Strategic Management

GLOBAL
professional
publishing

GLOBAL
professional
publishing

Strategic Management

Concepts and Tools

Dr. Jae K. Shim, MBA, Ph.D.

Professor of Business
California State University, Long Beach
and
CEO, Delta Consulting Company

GLOBAL
professional
publishing

© Jae K Shim 2011

Apart from any fair dealing for the purpose of research or private study, or criticism or review, as permitted under the Copyright, Designs and Patents Act 1988, this publication may only be reproduced, stored or transmitted, in any form or by any means, with the prior permission in writing of the publisher, or in the case of reprographic reproduction in accordance with the terms and licences issued by the Copyright Licensing Agency. Enquiries concerning reproduction outside those terms should be addressed to the publisher. The address is below:

Global Professional Publishing Ltd
Random Acres, Slip Mill Lane
Hawkhurst, Cranbrook
Kent TN18 5AD
Email: publishing@gppbooks.com

Global Professional Publishing believes that the sources of information upon which the book is based are reliable, and has made every effort to ensure the complete accuracy of the text. However, neither Global Professional Publishing, the authors nor any contributors can accept any legal responsibility whatsoever for consequences that may arise from errors or omissions or any opinion or advice given.

ISBN 978-1-906403-XX-X

Printed by Berforts, United Kingdom

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that neither the author nor the publisher is engaged in rendering legal, accounting, or other professional service. If legal advice or other expert assistance is required, the services of a competent professional person should be sought.
All numerical values in this book are examples subject to change. The current values may vary and may not be valid in the present economic environment.

For full details of Global Professional Publishing titles in Management, Finance and Banking see our website at:
www.gppbooks.com

Contents

Preface		vii
Chapter 1	Strategic management: an overview	1
Chapter 2	Environmental Analysis	27
Chapter 3	Industry and Competitor Analysis	43
Chapter 4	Internal Appraisal	55
Chapter 5	Strategic Formulation	81
Chapter 6	Strategic Choice	105
Chapter 7	Strategic Implementation Issues	119
Chapter 8	Strategic Evaluation and Control	131
Chapter 9	Crafting Global Strategy	157
Glossary		183
Index		195

GLOBAL professional publishing

GLOBAL
professional
publishing

Preface

Strategic management is a continuing process that evaluates and controls the business and the industries in which the company is involved; assesses its competitors and sets goals and strategies to meet all existing and potential competitors; and then reassesses each strategy regularly to determine how it has been implemented and whether it has succeeded or needs replacement by a new strategy to meet changed circumstances, new technology, new competitors, a new economic environment., or a new social, financial, or political environment.

Strategic vision and action are necessary to enhance a company's competitive superiority, achieve superior performance, and improve its value. It entails specifying the organization's mission, vision and objectives, developing policies and plans, often in terms of projects and programs, which are designed to achieve these objectives, and then allocating resources to implement the policies and plans, projects and programs. A balanced scorecard is often used to evaluate the overall performance of the business and its progress towards objectives. Recent studies and leading management theorists have advocated that strategy needs to start with stakeholders expectations and use a modified balanced scorecard which includes all stakeholders.

This book introduces, explains, and analyzes the activities needed to develop, select, implement, and evaluate a firm's competitive strategy. It illustrates development, implementation, and reformulation of corporate, business, and functional strategies. Emphasis is placed on the need for awareness of, and accommodation to, changes in an organization's internal and external environments. Generic types of strategies and techniques for analyzing strategies are also covered.

Jae K Shim

GLOBAL
professional
publishing

Jae K Shim

Dr. Jae K. Shim is a Professor of Business at California State University, Long Beach and CEO of Delta Consulting Company, a financial consulting and training firm. Dr. Shim received his M.B.A. and Ph.D. degrees from the University of California at Berkeley (Haas School of Business). Dr. Shim has been a consultant to commercial and nonprofit organizations for over 30 years.

Dr. Shim has over 50 college and professional books to his credit, including, *Barron's Accounting Handbook*, *Barron's Dictionary of Accounting Terms*, *2010 GAAP: Handbook of Policies and Procedures*, *Strategic Business Forecasting*, *Management Accountant's Standard Desk Reference*, *Analysis and Uses of Financial Statements*, *Budgeting Basics and Beyond*, *2010-2011 Corporate Controller's Handbook of Financial Management*, *US Master Finance Guide*, *Uses and Analysis of Financial Statements*, *Investment Sourcebook*, *Dictionary of Real Estate*, *Dictionary of International Investment Terms*, *Dictionary of Business Terms*, *The Vest-Pocket CPA*, *The Vest-Pocket CFO*, and the best-selling *Vest-Pocket MBA*.

Thirty of his publications have been translated into foreign languages such as Chinese, Spanish, Russian, Polish, Croatian, Italian, Japanese, and Korean. Professor Shim's books have been published by CCH, Barron's, John Wiley, McGraw-Hill, Prentice-Hall, Penguins Portfolio, Thomson Reuters, Global Professional Publishing, American Management Association (Amacom), and the American Institute of CPAs (AICPA).

Dr. Shim has also published numerous articles in professional and academic journals. He was the recipient of the Financial Management Association International's 1982 Credit Research Foundation Award for his article on cash flow forecasting and financial modeling.

Dr. Shim has been frequently quoted by such media as the *Los Angeles Times*, *Orange County Register*, *Business Start-ups*, *Personal Finance*, and *Money Radio*. He also provides business content for mobile learning apps to iPhone, iPod, iPad, Blackberry, Android, Droid, and Nokia.

GLOBAL professional publishing

GLOBAL
professional
publishing

CHAPTER 1

Strategic management: an overview

Strategy can be defined as "a course of action or a plan, including the specification of resources required, to achieve a specific objective." What separates a powerful strategy from an ordinary or weak one is management's ability to forge a series of moves, both in the marketplace and internally, that sets the company's product or service apart from those of rivals and produces sustainable competitive advantage.

All business organizations have objectives, but because of the dynamic nature of the organizations' environment, overall plans or strategies are needed to specify in broad terms just how the objectives of the organization can be achieved, given the uncertainty of the environment.

When considering strategies, the three key focuses are economy, effectiveness, and efficiency (known as the 3E's). Effectiveness focuses on the achieving of the goals and objectives, economy focus on the most cost effective obtaining of resources (manpower, materials, machinery, and money - the 4M's) and efficiency focus on the best usage of the resources.

Strategic management is therefore concerned with deciding on a strategy and planning how that strategy is to be put into effects. As such, strategic management has general relevance in that strategic management is relevant for managers in all types of organizations, both profit seeking and non-profit organizations, state and private sector. Strategic Management is the process by which top management determines the long-run direction and performance of the organization by ensuring that careful formulation, effective implementation. And continuous evaluation of the strategy takes place.

Moreover, strategic management is an iterative process - it is a continuous process. Today's strategic change will become tomorrow's situation. Strategic management also embraces decisions, which may not have been considered strategically important

when they were made, but may become very significant in time. Seemingly innocuous decisions may in time become strategically important, and so even seemingly innocuous decisions therefore require a strategic perspective to ensure that all of the ramifications of the action are considered.

The strategic management process

A description of the strategic management process involves the use of terms and expressions that have a variety of meanings and interpretations depending on the author and source. For example, some of the phrases used interchangeably with strategic management are *strategy and policy formulation, long-range planning,* and *business policy*. The purpose of this chapter is to define the terminology used in this course and to present a framework for analysis of the strategic management process.

Basically, strategic management can be broken down into three phrases: strategy planning and strategy formulation, strategy implementation, and strategy evaluation. *Strategy planning and strategy formulation* involves the following steps:

1. Defining the organization's guiding philosophy, purpose, and mission.
2. Establishing long-range objectives to achieve the mission.
3. Selecting the strategy to achieve the long-range objectives.

Strategic implementation is concerned with aligning the organizational structure, systems, and processes with the chosen strategy. It involves making decisions with regard to:

1. Developing an organizational structure, selecting leadership, and providing motivational systems to achieve the strategy.
2. Establishing short-range objectives, developing budgets, and developing functional strategies to achieve the strategy.

Strategy evaluation, sometimes referred to as strategic evaluation and control, involves the following activities:

1. Establishing standards of performance for the overall organization and its different units or functional areas.
2. Monitoring progress in the execution of the organization's strategy. This requires assessing and measuring the implementation of the strategies pursued by different units throughout the organization.
3. Initiating corrective actions to ensure continued commitment to the implementation of the strategy. Taking corrective actions requires the timely dissemination of feedback data to the managers of the organization's different units, its top executives, and members of its board of directors.

GLOBAL professional publishing

Strategic planning

Strategic planning is the process of setting overall organizational objectives and drafting strategic plans. It is a process of long-term planning. Setting ultimate objectives for the firm is a necessary prelude to developing strategies for achieving those objectives. Strategic planning, also *called long-term planning*, covers periods from 1 to 20 years. Strategic planning is somewhat difficult because of uncertainty about future conditions. Thus, long-range plans are more general and exclude operational detail (for example, functional aspects such as departmental budget preparation, variance analysis, outsourcing decisions, material procurement, etc.) and short-term activity. Therefore, top-level management participation is a crucial element of strategic planning. Strategic planning follows a formal five-step process.

1. *Formulate the mission statement.*
    1) A mission statement formally conveys the definition of the firm for the stakeholders, the firm's vision, a broad description of how to realize that vision, firm priorities, and common objectives. It answers "Who are we and what do we do?"
    2) Moreover, it should state a philosophy that informs all firm activities and inspires all members of the firm to believe they are important to its success.
    3) Accordingly, a mission statement should address reasonably limited objectives, define the firm's major policies and values (e.g., service, quality, social responsibility, and financial performance), and state the firm's primary competitive scopes (e.g., industries, products and services, applications, core competencies, market segments, degree of vertical integration, and geographic markets).

2. *Analyze the firm's external environment.*
    1) Opportunities and threats (the external environment) are identified by considering macroenvironment factors (economic, demographic, political, legal, social, cultural, and technical) and microenvironment factors (suppliers, customers, distributors, competitors, and other competitive factors in the industry).
    2) Opportunities and threats arise from such externalities as government regulation, advances in technology, and demographic changes. They may be reflected in such competitive conditions as
        a) Raising or lowering of barriers to entry into the firm's industry by competitors
        b) Changes in the intensity of rivalry within the industry, for example, because of overcapacity or high exit barriers

c) The relative availability of substitutes for the firm's products or services
d) Bargaining power of customers, which tends to be greater when switching costs are low and products are not highly differentiated
e) Bargaining power of suppliers, which tends to be higher when suppliers are few

3) Risks should be assessed based on forecasts of the effects of factors relevant to the organization, such as market trends, technology development, international competition, governmental changes, and social evolution.

3. *Analyze the firm's internal environment.*

1) A situational analysis considers organizational strengths and weaknesses (a capability profile) and their interactions with environmental opportunities and threats. Such an evaluation is also called a SWOT analysis.
2) Strengths and weaknesses (the internal environment) are usually identified by considering the firm's capabilities, resources, and limitations.
3) Strengths and weaknesses are internal resources or a lack thereof. For example, technologically advanced products, a broad product mix, capable management, leadership in R&D, modern production facilities, and a strong marketing organization.
4) What the firm does particularly well or has in greater abundance are known as core competencies. Core competencies are the source of competitive advantages. For example, speed in reacting to environmental changes or in introducing new products. To exploit a competitive advantage to the fullest, the organization may have to reengineer its processes.
5) Cost and quality are other basic factors highlighted in the SWOT analysis.

4. *Select appropriate strategies and create strategic business units.*

1) Businesses should be defined in market terms, that is, in terms of needs and customer groups. Moreover, a distinction should be made between a target market definition and a strategic market definition. For example, a target market for a railroad might be freight hauling, but a strategic market might be transportation of any goods and people.

2) A business also may be defined with respect to customer groups, their needs, and the technology required to satisfy those needs.
3) A large firm has multiple businesses. Thus, the concept of the strategic business unit (SBU) is useful for strategic planning by large firms. An SBU is a business (or a group) for which separate planning is possible. An SBU also has its own competitors and a manager who engages in strategic planning and is responsible for the major determinants of profit. Determining the strength of each SBU with respect to its potential markets and the position of businesses in those markets is called business portfolio management.

5. *Implement the chosen strategies.*
   1) Strategic plans must be filtered down the organizational structure through development of plans at each lower level that are congruent with higher level plans.
   2) This process is most likely to succeed if the structure is compatible with strategic planning, personnel have the necessary abilities, the organizational culture is favorable or can be changed, and controls exist to facilitate implementation.

Note: Strategic analysis, which is the analytical process of strategic (long-range) planning. Sometimes, the terms strategic *analysis* and *strategic planning* are used interchangeably. Strategic analysis includes identifying organizational objectives, evaluating the strengths and weaknesses of the organization, assessing risk levels, and forecasting the future direction and influences of factors relevant to the organization, such as market trends, changes in technology, international competition, and social change. The final step is to derive the best strategy for reaching the objectives.

Defining the organization's Guiding Philosophy

An organization's guiding philosophy establishes the values and beliefs of the organization about what is important in both life and business, how business should be conducted, its view of humanity, its role in society, the way the world works, and what is to be held inviolate. An organization's philosophy establishes the relationship between the organization and its stakeholders, employees, customers, shareholders, suppliers, government, and the public at large.

The guiding philosophy of an organization should normally be a rather permanent statement and is usually articulated by the chief executive officer. For small businesses, the owner establishes the philosophy either in writing or through his or her personal

behavior. In many larger organizations, the founder of the business establishes the corporate philosophy and it is maintained throughout the life of the organization.

The content and specific wording of organizational statements of philosophy vary from organization to organization. The philosophies of excellent companies typically include the following basic beliefs:

1. Belief in being the best,
2. Belief in the importance of the details of execution, the nuts and bolts of doing the job well.
3. Belief in the importance of people as individuals.
4. Belief in superior quality and service.
5. Belief that most members of the organization should be innovators, and, its corollary, the willingness to support failure.
6. Belief in the importance of informality to enhance communication.
7. Belief in recognition of the importance of economic growth and profits.

It is extremely important to remember that, if an organization's philosophy is to have meaning, it must be adhered to in all situations. Ignoring the organizational philosophy in crisis situations is a major mistake for management. It is through the day-to-day decisions and actions of management that philosophies are confirmed and strengthened or become meaningless words on a piece of paper.

Developing organizational policies from the Guiding Philosophies

Finally, an organization's guiding philosophy provides the general framework for the establishment of organizational policies. *Organizational policies provide guides to action for employees of the organization*. Policies help to ensure that all units and levels of an organization operate within the guiding philosophy. They also facilitate coordination and communication between various organizational units. For example, in an organization with empowered work teams, organizational policies should define the limits or constraints within which the work teams must act if they are to remain self-directing. Once the organization defines its objectives and guiding philosophy and sets appropriate policies, the work teams are able to make and implement decisions within those boundaries.

Several other factors influence the formulation of policies. One important factor has been federal, state, and local government. Government regulates organizations in such areas as competition (antitrust and monopoly), product standards (safety and quality), pricing (utilities), hiring practices (civil rights), working conditions (Occupational Safety and Health Administration, or OHSA, regulations), wages (minimum wages), accounting practices (income tax regulation), and issuance of

stock (Securities and Exchange Commission, or SEC regulations). Policies need to be developed to guide employees in following these regulations. For example, as a result of government regulation, many organizations have developed a policy that declares the organization's unqualified opposition to all forms of discrimination. Policies of competitors also influence an organization's policies. This is especially true with human resource policies, such as wages, benefits, and working conditions.

An extremely important consideration in policy formulation is that policies should facilitate the successful accomplishment of organizational objectives. All too frequently policies emerge from history, tradition, and earlier events. Changing environment conditions and changed organizational objectives should trigger an evaluation of organizational policies to ascertain if they are still appropriate or should be changed. Exhibit 1.1 presents several examples of organizational policies.

Exhibit 1.1: Examples of Organizational Policies

1. To answer all written consumer complaints in writing (e.g., *policy of a firm's public relations department*.)
2. To distribute at least 30 percent of net earnings to stockholders (e.g., *policy of any organization*.)
3. To accept all returns that are accompanied by a sales slip (e.g., *policy of retail store*.)
4. To require a minimum down payment of 10 percent of the purchase price (e.g., *policy of a mortgage company*.)
5. To pay the shipping costs of all goods bought from the company (e.g., *policy of an online retail store or shopping club*.)

Note: Formal written policies are recommended. However, the presence of certain conditions in an organization minimizes the need for written policies. One condition that minimizes the need for written policies is a strong organizational culture. If the culture is strong, the organization's key values are intensely held and widely shared. Substantial training has been expended to achieve this high degree of acceptance, minimizing the need for formal, written policies.

