and distributor of nonalcoholic beverage concentrates. The company produced soft drinks, juice and juice drinks, sports drinks, water, and coffee and was best known for Coca-Cola, which has been called the world’s most valuable brand. In 2005, the company sold more than 20.6 billion cases of beverages worldwide to record revenues of $23.1 billion. Coca-Cola’s net income for 2005 was nearly $4.9 billion. Seventy-three percent of Coke’s gallon sales were generated outside of North America, with four international markets (Mexico, Brazil, China, and Japan) accounting for 27 percent of Coca-Cola’s sales by volume. Sales in the United States also accounted for 27 percent of the company’s total volume.

Along with the universal appeal of the Coca-Cola brand, Coca-Cola’s vast global distribution system that included independent bottlers, bottlers partially owned by Coca-Cola, and company-owned bottlers made Coke an almost unstoppable international
Cola’s sales of bottled water to increase from $765 million in 2002 to $1.3 billion in 2003, the three-tier strategy seemed to be failing in some regards since Coke’s three water brands had collectively lost 2.2 market share points between 2003 and 2004. Coca-Cola’s loss of market share seemed to be attributable, to some to degree, to Nestlé’s growth during 2004 and the increasing popularity of private-label brands, which had grown by more than 60 percent during 2004. However, some lost market share for the three brands combined might have been a result of weak support for Evian and Dannon brands. Coca-Cola had committed to increasing advertising and promotion for Evian by 20 percent between 2005 and 2010, but beverage industry analysts believed it was unlikely that Evian would ever return to its previous top-five ranking in the United States.

Coca-Cola tested a vitamin- and flavor-enhanced Dasani NutriWater sub-brand during 2002 and 2003, but it abandoned the concept after poor test-market performance. In 2005, the company did go forward with Splenda-sweetened lemon- and raspberry-flavored varieties of Dasani. The company later added strawberry and grape flavors to the Dasani line. Fruit-flavored Dasani had proved to be successful in the market by 2006, with most retailers stocking at least two flavors of Dasani in addition to unflavored Dasani water. Coca-Cola extended the Dasani line in 2006 with the introduction of Dasani Sensations—a flavored water with light carbonation. Like other varieties of Dasani, Dasani Sensations contained no calories. Powerade Option was another functional water developed by Coca-Cola that was introduced in 2005. Powerade Option was a competing product to Gatorade Propel Fitness Water and was available in grape and strawberry flavors in 2006. As of 2006, Powerade Option had been largely unsuccessful in capturing share from Propel Fitness Water and was unavailable in many retail locations.

Coca-Cola had long produced and marketed, bottled water in foreign countries under local brand names, such as its Bon Aqua brand in the German market and NaturAqua in Hungary, but began efforts to make Dasani an international brand in 2004 with expansion into Africa, Brazil, and the United Kingdom. Coca-Cola management chose the United Kingdom as its entry point to Western Europe with launches planned for 20 additional European countries by mid-2004. Coca-Cola supported the March 2004 launch of Dasani in the United Kingdom with a $3.2 million advertising budget and a
4-million-bottle sampling campaign but voluntarily recalled all Dasani bottles from retailers’ shelves just two weeks after the launch.

The recall was predicated on test results performed by the company that indicated the bottles were tainted with bromate—a cancer-causing agent. Bromate became introduced to the product when calcium, a mandatory ingredient for bottled waters sold in the United Kingdom, was added to Coca-Cola’s proprietary formula of minerals used to distinguish Dasani from other bottled waters. The bromate levels present in Dasani exceeded regulatory limits in the United Kingdom but met standards for purity on the European continent. Nevertheless, Coke management believed it best to recall the product and discontinue immediate plans to distribute Dasani not only in the United Kingdom but also in all other European markets. The Dasani launch was viewed by many in the business press as one of the all-time great marketing disasters and resulted in Coke’s abandoning the Dasani brand in Europe. Coca-Cola management announced during a June 2006 Deutsche Bank conference for consumer goods that it would expand its line of noncarbonated beverages in Europe through acquisitions. Within two weeks of the announcement, Coca-Cola had acquired the Italian mineral water company Fonti del Vulture and the Apollinaris mineral water brand sold in Germany by Orangina. Coca-Cola also acquired two HOD bottled water producers in Australia during 2006.

**PepsiCo Inc.**

In 2006, PepsiCo was the world’s fourth largest food and beverage company, with sales of approximately $32 billion. The company’s brands were sold in more than 200 countries and included such well-known names as Lay’s, Tostitos, Mountain Dew, Pepsi, Doritos, Lipton Iced Tea, Gatorade, Quaker, and Cracker Jack. Six of PepsiCo’s products were among the top-15 largest selling products sold in U.S. supermarkets. PepsiCo also produced and marketed Aquafina—the best-selling brand of bottled water in the United States between 2002 and 2006.

PepsiCo had made attempts to enter the bottled water market in as early as 1987, when it purchased a spring water company, but its attempts were unsuccessful until its 1997 introduction of Aquafina. After experimenting with spring water and sparkling water for several years, Pepsi management believed it would be easier to produce a national brand of bottled water that could utilize the same water purification facilities in Pepsi bottling plants that were used to produce the company’s brands of soft drinks. Pepsi management also believed that the company could distinguish its brand of purified bottled water from competing brands by stripping all chlorine and other particles out of tap water that might impart an unpleasant taste or smell. PepsiCo began testing a filtration process for Aquafina in 1994 when it installed $3 million worth of reverse osmosis filtration equipment in its Wichita, Kansas, bottling plant to further purify municipal water used to make soft drinks. The system pushed water through a fiberglass membrane at very high pressure to remove chemicals and minerals before further purifying the water using carbon filters. The water produced by Pepsi’s process was so free of chemicals that the company was required to add ozone gas to the water to prevent bacteria growth.

Since the company’s introduction of Aquafina, PepsiCo had expanded its water brands in the United States to include Gatorade Propel Fitness Water, SoBe Life Water, and functional versions of Aquafina. The product lines for its water business were developed around customer type and lifestyle. Propel was a flavor- and vitamin-enriched water marketed to physically active consumers, while Life Water was a vitamin-enhanced water similar to Glacéau Vitamin Water in formulation and packaging that was marketed to image-driven consumers. The company targeted mainstream water consumers with unflavored Aquafina, Aquafina FlavorSplash (offered in four flavors), and Aquafina Sparkling (a zero-calorie, lightly carbonated citrus or berry-flavored water). Aquafina Alive, planned for a 2007 launch, included vitamins and natural fruit juices. The company’s strategy involved offering a continuum of healthy beverages from unflavored Aquafina to nutrient-rich Gatorade. In 2006, Gatorade, Propel, and Aquafina were all number one in their categories, with market shares of 80 percent, 34 percent, and approximately 14 percent, respectively.

PepsiCo was slowly moving into international bottled water markets, with its most notable effort occurring in Mexico. In 2002, PepsiCo’s bottling operations acquired Mexico’s largest Pepsi bottler, Pepsi-Gemex SA de CV, for $1.26 billion. Gemex not only bottled and distributed Pepsi soft drinks in Mexico but also was Mexico’s number one producer.
of purified water. After its acquisition of Gemex, PepsiCo shifted its international expansion efforts to bringing Aquafina to selected emerging markets in Eastern Europe, the Middle East, and Asia. In 2006, Aquafina was the number one brand of bottled water in Russia and Vietnam and the number two brand in Kuwait.

Other Sellers

In addition to the industry’s leading sellers of bottled water, there were hundreds of regional and specialty brands of bottled water in the United States. Most of these companies were privately held bottlers with distribution limited to small geographic regions that competed aggressively on price to make it onto convenience store and supermarket shelves as third-tier brands. Many of these bottlers also sought out private-label contracts with discounters and large supermarket chains to better ensure full capacity utilization and to achieve sufficient volume to purchase bottles and other packaging at lower prices. CG Roxanne was the most successful privately owned bottled water company in the United States. The company’s Crystal Geyser brand made it the fourth largest seller of bottled water in the United States in 2004, with a 7.4 percent market share. Crystal Geyser competed at the lower price points in U.S. supermarkets and convenience stores and was bottled from springs in California, Tennessee, South Carolina, and New Hampshire. The company did not disclose its financial performance.

Another group of small bottlers such as Fiji, Penta and Trinity Springs used differentiating features to avoid the fierce price competition at the low end of the market and sold in the superpremium segment, where bottled water retailed from $1.50 to $2.25 per 16-ounce PET container. Superpremium brands were most often sold in natural foods stores, with Trinity Springs being among the leaders in the channel in 2005. Trinity’s differentiation was based on its water source, which was a 2.2-mile-deep artesian well located in the Trinity Mountains of Idaho. Trinity Springs’ distribution halted in March 2006 when a court invalidated the 2004 sale of the company to Amcon Distributing. Amcon, which had lost $2 million in fiscal 2005 and another $1.8 million during the first six months of fiscal 2006, shut down its Trinity Springs water division after the ruling and was negotiating a settlement with Trinity Springs shareholders in late 2006.

Penta’s differentiation was based on a proprietary purification system that the company claimed removed 100 percent of impurities from tap water. The company had also built brand recognition through product placements in motion pictures, music videos, and more than 25 television series. Penta also sponsored a large number of triathlons across the United States and was endorsed by a wide variety of entertainers and professional athletes. In 2006, Penta was distributed in more than 5,000 health food stores in the United States. Penta was also available in Australia, Japan, the United Kingdom, and Canada. Fiji was also among the best-selling brands of superpremium water sold in natural foods stores in 2006 but was also sold in many supermarkets, convenience stores, and drugstores across the United States. Like Penta, Fiji received considerable exposure from its placement in network television series and motion pictures.

Voss achieved differentiation not only from the purity of its source in Norway but also through its distinctive glass bottle and limited channels of distribution. The brand was available only in the most exclusive hotels, spas, and resorts. Another superpremium brand, Eon, achieved its differentiation through its anti-aging claims. The company’s anti-aging properties were said to result from the basic atomic structure of Eon water, which was altered through a proprietary reverse osmosis technology. The structure of Eon was similar to that naturally occurring in snowflakes and glacier ice and was suggested to improve cellular hydration and cell detoxification properties better than unstructured water. Many other superpremium brands of bottled water were sold in the United States during 2006, with each attempting to support its premium pricing with some unique characteristic.

Endnote

A 2006 issue of *Kiplinger’s Personal Finance* cited the experience of a couple in Hawaii who were shopping for an engagement ring.1 The bride-to-be knew what she wanted, so she took a lead role in conducting the search. Several retail jewelry stores in Honolulu quoted her a price of about $7,900 for a nearly flawless diamond ring just under a carat. But the bride-to-be, a policewoman who took pride in thorough investigations, decided to continue her search online. She found a similar ring at BlueNile.com for $4,263 and her fiancé agreed to buy it. As soon as the order was placed, Blue Nile acquired the diamond, which had been selected from the New York diamond cutter whose diamond inventory was displayed on BlueNile.com, and the cutter shipped the diamond overnight to Blue Nile’s 13,000-square-foot warehouse in Seattle. A Blue Nile bench jeweler, using a magnifying visor and assorted tools of the trade, mounted the diamond in the setting that the bride-to-be had selected. The ring was cleaned in a tiny hot tub, blasted with steam, placed in a blue-and-silver box that was packed inside a cardboard shipping box, and shipped via FedEx for overnight delivery to the bride in Honolulu. The whole process took just three days. According to the bride-to-be, “It looks absolutely brilliant. It blinds you.”

Founded in 1999, Blue Nile had grown to become the world’s largest online retailer of certified diamonds and fine jewelry, with sales of $251.6 million in 2006 (up from $169.2 million in 2004). According to *Internet Retailer* magazine, in 2006 Blue Nile was larger than the next three largest online jewelers combined; the magazine had ranked Blue Nile number 48 in its “Top 400 Guide to Retail Web Sites”; in its December 2006 issue, the magazine went a step further and named Blue Nile an Internet Retailer Best of the Web 2007 company (one of five companies cited).3 *Forbes* magazine had selected Blue Nile as a Forbes Favorite every year during 2000–2005. The company had been awarded the BizRate.com Circle of Excellence Platinum Award, which recognized the best in online customer service as ranked by actual consumers; Blue Nile was the only jeweler to have ever received this award, and had been the recipient of this award every year since 2002. *Kiplinger’s Personal Finance* named Blue Nile as the best online jeweler in November 2006.4 Blue Nile had also received notice in *Time* and *Money* magazines.

In 2006, jewelry in the United States was an estimated $55–$60 billion industry.5 Annual sales of diamond jewelry were in the $30–$35 billion range, with diamond engagement rings accounting for sales of $4–$5 billion. About 72 percent of Blue Nile’s 2005 revenues involved sales of engagement rings; Blue Nile’s average engagement ring sale in 2005 was $5,600. Blue Nile management believed that the company’s market share of online sales of engagement rings exceeded 50 percent and that its 2005 share of the overall engagement ring market in the United States was approximately 3.2 percent.6 Sales of diamond jewelry other than engagement rings accounted for 18 percent of Blue Nile’s 2005 sales; management considered this segment to present significant growth opportunities because satisfied buyers of Blue Nile engagement rings would...
likely consider Blue Nile in their future purchases of diamond jewelry. Blue Nile provided engagement rings for over 80,000 couples from 2000 to mid-2006. Sales of jewelry not containing diamonds accounted for 10 percent of Blue Nile’s 2005 revenues; sales of these typically lesser-priced items were considered important because they helped develop both trial and repeat purchase opportunities.

BLUE NILE’S BUSINESS MODEL AND STRATEGY

In an industry famous for big markups, frequent closeout sales, and myriad judgments of value that often mystified consumers, the marketing challenge for online jewelers was to convince understandably skittish shoppers to purchase fine jewelry online. It was one thing to shop for a diamond in a reputable jewelry store where one could put on a ring or other jewelry item to see how it looked, perhaps inspect a stone with a magnifying glass or microscope, and have a qualified jeweler describe the features of various stone(s) and cuts, compare the character and merit of various settings, and explain why some items carried higher price tags than others. It was quite another thing to commit to buying expensive jewelry based on pictures and information provided on an Internet Web site.

Blue Nile’s strategy to attract customers had two core elements. The first was offering high-quality diamonds and fine jewelry at competitively attractive prices. The second entailed providing jewelry shoppers with a host of useful information and trusted guidance throughout their purchasing process. Top management believed its strategy of providing educational information, in-depth product information, and grading reports—coupled with its wide product selection and attractive prices—was the key driver of the company’s success and, ideally, would lead to customers looking upon Blue Nile as their jeweler for life:

We have established and are continuing to develop a brand based on trust, guidance and value, and we believe our customers view Blue Nile as a trusted authority on diamonds and fine jewelry. Our goal is for consumers to seek out the Blue Nile brand whenever they purchase high-quality diamonds and fine jewelry. 7

Competitive Pricing, Lean Costs, and Supply Chain Efficiency

Blue Nile’s domestic and international Web sites showcased as many as 60,000 independently certified diamonds and hundreds of styles of fine jewelry. The product offerings ranged from simple classic designs suitable for wearing every day to an impressive signature collection of some of the finest diamonds in the world. Diamonds were the most significant component of Blue Nile’s merchandise offerings, but the selection was limited chiefly to high-quality stones in terms of shape, cut, color, clarity, and carat weight. Complementing the large selection of individual diamonds and gems was a broad range of diamond, platinum, gold, pearl, and sterling silver jewelry that included settings, rings, wedding bands, earrings, necklaces, pendants, bracelets, and watches.

Blue Nile offered a Build Your Own feature that allowed customers to customize diamond rings, pendants, and earrings. Customers could select a diamond and then choose from a variety of ring, earring, and pendant settings that were designed to match the characteristics of each individual diamond.

Blue Nile’s economical supply chain and comparatively low operating costs allowed it to sell comparable-quality diamonds, gemstones, and fine jewelry pieces at substantially lower prices than those of reputable local jewelers. The supply chain bypassed the markups of traditional layers of diamond wholesalers and brokers, thus generally allowing Blue Nile to obtain most of its product offerings more cost-efficiently than traditional brick-and-mortar jewelers. The distinctive feature of Blue Nile’s supply chain was its set of arrangements that allowed it to display leading diamond and gem suppliers’ products on its Web site; some of these arrangements entailed multiyear agreements whereby designated diamonds were offered only at Blue Nile. Blue Nile’s suppliers represented more than half of the total supply of high-quality diamonds in the United States. 5 Blue Nile did not actually purchase a diamond or gem from these suppliers until a customer placed an order for it; this enabled Blue Nile to minimize the costs associated with carrying large inventories and limited its risk of potential markdowns. However, Blue Nile did selectively purchase finished pieces (usually bracelets,
necklaces, earrings, pendants, wedding bands, and watches), stocking them in its own inventory until customers purchased them. Even so, Blue Nile had inventories of only $11.7 million at year-end 2005 (versus sales of $203.2 million). In contrast, traditional jewelers had far bigger inventories relative to annual sales. For example, Zale Corporation—which not only sold online but also was the parent of Zales Jewelers (780 stores in the United States and Puerto Rico), Zales Outlet, Gordon’s Jewelers, Bailey Banks & Biddle (a luxury retail jeweler with 70 locations in 31 states and Puerto Rico), Peoples Jewelers (the largest Canadian jeweler), Mappins Jewelers (another Canadian jewelry chain), and Piercing Pagoda—reported year-end inventories of $853.6 million on 2005 sales of $2.4 billion. Luxury jewelry retailer Tiffany & Co. reported year-end inventories of $1.06 billion on 2005 sales of $2.4 billion.

Blue Nile’s supply chain savings gave it a significant pricing advantage. For every dollar that Blue Nile paid suppliers for stones, settings, and other purchased items, it sold its finished jewelry for a markup of about 33 percent over cost (equal to a gross profit margin of 22 percent). In contrast, Zale sold at an average markup of 100 percent over cost of goods sold and Tiffany sold an average markup over cost of goods sold of 127 percent in 2005 (equal to a gross profit margin of 56 percent).

Another cost-saving element of Blue Nile’s strategy was lean operating costs. The company had only 146 employees as of early 2006, of whom 133 were full-time; independent contractors and temporary personnel were hired on a seasonal basis. Blue Nile conducted its operations via a combination of proprietary and licensed technologies. It licensed third-party information technology systems for financial reporting, inventory management, order fulfillment, and merchandising. Also, it used redundant Internet carriers to minimize service interruptions and downtime. Management continuously monitored various operating systems using third-party software, and an on-call team responded to any emergencies or technology issues. Management also continuously explored avenues to improve operating efficiency, refine the company’s supply chain, and leverage its investment in fixed-cost technology. Blue Nile’s selling, general, and administrative (SG&A) expenses were only 13.3 percent of 2005 annual sales, down from 14.1 percent in 2003 and 19.6 percent in 2002; in contrast, SG&A expenses were 41.2 percent of 2005 sales at Zale Corporation and 40.1 percent of 2005 sales at Tiffany & Co.

Blue Nile’s agreements with suppliers and low operating costs enabled it to earn respectable profits while selling at prices that ranged from 20 to 40 percent below those of local retail jewelry stores. Blue Nile had a net profit margin of 6.5 percent in 2005, compared to 2005 net profit margins of 4.5 percent at Zale and 10.6 percent at Tiffany.

Blue Nile cut the retail prices of its diamonds in the second quarter of 2006 in an effort to drive sales gains; the price cuts helped produce a 30 percent sales gain in the quarter, the largest increase of the past six quarters. Sales in the second quarter of 2006 included seven customer sales above $100,000 and one sale above $200,000. In the third quarter, the company’s biggest sale was a premium-quality seven-carat engagement ring purchased for $324,000. CEO Mark Vadon, in an interview with The Motley Fool, talked about Blue Nile’s sales of diamonds at six-figure prices:

> Back in Q2, I believe we announced we had seven transactions in the quarter above $100,000, and over time, as the business has established more of a brand name out there, that part of the market for us is very, very active. We have always had products in that type of price range, and it used to be unusual for us to see a six-figure purchase. Now those are becoming pretty common around here.

What we typically do as our price points rise, we drop our percentage gross margin. So if you look at a purchase at, say, $100,000 price point, we are only making 8% or 9% gross margin on something like that. We are being as aggressive as possible to make the sale, so we will make more selling $100,000 of small rings as opposed to a single $100,000 ring, but we are really excited to have those types of sales.

We are obviously looking at the dollars of profit we are making on the transaction, and we just love that people walk around with a Blue Nile ring that is that extraordinary and [tell] people where they bought it.

**Educational Information and Certification**

Blue Nile went to considerable lengths to put to rest any concerns shoppers might have about buying fine jewelry online. It employed an informative
Carat

Refers to a diamond's weight, not its size. One carat equals one-fifth of a gram. While lighter diamonds often carry a lower price per carat, a 1.0 carat diamond might sparkle more than a 1.25 carat diamond if it is cut differently or has better color and clarity.

Clarity

The degree to which a diamond is free of flaws or inclusions—blemishes, internal imperfections, scratches, trace minerals, or other tiny characteristics that can detract from a diamond's beauty. Diamonds that are absolutely clear are the most sought after and therefore the most expensive. The lower the clarity (and the greater the flaws and inclusions), the lower the value of the diamond. The naked eye can see flaws in diamonds with very poor clarity, but even using a magnifying glass an untrained person would have trouble seeing flaws in a high-clarity diamond. The 11 grades of clarity—ranging from flawless to included—are based on the number, location, size, and type of inclusions present in a diamond. Inclusions and flaws are more visible to the naked eye in lower-grade emerald cuts than in lower-grade round diamonds.

Color

Concerns a diamond’s transparency. Acting as a prism, a diamond can divide light into a spectrum of colors and reflect this light as colorful flashes called fire. Like colored glass, color in a diamond will act as a filter and will diminish the spectrum of color emitted. The less color in a diamond, the more colorful the fire and the better the color grade. A little color in a white diamond could diminish its brilliance. White diamonds with very little color were the most highly valued and are priced accordingly. Color grades range from D (absolutely colorless and extremely rare) to Z. White diamonds with grades of D, E, or F are considered "colorless" grade and very high quality; diamonds with grades of G or H are near colorless and offer excellent value; diamonds with grades of I or J have slightly detectable color but still represent good value; the color in diamonds graded K–Z detracts from the beauty of the stone and is especially noticeable in platinum or white gold settings. (Blue Nile only sold diamonds with color grades of J or higher.) Yellow diamonds (some of which are fancy and highly valued) are graded on a different scale than white diamonds.

Cut

A diamond's shape (round, square, oval, pear, heart, marquise, and so on) and style (width, depth, symmetry, polish, and number/position of flat surfaces). Most diamonds are cut with 58 facets, or separate flat surfaces; it is the diamond cutter's job, using precise mathematical formulas, to align the facets at precise angles in relation to each other to maximize the reflection and refraction of light. Cut style affects how light travels within a diamond, thus determining its brightness, fire, and face-up appearance. The cutter's goal is to transform a diamond in the rough into a sparkling, polished stone of the largest possible size and greatest optical beauty; a poor or less desirable cut can dull the look and brilliance of diamonds with excellent color and clarity. There is no single measurement of a diamond that defines its cut, but rather a collection of measurements and observations that determine the relationship between a diamond's light performance, dimensions, and finish.

Cut Grade

This newest of the 5 C's is perhaps the overall best measure or indicator of a diamond's brilliance, sparkle, and “wow effect.” Fewer than 5% of diamonds on the market qualified for the highest cut grade rating. Cut grade was a summary rating that took into account such measures as the diamond's table size (the flat surface at the top of the diamond) as a percentage of the diamond's girth (the widest part of the diamond), the crown of the diamond (the portion above the girth) and the crown angle, the pavilion (the portion of the diamond below the girth)—the height of the pavilion contributed to its brilliance, the pavilion angle, the depth of the diamond (from the top facet to the culet), culet size, the diamond's polish and symmetry, and several other factors affecting sparkle, radiance, and brilliance.
Blue Nile’s management believed that having reputable industry professionals certify and grade each gemstone offered for sale had many advantages. The grading reports provided valuable guidance to consumers in choosing a stone that was right for them and their pocketbook—the carat weight, color, cut, and clarity of a diamond were critical in providing the buyer with the desired sparkle, brilliance, and dazzling or sophisticated look. In addition, a jewelry shopper’s ability to immediately review professionally prepared grading reports for a gemstone of particular interest instilled confidence in shopping for fine jewelry at Blue Nile, typically quelling any fears that the stone might not live up to expectations. Furthermore, the grading reports that Blue Nile provided facilitated comparison shopping, allowing jewelry shoppers not only to compare alternative Blue Nile gems but also to see how Blue Nile’s products stacked up against the products they might be considering at competing jewelers.

Customers interested in a particular diamond displayed at Blue Nile’s Web site could view or print out an accompanying diamond grading or certification report, prepared by an independent team of professional gemologists, that documented the specific characteristics of the diamond—see Exhibit 2. A diamond grading report (also called a diamond certificate or diamond quality document) was a report created by a team of gemologists who evaluated, measured, and scrutinized the diamond using trained eyes, a jeweler’s loupe, a microscope, and other professional equipment. The grading report included a detailed description of the diamond’s characteristics, such as carat weight, color, cut, and clarity, as well as an overall quality rating and a description of any visible inclusions or blemishes.

The following table shows price variations in diamonds with varying clarity but the same carat weight and color grade.

<table>
<thead>
<tr>
<th>Clarity Grade</th>
<th>Description</th>
<th>Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>FL</td>
<td>Flawless No internal or external finish flaws.</td>
<td>$7,500</td>
</tr>
<tr>
<td>IF</td>
<td>Internally flawless No internal flaws.</td>
<td>$7,200</td>
</tr>
<tr>
<td>VVS1</td>
<td>Very very slightly included Very difficult to see inclusions under 10× magnification.</td>
<td>$6,900</td>
</tr>
<tr>
<td>VVS2</td>
<td>Very slightly included Difficult to see inclusions under 10× magnification, typically unable to see inclusions with unaided eye.</td>
<td>$6,600</td>
</tr>
<tr>
<td>VS1</td>
<td>Slightly included Easy to see inclusions under 10× magnification, may not be able to see inclusions with unaided eye.</td>
<td>$5,000</td>
</tr>
<tr>
<td>VS2</td>
<td></td>
<td>$4,300</td>
</tr>
<tr>
<td>SI1</td>
<td></td>
<td>$5,500</td>
</tr>
<tr>
<td>SI2</td>
<td></td>
<td>$4,500</td>
</tr>
</tbody>
</table>

The following table compares the prices of diamonds with varying color grades but the same clarity grade (VS1) and carat weight:

<table>
<thead>
<tr>
<th>Colorless</th>
<th>Near-Colorless</th>
</tr>
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<tbody>
<tr>
<td>D</td>
<td>G</td>
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<tr>
<td>E</td>
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<td>F</td>
<td>I</td>
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<td>J</td>
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</tbody>
</table>

Exhibit 2  Diamond Characteristics Documented in a GIA Diamond Grading Report

Shape and Cutting Style: The diamond shape and cutting style.
Measurement: The diamond's dimensions in millimeters.
Carat Weight: The weight of diamond listed to the nearest hundredth of a carat.
Color Grade: A grading that assesses the absence of color in a diamond.
Clarity Grade: Clarity grade determined under 10× magnification.
Cut Grade: A grade of cut as determined by a diamond's face-up appearance, design, and craftsmanship. A GIA cut grade was available on round diamonds graded after January 1, 2006. The addition of cut grade to grading reports was particularly important because cut grade was the best indicator of a diamond's sparkle, brilliance, and “wow effect.” (A diamond's cut concerned its shape and number of facets but was not a reliable indicator of the sparkle and brilliance across the stone when looking at it face up.) The GIA's cut grades used a five-point scale from Poor to Excellent; in 2006, GIA cut grades were available only for select round diamonds, the most popular cut for engagement rings. GIA was said to be considering expanding its cut grade ratings to stones in other shapes (square, pear, and marquise). (According to one source, fewer than 5 percent of diamonds qualified for the highest cut grade.)
Finish: Grades that represent a diamond's surface and facet placement.
Polish: Rating the overall smoothness of the diamond's surface.
Symmetry: Measuring the shape, alignment and placement of the diamond’s facets in relation to one another as well as the evenness of the outline.
Fluorescence: Color and strength of color when diamond is viewed under ultraviolet light.
Comments: A description of additional diamond characteristics not already mentioned in the report.
Clarity Plot: A map of the approximate size, type, and position of inclusions as viewed under a microscope.
Proportion Diagram: A map of the diamond's actual proportions that typically includes information about the following:
- Culet: Appearance, or lack thereof, of the culet facet. The culet (pronounced “que-lay” or the French-sounding “que-lay”) was a tiny flat surface formed by polishing off the tip at the bottom of a diamond. The presence of a culet protected the fragile tip of the diamond from chipping during the cutting, handling, and setting of the diamond. However, Asians often preferred diamonds without a culet, so the practice of downgrading diamonds without culets had been discontinued.
- Table: Located at the top of the diamond, the table was the largest facet (or flat surface) of a diamond.
- Depth: The height of a gemstone measured from the culet to the table.
- Girdle: Range of girdle thickness.

and other industry tools. A completed certificate included an analysis of the diamond's dimensions, clarity, color, polish, symmetry, and other characteristics. Many round diamonds had a cut grade on the report. Every loose diamond sold by Blue Nile was analyzed and graded by either the Gemological Institute of America (GIA) or the American Gem Society Laboratories (AGSL):

- The GIA was regarded as the world’s foremost authority in gemology; its mission was to promote public trust in gems and jewelry. In the 1950s, the GIA had created an International Diamond Grading System and established standards that revolutionized the diamond industry. Most recently, the GIA had introduced a new Diamond Cut Grading System, which used computer modeling to assess and predict the cut quality in round brilliant cut diamonds. The GIA’s research revealed that there was no single set of proportions that defined a well-cut round brilliant diamond; according to the GIA, many different proportions could produce attractive diamonds. The GIA had also developed software that provided a method of estimating a cut grade—and a database that was embedded into a number of leading diamond measuring devices so that cut grade estimation could be automated. As a result, manufacturers could plan and, in effect, predict cut grades; buyers could compare cut qualities; and retailers could communicate the effects of cut on round brilliant diamonds. On January 1, 2006, the GIA laboratory introduced new versions of the GIA Diamond Grading Report and Diamond Dossier that provided a single, comprehensive cut grade for all standard round brilliant diamonds falling in the GIA D-to-Z color scale and
Flawless-to-I3 clarity scale. Diamonds received one of five cut grades, from Excellent to Poor.

- Founded in 1996, the AGSL was the only diamond grading laboratory to offer a unique 0 to 10 grading system that provided easy-to-read, clear, and accurate information about each diamond it graded. A cut grade of 10 was the lowest quality, and a grade of 000 was the absolute finest or ideal quality, but so far AGSL had only awarded cut grades to select round and square-cut diamonds. (It was, however, considering expanding the grading system to other cuts.) AGSL grading reports were based on the gemological industry’s highest standards of evaluating the four C’s of cut, color, clarity, and carat weight. AGSL grades allowed a shopper to compare the quality of the diamond against the price.

These two laboratories, among the most respected laboratories in the diamond industry, were known for their consistency and unbiased diamond grading systems. Diamonds that were accompanied by GIA and AGSL grading reports were the most highly valued in the industry.

In addition to being graded by the GIA or AGSL, all diamonds in Blue Nile’s signature collection were also certified by the Gem Certification and Appraisal Lab (GCAL). This provided a second authoritative analysis of the diamond. GCAL verified that a diamond met all the specific quality requirements of the Blue Nile Signature Collection—see Exhibit 3.

**Marketing**

Blue Nile’s marketing strategy was designed to increase Blue Nile brand recognition, generate consumer traffic, acquire customers, build a loyal customer base, and promote repeat purchases. Top executives at Blue Nile believed that jewelry shoppers preferred to seek out high-quality diamonds and fine jewelry from a trusted source in a non-intimidating environment, where information, guidance, reputation, convenience, and value were important characteristics. Hence, a major portion of Blue Nile’s marketing effort was focused on making sure that site visitors had a positive, informative experience shopping at Blue Nile, one that inspired their confidence to buy diamonds and fine jewelry from the company. One key initiative to provide a good customer experience was the development of a user-friendly interactive search tool that allowed shoppers to customize their search and quickly identify diamonds with the characteristics they were looking for. An advanced version of Blue Nile’s diamond search tool launched in March 2006 allowed site visitors to search Blue Nile’s diamond collection according to any of 12 criteria, including price, carat weight, cut,

**Exhibit 3  Contents of a Certificate of Authenticity Issued by the Gem Certification and Appraisal Lab (GCAL)**

- **Actual Size Photo**—A photo of the diamond at its true size.
- **Laser Inscription Photo**—A close-up shot of the laser inscription on the diamond taken at 50x magnification.
- **Proportion Diagram**—A diagram noting the diamond’s actual scale, and noting its specific measurements. These measurements were used to determine the cut grade.
- **Enlarged Photomicrograph**—A photo of the diamond from top and bottom.
- **An Optical Brilliance Analysis**—Images of the diamond were captured using a controlled lighting environment and carefully calibrated amounts of light at specific viewing angles. These tests showed the amount of light return or brilliance as it exited the diamond’s crown.
- **Optical Symmetry Analysis**—A test analyzing the light exiting the diamond and showing the discrepancies in the balance of the diamond. An even and symmetrical pattern showed that the light was well balanced and indicated exceptional diamond quality.
- **Certification Statement**—A statement signed by the GCAL laboratory director verifying the quality of the graded diamond.
- **Diamond Grading Analysis**—This analysis noted the diamond’s shape, measurements, carat weight, and cut grade based on its proportions, polish, symmetry, color, and clarity grades. It also contained any comments regarding the diamond.

color, clarity, polish, symmetry, fluorescence, culet, diamond grading report, depth percentage, and table percentage. The Blue Nile customer experience was designed to empower customers with knowledge and confidence as they evaluated, selected, and purchased diamonds and fine jewelry.

The company’s efforts to draw more shoppers to its site and boost awareness of Blue Nile included both online and offline marketing and advertising efforts. Most of Blue Nile’s advertising dollars went for ads at Web portals (Yahoo!, America Online, and MSN), search engine sites (Google), and select other sites. The company also did some direct online marketing. Advertising expenses were $4.5 million in 2003, $6.5 million in 2004, $7.6 million in 2005, and $9.7 million in 2006.

Blue Nile pulled back on advertising during December 2005 because the cost to buy keywords on Internet search engines rose dramatically. Search keyword bidding pushed up Blue Nile’s cost per click on Google to more than 50 percent above December 2004 levels; moreover, the price of Google’s top five keywords rose by over 80 percent. According to Blue Nile’s CEO, Mark Vadon, the aggressive competition in the crowded search market converted fewer searchers into Blue Nile buyers.

Customer Service and Support

Blue Nile strove to provide a high level of customer service and was continuously engaged in refining the customer service aspects in every step of the purchase process. Complementing the extensive information resources on its Web site was a call center staffed with knowledgeable, highly trained support personnel. Blue Nile diamond and jewelry consultants were trained to provide guidance on all steps in the process of buying diamonds and fine jewelry, including the process for selecting an appropriate item, the purchase of that item, financing and payment alternatives, and shipping services. Customers with questions could call a prominently displayed toll-free number or send an e-mail to service@bluenile.com; most calls to the Blue Nile call center were answered within 10 seconds.10 There were personnel assigned to creating and enhancing the features and functionality of the company’s Web site and order processing and fulfillment systems. Policies relating to privacy, security, product availability, pricing, shipping, refunds, exchanges, and special orders were readily accessed at the company’s Web site.

Order Fulfillment Operations

Order fulfillment at Blue Nile was designed to enhance customer value and confidence by filling customer orders accurately and delivering them quickly and securely. When an order for a customized diamond jewelry piece was received, the supplier holding the diamond in inventory generally shipped it to Blue Nile (or an independent third-party jeweler with whom Blue Nile maintained an ongoing relationship for assembly) within one business day. Upon receipt at Blue Nile, the diamond was sent to assembly for setting and sizing, tasks performed by either Blue Nile bench jewelers or independent third-party bench jewelers. Each diamond was inspected upon arrival from suppliers; additionally, each finished setting or sizing was inspected prior to shipment to a customer. Prompt and secure delivery was a high priority, and Blue Nile shipped nearly all diamond and fine jewelry products via FedEx. The company had an on-time order delivery rate of 99.96 percent, which it was striving to push to 100 percent.11

Order fulfillment costs, which were included as part of SG&A expenses, totaled $1.5 million in 2003, $1.6 million in 2004, $1.8 million in 2005, and $2.4 million in 2006. These costs included all expenses associated with operating and staffing the Seattle warehouse and order fulfillment center, including costs attributable to receiving, inspecting, and warehousing inventories and picking, preparing, and packaging customers’ orders for shipment.