Defining the organization's purpose

Organizational purpose defines the fundamental reason for the organization's existence. Organizations should be able to describe their reason for being in one or

two sentences. The reason for being should clearly describe how the organization fills basic human needs or how it impacts the world. Some examples of organizational statements of purpose include the following:

Merck

Our business is preserving and improving human life. We also work to improve animal health. (ww.merck.com/about/our-values/home.html?WT.svl=mainnav)

Intel

We are Intel Sponsors of Tomorrow™, not only through our technical innovation, but through our endless efforts in education, environmental sustainability, healthcare, and much, much more. We believe that technology makes life more exciting and can help improve the lives of people around the world. Therein lies the endless opportunity. (www.intel.com/about/index.htm?iid=gg_about+intel_aboutintel)

Chick-fil-a

To be America's best quick-service restaurant. (www.chick-fil-a.com/#facts)

While many organization's explicitly record their organizational purpose, purpose may also be implicit. The term *organizational purpose* is used to refer to an explicit or implicit understanding of why the organization exists. When this understanding is shared and agreed on by the management of an organization, it provides a common framework for decision making that provides direction for the organization.

An explicit statement of purpose guides a variety of decisions that insiders, as well as outsiders, make regarding their association with, support of, and actions for the organization. While an explicit statement of purpose is typically simple and straightforward, it is an important determinant of organizational direction and commitment. Organizational purpose is communicated to outsiders through public statements, corporate mottoes, and slogans. These outsiders become stakeholders

in the organization if the purpose of the organization attracts them as customers, investors, or employees. Organizational purpose if communicated to the employees through not only the written and oral statements of management but also by the actions of management. Organizational philosophy and purpose influence ethical, personal, and strategic decisions made by management and employees and set limits within which the organization will operate.

Organizational slogans or mottoes can be indicators of organizational purpose. Lexus the phrase, "Pursuing Perfection."; for many years General Electric's Motto has been, "Imagination at Work." Both mottoes associated the organizations with advancement through technology without being specific enough to be restrictive.

Organizational statements of purpose are determined by an organization by asking itself the following types of questions: What would the world lose if our company ceased to exist? Why do we want to dedicate our creative energies to this company's efforts? What does our organization do to fill basic human needs? What does our organization do that impacts the world?

Defining the organization's mission

An organization's mission is an overall goal of the organization that provides a sense of direction and a guide to decision making for all levels of management. Without a clear mission, it is virtually impossible for an organization to develop objectives and strategies. *Organizational mission* should define the organization's line or lines of business, identify its products and services, and specify the markets it serves at present and within a time frame of three to five years. It provides an overall guide to those in high-level, decision-making positions. It increasingly is concerned with the moral and ethical principles that guide the actions of the firm.

An effective mission should be challenging to the organization, but should be achievable. It should be in writing and should also have a time frame for achievement. Thus, a mission statement does *not* announce specific operating plans. It does not describe strategies for technological development, market expansion, or product differentiation because these are tasks for operating management.

No widely accepted standard exists for the contents and format of a mission statement. One study suggested that a mission statement should include the following components:

Target customers and markets.

Principal products and services.
Geographical domain
Core technologies.
Concern for survival, growth, and profitability.

Organizational self-concept.
Desired public image.

It is important to note, however, that organizational philosophy, purpose, and mission statements are not always separate and distinct documents. Often these statements are combined into one document, but that one document still embodies the essential features of the philosophy, purpose, and mission statements from the previous paragraphs.

Exhibit 1.2 presents some examples of mission statements from real enterprises.

Exhibit 1.2: Examples of Mission Statements

Walgreens

We will treat each other with respect and dignity and do the same for all we serve.

We will offer employees of all backgrounds a place to build careers.

We will provide the most convenient access to healthcare services and consumer goods in America.

We will earn the trust of our customers and build shareholder value.

Trader Joe

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.

3M

"To solve unsolved problems innovatively"

Mary Kay Cosmetics

"To give unlimited opportunity to women."

Merck

"To preserve and improve human life."

GLOBAL professional publishing

Wal-Mart

"To give ordinary folk the chance to buy the same thing as rich people."

Walt Disney

"To make people happy."

Starbuck

"To inspire and nurture the human spirit – one person, one cup and one neighborhood at a time."

These are the 'one-liners', but each is supported by a set of values that set the performance standards and direct the implementation of the mission. For example, Merck, a company that produces pharmaceutical products and provides insurance for pharmacy benefits, publicly states the following values.

- Corporate social responsibility
- Unequivocal excellence in all aspects of the company
- Science-based innovation
- Honesty & integrity
- Profit, but profit from work that benefits humanity

And Walt Disney, an entertainment business states their values as follows.

- No cynicism
- Nurturing and promulgation of "wholesome American values"
- Creativity, dreams and imagination
- Fanatical attention to consistency and detail
- Preservation and control of the Disney "magic"

An organization's mission is not determined by the organization itself but rather by its customers. Customer satisfaction with an organization's products and services defines its mission. Thus, defining an organization's mission starts with a clear description of its customers. Questions that need to answered are:

1. Who is the customer?
    a. Where is the customer located?
    b. How does the customer buy?
    c. How can the customer be reached?

2. What does the customer buy?
3. What does the customer consider value? (What does the customer look for when he or she buys the product?)

Since a mission statement is also concerned with an organization's future business activities, its potential customers must also be described. The following questions need to be answered:

1. What are the market trends and market potential?
2. What changes in market structure might occur as a result of economic developments, changes in styles or fashions, or moves by the competition?
3. What innovations will alter the customer's buying habits?
4. What needs does the customer currently have that are not being adequately met by available products and services?

One final question needs to be addressed in determining an organization's mission: Is the organization in the right business, or should it change its business?

Mission and management

Mission must be communicated to and internalized by managers and employees. When a mission is recognized and accepted by managers and employees, it becomes a common framework for making decisions and setting priorities. It is something that everyone in the organization is aware of, and employees can relate their activities to other activities through the mission.

Mission provides criteria for strategy selection by the management of the organization. Many potential acquisitions or diversification moves have been ruled out because the new business was not within the framework established by the organization's mission. Mission defines the boundaries or domain within which the organization will operate. These boundaries may be defined as industries or types of industries. Mission does not prevent change, it simply provides direction for seeking new opportunities. A good mission statement is broad enough to allow exploration of new opportunities but specific enough to prevent the organization from going too far afield.

Mission and stakeholders

Many individuals and groups outside the organization make decisions crucial to organizational success. The investment community makes judgments concerning the level of financial support it will provide; customers judge whether to support the organization by purchasing goods and services; and potential employees determine

whether their individual goals will be furthered by joining the organization. The mission of the organization can affect these decisions. There is little doubt that potentially valuable supporters can be lost if they do not approve the organization mission. It is important, therefore, that the mission be explicitly communicated to avoid misunderstanding of the fundamental purpose of the organization.

Changing the mission

An organization's mission must not only be defined at its inception but also must be reexamined regularly. Several factors can signal a need for a reexamination: declining profits and market share, changes in competitive position or top-level management personnel, new technologies, decreased availability or increased cost of resources, and changes in market demographics, government regulations, management in vague or undefined terms (i.e., things simply do not seem to be going right.) Top managers' skill in recognizing the need for change in mission and their ability to clearly delineate the new mission play a significant role in the future success of the organization.

Uniting for a mission

A company should not have mission soup: Each department has its own values, standards and loyalties that have melted into a chaotic mess. The fix is to become a "regular"—to identify a single corporate mission, and then make sure that all aspects of your organization serve that overarching goal. Below are some possible missions and examples of organizations that operate with them.

- Are you customer-focused? Wal-Mart's mission is simple: "We exist to provide value to our customers:' The entire focus of the organization is on doing whatever they can to keep prices low and selection high.

- Are you employee focused? Hewlett Packard, on the other hand, focuses on respect and opportunity for HP people, including giving them an opportunity to share in the success of the organization.

- Are your products and services the focus of your competitive advantage? Who can forget the classic Ford commercials that proclaimed that quality is job No. I? At a time when the quality of American cars was in decline, Ford's efforts went a long way to putting quality back into the vocabulary of American car producers.

- Do you value taking risks? Sony focuses its efforts on being a pioneer—not just following others, but doing the "impossible." Their support for employee risk-taking has resulted in products that have changed the way we spend our time.

Once each of these companies established a core mission, that mission became the driver of all operations.

Strategic vision versus Mission

Very early in the strategy-making process, a company's senior managers must wrestle with the issue of what directional path the company should take and what changes in the company's product-market-customer-technology focus would improve its current market position and future prospects. Top management's views and conclusions about the company's direction and the product-consumer-market-technology focus constitute a *strategic vision*. A strategic vision delineates management's aspirations for the business, providing a panoramic view of "where are we going" and a convincing rationale for why this makes good business sense for the company.

A strategic vision points an organization in a particular direction, charts a strategic path for it to follow in preparing for the future, and molds organizational identity. A clearly articulated strategic vision communicates management's aspirations to stakeholders and helps steer the energies of company personnel in a common direction. A strategic vision is a roadmap showing the route a company intends to take in developing and strengthening its business. It paints a picture of a company's destination and provides a rationale for going there.

Well-conceived visions are distinctive and specific to a particular organization; they avoid generic, feel-good statements. For a strategic vision to function as a valuable managerial tool, it must provide understanding of what management wants its business to look like and provide managers with a reference point in making strategic decisions and preparing the company for the future. Having a vision is not a panacea but rather a useful management tool for giving an organization a sense of direction. Like any tool, it can be used properly or improperly, either conveying a company's strategic course or not.

A strategic vision is different from a mission Statement: Whereas the chief concern of a strategic vision is with "where we are going and why", a company's mission statement usually deals with a company's present business scope and purpose –"who we are, what we do, and why we are here." A company's mission is defined by the buyer needs it seeks to satisfy, the customer groups and market segments it is endeavoring to serve, and the resources and technologies that it is deploying in trying to please its customers. Many companies prefer the term business purpose to mission statement, but the two phrases are essentially conceptually identical and are used interchangeably. Company mission statements almost never say anything about where the company is headed, the anticipated changes in its business, or its aspirations.

The distinction between a strategic vision and a mission statement is fairly clear-cut. A strategic vision portrays a company's future business scope ("where we are

going)" whereas a company's mission typically describes its present business scope and purpose ("what we do, why we are here, and where we are now").

Occasionally, companies couch their mission in terms of making a profit. The notion that a company's mission or business purpose is to make a profit is misguided – profit is more correctly an objective and a result of what a company does. If a company's mission statement is to have any managerial value or reveal anything useful about its business, it must direct attention to the particular market arena in which it operates – the buyer needs it seeks to satisfy, the customer groups and market segments it is endeavoring to serve, and the types of resources and technologies that it is deploying in trying to please customers.

Exhibit 1.3: Examples of strategic visions

Black & Decker Corporation

Establish the company as the preeminent global manufacturer and marketer of power tools and accessories, hardware and home improvement products, and technology-based fastening systems.

eBay

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

Red Hat Linux

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

Wells Fargo

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

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

Source: *Company documents and Web sites.*

Establishing organizational objectives

An *objective* is a statement of what is to be achieved. Objectives normally are stated in terms of desired level of attainment within a specific time frame. For example, one objective might be, "to increase sales revenues to $8 million by the end of the current fiscal year." Ideally, objectives are quantifiable, simply stated, and measurable.

Objectives can be classified as either short range or long range. Normally, objectives with a time span of one year or less are classified as short range: objectives spanning more than one year are classified as long range. While many managers use only short-range and long-range objectives, some also utilize intermediate-range objectives. In this context, intermediate range usually means one to three years, and long range means anything over three years.

Objectives also can be classified according to their breadth of influence in the organization. For example, objectives that apply to the entire organization are called *corporate*, or *organizational objectives*. Objectives that apply only to a certain division within an organization are referred to as *functional* or *departmental objectives*. Objectives are needed at the corporate level, at the line-of-business level, in key functional areas, and in key operating departments.

An organization's objectives depend on the particular organization and its mission. Although objectives can vary widely from organization to organization, normally they can be categorized as follows: (1) profitability; (2) service to customers, clients, or other recipients; (3) employee needs and well-being; and (4) social responsibility. Exhibit 1.4 presents examples of organizational objectives.

Many managers use the term *goal* interchangeably with *objective*, others envision goals as being somewhat broader and having longer range than objectives. Still others

refer narrowly to specific targets as goals. The problem with differentiating between goals and objectives is deciding just what the difference is. In other words, when does an objective become a goal, and vice versa? The terms objective and goal are used interchangeably in this course.

Exhibit 1.4: Examples of organizational objectives

DuPont

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

3M Corporation

To achieve long-term sales growth of 5 to 8 percent organic plus 2 to 4 percent from acquisitions; annual growth in earnings per share of 10 percent or better, on average; a return on stockholders' equity of 20 to 25 percent; a return on capital employed of 27 percent or better; to double the number of qualified new 3M product ideas and triple the value of products that win in the marketplace; to have at least 30 percent of sales come from products introduced in the past four years; and to build the best sales and marketing organization in the world.

GLOBAL professional publishing

Selecting a strategy

Originally, strategy literally meant the art and science of directing military forces. Today, the term is used in business to describe the steps taken by an organization in achieving its objectives and mission. Most organizations have several options available to them. Strategy is concerned with deciding which option is to be used. *Strategy is the determination and evaluation of alternatives available to an organization in achieving its objectives and mission and the selection of the alternative to be pursued.*

Identifying a Strategy

One approach to identifying the presence of a strategy is summarized below.

1. An organization that has no explicit strategy is relatively easy to identify. Its activities usually don't have a common thread, and executives leap at every opportunity as equally attractive or turn down all new ideas as equally risky. Lack of strategy does not always show up on the bottom line, especially in the short run. However, the probabilities of long-term success are greatly reduced without a consciously developed strategy.

2. Strategy may exist even when it is not formally developed and explicitly communicated. Entrepreneurs, for example, may have an intuitive understanding, which they have never really recorded or even verbalized, of how their company can successfully compete. Similarly, larger organizations may develop a strategy through a trial-and-error process without really articulating why they are able to exploit certain products and markets and are not able be successfully with others. The process of identifying strategy in the entrepreneurial or adaptive mode is similar to a detective process. The clues are provided by key decisions made over time. Similarities in these decisions allow the analyst to find patterns. These patterns constitute strategy.

3. If the strategy has been developed but not written, it becomes necessary to look for evidence (or components) of strategy, rather than for a statement of the strategy itself. The evidence is then used to construct a strategy statement. This may occur when an organization is in the early phases of the planning mode.

4. In this situation, a formally developed, written strategy makes identification simply a process of locating the statement of strategy or an individual who can divulge it. The situation usually occurs when an organization is in the later phases of planning.

Hierarchy of strategy

Strategies exist at different levels in an organization; they are classified according to the scope of what they are intended to accomplish. Most organizations can be segmented into business units (or strategic business units as they are frequently called.) Strategic business units (SBUs) are described in more detail later in this chapter. The typical large, multidivisional business firm has three levels of strategy: (1) corporate, (2) business, and (3) functional.

Corporate strategy describes a company's overall direction in terms of its general attitude toward growth and the management of its various businesses and product lines to achieve a balanced portfolio of products and services. Additionally, it is (a) the pattern of decisions regarding the types of businesses in which a firm should be involved, (b) the flow of financial and other resources to and from its divisions, and (c) the relationship of the corporation to key groups in its environment. Corporate strategy may be one of stability, growth, or retrenchment.

Business strategy, sometimes called *competitive strategy*, usually is developed at the divisional level, and emphasizes improvement of the competitive position of a corporation's products or services in the specific industry or market segment served by that division. A division's business strategy probably would stress increasing its profit margin in the production and sales of its products and services. Business strategies also should integrate various functional activities to achieve divisional objectives. Business (competitive) strategy may be one of overall cost leadership or differentiation.

Functional strategy is concerned primarily with maximizing resource productivity. Within the constraints of the corporate and business strategies around them, functional departments develop strategies to pull together their various activities and competencies to improve performance. For example, a typical strategy of a marketing department might center on developing ways to increase the current year's sales over those of the previous year. Under a market development functional strategy, the department would attempt to sell current products to different customers in the current market or to new customers in a new geographical area. Examples of R&D functional strategies are technological followership (imitate the products of other companies) and technological leadership (pioneer an innovation).

`The three levels of strategy—corporate, business, and functional—form a hierarchy of strategy within a large corporation. They interact closely and constantly and must be well integrated for corporate success. A division's external environment, for example, includes not only those task and societal variables of special importance to the division, but also the corporate mission, objectives, strategies, and policies. Similarly, both corporate and divisional constraints form a large part of the external environment of a functional department. Therefore the strategic plan for each lower level is constrained by the strategic plan(s) of the next higher level(s).

Exhibit 1.5 illustrates the Hierarchical relationships between purpose, vision, mission, objectives, corporate strategy, business (competitive) strategies, and functional strategies.

Exhibit 1.5: Hierarchy of Strategies

The specific operation of the hierarchy of strategy may vary from one corporation to another. In *top-down strategic planning,* corporate-level management initiates the strategy formulation process and calls on divisions and functional units to formulate their own strategies as ways of implementing corporate-level strategies. Another approach is *bottom-up strategic planning,* in which the strategic proposals from divisional or functional units initiate the strategy formulation process. Strategy formulation leads from the functional level to the divisional level and from the divisional to the corporate level. A third means of strategic planning, the *interactive approach,* emphasizes the fact that in most companies the origin of the strategy formulation process isn't as important as the resultant interaction between levels. This approach involves a lot of negotiation between levels in the hierarchy so that the various objectives, strategies, policies, programs, budgets, and procedures fit and reinforce each other. It represents a continuous process of adjustment between the formulation and implementation of each level of strategy.

Note: If a global company is to function successfully, strategies at different levels need to inter-relate. The strategy at corporate level must build upon the strategies at lower levels in the hierarchy (the bottom-up element of strategy). However, at the same time, all parts of the business have to work to accommodate the overriding corporate goals (the top-down approach).

Strategic business units

Strategic business unit (SBU) needs to be discussed before the strategic management process is analyzed in detail. Normally, an organization's activities can be segmented into business units. A business unit is an operating unit in an organization that sells a distinct set of products of services to an identifiable group of customers in competition with a well-defined set of competitors. Generally, the following criteria should be considered in classifying an organizational unit as an SBU:

1. An SBU should serve an external, rather than an internal, market: That is, it should have a set of external customers and not merely serve as an internal supplier.
2. It should have a clear set of external competitors, which it is trying to equal or surpass.
3. It should have control over its own destiny. This means that it must be able to decide for itself what products to offer, how and when to go to market, and where to obtain its supplies, components, or even products. This does not mean that it cannot use pooled resources, such as a common manufacturing plant, or a combined sales force, or even corporate R&D. The key is choice. It must be able to choose and not merely be the victim of someone else's decisions. It must have options from which it may select the alternative(s) that best achieves the corporate and the business objectives.

Its performance must be measurable in terms of profit and loss; that is, it should be a true profit center. SBUs operate within the objectives and strategy set by top management. Within that framework, each SBU performs its own strategic management process. The SBU's operations are either strengthened or weakened depending on the resources allocated to it at the corporate level.

Strategy and corporate social responsibility

The food industry is blamed for obesity. Mobile phone operators are challenged to protect teenagers from online pornography. Record companies are attacked when they sue music-lovers for sharing illegal files on the internet. Fair or not, big business is being called to justify its approach to a growing array of social, environmental and ethical concerns. Despite the economic downturn, many companies are concluding that they cannot afford not to invest in being seen as responsible.

Business for Social Responsibility (BSR), a non-profit advisory organization reports that its membership includes many top multinationals. Microsoft, Lucent and United Technologies have joined BSR this year, as well as Altria, a more traditional target for pressure groups and litigation as the parent company of both Kraft Foods and Philip Morris. .

Financial constraints have forced companies to think more carefully about where to put scarce resources, he says. Their priority is to embed social, environmental and ethical considerations in every operation, including their supply chain. This is a long-term task requiring sensitive antennae.

This is pushing many more companies to have a serious engagement with their stakeholders so that they can anticipate some of these issues and deal with them proactively, rather than waiting until they reach the front pages of journals and then appearing to be acting only under pressure.

The financial sector, tarnished by Wall Street's conflicts of interest and role in corporate scandals, has come under scrutiny over lending to controversial projects in the developing world. In June, a group of leading banks including Citigroup, Barclays and ABN Amro, pledged to avoid loans for socially or environmentally questionable projects under the so-called "Equator Principles".

The concept of corporate social responsibility involves more than serving the interests of the organization and its shareholders. Rather, it is an extension of responsibility to embrace service to the public interest in such matters as environmental protection, employee safety, civil rights, and community involvement. Socially responsible behavior clearly has immediate costs to the entity, for example, the expenses incurred in affirmative action programs, pollution control, and improvements in worker safety. When one firm incurs such costs and its competitor does not, the other may be able to sell its products or services more cheaply and increase its market share at the expense of the socially responsible firm. The rebuttal argument is that in the long run the socially responsible company may maximize profits by creating goodwill and avoiding or anticipating governmental regulation.

If corporations want to stay on the right side of the global economy's growing protest movement what can they do? Here are some suggestions for corporate social responsibility (CSR).

1. First and foremost, a company should match its words with deeds. CSR is not a box-ticking exercise. Do not nominate a CSR director as an afterthought and then forget about the subject until the next annual report.

2. It is easy to become tarnished by bad practice via a business association, so check that suppliers and contractors share your standards. Any group within your supply chain should comply with the best CSR practice. If not, it could drag an otherwise ethical business into trouble.

3. Remember that no business acts in isolation and all should behave as responsible members of a wider society. Your employees see themselves as part of that society. So a strong lead in CSR will motivate them. The decision of South African mining company Anglo American in August 2002 to provide free HIV/Aids drugs for its vast workforce is an example of this.

4. Join forces with the CSR movement. It is not going away. The issues it raises involve too many interest groups across the world to be temporary phenomena.
5. Remember Machiavelli. CSR could be a defining attribute of winning companies in the 21st century.

Executives are fond of the saying "what gets measured, gets managed" - and measuring corporate social responsibility (CSR) performance has been a boom industry in the past few years.

Morley Fund Managers, the investment arm of Aviva, provides some help with its socially responsible investment matrix. Morley's analysts have graded FTSE100 companies according to two dimensions - the nature of the business they are in, and the level of responsibility with which the company is managed. Thus, BP and Shell are ranked D on an A to E scale, because the oil business is inherently unsustainable. But they both gain a score of two on the one-to-five management scale because Morley thinks highly of their management vision and strategy (none of the top 100 yet merits a perfect score of one).

Specialist rating agencies have now taken this kind of approach further. Organizations, such as CoreRatings and Innovest, assign CSR ratings in the style of the debt markets, with a pinnacle of AAA, down through AA, A to BBB, and so on. These grades are based on in-depth analysis of the issues facing companies and how well they deal with them.

These approaches are all aimed specifically at investors. Business in the Community (BitC) has developed an index for wider consumption, which aims to create responsibility league tables, based on information supplied by the participating companies. It covers companies' impacts in the community, the environment, the market and the workplace and aims to assess the extent to which companies translate strategy into responsible practice.

The first Corporate Responsibility Index was published earlier this year, and proved highly controversial, especially among companies which were ranked at the bottom of the league, despite what they regarded as important social responsibility initiatives.

<table>
<tr><td colspan="2">Measuring corporate social responsibility: basic indicators
Here are basic core indicators that count, according to Business in the Community (BitC)</td></tr>
<tr><td>In the marketplace:
Customer complaints
Advertising complaints upheld
Upheld cases of anti-competitive behavior
Customer satisfaction levels
Provision for customers with special needs</td><td>Community indicators:
Cash value of company support as a percentage of pre-tax profit
Individual value of staff time, gifts in kind, and management costs</td></tr>
<tr><td>Indicators in the workplace include:
Workforce profiles by gender, race, disability, age
Staff absenteeism
Number of legal non-compliances on health and safety, plus equal opportunities legislation
Number of staff grievances
Upheld of cases of corrupt or unprofessional behavior
Number of recordable safety incidents, (fatal and non-fatal)
Staff turnover
Value of training and development provided to staff
Perception measures of the company by its employees
Existence of confidential grievance procedures for workers</td><td>Environmental indicators:
Energy consumption
Water usage
Solid waste produced
Successful environmental prosecutions
CO2/greenhouse gas emissions
Other emissions, such as ozone, radiation CO2/greenhouse gas measures and offsetting effect</td></tr>
</table>

CSR Best Practice

Many CSR specialists recommend that, as a first step, companies join one or more of the international organizations devoted to CSR, including the United Nations' Global Compact or the Global Reporting Initiative (GRI). Other recommendations from CSR specialists include:

- Engaging stakeholders in a dialogue

- Establishing principles and procedures for addressing difficult issues such as labor standards for suppliers, environmental reporting and human rights
- Adjusting reward systems to reflect the company's commitment to CSR
- Collecting, maintaining and publishing data relevant to CSR
- Having the senior leadership team and members of the board of directors engage regularly in an ongoing process of CSR risk and evaluation
- Establishing anonymous reporting and whistle-blowing policies and procedures
- Educating employees and managers about CSR policies and the company's commitment to CSR
- Having the senior leadership team communicate CSR priorities and set an example through their own behavior.

One of the most recent recommendations for best practice invokes creative philanthropy. It involves engaging in "Corporate social initiatives". Corporate social initiatives differ from traditional philanthropy by being linked to the company's core values in a way that leverages core competencies. For example, in response to the recent Asian tsunami disaster, UPS, the logistics company, agreed to ship without charge up to £1m of emergency relief supplies from around the world; Johnson and Johnson distributed medical supplies throughout the affected region; and pharmaceutical giants, Novartis and GlaxoSmithKline contributed antibiotics, adult nutritional supplements and infant formula. In a globalize market economy, CSR is part of modern business.

Strategy and ethics: Passing the test of moral scrutiny

1 In choosing among strategic alternatives, company managers are well advised to embrace actions that are aboveboard and can pass the test of moral scrutiny.

2 Crafting an ethical strategy means more than keeping a company's strategic actions within the bounds of what is legal.

3 A strategy is ethical only if it meets two criteria:
   a. It does not entail actions and behaviors that cross the line from "can do" to "should not do".
   b. It allows management to fulfill ethical duties to all stakeholders.

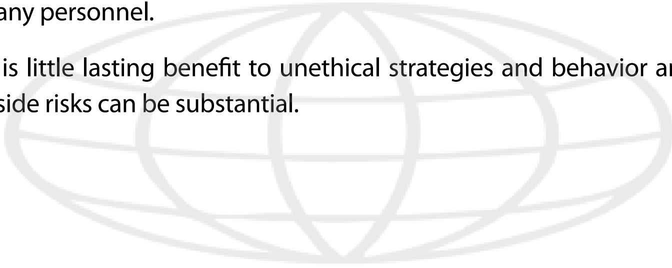
4 It is not always easy to categorize a given strategic behavior as definitely ethical or definitely unethical. Whether they are deemed ethical or unethical hinges on how high the bar is set.

5 Senior executives with strong character and ethical convictions are generally proactive in linking strategic action and ethics; they forbid the pursuit of

ethically questionable business opportunities and insist all aspects of company strategy reflect high ethical standards.

6 Recent instances of corporate malfeasance, ethical lapses, and misleading or fraudulent accounting practices at Enron, WorldCom, Tyco, Adelphia, Dynergy, 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.

7 There is little lasting benefit to unethical strategies and behavior and the downside risks can be substantial.



GLOBAL professional publishing

CHAPTER 2 Environmental Analysis

In deciding on an organization's future direction, management must answer three basic questions:

1. What is the organization's present position?
2. Where does management want the organization to be (i.e., what are its objectives)?
3. How does the organization move from its present position to where management wants it to e (i.e., what strategy is to be used)?

To answer the first question, management must analyze the organization's external and internal environment. An organization's external environment consists of competitors and other forces outside its industry that are not under the direct control of the organization and its industry. Competitive analysis is described in detail in Chapter 3. An organization's internal environment is analyzed through a process called internal appraisal, which is described in detail in Chapter 4. Environmental analysis, which is the subject of this chapter, is concerned with examining those forces not under the direct control of the organization or its industry but which can profoundly influence the industry and organization within the industry.

It can be said that strategy is about matching organizational capability with the external environment. All organizations interchange with their external environment by drawing inputs from it and output goods and services to it. In order to build an effective strategy, we need to analyze both the external and the internal environment so as to develop a proper fit between the two. A company's external environment can be broken down into two parts: the industry environment that the company competes in and the macro-environment. Both environments and their relationship to the company are illustrated in Exhibit 2.1. A company's industry environment consists of elements that directly affect the company, such as competitors, customers, and suppliers. The macro-environment consists of the broader economic, social, demographic, political, legal, and technological setting within which the industry and the company are placed.

Exhibit 2.1: The external environment

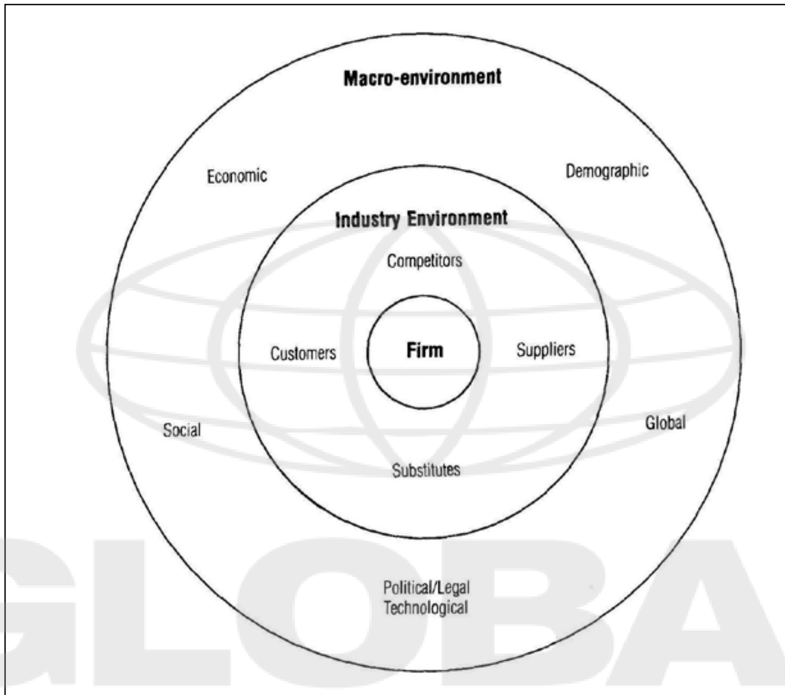
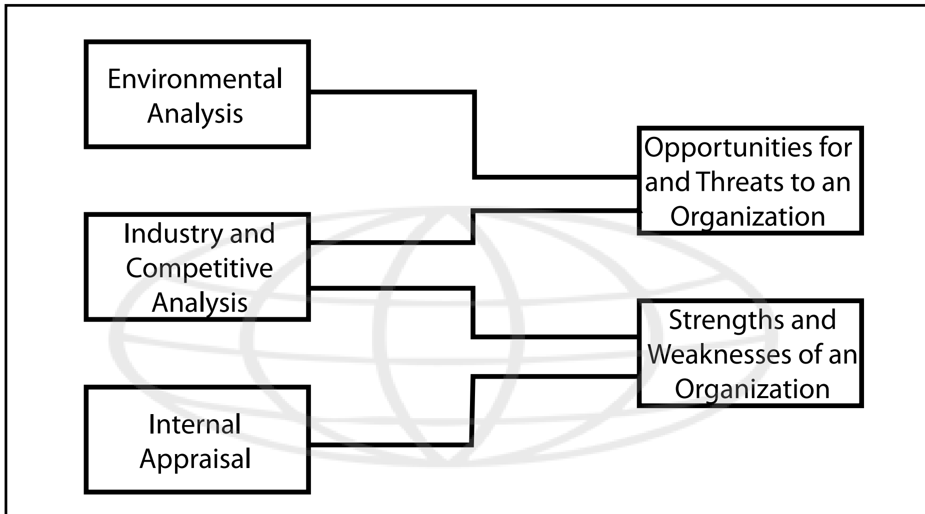


Exhibit 2.2 illustrates the relationships among environmental analysis, competitive analysis, and internal appraisal. Environmental analysis and competitive analysis identify threats to and opportunities for the organization. Competitive analysis and internal appraisal identify the strength and weaknesses of the organization. This type of analysis is often referred to as strengths, weaknesses, opportunities, and threats (SWOT) analysis.

Environmental analysis

Environmental analysis seeks to uncover relevant information, rather than extensive information; it rewards the pursuit of quality, rather than quantity. Furthermore, the process must be future-oriented to provide for adequate response time, whether the desired response is to capitalize on a trend or to influence its direction. Finally, the information must be translated into a form that facilitates its use in formulating strategy. From these requirements, environmental analysis can be divided into three major steps:

Exhibit 2.2: Relationships between environmental analysis, competitive analysis, and internal appraisal



1. *Defining.* Determining the relevant environmental forces and the geographical scope of operations.
2. *Scanning and forecasting.* Ensuring that information is available concerning the defined environment.
3. *Interpreting.* Packaging the information into forms that are useful for strategic planning.

We need first to analyze a company's "macro-environment," which refers to all the relevant forces and factors outside a company's boundaries–general economic conditions, population demographics, societal values and lifestyles, technological factors, governmental legislation and regulation, and the immediate industry and competitive environment in which it operates.

Environmental information is readily available from many different sources. In fact, chances are more likely that the volume of relevant information will overwhelm the organization unless the environmental scanning is conducted strategically and systematically.

Sources of environmental information include newspapers and periodicals, trade journals, government statistical office, national export boards, patent offices, companies' own promotional information, market research databases, or public databases. In general, strategic planners should focus on only relevant data, which should include:

- Competitive data - data relevant to the competitions.
- Economic data - GDP, disposable income, interest rates, inflation rate, unemployment levels, taxation rates, etc.