Product Line Expansion

Blue Nile was selectively expanding its product offerings in terms of both price points and product mix. New product offerings included both customized and noncustomized jewelry items. Management believed that the online nature of Blue Nile’s business, coupled with its supply arrangements where diamonds and other gemstones were purchased form suppliers only when an order was placed, allowed it to readily test shopper response to new diamond and gemstone offerings and to efficiently add promising new merchandise to its overall assortment of fine jewelry.
Expansion into International Markets

Blue Nile was selectively pursuing opportunities in those international markets where management believed the company could leverage its existing infrastructure and deliver compelling customer value. The decision to enter a new country market was based on the volume of consumer spending on jewelry, the extent to which consumers in a country were adopting online purchasing, the competitive landscape, and other factors. In August 2004, Blue Nile launched a Web site in the United Kingdom (www.bluenile.co.uk), offering a limited number of products; in September 2005, Blue Nile began providing customers at its U.K. Web site with the ability to customize their diamond jewelry purchases and to buy wedding bands. A Web site in Canada (www.bluenile.ca) was launched in January 2005. In 2006, both the U.K. and Canadian Web sites had more limited merchandise selections than the U.S. Web site and less developed search and educational features; the two international sites had combined sales of only $3.3 million in 2005.

Other Strategy Elements

Blue Nile’s strategy had three other key elements:

- Blue Nile automatically provided an appraisal stating the approximate retail replacement value of the item to customers who bought (1) a preset engagement ring priced under $2,500; (2) a diamond jewelry item priced $1,000 and over (except preset solitaire engagement rings, preset earrings, or preset solitaire pendants priced $2,500 or over which come with International Gemological Institute appraisals); or (3) any custom diamond ring, earring, or pendant. The appraisal value was based on current market data, typical retail prices, the weight of precious metal included in the item, craftsmanship, and the cut, color, clarity, and carat weight of the gemstone(s). Included with the appraisal was a brief description of the item being appraised, a photograph of the item, and the cut, color, clarity, and either carat weight for any diamonds, or millimeter dimensions for any gemstones. An appraisal represented value-added to customers because a customer had to have one to obtain insurance coverage and determine what constituted equal replacement in case of loss, theft, or damage.

BLUE NILE’S FINANCIAL AND STRATEGIC PERFORMANCE

During the 2001–2006 period, Blue Nile’s sales jumped from $48.7 million to $251.6 million, a compound average growth rate of almost 39 percent. Gross profits (sales minus cost of goods sold) rose from $11.1 million in 2001 to $50.9 million in 2006, equal to a compound average growth rate of 35.6 percent. And the company’s bottom-line performance was vastly improved, going from a net loss of $7.4 million in 2001 to a net profit of $13.1 million in 2006 (although net profit was flat from 2005 to 2006). The company generated $40.5 million in cash from operations in 2006 and had a largely debt-free balance sheet going into both 2006 and 2007. Exhibit 4 presents highlights of Blue Nile’s financial results from fiscal years 2001 through 2006. In fiscal year 2007, Blue Nile’s management expected that net sales would be between $290 million and $300 million, with net income in the range of $0.80 to $0.85 per diluted share.
($ in thousands, except per share data)

<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>2003</td>
</tr>
<tr>
<td>Net sales</td>
<td>$251,587</td>
<td>$203,169</td>
<td>$169,242</td>
<td>$128,894</td>
</tr>
<tr>
<td>Cost of sales*</td>
<td>200,734</td>
<td>158,025</td>
<td>131,590</td>
<td>99,476</td>
</tr>
<tr>
<td>Gross profit</td>
<td>50,853</td>
<td>45,144</td>
<td>37,652</td>
<td>29,418</td>
</tr>
<tr>
<td>Selling, general and</td>
<td>34,296</td>
<td>27,095</td>
<td>22,295</td>
<td>18,207</td>
</tr>
<tr>
<td>administrative expenses</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Restructuring charges</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>(87)</td>
</tr>
<tr>
<td>Operating income (loss)</td>
<td>16,557</td>
<td>18,049</td>
<td>14,857</td>
<td>11,298</td>
</tr>
<tr>
<td>Other income (expense)</td>
<td>3,423</td>
<td>2,504</td>
<td>772</td>
<td>(12)</td>
</tr>
<tr>
<td>Income (loss) before income taxes</td>
<td>19,980</td>
<td>20,535</td>
<td>15,629</td>
<td>11,286</td>
</tr>
<tr>
<td>Income tax expense (benefit)</td>
<td>6,916</td>
<td>7,400</td>
<td>5,642</td>
<td>(15,700)</td>
</tr>
<tr>
<td>Net income (loss)</td>
<td>$13,064</td>
<td>$13,153</td>
<td>$9,987</td>
<td>$26,986</td>
</tr>
<tr>
<td>Basic net income (loss) per share</td>
<td>$0.79</td>
<td>$0.75</td>
<td>$0.80</td>
<td>$6.98</td>
</tr>
<tr>
<td>Diluted net income (loss) per share</td>
<td>$0.76</td>
<td>$0.71</td>
<td>$0.51</td>
<td>$1.65</td>
</tr>
<tr>
<td>Weighted average shares outstanding:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Basic</td>
<td>16,563</td>
<td>17,550</td>
<td>12,450</td>
<td>3,868</td>
</tr>
<tr>
<td>Diluted</td>
<td>17,278</td>
<td>18,597</td>
<td>17,885</td>
<td>16,363</td>
</tr>
<tr>
<td>Balance Sheet Data</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash and cash equivalents</td>
<td>$78,540</td>
<td>$71,921</td>
<td>$59,499</td>
<td>$30,383</td>
</tr>
<tr>
<td>Marketable securities</td>
<td>19,767</td>
<td>42,748</td>
<td>41,868</td>
<td>—</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>1,640</td>
<td>1,877</td>
<td>1,028</td>
<td>916</td>
</tr>
<tr>
<td>Inventories</td>
<td>14,616</td>
<td>11,764</td>
<td>9,914</td>
<td>10,204</td>
</tr>
<tr>
<td>Total current assets</td>
<td>116,018</td>
<td>132,496</td>
<td>121,529</td>
<td>47,595</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>66,625</td>
<td>50,157</td>
<td>37,775</td>
<td>26,288</td>
</tr>
<tr>
<td>Total current liabilities</td>
<td>74,137</td>
<td>55,327</td>
<td>43,754</td>
<td>20,307</td>
</tr>
<tr>
<td>Working capital</td>
<td>41,881</td>
<td>76,869</td>
<td>77,838</td>
<td>16,683</td>
</tr>
<tr>
<td>Total assets</td>
<td>122,106</td>
<td>138,005</td>
<td>128,382</td>
<td>62,305</td>
</tr>
<tr>
<td>Total long-term obligations</td>
<td>666</td>
<td>863</td>
<td>1,071</td>
<td>1,126</td>
</tr>
<tr>
<td>Total stockholders’ equity (deficit)</td>
<td>47,303</td>
<td>81,515</td>
<td>83,620</td>
<td>(27,238)</td>
</tr>
<tr>
<td>Cash Flow Data</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net cash provided by operating activities</td>
<td>$40,518</td>
<td>$31,272</td>
<td>$29,751</td>
<td>$19,816</td>
</tr>
<tr>
<td>Net cash used in investing activities</td>
<td>21,065</td>
<td>(2,053)</td>
<td>(43,296)</td>
<td>(3,503)</td>
</tr>
<tr>
<td>Net cash provided by (used in ) financing activities</td>
<td>(54,964)</td>
<td>(16,797)</td>
<td>42,661</td>
<td>(8,527)</td>
</tr>
</tbody>
</table>

*Cost of sales included purchases from suppliers, inbound and outbound shipping costs, insurance on shipments, and jewelry assembly costs.

n.a. = not available.

One of the big appeals of Blue Nile’s business model was the ability to generate cash 40 to 55 days ahead of the need to pay suppliers; in a very real sense, Blue Nile’s business model was self-funding because suppliers financed Blue Nile’s sales growth—see Exhibit 5. Moreover, the company’s business model was readily scalable to substantially higher sales volumes with minimal additional capital investment. Blue Nile’s capital expenditures for facilities and equipment were a meager $3.5 million in 2003, $1.4 million in 2004, $1.1 million in 2005, and $1.9 million in 2006. Capital expenditures for fiscal 2007 were budgeted at $4.0 million.

Blue Nile executives believed the company’s market position was highly defensible. The company had negotiated exclusive and highly favorable arrangements with a number of diamond and gemstone suppliers that allowed it to offer a broad range and selection of fine jewelry products with minimal inventory, it had a very lean cost structure, and it had created a premium brand name and brand awareness that competitors would have difficulty replicating. While Blue Nile’s competitiveness was dependent on maintaining favorable arrangements with its suppliers, the company was somewhat protected by having negotiated agreements with a variety of suppliers, thus limiting its dependence on particular suppliers—in 2004 and 2005, the top three suppliers accounted for only 25 percent of the company’s purchases. Moreover, the supply arrangements were favorable to suppliers, providing them with real-time market intelligence about what items were selling, the potential of high sales volume through a single account, and a way to achieve more inventory turns and otherwise manage their own inventories more efficiently.

**Stock Issues and Repurchases**

Blue Nile became a public company in 2004, selling some 2.3 million shares of common stock at $20.50 per share and realizing proceeds of $42.5 million after expenses. Trading of the company’s stock began on May 20, 2004, on the NASDAQ exchange under the symbol NILE. Since trading began, the stock had traded as low as $22.50 (August 2004) and as high as $43 (December 2005); the stock price hovered in the $30 to $35 range during the January–August 2006 period.
Blue Nile had several stock-based compensation plans, under which stock options could be issued to officers, employees, non-employee directors, and consultants. Going into 2006, stock options for just over 2 million shares were outstanding, about 1.1 million of which were exercisable in 2006. Blue Nile also had an employee stock purchase plan, but no shares had been issued as of January 1, 2006.

Blue Nile repurchased about 3.3 percent of its outstanding shares of common stock in 2005 at a cost of $17.4 million; the company spent $57.4 million to repurchase about 1.8 million shares in 2006.

INDUSTRY GROWTH AND COMPETITION

According to U.S. Department of Commerce data, total U.S. jewelry sales, including watches and fashion jewelry, were $59 billion in 2005, up from $57 billion in 2004. The U.S. jewelry market had grown at a compound annual growth rate of 5.7 percent over the last 25 years. Jewelry sales in the United States grew by 4.6 percent in 2004, 2.9 percent in 2003, 8.0 percent in 2004, and 2.7 percent in 2005; they were forecast to grow 6.0 percent in 2006. Sales were somewhat seasonal, with relatively higher sales in February (Valentine’s Day), May (Mother’s Day), and the October–December holiday shopping season. Sales of diamond jewelry in the United States were an estimated $32.5 billion in 2005 and were believed to represent about 50 percent of the global diamond jewelry market.

The diamond and fine jewelry retail market was intensely competitive, with sales highly fragmented among locally owned jewelry stores (34 percent); retail jewelry store chains with 100+ stores (13 percent); numerous chain department stores

### Exhibit 6  Major U.S. Retailers of Jewelry, 2005

<table>
<thead>
<tr>
<th>Rank</th>
<th>General Retailers of Jewelry</th>
<th>2005 Sales (in billions)</th>
<th>Specialty Retailers of Jewelry</th>
<th>2005 Sales (in billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Wal-Mart</td>
<td>$2.7</td>
<td>Zale Corp.</td>
<td>$2.4</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(2,300+ locations in the United States, Canada, and Puerto Rico)*</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>QVC</td>
<td>1.4</td>
<td>Sterling (Kay Jewelers, Jared, and assorted regional retailers)*</td>
<td>2.3</td>
</tr>
<tr>
<td>3</td>
<td>JCPenney</td>
<td>1.2</td>
<td>Tiffany (150 stores in U.S. and international locations)</td>
<td>1.2</td>
</tr>
<tr>
<td>4</td>
<td>Sears</td>
<td>1.1</td>
<td>Helzberg Diamonds (270 locations)</td>
<td>0.5</td>
</tr>
<tr>
<td>5</td>
<td>Finlay</td>
<td>1.0</td>
<td>Fred Meyer (430 stores in 34 states under the brands Fred Meyer Jewelers, Littman Jewelers, and Barclay Jewelers)</td>
<td>0.5</td>
</tr>
<tr>
<td>6</td>
<td>Costco</td>
<td>0.4</td>
<td>Whitehall (386 stores in 38 states under the brands Whitehall, Lundstrom, and Marks Bros.)</td>
<td>0.3</td>
</tr>
<tr>
<td>7</td>
<td>Home Shopping Network</td>
<td>0.4</td>
<td>Friedman’s (420+ locations in 20 states)</td>
<td>0.3</td>
</tr>
<tr>
<td>8</td>
<td>Target</td>
<td>0.4</td>
<td>Ross-Simon (14 stores in 9 states, plus catalog sales)</td>
<td>0.3</td>
</tr>
<tr>
<td>9</td>
<td>Jewelry Television</td>
<td>0.4</td>
<td>Tourneau (30 locations in 13 states)***</td>
<td>0.3</td>
</tr>
<tr>
<td>10</td>
<td>Neiman-Marcus</td>
<td>0.4</td>
<td>Ben Bridge Jewelers (70+ stores in 12 mostly western states)**</td>
<td>0.2</td>
</tr>
<tr>
<td></td>
<td>**Share of Overall Market</td>
<td>15.9%</td>
<td>**Share of Overall Market</td>
<td>13.7%</td>
</tr>
</tbody>
</table>

*Sterling was a wholly owned subsidiary of Britain-based Signet Group, PLC; Sterling operated 781 Kay’s Jewelry stores in 50 states, 110 Jared Galleria of Jewelry showrooms in 26 states, and 330 other regional stores under a variety of brand names in 31 states.

**Became a subsidiary of Warren Buffett's Berkshire Hathaway in 2000.

***Tourneau’s sales were heavily concentrated in fine watches.

Blue Nile’s Online Competitors

There were dozens of online retailers of diamonds in 2006. Some were more reputable than others, and the sites varied considerably in terms of diamond selection, prices, customization options, educational information, product information, and access to professional grading reports, responsive customer service, and return policies. Popular sites, in addition to market leader Blue Nile, included Diamonds.com, Whiteflash.com, Ice.com, JamesAllen.com, Overstock.com, and Amazon.com.

**Diamonds.com.** Diamonds.com was founded in 2000 and headquartered in Las Vegas; the principal owners had over 25 years experience in all areas of the diamond industry. The company’s product offering included over 40,000 loose diamonds sourced from New York City’s famed 47th Street diamond district, along with a selection of settings, rings, bracelets, necklaces, and earrings. There was extensive educational information on the Diamonds.com Web site; the discussion of the four C’s of purchasing a diamond was lucid and informative. There was a search function that allowed site visitors to search the loose diamond inventory based on shape, carat size, cut, color, clarity, and price. Shoppers had the ability to customize their purchase by choosing a stone and a setting. Diamond grading reports issued by either the Gemological Institute of America or the American Gemological Society Laboratory could be viewed online for all loose diamonds, shipping was free, and orders came with an identifying grading reports and warranty document. Customers could return noncustomized orders for a full refund (excluding shipping, handling, and insurance) for up to 30 days after delivery; returns were not accepted on custom work or special orders unless an error had been made. The staff at Diamonds.com included expert gemologists trained at the world’s leading gemological laboratories; shoppers could call a toll-free number for assistance or to place a phone order.

**Whiteflash.com.** About half of Whiteflash’s sales involved orders for customized jewelry. Whiteflash had a small inventory (about 1,000 stones) and was said to charge higher prices than Blue Nile and many other e-tailers. One distinctive strategy element was its trade-up program, whereby a customer could trade in a jewelry item purchased from Whitehall for a higher-priced item and only pay the difference.

(12 percent); online retailers that sold fine jewelry and online auction sites (4 percent); television shopping retailers (4 percent); mass merchants, such as discount superstores and wholesale clubs whose merchandise offerings included fine jewelry (10 percent); and all other retailers, such as general merchandise and clothing stores and catalog retailers (23 percent). The Jewelry Board of Trade estimated that there were some 24,500 specialty jewelry firms in the United States in 2005, down from 26,750 specialty jewelry retailer in 1999. However, the number of stores operated by specialty jewelry retailers increased by about 700 stores over the same period, reflecting a continuing industry trend toward consolidation; the five largest specialty jewelry retailers in the United States had increased their collective share from about 18 percent to about 24 percent of specialty jewelry sales since 1999. Nonetheless, independent jewelers, including those with fewer than 100 stores, accounted for about 70 percent of the sales made by specialty jewelry retailers.

Blue Nile’s primary competition came from both online and offline retailers that offered products within the higher value segment of the jewelry market. Many brick-and-mortar jewelry retailers (including market leaders Zale, Sterling, Tiffany, and Helzberg, among many others) had recently begun selling jewelry online at their Web sites. The principal competitive factors in the fine jewelry market were product selection and quality, price, customer service and support, brand recognition, reputation, reliability and trust, and, in the case of online retailers, Web site features and functionality, convenience, and speed of delivery.

**The Online Jewelry Industry**

Jewelry e-tailers sold approximately $340 million worth of engagement rings in 2005; online sales of other types of rings and jewelry items were another $2 billion in 2005. A majority of those sales were said to be to men, chiefly because they were more amenable than women to shopping for jewelry online. The primary appeal of buying diamonds and jewelry online was lower prices. Most online jewelry retailers employed a business model similar to Blue Nile’s, keeping their inventories lean, purchasing stones from suppliers only when an order for a specific stone was received, and delivering the merchandise a few days after the order was placed.
between the new item and the previously purchased item. Whiteflash had a policy of not accepting returns on customized jewelry products unless an error had been made in doing the custom work; for loose stones and standard settings, Whiteflash offered a full refund 10 days from receipt for any reason. The education materials at the Whiteflash Web site included video tutorials.

**Ice.com.** Over 300,000 customers had made purchases at Ice.com since it began online operations in 2001. Ice’s product line included rings, necklaces, earrings, bracelets, pendants, and watches. Its product offerings were all finished products; no customization options were available. The average purchase was about $210 (versus over $1,600 at Blue Nile). The company had a monthly payment option, provided free shipping on orders over $150, and had an unconditional 30-day money-back guarantee. Bridal and engagement rings came with an appraisal certificate. There was no educational information on the company’s Web site, and the information provided about the quality of its diamond jewelry was limited. Customers could make inquiries via a toll-free number or e-mail.

**JamesAllen.com.** Founded in 1998 by James Allen Schultz and his wife Michele Sigler, JamesAllen.com had grown to be one of the largest online diamond retailers. The firm’s strategy centered around offering “the world’s most beautiful engagement rings coupled with the finest laboratory graded diamonds, all at an extraordinary value.” It had been featured in such trade magazines as *National Jeweler* and profiled by the *Washington Post, U.S. News & World Report, NBC News,* and *National Public Radio.* While an estimated 3 percent of the round diamonds sold in the United States qualified as “Ideal” under AGSL grading standards, over 90 percent of the customers shopping at JamesAllen.com chose diamonds from the retailer’s Signature Ideal, Ideal, or Premium categories. All stones came with grading reports from either the Gemological Institute of America or the American Gemological Society Laboratory.

Management claimed that no other company offered a finer collection of top-quality cut diamonds. The product offerings at JamesAllen.com product offerings included 55,000 loose diamonds, preset engagement rings, preset wedding and anniversary rings, diamond studs, diamond jewelry, and designer jewelry by Amy Levine, Danhov, and Leo Popov. Shoppers could customize their own diamond rings, studs, and pendants. The JamesAllen.com Web site had a comprehensive Education section that featured an interactive demonstration of the importance of diamond cut, 3D viewing, and tips and search tools. An expert staff answered questions via phone or e-mail. Payment options included credit card, wire transfer, personal check, certified check, or money order. JamesAllen.com provided free overnight shipping via FedEx or UPS on all orders within the United States. Orders outside the United States had to be prepaid via wire transfer and carried a shipping fee of $100. The company had a full 30-day return policy, but loose diamond returns that did not include the original laboratory grading report were subject to a charge of $150.

**Endnotes**

2. Ibid.
6. Ibid.
EAT2EAT.COM

Eat2Eat.com was the most highly rated Internet-based restaurant reservation service covering major cities in the Asia Pacific region. It was the principal business of Singapore-based Eat2Eat Pte Ltd (Eat2Eat). Eat2Eat.com had firmly established its technology, business model and industry relationships. However, after five years of operation, the Web site’s registered user base remained at approximately 12,000 customers. In January 2006, founder and Chief Executive Officer Vikram Aggarwal was considering new ways to promote the company and the Web site. Eat2Eat had limited resources, so Aggarwal knew his methods would have to be innovative, efficient and effective.

COMPANY ORIGIN

In the late 1990s, Aggarwal had been an investment banker specializing in the high-technology sector at Chase Manhattan in Tokyo. He had seen many entrepreneurs launch their own companies and was confident he could do the same. When Chase Manhattan merged with JP Morgan in 2000, Aggarwal’s group was dissolved. He accepted an exit package, voluntarily left the bank and decided to launch his own Internet company.

Aggarwal saw an opportunity in online restaurant bookings. He noticed that airline bookings, hotel reservations and car rentals were highly automated processes, with customers frequently searching for information and transacting business online. However, there was little or no similar automation for restaurant reservations. The technology discrepancy was particularly noticeable in the case of hotel restaurants: a consumer could reserve a room at a hotel online, but not a table at the hotel’s restaurant. Many corporations—particularly large ones—negotiated special room rates for employees at preferred hotels, but did not negotiate discounts at preferred restaurants. Given that business dinners were a common occurrence, Aggarwal wondered why corporations had not extended their purchasing power to restaurants in the same way they exercised it with hotels.

Aggarwal believed there was a value proposition in connecting diners—both corporate and personal—with restaurants. He believed diners could benefit
from accessing a wealth of information on restaurant options, conveniently reserving tables online and receiving loyalty points or discounts. Moreover, he believed restaurants could benefit by having a presence on the Internet, an increasingly popular medium.

**ESTABLISHMENT AND BUSINESS MODEL**

In 2000, Aggarwal relocated to Singapore, registered Eat2Eat Pte Ltd and began running the company out of his home. He hired a chief technology officer and a programmer, both based in India, to develop the Web site and the supporting technology. Aggarwal himself signed up the first participating restaurants. The English version of the Web site was launched in July 2001. Aggarwal wanted to retain full ownership and control, and subsequently financed the company himself. He invested US$1 million from his personal savings and his exit package from Chase Manhattan. Aggarwal eventually hired two other people to help with the workload, one in Singapore and one in Sydney.

Eat2Eat.com was an Internet-based restaurant portal promoting fine dining in the Asia Pacific region. The Web site was a guide to the region’s best restaurants with an online reservation service. Features included restaurant reviews, recipes, interviews with leading chefs and lists of top establishments in various categories. By January 2006, Eat2Eat.com covered more than 800 restaurants in Bangkok, Hong Kong, Kuala Lumpur, Shanghai, Singapore, Seoul, Sydney, Taipei and Tokyo. The company was also launching in Kyoto, Melbourne and Phuket. The original Web site appeared in English, but equivalent sites had also been launched in Japanese and Korean to cover the restaurants in Tokyo and Seoul, respectively.

**Core Business: Restaurant Reservations and Advertisements**

Eat2Eat.com allowed diners to reserve tables through the Internet, conveniently and with a wealth of supporting information. Aggarwal met with restaurant managers in cities across the Asia Pacific region and encouraged them to participate. (See Exhibit 1 for participating restaurants by city.) He negotiated discounts for corporate customers and commissions for Eat2Eat, and then listed the restaurants on the Web site. A registered customer wishing to make a meal reservation visited the Web site and used a simple booking interface to select a restaurant, date, time and party size. See Exhibit 2 for registered customers by city.

**Exhibit 1** Eat2Eat.com Participating Restaurants by City, 2000–2005

<table>
<thead>
<tr>
<th>Participating Restaurants</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bangkok</td>
<td>–</td>
<td>–</td>
<td>12</td>
<td>32</td>
<td>58</td>
<td>98</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>–</td>
<td>18</td>
<td>42</td>
<td>84</td>
<td>97</td>
<td>112</td>
</tr>
<tr>
<td>Kuala Lumpur</td>
<td>–</td>
<td>6</td>
<td>30</td>
<td>54</td>
<td>66</td>
<td>72</td>
</tr>
<tr>
<td>Shanghai</td>
<td>–</td>
<td>6</td>
<td>48</td>
<td>60</td>
<td>62</td>
<td></td>
</tr>
<tr>
<td>Singapore</td>
<td>–</td>
<td>24</td>
<td>84</td>
<td>102</td>
<td>120</td>
<td>174</td>
</tr>
<tr>
<td>Seoul</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>4</td>
<td>18</td>
<td>72</td>
</tr>
<tr>
<td>Sydney</td>
<td>–</td>
<td>30</td>
<td>66</td>
<td>94</td>
<td>98</td>
<td>137</td>
</tr>
<tr>
<td>Taipei</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>23</td>
<td></td>
</tr>
<tr>
<td>Tokyo</td>
<td>–</td>
<td>–</td>
<td>6</td>
<td>14</td>
<td>44</td>
<td>73</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>0</td>
<td>78</td>
<td>246</td>
<td>432</td>
<td>561</td>
<td>823</td>
</tr>
</tbody>
</table>

Note: Actual figures have been disguised for the purpose of confidentiality.

Note: Figures do not include Kyoto, Melbourne or Phuket. Eat2Eat was in the process of launching in those cities.

Source: Company files.
The restaurants could be searched by various criteria, including location, ambiance, accessibility for disabled diners, smoking preference, cuisine, price range, quality rating and hotel affiliation (if applicable). Customers received loyalty points that could be redeemed during future restaurant visits.

Eat2Eat contacted the restaurant the day after the reservation date, confirmed that the customer had actually eaten there and invoiced the restaurant for the agreed-upon commission. Commissions varied depending on the restaurant in question, but typically were between seven to 10 percent of the customer’s bill. In 2005, these reservations contributed 40 percent of Eat2Eat’s total revenue of US$478,000. (See Exhibit 3 for annual revenue, profit and loss figures.)

The company also sold Web site banner advertisements to restaurants wanting additional promotion. In 2005, advertisements on Eat2Eat.com contributed an additional 20 percent of the company’s total revenue.

Eat2Eat.com had received considerable recognition. A poll taken by the Smart Diners Organization in the United States had rated Eat2Eat.com as the top restaurant information and reservation site in the world. In addition, Google and Yahoo! search engines consistently ranked Eat2Eat.com first in search results for Asian restaurant reviews and reservations.

There were other restaurant portals on the Internet, covering Asia Pacific and other regions, but Eat2Eat.com was different. Most of the other portals derived revenue from advertising alone, and subsequently depended on hits and click-through statistics. Also, the other Asia Pacific portals were city-specific, whereas Eat2Eat.com offered regional coverage.

In 2004 Aggarwal adapted Eat2Eat.com to make its content and booking function accessible through WAP-enabled mobile phones. He believed this added accessibility would significantly extend the company’s reach and utilization, considering the high penetration of mobile phones in the region. The service became popular in Tokyo and Seoul, but lagged elsewhere. Aggarwal was disappointed the service had not found greater acceptance in cities such as Hong Kong and Singapore. In the latter cities, virtually every person carried a multi-function mobile phone and people were very savvy about applications such as customized ring tones, photographs and games. Aggarwal suspected people in these cities were uncomfortable in actually making transactions using the new technology.

### Complementary Business: Third-Party Sourcing

Aggarwal also engaged in another, complementary business: negotiating preferred arrangements between credit card companies and restaurants for

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**Exhibit 2** Eat2Eat.com New Customer Registrations by City, 2000–2005

<table>
<thead>
<tr>
<th>Registered Users</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bangkok</td>
<td>–</td>
<td>–</td>
<td>30</td>
<td>18</td>
<td>48</td>
<td>100</td>
<td>196</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>–</td>
<td>300</td>
<td>324</td>
<td>94</td>
<td>576</td>
<td>804</td>
<td>2,098</td>
</tr>
<tr>
<td>Kuala Lumpur</td>
<td>–</td>
<td>60</td>
<td>126</td>
<td>30</td>
<td>324</td>
<td>509</td>
<td>1,049</td>
</tr>
<tr>
<td>Shanghai</td>
<td>–</td>
<td>30</td>
<td>65</td>
<td>14</td>
<td>54</td>
<td>70</td>
<td>233</td>
</tr>
<tr>
<td>Singapore</td>
<td>–</td>
<td>126</td>
<td>204</td>
<td>42</td>
<td>391</td>
<td>778</td>
<td>1,541</td>
</tr>
<tr>
<td>Seoul</td>
<td>–</td>
<td>48</td>
<td>222</td>
<td>90</td>
<td>204</td>
<td>402</td>
<td>690</td>
</tr>
<tr>
<td>Sydney</td>
<td>–</td>
<td>152</td>
<td>466</td>
<td>694</td>
<td>1,176</td>
<td>2,580</td>
<td>5,068</td>
</tr>
<tr>
<td>Taipei</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>30</td>
<td>300</td>
</tr>
<tr>
<td>Tokyo</td>
<td>–</td>
<td>716</td>
<td>1,437</td>
<td>1,066</td>
<td>2,893</td>
<td>5,747</td>
<td>11,859</td>
</tr>
<tr>
<td>Total</td>
<td>0</td>
<td>716</td>
<td>1,437</td>
<td>1,066</td>
<td>2,893</td>
<td>5,747</td>
<td>11,859</td>
</tr>
</tbody>
</table>

Note: Actual figures have been disguised for the purpose of confidentiality.

Note: Figures do not include Kyoto, Melbourne or Phuket. Eat2Eat was in the process of launching in those cities.

Source: Company files.
Exhibit 3  Eat2Eat Revenue, Profit and Loss by City, 2000–2005

<table>
<thead>
<tr>
<th>City</th>
<th>Revenue</th>
<th>Profit / (Loss)</th>
<th>Cost</th>
<th>Profit / (Loss)</th>
<th>Profit / (Loss)</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bangkok</td>
<td>-</td>
<td>-</td>
<td>18</td>
<td>(18)</td>
<td>(26)</td>
<td>18</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>8</td>
<td>(26)</td>
<td>30</td>
<td>(11)</td>
<td>(22)</td>
<td>66</td>
</tr>
<tr>
<td>Kuala Lumpur</td>
<td>18</td>
<td>(41)</td>
<td>30</td>
<td>(22)</td>
<td>(2)</td>
<td>56</td>
</tr>
<tr>
<td>Shanghai</td>
<td>20</td>
<td>0</td>
<td>30</td>
<td>(22)</td>
<td>(2)</td>
<td>22</td>
</tr>
<tr>
<td>Singapore</td>
<td>12</td>
<td>(41)</td>
<td>30</td>
<td>(22)</td>
<td>(2)</td>
<td>91</td>
</tr>
<tr>
<td>Seoul</td>
<td>-</td>
<td>-</td>
<td>42</td>
<td>54</td>
<td>54</td>
<td>227</td>
</tr>
<tr>
<td>Sydney</td>
<td>18</td>
<td>(41)</td>
<td>42</td>
<td>(22)</td>
<td>(2)</td>
<td>220</td>
</tr>
<tr>
<td>Taipei</td>
<td>-</td>
<td>-</td>
<td>48</td>
<td>46</td>
<td>46</td>
<td>48</td>
</tr>
<tr>
<td>Tokyo</td>
<td>-</td>
<td>-</td>
<td>24</td>
<td>22</td>
<td>22</td>
<td>128</td>
</tr>
<tr>
<td>Total</td>
<td>56</td>
<td>(30)</td>
<td>347</td>
<td>478</td>
<td>478</td>
<td>1,213</td>
</tr>
</tbody>
</table>

Note: Actual figures have been disguised for the purpose of confidentiality.
Source: Company files.

the benefit of credit card holders. Credit card companies typically offered special deals and perks for cardholders, including discounts at preferred restaurants, spas, sporting venues and retail stores. The card companies’ motivations were to attract and retain cardholders by offering superior value, and to encourage cardholders to use the cards, thereby bolstering loyalty and increasing transaction volume.

The credit card companies did not negotiate the arrangements themselves; instead, their marketing
teams outsourced the job to third parties. Because Aggarwal already negotiated with restaurants to sign them up for the Web site, he found it was a natural extension to source restaurants for credit card companies as well. In 2005, third-party negotiations contributed the remaining 40 percent of Eat2Eat’s revenue.

SEGMENENTATION AND APPROACH TO MARKET

Reaching the Restaurants

Aggarwal dealt exclusively with what he described as first-tier restaurants. First-tier restaurants were typically those that accepted reservations, were moderately expensive, or were very popular and busy. Second-tier restaurants did not accept reservations and therefore were of no concern to Aggarwal.

Aggarwal approached the restaurants himself to sign them up as suppliers. This task typically involved traveling to the 12 cities covered by Eat2Eat.com and personally meeting with restaurant managers. In some cities, the restaurants were predominantly chain organizations, while in other cities they were predominantly independently owned. A single chain might have many restaurants, so at first glance a chain-focused approach seemed more efficient. However, it usually took much more time and effort to sign up a chain than a single independent restaurant.

The restaurant reviews posted on Eat2Eat.com were written by Aggarwal and his two employees. He had considered adding reviews by professional restaurant critics, but had decided against it since critics and their publications typically demanded payment for reprinting their reviews. Also, many restaurant reviews in Asia were actually written as promotional pieces on the restaurants’ behalf, and Aggarwal felt such reviews were neither independent nor objective. He did consider adding user reviews, as Asia-Hotels.com did for hotels, but had not yet taken any action in that direction.

Market Characteristics

As he traveled, Aggarwal gathered information on the different markets. He was particularly interested in population density, dining habits, the presence of first-tier restaurants, broadband Internet penetration and receptivity to new marketing and distribution tactics. The information helped him select new restaurants to pursue as suppliers. See Exhibit 4 for some of Aggarwal’s market observations.

Promotional Strategies

In the beginning, Aggarwal focused his promotional efforts on corporate customers. People who planned business dinners invariably made reservations; by contrast, timing and restaurant choice for personal dining were often spontaneous. Also, Aggarwal thought personal diners were too numerous and, consequently, too difficult and expensive to reach. He thought the corporate approach would bring more value for his efforts and would be the best way to reach customers.

Aggarwal approached large corporations and asked them to encourage their employees to sign up for the service. Because corporations reimbursed their employees for business lunches and dinners, the discounts available for meals reserved through Eat2Eat.com essentially offered the corporations a cost reduction. The service was easy for clients to find, preview and reserve at good restaurants, and users received loyalty points that could be redeemed for free meals in the future.

Aggarwal was pleased with the adoption rates from the targeted corporations. Roughly 80 percent of the companies he approached endorsed the program. At those companies, typically 15 percent of employees would register as Eat2Eat.com users with 10 percent becoming active users. Most of the active users were secretaries and personal assistants to executives because they were the people typically tasked with arranging business functions. They spent most of the workday at their desks with broadband Internet connections, so it was easy for them to access Eat2Eat.com. Also, Eat2Eat.com simplified the task of finding and reserving at an appropriate restaurant.