- Political data - governmental influence on particular industries.
- Legal data - implications of legislation, legislation developments, etc.
- Social data - changing habits, attitudes, cultures, educational standards, demographics, etc.

The external environment of the organization can be described in terms of the physical environment, the social environment, and the competitive environment.

The physical environment almost "go without saying"; it is the given. Physical environmental conditions are important for organizations because it is the source of resource input (e.g. oil, gas, minerals), and thus a good source of profit, especially if resources are scarce.

However, it also present physical problems or opportunities in logistics (mountain roads, deep sea harbors). The physical environment may be controlled by other organizations (e.g. local authority development, governmental environmental legislation), and it may even be a threat (e.g. earthquakes, floods).

Another way to look at interaction between organizations and the physical environment is that the organizations input materials from the physical environment, and output wastes and pollution back into the physical environment.

The macro environment refers to the larger political, economic, social, technical, environmental, and legal issues that confront the firm. To analyze the macro environment, we introduce the PESTEL model.

Defining the external environment – PESTEL analysis

A simple but important and widely used tool that can be used to develop an understanding of the big picture of a firm's external environment is **PESTEL** analysis. PESTEL is an acronym for the political, economic, sociocultural, technological, environmental, and legal context(s) in which a firm operates. It provides a nonexhaustive list of potential influences of the environment on the organization. It helps managers gain a better understanding of the opportunities and threats they face and consequently aids them in building a better vision of the future business landscape and how the firm might compete profitably. The PESTEL analysis is a useful tool for understanding market growth or decline. Its primary focus is on the future impact of macro environmental factors.

Firms need to understand the macro environment to ensure that their strategy is aligned with the powerful forces of change that are affecting their business landscape. When firms exploit changes in the environment, they are more likely to be successful than when they simply try to survive or oppose change. A good understanding of PESTEL also helps managers avoid strategies that may be doomed to failure for reasons beyond their control. Finally, understanding PESTEL is a good starting point for entering into a new country or region.

The fact that a strategy is congruent with PESTEL in the home environment gives no assurance that it will be so aligned in new geographic arenas. For example, when the online clothier Lands' End sought to expand its operations from the United States to Germany in 1996 it ran into local laws prohibiting Lands' End from offering unconditional guarantees on its products. In the United States, Lands' End had built its reputation for quality on its no-questions-asked money-back guarantee. However, this practice was considered illegal under Germany's regulations governing incentive offers and price discounts. The political skirmish between Lands' End and the German government finally came to an end in 2001, when the regulations were abolished. Although the regulations did not put Lands' End out of business in Germany, they did slow its growth there until the laws against advertising unconditional guarantees were abolished.

A PESTEL analysis involves three steps. First, you should consider the relevance of each of the PESTEL factors to your particular context. Second, you identify and categorize the information that applies to these factors. Third, you analyze the data and draw conclusions. A mistake too many students make is to stop after the second step. A second common mistake is to assume that your initial analysis and conclusions *are* correct without testing your assumptions and investigating alternative scenarios.

The PESTEL analysis framework is detailed in Exhibit 2.3. It has six sections, one for each of the PESTEL headings. The table includes sample questions or prompts, the answers to which will help you determine the nature of opportunities and threats in the macro environment. The questions are not meant to be exhaustive; rather, they are merely examples of the types of issues that you should be concerned about in the macro environment.

Exhibit 2.3: The Dimensions of PESTEL Analysis

Political

- How stable is the political environment?
- What are local taxation policies and how do these affect your business?
- Is the government involved in trading agreements such as EU, NAFTA, ASEAN, or others?
- What are the foreign-trade regulations?
- What are the social-welfare policies?

Economic

- What are current and projected interest rates?
- What is the level of inflation, what is it projected to be, and how does this projection reflect the growth of your market?

Exhibit 2.3: The Dimensions of PESTEL Analysis

- What is the prospect of currency devaluation/revaluation?
- What are local employment levels per capita and how are they changing?
- What are the long-term prospects for gross domestic product (GDP) per capita and so on?
- What are exchange rates between critical markets and how will they affect production and distribution of your goods?
- What about energy availability and cost?

Sociocultural

- What are local lifestyle trends?
- What are the current demographics and how are they changing?
- What is the level and distribution of education and income?
- What are the dominant local religions and what influence do they have on consumer attitudes and opinions?
- What is the level of consumerism and what are popular attitudes toward it?
- What pending legislation affects corporate social policies (e.g., domestic-partner benefits or maternity/paternity leave)?
- What are the attitudes toward work and leisure?

Technological

- What is the level of research funding in government and industry and are those levels changing?
- What is the government and industry's level of interest and focus on technology?
- How mature is the technology?
- What is the status of intellectual-property issues in the local environment?
- Are potentially disruptive technologies in adjacent industries creeping in at the edges of the focal industry?

Environmental

- What are local environmental issues?
- Are there any pending ecological or environmental issues relevant to your industry?
- How do the activities of international pressure groups (e.g., Greenpeace, Earth First, PETA) affect your business?

GLOBAL professional publishing

Exhibit 2.3: The Dimensions of PESTEL Analysis
▶ Are there environmental-protection laws? ▶ What are the regulations regarding waste disposal and energy consumption? **Legal**
▶ What are the regulations regarding antitrust and private property? ▶ Does intellectual property have legal protections? ▶ Are there relevant consumer laws? ▶ How about tax laws? ▶ What is the status of employment, health-and-safety, and product-safety laws?

Political factors

The political environment can have a significant influence on businesses as well as affect consumer confidence and consumer and business spending. Managers need to consider numerous types of political factors. For instance, the stability of the political environment is particularly important for companies entering new markets. In addition, government policies with respect to regulation and taxation vary from state to state and across national boundaries. Political considerations also encompass trade treaties, such NAFTA, and regional trading blocs, such as ASEAN and the European Union (EU). Such treaties and trading blocs tend to favor trade among the member countries and to impose penalties or less favorable trade terms on nonmembers. Regarding political factors, the four political levels should be noted:

- Local regions (e.g. local politics, local state politics in USA).
- National regions.(e.g. government policies).
- Trade Regional. (e.g. European Unions, ASEAN in Asia, Arab Africa, Americas, or former Soviet bloc).
- International Regions (e.g. International Courts, United Nations).

Economic factors

Managers also need to consider the macroeconomic factors that will have near- and long-term effects on the success of their strategies. . Of all the environments, the economic environment is considered the most volatile, and is usually subjected to frequent and rapid changes. In assessing the economic environment, the key factor is national growth rate. The national rate of growth provides information concerning the overall change in demand for goods and services. As such, the GDP growth would

indicate potentials in both demand for consumer goods (e.g. domestic equipment), as well as demand for services (e.g. theatre, restaurant, holidays). Other important indicators include the inflation rate, the unemployment rate (showing the availability of labor), the interest rates (indicating the availability of credits), foreign exchange rates, balance of trade figures, taxation level and incentives, government grants and subsidies availability, import export restrictions, freedom of capital movement, or national and international economic agreements. These factors may form the basis for influencing an organization's strategic choice for expansion and survival. When analyzing the economic environment, it is important to encompass all levels of economic trend, namely, the regional (local), the national, and the international levels. For example:

- Higher interest rates may deter investment because it costs more to borrow.
- A strong currency may make exporting more difficult because it may raise the price in terms of foreign currency.
- Inflation may provoke higher wage demands from employees and raise costs.
- Higher national income growth may boost demand for a firm's products.

Sociocultural factors

The social and cultural influences on business vary from country to country. Depending on the type of business the firm operates, factors such as the local languages, the dominant religions, leisure time, and age and lifespan demographics maybe critical. Local sociocultural characteristics also vary on such things as attitudes toward consumerism, environmentalism, and the roles of men and women in local society. Making assumptions about local sociocultural norms derived from your experience in your home market is a common cause of early failure when entering new markets. However, even home-market norms can change over time, often caused by shifting demographics due to immigration or aging populations. For example, Coca-Cola and Pepsi have grown in international markets due to increasing levels of overall consumerism outside of the United States.

Technological factors

Technological factors have a major bearing on the threats and opportunities firms encounter. Does technology enable products and services to be made more cheaply and to a better standard of quality? Do technologies provide the opportunity for more innovative products and services, such as online stock trading, reduction in communications costs, and increased remote working? How might distribution of products or services be affected by new technologies? All of these factors have the potential to change the face of the business landscape. The technological environment

is also a rapidly changing area. It is a fact that there have been more technological changes in the last 50 year than all the previous history added together. Technology changes impact the entire organization and all its processes. In particular, technology affects:

- The nature of the products and services offered (e.g. computers, caller identification on telephone services).
- The way products are made (e.g. manufacturing processes, computer aided designs (CAD), computer-aided manufacturing (CAM)).
- The way services are offered (e.g. cash dispensers, world-wide hotel booking).
- The way information is made available (e.g. marketing database, Internet).
- Employment itself (e.g. technology replaces certain jobs or managerial layers, or encourages leisure and creativity).

Environmental factors

The environment has long been a factor in firm strategy, primarily from the standpoint of access to raw materials. Increasingly, however, this factor is best viewed as a direct- and indirect-operating cost for the firm, as well as from the lens of the footprint left by a firm on its respective environments in terms of waste, pollution, and so on. For consumer products companies such as Pepsi, for example, this can mean waste management and organic farming practices in the countries from which raw materials are obtained. Similarly, in consumer markets it may refer to the degree to which packaging is biodegradable or recyclable.

Legal factors

The difference between legal and political factors must be clearly identified. Legal factors related to the law, whereas political factors are more to do with influences and power. Legal issues affect the organization in that they influence the organization in their operations (law of contract, fair trade, safety etc.), in their external interface (marketing - packaging, descriptions, weights and measures), in their employee treatment (employment laws, union laws), in their owners/shareholders treatment (Companies Act), in their internal organizational structure (by say, defining the duties of the directors), in their finances (taxation, credit control), in their technologies (environmental concerns or political concern), or in their ethical and legal behavior (civil and criminal laws). Legal factors reflect the laws and regulations relevant to the region and the organization. Legal factors may include whether the rule of law is well established and how easily or quickly laws and regulations may change. It may also include the costs of regulatory compliance. For instance, Coca-Cola's market share in

Europe is greater than 50 percent, and as a result, regulators have asked that Coke give up shelf space to competitors' products in order to provide greater consumer choice.

Different categories of law include:

- Consumer laws; these are designed to protect customers against unfair practices such as misleading descriptions of the product
- Competition laws; these are aimed at protecting small firms against bullying by larger firms and ensuring customers are not exploited by firms with monopoly power
- Employment laws; these cover areas such as redundancy, dismissal, working hours and minimum wages. They aim to protect employees against the abuse of power by managers
- Health and safety legislation; these laws are aimed at ensuring the workplace is as safe as is reasonably practical. They cover issues such as training, reporting accidents and the appropriate provision of safety equipment

As you can see, many of the PESTEL factors are interrelated. For instance, the legal environment is often related to the political environment in that laws and regulations will change only when politicians decide that such changes are needed.

Scanning and forecasting

In order to obtain accurate information concerning current events and reasonable assessments of future trends, an intelligence function must be in place. It may be informal or part of a sophisticated information system. The intelligence function must be designed and judged on the basis of the benefit to the organization, rather than the size, sophistication, or cost of the effort. In the face of information overload, it is probably more important to pick up a few key trends and incorporate them into strategy formulation than to amass a vast collection of detailed information that no one knows how to use.

Research indicates that organizations often overlook important sources of information if they fail to maintain contacts with customers, suppliers, and competitors. However, maintaining these contacts is not enough; the information gleaned must reach the place in the organization where its significance can be evaluated.

Two basic approaches can be used in environmental scanning. With the first approach, an organization selects areas for intelligence gathering that are based on those areas of the organization's activities most sensitive to environmental change. A IT software producer, for example, might concentrate most of its environmental intelligence effort on the changes in microprocessor technology and on the activities of key competitors. This approach has the advantage of focusing the effort and expending resources on proven areas of critical influence. With the second approach,

an organization would take a broad-based look at many environmental areas without initial reference to the organization's particular areas of vulnerability. The advantage of this approach is that threats frequently come from new sectors not necessarily important in the past. The disadvantage is that much information of marginal usefulness may also be acquired. Which approach to follow should be a conscious decision by top management and should periodically be reevaluated.

Gathering information about the environment may be done by top managers, corporate staff, line middle managers, or consultants. While staff and consultants have the advantage of specialization and concentration in intelligence gathering, top management and line management participation is necessary to ensure that the information is incorporated into strategic planning in a meaningful way. Employees on all levels can be particularly valuable sources of information when they have their direct contact with distributors, end users, raw-materials suppliers, substitute-product manufacturers, machinery suppliers, advertising agencies, investment bankers, and financial analysts. Top management can encourage the upward flow of information by using the information, rather than ignoring it, by preventing negative consequences for passing along information, and by providing suitable rewards for useful information. Other managers can enhance their ability to contribute by:

- Maintaining an awareness of the strategy of the organization.
- Cultivating contacts who have needed information.
- Keeping current in their own functional areas.
- Passing on information in a form that is likely to be accepted (brief and through proper channels.)

Published data are plentiful and can provide insights into environmental events and trends. The appendix to this chapter lists some of these sources. Forecasts are also available for selected sectors of the environment. Forecasters have been most active in projecting events in the economic sector and in the social sector through demographic projections. Economic forecasts are in plentiful supply from many university business scholars, the federal government, and various private organizations. Demographic forecasts may be prepared by consultants for special purposes or may be available from a variety of public and private sources concerning general trends, such as age distribution of the population.

Environmental forecasting methods

No one can deny that economic, technological, political, and social change are a part of organizational life. Given that fact, the obvious question is, how can these changes be forecast?

To say the least, forecasting is a most difficult process. At this point it may be consoling to recall some humorous forecasting rules:

1. It is very difficult to forecast, especially the future.
2. Those who live by the crystal ball soon learn to eat ground glass.
3. The moment you forecast you know you're going to be wrong – you just don't know when and in which direction.
4. If you're right, never let them forget it.

Regardless of the possibility of error, to be successful, organizations mush forecast their future environment.

Forecasting methods and levels of sophistication vary greatly. The methods employed may vary from educated guesses to computer projections using sophisticated statistical analyses. Several factors determine the most appropriate methods of forecasting, including the nature of the desired forecast, the available expertise, and the available financial resources.

All forecasting techniques can be classified as either qualitative or quantitative.

Qualitative techniques are based primarily on opinions and judgments. *Quantitative techniques* are based primarily on the analysis of data and the use of statistical techniques. The following sections discuss several different qualitative and quantitative techniques.

Qualitative forecasting techniques

Several qualitative forecasting methods are available. Some of the most frequently used methods are described below.

Jury of expert opinions

With this method, several managers get together and devise a forecast based on their pooled opinions. Advantages of this method are simplicity and low cost. The major disadvantage is that the forecast is not necessarily based on facts.

Sales force polling

Under the sales force composite method, a forecast of sales is determined by combining the sales predictions of experienced salespeople. Because sales people are in constant contact with customers, they are often in a position to accurately forecast sales. Advantages of this method are the relatively low cost and simplicity. The major disadvantage is that sales personnel are not always unbiased, especially if their sales quotas are based on sales forecasts.

Customer evaluation

This method is similar to the sales force polling, except that it goes to customers for estimates of what the customers expect to buy. Individual customer estimates are then pooled to obtain a total forecast. This method works best when a small number of customers make up a large percentage of total sales. Drawbacks are that the customer may not be interested enough to do a good job and that the method has no provisions for including new customers.

Brainstorming

This is a nonquantitative approach simply requiring the presence of people with some knowledge of the situation to be predicted. The basic ground rule is to propose ideas without first mentally screening them. No criticism is allowed, and ideas tend to build on previous ideas until a consensus is reached. This technique is a good one to use with operating managers who have more faith in "gut feelings" than quantitative "number-crunching" techniques.

Delphi technique

The Delphi technique is a method for developing a consensus of expert opinion. Under this method, a panel of experts is chosen to study a particular question. The panel members do not meet as a group and may not even know each other's identity. Panel members are then asked (usually by mailed questionnaire) to give their opinions about future events or forecasts. After the first round of opinions has been collected, the coordinator summarizes the opinions and sends this information to the panel members. Based on this information, panel members rethink their earlier responses and make a second forecast. This same procedure continues until a consensus is reached or until the responses do not change appreciably. The Delphi technique is relatively inexpensive and moderately complex.

Surveys and opinion polling

With this method, mailed questionnaires, telephone interviews, or personnel interviews are used to forecast customer intentions. Surveys and opinion polling are a form of sampling, in that those surveyed are intended to represent some larger population. Potential drawbacks of this method are that stated intentions are not necessarily carried out and that the sample surveyed does not represent the population. This method is usually accompanied by medium costs and medium complexity.

Quantitative forecasting techniques

Several quantitative forecasting methods are also available. In general, these methods are more sophisticated than are qualitative methods.

Time-series analysis

This technique forecasts future demand based on what has happened in the past. The basic idea of time-series analysis is to fit a trend line to past data and then to extrapolate this trend line into the future. Sophisticated mathematical procedures are used to derive this trend line and to identify any seasonal or cyclical fluctuations. Usually a computer program is used to do the calculations required by a time-series analysis. One advantage of this technique is that it is based on something other than opinion. This method works best when a significant amount of historical data is available and when the environmental forces are relatively stable. The disadvantage is that the future may not be like the past.

Regression analysis

Regression analysis is a mathematical forecasting technique in which an equation with one or more input variable is derived to predict another variable. The variable being predicted is called the *dependent variable*. The input variables used to predict the dependent variable are called *independent* or *explanatory variables*. The general idea of regression analysis is to determine how changes in the independent variables affect the dependent variable. Once the mathematical relationship has been determined (in the form of an equation,) future values for the dependent variable can be forecast based on known or predicted values of the explanatory variables.

Econometric modeling

Econometric modeling is one of the most sophisticated methods of forecasting. In general, econometric models attempt to mathematically model an entire company. Most econometric models are based on numerous regression equations that attempt to describe the relationships between the different sectors of the economy. Very few organizations are capable of developing their own econometric models. Those organizations that do use econometric models usually hire the services of consulting groups or companies that specialize in econometric modeling. Econometric modeling is very expensive and complex and is, therefore, primarily used only by very large organizations.

Note: A distinction between forecasting and planning is that forecasts are used in strategic planning. Strategic planning is the determination of what is to be done, and of how, when, where, and by whom it is to be done. Plans serve to direct the activities that all organizational members must undertake to move the organization from where it is to where it wants to be. Forecasting is an essential element of strategic planning. Forecasting is a means of projecting the future. Forecasts are the basis for environmental scanning.

Scenario planning

Scenario planning is a qualitative forecasting method that requires preparation of conceptual scenarios of future events given carefully defined assumptions. It entails writing multiple different but equally likely descriptions of future states. Scenarios are specially constructed stories about the future. Each scenario represents a distinct, plausible world. The purpose of scenario planning is not to predict the future; but rather, to show how different forces can manipulate the future in different directions. It is very important to realize this, for this procedure helps to identify these forces if and when they happen. The utility of scenario planning lies in its ability to anticipate the future. When this is accomplished, the ability to better respond to future events is increased. *Discovery-driven planning* (to be discussed in Chapter 8) is a scenario-based planning tool. It's a systematic process used to convert ignorance into knowledge in uncertain environments. Managers can use it to make strategic adjustments and speedier decisions about whether to, for example, pull out of a failing venture.

GLOBAL professional publishing

GLOBAL

professional

publishing

CHAPTER 3

Industry and Competitor Analysis

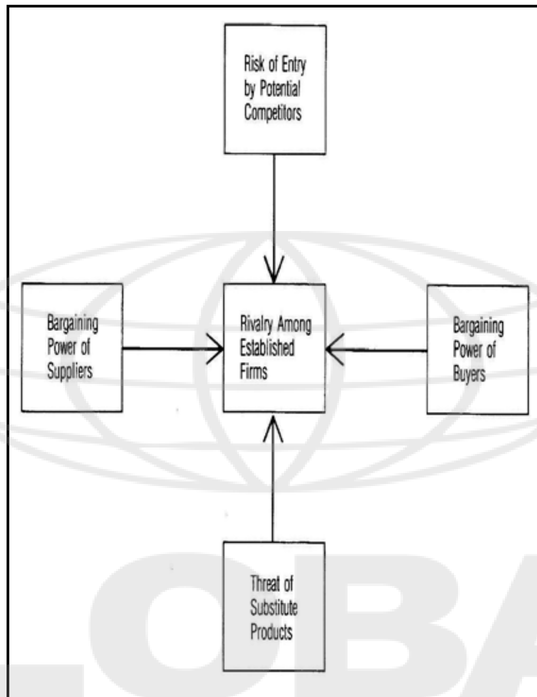
Once the boundaries of the industry to be analyzed have been identified, the next step is to examine the industry's fundamental characteristics and structure. Porter's *five-forces model* identifies five forces that determine the basic structure of an industry. A sixth force, complementors, is added to the model because it's an increasingly critical industry force, and therefore an input into strategic analysis.

Porter five forces model

Industrial analysis may be carried out using Michael Porter's five forces model (see Exhibit 3.1). The way one uses the five-forces model of competition to determine what competition is like in a given industry is to build the picture of competition in three steps or stages: (1) identify the specific competitive pressures associated with each of the five competitive forces; (2) evaluate how strong the pressures comprising each competitive force are; and (3) determine whether the collective impact of all five competitive forces is conducive to earning attractive profits.

The five forces are: potential entry, the power of buyers, the power of suppliers, substitutes, and rivalry among existing competitors. The five forces represent the major influences on the nature of the particular industry the organization is in.

Exhibit 3.1: Michael Porter's Five Forces Model



The five-forces model draws attention to factors that systematically alter the negotiating strength in favor of suppliers, industry members, or buyers. Likewise, the model draws attention to threats posed by the possibility of new entrants (and conversely, the difficulty of exit) and possible substitute products from other industries or industry segments, either of which can pose threats to industry participants.

Threat of entry

Several variables can reduce entry into the industry. They may include economies of scale, product differentiation, capital requirements, access to distribution channels, and regulatory forces. . The degree to which new competitors may enter an industry and make rivalry more intense is known as the **threat of new entry.** Conditions that make it difficult to enter an industry are known as **barriers to entry.** Entry barriers also include the reputation and goodwill of existing companies. Finally, switching costs can deter competition. These costs arise when a customer switches from one supplier to another. In some cases, these costs can be substantial, as in the aircraft manufacturing and steel furnace industries. Barriers to entry also affect the existing companies' response to entry. For example, where economies of scale are abundant, an existing company

may reduce its prices significantly to preempt a newcomer's entry. Further, the threat of retaliation by existing companies can become a barrier to entry. For instance, if a new company is contemplating entry and recognizes that existing firms will retaliate swiftly and vigorously, entry may not occur.

Factors that **increase the threat of entry** are the following:

1. Economies of scale (and learning curve effects) are not significant.
2. Brand identity of existing products is weak.
3. Costs of switching suppliers are low.
4. Existing firms do not enjoy the cost advantages of vertical integration.
5. Proprietary product differences are few.
6. Access to existing suppliers is not blocked, and distribution channels are willing to accept new products.
7. Capital requirements are low.
8. Retaliation against a new firm by existing firms that follow the industry leader is unlikely.
9. The government's policy is to encourage new entrants.

The most favorable industry condition is one in which entry barriers are high and exit barriers are low. Exhibit 3.2 reflects Porter's view of the relationship of returns to entry barriers and exit barriers:

Exhibit 3.2: Relationship of returns to entry barriers and exit barriers

		Exit Barriers	
		Low →	High
Entry Barriers:	Low →	Low, stable returns →	Low, risky returns
	High →	High, stable returns →	High, risky returns

When the threat of new entrants is minimal and exit is not difficult, returns are high, and risk is reduced in the event of poor performance. Low entry barriers keep long-term profitability low because new firms can enter the industry, increasing competition and lowering prices and the market shares of existing firms. Exit barriers are reasons for a firm to remain in an industry despite poor (or negative) profits. They include

- Assets with a low residual value because of obsolescence or specialization
- Legal or ethical duties to stakeholders, such as employees, creditors, suppliers, or customers

- Governmental regulations
- Lack of favorable alternative investments
- Substantial vertical integration
- Emotional factors, such as history and tradition

Bargaining power of buyers

In some industries buyers exert considerable influence on producers. This may happen under the following conditions:

- Buyers are few and they buy in large volumes relative to the total industry sales. For example, Toyota can exert considerable influence on its suppliers because it is their major buyer.
- The product represents a major component of the buyer's cost. This means that the buyer has an incentive to reduce the cost. PC makers, for instance, have pressured chip suppliers to reduce their costs. With rapidly advancing technologies and a fiercely competitive market, PC makers themselves have been pressured to reduce costs in order to lower prices.
- The product is not differentiated and, therefore, easily substitutable. PC keyboards have approached this stage. Often PC makers can easily substitute one keyboard for another.
- The buyer earns low profits and is pressured to reduce costs.
- The buyer has little switching costs. For example, customers have virtually no switching cost in buying from a new grocery store, staying in a new hotel or buying a different keyboard.
- The buyer can integrate backward and produce its own parts internally.

Bargaining power of suppliers

Suppliers can exert considerable influence on companies in an industry, especially when:

- There are very few suppliers.
- There are very few substitute products.
- The products are differentiated and have built-in significant switching costs.
- Suppliers can integrate forward.

For example, producers of specialized scientific equipment exert considerable influence on buyers because there are very few substitutes for their products. Moreover, the

products are very expensive and require specialized expertise to assemble and operate. The same situation exists in the medical and surgical equipment industry, where producers have significant powers over hospitals. Consider the extreme case of the Green Bay Packers of the National Football League. The Packers have maintained a waiting list for season tickets for the past 45 years; the average wait is 30 years. Because there are few other entertainment alternatives in Green Bay, Wisconsin, there is essentially one seller and many buyers for the opportunity for professional sports entertainment. The team is certainly under no pressure to discount prices.

The threat of forward integration can increase the supplier's power over buyers. For example, in the apparel industry some manufacturers (e.g., Levi's) have established their own retailing outlets. Understandably, this has weakened retailers' bargaining power with suppliers.

Threat of substitutes

The extent to which substitute products exist affects the intensity of rivalry and the dynamics of competition. Substitutes are products that accomplish the same purpose or fulfill the same needs. For example, to many people, cars, trains, and airplanes are substitute means of transportation Similarly, FedEx, fax machines, and e-mail have emerged as substitutes to the traditional services of the post office. Therefore, companies need to identify potential substitutes for their products and services and use this information in designing their competitive strategy.

Structural considerations such as relative price, the cost of switching, and a customers' inclination to use a substitute determine the effect substitutes have on one another. However, because substitutes are types (not brands) of goods and services that have the same purposes, brand identity is not a structural consideration affecting the threat of substitutes.

However, the concept of substitutes is often elusive and hard to define. For one thing, customers define their needs quite differently and, therefore, may view the product as fulfilling different needs. To some, travelling by a boat is quite different from flying. Therefore, in conducting competitive analysis, it is important to recognize how customers view competing brands (or products). Producers of cosmetics understand this point well. With multiple brands in existence, customer loyalty is questionable. Therefore, a two-pronged strategy is followed: producers innovate and introduce new products, and they spend heavily in building brand recognition and customer loyalty. Cosmetics manufacturers understand that only by building brand name recognition can customer loyalty be maintained.

Rivalry among existing firms

Rivalry among existing firms will be intense when an industry contains many strong competitors. Price-cutting, large advertising budgets, and frequent introduction of new products are typical of intense competitive rivalry. The intensity of rivalry and the threat of entry vary with the following factors:

1. The stage of the *industry life cycle*, e.g., introduction, rapid growth, growth, maturity, decline, or rapid decline. Thus, growth is preferable to decline. In a declining or even a stable industry, a firm's growth must come from winning other firms' customers, thereby requiring intensified competition.

2. The *degree of product differentiation* and the *costs of switching* from one competitor's product to another. Less differentiation tends to heighten competition based on price, with price cutting leading to lower profits. On the other hand, high costs of switching suppliers weakens competition.

3. Whether *fixed costs* are high in relation to variable costs. High fixed costs indicate that rivalry will be intense. The greater the cost to generate a given amount of sales revenues, the greater the investment intensity and the greater the need to operate at or near capacity. Hence, price cutting to sustain demand is typical of such firms.

4. *Capacity expansion*. If it must be made in large increments, competition will be more intense. The need for large-scale expansion to achieve production efficiency may result in an excess of industry capacity over demand.

5. *Concentration and balance*, e.g., when no firm is dominant. If an industry has a few equal competitors, the situation tends to be unstable and the rivalry intense.

6. *The extent of exit barriers*. Low exit costs make an industry more attractive.

7. *Competitors' incentives* to remain in the industry. When incentives are low, competitors are less likely to incur the costs and risks of intense rivalry.

The impact of complementors

As we noted at the beginning of this discussion, the five forces that we've just described comprise a model of industry structure proposed by Michael Porter. When these forces are strong, industry profitability tends to be reduced. Some argue that the players outlined in the five-forces model do not always compete exclusively in zero-sum games. Sometimes these players work together to create value jointly rather than competing

to divide the market. Complementors are players who provide complementary rather than competing products and services. Firms in the music and electronics industries, for example, sell products that must be used together—such as iPods, headphones, and music. Each benefits from the other's presence. Likewise, when people buy hot dogs, an increase in sales of buns, condiments, and beverages is likely. These three products are marketed by complementary industry segments (which is why grocers can sell buns below cost to stimulate sales of higher-margin hot dogs). Sometimes firms in the same industry or suppliers and buyers simultaneously play the role of complementors. For instance, United and Delta compete fiercely in trying to attract customers to fill their seats. However, when upgrading their fleets to a newer plane, both airlines are probably better off when they jointly order a new model from Boeing or Airbus. Because both are in the market for new planes at the same time, aircraft manufacturers are able to achieve greater economies of scale with larger orders, thereby lowering the cost of new planes.

A complementor is any factor that makes it more attractive for suppliers to supply an industry on favorable terms or that makes it more attractive for buyers to purchase products or services from an industry at prices higher than it would pay absent the complementor. However, even though a firm or industry segment fulfills a complementor role, it may still compete with firms in the focal industry. A firm or industry segment may simultaneously play the roles of complementor and competitor (as in the Delta/United example). In addition, a complementor that results in increased focal-industry sales will not necessarily share equally in the increased bounty. These relationships still have elements of bargaining power akin to supplier and buyer relationships; one party to a complementor relationship may receive more of the benefit than the other even though both are better off

Customers, then, are likely to put a higher value on the products of one industry segment when they already have or have access to complementary products from another segment. The value of computer peripherals obviously increases as the number of PCs increases. Likewise, the value of a commercial real estate development is enhanced if there are neighboring amenities valued by business tenants, such as restaurants, entertainment venues, and transportation facilities. More new cars are sold when affordable financing is easier to get or dealers offer extended service warranties. Thus, financing and warranty arrangements can be regarded as complementors to the retail new-car market.

Finally, note one important difference between complementors and the other five forces in this model of industry analysis: Whereas the five forces typically work to decrease industry profitability, the presence of strong complementors may increase profits by increasing demand for an industry's products.

It's sometimes useful to think of these forces as countervailing sources of power all vying for a larger piece of the industry's total profits. Recall that when an industry

is characterized by perfect competition, rivals in an industry will achieve normal levels of profitability—enough to pay for all factors of input, including the cost of capital. However, industries actually vary considerably in their average level of returns. A key reason for this variance in industry profitability is differences in the power of these five forces across different industries.

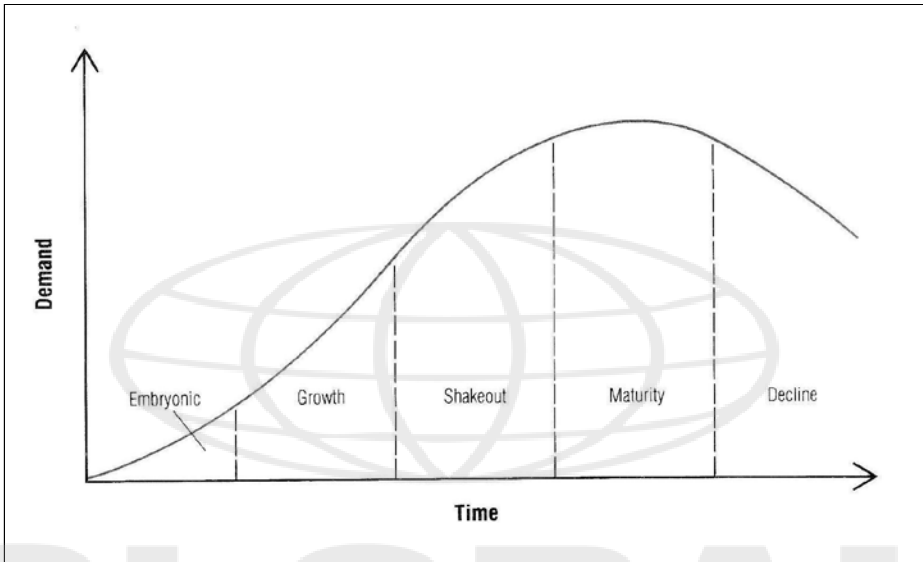
Industrial attractiveness and industry life cycle

The directional policy matrix is a very useful method to assess the attractiveness of a particular product or a particular business unit.

Each product or business unit is assessed in terms of the attractiveness of the product or the market it is in, as well as assessed in terms of the comparative strength. Each is assessed with respect to factors that are most relevant to the organization and its markets.