This approach worked well in most of the cities in question, but Aggarwal found a different strategy worked better in Tokyo. In his opinion, Japanese corporations were reluctant to try new ideas. Also, many first-tier restaurants in Japan had their own Web sites. Those Web sites provided information to customers, but did not support online reservations because the required technology was too complex. Eat2Eat.com enabled the reservations for the restaurants’ Web sites, so when a customer viewed a restaurant Web site and wanted to reserve a table,
## Exhibit 4  Market Observations

<table>
<thead>
<tr>
<th>City</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bangkok</td>
<td>● Fragmented restaurant industry with broad range of dining options</td>
</tr>
<tr>
<td></td>
<td>● Opportunities primarily in the mature hotel industry, particularly with</td>
</tr>
<tr>
<td></td>
<td>established chains that E2E has worked with elsewhere</td>
</tr>
<tr>
<td></td>
<td>● Low Internet penetration</td>
</tr>
<tr>
<td></td>
<td>● Language issues</td>
</tr>
<tr>
<td></td>
<td>● Difficult to gain customer acceptance</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>● High Internet penetration but low transaction volume</td>
</tr>
<tr>
<td></td>
<td>● High population density with easy movement around the island</td>
</tr>
<tr>
<td></td>
<td>● Many corporate head offices</td>
</tr>
<tr>
<td></td>
<td>● Many restaurants, but choice normally based on proximity to office</td>
</tr>
<tr>
<td></td>
<td>● Free local phone calls made it easy to reserve by phone</td>
</tr>
<tr>
<td></td>
<td>● Language issues</td>
</tr>
<tr>
<td>Kuala Lumpur</td>
<td>● Broad restaurant base and large dining population</td>
</tr>
<tr>
<td></td>
<td>● Tendency to choose restaurants by the type of food</td>
</tr>
<tr>
<td></td>
<td>● High restaurant turnover, which encouraged marketing innovations</td>
</tr>
<tr>
<td></td>
<td>● Customers willing to try new technology</td>
</tr>
<tr>
<td></td>
<td>● Growing market of visitors from the Middle East</td>
</tr>
<tr>
<td></td>
<td>● Spontaneity in dining leading to no-shows and multiple bookings</td>
</tr>
<tr>
<td></td>
<td>● Low Internet penetration</td>
</tr>
<tr>
<td>Shanghai</td>
<td>● Rapidly growing local market</td>
</tr>
<tr>
<td></td>
<td>● Strong business from overseas, with visitors to Shanghai willing to book</td>
</tr>
<tr>
<td></td>
<td>tables in advance</td>
</tr>
<tr>
<td></td>
<td>● Unscrupulous restaurant managers posing difficulties for E2E</td>
</tr>
<tr>
<td></td>
<td>● Busy restaurants not requiring any promotional support</td>
</tr>
<tr>
<td></td>
<td>● Language issues</td>
</tr>
<tr>
<td></td>
<td>● Low Internet penetration</td>
</tr>
<tr>
<td>Singapore</td>
<td>● Vibrant dining scene, with hotel restaurants and many new eateries</td>
</tr>
<tr>
<td></td>
<td>opening outside hotels as well</td>
</tr>
<tr>
<td></td>
<td>● Tendency for restaurants to cluster in common areas</td>
</tr>
<tr>
<td></td>
<td>● Willingness to try any restaurant at least once</td>
</tr>
<tr>
<td></td>
<td>● Government initiatives to support Internet business</td>
</tr>
<tr>
<td></td>
<td>● High Internet penetration but reluctance to transact business online</td>
</tr>
<tr>
<td></td>
<td>● Restaurateurs’ resistance to new promotion/distribution channels</td>
</tr>
<tr>
<td>Seoul</td>
<td>● High WAP acceptance</td>
</tr>
<tr>
<td></td>
<td>● Busy city with many dining options, so restaurant managers valued the</td>
</tr>
<tr>
<td></td>
<td>promotional assistance</td>
</tr>
<tr>
<td></td>
<td>● Many international visitors willing to book tables</td>
</tr>
<tr>
<td></td>
<td>● Language issues</td>
</tr>
<tr>
<td>Sydney</td>
<td>● Dining well-established as a pastime</td>
</tr>
<tr>
<td></td>
<td>● Many new restaurants</td>
</tr>
<tr>
<td></td>
<td>● Many visitors from overseas</td>
</tr>
<tr>
<td></td>
<td>● Higher margins for Eat2Eat.com</td>
</tr>
<tr>
<td></td>
<td>● Reluctance to provide personal information over the Internet</td>
</tr>
<tr>
<td>Taipei</td>
<td>● Busy city with established dining scene</td>
</tr>
<tr>
<td></td>
<td>● High Internet penetration</td>
</tr>
<tr>
<td></td>
<td>● Web-based reservations new and considered trendy</td>
</tr>
<tr>
<td></td>
<td>● Relatively low number of first-tier restaurants</td>
</tr>
</tbody>
</table>
Tokyo
- High Internet penetration
- Widespread WAP use, and marketing on mobile phones widely practiced and accepted
- Huge city with established dining culture and countless restaurants
- Widespread acceptance among local population
- Major foreign presence in the city as well
- Difficulty in growing fast enough and keeping up with the ever-changing environment

Note: Information unavailable for Kyoto, Melbourne, and Phuket.
Source: Company files.

Expanding in the Personal Market

Although Aggarwal had built a solid user base through the corporate market, he knew he would have to tap the personal market (beyond Tokyo) if Eat2Eat were to reach its potential. However, the company did not have the employees or financial resources needed to pursue such a vast market. Aggarwal believed Eat2Eat would have to partner with other companies that already had large, established user bases and “piggyback” with them.

There were many possible options, including airlines, hotel chains, and local and regional newspapers. “There is no end of possible partners we could work with,” he commented, “if we only had the time to approach them, convince them and develop the partnerships.”

In May and June of 2004, Eat2Eat partnered with leading regional newspaper, The Asian Wall Street Journal, for the first Eat! promotion. The promotion tied in with a regular feature of the paper’s Friday section in which food critics sought and reviewed the most authentic and exciting eateries in Asia’s culinary capitals. This promotion was one of the paper’s most popular features, with readers regularly contacting the paper to request more information or suggest additional eateries.

The three-week promotion featured 70 participating restaurants in Hong Kong, Kuala Lumpur and Singapore, with cuisine ranging from Mediterranean to Asian to fusion. The restaurants offered special set menus for lunch and dinner, featuring more variety and value than their regular offerings. Some restaurants also offered complementary glasses of wine or champagne. Diners could view restaurant details and menus and could make reservations online at www.eat2eat.com/awsj. The promotion was held for a second time in September 2005, when, in addition to the original cities, it was expanded to include Seoul and Taipei for a total of 101 participating restaurants.

The Eat! promotion had little immediate impact on Eat2Eat.com reservations and revenue, but it did give the Web site a great deal of publicity that would likely attract more users and reservations in the longer term. Also, it allowed Aggarwal to expand his restaurant base in current cities and establish his business in new cities, such as Taipei.

Aggarwal thought credit card companies would be another natural avenue for reaching personal customers. He had already negotiated restaurant deals on the companies’ behalf so he had the necessary
contacts and credibility. He thought it would be logical to extend the arrangements to cover online bookings.

When credit card companies sent monthly statements to cardholders, they often included brochures of benefits for cardholders, including discounts at restaurants, spas, hotels and entertainment venues. The credit card companies also maintained Web sites with the same information, but they were basic information Web sites and were rarely visited by cardholders. Aggarwal wanted to enhance the Web sites by tying them to Eat2Eat.com and providing booking functionality.

Credit card companies would benefit from such arrangements by driving more cardholders to their Web sites. Such interaction would build customer loyalty and also increase transactions on the credit cards, which would be the reason for offering such deals in the first place. Restaurants would likewise benefit by attracting more customers. Finally, Eat2Eat would benefit by leveraging the credit card companies’ large user bases. A partnership with a single credit card company might expose Eat2Eat.com to millions of new customers.

The idea made sense to Aggarwal, but he admitted it was hard to convince the credit card companies to buy into it. It required a shift in their thinking, which he was finding difficult to achieve. The marketing teams at credit card companies turned over quickly. Just when Aggarwal made headway with them, the representatives changed and he had to start over with new people. Aggarwal had been trying to negotiate such arrangements for five years and still had not closed any deals, although he felt he was close with at least one company.

RAISING ADDITIONAL CAPITAL

Eat2Eat had established a strong presence with Aggarwal’s initial investment, but additional funding would be required to reach the next level. Aggarwal and his two employees spent practically all their time managing the company’s day-to-day operations and had little time for additional strategic developments or promotional activities. Aggarwal thought this lack of strategic focus inhibited Eat2Eat’s growth and put the company at a competitive disadvantage. As he commented:

I feel like I’m in a Formula One race with a private entry car. I compete with professional teams with major funding, and I’m always one or two laps behind, just trying to keep up.

Aggarwal hoped to raise US$2 million in additional capital. Roughly 50 percent of those funds would be allocated to establishing three or four new sales representatives throughout the region. The sales representatives would add more restaurants to the company’s inventory. Each representative would be paid US$5,000 to US$6,000 per month and would incur related costs, including computers and travel expenses. It was difficult to estimate the return for investing in new sales representatives, but Aggarwal hoped the additional revenue would outweigh the additional costs by a factor of two to one.

Roughly 40 percent of the new capital would be spent on public relations and marketing activities to reach the personal dining market segment. Aggarwal planned to hire a well-known public relations firm with regional influence and expertise in the hospitality sector. A public relations campaign would begin in a single market, as a test of its effectiveness, before being rolled out to the rest of the region.

The remaining 10 percent of the new capital would be spent on a technology upgrade. The Eat2Eat.com Web site and the supporting software were currently hosted by a third party; Aggarwal wanted to set up his own server and support the Web site in-house. He also wanted to enhance the company’s mobile phone functionality to enable more reservations. While the technology upgrade would not have a direct impact on Eat2Eat.com’s revenue, it would support the company as a whole and improve operational efficiency.

Potential Sources for Additional Capital

Aggarwal considered debt financing but quickly dismissed the idea. He believed it would be difficult to obtain bank loans because Eat2Eat had not yet established a profitable track record. In fact, he believed it would be difficult for practically any early-stage Internet company to obtain bank loans for this
reason. “If I were a banker,” he mused, “I wouldn’t loan money to this company.”

He also contemplated a public stock offering, but likewise dismissed the idea. Eat2Eat simply did not have a big enough profile to make a public offering feasible or worthwhile.

Aggarwal thought he might find another Internet company willing to purchase a stake in Eat2Eat. He pointed to the recent example of Yahoo! purchasing a major stake in Alibaba.com, the Chinese online business-to-business marketplace. The deal had received a great deal of publicity, and Aggarwal hoped it would galvanize the Asian Internet investment scene and inspire more deals in the sector. However, no other Internet companies had yet expressed an interest in buying into Eat2Eat.

Venture capital was a more likely option, although not necessarily a more favorable one. Aggarwal had been approached by several venture capital firms in recent months, but he had low expectations. He believed venture capitalists and entrepreneurs had inherently opposing objectives. The former wanted to buy into companies cheaply while the latter wanted to maximize investment value, so the two parties would naturally dispute the true value of a company’s equity. Furthermore, a venture capitalist typically wanted to crystallize a profit from an investment within five years and wanted a return on investment in the 30 percent range. The venture capitalist would also impose a set of conditions (covenants) regarding the company’s management and financial performance, and Aggarwal believed that in most cases those conditions might be difficult to meet.

Aggarwal had received telephone calls from other Asian restaurant Web site entrepreneurs trying to sell their businesses to him. Their companies were specific to certain cities, whereas Eat2Eat.com covered the entire region. Aggarwal considered buying or merging with another company to increase his restaurant inventory and user base, but only if such an amalgamation could be accomplished at a reasonable price. However, each of the companies concerned expected several million U.S. dollars for their equity, and Aggarwal was confident he could build or expand his business in any given city organically with a lower investment.

Aggarwal thought he would have to make a decision about new funding in the first half of 2006. He also thought it would be difficult to raise the money. Not only would it be hard to find the right investor, but the task would require more of his time, and his time was already in short supply.

AGGARWAL’S CHALLENGE

Aggarwal was proud of what Eat2Eat had achieved in its first five years, including its technology, industry recognition and value to both diners and restaurants. However, he knew the company would have to significantly expand its user base in 2006 and beyond. Such growth would be a difficult challenge, considering his limited time and financial capital. Aggarwal reviewed his current promotional strategies and tactics and wondered what he should do in the year ahead.

Endnotes

1 While the example of hotel restaurants gave birth to the concept in Aggarwal’s mind, he believed there were also innumerable restaurants not affiliated with hotels that could also benefit from online reservations.

2 First-time users of the service were required to register as customers and provide some personal details. Registration was free.

3 Coordination with the restaurants could be automated and conducted online. For restaurants that were not connected to the Internet, the process was conducted using facsimile (fax) machines. Thus, restaurants did not require Internet access to participate, although Internet access made the process more efficient for both the restaurants and for Eat2Eat.com.

4 WAP, or wireless application protocol, was an open international standard for applications on wireless communication devices. A common example was Internet access on mobile phones.

5 Alibaba.com operated the world’s largest online marketplace for international and domestic China trade, as well as China’s most widely used online payment system, AliPay. It had a community of more than 15 million businesses and consumers in more than 200 countries and territories. In 2004, Alibaba.com facilitated more than US$4 billion in trade. In August 2005, Yahoo! Inc. and Alibaba.com announced a long-term strategic partnership in China. The arrangement would promote the Yahoo! brand in China. Also, Yahoo! purchased US$1 billion of Alibaba.com shares, giving Yahoo! approximately 40 percent economic interest in the company.
About 250 to 300 million people worldwide played video games in 2007. Historically, games were typically played by preteens, teens, and young adults, but by 2005 the average game player age had increased to 33, and 25 percent of gamers were over age 50. In 2000, only 13 percent of gamers were over age 50. In addition to video games appealing to a broader demographic base, gamers were spending more time playing video games. In 2003, the average American was said to spend 75 hours annually playing video games, which was more than double the amount of time spent playing video games in 1997.

More than $35 billion was spent on video game consoles, game software, handheld game devices, mobile games, and online games in 2005. Next-generation consoles launched by Microsoft in November 2005 and by Nintendo and Sony in November 2006 were expected to drive video game–related sales to more than $51 billion by 2010—see Exhibit 1. Sony’s PlayStation 3, Microsoft’s Xbox 360, and Nintendo’s Wii were all equipped with powerful microprocessors, hard drives, Internet connectivity, and high-definition (HD) resolution graphics, giving them new capabilities and visual effects that were expected to spur sufficient interest in video games by traditional gamers and current nongamers to drive sales of video game consoles from $3.9 billion in 2005 to $5.8 billion in 2010.

In 2007, Nintendo, Sony, and Microsoft were locked into a fierce battle for control of the projected $5.8 billion pie. Each company used differing business models to generate revenues and profits and varying strategies to try to build competitive advantage in the marketplace. With the next-generation battle video game hardware in full swing in 2007, the early results made it unclear who the eventual winner might be. Microsoft’s one-year head start with next-generation technology gave it an installed base of more than 10 million Xbox 360 units by January 2007, while Sony’s installed base of PlayStation 3 units stood at just over 2 million units. Nintendo had been able to sell more than 3 million Wii video game consoles between November 2006 and January 2007. Some analysts believed that Microsoft could sustain its first-mover advantage and achieve a market-leading position by 2011. Others were convinced that Sony’s 100-million-plus dedicated PlayStation 2 owners would eventually migrate to the PlayStation 3—giving it another 100-million-unit-selling console by 2012. It was unclear how appealing Nintendo’s Wii would prove among video game players, but the Wii was the winner of the 2006 holiday season sales battle. In fact, the combined sales of the Wii and Nintendo’s handheld DS and Game Boy Advance systems allowed Nintendo to account for 55 percent of all video game sales during the 2006 holiday gift-buying season. There was some thought that the Wii’s innovative wireless wand controller would prove to be a fad and the battle would ultimately be between Microsoft and Sony. With the next-generation battle already fierce, but only into its first months, there was ample opportunity for additional maneuvering by all three rivals.

<table>
<thead>
<tr>
<th>Sector</th>
<th>2000</th>
<th>2003</th>
<th>2005</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Console hardware</td>
<td>$4,791</td>
<td>$6,047</td>
<td>$5,894</td>
<td>$5,771</td>
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<tr>
<td>Console software (both sales and rentals)</td>
<td>9,451</td>
<td>16,449</td>
<td>13,055</td>
<td>17,164</td>
</tr>
<tr>
<td>Handheld hardware</td>
<td>1,945</td>
<td>1,501</td>
<td>3,855</td>
<td>1,715</td>
</tr>
<tr>
<td>Handheld software (both sales and rentals)</td>
<td>2,872</td>
<td>2,238</td>
<td>4,829</td>
<td>3,113</td>
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<tr>
<td>PC software (both sales and rentals)</td>
<td>5,077</td>
<td>3,806</td>
<td>4,313</td>
<td>2,955</td>
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<tr>
<td>Broadband</td>
<td>70</td>
<td>497</td>
<td>1,944</td>
<td>6,352</td>
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<tr>
<td>Interactive TV</td>
<td>81</td>
<td>249</td>
<td>786</td>
<td>3,037</td>
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<tr>
<td>Mobile</td>
<td>65</td>
<td>587</td>
<td>2,572</td>
<td>11,186</td>
</tr>
<tr>
<td>Total</td>
<td>$24,352</td>
<td>$31,370</td>
<td>$35,248</td>
<td>$51,292</td>
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</tbody>
</table>


HISTORY OF VIDEO GAME SYSTEMS

The development of video games began as early as 1947 when engineers working on television projects began to tinker with programs to play simple games using cathode ray tubes. Two noteworthy developments were the creation of Tennis for Two by Brookhaven National Laboratory researcher William A. Higinbotham in 1958 and the invention of Spacewar in 1962 by a trio of Massachusetts Institute of Technology graduate students. Ralph Baer, an engineer at Loral, filed the first patent for a video game in 1968, which led to the development of the Magnavox Odyssey. The Odyssey video game system, introduced to U.S. consumers in 1972, allowed users to play such games as table tennis, hockey, shooting gallery, and football on their black-and-white televisions. The graphics were limited to white lines, dots, and dashes projected on the picture tube, so Magnavox provided users with color transparencies to place on their TV screens to provide the appropriate background for each game. The Odyssey system sold approximately 350,000 units by 1975.

The introduction of Pong, an arcade game produced by Atari, was another key video game launch that occurred in 1972. Atari developed a Pong system for televisions in 1975, but its 1977 launch of the Atari 2600 was the first home game system to achieve success in the marketplace. The Atari 2600 offered full-color output, sound, and cartridge-based games such as Space Invaders. Atari eventually sold more than 30 million 2600 game systems.

By 1983, consumers had tired of simple arcade-type games and, for all practical purposes, the industry was dying. Nintendo rescued the video game industry in 1985 with its introduction of its Nintendo Entertainment System (NES), which was bundled with the soon-to-be ubiquitous Super Mario Brothers video game. Nintendo sold 61.9 million NES systems before its 1991 introduction of the Super NES. Nintendo built on the success of the NES with the launch of the Game Boy handheld model, which allowed users to take their games outside the home. Nearly 120 million Game Boy units had been sold by 2001. Nintendo’s ability to resurrect the industry with innovative game systems created a competitive, technology-driven industry environment that remained prevalent into 2007. Exhibit 2 presents a brief description of key video game systems along with their launch prices and number of units sold.

OVERVIEW OF THE GLOBAL MARKET FOR VIDEO GAME CONSOLES

The dramatic increase in the amount of time consumers spent playing video games during the late 1990s and early 2000s was primarily attributable to the improved capabilities of game consoles launched at the turn of the 21st century. The processing capabilities of the Sony PlayStation 2, in particular, allowed game developers to create complex games that were presented at a high screen resolution. Sports games such as NCAA Football, racing games such as Need for...
### Exhibit 2  Selected Information for the Best-Selling Video Game Hardware Systems, 1972–2006

<table>
<thead>
<tr>
<th>Launch Date</th>
<th>Manufacturer</th>
<th>System Name</th>
<th>Launch Price</th>
<th>Key Features</th>
<th>Units Sold</th>
</tr>
</thead>
<tbody>
<tr>
<td>1972</td>
<td>Magnavox</td>
<td>Odyssey</td>
<td>$100</td>
<td>Black-and-white display, color overlays</td>
<td>350,000</td>
</tr>
<tr>
<td>November 1977</td>
<td>Atari</td>
<td>Atari 2600</td>
<td>$200</td>
<td>Color output, sound, cartridge-based games</td>
<td>30 million</td>
</tr>
<tr>
<td>October 1985</td>
<td>Nintendo</td>
<td>NES</td>
<td>$199</td>
<td>8-bit processor</td>
<td>61.9 million</td>
</tr>
<tr>
<td>August 1989</td>
<td>Sega Enterprises</td>
<td>Sega Genesis</td>
<td>$200</td>
<td>16-bit processor</td>
<td>13 million</td>
</tr>
<tr>
<td>August 1989</td>
<td>Nintendo</td>
<td>Game Boy</td>
<td>$109</td>
<td>Handheld system</td>
<td>118.7 million</td>
</tr>
<tr>
<td>August 1991</td>
<td>Nintendo</td>
<td>Super NES</td>
<td>$199</td>
<td>16-bit processor</td>
<td>49.1 million</td>
</tr>
<tr>
<td>April 1995</td>
<td>Sega Enterprises</td>
<td>Sega Saturn</td>
<td>$399</td>
<td>32-bit processor</td>
<td>1.4 million</td>
</tr>
<tr>
<td>September 1995</td>
<td>Sony Computer Entertainment</td>
<td>PlayStation</td>
<td>$299</td>
<td>32-bit processor</td>
<td>102.5 million</td>
</tr>
<tr>
<td>September 1996</td>
<td>Nintendo</td>
<td>Nintendo 64</td>
<td>$199</td>
<td>64-bit processor</td>
<td>32.9 million</td>
</tr>
<tr>
<td>September 1999</td>
<td>Sega Enterprises</td>
<td>Sega Dreamcast</td>
<td>$199</td>
<td>200 MHz processor, 3D graphics</td>
<td>8.2 million</td>
</tr>
<tr>
<td>October 2000</td>
<td>Sony Computer Entertainment</td>
<td>PlayStation 2</td>
<td>$299</td>
<td>294 MHz processor, DVD, backward compatibility with PS One</td>
<td>106.2 million</td>
</tr>
<tr>
<td>June 2001</td>
<td>Nintendo</td>
<td>Game Boy Advance</td>
<td>$100</td>
<td>Handheld system, 32-bit processor, 32,000 color video resolution</td>
<td>75.8 million</td>
</tr>
<tr>
<td>November 2001</td>
<td>Microsoft</td>
<td>Xbox</td>
<td>$299</td>
<td>733 MHz processor, hard drive, Ethernet port</td>
<td>24 million</td>
</tr>
<tr>
<td>November 2001</td>
<td>Nintendo</td>
<td>GameCube</td>
<td>$199</td>
<td>485 MHz processor</td>
<td>20.9 million</td>
</tr>
<tr>
<td>November 2004</td>
<td>Nintendo</td>
<td>Nintendo DS/DS Lite</td>
<td>$199</td>
<td>Hand-held system, Wi-Fi connection, touchpad</td>
<td>21.3 million</td>
</tr>
<tr>
<td>March 2005</td>
<td>Sony</td>
<td>PlayStation Portable</td>
<td>$249</td>
<td>Hand-held system, 333-MHz processor, 3D graphics, music and movie playback</td>
<td>20 million</td>
</tr>
<tr>
<td>November 2005</td>
<td>Microsoft</td>
<td>Xbox 360</td>
<td>$299–$399</td>
<td>3.2 GHz processor, 500 MHz graphics card, Wi-Fi, 1080p HD resolution, 12x DVD, wireless controllers ($399 version only), 20 GB hard drive ($399 version only)</td>
<td>10.4 million</td>
</tr>
<tr>
<td>November 2006</td>
<td>Sony</td>
<td>PlayStation 3</td>
<td>$499–$599</td>
<td>3.2 GHz processor, 550 MHz graphics card, Wi-Fi ($599 version only), 1080p HD resolution, Blu-ray optical drive, wireless controllers, 20 or 60 GB hard drive</td>
<td>1.8 million</td>
</tr>
<tr>
<td>November 2006</td>
<td>Nintendo</td>
<td>Wii</td>
<td>$249</td>
<td>729 MHz processor, 243 MHz graphics card, Wi-Fi, 512 MB embedded flash memory, motion sensitive wireless controllers</td>
<td>3.2 million</td>
</tr>
</tbody>
</table>

Source: [www.businessweek.com](http://www.businessweek.com) (accessed March 1, 2007).
Speed, and shooter games like Call of Duty provided game players with high levels of interaction and backgrounds that were surprisingly realistic looking compared to early video game systems.

The sale of game systems and software tended to decline as the installed base grew and consumers had purchased most “must-have” titles. Industry sales slowed considerably between 2003 and 2005 as gamers postponed purchases until the eagerly awaited Xbox 360, PlayStation 3, and Wii became available. With sales of game software, hardware accessories, and online games expected to exceed $50 billion in 2010, spending on video game hardware and software was projected to account for a larger share of U.S. consumers’ entertainment dollars than the motion picture industry. In 2005, U.S. sales of video game hardware exceeded $10 billion, while Americans spent approximately $9 billion at movie theater box offices.

**COMPETITION AMONG THE MAKERS OF VIDEO GAME CONSOLES**

Technological leadership in computing power and graphics rendering were critical competitive capabilities needed in the console segment of the video game industry. However, such capabilities did not guarantee success in the industry. Sega consistently beat Nintendo and Sony to the market with next-generation computing capabilities but was unable to achieve success and eventually withdrew from the console market in 2001. Sonic the Hedgehog had been Sega’s only legitimate “hit” game title, which was not enough incentive for gamers to abandon their Nintendo or Sony systems. With Sega’s installed base failing to grow, game software developers focused their efforts on Nintendo and Sony. The small number of new game titles becoming available for Sega’s systems further compounded its problems in the marketplace. A survey of 16,670 players of video games conducted by the NPD Group found that, for 87 percent of survey respondents, “appealing game titles” was the single most important feature in choosing a game system.1

With the availability of intriguing games so important to gaining sales and increasing the installed base of consoles, Nintendo and, to a lesser extent, Microsoft had established internal game development capabilities. In fact, Nintendo’s most popular game titles, including Mario Brothers, Pokémon, and Donkey Kong, had been developed by the company’s own software development teams. Software operating profit margins that ranged from 35 to 40 percent had been a consistent contributor to Nintendo’s profitability. Independent game publishers such as Electronic Arts, Activision, Take Two Interactive, THQ, Square Enix, Capcom, Atari, and Sega paid console makers royalties on each software copy sold. Independent game publishers tended to spend the lion’s share, if not all, of game development budgets on new games for video game consoles with a large installed base and continuing sales growth; consequently, there were far fewer games developed for slow-selling video game systems than was the case for the best-selling consoles.

In addition to cooperative relationships with independent game publishers, makers of video game consoles were also required to collaborate with microprocessor and graphics accelerator producers to develop next-generation game systems. None of the established console manufacturers had the capability to produce all components needed for the assembly of game consoles—especially technologically advanced core components. In developing the PlayStation 3, Xbox 360, and Wii consoles that were launched in 2005 and 2006, Microsoft, Nintendo, and Sony each allied with IBM in the development of the console microprocessor. In all three cases, IBM and the console maker began with standard PowerPC microprocessor technology but customized the microprocessor to perform the complex calculations needed to run game software. The processing tasks needed to run video game software were much different from the processing tasks executed when running productivity software. All three companies maintained similar relationships with makers of graphics processing units (GPUs) to develop the technological capabilities to display HD-quality graphics and 3D effects. Companies such as Nvidia frequently co-developed graphics chips for more than one of the three console makers.

PC manufacturers also collaborated with microprocessor and GPU manufacturers to build computers capable of running 3D and HD video games. AMD’s four core, or “brain,” microprocessors were developed to perform tasks similar to what the nine-brain PowerPC chip used in the PlayStation 3 could do. Intel released its Core 2 Extreme microprocessor in 2006, which allowed gamers to play processing-intensive games on personal computers (PCs). In 2007,
AMD was developing an eight-core microprocessor that would allow extreme gamers to simultaneously play the most graphically intense video game, burn a DVD, download an HD movie, and make a Voice over Internet Protocol (VoIP) telephone call. The Mach V PC marketed by boutique computer maker Falcon Northeast used two gigabytes of memory, an Intel Core 2 Extreme CPU, and a $600 Nvidia 3D GPU to perform such multiple tasks. The Mach V sold for $16,000 and included a 30-inch LCD display and a wireless keyboard and mouse. Dell Inc., the world’s leading manufacturer of desktop and laptop computers in 2006, was broadening its product line to include PC models with advanced graphics, widescreen displays, and multiple processors that greatly enhanced the online gaming experience. Michael Dell believed that Microsoft’s new Vista operating system was a great platform for gamers, and Dell Inc. had an advanced technology group working with game developers to explore how to make the PC the best platform for gaming.

Competition in the industry also mandated that game console manufacturers to establish relationships with such value chain allies as discounters, electronics retailers, and toy stores. Big-box retailers such as Wal-Mart, Target, Best Buy, Circuit City, Toys “R” Us, and specialty retailers like Gamestop dedicated ample square footage to video game systems, accessories, and software. There was little price competition among retailers in the sale of video game consoles and software. More price competition at the retailer level among retailers in the sale of video game consoles and accessories, and software. There was little price competition among retailers in the sale of video game consoles and software. More price competition at the retailer level was found with video game accessories—especially accessories manufactured and marketed by third parties. Sony, Nintendo, or Microsoft accessories tended to sell at comparable price points across retailers.

Changes in the Competitive Landscape

**Console Technology.** Future generations of game systems would undoubtedly include even more impressive technological capabilities than the next-generation consoles launched in 2005 and 2006. Jen-Hsun Huang, CEO of graphic accelerator maker Nvidia, believed there was ample opportunity for higher levels of photorealism in video games since no console was yet able to deliver the industry’s aspirational “Toy Story standard.” Huang believed the industry was still “a good solid 10 years away from photorealism” and summarized the industry’s innovation focus by commenting:

*In the next several years, we will still just be learning to do the basics of film, like motion, blur, depth of field—all of that stuff alone chews up a lot of graphics processing. We’re pretty excited about moving to high-dynamic range where the color system has the fidelity of what we see in real life. The images don’t seem realistic yet. Articulating a human form and human animation, the subtleties of humans and nature, are still quite a ways away for us.*

**Online Gaming.** The manner in which video game software would be delivered to gamers was also set for change. The addition of Ethernet ports and Wi-Fi cards to video game consoles, coupled with the increased percentage of homes with broadband access, had given rise to online games. As shown in Exhibit 1, online game-playing via broadband connections was expected to constitute a $6.4 billion market worldwide by 2010, up from $1.9 billion in 2005. However, most online game revenue was expected to come from PC gamers, with only about 25 percent of online game subscription revenues in 2010 coming games played on consoles. Even though online games were expected to grow dramatically, DFC Intelligence expected that by 2011 less than 25 percent those owning consoles capable of playing online games would actually subscribe to an online game service.

**Mobile Gaming.** Historically, Nintendo’s handheld devices had been the dominant leaders in the mobile video game player market segment. The company sold nearly 120 million Game Boy systems between 1989 and 2001. Nintendo introduced the Game Boy Advance in 2001, which was succeeded by the Nintendo DS. Going into 2007, Nintendo had sold more than 75 million Game Boy Advance players, 330 million Game Boy Advance game cartridges, 21 million Nintendo DS devices, and over 60 million games for Nintendo DS models. Sony entered the handheld/mobile gaming segment in 2005 with its PlayStation Portable (PSP), quickly becoming an important market contender, with worldwide sales approaching 20 million units by year-end 2006. Despite the historical popularity of traditional handheld devices (Game Boy, Nintendo DS, and PSP) for game playing, the market for games software for such devices was expected to be stagnant, with projected sales of only $3.1 billion for gaming software on handheld sets in 2010 versus $4.8 billion in 2005.

However, mobile gaming on cellular phones and other wireless devices was expected to explode from a $2.6 billion market in 2005 to a $11.2 billion market in 2010 (see Exhibit 1). In the fall of 2006, Apple
announced that it was launching video games for its fifth-generation iPod models, with the games being downloadable directly from Apple’s iTunes store. (Buyers of these iPod models could also download over 75 movies and 220 TV shows from iTunes.)

Mobile gaming was a fast-developing market segment because advancing technology made it possible to incorporate high-resolution color displays, greater processing power, and improved audio capabilities on cellular handsets, iPods and other brands of MP3 players, and other sophisticated handheld devices (including those designed just for playing video games). There were over 1.5 billion cell phones in active operation across the world (about 35 percent of which were game enabled), and new models with enhanced game-playing capability were selling briskly—most cell phone users, intrigued by the new features of next-generation models, upgraded their phones every few years. While playing video games on handheld devices had historically been a favorite pastime of preteens and teenagers, the popularity of game-capable cell phones, iPods, and other sophisticated handheld devices was expected to spur increases in mobile gaming among the young adult population worldwide in the years ahead.

THE THREE MAIN CONTENDERS IN VIDEO GAME CONSOLES: MICROSOFT, SONY, AND NINTENDO

In 2007, there were only six leading video game consoles that had enough global market visibility and appeal to generate large-volume sales of new units: Microsoft’s Xbox 360; Sony’s PlayStation 3 and handheld PSP; and Nintendo’s Wii, Game Boy Advance, and DS/DS Lite. The makers of all the other game consoles were niche players for the most part. And, significantly, Microsoft, Sony, and Nintendo each had a differing history in the video game industry and differing competitive approaches.

Microsoft

In the 30 years since its founding in 1976, Microsoft had become the most important software company in the world through the development and sale of such omnipresent software packages as Windows, Word, Excel, PowerPoint, and Internet Explorer. In 2006, Microsoft’s software business, software consulting services business, online MSN service, and entertainment and devices division contributed to total revenues of $44.3 billion and net earnings of $12.6 billion. Microsoft spent almost 15 percent of its revenues on research and development activities in 2006 to ensure its future products offered levels of innovation and functionality necessary to sustain its advantage in the technology sector.

Microsoft’s Home and Entertainment Division.

Microsoft entered the video console industry in November 2001 with the introduction of the Xbox system, which was the industry’s most technologically advanced game console until the November 2005 launch of the Xbox 360. The original Xbox sold 24 million units by 2006. The company’s home and entertainment division included the Xbox 360 business and other such products and services as Xbox Live, video game software, Encarta learning products, PC keyboards and mice, and Internet Protocol Television (IPTV). Microsoft’s IPTV venture sought to change the delivery of television programming such that viewers could use broadband access and their home computers (or an Xbox 360) to watch TV broadcasts, on-demand programming, or archived episodes of classic TV series.

Revenues and operating losses for the division between 2004 and 2006 are shown in the following table:

<table>
<thead>
<tr>
<th>Year</th>
<th>Revenue (in millions)</th>
<th>Operating Loss (in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>$4,256</td>
<td>$(1,262)</td>
</tr>
<tr>
<td>2005</td>
<td>$3,140</td>
<td>$(485)</td>
</tr>
<tr>
<td>2004</td>
<td>$2,737</td>
<td>$(1,337)</td>
</tr>
</tbody>
</table>

Source: Microsoft 2006 annual report.

Revenue increases in 2006 were a result of the sale of 5 million Xbox 360 consoles during fiscal 2006, the popularity of Microsoft PC game titles such as Age of Empires III, and an increase in revenues from IPTV. The division’s operating loss in 2006 was largely the result of a $1.64 billion increase in cost related to Xbox 360 production and the development of Halo 2. The division’s relatively small operating loss in 2005 resulted from declining Xbox production costs and an increase in the sale of high-margin video games for the Xbox. Microsoft discontinued the sale of Xbox units once the Xbox 360 was in
production and Xbox inventory was cleared. The company expected the division’s operating loss in future years to decline as Xbox 360 production costs became lower and as the volume of video game software for the Xbox 360 increased.

**The Xbox 360.** Microsoft contracted its manufacturing activities for its game consoles and video game disks to third parties in Asia. The company had multiple sources for the commodity-like components used in the production of the Xbox 360, but it used single sources for core components. The company purchased all microprocessors from IBM, all GPUs from Taiwan Semiconductor Manufacturing Company, and all memory chips from NEC Corporation. Microsoft expected the life cycle for the Xbox 360 to reach five to seven years.

Upon its release, video game industry analysts were quite satisfied with the Xbox 360’s capabilities. The Xbox 360’s HD graphics impressed many, as did its ease of use. Reviewers were also very pleased with game titles that accompanied the Xbox 360 launch and Microsoft’s Xbox Live Arcade games, which could be played over the Internet. Analysts were particularly struck by Xbox 360 games that had been co-developed by Microsoft Game Studios and proven Hollywood screenwriters, directors, and producers. A full list of Xbox 360 features is presented in Exhibit 3.

The November 2005 Xbox 360 launch came one year earlier than the release of next-generation consoles by Sony and Nintendo. The one-year lead in technology gave Microsoft a temporary advantage in building Xbox’s installed base and variety of video games. By year-end 2006, more than 160 game titles were available for the Xbox 360. With more than 5 million Xbox 360s installed prior to the launch of the PlayStation 3 or Wii, third-party game developers had little choice but to develop games for the Xbox 360. Gamers were unlikely to buy new software for current-generation consoles once they began to anticipate the launch of a new-generation system. With the exception of annually updated games like Tiger Woods 2007, there was little point in developing new games for the PlayStation 2 or GameCube in 2005 and 2006.

**Xbox Live.** Microsoft’s one-year head start in making its next-generation console available also helped it build traffic to its Xbox Live Web site. Xbox Live provided Xbox users having broadband access the capability to play online games, chat, watch game trailers, demo new game titles, maintain a profile, participate in forums, download television programming and movies, and access massively multiplayer online games (MMOGs). Xbox Live generated revenue from advertising, subscription fees to its premium-level Xbox Live Gold, movie and television program download fees, and download fees charged to Xbox Silver members. Counting the complimentary Xbox Silver memberships, Xbox Live had approximately 6 million registered users by March 2007. The company found that approximately 25 percent of Xbox Silver members purchased the full version of free demo versions of new games.

In late 2006, Microsoft was testing a cross-platform version of Xbox Live called Xbox Live Anywhere that would allow users to play Xbox games from Xbox consoles, cell phones, handheld systems, or PCs. Some industry analysts believed that revenue gains from a cross-platform online gaming site would be limited since surveys had shown that only 18 percent of all gamers play games on consoles, cell phones, handheld systems, and PCs. Of that 18 percent, only 31 percent were interested in cross-platform play. However, 40 percent of gamers who regularly played games on both PCs and console systems were highly interested in cross-platform play. As of March 2007, Microsoft had not made a formal announcement about its plans for Xbox Live Anywhere. Even if Microsoft did not go forward with a launch of Xbox Live Anywhere, PC users using Microsoft’s Vista operating system would be able to connect to Xbox Live to play video games.

The addition of downloadable television programs and motion pictures to Xbox Live had the potential to change how Xbox 360 consoles were used. Xbox 360 owners could download TV shows and movies onto their hard drives from Xbox Live’s 1,000-hour library of programming for on-demand viewing at a later time. Xbox Live offered movie downloads from Paramount, Lionsgate, and Warner Bros., as well as selected television programming from all major networks and cable channels. Programming pricing was based on usage of points purchased online at Xbox Live or through Xbox 360 retailers. In March 2007, a 1,000-point card sold for $12.50, while a 1,600-point card sold for $19.50. The price of a standard-definition television program download was 160 points. HD programs sold for 240 points. Microsoft charged Xbox Live users 320 points for standard-definition movie downloads and 360 points for downloads of HD movies.
### Exhibit 3 Comparative Features of Microsoft Xbox 360, Sony PlayStation 3, and Nintendo Wii

<table>
<thead>
<tr>
<th></th>
<th>Xbox 360</th>
<th>PlayStation 3</th>
<th>Wii</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. launch date</td>
<td>May 12, 2005</td>
<td>November 17, 2006</td>
<td>November 19, 2006</td>
</tr>
<tr>
<td>Price</td>
<td>$299—core system</td>
<td>$499—20 GB version</td>
<td>$249</td>
</tr>
<tr>
<td></td>
<td>$399—premium system</td>
<td>$599—60 GB version</td>
<td></td>
</tr>
<tr>
<td>Microprocessor</td>
<td>3.2 GHz IBM PowerPC</td>
<td>3.2 GHz IBM PowerPC</td>
<td>729 MHz IBM PowerPC</td>
</tr>
<tr>
<td>Graphics processor</td>
<td>ATI 500 MHz</td>
<td>RSX 550 MHz</td>
<td>ATI 243 MHz</td>
</tr>
<tr>
<td>Video resolution</td>
<td>720 p, 1080i, 1080p</td>
<td>480i, 480p, 720p, 1080i, 1080p</td>
<td>480p</td>
</tr>
<tr>
<td>System memory</td>
<td>512 MB (shared with video)</td>
<td>256 MB dedicated</td>
<td>64 MB (shared with video)</td>
</tr>
<tr>
<td>Video memory</td>
<td>512 MB (shared with system)</td>
<td>256 MB dedicated</td>
<td>64 MB (shared with system)</td>
</tr>
<tr>
<td>Optical drive</td>
<td>12x DVD; optional HD-DVD priced at $199</td>
<td>Blu-ray HD</td>
<td>DVD available on models produced after late 2007</td>
</tr>
<tr>
<td>Storage/hard drive</td>
<td>64 MB memory card with core system; 20 GB hard drive with premium system</td>
<td>20 GB or 60 GB hard drive</td>
<td>512 MB embedded flash memory</td>
</tr>
<tr>
<td>Ethernet port</td>
<td>Yes</td>
<td>Yes</td>
<td>Optional Ethernet adapter priced at $29</td>
</tr>
<tr>
<td>Wireless networking</td>
<td>Wi-Fi</td>
<td>Wi-Fi available on 60 GB version only</td>
<td>Wi-Fi</td>
</tr>
<tr>
<td>Controllers</td>
<td>Wired controller with core system; wireless with premium system</td>
<td>Bluetooth wireless controller w/limited motion-sensing capabilities</td>
<td>Bluetooth wireless full motion-sensing controller</td>
</tr>
<tr>
<td>Online services</td>
<td>Free Xbox Live Silver service including online gaming and voice chat and text messaging; Premium Xbox Live service at $49/year; downloadable full-length movies and television programming starting at $2 per download</td>
<td>Web browser; Free PlayStation online gaming Network service providing game demos and game add-ons; online Sony store</td>
<td>Wii Network includes online shopping, weather, news, Web browsing, and e-mail, instant messaging</td>
</tr>
<tr>
<td>Game prices</td>
<td>$40–$60</td>
<td>$50–$60</td>
<td>$30–$50</td>
</tr>
<tr>
<td>Compatibility with previous generations</td>
<td>Compatible with approximately 300 Xbox titles</td>
<td>Compatible with most PlayStation 2 and PlayStation titles</td>
<td>Compatible with all GameCube titles; online access to titles originally released for Nintendo 64, SNES, NES, Sega Genesis, and TurboGrafx consoles</td>
</tr>
</tbody>
</table>


The Xbox 360’s 20-gigabyte hard drive could store 16 hours of standard definition programs or about 4½ hours of HD programming. Users who deleted programs to free hard drive space were allowed to download previously purchased programs at no charge. Standard-definition programming could be downloaded in minutes, while an HD movie might take hours to download. Even though HD downloads...
were lengthy, Xbox Live was the only HD programming download service available for televisions in March 2007. Movies downloaded to PCs could be watched only on a PC monitor. Peter Moore, a Microsoft vice president, explained to The Wall Street Journal that gaming was the primary selling point for the Xbox 360, but “we look at the console as an entertainment amplifier for the living room.”

Marketing. Microsoft used a variety of approaches to market the Xbox 360 and Xbox Live to consumers. The company supported the Xbox 360 with a $150 million ad campaign in fiscal 2007 and regularly entered into promotions to increase awareness of the Xbox 360. In 2006, Microsoft and Burger King agreed to a promotion to make Xbox 360 games available for purchase in Burger King restaurants. Microsoft also established a promotion with the Kellogg Company that placed Xbox-branded green fruit roll-ups on store shelves. In addition, Microsoft provided co-op advertising with its retail partners. During late 2006, Sears ran TV ads that showed a young boy dreaming about playing Xbox 360 games.

Microsoft had also developed highly innovative viral marketing campaigns for the Xbox 360 and its game titles. Viral marketing had proved to be important with gamers since many young consumers did not respond to, and even resented, traditional advertising. One such campaign involved Perfect Dark Zero, an Xbox Live game that relied on users sending links to friends asking them to join in to expand its subscriber base. The viral marketing campaign for Viva Piñata was highly sophisticated. Viva Piñata was Microsoft’s attempt at developing a game that might have the same level of appeal with young children that was achieved by Nintendo’s Super Mario Brothers and Donkey Kong. The campaign included a new Saturday-morning cartoon based on Viva Piñata characters that aired on Fox Television and a line of electronic action figures produced by Playmates Toys. The Viva Piñata toy could interact with Xbox Live by allowing users to download and upload “special powers” that added to the experience of playing with the toy or playing the video game.

Xbox 360’s Early Lead. Some analysts believed that Microsoft had developed a first-mover advantage by beating Nintendo and Sony to market with next-generation technology by a year. In an interview with BusinessWeek prior to the launch of the PlayStation 3 and Wii, Kevin Bachus, the former Microsoft executive who originally proposed the Xbox idea to Bill Gates, stated:

“[The] 360 still has a chance of winning the next-gen battle, but it’s far from a certainty. If our industry’s brief history has taught us anything it’s that there are no set “laws” regarding console adoption—despite what the manufacturers might claim. This generation will be decided not on production capabilities or technology, but on brand, price, and content. If Sony can leverage its brand, aggressively cut prices on both hardware and software, and deliver just a few platform-driving franchises as they’ve done in the past with Final Fantasy, Grand Theft Auto, and others, they can quickly reverse Microsoft’s early lead.”

By year-end 2006, Microsoft had sold more than 10.4 million Xbox 360 units, with more than 1.1 million units selling in December alone. By comparison, Sony sold 491,000 PlayStation 3 units in December 2006, while Nintendo sold 604,000 Wii systems. Microsoft expected to sell an additional 2 million units during the first six months of 2007. Microsoft was using its early sales lead to reduce production costs and increase accessories sales to speed profitability. In fact, by November 2006, it was estimated that Microsoft’s production costs for the Xbox 360 had fallen to $306 per unit. Microsoft executives expected for the company’s entertainment and devices division to become profitable by fiscal 2008. An NPD Group analyst believed that “Xbox is now poised to really take advantage of its lead in this generation’s race, provided they (and third-party supporters) keep bringing the games to market that keep consumers wanting to play on that system.”

Sony

The Sony Corporation was the world’s leading manufacturer and marketer of audio, video, communications, and information technology products, with fiscal 2006 revenues of $64 billion. Sony’s video game business contributed $7.8 billion to the company’s 2006 total revenues and had generated as much as two-thirds of Sony’s total operating profits in past years. However, Sony was confronted with a number of challenges in 2006 and 2007. The company had been unable to capitalize on the exploding growth in digital audio players, was losing market share in the liquid crystal display (LCD) flat-panel TV market, and expected its profits to fall by about 40 percent during fiscal 2007 because of an extensive laptop
Sony’s PlayStation and PlayStation 2. Introduced in 1995, the Sony PlayStation was an instant success, selling more than 100,000 units in North America during its first weekend on store shelves. By the PlayStation’s six-month anniversary, more than 1 million units had been sold in North America and the company hit the 4 million mark in North America in just over two years. The PlayStation’s cutting-edge graphics, CD optical drive, 32-bit processor, and variety of game titles made it much more appealing to adolescents and young adults than Nintendo’s Super NES system. Over 100 million PlayStation consoles were eventually sold, which was more than twice the number of Nintendo SNES units sold. By 2001, one in three U.S. households had purchased a PlayStation game console.

Nintendo launched its 64-bit Nintendo 64 console a year after the PlayStation was introduced, but it failed to take a considerable number of sales away from the PlayStation because of Nintendo’s limited game categories. While Sony’s third-party game developers were creating games that would be appealing to preteens, teenagers, and young adults, Nintendo’s game development focus was on smaller children. Because Sony targeted older gamers, it was able to add features to the PlayStation 2 (PS2) that might be difficult for young children to operate. The PS2 was able to play DVDs and could be connected to the Internet with an Ethernet adaptor. The $299 PS2 was powered by a 294-megahertz microprocessor, which was the most powerful game processor until the introduction of the Xbox.

As with the PlayStation, Sony’s third-party game developers took advantage of the massive installed base and directed their resources toward developing blockbuster game titles for Sony consoles. Third-party-developed games like Gran Turismo, Final Fantasy, Grand Theft Auto, Madden NFL, Medal of Honor, and Need for Speed were games likely to be found in most game collections. The Sony PS2 was also backward compatible with the game titles that had made the PlayStation a marketplace success. The combination of technological superiority and large number of hit game titles allowed Sony to sell more than 100 million PS2 consoles and achieve a 70 percent worldwide market share in game consoles. Even though Sony introduced the PlayStation 3 in November 2006, it planned to continue producing the PS2. Sony lowered the retail price of the PS2 to $129 in the United States once it began shipping PlayStation 3 consoles.

The Sony PSP. In 2005, Sony challenged Nintendo’s dominance in handheld systems with the introduction of the $249 PlayStation Portable (PSP). The PSP used a 333-megahertz microprocessor and a 4.3-inch LCD screen to allow gamers to play 3D games, watch television programs recorded with TiVo, connect to wireless Internet networks, review pictures from digital cameras, listen to MP3s, and watch full-length movies that were available on Universal Media Disc (UMD) minidisks. In addition, up to 16 PSP players in close proximity could connect wirelessly to play multiplayer games. The PSP achieved the status of top-selling handheld game in the United States shortly after its release, but users complained that PSP games were “just rehashes of what you would play on the console.” Sony had sold more than 20 million PSP handheld systems by December 2006.

Sony PlayStation 3. Sony hoped to replicate the success of the PlayStation 2 by following a similar strategy with the PlayStation 3. The PlayStation 3 (PS3) was packed with technological features that would allow game developers to create 3D and HD game titles that could exploits the processing power of its 3.2-gigahertz nine-brain processor and Nvidia GPU. (A full list of PlayStation 3 features is presented in Exhibit 3.) The PS3 also had the opportunity to become the central component of a home entertainment system since it included a state-of-the-art Blu-ray HD optical drive and Internet connectivity. Blu-ray was a next-generation DVD drive developed by Sony that could show movies in HD resolution. At the time of the PS3 launch, Sony was in a battle with Toshiba, which had developed a competing HD-DVD player, to become the video disk platform of the future. Clearly, the industry could support only one type of HD disk player. Sony’s expectation was that its massive installed base would migrate to the PS3—making it the dominant design in video game consoles and making its Blu-ray drive the industry standard for HD disks.

One of the few flaws evident in Sony’s strategy in the first months after the November 2006 launch of the PS3 was the pricing of the console. The PS3
sold at either $499 or $599, depending on hard drive size. Sony’s production cost for the PS3 was estimated at $805 for the 20-gigabyte version and $840 for the 60-gigabyte version. The company justified its PS3 pricing by noting the retail price of a Blu-ray player was $1,000. Sony hoped consumers would make the determination that purchasing a PS3 was at least $400 less expensive than purchasing a Blu-ray player and that they would get all of the video game capabilities of the PS3 as an added bonus. Analysts believed that Sony might lose as much as $2 billion on the PS3 in fiscal 2007, but could begin to achieve breakeven on its production costs once about 20 million PS3 units had been sold.

In some ways, the November 2006 launch of the PS3 was a deviation from Sony’s intended strategy. Sony had not planned to launch the PS3 when it did, but it was forced into an early launch date because of the November 2005 launch of the Xbox 360 by Microsoft. The PS3 was designed to be backward compatible with more than 16,000 PlayStation and PS2 game titles, but the launch of the system was accompanied by only 24 PS3 game titles. The PS3 had tremendous graphics and processing capabilities, but all of this was not needed to play PS2 games. A PlayStation or PS2 video game was not going to look any better played on a PS3. In addition, the 24 HD games that accompanied the launch did not fully utilize the capabilities of the PS3 since third-party software developers had been forced to shorten their planned development times. Whether or not a consumer owned an HDTV was another consideration that would have to be made before upgrading to a PS3.

Sony was barely able to get the PS3 to market in time for 2006 holiday shopping because of a variety of production problems. Some of its production problems centered on the use of the Blu-ray optical drive. An initial holdup involved the development of copy-protection technology for the Blu-ray drive, which was followed by a problem producing the laser component needed in the assembly of Blu-ray drives. Production problems also affected the PS3’s backward compatibility capacity, with many PS2 game titles not working on the PS3 when it was first launched. The cumulative effect of Sony’s supply chain and production problems allowed it to ship only an estimated 125,000 to 175,000 units for its North American launch. The company had planned to support the launch with 400,000 units. Sony was eventually able to ship nearly 500,000 units before the 2006 holiday season ended. However, the production problems continued into 2007, with Sony delaying its European launch of the PS3 until March 2007. Sony expected that 30 PS3 game titles would be available by its European launch.

Another factor that might hinder the sales of PS3 units for some time was the tremendous video game development costs necessary to produce games that could fully utilize the console’s capabilities. Even with the PS2, game development costs typically ran $2 to $7 million. Game developers were willing to make such an investment to develop games for the PS2 since a hit could easily sell 5 to 10 million units at $50 per unit. Analysts had projected that game development costs for the PS3 would average $20 million, with some titles requiring much higher investments. Game developers willing to make such an investment based on the PS3’s modest installed base of just over 2 million units in early 2007 were taking a huge risk. The president and CEO of game developer THQ commented in November 2006: “Using a crack development team to only sell a few hundred thousand units is not a good use of resources.”

With new game titles arriving to the market slowly, Sony could not rely on its PlayStation Network to satisfy the gaming expectations of consumers. Most video game industry analysts found the site’s online games to be very limited and no match for Xbox Live. However, the PlayStation Network did offer users free access to a limited number of multiplayer online games and text, voice, and video chat. The combination of the PS3’s high price, limited game titles, limited production, and uninspiring online experience made the PS2 its strongest competing game console during late 2006 and early 2007. During the 2006 holiday season, 1.4 million PS2s were sold in the United States, compared to 1.1 million Xbox 360s, 604,000 Nintendo Wii consoles, and 491,000 PS3 systems. Analysts expected that Sony would sell 11 million PS2s in 2007 and the PS2 would continue to outsell the PS3 through 2008. Even given its problems, the Sony PS3 hit the 2 million sales mark in fewer months than the PlayStation or the PlayStation 2.

**Nintendo**

The playing card manufacturer founded in 1889 in Kyoto, Japan, eventually became known as the Nintendo Company Ltd. in 1963 when it expanded...
outside playing cards to other types of games. The company had produced electronic toys as early as 1970, but its 1981 introduction of a coin-operated video game called Donkey Kong transformed the company into a household name in North America, Asia, and Europe. By 2007, Nintendo had sold more than 387 million game consoles and 2.2 billion video games worldwide. In the United States, one in four households had a Nintendo game system of one generation or another.

In fiscal 2006, Nintendo recorded revenues of $4.3 billion and earned profits of $840 million through the sale of Nintendo game systems and video game software. The company projected fiscal 2007 revenues and earnings of $7.6 billion and $1.0 billion, respectively.

**Nintendo’s Strategy.** With the company’s business limited to the sale of game consoles, handheld game systems, and game software, the company pursued a different strategic approach than that used by Sony and Microsoft. The company focused on earning profits from the sale of game consoles as well as from game software sales. A company senior vice president commented, “We don’t have other sister divisions that can underwrite big losses in our area. So we have to be able to get to breakeven, or profitability pretty quickly on the hardware and then the software-toe ratio becomes the icing on that.”

Based on that business model, Nintendo had never held a technological advantage in the industry and didn’t attempt to battle Sony and Microsoft for the allegiance of hard-core gamers. It had succeeded by developing game systems that were intuitive and easy to operate. Its video games were fun to play but didn’t offer a cinematic experience. Nintendo’s strategy was well matched to the interests of children and casual gamers. Nintendo’s president, Satoru Iwata, explained in the company’s annual report, “Nintendo has implemented a strategy which encourages people around the world to play video games regardless of their age, gender or cultural background. Our goal is to expand the gaming population.”

**The Nintendo GameCube.** At the time of the November 2001 launch of the GameCube system, its processing capabilities were nearly twice as great as that of the PS2 but far less than what the Xbox was capable of performing. The middle-path strategy did not give consumers much of a reason to get excited about the GameCube, since those wanting cutting-edge graphics might find the Xbox appealing and those enamored with PlayStation’s action games were still quite pleased with their PS2s. With no clear point of differentiation, the GameCube was Nintendo’s least successful game console in its history—selling just over 20 million units by year-end 2006. Even though the GameCube’s successor, the Wii, was introduced in November 2006, the company retained the GameCube in its product line for especially price-sensitive buyers. The GameCube’s retail price in early 2007 was $99.99.

**Game Boy Advance and DS/DS Lite.** Few in the video game industry anticipated the runaway success of Nintendo’s Game Boy handheld system when it was introduced in 1989. Nintendo paired the Game Boy with its new Pokémon video game in 1996, which was accompanied by an animated series and a line of trading cards. With the help of Pokémon, the low-screen-resolution Game Boy player sold nearly 120 million units. Even though the Game Boy had a life cycle of more than a decade, Nintendo kept its appearance fresh by making the handheld game in different colors and eventually adding a color display. Such cosmetic changes to handheld games were critical to sustaining sales since many children thought of the Game Boy as a fashion accessory.

Nintendo’s next-generation successor to the Game Boy was the Game Boy Advance. The Game Boy Advance allowed users to play Pokémon and other games on a larger, higher-resolution screen. Nintendo had sold more than 75 million Game Boy Advance units between its June 2001 launch and December 2006. Even though Nintendo launched the DS (a newer-generation handheld system) in November 2004, it continued to offer the Game Boy Advance through 2007 as a low-priced ($79.99) alternative to the Nintendo DS.

The Nintendo DS was developed to appeal to Nintendo’s core youth market as well as to such historically nongamers as women and those over age 35. The system included dual screens, a stylus-operated touchpad, voice recognition, and Wi-Fi capabilities to make operation of the system intuitive rather than an exercise in dexterity. The company developed innovative new games for the DS that would appeal to those who were uninterested in first-person shooters or other genres preferred by the PlayStation aficionados. Nintendo DS games such as Nintendogs, which allowed gamers to play with a virtual pet, and
Brain Training for Adults, which asked gamers to solve arithmetic puzzles, weren’t very popular with 18- to 30-year-old males, but they were a huge hit with people who had never before shown an interest in video games. Nintendo planned to introduce 20 new game titles during the first quarter of 2007 to appeal to the interests of new gamers and children.

The retail price of the DS was also an aspect of Nintendo’s handheld systems attractive to casual gamers. In March 2007, the retail price of the Nintendo DS Lite was $129.99, compared to a retail price of $199.99 for the Sony PSP. The DS Lite was a slightly smaller and more brightly lit successor to the DS. The Nintendo DS Lite had been the top-selling video game system during the 2006 holiday shopping period, with more than 1 million units sold in November alone. In addition, more than 641,000 Game Boy Advance systems were sold in November 2006, which made it the number three best-selling system during the month. The PS2 was the best-selling console and second best-selling system overall, with 664,000 units sold during November 2006.

The Wii. Nintendo followed its game plan used with the Nintendo DS in developing the Wii. As with the DS, Nintendo attempted to develop a game system that would appeal to nongamers—especially moms. Shigeru Miyamoto, a key Wii developer, explained this key consideration to BusinessWeek writers in 2006:

Our goal was to come up with a machine that moms would want—easy to use, quick to start up, not a huge energy drain, and quiet while it was running. Rather than just picking new technology, we thought seriously about what a game console should be. [CEO Satoru] Iwata wanted a console that would play every Nintendo game ever made. Moms would hate it if they had to have several consoles lying around.13

His colleague on the development team, Ken’ichiro Ashida, added, “We didn’t want wires all over the place, which might anger moms because of the mess.”14

The development team considered a variety of controller types that could be wireless and intuitive. Nintendo rejected such design inspirations as cell phones, car navigation remotes, and touch panels for a wireless wand. The wand took over one year to develop and was able to respond to hand motions that were used in throwing a ball, casting a fishing line, swinging a baseball bat, or pointing a gun. A separate “nunchuk” device allowed the user to create motion necessary to play games needing two hands. A Wedbush Morgan Securities analyst commented on the brilliance of the design by pointing out, “With the Wii remote, the learning curve for most games is 15 minutes or less. I think that will eliminate the intimidation factor and will attract a broader audience.”15

Although Nintendo executives knew early during the development of the Wii that it would be unable to compete with the next-generation consoles soon to be launched by Microsoft and Sony, they believed the wireless wand controller would have appeal with the masses. Reggie Fils-Aime, the president of Nintendo of America explained:

What makes the Wii so special is obviously the Wii Remote: the ability to play tennis with a flick of the wrist, to play baseball like you do it on the ball field. That allows the consumer to get more in the game by having a totally different type of interface, plus it allows game developers to create all new different types of games. We have everything from a game like “Trauma Center” from Atlas, where you’re the doctor, and you’re using the precision of the Wii remote to stitch up a patient and take shards of glass out of their arm—things of that nature. The new way to play “Madden Football,” a brand new Madden where you act like the quarterback, where you hike the ball, pass. All of that allows for totally unique game play.16

Another consideration was creating a game console that would easily fit within the family budget. Miyamoto explained, “Originally, I wanted a machine that would cost $100. My idea was to spend nothing on the console technology so all the money could be spent on improving the interface and software.”17 As a result, Nintendo wound up using a microprocessor, that although was twice as fast as that used in the GameCube, was less powerful that what Microsoft had used in the original Xbox. Also, the Wii contained only a 512 MB flash memory card to store data instead of a hard drive and could not play DVDs. The Wii could connect to the Internet through a wireless home network, but not with an Ethernet cable. A full list of Wii features is presented in Exhibit 3. Analysts believed that, at launch, Nintendo to earn a profit on every Wii console sold because of its modest components costs.

One additional benefit of Nintendo’s low-tech approach to a next-generation console was the low relative development costs needed for Wii video games. Analysts expected that on average the development cost for a Wii video game would be less than half of that necessary to develop games for the Xbox 360 or PS3. As a result, game developers were very interested in creating new games for the Wii. Electronic Arts
announced six Nintendo Wii titles during a July 2006 industry trade show, while it said little of its plans for new PS3 games. A video game analyst believed developers saw more opportunity for immediate profits from Wii games than those for PS3 and were “holding off on creating games for Sony” until its installed base grew. In addition to new games, Wii users could also access all older games on Nintendo’s Wii Connect24 online gaming site. Wii Connect24 also offered a weather channel, news channel, shopping channel, and Web browser. The Wii console also allowed users to view digital pictures stored on an SD memory card and create personalized Mii interfaces for each member of the family.

THE WINNER OF THE BATTLE FOR SUPREMACY: SONY OR MICROSOFT OR NINTENDO?

In early 2007, there were varying opinions about which company would end up as the market leader in video game consoles in 2010—Sony or Microsoft or Nintendo. During the 2006 holiday season, Nintendo had done surprisingly well, capturing a 55 percent market share based on the combined unit sales of the Wii, DS, DS Lite, and Game Boy Advance. In addition, Nintendo sold more than 1.5 million extra Wii consoles during November–December 2006 purchased, on average, three video game titles for the Wii. Even so, some observers contended that Microsoft had been the winner of the 2006 holiday season since sales of the Xbox 360 exceeded sales of either the PlayStation 3 or the Wii (although only limited supplies of the PS3 and Wii were available during that period since their production was still in the startup phase). By year-end 2006, Microsoft had sold over 10 million units of the Xbox 360, giving it a sizable lead over the PS3 and the Wii in terms of total users.

But whether Microsoft’s first-to-market strategy would translate into a sustainable first-mover advantage was debatable. Microsoft had more than 160 game titles available for the Xbox 360, compared to fewer than 30 for the PS3—but a wave of new games for both the PS3 and the Wii were coming to market in 2007. The Wii was no match for the Xbox 360’s HD video resolution, but there were indications that its innovative controller had big appeal to a number of ardent game players. There were also analysts who believed that once Sony opted to lower the price of the PS3 (if indeed Sony management did decide to be more price-competitive), it would replicate the success it had achieved with the PlayStation and PS2.

Endnotes

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In its elegant Sandton offices near Johannesburg, South Africa, under the watchful eye of the legendary champion of mobile communications for Africa’s poor, Strive Masiyiwa, founder and CEO of Econet Wireless International (EWI), the EWI top executive team was putting together its game plan for entering the next country market in Africa. The EWI footprint stretched across several African countries; however, the company did not have a network license to operate in South Africa, Africa’s largest mobile phone market and headquarters of EWI’s international operation. The company used a variety of ownership structures and had acquired a sizable number of network licenses. Its rapid expansion on the African continent had put it on a collision course with the Big Five mobile phone operators: South African giants MTN and Vodacom, Orascom Telecom of Egypt, Kuwait’s MTC, and Luxembourg-based Millicom.

Navigating the precarious African business environment had not been easy for the international upstart; EWI had spent a significant amount of its attention and resources on legal battles with governments, partners, and competitors. It was expanding faster than it could marshal the financial and technical resources to fully develop the markets in which it had won the licenses to operate. The company had resisted all merger and takeover attempts, preferring to maintain its African identity and continue its global expansion crusade. Although EWI had operations in 10 countries on three continents, its brand remained obscured by MTN, Vodacom, Orascom, MTC, and Millicom.

There were four strategic challenges facing the Masiyiwa-led management team. First was whether to continue to provide a complete package of telecommunications solutions (mobile networks, fixed networks, and Internet and data-streaming services) or to focus only on operating mobile networks, where EWI had a successful track record. A second issue was whether to focus on the African continent or to internationalize without regard to where licenses might be acquired. Third was the issue of whether to continue bidding for more new licenses or to zero in on building a critical mass of subscribers in the markets where it already operated, thereby avoiding spreading resources too thin and being relegated to second-tier status in all the regional markets where it operated. Fourth was the major challenge of how best to finance further growth and international expansion.

BACKGROUND

Econet Wireless was launched in Zimbabwe in 1993 by a consortium headed by Strive Masiyiwa, a young and aggressive entrepreneur who had formerly worked as a telecom engineer at the state-owned Posts and Telecommunications Corporation (PTC).
before founding a successful electrical firm called Retrofit. With the advent of mobile communications on the African continent in the mid-1990s, and the deregulation of the sector globally, the stage was set for the transformation of the communications landscape. In 1993, Masiyiwa proposed a joint venture to establish Zimbabwe’s first mobile network with his former employer PTC, which held a monopoly over all telecommunications at the time. PTC turned down the proposal, arguing that there was no need for the service in Zimbabwe. Masiyiwa went to court seeking to overturn PTC’s monopoly over telecommunications so that he could start his own mobile telephone company. In 1995, the Supreme Court of Zimbabwe agreed with the plaintiff that the state’s monopoly over telecommunications through PTC was unconstitutional and thus granted Masiyiwa the right to operate a mobile phone network. Econet, in partnership with Ericsson of Sweden, began setting up base stations around Harare, the capital of Zimbabwe.

In February 1996, however, a presidential decree barred the establishment of any private mobile networks—offenders were subject to a two-year jail term. Again Masiyiwa went to court, this time challenging the constitutionality of the presidential decree. In the meantime, the government, through PTC, began a frantic effort to establish its own mobile network (NetOne) and avoid the inconvenience of competition. At the same time, the government sought to block the entry of the Masiyiwa-led group into the market by announcing that there would be two Global System for Mobile Communications (GSM) network licenses, one of which was to be awarded to NetOne and the other to the Telecel consortium (a member of the Orascom Telecom group). Yet again Masiyiwa went to court, arguing that the Telecel consortium did not meet the tender specifications and therefore should be disqualified.

By the end of 1997, Masiyiwa had won both court cases and for the final time was granted a license to operate. This time he was also supported by the then vice president, Joshua Nkomo, to whom he had appealed to end the embarrassing travesty of justice. In a face-saving move, the government issued a third GSM network license in order to accommodate the Telecel Consortium that was led locally by some prominent members of the ruling party. In 1997, while awaiting the final determination of the cases pending in the courts, Econet formed a consortium involving Portugal Telecom to bid for a 15-year GSM network license in Botswana, which it won in 1998. Econet launched its mobile phone service in July 1998 and then went on to list itself on the Zimbabwe Stock Exchange in September 1998, raising capital to retire debts, finance network expansion, and pursue new international opportunities. In the meantime, NetOne had been operating for two years and had entrenched itself as the market leader.

Since its launch, Econet had become popular with the general public as a symbol of resistance; moreover, its innovative product range and low prices made it the network of choice for many. Consequently, the demand for Econet lines far outstripped the company’s ability to supply them; this led to the birth of a black market for Econet lines, in which a line could cost as much as 20 times its official retail price. Within one year Econet had overtaken NetOne as the market leader, and by 2006 it had a 60 percent market share, with NetOne and Telecel sharing the balance. By the end of 2005, Econet had become one of the four largest firms on the Zimbabwe Stock Exchange, with a market capitalization of over US$300 million.

Not wishing to be restricted in its international ambitions by the economic and political meltdown occurring in Zimbabwe at the time, Econet decided to relocate its headquarters to Johannesburg in 2000. Since then, it had entered a number of foreign markets, including Nigeria, Kenya, Burundi, Lesotho, Morocco, Malawi, the United Kingdom, and New Zealand. By 2006, Econet had become a recognized player in the African mobile phone market. For some time, the company had been considering a London Stock Exchange listing to facilitate raising up to US$500 million in capital to develop its global business and become a larger player in the telecom marketplace.

**MOBILE TELEPHONY IN AFRICA**

Like elsewhere in the world, the telecommunications sector in Africa had historically been dominated by state monopolies. Due to the undercapitalization of these state monopolies and guaranteed government...
subsidiaries, there was no pressure for innovative management practices; consequently, service delivery and telephone penetration rates across Africa were low. The average density in 2000 was one telephone line for every 70 people, although the density rates differed markedly by country. In Chad, for example, the penetration rate was one land-based line per 700 people. However, between 2000 and 2005, the use of mobile phones in Africa grew at the highest rates in the world: The number of mobile phone subscribers skyrocketed from 15.6 million to 135 million subscribers (an average compound rate of 54 percent versus a global average of 24 percent). Within the space of 12 years (1994–2006) the Africa and Middle East market (combined population of 1.2 billion) grew from almost zero to US$25 billion and counting. Still, since Africa’s population was approximately 1 billion, the mobile phone penetration rate stood at less than 15 percent against a global average of 33 percent (2 billion mobile phone users worldwide from a world population of 6 billion). Mobile phone users accounted for 83 percent of Africa’s telephone users, indicating the poor state of the fixed telephone infrastructure. But in spite of that, network coverage was still very low at an average of 15 percent. Consequently, it was not uncommon for subscribers to subscribe to two networks depending on where they were located or where they traveled.

Mobile phone capital investments in Africa had exploded to approximately US$14 billion in the last five years, while the average revenue per user (ARPU) had declined to between US$5 and US$10 a month from rates as high as US$40 (e.g., in Nigeria) in the early days of mobile communications. With a few exceptions, most countries in Africa had at least two mobile phone operators, and in some cases governments wishing to cash in on mobile operator license fees had overlicensed the sector, meaning that operators were not able to fully benefit from their investments. A case in point was Burundi, with a population of 7 million but four licensed mobile phone operators.

The number of traditional land-based telephone lines in Africa rose from 25.1 million in 2003 to 27.3 million in 2006, a sluggish 2.8 percent compound annual growth rate. Historically, growth in the number of land-based lines had averaged less than 7 percent annually. For the most part, the state-owned and operated telecommunications enterprises in Africa were capital-poor and had not invested very aggressively in modern telecommunications technologies. As a consequence, interconnectivity between calls made on mobile phones and land-based telephones had suffered; this, in turn, had restricted the range of services that mobile operators could provide, since some of these depended on good interconnections with land-based telephone networks and their customers. For example, the use of telephone systems for high-speed data transfer and Internet services had been slow to take off because of the poor fixed-line infrastructural backbone, relatively high user costs, and low literacy levels in the population. Mobile communications systems were thus used chiefly for voice communications. Ironically, mobile phone subscribers in Africa had benefited from the poor state of land-based telephone networks because they gained speedier access to fast-advancing mobile technologies at competitive prices from mobile phone operators, most of which were subsidiaries of large international network operators. These new technologies included broadband and even third-generation (3G) technology that supported color phone handsets, digital photography, television, Internet services, and other high-technology facilities that older first- and second-generation (1G and 2G) phones, available at the beginning of telecommunications revolution, could not support. All this rapid access to leading-edge technology on such a large scale on the African continent might not have been possible had there been a high subscription rate to traditional landline telephone networks.

The cash-rich Middle Eastern operators and the cash-rich South African operators had been jockeying for acquisitions in a strategic effort to build a strong competitive position in the African mobile phone marketplace, where the potential for sustained long-term growth seemed so promising. The five largest competitors had led the drive to acquire smaller competitors and consolidate the supply side of the market. Recent major acquisitions included MTN’s US$5.5 billion acquisition in 2006 of Investcom, a player in the African and the Middle Eastern markets, and MTC’s US$3.4 billion acquisition in 2005 of Celtel, a major player in 14 African countries. However, there were a few remaining attractive acquisition candidates, including Portugal Telecom’s African interests, France Telecom’s interests, and even Econet Wireless. The prospect of South Africa’s MTN, one of the Big Five, being itself a takeover target either by one or a consortium of Gulf-based telecom companies, had also been
mentioned in some press reports. Some observers believed the Big Five in Africa were destined to become the Big Three.

Exhibit 1 presents comparative data for the five biggest mobile telecom operators in Africa.

GSM technology was the standard for mobile phone operators in Africa. However, there were five fairly important mobile operators in Africa that employed Code Division Multiple Access (CDMA) technology: Movicel in Angola, Telecel in the Democratic Republic of the Congo (DRC), Kasapa Telecom in Ghana, Telecel in Zambia, and five in Nigeria that accounted for 2 percent of Nigeria’s nearly 30 million mobile phone subscribers. One difficulty that subscribers encountered in areas where some competing operators used CDMA technology and other operators used GSM technology was that subscribers with CDMA handsets could not switch to an operator using GSM technology without buying a new handset—and vice versa. CDMA handsets were more expensive than GSM handsets.

Moreover, over 90 percent of Africa’s mobile phone business was conducted on a prepaid basis, and many GSM mobile phone users had purchased prepaid cards from two or more GSM mobile phone operators in order to be able to make calls in areas where their GSM subscriber did not have good coverage. For example, a mobile phone subscriber of a particular GSM network, say MTN, might also have a prepaid card to make calls on Celtel (also a GSM network) in order to (1) be able to make calls in areas where Celtel had coverage and MTN did not, or (2) take advantage of lower charges that Celtel might offer on specific occasions. The propensity of subscribers to have prepaid cards for different network operators had the further effect of limiting a subscriber’s loyalty to a particular network and provided subscribers to a GSM network the flexibility to switch between GSM mobile service providers at low cost.