Industry is a much broader classification than product; an industry consists of many similar groups of products. The product groups of mid-size sedan, pickup truck, and sport-utility vehicle all belong to the automobile industry. Generally, industries have longer life cycles than products. Different analyses posit different stages of an *industry life cycle* (Exhibit 3.3), but all emphasize that an industry has a beginning, with technological innovation; a period of rapid growth; maturity and consolidation; and finally decline and possibly death. For example, in the video cassette recording (VCR) industry, the mid-1970s were a period of decentralized technological innovation, with VHS and Betamax formats vying for dominance. Later, video cassettes very quickly became a common household item. In the maturity phase, different companies selling VCRs attempted to corner a greater market share for their own (identical) versions of the product. During this stage of the industry life cycle, competition is marked by mergers and acquisitions. Finally, the industry declined and was eventually supplanted by DVD players. An industry life cycle can be prolonged by several factors, including opening new markets to the product, finding new uses for the same product, or even attaining government subsidies. The concept of an industry life cycles applies most readily to the sale of goods and it is difficult to gauge how it works in a service economy.

Exhibit 3.3: Stages of the industry life cycle



Key success factors (KSFs)

The identification of the key factors for success in a particular industry helps to focus the analysis on particularly important environmental matters.

Key success factors, also called *critical success factors (CSFs*), are the resources, skills and attributes of the organization that are essential to deliver success in the market place. They are related to the industry and are likely to provide differentiation between organizations in the industry.

To identify the key success factors in a particular industry, the organization must examine the type of resources and the way that they are employed in the industry and then to use the information to analyze the environment outside the organization. As such, key success factors need therefore to be developed from an analysis of the organization's resources.

Apart from the analysis of resources, key factors also concern the competitive environment. In particular, three environmental areas need to be analyzed:

- Customers - who are the customers and what do they really want?
- Competition - How can the organization beat or at least survive against the competition? What would make the organization particularly successful?
- Corporation - What special resource does the organization itself possess and how do they compare with the competitors?

Competitor analysis

In general, the main reasons for assessing competitors are to assess the possibility and likelihood for survival, growth and profit:

More specifically, competitor analysis is necessary in order to avoid surprises, or to avoid hostile take-over, or to evaluate your own performance, to exploit weaknesses detected in your competitors, to respond quickly to actions initiated by competitors, to gain and keep competitive advantage, or to cope with shrinking markets.

In other words, knowing your competitors well enables you to predict their next moves and exploit their weaknesses, or to steer clear of obvious threats.

The strategic intelligence "cycle" is as follows:

- Decide what intelligence you want and why.
- Plan the collection of intelligence.
- Use the relevant sources to collect data.
- Record, evaluate and interpret.
- Write assessment and circulate to appropriate people for action.

Note that "useful intelligence" means "information that pinpoints where management effort could improve relative competitiveness." In other words, competitive intelligence is only useful if it is action oriented.

Be careful, however, to assess for the reliability of the source as well as to assess for the accuracy of information before taking actions based on the information.

Product life cycle

One of the most useful concepts in marketing as far as strategic management is concerned is that of the product life cycle. As depicted in Exhibit 3.4, the *product life cycle* is a graph showing time plotted against sales as a product moves from introduction through growth and maturity to decline. The product life cycle consists of the product development, introduction, growth, maturity, and decline stages.

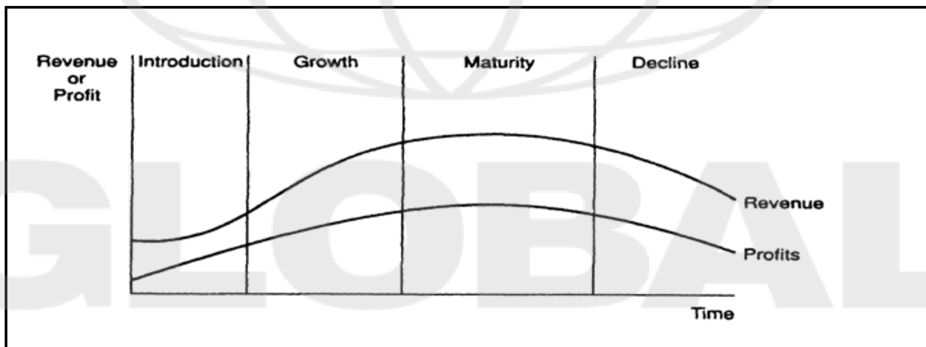
In the product development stage, the company incurs investment costs but makes no sales. In the introduction stage, sales are slow because the product is being introduced, profits and cash flows are negative, and investment in marketing is high. The introduction stage is characterized by slow sales growth and lack of profits because of the high expenses of promotion and distribution. Competitors are few, basic versions of the product are produced, and higher-income customers are usually targeted. Prices may initially be high to permit cost recovery when unit sales are low.

In the growth stage, profits are at their highest, although cash flow may be negative because of high investment.

In the maturity stage, sales decrease and profits level off or begin to decline. During the maturity stage, many competitors are in market. Given a decline in absence of growth or negative growth, the industry also may have excess capacity. For these and other reasons, competitive rivalry will be strong. Firms may attempt to modify the market, the product, or the marketing mix. Thus, price competition (an element of the marketing mix) will be most intense during the maturity stage.

In the decline stage, sales and profits drop. This concept enables a manager to examine the marketing mix of a particular product or group of products in terms of its life-cycle position. Although different products have different-shaped life cycles, consideration of product life cycle is important factor in strategy formulation.

Exhibit 3.4: The product life cycle



Competitive positioning

An organization's competitive position may be described as either dominant, strong, favorable, tenable, weak, or non-viable.

In terms of behavior, an organization may be classified as either being a market leader, a market challenger, a market follower or a market nicher. Combining this market behavior categorization with understanding the general economic climate and the product life cycle stages, the organization's position relative to the product life and the market position can be drawn as a grid.

With respect to the analysis of strength and weaknesses, the operating position may be classified as either ideal, speculative, mature or troubled. Ideal position is a position high in major opportunities and low or devoid of major threats. Speculative position is where it is high in major opportunity, but also high in threats. Mature position is a position low in major opportunity, and low in threats. And a troubled position is where it is low in opportunity, but high in threats.

The organization's posture can be determined by examining the organization's competitive advantages with respect to their strength and the stability of the

environment. The posture may be aggressive, competitive, conservative or defensive. Aggressive posture is applicable to strong organizations with distinct competitive advantage in an attractive, non-turbulent industry. Competitive posture may be applied to strong organizations with competitive advantages in an attractive industry, but the environment is unstable. In this case, the organization's financial strength is critical. The conservative posture is for organizations in a low growth but stable market. Organizations in this posture need to work hard to remain competitive while maintaining reasonable profitability. The defensive posture is for organizations that are in unattractive industries and without competitive product and financially weak. Such organizations should ideally harvest or withdraw.

Assessing competitors

Competition needs to be assessed in terms of their relative positions and strategies, and identify how each is attempting to cope with the environment it faces.

The following checklist of questions might be helpful to understand the position of a particular competitor:

- What are the objectives of the organization? Is it seeking growth? If so, is it mainly concerned with profit growth, revenue growth or market share?
- What resource strength does the organization have, and what are their weaknesses?
- What is the record of performance of the organization? What is the financial analysis of performance trend?
- What is the current strategy of the organization? Is there evidence of a consistent approach to strategy development?
- What are the assumptions underlying the organization's approach to their strategic development? Is it possible to detect what the core beliefs or the paradigm of the organization?

Uncovering these strategic aspects of the organization can help to understand how the organization have in the past dealt with the particular forces identified as important in their competitive and wider environment, and how they are likely to deal with them in the future.

CHAPTER 4 Internal Appraisal

An organization's ability to achieve its desired levels of performance can be enhanced or diminished by its environment. However, an organization is not helpless in the face of environmental threats nor is it guaranteed success by the presence of opportunities. The ability to minimize threats and capitalize on opportunities depends on the actions that the organization can take in the face of environmental trends. These action capabilities may be thought of as strengths with strategic significance. It is impossible to consider an organization's fitness for the future without enumerating the organization's strengths and evaluating the significance of those strengths. It is also necessary to determine areas of vulnerability.

Internal appraisal begins with identification of the organization's resource allocations. This analysis should produce an enumeration of organizational strengths—what the organization does well. Strengths must then be analyzed for their strategic significance. It is also necessary to identify areas of weakness and to determine whether these weaknesses have strategic significance—that is, whether they make the organization vulnerable. All these assessments are relative; they must incorporate environmental information.

Once the external environmental analysis and internal appraisal have been completed, organizational objectives can then be formulated. This chapter discusses internal appraisal and the establishment of organizational objectives.

Responsibility for performing an internal appraisal

Who is responsible for performing internal organizational analyses? Some organizations assign this responsibility to their planning department. Others contract with outside consulting firms. Recently, however, the trend has been toward having a team of line managers in the organization develop the analysis with technical assistance

Global professional publishing

and coordination from the planning staff. The premises for this trend are that, if line managers develop the analysis, they will understand it, perceive its implications for the future direction of the organization, and use it to guide their own strategic planning decisions. For example, if an organization has several strategic business units, a group of managers in each SBU would be responsible for developing an internal organizational analysis for their unit. Each analysis would be reviewed and approved by the top management of the particular business unit and by the top management of the organization as a whole.

Areas covered by internal appraisal

Internal appraisal evaluates relevant factors in an organization in order to determine its strengths and weaknesses. Typically, every area of the organization that can significantly influence its long-term survival and success should be analyzed. Some of the areas that most organizations should analyze include the |following:

1. Financial position.
2. Product/service position.
3. Product/service quality.
4. Marketing capability.
5. Research and development capability.
6. Organizational structure.
7. Human resources.
8. Condition of facilities and equipment.
9. Past and current objectives and strategies.

Of course, the specific areas to be studied and the weight given to each area vary from organization to organization. For all organizations, however, the analysis should give management an understanding of the organization's major strengths, on which its future should be built, and major weaknesses, which should be corrected whenever possible. The following sections describe the major issues that should be addressed when analyzing each of these areas as part of an internal environmental analysis.

Financial position

The financial position of an organization plays a crucial role in determining what it can or cannot do in the future. Financial analysis is a comprehensive term that refers to any use of available financial data to evaluate the financial position of an organization. Many tools and techniques are available for examining an organization's financial position. Cash flow statements, income statements, and balance sheets are some of the basic information sources used by management. Primary sources of company

GLOBAL professional publishing

financial data for outsiders are the company's annual report and Form 10-K. Form 10-K is a financial report that is required by law to be filed annually with the Securities and Exchange Commission by all companies listed on the stock exchange. Most companies will provide a copy of their annual report on request. Many college and public libraries maintain files of the annual reports and 10-K reports of various public companies.

Very few of the data in financial statements are significant when taken in isolation. The objective of a financial analysis is to establish relationships between data items and to highlight changes and trends that may explain a company's past performance and give clues to its future performance. Thus, the most useful financial analysis tools for managers are those that increase the understanding of the cause-and-effect relationships in the organization, those that identify company and industry trends, and those that allow comparisons with other organizations.

Product/service position

For a business to be successful, it must be acutely aware of its product or service position in the marketplace. Without this type of information, no business can survive very long in today's competitive environment. When assessing an organization's product/service position, managers need to first determine the market share of its major products and or services. What share of the market does the organization's product(s) or service(s) currently hold? How firm is the hold on the market share? Is the market share increasing or decreasing? How do the present market share and trends in the market share compare to those of the competitors? Is the share concentrated in a small number of customers, or is it diversified? Another issue that needs to be addressed concerns the relative prices of major product(s) or service(s). With regard to major product(s) or service(s), is the company a price leader or a price follower?

Product/service quality

Product/service quality has become a major issue in almost all markets today. If a product/service is to survive and grow it must be perceived in the marketplace as providing high quality relative to its price. In this light an evaluation should be undertaken to evaluate the quality of the firm's major product(s) and service(s) relative to that of the competition. Direct feedback from customers, service and repair records, and general customer acceptance are some potential sources of data reflecting product/service quality.

Marketing capability

Closely allied with an organization's product position is its marketing capability (i.e., its ability to deliver the right product or service at the right place at the right time and at the right price). Areas that should be investigated regarding an organization's

marketing capability include its distribution channels, the types of advertising and promotions used, and identification of the specific markets being targeted.

Research and development capability

Every organization, whether it has a formal research and development department or not, must be concerned about its ability to develop new products and services. For some industries, such as computers and medical technology, the research and development (R&D) capability of a business is critical if it is to survive. For those businesses in which research and development is crucial, an assessment of what new products or services have been developed by R&D over the past few years should be made. Are any new product(s) or service(s) developed by R&D first in the market, or are they a reaction to a competitor's new product(s) or service(s)?

Organizational structure

All organizations produce and market their products through an organizational structure. This structure can either help or hinder an organization in achieving its objectives. To assess an organization's internal strengths and weaknesses, its structure must be evaluated. What is the current form of structure and is it effective? Factors that may shed some light on the effectiveness of the structure include the time it takes to make decisions, the paperwork required by the structure, and the degree of cooperation among the different organizational units.

Human resources

All the activities of an organization are significantly influenced by the quality and quantity of its human resources. Training programs, compensation systems, performance appraisal systems, and management and employee development programs help determine not only the quantity and quality of current employees but also the type of employee that can be expected in the future. Effective human resource systems can give an organization a very real competitive edge in attracting and retaining high-quality personnel.

Thus, to accurately assess its strengths and weaknesses, an organization must make an objective evaluation of its human resources. This assessment must include not only operative employees but also all levels of management.

Condition of facilities and equipment

The condition of an organization's facilities and equipment can either enhance or hinder its competitiveness. For example, for years the U.S. steel industry has been at a competitive disadvantage with the Japanese steel industry largely because of the

obsolete production facilities in the United States. An evaluation of the facilities and equipment should also include an evaluation of the production service processes used. Are the facilities, equipment, and processes modern and up to date or are they aged and in danger of becoming obsolete?

Past and Current Objectives and Strategies

In assessing its internal environment, every business should! attempt to explicitly describe its past and current objectives and strategies. In general, it can be said that past and current objectives and strategies are a strong indicator of future objectives and strategies. Four basic questions need to be answered in this area:

1. What have been the organization's major objectives in the relatively recent past?
2. Has it achieved these objectives?
3. What strategies has it employed in the relatively recent past?
4. Have these strategies been successful?

Once the relevant factors in the organization's internal environment have been analyzed, this information must be coupled with external environmental information to determine which strengths have strategic significance and where the organization is vulnerable to attack. Strengths have strategic significance when:

- **They** result in a distinctive competency. A distinctive competency occurs when an organization's strengths cannot be easily matched or imitated by a competitor. For example, Coca-Cola has name recognition throughout the world and this strength cannot be easily matched by anyone.
- **They** provide a competitive advantage. A competitive advantage is the ability to do something that competitors cannot do or at least cannot do nearly as well. Typically, developing a competitive advantage results from taking advantage of one or more distinctive competencies and building some type of strategic superiority. In the production of jug wine for the mass market, national advertising has become a necessity, but quality control and consistency are also important. The top five wineries have developed strengths in all these areas. What has kept Gallo on top of the industry, however, is its tight control of its distributors and its cost control through vertical integration. These are Gallo's competitive advantages; existence of strengths in these areas gives Gallo an edge over the competition.
- **They** enable the organization to maintain its position by performing the activity in question at the same level as other organizations in the industry.

> This is called a business requirement. Business requirements are determined by the dynamics of the competitive environment. They are the factors that are critical to success in the industry and that competitors cannot afford to ignore for very long. They can be identified by asking the question, "What skills must competitors possess in order to survive in this business?" Some examples of answers are:

We must maintain consistency of service from location to location (lodging, fast foods).

We must maintain efficient operations for low operating costs (airlines, meat packing).

Weaknesses may also have strategic significance. While an organization tries to do as many things well as possible, it is inevitable that an organization will not have strengths in all areas. When a given weakness is being evaluated, the key question to ask is, "How does this area of weakness compare with the competition?" A weakness becomes a *key vulnerability* when it is a capability that is held by most competitors and is necessary for success in that competitive environment. For example, lack of cost-efficient facilities is a key vulnerability for many American steel manufacturers because of international competition. A weakness can become a key vulnerability when environmental changes redefine the business requirements in the industry. Domestic airlines once depended on their ability to obtain favorable route and rate structures from the Civil Aeronautics Board; they were less concerned about cost control. With the deregulation of the airlines industry, the "old" airlines found that unionized work forces and high fixed costs made them vulnerable to competition from "new" airlines with streamlined operations and lower labor costs.

The nine areas discussed above are certainly not exhaustive in terms of conducting an internal analysis. However, they represent major areas that, at minimum, should be evaluated in most situations.