**PROFILES OF THE STRATEGIES AND POSITIONS OF AFRICA’S BIG FIVE MOBILE OPERATORS**

**Millicom**

Luxembourg-based Millicom was formed in 1990. Millicom executives had anticipated the worldwide mobile telecom revolution early, and the company had been a first-mover in acquiring operating licenses in the developing world when they were relatively cheap. The population under license in Africa, Asia, and South America was approximately 433 million in 2006. Millicom’s subscriber base was 13 million worldwide (3.2 million in Africa)—see Exhibit 2. Millicom had sales revenues of US$1.4 billion in 2006, with its African operations contributing over US$200 million in revenues. Millicom had market leader status in three relatively fragmented markets within South America (El Salvador, Honduras, and Paraguay) and one market in South East Asia (Cambodia); the combined population of these four areas was 34 million. In Africa, where Millicom
had operations in seven countries, the company had market challenger status in four markets and market share laggard status in the remaining three. The biggest market in Africa by population where Millicom had operations was the Democratic Republic of Congo (population 60 million), where it had a 100 percent ownership of local mobile operator, Oasis.

From a strategic point of view, Millicom had followed a mass-market strategy anchored around the appeal of low pricing. Millicom employed a multi-branding strategy, using the Millicom brand in only 3 (Chad, Sierra Leone, and Laos) of its 16 markets. Given its investment strategy of going for relatively low population markets with a sprinkling of relatively high population markets, and a less aggressive business approach, Millicom was the weakest competitor of the Big Five. It had been the target of a takeover by China Mobile; the deal eventually failed to go through because Millicom considered the price offered by China Mobile unsatisfactory. However, several other operators were said to be interested in acquiring Millicom.

**MTC**

MTC, established in 1983, was the first mobile operator in the Middle East and Africa. It had revenues of US$3 billion during the first nine months of 2006, employed 12,000 people, and had operations in 6 Middle Eastern countries and 14 African countries. MTC’s market capitalization at the end of 2006 was approximately US$15 billion. In 2005, it paid US$3.36 billion to acquire Celtel International BV, a company that had mobile network operations in 14 African countries (and market-leader status in 10 of them). This acquisition was followed by increasing its ownership from 39 percent to 100 percent of Mobitel of Sudan and to 65 percent in Vee-Mobile of Nigeria (formerly Econet Wireless Nigeria), at costs of US$1.3 billion and US$1 billion, respectively. These transactions catapulted MTC into major-player status in both Africa and the Middle East and gave it a total subscriber base of 23 million (see Exhibit 2). However, there was potential for substantially greater subscriber growth, in that there were 400 million people in the countries where MTC had mobile phone licenses.

MTC’s strategic approach was to fully segment the market, building a formidable competitive web in each segment that was difficult for competitors to penetrate. The company aimed to capture more than a 50 percent share in markets where it had market-leader status and at least a 30 percent share in countries where it had enough competitive strength to be an up-and-coming market challenger. Its investment strategy was to concentrate resources on large population markets with relatively low mobile phone penetration rates, fast mobile phone adoption rates, and relatively high rates of economic growth. MTC was an aggressive player, striving to dominate the African and Middle Eastern mobile phone markets in which it operated. In Africa, MTC had continued to operate under the Celtel brand in all the markets where Celtel had operated prior to its acquisition by MTC. Similarly, it operated as Mobitel in Sudan after the acquisition. The MTC brand was employed in Middle Eastern countries, except in Jordan, where MTC operated under the Fastlink brand.

**MTN**

MTN, with a current workforce of 8,360 people, began operations in 1994 after winning the second of three mobile phone operator licenses awarded by the South African government. In South Africa, a market with a population of 47 million and a mobile phone penetration rate of 72 percent, it had 10 million subscribers (versus 20 million for major competitor Vodacom). MTN had begun entering other countries in Africa in 1997 when it acquired a license in Uganda. This was followed by the acquisition of operating licenses in Rwanda, Swaziland, and Cameroon in 1998–2000. In 2001, MTN acquired a license to operate in Nigeria, Africa’s most populous country, with approximately 151 million people. The mobile phone penetration rate in Nigeria was 19 percent; MTN had a 41 percent market share (12 million subscribers) in 2006, making it the market leader ahead of Gloacom (29 percent), Celtel, (24 percent), M-Tel (4 percent), and CDMA Networks (2 percent).

MTN was focused on expanding northward into the Middle Eastern market, currently awash with petrodollars owing to high oil prices. The mobile phone market in the Middle East was growing rapidly, but competition among regional and European market contenders was quite strong. In 2006, MTN acquired Investcom for US$5.5 billion, giving it a foothold in 10 new country markets (Benin, Ghana, Guinea Bissau, Guinea Republic, Liberia, Sudan,
MTN had a regional office in Iran, where it had an ownership interest in IranCell. MTN expected its investments in Investcom and IranCell would be the platforms for building its business in the Middle Eastern market. In 2006 MTN’s mobile phone operations extended to 21 countries in Africa and Middle East with a total subscriber base of 32 million, making it the biggest and arguably the most successful mobile phone company in Africa, ahead of its arch-rival Vodacom. MTN had mobile phone licenses in countries with a total population close to 500 million.

MTN’s international strategy had two main elements: leveraging existing businesses and growing new markets. Consequently, the group had pursued license acquisition opportunities in emerging markets that consolidated their regional positions and economies of scale. This made it possible for the group to acquire small, otherwise uneconomic licenses in some markets where the group had as much as 100 percent of the market (for example, Swaziland and Rwanda). MTN’s strategy also balanced the use of existing infrastructure with its own research and development to develop new applications for market opportunity exploitation. The company remained exclusively focused on mobile phone operations, providing a wide product range, including 3G technology-based services and a strong retailing and franchising system. It operated under a single corporate brand name in all its markets.

**Orascom**

Orascom was an Egypt-based conglomerate with telecom revenues of US$2.1 billion; it had 15,000 employees. Orascom had both mobile, fixed-line, and Internet operations in nine markets: Egypt, Tunisia, Algeria, Iraq, Malta, Pakistan, Bangladesh, Zimbabwe, and the British Virgin Islands. Rather than expand further in Africa, the company had been disposing of its shareholdings in several African mobile operators in Africa and was currently targeting high-population, high-growth markets in Europe, the Middle East, and Asia that had relatively low mobile phone penetration rates. Orascom had attracted a critical mass of 7 million mobile phone subscribers in the Egyptian market, equal to a 51 percent market share; Egypt had a population of 62 million people. In terms of subscriber numbers, Orascom was the biggest mobile phone operator in Africa, with over 46 million subscribers in its operating regions (Africa, the Middle East, and South Asia). There were about 460 million people in the countries where Orascom had licenses to operate a mobile phone network. Orascom also owned 19.3 percent of Hutchison Telecom, which had operations in eight Asian countries. Orascom operated under several brand names—Mobinil in Egypt and Pakistan, Bangalink in Bangladesh, IraQna in Iraq, Tunisiana in Tunisia, and Telecel in Zimbabwe.

**Vodacom**

Vodacom was a US$3 billion South Africa–based company that employed 5,300 people. Vodacom was the product of a 50–50 joint venture between Vodafone Group PLC and Telkom SA. Vodafone Group was the world’s largest mobile phone operator based on revenues (China Mobile was the biggest based on the number of subscribers), and Telkom in 1994 had won the first of three mobile phone licenses awarded in South Africa. The Vodacom Group used a business model paralleling that of Vodafone Group—it operated mobile networks, was an important retailer of mobile phones and accessories, and had a business franchising service. Vodacom was the least internationalized of the Big Five, operating in only five African countries; its largest subscriber base was in South Africa, where it had a 59 percent market share against MTN’s 35 percent and Cell-C’s 6 percent. Prior to November 2006, Vodacom was limited to operating south of the Equator due to an agreement with Vodafone Group, but that agreement had expired. Vodacom had adequate resources for expansion and was actively searching for investment opportunities chiefly in Africa. But it was also focusing on cementing its position as the number one operator in South Africa, the most prosperous mobile phone market in all of Africa. Vodacom, like its rival MTN, had invested heavily in 3G technology, even though the evidence from Europe and elsewhere so far had been that 3G systems had not delivered the expected big profits for the operators that had deployed 3G technology. To date, Vodacom’s expansion in Africa had been in countries that were neighbors of South Africa: Lesotho, Mozambique, Tanzania, and the Democratic Republic of Congo (DRC). DRC, with a population of 60 million, was Vodacom’s second largest country market in Africa, followed by Tanzania (population of 37 million).
Vodacom had belatedly tried to enter Nigeria via a management contract with Econet Wireless Nigeria (EWN) in 2004, attracted by the spectacular good fortune that the Nigerian market had brought to MTN. But Vodacom’s agreement with EWN lasted only two months, allowing MTN to reign supreme in Nigeria. However, observers believed that Nigeria was too important a market for Vodacom to ignore for long, leading to speculation that Vodacom might return to the Nigerian market via an acquisition of one of the GSM operators, possibly Globacom.

See Exhibit 2 for comparative numbers of subscribers of selected mobile telecom operators.

THE ECONET WIRELESS GROUP IN AFRICA

The Econet Wireless Group had a subscriber base of 5 million in four networks and a workforce of 1,400. Its most successful majority-owned network was in Zimbabwe, where it was the leading network, with a subscriber base of about 800,000 in a market with a population of 14 million. Econet Wireless Holdings owned 51 percent of Econet Wireless International. Econet’s efforts to expand into other African countries had been weakened by its strong dependence on its Zimbabwean operations. However, Econet’s ability to tap its substantial cash flows from its Zimbabwe operations were largely blocked due to Zimbabwe’s lack of foreign currency and stringent government controls on hard currency remittances. The blocked funds had been partly used to acquire sizable equity investments in selected blue-chip companies in Zimbabwe and to buy back the company’s shares on the Zimbabwe Stock Exchange. (Econet’s stock had a market capitalization of Z$1.5 trillion, or US$375 million, at January 2007—the exchange rate was US$1 = Z$4000.)

Until 2006, mobile phone licenses in Africa were cheap by international standards. Consequently, Econet had been able, with the help of various consortium partnerships in which Econet had a minority position, to acquire mobile licenses in such important markets in Africa as Nigeria and Kenya. In each of these markets, the licenses were for second, third, or fourth network operator licenses.
Econet’s internationalization sequence had been to enter Botswana in 1998 through a 20 percent stake in Mascom; Morocco in 2000 through a 35 percent stake in Gulfsat Maghreb SA; New Zealand in 2001 through a 65 percent stake in Econet New Zealand; Nigeria in 2001 through a 5 percent stake in Econet Wireless Nigeria; Lesotho in 2002 through a 21 percent stake in Mountain Kingdom Communications; Kenya in 2004 through a 10 percent stake in the Econet Consortium; Malawi in 2006 through a 60 percent stake in Telecom Networks Malawi; and Burundi in 2006 through a 65 percent stake in ST Cellular, formerly Spacetel Burundi. The Econet brand was used in all the markets where the company had a controlling stake or where it was able negotiate use of its brand name (Nigeria and Lesotho).

Econet’s original business model and strategy was to be exclusively a mobile phone company that offered an up-to-date and comprehensive product range at competitive prices. Over time, Econet Wireless International’s business model and strategy had evolved into becoming a full-service communications company offering mobile telephony, traditional landline telephony, Internet services, data streaming services, transactions systems, and contract services for other operators.

Early on, Econet had partnered with Ericsson (its supplier of base stations, network equipment, and cheap handsets), which had helped propel Econet’s exponential growth in the mobile phone market in Zimbabwe. More recently, a new technical partnership had been developed with China’s Huawei Technologies for the supply of base stations and other network equipment in some markets, particularly in New Zealand.

From a human resources point of view, Econet combined an ethnocentric approach with a polycentric approach. Experts from the parent company were sent to operating subsidiaries for periods of up to six months and on two-year contracts. Host country nationals were generally put in charge of each country’s operations, with finance functions usually under the direction of an expatriate manager from Econet Wireless International.

The size of the total population in countries where Econet Wireless International had licenses to operate and had established mobile networks in competition with rivals was approximately 188 million (Exhibit 3). This figure excluded Kenya (population: 33 million), Malta (population: 383,000), Morocco (population: 31 million), and New Zealand (population: 3.8 million), where Econet had licenses to operate but had not yet begun network operations and the process of signing up subscribers.

### Econet in Nigeria

Mobile phone operators considered Nigeria to be the most attractive long-term country market in Africa because it had the largest population on the continent (151 million people) and because of the expected rapid growth in mobile phone use in Nigeria—predictions called for the number of Nigerian subscribers to surpass the number of subscribers in South Africa by 2010 and reach as many as 90 million subscribers in the post-2010 period. Nigeria had nine mobile phone network competitors, four of which used GSM technology and five of which had CDMA systems. Econet and its consortium partners had entered Nigeria in 2001, even before MTN, and had grown to be the second largest mobile operator in Nigeria. Econet was a 5 percent shareholder in the consortium of 21 partners but had the option of increasing its ownership stake to 33 percent. Econet had not exercised this option early on due to lack of funds; more recently, Econet’s consortium partners had resisted a higher stake for Econet, believing Econet lacked the financial means and resources to invest in strengthening the partnership’s competitive position in Nigeria.

On the first day of operation in Nigeria, the Econet consortium signed up 30,000 subscribers. But its growth in Nigeria was held back by having to wait for more than a year for Nitel, the government-controlled telecom operator, to provide transmission links to some of Nigeria’s states. These delays worked to MTN’s advantage because MTN had its own network transmission backbone and was not dependent on Nitel for essential customer connection services. In 2002, Econet opted to suspend the sale of its prepaid Buddie cards for six months due to quality problems; use of prepaid cards was highly popular among Nigerian mobile phone users. Econet’s decision proved somewhat catastrophic because it triggered a mass exodus of subscribers over to MTN. Indeed, MTN’s network was temporarily overwhelmed by the unanticipated burst in call
volume brought on by the new subscribers switching from Econet, but the sudden surge of growth stimulated MTN to aggressively expand the call volume that its network could handle reliably. When Econet later reintroduced its Buddie card, it priced the cards so cheaply that the number of new subscribers quickly soared. Unfortunately, the resulting growth in call volume strained the Econet network’s call-carrying capacity and led to network quality problems. However, unlike MTN, which had experienced a call-volume problem earlier, Econet did not have the money to upgrade its network and came under government threat of having its license revoked for failing to provide an acceptable mobile phone service. To resolve its difficulties, Econet managed to secure a $75 million loan from the U.S.-based Export-Import Bank to finance network expansion and save its fledgling Nigerian business. While Econet’s network expansion was in process, Econet management decided to limit the number of days that subscribers could access the network, a highly unpopular move that worked to MTN’s advantage and solidified its status as the market leader in Nigeria (a position MTN had held since it launched operations in Nigeria in August 2001).

In April 2004, Econet Wireless Nigeria (EWN) entered into an agreement that would lead to Vodacom becoming a 51 percent ownership partner in the EWN consortium within 18 months. The intent of the arrangement to bring Vodacom in as a consortium partner was to give EWN access to the resources to increase EWN’s network capacity and put EWN in a stronger position to rapidly grow its subscriber base and serve the fast-growing Nigerian market. EWN management and other consortium partners in Econet Wireless Nigeria believed that
allying with a new strategic partner having stronger financial resources and network operating experience was vital to the long-term interests of their business. Econet Wireless International, with only a 5 percent ownership in the Econet Wireless Nigeria consortium, bitterly opposed the arrangement between EWN and Vodacom, believing that Vodacom control of the business would permanently limit Econet Wireless International’s role and future in the Nigerian business that it helped establish. Econet Wireless International argued that it had preemptive rights to increase its ownership to 33 percent before Vodacom or any other entity could be offered shares. EWI executives accused Econet Wireless Nigeria management of acting in bad faith and even in rebellion, claiming that EWI had not been given an opportunity to exercise its rights before Vodacom was offered the 51 percent ownership stake. Econet Wireless International also accused Vodacom of corruptly inducing Econet Wireless Nigeria management to enter into the agreement with Vodacom at the expense of Econet Wireless International’s preemptive rights. EWI opted to file a lawsuit against Vodacom seeking $1.8 billion in damages. For its part, EWN management argued that Econet Wireless International had demonstrated difficulty and even inability to raise the capital required to compete effectively. EWN management claimed that a joint venture with Vodacom was essential for EWN to compete on a more equal footing with MTN and eventually overtake MTN as the market leader in Nigeria.

Vodacom’s interest in assuming a 51 percent ownership of the EWN venture was to use EWN’s market position as a platform not only for competing with MTN in Nigeria but also for better competing with MTN across Africa—MTN’s success in Nigeria had catapulted MTN into the number one mobile phone operator in Africa. The attraction of using EWN as its entry vehicle into the Nigerian market had galvanized Vodacom management to vigorously defend against Econet Wireless International’s legal challenge. Prior to signing the agreement to be a 51 percent partner in the EWN venture, Vodacom had conducted a nine-month due diligence exercise that concluded that all was well at Econet Wireless Nigeria.

The Vodacom-EWN relationship began with a management agreement to provide technical and managerial expertise and to finance expansion of the EWN network. In return, Vodacom was to receive a 51 percent controlling stake in Econet Wireless Nigeria that was valued at $150 million. Econet Wireless Nigeria was to be rebranded Vodacom Nigeria (Vee-Mobile). Two months after the agreement came into force, it emerged that Econet Wireless Nigeria had paid nearly $3 million to three parties as commission/brokerage payments for its investment in the company. This was determined to be lawful in Nigeria, but Vodacom’s principal shareholders—Telkom SA, Vodafone Group PLC, and U.S. telecom company SBC, all of whom were listed on the New York Stock Exchange (NYSE)—took a different view. They concluded that it was corruption and demanded that Vodacom pull out of Nigeria immediately, fearing possible U.S. prosecution under laws that forbade U.S. firms from engaging in corrupt practices abroad. Such prosecution could lead to jail terms for offenders or fines that could run into hundreds of millions of U.S. dollars for offending companies.

These unexpected developments broke the two-month-old Vodacom-EWN marriage apart, leaving EWN with an identity crisis since a switch had already been made to the Vodacom Nigeria (Vee-Mobile) brand. It also left EWN without the resources to compete on a more level playing field against market leader MTN. Vodacom agreed to let EWN use its brand name for three months and to keep Vodacom’s technical and managerial staff at EWN for six months to smooth the transition. In return for this gesture, EWN agreed not to sue Vodacom for breach of contract. In spite of Vodacom’s exit in Nigeria, EWI did not drop its lawsuit against Vodacom. EWN management moved quickly to consider new strategic partners to fill the void left by Vodacom; three operators became the focus of attention: Orascom, MSI-Celtel of the Netherlands, and Orange, a company based in the United Kingdom. In the interim, Econet Wireless International managed to raise $1 billion and made an offer to purchase 65 percent of Vee-Mobile; the other consortium partners in EWN spurned Econet Wireless International’s offer. In May 2006, Celtel announced that it had acquired a 65 percent controlling stake in Vee-Mobile (formerly EWN) and proceeded to rebrand the operation as Celtel Nigeria.
In spite of Econet Wireless International’s legal and other efforts, the Econet brand disappeared from the Nigerian mobile phone landscape, as did any hope of amicable business relationships with its former EWN partners. At the beginning of 2007, Celtel Nigeria (formerly Econet Wireless Nigeria and Vee-Mobile) had approximately 7 million subscribers in Nigeria versus MTN’s 12 million.

**Econet in Kenya**

In 2004 the Econet Wireless Consortium—whose owners consisted of Econet Wireless International (10 percent), Kenya National Federation of Cooperatives (82 percent), Rapsel Limited (4 percent), and Corporate Africa Limited (4 percent)—bid $27 million and won Kenya’s third GSM mobile phone license. Econet Wireless Kenya was privately registered without the knowledge and agreement of the original partners in order to gain sole control of the Kenyan operation. The Kenya Telecommunications Investment Group (KTIG), an interested party in the GSM mobile license, argued to the Communication Commission of Kenya that Econet Wireless Kenya was a different entity from the one that had won the license. Econet Wireless Kenya was accused of abusing the goodwill of its Kenyan partners, drafting them into a partnership for the specific purpose of winning the license only to drop them from the partnership after qualification. Consequently, KTIG’s argument was that the Communication Commission of Kenya erred in giving a license to a company that was different in name and ownership from the consortium that had won the tender and that therefore Econet Wireless Kenya should not be allowed to operate and the whole license award process should be started afresh.

Two months after the license award, the license was canceled by the Kenyan authorities, citing irregularities in the award process and the failure by the consortium to fully honor the license fee obligations within the stipulated period. In relation to the license fee, the Kenyan government maintained that Econet Wireless International’s partners in Kenya had failed to come up with their part of the license fee even though EWI had paid its part of the fee and had guaranteed the payment of the amounts owed by its partners. A series of lawsuits followed, involving EWI as both plaintiff and defendant. One of these lawsuits involved Econet Wireless International suing the Kenyan Minister of Information, Raphael Tuju, for $989 million for damaging the Econet trademark and for loss of business owing to the minister’s remarks that Econet Wireless Kenya lacked the financial capability to roll out a network in Kenya and that it had won the license under questionable circumstances.

Whether Econet would gain a license to operate in Kenya was still up in the air in early 2007.

**Econet and Altech**

In a move to strengthen its capabilities to establish mobile phone operations in more parts of Africa, in 2004 Econet Wireless International entered into a 50–50 joint venture with Altech, a communication and technology firm listed on the Johannesburg Stock Exchange, to establish Newco; each partner contributed $70 million to the venture. Newco was expected to eventually take control of all of Econet Wireless International’s interests except those in Zimbabwe (because of foreign exchange restrictions and the political and economic climate) and in Kenya and Nigeria (because of the ongoing legal wrangles in those two countries).

Both parties believed there was a good strategic fit and operational synergies to be gained from the venture. The directors of Econet Wireless International felt that EWI could benefit from Altech’s technology products, finance, and administrative structures. For Altech, the benefit lay in diversifying into the mobile phone business, the growth prospects of Econet’s existing mobile telecommunications networks, the appeal of jointly expanding in other mobile operations across Africa and elsewhere, and improving Altech’s Black Economic Empowerment credentials (which put Altech in better position to take advantage of South African government contracts where there was a stipulation of significant black share participation in a company before it could be awarded any government business. Barely a year after the announcement of the partnership, it was dissolved amid allegations of breach of contract and racism against Econet’s black leadership. In 2005, Econet paid $87.5 million to walk away from the contract.
ECONET IN NEW ZEALAND AND EUROPE

In New Zealand, which had a population of 3.8 million people and 3.3 million mobile phone users, Econet had a license to operate a mobile network in partnership with the Maori investment group, Hautaki. The partnership bought an open (not limited to GSM or CDMA) network license in 2001 at a cost of NZ$13.2 million. The mobile phone market in New Zealand was a duopoly, with a GSM network operated by Vodafone (which had a 66 percent share) and a CDMA network owned by Telecom (which had a 34 percent share). The lack of competition between the two networks had resulted in New Zealand having the highest mobile phone calling rates of all 30 countries that belonged to the Organization for Economic Cooperation and Development (OECD). Even before the network rollout, Econet complained to the New Zealand Telecom’s regulator that the playing field was tilted in favor of the two incumbent mobile phone operators who acted aggressively and even unfairly to block any chance of a third operator could enter the New Zealand market and be competitively successful. This had prompted Econet to join forces with groups in other OECD countries in lobbying for amendments to the Telecommunications Act of 2001 that would promote greater ease of entry and competition among more mobile phone operators.

As of early 2007, Econet New Zealand did not have a network in New Zealand, some six years after the license award. It had not been able to raise the hundreds of millions of U.S. dollars needed to establish a network and fund a startup operation. The company was spending a small fortune monthly to maintain the New Zealand office with revenue from other operations. A decision had recently been made to reduce the staffing in the Econet New Zealand office to the barest minimum consistent with maintaining efforts to find the necessary funding to enter into competition against Vodafone and Telecom.

In Europe and the Middle East, Econet Wireless International did not operate any mobile phone network as of 2007 and had not announced any plans to begin any such operations despite having some operating licenses. However, Econet Wireless International did have fragmented interests in that region through operating subsidiaries and equity investments in such telecom-based service ventures as Econet Satellite Services, a London-based satellite and broadband service; Ecoweb Malta, an Internet service provider that was a joint venture with Comtel of Malta; and GulfSat Maghreb, a VSAT technology-based company in Morocco in which Econet had a 35 percent ownership.

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In 2003, top executives at Rayovac Corporation, concerned about fierce competition and limited growth opportunities in its global consumer battery business, decided to embark on a long-term program to diversify the company’s revenue stream away from such heavy dependence on selling alkaline and rechargeable AA and AAA batteries, coin batteries for watches and calculators, hearing aid batteries (where it was the worldwide leader), and flashlight products. Three years later, via a series of acquisitions, Rayovac had transformed itself into a global branded consumer products company with positions in seven major product categories: consumer batteries, portable lighting, pet supplies, lawn and garden, electric shaving and grooming, electric personal care products, and household insect control. The resulting change in the company’s revenue mix was dramatic:

<table>
<thead>
<tr>
<th>Product Category</th>
<th>Percentage of Company Net Sales, Fiscal Year Ending September 30</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2003</td>
</tr>
<tr>
<td>Consumer batteries</td>
<td>90%</td>
</tr>
<tr>
<td>Portable lighting</td>
<td>10%</td>
</tr>
<tr>
<td>Pet supplies</td>
<td>—</td>
</tr>
<tr>
<td>Lawn and garden</td>
<td>—</td>
</tr>
<tr>
<td>Electric shaving and grooming</td>
<td>—</td>
</tr>
<tr>
<td>Electric personal care products</td>
<td>—</td>
</tr>
<tr>
<td>Household insect control</td>
<td>—</td>
</tr>
<tr>
<td></td>
<td>100%</td>
</tr>
</tbody>
</table>

In recognition of the strategic shift in its business composition, Rayovac changed its name to Spectrum Brands in May 2005.
But while the company’s revenues had jumped from $573 million in fiscal 2002 to $2.55 billion at the end of fiscal 2006, its financial performance and financial condition were less than inspiring. Net income had dropped from $55.8 million in fiscal 2004 to $46.8 million in fiscal 2005 to a loss of $434 million in fiscal 2006. Despite the company’s much bigger size and revenue stream, net cash flows from operations in 2006 were below the level in 2002. The company had long-term debt of more than $2.2 billion and interest expenses of $177 million in 2006 versus long-term debt of $188 million and interest expenses of $16 million in 2002. Moreover, investors were a bit uneasy about Spectrum Brands’ future prospects. Spectrum’s stock price, which had traded as high as $46 in February 2005, traded in the $6 to $12 range between July 2006 and February 2007. Exhibits 1 and 2 present recent financial performance data for Spectrum Brands.
COMPANY BACKGROUND

In 1906, a company founded as the French Battery Company began operations in a plant in Madison, Wisconsin; French Battery was renamed Ray-O-Vac in 1930. Over the next several decades, Ray-O-Vac gained a reputation for innovation in batteries and flashlights:

- 1933: Patented the first wearable hearing aid tube
- 1939: Introduced the first leak-proof “sealed in steel” dry cell battery
- 1949: Introduced the crown cell alkaline for hearing aids and launched its soon-to-be-famous steel Sportsman flashlight
- 1970: Patented a silver oxide button cell battery
- 1972: Introduced the first heavy-duty, all-zinc chloride battery with double the life of general purpose batteries
- 1984: Introduced the Workhorse premium flashlight with lifetime warranty
- 1988: Introduced a battery to power the real-time clocks of personal computers
- 1993: Introduced a line of long-life rechargeable batteries
- 2001: Introduced breakthrough chargers for high-capacity Nickel Metal Hydride (NiMH) batteries; developed a new zinc air battery that combined long life and unprecedented power for hearing aids used by the severely hearing impaired
- 2002: Introduced 15-minute battery recharging technology

In 1946, company sales surpassed 100 million batteries for the first time; Ray-O-Vac produced its one billionth leakproof cell battery in 1950.1 In 1981, Ray-O-Vac debuted a new logo and a new corporate name minus the hyphens, Rayovac. During the 1970s and 1980s, Rayovac established firmly itself as the leading marketer of value-priced batteries in

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<table>
<thead>
<tr>
<th>Balance Sheet Data</th>
<th>Fiscal Years Ending September 30</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash and cash equivalents</td>
<td>$28.4</td>
</tr>
<tr>
<td>Inventories</td>
<td>460.7</td>
</tr>
<tr>
<td>Current assets</td>
<td>959.8</td>
</tr>
<tr>
<td>Property, plant, and equipment, net</td>
<td>311.8</td>
</tr>
<tr>
<td>Goodwill</td>
<td>1,130.2</td>
</tr>
<tr>
<td>Intangible assets, net</td>
<td>1,016.1</td>
</tr>
<tr>
<td>Total assets</td>
<td>3,549.3</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>562.6</td>
</tr>
<tr>
<td>Long-term debt, net of current maturities</td>
<td>2,234.5</td>
</tr>
<tr>
<td>Total shareholders’ equity</td>
<td>452.2</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cash Flow and Related Data</th>
<th>Fiscal Years Ending September 30</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net cash provided by operating activities</td>
<td>$44.5</td>
</tr>
<tr>
<td>Capital expenditures</td>
<td>60.4</td>
</tr>
<tr>
<td>Depreciation and amortization</td>
<td>87.5</td>
</tr>
<tr>
<td>Working capital</td>
<td>397.2</td>
</tr>
</tbody>
</table>

* Figures for 2004–2006 are as reported in the company’s 10-K reports for 2005 and 2006.
** Figures for 2002 and 2003 are as reported in the company’s 10-K report for 2003.
North America—the company’s core competitive strategy was to sell a battery comparable in quality to those of competing brands but at prices averaging about 10–15 percent less.

During the early 1990s, Rayovac suffered an erosion of market share to its two primary competitors, Duracell and Energizer, becoming a distant third in market share. In 1996, a private-equity company, Thomas H. Lee Partners, purchased Rayovac and instituted a number of restructuring initiatives and organizational changes. David A. Jones was made chairman and CEO in September 1996. In 1997, Thomas H. Lee Partners took the company public with an initial offering of common stock; trading of shares began on the New York Stock Exchange in November 1997. However, Thomas H. Lee Partners retained a sizable ownership share in the company; it was the company’s largest shareholder as of early 2007, controlling about 23 percent of the company’s outstanding shares. Rayovac had sales of $427 million and profits of $6 million in 1997, the year it went public.

Shortly after Rayovac became a public company, CEO David Jones put it on a long-term course to rejuvenate its battery business and spur sales growth. The strategy to reshape Rayovac and grow market share was comprehensive, involving efforts to (1) build the Rayovac brand via increased advertising and promotion, (2) broaden the battery lineup via technological innovation, (3) improve merchandising and attractiveness of packaging, (4) expand distribution to include more retailers of Rayovac in more countries, (5) revamp battery manufacturing operations to slash production costs and increase plant capacity, (6) refine the supply chain and consolidate purchasing, (7) offer very attentive customer service, and (8) create a results-oriented, entrepreneurial culture.

Starting in 1999, Jones embarked on a strategy to globalize Rayovac’s battery and flashlight business via a series of acquisitions in key foreign markets:

1999: Acquired ROV Limited for $155 million; ROV had been spun off from Rayovac as an independent company in 1982 and was Rayovac’s largest distributor of batteries in Latin America. ROV had sales of approximately $100 million compared to Rayovac’s sales in Latin America of about $20 million.

2002: Acquired the consumer battery business of Germany-based Varta AG for $258 million. Varta was the leading European maker of general batteries, with 2001 revenues of $390 million. About 86 percent of Varta’s sales came from Europe, but both Rayovac and Varta had operations in Latin America. Following the acquisition, redundant manufacturing plants were closed and the Latin American production and distribution operations of the two companies were combined to generate expected cost savings of $30–$40 million. The acquisition solidified Rayovac’s market lead in Latin America (with the exception of Brazil), made Rayovac the second leading battery producer in Europe, and the market leader in consumer batteries in Austria and Germany.

2004 Acquired 85 percent of Ningbo Baowang Battery Company in Ninghai, China, for a cash price of $17 million plus $14 million in assumed debt. Ningbo Baowang was a producer of high-performance alkaline and heavy-duty batteries and had a modern manufacturing facility that Rayovac believed was among the lowest cost battery manufacturing operations in the world; the plant had manufacturing capacity of up to one billion batteries per year and gave Rayovac strong access to export markets around the globe. Baowang was also a leading battery brand in China with 2004 sales approaching $35 million, and the acquired company had an established sales and marketing organization that would help Rayovac penetrate the rapidly growing battery market in China.

2004 Acquired Microlite, a low-cost battery manufacturer headquartered in São Paulo, Brazil, for a price of $21 million plus $8 million in assumed debt and contingent cash payments of up to $7 million depending on Microlite’s performance through June 30, 2005. Microlite was Brazil’s leading battery company with $53 million in net sales in 2003 and a 49 percent market share. Microlite manufactured and sold both alkaline and zinc carbon batteries as well as battery-operated lighting products; it operated two battery manufacturing facilities in Recife, Brazil and had several sales and distribution centers throughout Brazil. The Microlite acquisition gave Rayovac an even stronger number-one market position in Latin America (Brazil was the largest market for batteries in Latin America). Moreover, since Microlite owned the Rayovac brand name in Brazil, the acquisition secured rights to the Rayovac name worldwide.
Following these moves, Rayovac established itself as the leading value brand of alkaline batteries in North America and Latin America, the top supplier of rechargeable batteries in the United States and Europe, and the world’s largest manufacturer and marketer of hearing aid batteries (with a market share approximating 60 percent). Since 1997, the company’s sales of battery and lighting products sales had grown from $427 million to just over $1 billion at the end of fiscal 2004. Going into fiscal 2005, Rayovac’s battery and lighting products were sold by 19 of the world’s 20 largest retailers and were available in 1 million store locations in 120 countries. It had a full lineup of battery products and was continuing to introduce new products. Rayovac had more hearing aid battery patents than all of its competitors combined.

SPECTRUM BRANDS’ DIVERSIFICATION STRATEGY

Starting in 2003, David Jones and other top executives at Rayovac determined that the company needed to expand beyond its battery and lighting products business, partly due to stiff competition in batteries and partly due to a maturing global market demand for batteries that diminished the company’s prospects for achieving 8–10 percent annual growth in revenues and profits. Just as the strategy for becoming a global battery company had been predicated largely on acquisition, so also was the strategy to diversify into new businesses and product categories. During the 2003–2005 period, the company made four important diversification-related acquisitions:

### 2003:
- **Acquired Remington Products Company**, a leading designer and distributor of battery-powered electric shavers, beard and mustache trimmers, grooming products, and personal care appliances. The purchase price was $222 million, including the assumption of Remington’s debt; in the 12 months prior to the acquisition, Remington had sales of $360 million and net income of $20 million.
  - Headquartered in Bridgeport, Connecticut, Remington was the number one selling brand in the United States in the combined dry shaving and personal grooming products categories based on units sold.
  - Remington had acquired Clairol’s worldwide personal care appliance business (consisting of hair dryers, stylers, hot rollers, and lighted mirrors) in 1993.
  - Remington products were sold in more than 20,000 retail outlets in the United States; more than 70 percent of Remington’s sales were in North America. Remington’s core North American shaving and grooming products business had grown an average of 18 percent per year from 1998 through 2002. Internationally, Remington products were sold through a network of subsidiaries and distributors in more than 85 countries.
  - Following the acquisition, Rayovac closed Remington’s headquarters, transferred all of Remington’s headquarters operations to Rayovac’s headquarters, moved all of Remington’s manufacturing operations to a Rayovac plant in Wisconsin, merged Remington and Rayovac R&D functions into a single department, and closed Remington’s distribution operations and 65 U.S. service centers and relocated their functions to Rayovac’s North American and European facilities. In North America, Rayovac and Remington sales management, field sales operations, and marketing were merged into a single North American sales and marketing organization.

### 2005:
- **Acquired privately owned United Industries Corporation**, for a total value of approximately $1.2 billion including the assumption of approximately $880 million of United Industries debt and a cash tax benefit of $140 million. United Industries, based in St. Louis, was a leading manufacturer and marketer of consumer products for lawn and garden care and household insect control; United also manufactured and marketed premium-branded specialty pet supplies. In lawn and garden products and household insect control, United operated as Spectrum Brands in the United States and NuGro in Canada. In pet supplies, it operated as United Pet Group. United’s brands included Spectracide, Vigoro, Sta-Green, Schultz, and C.I.L in the lawn and garden market; Hot Shot, Cutter and Repel in the household insect control market; and Marineland, Perfecto, and Eight in One in pet supply products. United had sales of approximately $950 million in 2004; major customers included Home Depot, Lowe’s, Wal-Mart, PETCO, and PETsMART.
These acquisitions drove Rayovac’s decision to change its name to Spectrum Brands and prompted management to begin touting Spectrum Brands as “a brand new 100-year-old company.” Exhibit 3 shows the performance of Spectrum Brands’ stock price as it became a more broadly diversified company.

AN OVERVIEW OF SPECTRUM BRANDS’ BUSINESSES AND PRODUCT CATEGORIES

Beginning with fiscal year 2006, Spectrum Brands began managing its business in four reportable segments:

1. North America, which consisted of the sales and operations of its consumer battery, shaving and grooming, personal care, lawn and garden, household insect control, and portable lighting product categories in the United States and Canada.
2. Latin America, which consisted of the sales and operations of its consumer battery, shaving and grooming, personal care, lawn and garden, household insect control, and portable lighting product categories in Mexico, Central America, South America, and the Caribbean (“Latin America”).
3. Europe/Rest of the World, which consisted of the sales and operations of its consumer battery, shaving and grooming, personal care, lawn and garden, household insect control, and portable lighting product categories in the United Kingdom, continental Europe, China, Australia, and all other countries not included in the first two segments.
4. Global Pet, which consists of the acquired operations of United Pet Group, Tetra Holdings, and Jungle Labs.

Exhibit 4 shows the company’s operating performance and selected financial data for these four segments for the period 2003–2006.

The Global Battery Business

Going into 2007, most consumer batteries around the world were manufactured and marketed by one of four companies: Procter & Gamble (manufacturer/distributor of the Duracell brand), Energizer...
Holdings (the maker/distributor of the Energizer brand of batteries), Spectrum Brands (the maker/distributor of VARTA batteries in Europe and Rayovac batteries in the rest of the world), and Matsushita (manufacturer/distributor of the Panasonic brand). Some major retailers, especially in Europe, marketed private-label brands of batteries. Duracell was the market leader worldwide, followed in order by Energizer, Rayovac/VARTA, and Panasonic.

Batteries were used chiefly to power toys and games; remote-control devices for a variety of electronics products (TVs, DVD players); handheld video game players; MP3 players like the Apple iPod; digital cameras; clocks and watches; hearing aids;
and flashlights. Growth in consumer battery sales was in the low single digits in the United States and much of Europe, owing to already widespread battery use and a mature marketplace. In Latin America and Southeast Asia (particularly China), consumer use of batteries was much lower and there was good long-term potential for sales growth in the high single digits as consumers purchased more devices powered by batteries. In North America and Europe, most consumers purchased alkaline batteries; less expensive zinc carbon batteries were most popular in Latin America, but the Latin American market was slowly converting to alkaline batteries as disposable incomes increased.

In 2001, the global market for batteries was about a $21 billion industry and had grown at a historical rate of about 6–7 percent. About one-third of total sales occurred in the United States. Since 2001, global growth had slowed to an average of 4–5 percent, resulting in global sales close to $25 billion in 2006. However, battery sales were affected by ups and downs in the economy and by the strength of sales of battery-using products.

Spectrum Brands manufactured and distributed alkaline and zinc carbon batteries, hearing aid batteries, rechargeable batteries and battery chargers, photo batteries, lithium batteries, silver oxide batteries, keyless entry batteries, and coin cells for use in watches, cameras, calculators, communications equipment, and medical instrumentation. A full line of alkaline batteries (AA, AAA, C, D, and nine-volt sizes) was sold to both retail and industrial customers, primarily under the VARTA brand in Europe and under the Rayovac brand in the rest of the world. Alkaline batteries were also manufactured for sellers of private-label batteries. Zinc carbon batteries (used primarily for low- and medium-drain battery-powered devices), Nickel Metal Hydride (NiMH) rechargeable batteries, and a variety of battery chargers were marketed primarily under the Rayovac and VARTA brands.

In the U.S. alkaline battery marketplace, the Rayovac brand was positioned as a value brand offering comparable performance to the Duracell and Energizer brands at a lower price. In Europe, the VARTA brand was competitively priced with other premium brands. In Latin America, where zinc carbon batteries outsold alkaline batteries, the Rayovac brand was also competitively priced against other leading brands. In 2005–2006, Rayovac was the third-ranked brand in North America, with an estimated 19 percent market share (based on dollar sales). VARTA was the second-ranked brand in Europe, with an estimated market share of 25 percent; in Latin America, Rayovac was the leading brand.

The retailers of private-label batteries typically sold their batteries at prices below the leading name brands; however, private-label brands were normally not supported by advertising or promotional activities. On the whole, competition in the global battery marketplace was relatively strong, but competitive pressures varied by geographic location. Competitive factors included distribution capability (as measured by the ability to win the battle for limited space on retailer’s shelves), brand-name recognition (affected by advertising and promotion strategies), perceived product quality, price, product performance, and product packaging and design innovation. The main barriers to entry for new competitors were investment in technology research, the cost of building manufacturing capacity, and the expense of building retail distribution channels and brand awareness.

Industry leader Duracell had a 45 percent U.S. market share in 2005 and extended its lead in 2006. Some of Duracell’s growth in the United States came at Rayovac’s expense as Spectrum Brands’ U.S. battery sales declined by $18 million between 2005 and 2006. Spectrum Brands’ battery sales declined by $89 million outside the United States as consumers showed a growing preference for private-label alkaline batteries and since the company had elected not to bid on certain private-label contracts. Declining sales of VARTA batteries in Europe took the company partly by surprise because sales of private-label batteries grew unexpectedly fast in Germany, France, Italy, and several other countries.

Spectrum Brands’ battery business also suffered from declining gross margins in 2006 as increases in raw materials prices reduced gross profit by $18 million. However, market leaders Duracell and Energizer were able to avoid margin declines by increasing prices in the United States. Spectrum Brands management addressed the cost disadvantage in batteries in 2005 and 2006 by relocating production from Europe to its recently acquired manufacturing facilities in China. The company also restructured
operations in its German packaging center to reduce its total workforce in Europe by 350.

Pet Supplies

The United Industries, Tetra, and Jungle Labs acquisitions resulted in a global pet supplies group with broad representation in products for fish, dogs, cats, birds, and other small domestic animals. The aquatics lineup included such consumer and commercial aquatics products as integrated aquarium kits, stand-alone tanks and stands, filtration systems, heaters, pumps, sea salt, aquarium hoods and lights, and other aquarium supplies and accessories. The largest aquatics brands were Tetra (aquarium and pond supplies, world’s leading brand of fish flakes); Marineland (aquarium heaters, filters, and décor); Perfecto (aquariums and fish tanks; aquarium stands, hoods, lights, and filters); Jungle (aquariums, pond kits, fountain maintenance, fizz and water conditioner products for ponds); and Instant Ocean (aquarium salt). The lineup of products for birds and animals include animal treats, stain and odor removal products, grooming aids, bedding products, premium food, medications; and vitamin supplements. The largest specialty pet brands were 8in1 (dog shampoos and conditioners, bird food and health care products, cat litter and health care products, stain and odor products); Nature’s Miracle (stain and odor products); Dingo (dog chews and bones); Wild Harvest (bird food); and Firstrax (pet bedding, crates, and toys).

John Heil, the president of the United Pet Group at Spectrum Brands, was bullish on the group’s growth prospects in 2007 and beyond due to several key trends:

- Projected continued growth in the number of households owning pets (pet ownership was growing fastest in the 55–64 age group).
- Increases in the number of pets per household (47 percent of households had more than one pet).
- Pets were increasingly viewed as family members.
- Spending by pet owners on pet supplies was relatively insensitive to ups and downs in the economy.
- The number of major retailers of pet supplies was consolidating—in the United States, for example, Wal-Mart, Target, PETsMart, PETCO, and large supermarket chains were accounting for a bigger percent of total pet supply sales.

Spectrum Brands had also begun accelerating plans to source its pet supply production from Chinese contract manufacturers.

The global pet supply industry was highly fragmented, consisting primarily of small companies with limited product lines; in the United States alone, there were over 500 manufacturers. Global sales of pet supplies of all types were an estimated $60 billion in 2006. Global growth in specialty pet supplies was in the 4–6 percent range. Spectrum Brands’ management estimated that the retail value of the U.S. pet supplies industry in just those product categories where it competed was about $8 billion in 2004, with another $4 billion in Europe. The industry had grown at a 6–8 percent rate annually in the United States since the mid-1990s and was expected to grow in the 4–7 percent range in the near future.

Spectrum Brands’ global pet supplies group had an estimated 8 percent market share worldwide in the product categories where it competed, with broad distribution in North America, Europe, and Japan. Its largest competitors in North America were Hartz Mountain and Central Garden & Pet Company. Hartz Mountain, acquired by Sumitomo Corporation in 2004, marketed over 1,500 products for dogs, cats, birds, hamsters, reptiles, and other animals; Hartz’s acquisition by Sumitomo had provided the resources to pursue the development of new markets and distribution channels in Asia and Europe. Central Garden and Pet’s product line consisted of six brands of aquatics products, seven brands of dog and cat products, three brands of bird and small animal products, and five brands of animal health and insect control products. Sales of pet products at Central Garden and Supply were $569 million in fiscal 2004, $639 million in fiscal 2005, and $819 million in fiscal 2006; operating income from sales of pet products before deduction of corporate-level expenses totaled $61 million in 2004, $84 million in 2005, and $105 million in 2006. Central marketed its pet products only in the United States, where its sales of $819 million in 2006 made it far and away the sales leader—Spectrum Brands and Hartz were tied at second, with U.S. sales of approximately $350 million in 2006. (However, Spectrum’s international
sales were greater than Hartz Mountain’s, making it number two in terms of worldwide sales.) Central management estimated that total U.S. sales of pet products in 2006 amounted to about $39 billion, that the product categories in which it competed had total U.S. sales of $13 billion, and that its brands typically ranked first or second in market share in their respective segments.

Doskocil, the fourth largest seller of pet supplies in the United States, with 2006 sales of $160 million, was the only other U.S. manufacturer of pet supplies that competed in a broad number of product categories. Most other manufacturers had limited product lines that included only such specialized products as sea salt, aquariums, pet treats, or bird seed.

Lawn and Garden

Spectrum Brands’ lawn and garden business consisted of several leading lawn and garden care products, including lawn fertilizers, professional fertilizers, lawn control products, herbicides, garden and indoor plant foods, plant care products, potting soils and other growing-media products and grass seed. During fiscal 2006, three new lawn and garden products were introduced—Mulch with Weed Stop (the first premium landscape mulch with weed preventer), the Smart Seeder (the first ready-to-use combination grass seed container and spreader), and the only termite killing stakes product for the do-it-yourself market. Brands with the largest sales were Spectracide, Schultz, Real-Kill, Garden Safe, and Vigoro. The company distributed its branded products primarily through Wal-Mart, Lowe’s, and Home Depot and also produced private-label fertilizers for all three retailers. Sta-Green fertilizer was produced exclusively for Lowe’s, Vigoro was produced exclusively for Home Depot, and Expert Gardener fertilizers were made exclusively for Wal-Mart. In Canada, lawn and garden products were sold under the Wilson, Nu-Gro, and So-Green brands.

In lawn and garden products, as in batteries, Spectrum Brands targeted value-conscious consumers who preferred products that sold at lower prices than premium-priced brands but that were still very comparable in quality and packaging. Management believed that its lawn and garden business had a strong second-place market share of 23 percent in the North American lawn and garden segments where it had product offerings, with its brands primarily positioned as value-priced alternatives.12

Primary competitors in the lawn and garden market were:13

- The Scotts Miracle-Gro Company, which marketed lawn and garden products under the Scotts, Ortho, Roundup, Osmocote, and Miracle-Gro brand names. Scotts Miracle-Gro products were number one in every major category in which the company competed—management believed the company had an overall market share of 52 percent in the segments where it had product offerings. Scotts also owned Smith & Hawken, a leading retailer of garden-inspired products that included pottery, watering equipment, gardening tools, outdoor furniture, and live plants. Scotts had sales of $2.1 billion in 2004, $2.4 billion in 2005, and $2.7 billion in 2006; over 80 percent of sales were in the United States, with the remainder in Europe. Net income was $101 million in 2004, $101 million in 2005, and $133 million in 2006. Scotts’ recorded market share and revenue gains in all categories during 2006, with sales of Scotts fertilizer increasing by 14 percent, sales of Miracle-Gro garden soils increasing by 17 percent, and sales of Ortho insect control products increasing by 7 percent.

- Central Garden & Pet Company, which had a product line consisting of wild bird feed, grass seed, lawn and garden chemicals and fertilizers, and indoor and outdoor pottery products. Products were marketed under 20 brands, including AMDRO (fire ant bait), Sevin (insecticides), and Pennington (the leader in both grass seed and wild bird feed). Sales of lawn and garden products at Central Garden and Supply were $698 million in fiscal 2004, $741 million in fiscal 2005, and $802 million in fiscal 2006; operating income from sales of lawn and garden products before deduction of corporate level expenses totaled $43 million in 2004, $47 million in 2005, and $57 million in 2006. Management estimated that the lawn and garden categories in which it participated had total U.S. sales of approximately $27 billion in 2006.

- Bayer AG, which marketed lawn and garden products under the Bayer Advanced brand name in North America, Europe, and Latin America and was the fourth leading seller behind Scotts,
Central Garden, and Spectrum. Bayer’s product line consisted of weed and insect control products, fire ant killer granules, lawn disease control products, potting mixes, and fertilizers for flowers, shrubs, and trees. Bayer, headquartered in Germany and best known for its aspirin and other health care products, had 2006 sales of about €28 billion worldwide, of which about €6 billion involved crop protection and seed treatment products, fungicides, insecticides, herbicides, fertilizers, and other crop, lawn, and garden products. Bayer’s 2006 sales in the United States were said to be about $125 million.

Favorable demographic trends were expected to continue to spur sales of lawn and garden products, leading to mid-single-digit growth. Gardening was the number one leisure activity in the United States, with approximately 80 percent of homeowners working in their lawns on a regular basis. The industry, with $5 billion in 2006 retail sales, was expected to grow at 3–5 percent as the number of retirees grew and spent more time at home. Due to the rapid expansion of mass merchants with lawn and garden departments (Home Depot, Lowe’s, and others) and full-line lawn and garden centers in the past 15 years, the buying power of retailers selling lawn and garden supplies had increased considerably.

Electric Shaving and Grooming

This product/business group consisted of Remington-branded men’s rotary and foil shavers, women’s shavers, beard and mustache trimmers, nose and ear trimmers, haircut kits, and related accessories. During fiscal 2006, several new products designed to improve the comfort and closeness of the shaving experience were introduced. These products were distributed broadly in North America and the United Kingdom and had been recently introduced in continental Europe and Latin America.

The worldwide retail sales of men’s and women’s electric shavers totaled $3.3 billion in 2006. The industry grew by 3 percent in 2006 and was expected to grow at a comparable rate during the next few years. Remington’s two primary competitors in the electric shaving and grooming market were Norelco, a division of Koninklijke Philips Electronics NV (Philips), which sold and marketed foil shavers, and Braun, a division of the Procter & Gamble Company, which sold and marketed foil shavers (Remington sold both foil and rotary shavers). Philips Norelco had long held the number one position in every geographic region of the world and increased its market share in North America from 46 percent in 2005 to 53 percent in 2006. Similarly, Norelco’s share of the Western European market for men’s and women’s electric shavers increased from 56 percent in 2005 to 59 percent in 2006. The keys to Philips Norelco’s growth were design and performance innovations. Test-marketing results indicated that the company’s new Williams F1 electric shaver, which resembled a handheld industrial power tool and could be washed and cleaned in seconds, would prove to be very popular in 2007. Procter & Gamble’s Braun was the world’s best-selling brand of foil shavers and the second largest seller of men’s and women’s electric shavers overall, with 28 percent of the worldwide market in 2006.

Remington-branded shaving products had an overall market share of approximately 30 percent in North America. In North America, Spectrum management estimated that the Remington brand was number two in men’s rotary shavers; number one in men’s foil shavers; number one in women’s shavers; and number one in men’s beard and mustache trimmers, nose and ear trimmers, haircut kits, and related accessories. Worldwide, Remington shavers were estimated to be the third best-selling brand. Both Braun and Remington experienced sales declines in North America and Europe due to Norelco’s gains in market share in 2006. Braun’s sales in other parts of the world increased during 2006.

Household Insect Control

The company’s household insect control business was comprised of several leading products that enabled consumers to maintain a pest-free household and repel insects. These included spider, roach, and ant killer; flying insect killer; insect foggers; wasp and hornet killer; flea and tick control products; and roach and ant baits. It also manufactured and marketed a line of insect repellents. The largest brands were Hot Shot, Cutter, and Repel. The company enjoyed broad distribution of its insect control products across North America and a second-ranking market share of about 23 percent. The North American market for insect control products was growing at around 4–6 percent.
Chief competitors in the household insect control market were (1) S. C. Johnson & Son, Inc., which marketed the Raid and OFF! brands of insecticide and repellent products; (2) the Scotts Miracle-Gro Company, the marketer of Ortho household insect control products; and (3) Henkel KGaA, which marketed Combat brand products.

Spectrum Brands estimated the size of the U.S. household insect control industry at approximately $1 billion in 2003. The company’s management expected the industry to slightly exceed its historical 4 percent annual growth rate over the next several years because of an increasing awareness of the West Nile virus and eastern equine encephalitis. Spectrum Brands’ Hot Shot, Cutter, and Repel were distant seconds to the Raid and OFF! brands marketed by S. C. Johnson. S. C. Johnson was a privately held business that also produced such well-known household products as Windex glass cleaner, Ziploc bags, Glade air freshener, and Pledge furniture polish.

Electric Personal Care Products

Electric personal care products were marketed under the Remington brand name and included hair dryers, straightening irons, and hair setters. Remington personal care products had an estimated 21 percent share in the United Kingdom, and Remington was the number two brand in Western Europe.16

The global market for such electric personal care products as hair dryers, curling irons, hair straighteners, and lighted mirrors grew by 1.2 percent in 2006, to approximately $2.6 billion. Conair had been the worldwide best-selling brand of such products for decades. In addition to electrical hair care products, Conair also manufactured and marketed Cuisinart and Waring kitchen appliances, Weight Watchers bathroom scales, and Pollenex shower heads. Conair management believed that its success in the industry was related to its low-cost production capabilities and its ability to quickly bring products popularized in salons to consumers.

Vidal Sassoon, Remington, and Revlon were other brands of personal care products frequently carried by U.S. retailers. In 2005, about 59 percent of electric personal care products were sold by discounters like Wal-Mart or Target, 7 percent were sold by department stores, 23 percent were sold by drugstores and supermarkets, 7 percent were sold by specialty stores, and 4 percent were sold by other types of retailers.

Portable Lighting

Spectrum Brands sold a broad line of flashlights, lanterns, and other portable battery-powered devices for both retail and industrial markets. These were marketed under both the Rayovac and VARTA brand names, under several other brand names, and under licensing arrangements with third parties. The three major competitors were Energizer Holdings, Mag Instrument, and Eveready. Sales of Rayovac and VARTA lighting products had been flat for the past four years (see Exhibit 3).

Global retail sales of flashlights and lanterns had remained flat at about $1.5 billion during 2003–2006; no significant market growth was expected in the future. However, flashlights equipped with light emitting diodes (LEDs) were growing in popularity because of their small size, bright light, and low power usage. The industry was fragmented geographically and included few global brands. Maglite, Rayovac, and Eveready were the best-selling brands of portable lights in the United States. Mag Instruments’ flashlights were considered the highest quality in the industry since the 1979 introduction of the Maglite. The all-aluminum flashlights were first marketed to police departments because of their exceptionally bright light, durability, and reliability, but consumers quickly became the biggest purchasers of the superior Mag flashlights. Maglite flashlights had been recognized for design excellence by the Japan Institute of Design and by the Museum for Applied Art in Cologne, Germany, and were named by Fortune as one of the 100 products “America makes best.”17 Eveready and Rayovac produced much less expensive plastic flashlights and lanterns.

SPECTRUM BRANDS’ ORGANIZATION AND OPERATING PRACTICES

Sales and Distribution

Spectrum Brands used a variety of distribution channels, including retailers, wholesalers and distributors, hearing aid professionals, industrial products...
distributors, and original equipment manufacturers (OEMs). Sales to Wal-Mart stores accounted for about 18 percent of consolidated net sales in fiscal 2005 and for about 19 percent in fiscal 2006; no other customer accounted for more than 10 percent of total sales in fiscal 2005 or 2006. Sales and distribution practices in each of the four reporting segments were as follows:18

- **North America:** Spectrum Brands’ sales force in North America was organized by distribution channel, with separate sales groups for (1) retail sales and distribution channels, (2) hearing aid professionals, and (3) industrial distributors and original equipment manufacturers (OEMs). In some cases, independent brokers were used to service customers in selected North American distribution channels.

- **Latin America:** The sales force in Latin America was organized both by distribution channel and geographic territory. The Latin American sales force sold directly to large retailers, wholesalers, distributors, food and drug chains and retail outlets in both urban and rural areas. In Latin American countries having no company sales representatives, the company used independent distributors who marketed Spectrum products through all channels in that country.

- **Europe/ROW:** A sales force group, supplemented by an international network of distributors, promoted the sale of Spectrum products in Europe and the rest of the world (ROW). Sales operations throughout Europe/ROW were organized by geographic territory and three different sales channels: (1) food/retail, which includes mass merchandisers, discounters, drugstores, and food stores; (2) specialty trade, which includes wholesale clubs, consumer electronics stores, department stores, photography stores, and wholesalers/distributors; and (3) industrial, government, hearing aid professionals, and OEMs.

- **Global Pet:** The sales force for pet supplies was aligned by type of customer—mass merchandisers, grocery and drug chains, pet superstores, independent pet stores, and other retailers.

### Manufacturing, Raw Materials, and Suppliers

Spectrum operated two major alkaline battery plants (one in Wisconsin and one in Germany), a combination zinc carbon/alkaline battery plant in China, three zinc carbon manufacturing plants and a zinc carbon battery component plant in Latin America, and two plants that made zinc air button cell plants, one of which also produced lithium cell batteries and foil shaver components for its Remington shavers.19 Substantially all of the company’s rechargeable batteries and chargers, portable lighting products, hair care and other personal care products and electric shaving and grooming products were manufactured by third-party suppliers primarily located in the Asia/Pacific region. The lawn and garden group had four combination production-distribution facilities; eight blend, pack, and warehouse facilities, and three distribution facilities that with shared with other Spectrum product groups. The pet supplies group had five production facilities (four in the United States and one in Germany), a specialty pet facility, and three distribution centers, one of which was shared with lawn and garden products. A number of manufacturing facilities had been closed during the past five years. Management believed that existing facilities were adequate for the company’s present and foreseeable needs.

The principal raw materials used in manufacturing battery products—zinc powder, granular urea, electrolytic manganese dioxide powder, and steel—were sourced on either a global or a regional basis. The prices of these raw materials were susceptible to price fluctuations due to supply/demand trends, energy costs, transportation costs, government regulations and tariffs, changes in currency exchange rates, price controls, economic conditions, and other unforeseen circumstances. As a consequence, Spectrum regularly engaged in forward purchase and hedging derivative transactions to manage raw material costs in the upcoming 12 to 24 months.

Research and development activities were centralized at a single facility in Madison, Wisconsin. The company’s R&D strategy was focused on new product development and performance enhancements of existing products.20 Management saw efforts to introduce innovative products and improve the designs and functionality existing products as keys to organic sales growth and enhanced value to consumers. However, while R&D expenditures had increased from $13.1 million in fiscal 2002 to $30.6 million in fiscal 2006, R&D expenditures as a percentage of net sales had declined from 2.3 percent in fiscal 2002 to 1.2 percent in fiscal 2006 (see Exhibit 1).
### Exhibit 4  
Selected Data for Spectrum Brands, by Business Segment and/or Geographic Area, Fiscal Years 2002–2006 ($ in millions)

<table>
<thead>
<tr>
<th></th>
<th>Fiscal Years Ending September 30</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net sales to external customers</strong></td>
<td></td>
</tr>
<tr>
<td>North America</td>
<td>$1,212.4</td>
</tr>
<tr>
<td>Europe/ROW</td>
<td>559.9</td>
</tr>
<tr>
<td>Latin America</td>
<td>236.2</td>
</tr>
<tr>
<td>Global Pet</td>
<td>543.2</td>
</tr>
<tr>
<td><strong>Segment total</strong></td>
<td>$2,551.7</td>
</tr>
<tr>
<td><strong>Segment profit</strong></td>
<td></td>
</tr>
<tr>
<td>North America</td>
<td>$ 146.4</td>
</tr>
<tr>
<td>Europe/ROW</td>
<td>55.2</td>
</tr>
<tr>
<td>Latin America</td>
<td>23.4</td>
</tr>
<tr>
<td>Global Pet</td>
<td>83.6</td>
</tr>
<tr>
<td><strong>Segment total</strong></td>
<td>$308.6</td>
</tr>
<tr>
<td><strong>Product line net sales</strong></td>
<td></td>
</tr>
<tr>
<td>Batteries</td>
<td>$ 861.0</td>
</tr>
<tr>
<td>Lighting products</td>
<td>88.0</td>
</tr>
<tr>
<td>Electric shaving and grooming</td>
<td>252.0</td>
</tr>
<tr>
<td>Personal care</td>
<td>150.0</td>
</tr>
<tr>
<td>Lawn and garden</td>
<td>507.0</td>
</tr>
<tr>
<td>Household insect control</td>
<td>151.0</td>
</tr>
<tr>
<td>Pet products</td>
<td>543.0</td>
</tr>
<tr>
<td><strong>Segment total</strong></td>
<td>$2,552.0</td>
</tr>
<tr>
<td><strong>Segment total assets</strong></td>
<td></td>
</tr>
<tr>
<td>North America</td>
<td>$1,503.6</td>
</tr>
<tr>
<td>Europe/ROW</td>
<td>551.3</td>
</tr>
<tr>
<td>Latin America</td>
<td>239.6</td>
</tr>
<tr>
<td>Global Pet</td>
<td>1,170.8</td>
</tr>
<tr>
<td><strong>Segment total</strong></td>
<td>3,465.4</td>
</tr>
<tr>
<td>Corporate</td>
<td>83.9</td>
</tr>
<tr>
<td><strong>Company total</strong></td>
<td>$3,549.3</td>
</tr>
<tr>
<td><strong>Depreciation and amortization</strong></td>
<td></td>
</tr>
<tr>
<td>North America</td>
<td>$ 50.8</td>
</tr>
<tr>
<td>Europe/ROW</td>
<td>10.6</td>
</tr>
<tr>
<td>Latin America</td>
<td>4.5</td>
</tr>
<tr>
<td>Global Pet</td>
<td>21.7</td>
</tr>
<tr>
<td><strong>Segment total</strong></td>
<td>$ 87.5</td>
</tr>
<tr>
<td><strong>Capital expenditures</strong></td>
<td></td>
</tr>
<tr>
<td>North America</td>
<td>$ 23.5</td>
</tr>
<tr>
<td>Europe/ROW</td>
<td>18.6</td>
</tr>
<tr>
<td>Latin America</td>
<td>5.1</td>
</tr>
<tr>
<td>Global Pet</td>
<td>13.2</td>
</tr>
<tr>
<td><strong>Segment total</strong></td>
<td>$ 60.4</td>
</tr>
</tbody>
</table>

Note: Totals may not add due to rounding; segment accounting treatments and allocation methodology may not be entirely consistent for 2002 and 2003 data versus 2004–2006 data.

RECENT EVENTS AT SPECTRUM BRANDS

In January 2006, Spectrum Brands sold its fertilizer technology and Canadian professional fertilizer products businesses of Nu-Gro (Nu-Gro Pro and Tech) to Agrium Inc. for net proceeds of approximately $83 million. Monies from the sale were used to reduce outstanding debt. Spectrum management was using earnings and cash flows from operations to reinvest in its businesses and to pay down debt—since going public in 1997, the company had never paid a dividend to shareholders and did not expect to pay a dividend in the near future.

Exhibit 5 shows the composition of the company’s long-term debt and the repayment schedule as of year-end fiscal 2006.

Late in fiscal 2006, Spectrum management began to contemplate the divestiture of portions of its business portfolio in order to better sharpen the company’s focus on strategic growth businesses, reduce outstanding indebtedness, and increase the company’s lackluster stock price. Wall Street advisers were engaged to assist with any divestitures; the plan was to complete any asset sales by mid-2007. Proceeds from any asset sales were expected to be used for debt repayment.

Spectrum Brands failed to capture all of the expected $100 million in cross-business strategic fits

### Exhibit 5  Spectrum Brands’ Debt Obligations, Fiscal Years 2005 and 2006

<table>
<thead>
<tr>
<th></th>
<th>September 30, 2006</th>
<th></th>
<th>September 30, 2005</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Amount (in $000s)</td>
<td>Rate(A)</td>
<td>Amount (in $000s)</td>
<td>Rate(A)</td>
</tr>
<tr>
<td>Senior Subordinated Notes, due February 1, 2015</td>
<td>700,000</td>
<td>7.4%</td>
<td>700,000</td>
<td>7.4%</td>
</tr>
<tr>
<td>Senior Subordinated Notes, due October 1, 2013</td>
<td>350,000</td>
<td>8.5%</td>
<td>350,000</td>
<td>8.5%</td>
</tr>
<tr>
<td>Term Loan, US Dollar, expiring February 6, 2012</td>
<td>604,827</td>
<td>8.6%</td>
<td>661,725</td>
<td>5.8%</td>
</tr>
<tr>
<td>Term Loan, Canadian Dollar, expiring February 6, 2012</td>
<td>72,488</td>
<td>7.4%</td>
<td>74,081</td>
<td>4.9%</td>
</tr>
<tr>
<td>Term Loan, Euro, expiring February 6, 2012</td>
<td>134,721</td>
<td>6.3%</td>
<td>137,142</td>
<td>4.7%</td>
</tr>
<tr>
<td>Term Loan, Euro Tranche B, expiring February 6, 2012</td>
<td>332,315</td>
<td>6.2%</td>
<td>338,288</td>
<td>4.4%</td>
</tr>
<tr>
<td>Term C Loan, expiring September 30, 2009</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Euro Term C Loan, expiring September 30, 2009</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Revolving Credit Facility, expiring February 6, 2011</td>
<td>26,200</td>
<td>10.3%</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Revolving Credit Facility, expiring September 30, 2008</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Euro Revolving Credit Facility, expiring February 6, 2011</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Other notes and obligations</td>
<td>42,698</td>
<td>5.7%</td>
<td>38,701</td>
<td>—</td>
</tr>
<tr>
<td>Capitalized lease obligations</td>
<td>13,922</td>
<td>5.0%</td>
<td>17,396</td>
<td>—</td>
</tr>
<tr>
<td><strong>Total long-term debt</strong></td>
<td><strong>2,277,171</strong></td>
<td><strong>$2,307,333</strong></td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td><strong>Less current maturities payable in upcoming fiscal year</strong></td>
<td>42,713</td>
<td>9,575</td>
<td>39,308</td>
<td>8,939</td>
</tr>
<tr>
<td><strong>Long-term debt outstanding</strong></td>
<td><strong>$2,234,458</strong></td>
<td><strong>$2,268,025</strong></td>
<td>—</td>
<td>—</td>
</tr>
</tbody>
</table>

Aggregate scheduled maturities of debt as of September 30, 2006:

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount (in $000s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>42,713</td>
</tr>
<tr>
<td>2008</td>
<td>9,575</td>
</tr>
<tr>
<td>2009</td>
<td>8,939</td>
</tr>
<tr>
<td>2010</td>
<td>8,711</td>
</tr>
<tr>
<td>2011</td>
<td>242,172</td>
</tr>
<tr>
<td>Thereafter</td>
<td>$1,965,061</td>
</tr>
<tr>
<td>Thereafter</td>
<td>$2,277,171</td>
</tr>
</tbody>
</table>

by year-end 2006, but management believed the company would be more successful in 2007. Kent Hussey pinpointed the difficulties in April 2006:

When you make acquisitions in categories that are outside your core competency, there’s a certain amount of learning that takes place, developing your own business model and dealing with new competitors in new marketplaces. So far, we think we’ve been very successful, but we’re still in the early stages of the acquisitions in lawn and garden and pet supplies.21

Top executives at Spectrum Brands announced a new organizational structure in January 2007 that was expected to aid efforts to capture the expected cost-savings from cross-business strategic fits. Starting in 2007, management decided to abandon the four operating segment structure in favor of a three-business-segment structure—Global Batteries & Personal Care, Home & Garden, and Global Pet Supplies. According to CEO David Jones, the new structure would enable “Spectrum to operate more efficiently and profitably by eliminating duplicative staff functions and overhead in each of our business units, and downsizing our corporate infrastructure.”22

In addition, Jones said:

By streamlining the business into three product-oriented operating units, we will significantly enhance our competitive focus and improve our cost structure. These changes will allow us to go to market faster with new, innovative products, as well as improve our ability to efficiently allocate resources on a worldwide basis. This business unit realignment will also facilitate the orderly execution of the asset sale process we announced in July.23

In February 2007, Spectrum announced net sales of $564.6 million and a net loss of $0.38 per share for the first quarter of fiscal 2007 that ended December 31, 2006. Global battery sales declined 6 percent as compared to the first quarter of fiscal 2006, as strong results from Latin America were offset by sales declines in North America and Europe/ROW. Sales of Remington branded products increased by 7 percent on a worldwide basis. Global Pet reported sales growth of 4 percent. Favorable foreign exchange rates had a $16.2 million positive impact on net sales during the quarter, mostly driven by the strong euro. The company generated operating income of $37.5 million versus $67.6 million in fiscal 2006’s first quarter. The primary reasons for the decline in operating income were increased advertising and marketing expense of approximately $14 million and higher commodity costs, including an increase of $7 million in zinc costs.

Endnotes

3 2004 annual report, p. 2.
5 2005 annual report.
8 2006 10-K report.
13 Company Web sites, SEC filings, and annual reports.
15 Ibid., p. 9.
16 Ibid., p. 8.
17 Mag Instruments Company History (www.maglite.com/history.asp).
20 Ibid.
21 As quoted in an interview with The Wall Street Transcript, April 2006.
23 Ibid.
The 2004 financial performance was very encouraging for Varina Nissen, who was then in the second year of her role as managing director for Manpower Australia. Revenue had increased by 10 percent, while costs were well below target. The overall measure of performance, return on sales, had been improved. Scott McLachlan, the CFO and director of corporate services, announced confidently, “We have achieved the budget targets. It’s never happened before in the history of Manpower Australia.” The corporate strategy developed by Nissen and her team, and executed through the balanced scorecard (BSC), had achieved the short-term financial objectives for the company and a turnaround in a relative short time. However, future challenges awaited Nissen and McLachlan, not least of which was how to use the BSC to secure further performance improvements.

The recruitment industry in Australia heading into 2005 continued to become more challenging. Since the industry had reached relative maturity, profit margins were being eroded. Manpower’s major competitors had also focused on improving productivity and were often able to offer clients better prices. This had affected the company’s core business of temporary placements, which had been flat for the last couple of years. There were also candidate shortages in certain segments of the market, while customers were demanding total solutions for their human resource management needs, ranging from the existing recruiting services to learning/development and performance management/succession planning activities. An opportunity existed for growth through innovation—developing and marketing new products and services to target customers.

Under Nissen’s leadership, a new strategic vision had been developed and communicated: Manpower was to become a “leader in innovative people solutions.” The emphasis was on innovation and growth of higher-margin business, such as human resource services, while maintaining high service-delivery speed at lower costs in Manpower’s core business of recruitment. To help communicate and implement her strategy, Nissen had developed and implemented a Strategy Map and BSC for the organization in 2004. According to Manpower’s senior management, the BSC at Manpower had been important in communicating the key behaviors required for improved productivity and demonstrating the financial impacts of doing so, with the improved financial performance in 2004 being seen as proof that it worked.

However, given the changing business environment, Nissen wanted to know whether the value...
propositions were being delivered to targeted customers and, if so, whether they were leading to improved customer and financial outcomes. Was the company progressing fast enough in performing activities and services that were valued by targeted customers? In addition, the CFO of Manpower’s global operations was still concerned over the slow pace of productivity gains in Manpower Australia as compared to Manpower’s global standards. Beating the productivity targets agreed on with the parent company represented another challenge for Manpower Australia, where return on revenue had to be increased by 2 percent and the expense to gross profit ratio decreased by 10 percent.

Nissen and McLachlan both felt that the BSC could help the business implement its strategy more effectively and attain a higher level of performance than that already achieved. However, they were also aware that the BSC was not being used as extensively as they had envisaged in some parts of the business and, in some cases, was being totally ignored in managerial decision making. Also, there was a lack of consistent communication to teams on effective progress on performance. Overall, they thought that the BSC needed to be improved if it was to focus the entire organization on the critical leading indicators of success for the business.

THE AUSTRALIAN RECRUITMENT EMPLOYMENT SERVICES INDUSTRY

Market Size

The Australian market for employment services was estimated at A$12.5 billion (US$8.1 billion) in 2003, and had grown by 13.0 percent from 2002. During the last five years, the market had grown by over 60 percent. One of the major drivers for this growth was that companies were focusing more on investing and strengthening their core competencies, and turning to strategic alliances with employment service providers to manage and operate noncore activities such as staff recruitment and related human resource management activities.