Resources and capabilities

Resources and capabilities (or competencies) are the fundamental building blocks of a firm's strategy. For instance, if a firm wants to enter new arenas, it will need appropriate resources and capabilities in order to compete there. In addition, no matter how a firm plans to differentiate its products—whether on quality, image, or price—it needs the right resources and capabilities to make the differentiation real. Likewise, when a firm is deciding on the best way to enter a new market—whether by means of acquisition, alliance, or internal development—it has to consider its available resources and capabilities. Sometimes a firm uses a vehicle such as an acquisition or an alliance specifically for the purpose of acquiring resources or capabilities that it does

not currently own. Not surprisingly, successful strategies exploit the resources and capabilities that a firm enjoys and put the firm on a path to acquire missing resources and capabilities and upgrade existing ones; whereas unsuccessful strategies often reflect the fact that critical resources and capabilities are lacking.

Resources are the inputs that firms use to create goods or services. Some resources are rather undifferentiated inputs that any firm can acquire. For instance, land, unskilled labor, debt financing, and commodity-like inventory are inputs that are generally available to most firms. Other resources are more firm-specific in nature. They are difficult to purchase through normal supply chain channels. For instance, managerial judgment, intellectual property, trade secrets, and brand equity are resources that are not easily purchased or transferred. From this description, it is clear that some resources have physical attributes; these are referred to as *tangible* resources. Other resources, such as knowledge, organizational culture, location, patents, trademarks, and reputation are *intangible* in nature. Some resources have both tangible and intangible characteristics. Land, for instance, has physical properties and satisfies certain functional needs. At the same time, some properties may have value as a resource by virtue of their location, which is an intangible benefit arising from unique proximity to customers or suppliers due to preferences or relative location.

Because tangible resources are easier to identify and value, they may be less likely to be a source of competitive advantage than intangible resources. This is because their tangible nature gives competitors a head start on imitation or substitution. But some tangible resources are quite instrumental in helping firms achieve favorable competitive positions, partly because of their intangible benefits. Union Pacific Railroad's control of key rail property, for example, gives it a competitive advantage in the transportation of certain materials, such as hazardous chemicals.

Capabilities, also called *competencies,* refer to a firm's skill in using its resources (both tangible and intangible) to create goods and services. Capabilities may be possessed by individuals or embedded in company-wide rules and routines. In essence, they are the combination of procedures and expertise that the firm relies on to engage in distinct activities in the process of producing goods and services. For instance, Wal-Mart is widely regarded as having excellent capabilities related to the management of logistics, which it uses to exploit resources such as large stores, store locations, its trucking fleet, and massive distribution centers.

Capabilities span from the rather simple tasks that firms must perform to accomplish their daily business, such as taking and fulfilling orders, to more complex tasks, such as designing sophisticated systems, creative marketing, and manufacturing processes. Collectively, these capabilities are the activities that constitute a firm's *value chain.* Not all capabilities are of equal value to the firm—a fact that has, in turn, given rise to the rapid growth of *outsourcing.* Outsourcing is contracting with external suppliers to perform certain parts of a company's normal value chain of activities.

Two other special classes of capabilities with which you should be familiar, if for no other reason than that they are part of the generally used business vocabulary, are *distinctive competences* and *core competences. Distinctive competences* (or *distinctive capabilities)* are the capabilities that set a firm apart from other firms. They are the capabilities that are unique to the firm within its competitive landscape. *Core competences* (or *core capabilities)* are those capabilities that are central to the main business operations of the firm; they are the capabilities that are common to the principal businesses of the firm and that enable the firm to generate new products and services in these businesses.

The relationship between resources and capabilities can be further illustrated by a few more examples. Intel's manufacturing capacity (i.e., its plants, equipment, and production engineers), its patented microprocessor designs, and its well-established brand name are among its key resources. Like its capabilities in speed-to-market, these other internal factors contribute to its strategic differentiators, in terms of the strategy diamond. Intel has also demonstrated the organizational capability to design new generations of leading-edge microprocessors and to do so rapidly. In addition, Intel has demonstrated marketing adroitness by creating the "Intel Inside" campaign, which stimulated greater demand and higher switching costs among end users—the customers of Intel's customers. This clearly suggests a marketing capability. The combination of Intel's resources and capabilities collectively comprise its differentiators, and enable its managers to execute a value-creating strategy and achieve a formidable competitive advantage in the microprocessor industry.

The important complementary relationship between one of McDonald's tangible resources (real estate) and one of its capabilities (its site-location skills) are highlighted in the following example. Few people go out for the sole purpose of buying a hamburger or a taco. Most fast-food purchases are impulse buys, and this fact points to just one reason why site location is so important in the fast-food industry. Like magazines and candies strategically placed at supermarket checkout counters, fast-food outlets are situated by design. At one time, McDonald's used helicopters to assess the growth of residential areas: Basically, planners looked for cheap land alongside thoroughfares that would one day run through well-populated suburbs.

Resource and capability audits

Assessing the organization's resources is to examine the resources "available" to the organization and to examine the utilization, the control and the linkage of these resources. Resource "availability", whether the resources reside inside or outside of the organization, is assessed through the resource audit. The utilization, control and linkage of the resources are assessed through the value chain analysis. The key objective of resources analysis is to maximize the economy, efficiency and the effectiveness of the organization's resources.

The resource audit attempts to assess the inherent strength of the resource base. The objective of the audit is to identify the quantity of resources available and the nature of those resources. Assessment of the physical resources identify the machinery and materials, and assess these resources in terms of their age, condition, capability as well as locations. The analysis of the human resources examines the number and types of different skills, and their adaptability to strategic changes. The audit of financial resources examines the sources and uses of the financial capital, the managing of the cash flow, and the relationship with financiers, debtors and creditors.

Other intangible resources such as goodwill generated by brand names, by well-known contacts, by established image or by any other reasons should also be assessed.

The VRINE criteria

In a given industry, then, all competitors do not have access to the same resources and capabilities—a fact that should have significant implications for the strategies that they develop. In addition, one firm's resources or capabilities aren't necessarily as effective as another's in helping it develop or sustain a competitive advantage. Why do some resources and capabilities enable some firms to develop a competitive advantage? Exhibit 4.1 summarizes five basic characteristics that determine whether a resource or capability can help a firm compete and, indeed, achieve superior performance: (1) value, (2) rarity, (3) inimitability, (4) nonsubstitutability, and (5) exploitability.

Exhibit 4.1: Applying the VRINE criteria

	The Test	**The Competitive Implication**	**The Performance Implication**
Is it valuable?	Does the resource or capability allow the firm to meet a market demand or protect the firm from market uncertainties?	If so, the company is able to compete in an industry, but value by itself does not convey an advantage.	Valuable resources and capabilities have the potential to contribute to normal profits (profits that cover the cost of all inputs, including capital).

	The Test	The Competitive Implication	The Performance Implication
Is it rare?	Assuming that the resource or capability is valuable, is it scarce relative to demand or is it widely possessed by competitors?	Valuable resources that are also rare contribute to a competitive advantage, but that advantage may be only temporary,	A temporary competitive advantage can contribute to above-normal profits, at least until the advantage is nullified by other firms.
Is it inimitable and/or non-substitutable?	Assuming that the resource is both valuable and rare, how difficult is it for competitors either to imitate it or substitute other resources and capabilities that yield similar benefits?	Valuable and rare resources and capabilities that are also difficult to imitate or substitute can contribute to sustained competitive advantage.	A sustained competitive advantage can contribute to above-normal profits for extended periods of time (until competitors find ways to imitate or substitute or environmental changes nullify the advantage).
Is it exploitable?	It the resource or capability satisfied any or all of the preceding VRINE criteria can the firm actually exploit it?	Resources and capabilities that satisfy the first four VRINE criteria but that cannot be exploited do not convey competitive advantage, In fact, they may increase opportunity costs.	Firms that control but don't exploit their VRINE resources and capabilities (even after they satisfy the V, R, I, and N criteria) generally suffer from lower levels of financial performance and depressed market valuations relative to what they would enjoy if they could in fact exploit them (although they won't be in as bad a shape as competitors who don't control any VRINE-certified resources and capabilities).

According to the **VRINE criteria** (for value, rarity, inimitability, nonsubstitutability, and exploitability), resources and capabilities contribute to competitive advantage to the extent that they satisfy the five components of the criteria. VRINE analysis helps managers systematically test the importance of particular resources and capabilities and the desirability of acquiring new resources and capabilities. VRINE analysis also suggest how a firm might use its resources and capabilities to differentiate its products or services in valuable ways that competitors cannot imitate; that is, it suggests what the firm might do in terms of the differentiator facet of the strategy diamond. In the following sections, we'll explain and provide examples of each VRINE characteristic.

Value

A resource or capability is *valuable* if it enables a firm to take advantage of opportunities or to fend off threats in its environment. Union Pacific (UP) Railroad, for example, maintains an extensive network of rail-line property and equipment on the U.S. Gulf Coast. The company enjoys this advantage because it owns the physical resources necessary to compete in this market—the railway rights of way through strategic areas—and because it has the specialized capability to transport chemicals safely and cost effectively. Government studies indicate that railroads are very efficient compared to alternative forms of transportation (such as truck and air) for the transportation of chemicals. Thus, railroad assets are valuable because they enable the company to provide a cost-effective means of transporting chemicals. In addition, because the Gulf Coast is the source for most chemical production in the United States, this network permits UP to take advantage of a market opportunity.

If a firm cannot use a resource to minimize threats or take advantage of opportunities, then it probably doesn't enhance its competitive position. Owning resources that *don't* meet the VRINE criteria for value actually puts a firm at a competitive *disadvantage*. The reason is that the capital tied up in the resource could be put to better use, the capital could be reinvested in other resources that do satisfy the value requirement of VRINE, or the capital could be redistributed to shareholders.

Rarity

Rarity is defined as scarcity relative to demand. An otherwise valuable resource that isn't rare won't necessarily contribute to competitive advantage. Valuable resources that are available to most competitors simply enable a firm to achieve parity with everyone else. Sometimes such resources may be called *table stakes,* as in poker, because they are required to compete in the first place. But when a firm controls a valuable resource that's also rare in its industry, it's in a position to gain a competitive advantage. Such resources, for example, may enable a company to exploit opportunities or fend off threats in ways that competitors cannot. When McDonald's signs an agreement to build a restaurant inside a Wal-Mart store, it has an intangible location advantage over Burger

King and Wendy's that is not only valuable but also rare because it has an exclusive right to that geographic space.

Satisfying the rarity condition, however, doesn't necessarily require *exclusive* ownership. When a resource is controlled by a handful of firms, those firms will have an advantage over the rest of the field. Pfizer was first to the market for a drug to treat erectile dysfunction with its Viagra product, but it was later joined by two other products offered by competitors (Levitra and Cialis). Pfizer no longer has a monopoly in the market to treat this condition, but the three firms collectively control resources that are scarce relative to demand. Thus, Pfizer's resource, the patent for Viagra, would still seem to satisfy both the value and the rarity requirements of VRINE. Consider an example from another context. The criterion of rarity requires only that a resource be scarce *relative to demand.* It also follows, of course, that the more exclusive the access to a valuable resource, the greater the benefit of having it.

A firm that controls a valuable and scarce resource or capability may create a competitive advantage, but there is no assurance that the advantage will persist. We now turn to the two criteria that must be satisfied if the advantage is to be sustained.

Inimitability and Nonsubstitutabflity

A valuable and rare resource or capability will grant an advantage only so long as competitors don't gain possession of it or find a close substitute. We review these two criteria jointly because they work in similar fashions. The criterion of *inimitability* is satisfied if competitors cannot acquire the valuable and rare resource quickly or if they face a cost disadvantage in doing so. The *nonsubstitutability* criterion is satisfied if a competitor cannot achieve the same benefit using different combinations of resources and capabilities. When a resource or capability is valuable and rare and contributes to a firm's advantage, one can assume that competitors will do all they can to get it. Of course, firms can acquire needed resources or capabilities in a number of different ways, including internal investment, acquisitions, and alliances. They can, for instance, form alliances in order to learn from and internalize a partner's capabilities.

Some firms find alternative resources or capabilities that "mimic" the benefits of the original. For several years, for example, Barnes & Noble and Borders enjoyed formidable advantages in the retail-book industry. Their sheer size gave them an immense advantage over smaller players: Because they had access to more customers, they were able to take advantage of greater buying power. Eventually, however, Amazon.com's ability to substitute online for conventional retail marketing provided a feasible substitute for geographic accessibility to consumers. Generally speaking, then, valuable and rare resources can provide competitive advantage only as long as they're difficult to imitate or substitute.

The High Cost of Imitation and Substitution

Several factors can make some resources and capabilities difficult to duplicate or substitute. A rival might, for instance, try to acquire a competitor or supplier that possesses the resource it needs) But acquisitions of this kind often entail large premiums that result in a buyer paying more for a resource than it cost competitors to develop the original.

Inimitability, Nonsubstitution, and Property Rights

Perhaps the most straightforward cause of resources and capabilities being difficult to imitate or substitute is property rights. Competitors can be prevented from copying resources if they are protected by ownership rights. For instance, patented items or processes cannot be directly copied during the term of the patent without the imitator being subject to severe legal repercussions.

Causal Ambiguity

Another factor that makes imitation difficult is causal ambiguity. For a number of reasons, it may be difficult to *identify* or *understand* the causal factors of a resource or capability—the complex combination of factors that make it valuable. For instance, what makes Apple, Google, 3-M, and Toyota so much more innovative than their direct competitors? There is clearly something special about these firms but you would be hard-pressed to create a carbon copy from scratch, even if you had the money to do so.

Exploitability

The fifth and final VRINE criterion stresses that mere possession of or control over a resource or capability is necessary but not sufficient to gain a competitive advantage: A firm must be able to *exploit* it; that is, the firm must be able to nurture and take advantage of the resources and capabilities that it possesses. The question of exploitability is, quite broad, but in this case, we're focusing on *a company's ability to get the value out of any resource or capability that it may generate.* Thus, the issue of an organization's exploitative capability incorporates all of the dimensions of a firm's value-adding processes. A valuable resource or capability that is also possessed by many other competitors has the potential to give the firm competitive parity, but only if the firm also has the exploitative capabilities to implement a strategy that utilizes the resource or capability. Likewise, a firm that possesses a valuable and rare resource will not gain a competitive advantage unless it can actually put that resource to effective use.

The VRINE criteria can be used to assess any resource or capability in order to determine if it is a source or potential source of competitive advantage and, if so, whether that advantage is likely to be temporary or sustained.

Where Do Resources Come From?

Resources and *capabilities* are described as something the firm may own or possess. However, note that many resources and capabilities cannot be easily purchased. Brand equity, for example, can't be readily purchased unless a company purchases an existing brand from another company. Otherwise, a brand will need to be developed, and that takes time. The brand equity of Coke, for example, has been developed through decades of marketing efforts with investments in the hundreds of millions per year. Toyota's reputation for quality automobiles has been developed through stringent quality-control methods; Intel's R&D capability is the result of years of investment. In other words, intangible resources such as brand equity, reputation, and innovative capability result from policies and strategies that have been implemented over extended periods of time; they can't be acquired through onetime purchases.

Strategy and internal structure

A lot of research was done on the relationship between organizational structure and strategic management. Five approaches have been identified to organizational designs that can be applied to organization in specific situations. They are simple structure, machine bureaucracy, professional bureaucracy, adhocracy and the matrix design.

Simple structure is suitable for a simple and unstable environment. It implies little specialization, organic structure with little formalization, and very concentrated power and decision making. Direct supervision is the primary coordination mechanism.

Machine bureaucracy is suitable for a simple and stable environment. It has high work specialization; mechanistic and highly formalized procedures with concentrated power and decision making from the top. It is slow to change, with standardization of work processes as the primary co-ordination mechanism.

Professional bureaucracy is suitable for a complex and stable environment. Horizontal specialization by professional area of expertise with little formalization is the key characteristic. It has decentralized power and decision making, and standardization of skill is the primary co-ordination mechanism.

Adhocracy is for a complex and unstable environment. It has little formalization and is highly organic in nature. Power is in the hands of experts, and decision making is spread throughout the organization. Mutual adjustment through liaison is the primary co-ordination mechanism.

Matrix design is a design that is a combination of two different designs to gain the benefit of both. A very common combination is to combine the team structure with a functional structure.

Strategy and internal culture

Relating organizational culture to strategies, The following might be considered as "strategic" cultures:

- **The defender's culture** – adopted by organizations in low risk, secured markets, and using tried and trusted solutions. The culture reflects continuity and consensus. Decision making is highly formalized, and the focus is on efficiency.
- **The prospector's culture** – adopted by organizations that prefer to take risks. The culture is characterized by decentralized structures with short lines of communications. The focus is on effectiveness and doing the right things regardless of how.
- **The analyzer's culture** – adopted by organizations seeking a balance between risks and secured profits. This culture uses a core of stable businesses as a source of earning to support risky prospecting. These organizations are followers of change and not initiators.
- **The Reactor's culture** – can be considered as having no strategies whatsoever. Survive (if at all) by reacting and muddling through.

Excellent organizations seem to share certain common characteristics, including:

- A bias for action and experimentation.
- Closeness to the customer & customer driven.
- Autonomy and entrepreneurship.
- Productivity through people - high value placed on human resource.
- Value driven hands-on management.
- "Stick to the knitting" - stick to what you know and can manage.
- Simple structure & lean management staff.
- Simultaneous loose-tight properties - decentralized decision making but tightly centralized on key values.