General temporary jobs, growing by 107.9 percent during 1999–2003 (see Exhibit 1), constituted the largest sector in employment services industry, with 37.7 percent (A$4.7 billion) of the total revenue mix. Temporary employment provided flexibility for organizations in times of economic uncertainty as well as flexibility on the side of employees. Although executive employment market remained flat during 2003, there was consistent growth in this sector due to increased pressure to improve corporate performance and the growth of global firms. In Australia, the demand for talent and experience had increased at most levels in organizations, particularly in information technology (IT) and financial services–related jobs.

Competitor Dynamics

Industry statistics revealed that there were approximately 2,750 organizations in the employment services (recruiting) industry in 2002/2003. The employment services industry in Australia was highly fragmented, with low barriers to entry and the nondominance of global players. Adecco Group SA had been the market leader for the last six years, with a market share of 11.6 percent. Manpower Services (Australia) Pty. Ltd. had the second largest market share (6.0 percent), while Skilled Engineering, a strong performer in temporary placement, was third with a market share of 5.8 percent (see Exhibit 2). There were also a number of niche service providers

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Exhibit 1 SIZES OF MARKET SECTORS IN EMPLOYMENT SERVICES INDUSTRY IN AUSTRALIA, 1999–2003 (A$ IN MILLIONS)

<table>
<thead>
<tr>
<th>Service Type</th>
<th>1999</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Executive search</td>
<td>A$579.5</td>
<td>A$1,191.2</td>
</tr>
<tr>
<td>General permanent jobs</td>
<td>2,429.1</td>
<td>2,883.9</td>
</tr>
<tr>
<td>General temporary jobs</td>
<td>2,273.2</td>
<td>4,727.1</td>
</tr>
<tr>
<td>Outplacement consultancy</td>
<td>497.5</td>
<td>877.7</td>
</tr>
<tr>
<td>Specialist agencies</td>
<td>2,038.7</td>
<td>2,858.9</td>
</tr>
</tbody>
</table>

Source: Euromonitor International.
Market Growth Forecasts

The recruiting (employment services) market was forecast to grow 61.7 percent from 2003 to 2008, to reach a value of A$20.3 billion (US$13.2 billion). The major drivers for growth were the positive economic outlook, existing low unemployment levels (which, at 5.6 percent, were the lowest in 14 years), and high confidence levels positively affecting investments in human resources. While general temporary jobs were projected to continue to be the largest sector in the Australian employment services market, with a value of A$7.6 billion and 37.5 percent of total industry revenues, the other forecasted growth sector was executive search, with a forecast of 61 percent growth.

In addition, companies were looking to outsource more of the human resource management function. Alongside the provision of core recruiting and staff services, opportunities existed for participants in the employment services industry to provide core human resource management functions such as employee records maintenance, payroll services, and health/wealth benefits services, together with learning/development and performance/succession planning advice. Overall, opportunities existed for recruitment firms to become more proactive in offering solutions to their clients across the entirety of the human resource management spectrum.

Exhibit 2 Market Shares of Leading Employment Services Providers in Australia, 2003

<table>
<thead>
<tr>
<th>Company</th>
<th>Market Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adecco Group SA</td>
<td>11.6%</td>
</tr>
<tr>
<td>Manpower Services (Australia) Pty Ltd.</td>
<td>6.0%</td>
</tr>
<tr>
<td>Skilled Engineering Ltd.</td>
<td>5.8%</td>
</tr>
<tr>
<td>Hudson Global Resources</td>
<td>4.6%</td>
</tr>
<tr>
<td>Chandler Macleod Group Pty Ltd.</td>
<td>3.1%</td>
</tr>
<tr>
<td>Hays Personnel Services (Australia) Pty Ltd.</td>
<td>3.0%</td>
</tr>
<tr>
<td>Kelly Services Australia</td>
<td>2.5%</td>
</tr>
<tr>
<td>Spherion Group</td>
<td>1.7%</td>
</tr>
<tr>
<td>Julia Ross</td>
<td>1.6%</td>
</tr>
<tr>
<td>Candle Australia Ltd.</td>
<td>1.6%</td>
</tr>
<tr>
<td>Drake</td>
<td>1.5%</td>
</tr>
<tr>
<td>Integrated Group</td>
<td>1.5%</td>
</tr>
<tr>
<td>Michael Page</td>
<td>0.7%</td>
</tr>
</tbody>
</table>

Source: Euromonitor International.

MANPOWER GLOBAL

Manpower Inc., established in 1948 in Milwaukee, Wisconsin, was a world leader in the employment services industry, offering customers a continuum of services to meet their needs throughout the employment and business cycle. A Fortune 500 company, it specialized in permanent, temporary, and contract recruitment; employee assessment; training; career transition; and organizational consulting services. Manpower’s global network of 4,300 offices in 74 countries and territories enabled the company to meet the needs of its 440,000 customers per year. These ranged from small and medium-sized enterprises across all industry sectors to some of the world’s largest multinational corporations. During 2003, the company’s 21,400 staff employees and 1.6 million temporary workers worldwide supplied 780 million hours of work. Manpower Inc. claimed to be able to help any company—no matter where it was in its business evolution—to raise productivity through improved strategy, quality, efficiency, and cost reduction, thereby enabling clients to concentrate more on their core business activities.

Manpower had shown impressive financial performance worldwide during financial year 2004. Revenues from services increased by 22.5 percent, to US$14.9 billion; gross profit increased by 30.5 percent, to US$ 2.8 billion; and net earnings per share, diluted, increased by 53.3 percent, to US$ 2.59. The company’s global vision, strategies, and values (see Exhibit 3) represented a framework for direction and
priorities in making decisions, developing opportunities, and building relationships for Manpower’s people and customers around the world.

**MANPOWER AUSTRALIA**

Manpower had been operating in Australia and New Zealand as a human resources solution provider for over three decades. It was first established as a franchised operation in 1965 but was later purchased by Manpower Inc. in 1996. There were 72 offices in Australia/New Zealand, with 34,000 temporary workers. During 2003, over 85,000 permanent and temporary jobs were filled in Australia/New Zealand by Manpower. In Australia, Manpower operated under the brand names of Manpower, Right Management Consultants, Manpower Executive, Elan, and Manpower City. The company’s current organization structure is shown in Exhibit 4.

The company had four divisions: Recruitment & Staffing Solutions (R&SS), Major Client Services (MCS), Corporate Services, and Strategic Services. R&SS, the retail arm of the company, operated

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**Exhibit 3  Manpower Global: Vision, Strategies, and Values**

<table>
<thead>
<tr>
<th>Vision</th>
</tr>
</thead>
<tbody>
<tr>
<td>To be the best worldwide provider of higher-value staffing services and center for quality employment opportunities.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Strategies</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue</strong>—Rigorously focus on industries, geographies and customers that have the strongest long-term growth opportunities for staffing services and solutions.</td>
</tr>
<tr>
<td><strong>Efficiency</strong>—Continuously improve profit margins and returns through disciplined internal processes and increased productivity.</td>
</tr>
<tr>
<td><strong>Acquisitions</strong>—Identify and pursue opportunities for strategic acquisitions that have the best potential to catalyze and enrich the core temporary staffing business.</td>
</tr>
<tr>
<td><strong>Technology</strong>—Aggressively explore and implement the transformational opportunities of information technology and e-commerce to continuously develop defensible competitive advantage in all aspects of the company’s activities.</td>
</tr>
<tr>
<td><strong>Organization and culture</strong>—Capitalize on our entrepreneurial corporate culture to make the most of our internal talent and develop meaningful career paths for employees, striving toward “best practices” in everything we do throughout the global organization.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Values</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manpower global core values are based on three principles pertaining to people, knowledge and innovation.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>People—<strong>We care about people and the role of work in their lives.</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>We respect all our people as individuals, enabling and trusting them to meet the needs of colleagues, customers and the community.</td>
</tr>
<tr>
<td>We are committed to developing professional service according to our high quality and ethical standards.</td>
</tr>
<tr>
<td>We recognize everyone’s contribution to our success.</td>
</tr>
<tr>
<td>We help people develop their careers through planning, work experience, coaching and training.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Knowledge—<strong>We learn and grow by sharing knowledge and resources.</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>We actively listen to our people and customers and act upon this information to improve our relationships and services.</td>
</tr>
<tr>
<td>We pursue the adoption of the best practices worldwide.</td>
</tr>
<tr>
<td>We share one global identity and act as one company while recognizing the diversity of national cultures and working environments.</td>
</tr>
<tr>
<td>We reward team behavior.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Innovation—<strong>We dare to innovate and be pioneers.</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>We thrive on our entrepreneurial spirit and speed of response.</td>
</tr>
<tr>
<td>We take risks, knowing that we will not always succeed.</td>
</tr>
<tr>
<td>We are willing to challenge each other and not accept the status quo.</td>
</tr>
<tr>
<td>We lead by example.</td>
</tr>
</tbody>
</table>
through a network of 58 branches and was generally organized by regions, whereas MCS was generally structured into teams that serviced the needs of high-volume clients such as major information technology companies. The core business of R&SS and MCS was the fulfillment of both temporary jobs (temps) and permanent jobs (perms). Across both business units, the Manpower consultant was responsible for servicing client needs through the sourcing of the right candidate.

In general, the MCS business was considered to be at the lower-margin end of the spectrum of Manpower’s offerings, while executive permanent recruitment and human resources (HR) services tended to be of higher margin. In recognition of this, a significant effort had been made to augment the existing portfolio of clients with volume business with HR services as well as compete in retail and, in particular, expand its executive placement business.

The Strategy

Varina Nissen joined Manpower Australia and New Zealand as managing director in 2003. According to Nissen and McLachlan, when Nissen joined Manpower, the company was facing a number of significant challenges:

- The company was challenged by competitor discounting.
- Culture and processes did not support innovation or have the capability of the company’s rapid commercialization.

All key areas of the business were thus challenged to create value and improve the company’s financial performance; however, there was no explicit strategy in place to give managers direction and focus. In the absence of a specific Australian strategy, the newly appointed managing director decided to develop a corporate strategy based on the corporate vision: “To be recognised as the Australasian Leader in delivering innovative people solutions.” Three strategic themes were identified:

1. A focus on clients and candidates.
2. The expansion of service offerings to provide people solutions throughout the HR value chain.

To make these strategic themes operational, Manpower required significant marketplace repositioning, cultural change, operational redirection, and an overall improvement in all major aspects of the business. Five strategic initiatives were proposed to address these challenges:

- Grow market share in growth industries and sectors.
- Contribute to the employment growth in communities.
- Meet industry benchmarks.
- Reposition the Manpower brand as “the authority on work.”
- Proactively manage risk.
In Australia, the market conditions for the recruiting industry were volatile. According to Scott McLachlan, the CFO of Manpower:

The recruiting industry in Australia is highly competitive and extremely fragmented. The market leader has only 10–11 percent of total market share and there are around 3,000 agencies in the country. There are all types of competitors across the board and also competitors in key categories and niche providers. The market has shifted from being volume and price driven to being profitable growth driven. It is a low return, low cost of entry market and therefore the purchasing power is starting to shift. The successful company is one that is both a low-cost provider and delivers products that are better than the competitors. Also, 70 percent of cost is related to people; therefore, the best gross profit return per consultant is important to achieve.

Initially, the focus was mainly on developing and clarifying Manpower Australia’s vision and strategy. However, Nissen was also concerned about the organization’s agility in aligning itself with the rapidly changing business environment and the strategy that had been developed. She knew that the mind-set and behaviors of the Manpower consultant, being the customer- and candidate-facing resource, were the keys to achieving this agility. In one meeting, she raised her concerns with other members of her team:

Recruiting is a commoditized industry with competitive margins at retail and margin squeeze in volume accounts. Therefore, in order to perform, our frontline staff, whether consultant or support staff must be able to understand and implement the company’s strategy. This could also be where we have our single-most potential point of failure—in the field. Our people need to understand, from the company’s strategy, what they can deliver to our customers and candidates, and how to price it, with effective operations and sales tools.

To help communicate and drive strategic priorities, Nissen developed a strategy map and a balanced scorecard (BSC) at Manpower.

The Strategy Map and Balanced Scorecard

After developing and finalizing strategic initiatives, the next challenge was to implement the strategy and measure the impact on business performance. Nissen and her team chose the BSC as the strategy implementation tool. According to both Nissen and McLachlan, the BSC was selected by Manpower because:

- Manpower’s vision and strategy needed to be translated into actions, with a common language, particularly a common, fact-based approach to measurement.
- Key changes were required in the measurement systems that would impact customer relationships, core competencies, and organizational capabilities.
- There was a need for a measurement and management framework that could link long-term financial success to current customers, internal processes, employees, and systems performance.
- BSC used measurements to inform employees about the drivers of current and future success.
- With BSC it was easier to channel collective energy, enthusiasm, knowledge, and abilities in the pursuit and achievement of long-term common goals.

According to Nissen, “The balanced scorecard is an easy to adopt methodology and is value focused. It clarifies the cause and effect linkages between employee, customers and financials. It’s a modern tool that helps analyse business effectively.” McLachlan was likewise happy with the selection of the BSC as the company’s strategic measurement system; he said, “The scorecard will monitor how we are going in our journey.” The CFO added, “Previously, the management was more focused on short term gains. With balanced scorecard, the management team started looking across at least a year’s horizon and the operational team started focusing on quarterly horizons.”

The management team decided to implement the BSC first in the R&SS division. It was envisaged that once successes were created, the program could then be rolled out efficiently and effectively to the entire organization. R&SS was selected because the company wanted to leverage its branch network to focus on growth sectors and occupations through the implementation of various strategic initiatives, and it was felt that the BSC framework could help this process.

To achieve clarity around Manpower’s strategy, a strategy map (see Exhibit 5) was first developed during various strategy sessions with the executive management. The strategy map was used to describe the corporate strategy and elaborate how the value would be created through the execution of strategy.
Exhibit 5  Manpower Australia’s Strategy Map, 2003–2004

Financial
- Improve Productivity
- Cost Containment
- Increase ROS
- Financial Growth
- Provide Return on Capital
- Improve Profitability

Customer
- Candidate Delivery
  - Speed of Response
  - Provide Reliable Service
- Differentiation
  - Provide the Right Person
  - Add Value to Client’s Business

Internal
- Delight the Candidate
  - Achieve Operational Excellence
  - Safety
  - Lower Cost base
- Develop New Business
  - Increase Customer Value
  - Increase Retail Client Base

Learning & Growth
- Competence
- Develop Strategic Competencies
- Climate for Action
  - Retain Key Staff
  - Enable Talented People to Collaborate and Deliver Results
One of the Manpower’s directors highlighted how Varina Nissen supported the strategy mapping process: “The major reason for adopting the strategy map was its cause and effect linkage and it was Varina who focused the team towards the cause and effect relationship. She repeatedly conveyed during various strategy meetings how the employee engagement and customer measures drove financial results.” The first version of the strategy map was developed by Nissen prior to discussion with senior management, most of whom agreed to its cause-and-effect linkages. A key feature of the strategy map was the integration and alignment of all levels of her management team and the overall organization. Nissen said, “The strategy map was developed to unite the leadership team by linking the divisions and business units through higher corporate goals like ROS, Expenses as a percent of gross profit, etc.”

Having developed the strategy map, the R&SS scorecard (see Exhibit 6) was developed and implemented in 2004. The scorecard was built from the top down using four steps:

1. Financial outcomes were set.
2. Key customer outcomes that created related financial outcomes were identified.
3. Internal processes relating to customers and productivity outcomes were identified.
4. The infrastructure needed to achieve all of the above was identified.

Initially, effort was not directed toward developing new measures for processes, as shown in the strategy map, but rather focus was on leveraging the existing information. Nissen emphasized, “Initially the focus was on capturing what was already available.”

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**Exhibit 6**  Manpower Australia’s Recruiting & Staffing Solution (R&SS) Scorecard, 2004

<table>
<thead>
<tr>
<th>Themes</th>
<th>Objectives</th>
<th>Measures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial Perspective</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Growth</td>
<td>• Provide return on capital</td>
<td>• YTD Return on sales</td>
</tr>
<tr>
<td></td>
<td>• Improve profitability</td>
<td>• Sales revenue</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Gross profit</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Operating unit profit</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• YTD gross profit margin</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Gross profit growth YoY</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Debtors over 29 days</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• DSO days</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• SG&amp;A Growth YoY</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• SG&amp;A as % of gross profit</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• YTD Gross profit/Total personnel cost</td>
</tr>
<tr>
<td>Productivity</td>
<td>• Improve productivity</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Cost containment</td>
<td></td>
</tr>
<tr>
<td>Customer Perspective</td>
<td>• Speed of response</td>
<td></td>
</tr>
<tr>
<td>Candidate delivery</td>
<td></td>
<td>• Job fill rate contract</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Job fill rate perm</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Job fill rate temp</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Job vacancy days contract</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Job vacancy days permanent</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Job vacancy days temporary</td>
</tr>
<tr>
<td>Internal Business Perspective</td>
<td>• Increase the retail client base as a % of gross profit</td>
<td>• Client retention—lapsed</td>
</tr>
<tr>
<td>Increase customer value</td>
<td>• Lower the cost base of the business</td>
<td>• Pay Bill error rate</td>
</tr>
<tr>
<td>Achieve operational excellence</td>
<td>• Safety</td>
<td>• Lost time injury frequency rate (LTIFR) rolling average</td>
</tr>
<tr>
<td>Safety</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Learning and Growth Perspective</td>
<td>• Retain key staff</td>
<td>• Staff retention</td>
</tr>
</tbody>
</table>

---
The R&SS scorecard consisted of four perspectives, seven strategic themes, nine objectives, and 21 measures. The four perspectives of the BSC were:

1. **Financial**
2. **Customer**
3. **Internal Processes**
4. **Learning & Growth**

**Financial Perspective** Financial measures indicated whether a company’s strategy, implementation, and execution were contributing to bottom-line improvement. Manpower was in the “sustain” stage of its life cycle, as the recruiting industry had reached maturity. Most companies in the sustain stage used measures related to accounting income, such as operating profit and gross margins. Manpower had chosen both growth and productivity themes for maximizing income (see Exhibit 7).

The financial perspective of the R&SS scorecard had two strategic themes, four objectives, and 11 measures. Return on sales (ROS) as the overall financial objective was driving the business toward operational efficiency. Thus, debtor measures were incorporated to improve asset utilization through improvement in the cash cycle, and the measures on the selling, general, and administration expenses focused on cost reduction. The productivity focus highlighted the company’s strategy to deal with the highly competitive market conditions with squeezing margins, while the various growth metrics were aimed at capturing the performance of Manpower in expanding its scale of business, share of revenue, and profit.

**Customer Perspective** The customer perspective articulated the customer-and market-based strategy that would deliver superior future financial returns. This perspective usually included identification of the customer and market segments, with common metrics comprising outcome measures and attributes of the specific value proposition offered that would drive the outcomes sought by the business. Common outcome measures usually included customer satisfaction, customer retention, customer acquisition, customer profitability, and market and account share in targeted segments. Measures of the value proposition typically focused on product/service attributes, the customer relationship, and/or brand image and reputation.

The customer perspective of the R&SS scorecard had one strategic theme, one objective, and six measures (see Exhibit 8). The focus on speed in candidate delivery clearly indicated the company’s emphasis on productivity, which was considered one of the major requirements for efficient branch operations.

**Internal Business Process Perspective** In the internal business perspective, critical processes were identified at which the organization must excel to achieve its financial and customer objectives. Internal processes accomplished two vital components of an organization’s strategy: (1) they produced and delivered the value proposition for customers, and (2) they directly impacted the productivity theme in the financial perspective. The organization’s internal processes could be grouped into four clusters: operations management processes, innovation processes,
customer management processes, and regulatory and social processes.

Manpower had focused mainly on three clusters of internal processes. Manpower’s corporate scorecard had three strategic themes, three objectives, and three measures under the internal business process perspective (see Exhibit 9). The customer and candidate management processes were focused on client retention and ensuring the longevity of the customer base. The operational excellence theme was geared to reducing the cost structure by reducing invoicing and other errors/disputes that impacted prompt client payments. Safety was given priority under the regulatory and social processes of the company, with the Lost Time Injury Frequency Rate (LTFIR) metric focused on candidates’ occupational health and safety issues, risk management, and cost related to injury compensation.

**Learning and Growth Perspective** The objectives in the learning and growth perspective provided the infrastructure to enable objectives in the other three perspectives to be achieved. This perspective focused on the longer-term enablers of the business and its readiness to implement the chosen strategy. Enablers were grouped into human capital readiness focused on employee skills and competencies (with common outcome measures comprising employee retention, productivity, and satisfaction), information system capabilities, and overall cultural alignment and values.

The learning and growth perspective in the R&SS scorecard had one theme, one objective, and one measure (see Exhibit 10). The main focus was on retaining key staff. Staff retention was arguably an outcome measure for employees’ satisfaction.

### The Implementation Process

Having developed the BSC for R&SS, Nissen developed BSCs for the other business units and cascaded down to regions and branches within R&SS. The monthly business review meeting, led by Nissen and

---

**Exhibit 8 Customer Perspective**

<table>
<thead>
<tr>
<th>Theme</th>
<th>Objective</th>
<th>Measures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Candidate delivery</td>
<td>• Speed of response</td>
<td>• Job fill rate contract</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Job fill rate permanent</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Job fill rate temporary</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Job vacancy days contract</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Job vacancy days permanent</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Job vacancy days temporary</td>
</tr>
</tbody>
</table>

**Exhibit 9 Internal Business Process Perspective**

<table>
<thead>
<tr>
<th>Themes</th>
<th>Objectives</th>
<th>Measures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase customer value</td>
<td>• Increase the retail client base as a % of gross profit</td>
<td>• Client retention—lapsed</td>
</tr>
<tr>
<td>Achieve operational excellence</td>
<td>• Lower the cost base of the business</td>
<td>• Pay bill error rate</td>
</tr>
<tr>
<td>Safety</td>
<td>• Safety</td>
<td>• Lost time injury frequency rate (LTFIR) rolling average</td>
</tr>
</tbody>
</table>

**Exhibit 10 Learning and Growth Perspective**

<table>
<thead>
<tr>
<th>Theme</th>
<th>Objectives</th>
<th>Measures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Climate for action</td>
<td>• Retain key staff</td>
<td>• Staff retention</td>
</tr>
</tbody>
</table>
comprising her senior management team, undertook to assess the development of BSCs, the selection of right measures, and the linking of initiatives with strategy, and to review the progress at each meeting. In addition, the initial implementation and rollout of the BSC at Manpower was made the responsibility of the general manager of human resources, and the BSC and strategic initiatives progress were reported in the monthly intranet communication to all staff.

A BSC evaluation interview-survey conducted at Manpower revealed that the BSC formulation process had been relatively top-down, with most of the respondents indicating that they had not been directly involved in the formulation of BSC objectives (see Exhibit 11). For most of the survey respondents, their journey started after receiving instructions from Nissen or her senior management team to develop the scorecard, with the majority of these adopting the strategic objectives and metrics that were prescribed.

A series of road shows and education workshops was held throughout Manpower and its branches to communicate the rationale for the BSC and how it was to be used, with a number of these led by Nissen. To ensure adoption and take-up of the BSC, periodic BSC reviews were made a part of the management reviews early in the implementation phase. These reviews monitored the progress of the BSC and its impact on the business. In addition, the BSC reporting and analysis was to be facilitated through technology and Manpower’s intranet. According to Nissen, “It was important to signal our revitalization of our Manpower company, that everyone should have a modern looking tool—not an Excel spreadsheet but a tool through which they could analyze the data and reach a fact-based conclusion.” As many measures were already in the company’s management information system, personnel responsible for maintaining this were also given responsibility to feed the data manually into the BSC reporting tool. Within R&SS in particular, a scoreboard form (Exhibit 12) was developed to ensure that the BSC was reviewed at the branch level on a timely basis and actions were taken by the branch managers in five areas: sales, staffing, skills, systems, and safety.

The BSC measures were also linked to compensation. Quarterly bonuses were introduced that were linked to the achievement of the financial numbers, with the BSC aimed at enabling learning about which lead indicators drove financial results. Nissen encouraged the team, “It’s okay to be away from your numbers. This is an opportunity for understanding and learning. Learn from the deviations and understand what to do in the future to meet the numbers.” In addition, the company also developed 27 incentive plans that were linked with the other nonfinancial measures on the BSC. While there was a common perception that these plans needed to be simplified and rationalized, linking incentives with the BSC measures suggested that Manpower’s leadership strongly believed in the BSC. One of the directors claimed, “HR incentive plans at Manpower are in place for sustainable performance and they are aligned with the balanced scorecard objectives and measures.”

In mid-2004, responsibility for the BSC was handed over to the directors of the individual business units to drive to lower levels of their respective areas. The BSC Evaluation Survey indicated that significant benefits had been achieved through the BSC implementation at Manpower (see Exhibit 13) in addition to the improvement in the company’s financial performance. Specifically, 85 percent of responses to an interview survey pointed out that the BSC had

---

**Exhibit 11  Survey Results on Role in BSC Development**

<table>
<thead>
<tr>
<th>Role Identified</th>
<th>% Response</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not a part of strategic objective formulation</td>
<td>39%</td>
</tr>
<tr>
<td>Only responsible for metrics in my business area</td>
<td>22%</td>
</tr>
<tr>
<td>I adopted the objectives suggested</td>
<td>11%</td>
</tr>
<tr>
<td>Involved in initial conversations and workshops</td>
<td>11%</td>
</tr>
<tr>
<td>Reviewed objectives with my team</td>
<td>6%</td>
</tr>
<tr>
<td>Senior management developed it along with IT</td>
<td>6%</td>
</tr>
<tr>
<td>Change scorecard to suit business needs</td>
<td></td>
</tr>
</tbody>
</table>

*Responses rounded to the next whole number.


**Exhibit 12  Scoreboard Form**

<table>
<thead>
<tr>
<th>Financials</th>
<th>Customer</th>
<th>Internal Business</th>
<th>Learning &amp; Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating profit margin (ROS as % revenues)</td>
<td>Temporary job fill rate/ cycle time</td>
<td>Pay bill error rate</td>
<td>Retention</td>
</tr>
<tr>
<td>Gross profit/Total salary cost</td>
<td>Temporary job fill rate/ cycle time</td>
<td>Last time injury frequency rate</td>
<td>Fill rate of internal jobs</td>
</tr>
<tr>
<td>Gross profit/branch personnel cost</td>
<td>Temporary job fill rate/ cycle time</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>From this period</th>
<th>To next period</th>
<th>Target period</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Sales</th>
<th>Action points:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>From what</td>
<td>To what</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Staffing</th>
<th>Action points:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>From what</td>
<td>To what</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Skills</th>
<th>Action points:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>From what</td>
<td>To what</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>System</th>
<th>Action points:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>From what</td>
<td>To what</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Safety</th>
<th>Action points:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>From what</td>
<td>To what</td>
</tr>
</tbody>
</table>

| Team name        |                   |
| Date agreed      |                   |
| Next review date |                   |
provided a better understanding of business, more focus on key issues, and learning and development of management team. However, the perception of the BSC as a strategic management system was still low among the participants, with 11 percent of responses indicating that Manpower would not be different without the BSC and 3 percent indicating that it did not drive business decision-making.

### PROBLEMS AND CHALLENGES

#### The Balanced Scorecard

Although the initial implementation of the BSC had resulted in productivity gains for Manpower, Nissen and McLachlan didn’t want to stop there. They were focused on leveraging this success by refining the BSC so that innovative and growth objectives could be better achieved. However, one problem was that there appeared to be a blockage in the business using the information embedded in the BSC to identify and better manage the critical lead indicators that would lead to success. Information from the BSC evaluation survey found low usage of the BSC (see Exhibit 14), especially by teams working under the senior to middle management. When the leadership team was questioned regarding the extent of their direct reports usage of the BSC, 65 percent of them reported low or no usage by their direct reports. They attributed this low take-up to the quality of the information presented on the scorecard. The measures were limited to past performance, lagging, not relevant, and at times inaccurate. Only 17 percent of responses claimed that the direct reports used it for business analysis purposes.

#### Business Challenges

The external business environment was also becoming increasingly challenging for the company. Discussions among Manpower’s senior and middle managers revealed issues relating to the external environment of clients, candidates, and competitors, while internal factors related to systems/processes, employees, and culture.

The major issues and challenges related to clients were identified as comprising:

- Pressure for low price.
- Required speedy service.
- Lack of understanding of customer needs.
- High level of service expectations.
- Increasing customer bargaining power.

The customers’ focus was on price, speed, and quality. However, there was a need for better understanding at Manpower for the customer needs and requirements. One of the general managers explained, “There are different industrial sectors and each sector

---

**Exhibit 13** Survey Results: Benefits of BSC

<table>
<thead>
<tr>
<th>Benefits Identified</th>
<th>% Response</th>
</tr>
</thead>
<tbody>
<tr>
<td>Helped in understanding of business</td>
<td>22%</td>
</tr>
<tr>
<td>Gives focus and insight on key issues</td>
<td>19</td>
</tr>
<tr>
<td>Helped in developing management team</td>
<td>14</td>
</tr>
<tr>
<td>Nothing will happen if BSC taken out</td>
<td>11</td>
</tr>
<tr>
<td>Consistency of communication by providing a common language</td>
<td>8</td>
</tr>
<tr>
<td>Gives a good snapshot of business</td>
<td>5</td>
</tr>
<tr>
<td>Improved decision making</td>
<td>3</td>
</tr>
<tr>
<td>Helped improved business results</td>
<td>3</td>
</tr>
<tr>
<td>Drives behavior</td>
<td>3</td>
</tr>
<tr>
<td>Helps in changing culture</td>
<td>3</td>
</tr>
<tr>
<td>Doesn’t drive business decision-making</td>
<td>3</td>
</tr>
<tr>
<td>Greater visibility</td>
<td>3</td>
</tr>
<tr>
<td>Mechanism for rewarding people</td>
<td>3</td>
</tr>
<tr>
<td>Drives business</td>
<td>3</td>
</tr>
</tbody>
</table>

*Responses rounded to the next whole number.*
is at a different stage of life cycle—therefore their demands and needs are different. There is no one-fits-all solution. We need to be more focused and analyze each of the sectors in detail to successfully execute our strategy.”

The major candidate issues were:

• Candidate shortage.
• Decreasing candidate loyalty and stability.
• Poor candidate care.

There was a severe shortage of candidates, especially in certain skill categories. A regional operations manager of Manpower within R&SS raised the candidate-related issues: “Sourcing candidates with the right skill set is a big issue. In addition to this shortage, candidate loyalty is another issue. Whether we are preferred supplier or not, it is a candidate-driven market and the candidate will move even for an extra 50 cents per hour.”

In relation to competition, the market had already matured with rivalry intensifying and a number of niche competitors emerging targeting higher margin business. In this scenario, the main issues and challenges that Manpower currently faced from this highly competitive market were:

• Offering low prices.
• Growth of niche agencies.
• Developing brands.

Another R&SS regional operations manager explained the market conditions as follows: “It’s a very competitive market. Pricing has become an issue as we choose to be profitable and the competition chooses to get the business at any cost.” Similarly, the general manager of one of the business units was worried about the increasing number of niche agencies, commenting: “As the market entry barriers are low there is a huge growth of consultants, usually a one-person or two-person company. This increasing competition has meant that clients preferred to maintain more suppliers on their preferred list.”

Internally, Manpower’s systems and processes were identified as an area that needed improvement. Key issues were identified as being:

• Lack of standardization/consistency in branches and between teams.
• Old and slow processes.
• Inefficient candidate handling processes.
• Too many applications and no end-to-end solution.

One of the R&SS regional operations managers identified processes as one of the greatest challenges: “Our processes are very long. They are not fully integrated and therefore we double handle a lot of work.” Furthermore, the lack of integration was seen as having competitive impacts, with one of the members of the senior management team explaining: “Our technology needs continuous upgrading. We don’t have an end-to-end recruiting system. We’ve got various brilliant applications but at times we lose speed as they are not totally integrated. We need to focus on our databases and make them more aligned towards customers’ and consultants’ needs and requirements. They should be made more users friendly and precise. For example, one should be

### Exhibit 14 Survey Results: BSC Usage

<table>
<thead>
<tr>
<th>Usage Identified</th>
<th>% Response</th>
</tr>
</thead>
<tbody>
<tr>
<td>Use it extensively for business analysis</td>
<td>17%</td>
</tr>
<tr>
<td>BSC don’t have any new info to review</td>
<td>17</td>
</tr>
<tr>
<td>Only interested in summary level data on monthly basis</td>
<td>14</td>
</tr>
<tr>
<td>Weekly financial reports are more relevant and useful</td>
<td>14</td>
</tr>
<tr>
<td>BSC information lagging—not useful</td>
<td>7</td>
</tr>
<tr>
<td>Drive behavior as it impacts incentives</td>
<td>7</td>
</tr>
<tr>
<td>Its part of their job</td>
<td>7</td>
</tr>
<tr>
<td>Measures not relevant to business</td>
<td>7</td>
</tr>
<tr>
<td>Not interested</td>
<td>3</td>
</tr>
<tr>
<td>Don’t have access to BSC</td>
<td>3</td>
</tr>
<tr>
<td>Accuracy of BSC questionable</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>100%</td>
</tr>
</tbody>
</table>

*Responses rounded to the next whole number.
quickly able to search for job specs or other requirements. We have got legacy systems and there is a cost of changing them.”

The nature of the industry also posed significant challenges in relation to the management of human capital. While the consultant was important—being the candidate- and client-facing resource—hiring and retaining skilled and effective consultants was difficult. McLachlan, who was also director of corporate services, claimed, “For the company there is a continuous battle in finding the right consultant, the client- and candidate-facing resources. The industry has a large attrition rate that we need to manage. We are continuously bridging the gaps, if any, in the leadership and management skills at business unit level.”

The current issues with the people side of the business were many, but the most important were:

- Finding the right consultant.
- Low staff retention.
- Slow career growth.

Finally, in implementing the new strategic direction, the whole organization was going through a change management process. Many within the organization considered it important to inculcate the right culture to support these initiatives. Challenges identified related to developing a high performance culture were:

- Changing the bureaucratic corporate culture.
- Shift required from customer service to sales culture.

The issues relating to the cultural readiness of Manpower to pursue the new strategic initiatives were summarized by one member of the senior management team as follows: “We need to focus on staff advocacy and engagement for achieving our targets. There is a service culture. Our people do selling but not as a selling culture. A selling culture is that if you have ten candidates you will place all of them, but in a service culture you will only focus on what is demanded by the customer and not what you can sell. We want to move to that culture of selling.”

**WHAT NEXT?**

Varina Nissen and her team believed their biggest challenge was to use the available information to evaluate the implementation and achievement of current strategic objectives and the initiatives, to help focus the business on the lead indicators of success, and refine the current strategic thinking if required to adapt to the emerging conditions and issues.
Importers of goods from China, Indonesia, Cambodia, Vietnam, Malaysia, Korea, Pakistan, Bangladesh, Sri Lanka, India, the Philippines, Peru, Honduras, the Dominican Republic, Tunisia, and other less developed countries had long had to contend with accusations by human rights activists that they sourced goods from sweatshop manufacturers that paid substandard wages, required unusually long work hours, used child labor, operated unsafe workplaces, and habitually engaged in assorted other unsavory practices. Since the 1990s, companies had responded to criticisms about sourcing goods from manufacturers in developing nations where working conditions were often substandard by instituting elaborate codes of conduct for foreign suppliers and by periodically inspecting the manufacturing facilities of these suppliers to try to eliminate abuses and promote improved working conditions. In several industries where companies sourced goods from common foreign suppliers, companies had joined forces to conduct plant monitoring; for example, Hewlett-Packard, Dell, and other electronics companies that relied heavily on Asia-based manufacturers to supply components or assemble digital cameras, handheld devices, and PCs had entered into an alliance to combat worker abuse and poor working conditions in supplier factories.

But a number of unscrupulous foreign manufacturers had recently gotten much better at concealing human rights abuses and substandard working conditions. In November 2006, BusinessWeek ran a cover story detailing how shady foreign manufacturers were deceiving inspection teams and escaping detection.1 According to the BusinessWeek special report, Ningbo Beifa Group—a top Chinese supplier of pens, mechanical pens, and highlighters to Wal-Mart, Staples, Woolworth, and some 400 other retailers in 100 countries—was alerted in late 2005 that a Wal-Mart inspection team would soon be visiting the company’s factory in the coastal city of Ningbo. Wal-Mart was Beifa’s largest customer and on three previous occasions had caught Beifa paying its 3,000 workers less than the Chinese minimum wage and violating overtime rules; a fourth offense would end Wal-Mart’s purchases from Beifa. But weeks prior to the audit, an administrator at Beifa’s factory in Ningbo got a call from representatives of Shanghai Corporate Responsibility Management & Consulting Company offering to help the Beifa factory pass the Wal-Mart inspection.2 The Beifa administrator agreed to pay the requested fee of $5,000. The consultant advised management at the Beifa factory in Ningbo to create fake but authentic-looking records regarding pay scales and overtime work and make sure to get any workers with grievances out of the plant on the day of the audit. Beifa managers at the factory were also coached on how to answer questions that the auditors would likely ask. Beifa’s Ningbo factory reportedly passed the Wal-Mart inspection in early 2006 without altering any of its practices.3 A lawyer for Beifa confirmed that the company had indeed employed the Shanghai consulting firm but said that...
factory personnel engaged in no dishonest actions to pass the audit; the lawyer indicated that the factory passed the audit because it had taken steps to correct the problems found in Wal-Mart’s prior audits.

**GROWING USE OF STRATEGIES TO DELIBERATELY DECEIVE PLANT INSPECTORS**

In 2007, substandard wages and abusive working conditions were thought to be prevalent in factories in a host of countries—China, Indonesia, Cambodia, Vietnam, Malaysia, Korea, Pakistan, Bangladesh, Sri Lanka, India, the Philippines, Peru, Honduras, the Dominican Republic, Tunisia, and several other countries in Latin America, Eastern Europe, the Middle East, and Africa. (See Exhibit 1 for a sample of the problems in eight countries.) Factories in China were particularly in the spotlight because of China’s prominence as the world’s biggest source of low-priced goods. China was the largest single source of goods imported into both the United States and the 25 countries comprising the European Union. U.S. imports from Chinese manufacturers amounted to about $280 billion in 2006.

Political support in many countries for growing trade ties with offshore manufacturers, especially those in China, often hinged on the ability of companies with global sourcing strategies to convince domestic governmental officials, human rights groups, and concerned citizens that they were doing all they could to ensure decent wages and working conditions.

**Exhibit 1** Comparative Labor and Workplace Conditions in Eight Countries, 2006

<table>
<thead>
<tr>
<th>Country</th>
<th>Labor and Workplace Overview</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>Primary problems in the manufacturing workplace are forced labor, inadequate occupational safety (work accidents are common in several industries), and wage discrimination (wages paid to females are 54% to 64% of those paid to males).</td>
</tr>
<tr>
<td>China</td>
<td>Factories are most prone to ignore minimum wage requirements, underpay for overtime work, subject workers to unsafe and unhealthy working conditions, and suppress worker attempts to join independent unions.</td>
</tr>
<tr>
<td>India</td>
<td>Most common issues concern underpayment of minimum wages, overtime pay violations, use of child labor (according to one estimate some 100 million children ages 5 to 14 work and at least 12.6 million work full-time), the use of forced labor (perhaps as many as 65 million people), and inattention to occupational safety.</td>
</tr>
<tr>
<td>Indonesia</td>
<td>The stand-out issues concern weak enforcement of minimum-wage rules and work hours in factories, overtime pay violations in factories, subpar occupational safety (especially in mining and fishing), and use of underage labor (particularly in domestic service, mining, construction, and fishing industries).</td>
</tr>
<tr>
<td>Mexico</td>
<td>Problem areas include sweatshop conditions in many assembly plants near the U.S. border and elsewhere, fierce opposition to unions, insistence on pregnancy tests for female job applicants of child-bearing age, and use of child labor in non-export economic sectors.</td>
</tr>
<tr>
<td>Peru</td>
<td>Worst workplace conditions relate to lack of enforcement of wage and overtime provisions in factories, mandatory overtime requirements for many workers, and inattention to occupational safety.</td>
</tr>
<tr>
<td>South Africa</td>
<td>Most frequent offenses entail failure to observe minimum-wage and overtime pay rules (particularly in garment industry), use of child labor, occupational safety violations (especially in non-export sectors where outside monitoring is nonexistent), and low pay for women.</td>
</tr>
<tr>
<td>Sri Lanka</td>
<td>Most frequent violations relate to underpayment of wages, forced overtime requirements, compulsory work on Sundays and holidays, and inattention to worker health and safety (such as excessive noise, blocked exits, and disregard for worker safety—one study found 60% of grain and spice mill workers lost fingers in work-related accidents and/or contracted skin diseases).</td>
</tr>
</tbody>
</table>

Source: Compiled by the author from information in “How China’s Labor Conditions Stack Up Against Those of Other Low-Cost Nations,” *BusinessWeek* Online, November 27, 2006, www.businessweek.com (accessed January 26, 2007). The information was provided to *BusinessWeek* by Verité, a Massachusetts-based nonprofit social auditing and research organization with expertise in human rights and labor abuses in supplier factories around the world.
could do to police working conditions in the plants of suppliers in low-wage, poverty-stricken countries where sweatshop practices were concentrated. A strong program of auditing the offshore plants of suspect employers was a way for a company to cover itself and negate accusations that it was unfairly exploiting workers in less developed countries.

**Workplace Rules in China**

Minimum wages in China were specified by local or provincial governments and in 2006 ranged from $45 to $101 per month, which equated to hourly rates of $0.25 to $0.65 based on a 40-hour workweek. According to Chinese government income data compiled by the U.S. Bureau of Labor Statistics and a Beijing consulting firm, the average manufacturing wage in China was $0.64 per hour (again assuming a 40-hour workweek). While the standard workweek in Chinese provinces officially ranged from 40 to 44 hours, there were said to be numerous instances where plant personnel worked 60 to 100 hours per week, sometimes with only one or two days off per month. Such long work hours meant that the actual average manufacturing wage in China was likely well below $0.64 per hour in 2005–2006.

According to estimates made by a veteran inspector of Chinese factories, employees at garment, electronics, and other plants making goods for export typically worked more than 80 hours per week and earned an average of $0.42 per hour. Overtime pay rules in Chinese provinces officially called for time-and-a-half pay for all work over eight hours per day and between double and triple pay for work on Saturdays, Sundays, and holidays. However, it was commonplace for Chinese employers to disregard overtime pay rules, and governmental enforcement of minimum wage and overtime requirements by both Beijing officials and officials in local Chinese provinces was often minimal to nonexistent. At a Hong Kong garment plant where 2,000 employees put in many overtime hours operating sewing and stitching machines, worker pay averaged about $125 per month—an amount that the owner acknowledged did not meet Chinese overtime pay requirements. The owner said that overtime rules were “a fantasy. Maybe in two or three decades we can meet them.”

Many young Chinese factory workers were tolerant of long hours and less than full overtime pay because they wanted to earn as much as possible, the idea being to save enough of their income to return to their homes in the countryside after a few years of factory employment.

Chinese export manufacturing was said to be rife with tales of deception to frustrate plant monitoring and escape compliance with local minimum wage and overtime rules and supplier codes of conduct. Indeed, a new breed of consultants had sprung up in China to aid local manufacturers in passing audits conducted both by customer companies and industry alliance groups.

**Emerging Strategies to Frustrate Plant Monitoring Efforts**

The efforts of unscrupulous manufacturers in China and other parts of the world to game the plant monitoring system and use whatever deceptive practices it took to successfully pass plant audits had four chief elements:

1. *Maintaining two sets of books*—Factories generated a set of bogus payroll records and time sheets to show audit teams that their workers were properly paid and received the appropriate overtime pay; the genuine records were kept secret. For example, at an onsite audit of a Chinese maker of lamps for Home Depot, Sears, and other retailers, plant managers provided inspectors with payroll records and time sheets showing that employees worked a five-day week from 8 a.m. to 5:30 p.m. with a 30-minute lunch break and no overtime hours; during interviews, managers at the plant said the records were accurate. But other records auditors found at the site, along with interviews with workers, indicated that employees worked an extra three to five hours daily with one or two days off per month during peak production periods; inspectors were unable to verify whether workers at the plant received overtime pay. According to a compliance manager at a major multinational company who had overseen many factory audits, the percentage of Chinese employers submitting false payroll records had risen from 46 percent to 75 percent during the past four years; the manager also estimated that only
20 percent of Chinese suppliers complied with local minimum-wage rules and that just 5 percent obeyed hour limitations.9

2. **Hiding the use of underage workers and unsafe work practices**—In some instances, factories in China, parts of Africa, and select other countries in Asia, Eastern Europe, and the Middle East employed underage workers. This was disguised either by falsifying the personnel records of underage employees, by adeptly getting underage employees off the premises when audit teams arrived, or by putting underage employees in back rooms concealed from auditors. A memo distributed in one Chinese factory instructed managers to “notify underage trainees, underage full-time workers, and workers without identification to leave the manufacturing workshop through the back door. Order them not to loiter near the dormitory area. Secondly, immediately order the receptionist to gather all relevant documents and papers.”10 At a toy plant in China, a compliance inspector, upon smelling strong fumes in a poorly ventilated building, found young female employees on a production line using spray guns to paint figurines; in a locked back room that a factory official initially refused to open, an apparently underage worker was found hiding behind co-workers.11

3. **Meeting requirements by secretly shifting production to subcontractors**—On occasions, suppliers met the standards set by customers by secretly shifting some production to subcontractors who failed to observe pay standards, skirted worker safety procedures, or otherwise engaged in abuses of various kinds.

4. **Coaching managers and employees on answering questions posed by audit team members**—Both managers and workers were tutored on what to tell inspectors should they be interviewed. Scripting responses about wages and overtime pay, hours worked, safety procedures, training, and other aspects related to working conditions was a common tactic for thwarting what inspectors could learn from interviews. However, in instances where plant inspectors were able to speak confidentially with employees away from the worksite, they often got information at variance with what they were told during onsite interviews—plant personnel were more inclined to be truthful and forthcoming about actual working conditions and pay practices when top-level plant management could not trace the information given to inspectors back to them.

There was a growing awareness among companies attempting to enforce supplier codes of conduct that all factories across the world with substandard working conditions and reasons to hide their practices from outside view played cat-and-mouse games with plant inspectors. In many less-developed countries struggling to build a manufacturing base and provide jobs for their citizens, factory managers considered deceptive practices a necessary evil to survive, principally because improving wages and working conditions to comply with labor codes and customers’ codes of conduct for suppliers raised costs and imperiled already thin profit margins. Violations were said to be most prevalent at factories making apparel, but more violations were surfacing in factories making furniture, appliances, toys, and electronics.

However, large global corporations such as General Electric, Motorola, Dell, Nestlé, and Toyota that owned and operated their own offshore manufacturing plants in China and other low-wage countries had not been accused of mistreating their employees or having poor working conditions. The offshore factories of well-known global and multinational companies were seldom subject to monitoring by outsiders because the workplace environments in their foreign plants were relatively good in comparison to those of local manufacturing enterprises who made a business of supplying low-cost components and finished goods to companies and retailers in affluent, industrialized nations.

**FOREIGN SUPPLIER COMPLIANCE PROGRAMS AT NIKE AND WAL-MART**

Corporate sensitivity to charges of being socially irresponsible in their sourcing of goods from foreign manufacturers had prompted hundreds of companies to establish supplier codes of conduct and to engage in compliance monitoring efforts of one kind or another manner. Most companies with global sourcing strategies and factory compliance programs worked
proactively to improve working conditions globally, preferring to help suppliers achieve the expected standards rather than abruptly and permanently cutting off purchases. The most commonly observed problems worldwide related to benefits such as pensions and insurance (medical, accident, unemployment) not being paid. Other frequent issues included workers not being paid for all hours worked, the use of false books, and incomplete or insufficient documentation.

Nike and Wal-Mart were two companies with supplier codes of conduct and rather extensive programs to monitor whether suppliers in low-wage, low-cost manufacturing locations across the world were complying with their codes of conduct. Both companies initiated such efforts in the 1990s because they came under fire from human rights activist groups for allegedly sourcing goods from sweatshop factories in China and elsewhere.

Nike’s Supplier Code of Conduct and Compliance Monitoring Program

Nike was the world’s leading designer, distributor, and marketer of athletic footwear, sports apparel, and sports equipment and accessories, but it did no manufacturing. All Nike products were sourced from contract manufacturers. In April 2005, Nike reported that there were over 730 factories actively engaged in manufacturing its products; of these, about 135 were in China (including Hong Kong and Macau); 73 in Thailand, 39 in Indonesia, 35 in Korea, 34 in Vietnam, 33 in Malaysia, 25 in Sri Lanka, and 18 in India. Nike’s contract factories employed roughly 625,000 workers, the majority of whom were women between the ages of 19 and 25 performing entry-level, low-skill jobs.

Nike drafted a code of conduct for its contract factories in 1991, distributed the code to all of its contract factories in 1992, and directed them to post the code in a visible place and in the appropriate local language. The code had been modified and updated over the years, and in 2007 also included a set of leadership standards that was adopted in 2002. Nike’s code of conduct is presented in Exhibit 2. In 1998, in a move to strengthen its opposition to the use of child labor in factories, Nike directed its contract factories to set age standards for employment at 16 for apparel and 18 for footwear; these age standards were more demanding than those set in 1991 and exceeded the International Labor Organization’s age minimum of 15 years.

Nike’s System for Monitoring Contract Manufacturers. During 2003–2006, Nike used three approaches to plant monitoring.\(^\text{11}\)

- **Basic monitoring or SHAPE inspections**: SHAPE inspections, used since 1997, sought to gauge a factory’s overall compliance performance, including environment, safety, and health. They were typically performed by Nike’s field-based production staff and could be completed in one day or less. Nike’s stated goal was to conduct two SHAPE audits on each active factory each year, but the actual number of such audits had fallen short of that target.

- **In-depth M-Audits**: The M-Audit was designed to provide a deeper measure of the working conditions within contract factories. As a general rule, Nike focused its plant inspection efforts on factories where noncompliance was most likely to occur. Factories located in highly regulated countries where workers were more informed about their rights and workplace laws and regulations were enforced were deemed less likely to be out of compliance. In 2003, Nike focused its M-audits on factories presumed to have the highest risk of noncompliance and the greatest size (as measured by worker population). In 2004 M-audits were focused on factories believed to be of medium risk for noncompliance. Nike’s stated goal was to conduct M-audits for approximately 25–33 percent of its active factory base each year. The M-Audit included four major categories of inquiry (hiring practices, worker treatment, worker–management communications, and compensation) and covered more than 80 labor–management issues.

In 2004 Nike had 46 employees who regularly conducted M-Audits. The typical M-Auditor was under the age of 30, and 74 percent were women. Nike tried to hire auditors who were local nationals and understood the local language and culture. In 2003–2004, over 9,200 factory workers were individually interviewed as part of the M-Audit process. Each interview took approximately 30 minutes. The typical M-Audit took an average of 48 hours to complete, including
Exhibit 2  Nike’s Code of Conduct for Its Suppliers and Contract Manufacturers, 2006

Nike, Inc. was founded on a handshake

Implicit in that act was the determination that we would build our business with all of our partners based on trust, teamwork, honesty and mutual respect. We expect all of our business partners to operate on the same principles.

At the core of the NIKE corporate ethic is the belief that we are a company comprised of many different kinds of people, appreciating individual diversity, and dedicated to equal opportunity for each individual.

NIKE designs, manufactures, and markets products for sports and fitness consumers. At every step in that process, we are driven to do not only what is required by law, but what is expected of a leader. We expect our business partners to do the same. NIKE partners with contractors who share our commitment to best practices and continuous improvement in:

1.  Management practices that respect the rights of all employees, including the right to free association and collective bargaining
2.  Minimizing our impact on the environment
3.  Providing a safe and healthy workplace
4.  Promoting the health and well-being of all employees

Contractors must recognize the dignity of each employee, and the right to a workplace free of harassment, abuse or corporal punishment. Decisions on hiring, salary, benefits, advancement, termination or retirement must be based solely on the employee’s ability to do the job. There shall be no discrimination based on race, creed, gender, marital or maternity status, religious or political beliefs, age or sexual orientation.

Wherever NIKE operates around the globe we are guided by this Code of Conduct and we bind our contractors to these principles. Contractors must post this Code in all major workspaces, translated into the language of the employee, and must train employees on their rights and obligations as defined by this Code and applicable local laws.

While these principles establish the spirit of our partnerships, we also bind our partners to specific standards of conduct. The core standards are set forth below.

Forced Labor
The contractor does not use forced labor in any form—prison, indentured, bonded or otherwise.

Child Labor
The contractor does not employ any person below the age of 18 to produce footwear. The contractor does not employ any person below the age of 16 to produce apparel, accessories or equipment. If at the time Nike production begins, the contractor employs people of the legal working age who are at least 15, that employment may continue, but the contractor will not hire any person going forward who is younger than the Nike or legal age limit, whichever is higher. To further ensure these age standards are complied with, the contractor does not use any form of homework for Nike production.

Compensation
The contractor provides each employee at least the minimum wage, or the prevailing industry wage, whichever is higher; provides each employee a clear, written accounting for every pay period; and does not deduct from employee pay for disciplinary infractions.

Benefits
The contractor provides each employee all legally mandated benefits.

Hours of Work/Overtime
The contractor complies with legally mandated work hours; uses overtime only when each employee is fully compensated according to local law; informs each employee at the time of hiring if mandatory overtime is a condition of employment; and on a regularly scheduled basis provides one day off in seven, and requires no more than 60 hours of work per week on a regularly scheduled basis, or complies with local limits if they are lower.

Environment, Safety and Health (ES&H)
The contractor has written environmental, safety and health policies and standards, and implements a system to minimize negative impacts on the environment, reduce work-related injury and illness, and promote the general health of employees.

Documentation and Inspection
The contractor maintains on file all documentation needed to demonstrate compliance with this Code of Conduct and required laws; agrees to make these documents available for Nike or its designated monitor; and agrees to submit to inspections with or without prior notice.

travel to and from the factory—travel hours accounted for between 25 and 30 percent of total M-Audit time.

- Independent external monitoring: Beginning in 2003, Nike became a member of the Fair Labor Association, an organization that conducted independent audits of factories that provided goods to members. The FLA applied a common set of compliance standards in all of its factory audits. About 40 factories supplying goods to Nike were audited by the FLA in 2003.

In 2004, Nike’s compliance team consisted of 90 people based in 24 offices in 21 countries. The typical Nike compliance team in each country spent about one-third of their time on monitoring and auditing activities, about half their time assisting and tracking factory remediation activities, and the remainder of their time on troubleshooting and collaboration/outreach work.\(^{14}\) In its 2004 Corporate Responsibility Report, Nike said

> With an average of one compliance staff for more than 10 factories—some of which are remote and some of which are large and complex businesses with 10,000 or more employees—tracking and assisting factory remediation is at times an overwhelming and incomplete body of work.\(^{15}\)

Nike’s factory audits were announced rather than unannounced because “much of the information we require in our evaluation of a factory is dependent upon access to relevant records and individuals within factory management.”\(^{16}\) When a factory was found to be out of compliance with the code of conduct, Nike’s compliance team worked with factory management and the Nike business unit for which products were being manufactured to develop a Master Action Plan (MAP) that specified the factory’s needed remediation efforts. The Nike production manager responsible for the business relationship with the contract factory monitored MAP progress and exchanged information about progress or obstacles with Nike’s country compliance team. The Nike general manager for production monitored the progress of all factories within his or her purview, and weighed in when factory remediation progress was too slow.

To further facilitate factory compliance with Nike’s Code of Conduct for suppliers, the company conducted or sponsored training and education programs for factory personnel. In 2004, over 16,500 factory managers and workers attended programs relating to labor issues, worker health and safety, and environmental protection.\(^{17}\)

Nike’s Compliance Rating System. Nike’s factory ratings for SHAPE and M-Audits resulted in numeric scores ranging from 0 to 100 (a score of 100 indicated full compliance); these numeric scores were then converted to one of four overall grades:\(^{18}\)

<table>
<thead>
<tr>
<th>Grade</th>
<th>Criteria</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>No more than 5 minor violations on a factory’s Master Action Plan for improving working conditions and achieving higher levels of compliance with Nike's Code of Conduct, and no more than 20 percent of MAP items past due.</td>
</tr>
<tr>
<td>B</td>
<td>No more than 5 minor violations, but no serious or critical issues outstanding on the MAP and no more than 30 percent of MAP items past due.</td>
</tr>
<tr>
<td>C</td>
<td>One or more C-level compliance issues outstanding on the MAP and no more than 30 percent of MAP items past due—examples of C-level issues included excessive work hours per week (more than 60 but less than 72), not providing 1 day off in 7, verbal or psychological harassment of workers, exceeding legal annual overtime work limit for 10% or more of workforce, conditions likely to lead to moderate injury or illness to workers, and conditions likely to lead to moderate harm to environment or community.</td>
</tr>
<tr>
<td>D</td>
<td>One or more D-level issues outstanding on the factory’s MAP or past due correction of prior D-level issues; or more than 40 percent of open MAP items past due. Examples of D-level issues included unwillingness to comply with code standards, falsified records, coaching of workers to falsify information, use of underage workers or forced labor, paying below the legal wage, no verifiable timekeeping system, exceeding daily work hour limit or work in excess of more than 72 hours per week for more than 10% of workforce, not providing one day off in 14, and conditions that could lead to serious worker injury or harm to the environment.</td>
</tr>
</tbody>
</table>

Note: A grade of E was assigned to factories for which there was insufficient information.
Exhibit 3  Summary Results of Nike’s Compliance Ratings for Contract Suppliers, Fiscal Years 2003–2004

<table>
<thead>
<tr>
<th>Geographic Region</th>
<th>Americas</th>
<th>Europe, Middle East, Africa</th>
<th>Northern Asia</th>
<th>Southern Asia</th>
<th>Worldwide Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of SHAPE audits in 2004</td>
<td>178</td>
<td>157</td>
<td>378</td>
<td>303</td>
<td>1,016</td>
</tr>
<tr>
<td>Number of M-Audits in 2003 and 2004</td>
<td>148</td>
<td>56</td>
<td>198</td>
<td>167</td>
<td>569</td>
</tr>
<tr>
<td>M-Audit Numeric Scores in 2003–2004</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lowest score</td>
<td>46</td>
<td>49</td>
<td>25</td>
<td>20</td>
<td>20</td>
</tr>
<tr>
<td>Average score</td>
<td>78</td>
<td>70</td>
<td>58</td>
<td>58</td>
<td>65</td>
</tr>
<tr>
<td>Highest score</td>
<td>94</td>
<td>96</td>
<td>95</td>
<td>95</td>
<td>99</td>
</tr>
<tr>
<td>Compliance Ratings for Contact Factories as of June 2004</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Grade of A</td>
<td>32</td>
<td>15</td>
<td>34</td>
<td>25</td>
<td>106 (15%)</td>
</tr>
<tr>
<td>Grade of B</td>
<td>64</td>
<td>40</td>
<td>147</td>
<td>76</td>
<td>327 (44%)</td>
</tr>
<tr>
<td>Grade of C</td>
<td>18</td>
<td>7</td>
<td>33</td>
<td>65</td>
<td>123 (17%)</td>
</tr>
<tr>
<td>Grade of D</td>
<td>5</td>
<td>35</td>
<td>14</td>
<td>8</td>
<td>62 (8%)</td>
</tr>
<tr>
<td>Grade of E</td>
<td>18</td>
<td>7</td>
<td>22</td>
<td>70</td>
<td>117 (16%)</td>
</tr>
</tbody>
</table>

Note: Worker population in M-Audited factories was 375,000 in fiscal year 2003 and 213,000 in fiscal year 2004.

Exhibit 3 presents a summary of Nike’s latest available factory ratings.

Cutting Off Orders to Noncomplying or Nonperforming Suppliers. A factory was cut from Nike’s supplier base when, over a specified period, Nike management determined that factory management lacked the capacity or the will to correct serious issues of noncompliance. One supplier in China, for example, was cited for repeated violations of overtime standards and falsification of records. The compliance team established action plans, which three different Nike business units worked with the factory to implement. After six months of continuous efforts, and no improvement, the factory was dropped. In November 2006, Nike severed its business relationship with a Pakistani supplier of soccer balls that failed to correct serious code of conduct violations.

More typically, Nike’s decisions to end a business relationship with problem suppliers was based on a balanced scorecard of factory performance that took into account labor code compliance along with such measures as price, quality, and delivery time. For example, a manufacturing group in South Asia had performed poorly on a range of issues, from overtime and worker–management communication to the quality of product and shipping dates. After a series of performance reviews, Nike management informed the factory group that it would not be placing orders for the next season. Nike did not report on factories dropped solely from noncompliance reasons related to its code of conduct because, management said, “it is often difficult to isolate poor performance on compliance as the sole reason for terminating a business relationship.”

To give its contract manufacturers greater incentive to comply with Nike’s workplace standards and expectations, during crunch production periods Nike management and plant auditors had given some factories latitude to institute long workweeks (above 72 hours) and not hold them to a strict standard of 1 day off out of every 14 days if the employer gave workers more days off during slack production periods. Nike was also working to streamline its methods of designing shoes and placing orders with key suppliers and helping foreign factories develop more
efficient production techniques, so as to help contract factories eliminate the need to institute long workweeks and excessive overtime. According to Nike’s vice president for global footwear operations, “If you improve efficiency and innovation, it changes the cost equation” for factories.20

Wal-Mart’s Supplier Code of Conduct and Compliance Monitoring Program

In 1992, Wal-Mart established a set of standards for its suppliers and put in place an ethical standards program to monitor supplier compliance with these standards.21 Since then, Wal-Mart’s standards for suppliers had been periodically evaluated and modified based on experience and feedback from the ethical sourcing community. The company’s standards for suppliers covered compensation, working hours, forced labor, underage labor, discrimination, compliance with applicable national laws and regulation, health and safety practices, environmental abuse, freedom of association and collective bargaining, rights concerning foreign contract workers, and the right of audit by Wal-Mart.

Prior to contracting with any supplier, Wal-Mart required suppliers to review and sign a supplier agreement, which incorporated an expectation that the supplier would comply with Wal-Mart’s standards for suppliers. In addition, it was mandatory that all suppliers display Wal-Mart’s “Standards for Suppliers” poster in all of the suppliers’ factories. Factory management was required to sign that it had read and fully understood the “Standards for Suppliers” poster, and a copy of the poster in the relevant language had to be posted in a public place within the factory. Wal-Mart’s “Standards for Suppliers” poster was available in 25 languages.

In February 2002, Wal-Mart created the Global Procurement Services Group (GPSG), which was charged with identifying new suppliers, sourcing new products, building partnerships with existing suppliers, managing Wal-Mart’s global supply chain of direct imports, providing workplace standards training to suppliers, and enforcing compliance with Wal-Mart’s supplier standards. All Wal-Mart personnel engaged in monitoring supplier compliance became part of the GPSG organization. In 2007, GPSG consisted of about 1,600 people working from offices in 23 countries, including China, Indonesia, India, Pakistan, Sri Lanka, Bangladesh, Honduras, Nicaragua, Guatemala, Mexico, Brazil, and Turkey (countries where supplier compliance presented big challenges).

In 2005–2006, Wal-Mart purchased goods from about 7,200 factories in over 60 countries; about 2,000 of the 7,200 factories had recently come into Wal-Mart’s compliance and factory audit system due to mergers, acquisitions, and new factory construction. About 200 Wal-Mart personnel scattered across GPSG’s offices in all 23 countries were engaged in monitoring suppliers for compliance with Wal-Mart’s standards for suppliers. Suppliers covered by Wal-Mart’s ethical standards program had to disclose the factory (or factories) used to fulfill each order placed by Wal-Mart.

Wal-Mart’s Supplier Auditing Program and Compliance Rating System

During 2005, Wal-Mart audited more factories than any other company in the world, performing 14,750 initial and follow-up audits of 7,200 supplier factories; in 2004, Wal-Mart conducted 12,561 factory audits. The company’s audit methodology and its factory rating system are described in Exhibit 4. A summary of Wal-Mart’s audit findings for 2004 and 2005 is contained in Exhibit 5. Wal-Mart management said that the greater incidence of violations in 2005 compared to 2004 was primarily due to a 100 percent increase in unannounced audits, increased rigor of supplier standards, a reclassification of violations to strengthen and reinforce their severity, the implementation of team audits, and greater auditor familiarity with the factories and their workers.

Rather than banning the placement of orders at supplier factories receiving Yellow (medium-risk violations) and Orange (high-risk violations) ratings, Wal-Mart’s policy was to work with supplier factories to reduce violations and achieve steady improvement of workplace conditions, a position widely endorsed by most human rights activists, concerned citizens groups, and nongovernmental agencies striving for better factory conditions for low-wage workers. To help promote higher levels of supplier compliance, Wal-Mart trained more than 8,000 supplier personnel in 2004 and another 11,000
suppliers and members of factory management in 2005. The training focused on increasing supplier familiarity with Wal-Mart’s standards for suppliers and encouraging an exchange of information about factory operating practices. Wal-Mart also actively worked with its foreign suppliers on ways to do better
production planning, enhance plant efficiency, better educate and train workers, make supply chain improvements, and adopt better factory operating practices. Wal-Mart also consulted with knowledgeable outside experts and organizations on ways to accelerate ethical compliance and the achievement of better working conditions in supplier factories.

Upon learning of the incident in the BusinessWeek report cited in the opening of this case, Wal-Mart began an investigation of the Beifa factory in Ningbo. Wal-Mart acknowledged that some of its suppliers were trying to deceive plant monitors and avoid complying with Wal-Mart’s standards for suppliers.

**COMPLIANCE EFFORTS OF INDUSTRY GROUPS AND NONGOVERNMENTAL ORGANIZATIONS—THE FAIR LABOR ASSOCIATION**

Some companies, rather than conducting their own supplier monitoring and compliance effort, had banded together in industry groups or multi-industry coalitions to establish a common code of supplier conduct and to organize a joint program of factory inspections and compliance efforts. For example, Hewlett-Packard, Dell, and other electronics companies that relied heavily on Asia-based manufacturers to supply components or else assemble digital cameras, handheld devices, and personal computers had entered into an alliance to combat worker abuse and poor working conditions in the factories of their suppliers.

**The Fair Labor Association**

One of the most prominent and best organized coalitions was the Fair Labor Association (FLA), whose members and affiliates included 194 colleges and universities, a number of concerned nongovernmental organizations, and a group of 35 companies that included Nike, the Adidas Group (the owner of both Reebok and Adidas brands), Puma, Eddie Bauer, Liz Claiborne, Patagonia, Cutter & Buck, Russell Corporation, and Nordstrom. As part of its broad-based campaign to eliminate human rights abuses and improve global workplace conditions, the FLA had established its Workplace Code of Conduct, a document to which all members and affiliates had subscribed. To aid in winning supplier compliance with the Workplace Code of Conduct, the FLA conducted unannounced audits of factories across the world that supplied its members and affiliates.

In 2004, FLA’s teams of independent plant monitors conducted inspections at 88 factories in 18 countries, the results of which were published in FLA’s 2005 annual public report. The audits, all of which involved factories that were supplying goods to one or more FLA members, revealed 1,603 instances of noncompliance with FLA’s Workplace Code of Conduct, an average of 18.2 violations per factory (versus an average of 15.1 per factory in 2003). The violations included excessive work hours, underpayment of wages and overtime, failure to observe legal holidays and grant vacations (27.5 percent); health and safety problems (44 percent);
and worker harassment (5.1 percent). The FLA concluded that the actual violations relating to underpayment of wages, hours of work, and overtime compensation were probably higher than those discovered because “factory personnel have become sophisticated in concealing noncompliance relating to wages. They often hide original documents and show monitors falsified books.”

In its 2006 public report, the FLA said that accredited independent monitors conducted unannounced audits of 99 factories in 18 countries in 2005; the audited factories employed some 77,800 workers. The audited factories were but a small sample of the 3,753 factories employing some 2.9 million people from which the FLA’s 35 affiliated companies sourced goods in 2005; however, 34 of the 99 audited factories involved facilities providing goods to 2 or more of FLA’s 35 affiliated companies. The 99 audits during 2005 revealed 1,587 violations, an average of 15.9 per audit. The greatest incidence of violations was found in Southeast Asia (chiefly factories located in China, Indonesia, Thailand, and India), where the average was about 22 violations per factory audit. As was the case with the audits conducted in 2004, most of the violations related to health and safety (45 percent); wages, benefits, hours of work, and overtime compensation (28 percent); and worker harassment and abuse (7 percent). Once again, the FLA indicated that the violations relating to compensation and benefits were likely higher than those detected in its 2005 audits because “factory personnel have become accustomed to concealing real wage documentation and providing falsified records at the time of compliance audits, making any noncompliances difficult to detect.”

The Fair Factories Clearinghouse

The Fair Factories Clearinghouse (FFC)—formed in 2006 by World Monitors Inc. in partnership with L. L. Bean, Timberland, Federated Department Stores, Adidas/Reebok, the Retail Council of Canada, and several others—was a collaborative effort to create a system for managing and sharing factory audit information that would facilitate detecting and eliminating sweatshops and abusive workplace conditions in foreign factories; membership fees were based on a company’s annual revenues, with annual fees ranging from as little as $5,000 to as much as $75,000 (not including one-time initiation fees of $2,500 to $11,500). The idea underlying the FFC was that members would pool their audit information on offshore factories, creating a database on thousands of manufacturing plants. Once a plant was certified by a member company or organization, other members could accept the results without having to do an audit of their own.

Audit sharing had the appeal of making factory audit programs less expensive for member companies; perhaps more important, it helped reduce the audit burden at plants having large number of customers that conducted their own audits. Some large plants with big customer bases were said to undergo audits as often as weekly and occasionally even daily; plus, they were pressured into having to comply with varying provisions and requirements of each auditing company’s code of supplier conduct—being subject to varying and conflicting codes of conduct was a factor that induced cheating. Another benefit of audit sharing at FFC was that members sourcing goods from the same factories could band together and apply added pressure on a supplier to improve its working conditions and comply with buyers’ codes of supplier conduct.

THE OBSTACLES TO ACHIEVING SUPPLIER COMPLIANCE WITH CODES OF CONDUCT IN LOW-WAGE, LOW-COST COUNTRIES

Factory managers subject to inspections and audits of their plants and work practices complained that strong pressures from their customers to keep prices low gave them a big incentive to cheat on their compliance with labor standards. As the general manager of a factory in China that supplied goods to Nike said, “Any improvement you make costs more money. The price [Nike pays] never increases one penny but compliance with labor codes definitely raises costs.”

The pricing pressures from companies sourcing components or finished goods from offshore factories in China, India, and other low-wage, low-cost
locations were acute. Since 1996, the prices paid for men’s shirts and sweaters sourced in China were said to have dropped by 14 percent, while the prices of clocks and lamps had dropped 40 percent and the prices of toys and games had fallen by 30 percent.28 Such downward pressure on prices made it financially difficult for foreign manufacturers to improve worker compensation and benefits, make their workplaces safer and more pleasant, introduce more efficient production methods, and overhaul inefficient plant layouts. Many factory managers believed that if they paid workers a higher wage, incurred other compliance costs, and then raised their prices to cover the higher costs that their customers would quickly cut and run to other suppliers charging lower prices. Hence, the penalties and disincentives for compliance significantly outweighed any rewards.

In a 2006 interview with BusinessWeek, the CEO of the Fair Labor Association, Auret van Heerden, offered a number of reasons why underpayment of wages and excessive overtime in supplier factories in China were such difficult problems to resolve:

The brands book and confirm orders really late. And they often change their orders after booking. The brands want to order later and they don’t want to hold product. Then you add price pressures into that and it is really tough for the supplier [to not overwork its workers].

But the factory often doesn’t order the materials until too late and they are often delivered late [to the factory], too. The factory production layout is often a mess, so the supplier gets behind schedule and over budget even before they know it. Then they have to catch up. And to save money, they extend hours, but don’t pay overtime premiums. And the suppliers also lack proper training. The styles [of clothing and footwear] are becoming more complicated and are changing more frequently.

Multiple codes are a big problem. The classic example is the height that a fire extinguisher should be kept off the ground—how high varies according to different codes. Companies like McDonald’s, Disney, and Wal-Mart are doing thousands of audits a year that are not harmonized. That’s where audit fatigue comes in.

And auditing in itself tells you a little about the problem, but not enough, and not why there is a problem. So you have an overtime problem, but you don’t know why. Is it because of electricity shortages, labor shortages, or a shorter order turnaround time? You don’t know.29

Endnotes

2Ibid., p. 50.
3Ibid., p. 52.
4Ibid., p. 54.
5Ibid., p. 54.
6Ibid., p. 50.
7Ibid., p. 55.
8Ibid., p. 53.
9Ibid., pp. 55–56.
10Ibid., p. 53.
13Ibid., p.25
14Ibid., p. 29.
15Ibid., p. 20.
16Ibid., p. 30.
17Ibid., p. 25.
20The content of this section was developed by the case author from information posted in the supplier section at www.walmartstores.com (accessed January 25, 2007).
21These results of the audits were published in the Fair Labor Association’s 2005 annual public report, posted at www.fairlabor.org (January 23, 2007).
22These results of the audits were published in the Fair Labor Association’s 2005 annual public report, posted at www.fairlabor.org (January 23, 2007).
25Ibid., p. 40.
27As quoted in ibid., p. 53.
28Ibid., p. 58.
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