It is worthwhile to note, however, that excellent for their time, some companies, such as Yahoo and GM, did not respond successfully to changing conditions - a flexible culture enabling the organization to change with the times was missing in many case.

From the analysis of the healthy aspects, the various characteristics of unhealthy culture can also be identified:

- No "visionary" element - lacking in articulated beliefs and shared value, with no sense of the future.
- No sense of unity - lacking in co-ordination and central driving force.
- Conflicts or hostilities amongst the various sub-cultures.

- Intense political conflicts and rivalry.
- Focus on internal issues at the expense of external (customer related) issues.
- Preoccupation with the short term.
- Low employee morale - expressed in low productivity, high absenteeism, high turnover, or high level of dissatisfaction and complains.
- Management apathy or irresponsibility.
- Resistance to innovation or to change.
- Over rigidity in control and disciplinary system.
- Lackluster marketing and projection of organization's image.

SWOT analysis

SWOT is an acronym for an organization's strengths, weaknesses, opportunities, and threats. It is also called *situational analysis*. As discussed previously, strategic management can be broken down into three phrases: strategy planning and strategy formulation, strategy implementation, and strategy evaluation. The SWOT analysis is a major tool for strategy formulation. The underlying assumption of a SWOT analysis is that managers can better formulate a successful strategy after they have carefully reviewed the organization's strengths and weaknesses in light of the threats and opportunities presented by the environment. SWOT analysis is to combine the assessment of the environment with the analysis of the organization's internal resources and capabilities. The key objective is to arrive at strategic fit - the matching of strength to opportunities, the elimination or avoidance of threats, and the strengthening or avoidance of weaknesses (see Exhibit 4.2). A key byproduct of the SWOT analysis is the identification of the core competence for the organization.

Exhibit 4.2: SWOT analysis

		INTERNAL	
		Strength	*Weakness*
EXTERNAL	*Opportunities*	Matching strength to opportunities	Use opportunities to strengthen or avoid weaknesses
	Threats	Use strength to eliminate or avoid threats	Dangerous position

The strategic response to the SWOT analysis is to develop strategies to exploit opportunities, to strengthen weaknesses, to match opportunity to strength, and to eliminate or avoid weaknesses and threats.

Points of strengths and weaknesses can be found in many internal aspects of the organization:

- Marketing aspects such as advertising, new product launches, public relations.
- Product aspects such as features, profits, demands.
- Distribution aspects such as efficiency, location factors.
- Research and development aspects such as potentials and abilities.
- Finance aspects such as funding, cash flows, returns.
- Fixed assets aspects such as plants, machinery, age, capacity.
- Human resource aspects such as management, staff, relationships, culture, management approach
- Organizational aspects such as structure, leadership style.
- Procurement aspects such as availability, relationships with suppliers.

In assessing organizational opportunities, the organization needs to consider the following:

- What are the opportunities?
- What are the potentials of each of the opportunities?
- What is the likelihood of the opportunities happening?
- Can the organization exploit the opportunities?
- What are the comparative capabilities to exploit the opportunities with respect to the competitors?

Similarly, in assessing the threats, the organization should consider the following:

- What are the threats?
- What is the likely impact of each of the threats on the organization?
- What is the likelihood of the threats becoming a reality?
- Can the organization overcome the threats if they become reality?
- What are the comparative capabilities to overcome the threats with respect to the competitors?

Exhibit 4.3 presents several factors that managers should consider when assessing an organization's strengths and weaknesses and the threats and opportunities presented by broad and competitive environments. Once the strengths, weaknesses, opportunities, and threats have been identified, the management team is then in a

position to complete the SWOT analysis by drawing conclusions about the attractiveness (or unattractiveness) of the organization's current situation and the need for strategic action. Exhibit 4.4 provides a step-by-step summary of a SWOT analysis. A SWOT analysis also provides useful information for the objective setting process.

Exhibit 4.3: SWOT analysis factors

Potential Internal Strengths	**Potential Internal Weaknesses**
◆ Core competencies in key areas.	◆ No clear strategic direction.
◆ Adequate financial resources.	◆ Obsolete facilities.
◆ Well thought of by buyers.	◆ Subpar profitability because.
◆ An acknowledged market leader.	◆ Lack of managerial depth and talent.
◆ Well-conceived functional area strategies.	◆ Missing some key skills or competencies.
◆ Access to economies of scale.	◆ Poor track record in implementing strategy.
◆ Insulated (at least somewhat) from strong competitive pressures.	◆ Plagued with internal operating problems.
◆ Proprietary technology	◆ Falling behind in R&D.
◆ Cost advantages.	◆ Too narrow a product line.
◆ Better advertising campaigns.	◆ Weak market image.
◆ Product innovation skills.	◆ Weak distribution network.
◆ Proven management.	◆ Below-average marketing skills.
◆ Ahead on experience curve.	◆ Unable to finance needed changes in strategy.
◆ Better manufacturing capability.	◆ Higher overall unit costs relative to key competitors.
◆ Superior technological skills.	
Potential External Opportunities	Potential External Threats
◆ Serve additional customer Groups.	◆ Entry of lower-cost foreign competitors.
◆ Enter new markets or segments.	◆ Rising sales of substitute products.
◆ Expand product line to meet broader range of customer needs.	◆ Slower market growth.

◆ Diversify into related products.	◆ Adverse shifts in foreign exchange rates and trade policies of foreign governments.
◆ Vertical integration (forward or backward).	◆ Costly regulatory requirements.
◆ Falling trade barriers in attractive foreign markets.	◆ Vulnerability to recession and business cycles.
◆ Complacency among rival firms.	◆ Growing bargaining power of customers or suppliers.
◆ Faster market growth.	◆ Changing buyer needs and tastes.
	◆ Adverse demographic changes.

Exhibit 4.4: Step-by-step summary of a SWOT analysis

Step 1	**Step 2**	**Step 3**	**Step4**
Environmental Analysis	**Industry and Competitive Analysis**	**Internal Appraisal**	**SWOT Analysis**
Areas for Analysis	**Areas for Analysis**	**Areas for Analysis**	**Areas for Analysis**
1.. Political. 2. Economic. 3. Sociocultural. 4. Technological. 5. Environmental 6. Legal.	1. Industry structure 2. Individual competitor.	1. Financial position 2. Product/ service 3. position. Product/ service quality. 4. Marketing capability. 5. Research and development capability. 6. Organizational structure. 7. Human resources. 8. Condition of facilities and equipment. 9. Past objectives and strategies.	1. Strengths. 2. Weaknesses. 3. Opportunities. 4. Threats.

GLOBAL professional publishing

Procedure	Procedure	Procedure	Procedure
1. Identify the key forces that are most likely to affect the organization. 2. Monitor information on the key environmental forces. 3. Select the method to be used in forecasting these forces. 4. Forecast the trends in these forces. Identify the 5. threats to and opportunities for the organization on the basis of the forecast of these forces.	1. Analyze the competitive nature of the 2. industry. Identify and analyze 3. competitors. Identify key strengths and weaknesses of the organization as compared 4. to those of its competitors. Identify the threats to and opportunities for the organization on the basis of its industry competitiveness.	1. Analyze each of the 2. above areas. Identify the internal strengths and weaknesses as a result of the analysis.	1. Assess the attractiveness of the organization's 2. situation. Draw conclusions regarding the need for strategic action.

Establishing long-range objectives

As discussed in Chapter 1, long-range objectives specify the results desired in pursuing the organization's mission and normally extend beyond the current fiscal year of the organization. Short-range objectives should follow logically from long-range objectives. Short range objectives, sometimes called "annual objectives," are performance targets normally covering one year or less, designed to achieve the organization's long-range objectives.

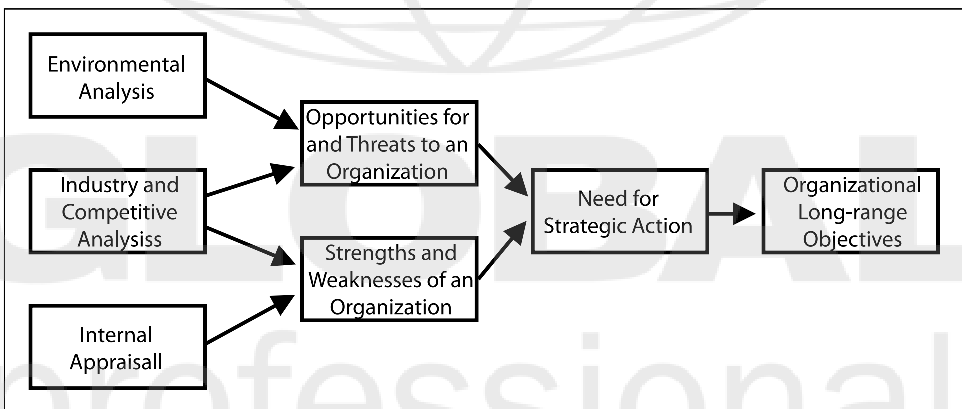
American managers have been criticized for failing to look beyond the accomplishment of short-range objectives. However, establishing and achieving long range objectives is extremely important. While extended planning horizons are critical to industries with large capital investments (e.g., utilities and automobiles), they are also important for most other industries. Even in the rapidly changing high-technology field the most savvy companies are, and have been for years, thinking about home robots,

GLOBAL professional publishing

telecommunications, and electronic libraries, applications of which are now in existence. Without losing sight of short-range performance, top managers must be strategically planning for the future (5, 10, 15, or more years ahead) of their organization.

Ideally, an organization's long-range objectives should match its strengths to opportunities, minimize its threats to the organization, and eliminate its weaknesses in the organization. Thus, an organization's long-range objectives should be directly impacted by the SWOT analysis. Exhibit 4.5 illustrates the interrelationships between the components of the SWOT analysis and organizational long range objectives. Organizational long-range objectives should support the organization's mission, and they need to be established for every area of the organization where performance directly influences its survival and success.

Exhibit 4.5: Swot analyisis and organizational objectives



Mix of organizational objectives

No one mix or combination of long-range objectives is applicable to all organizations. The type of objectives that are established depends on the nature of the particular organization. For example, the Boy Scouts of America would have a set of objectives different from the American Express Company.

The mix of organizational objectives is influenced by the purpose, mission, the SWOT analysis, and the mix of objectives from prior years. The degree of achievement of prior objectives influences the aspiration level of the management team and often serves as a starting point for determining the mix and exact nature of the objectives for a future time period.

Objectives should be expressed as clearly as possible and in quantitative terms whenever possible. The following items provide potential areas and examples for establishing objectives for most organizations:

1. *Customer Service*. Expressed in terms of delivery times or customer complaints. Example:
   a. To reduce the number of customer complaints by 40 percent over the next three years.

2. *Financial Resources*. Expressed in terms of the capital structure, new issues of common stock, cash flow, working capital, dividend payments, and collection periods. Examples:
   a. To increase working capital to $10 million within five years.
   b. To reduce long-term debt to $8 million within three years.

3. *Human Resources*. Expressed in terms of rates of absenteeism, tardiness, turnover, or number of grievances. Also can be expressed in !terms of number of people to be trained or number of training programs to be conducted. Examples:
   a. To reduce absenteeism by 8 percent within three years.
   b. To conduct a 40-hour supervisory development program for 300 supervisors at a cost not to exceed $400 per participant over the next four years.

4. *Markets*. Expressed in terms of share of the market or dollar or unit volume of sales. Examples:
   a. To increase commercial sales to 85 percent of total sales and reduce military sales to 15 percent of total sales over the next three years.
   b. To increase the number of units of product X sold by 500,000 units within four years.

5. *Organizational Structure*. Expressed in terms of changes to be made or projects to be undertaken. Example:
   a. To establish a decentralized organizational structure within three years.

6. *Physical Facilities*. Expressed in terms of square feet, fixed costs, or units of production. Examples:
   a. To increase storage capacity by 15 million units over the next three years.
   b. To decrease production capacity in the West Coast plant by 20 percent within three years.

7. *Product*. Expressed in terms of sales and profitability by product line or product or target dates for development of new products. Example:
   a. To phase out the product with the lowest profit margin within two years.

8. *Productivity*. Expressed in terms of a ratio of input to output or cost per unit of production. Example:
    a. To increase the number of units produced per worker by 10 percent per eight-hour day over the next three years.

9. *Profitability*. Expressed in terms of profits, return on investment, earnings per share, or profit-to-sales ratios. Example:
    a. To increase return on investment to! 15 percent after taxes within four years.

10. *Research and Development*. Expressed in terms of the amount of money to be spent on projects to be completed. Example:
    a. To develop an engine in the medium-price range within five years at a cost not to exceed $3 million.

11. *Social Responsibility*. Expressed in terms of types of activities, number of days of service, or financial contributions. Example:
    a. To increase our contribution to United Way by 30 percent over the next three years.

GLOBAL professional publishing

Value chain analysis

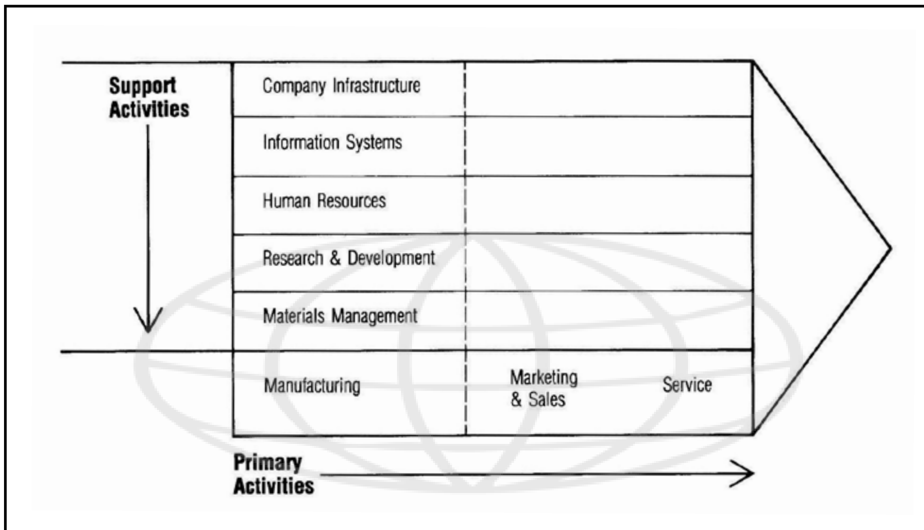
The value chain analysis identifies the activities that underpin the organization. Based on the approach to understand the "profitability" of each of these activities, the value chain analysis assesses the value added from each of these building blocks of activities.

From these value activities, cost or value drivers should be identified. These are factors which determine cost or value of each activities. It needs to be remembered that the concept of value must be assessed from the points of view of the final consumer or user of the product or services.

Specialization of roles often implies that any one organization is part of the wider value system which creates the product or the service. Thus external linkage within this whole value creation process need to be understood as well. One of the key outcomes of such a broad analysis is the reduction of sub-optimization.

Michael E. Porter's model of the value creation chain consists of primary and supporting activities. The primary activities are inbound and outbound logistics, operations, outbound logistics, marketing and sales, and service. The four support activities are infrastructure (e.g., administration, finance, and planning), procurement, human resources, and technology development. The form of the value chain is given in Exhibit 4.6.

Exhibit 4.6: The value chain



Inbound logistics relates to activities that are concerned with supply source, supply costing, process and product changes in suppliers, research and development planning and orientation, sources of funds such as working capital and investments, and relationship with suppliers.

Operations management focuses on production capacity, plant locations, capital investments and their timing, labor quantities, skill requirements, and flexibility of production.

Outbound logistics concerns areas such as warehousing and distribution, types of transport and timing of deliveries.

Marketing and sales involve product planning, promotion materials, and deliveries.

Services takes place after the sales, and involve the information system, warranties, returns and servicing, and maintenance.

As for the secondary activities, these activities transcend the entire organization. Procurement refers to the process for acquiring the various resource inputs to the primary activities. Technology development provides the technical support to the primary activities. Human resource management links the human resources in all the primary activities. And the infrastructure provides the structural and process support to the entire organization.

Value chain analysis is a strategic analysis tool that allows a firm to focus on those activities that are consistent with its overall strategy. The first step in a value chain analysis is to identify the firm's value-creating activities. The second step in a

value chain analysis is to determine how each value-creating activity can produce a competitive advantage for the firm. This step has multiple substeps: (1) identify the firm's competitive advantage (e.g., cost reduction, product differentiation) so that the firm's position in the industry's value chain can be clarified. (2) identify the ways in which the firm's value-creating activities can generate additional customer value. (3) identify activities that are candidates for cost reduction or, in the case of non-core competencies, outsourcing. (4) identify value adding ways in which the firm's remaining activities can be linked.

Cost driver analysis

Cost driver analysis is the basis of linking resource utilization to competitive advantages. One of the key aspects of value chain analysis is the recognition that organizations are much more than just a random collection of resources. These resources are of no value unless organized in such a way that produces products or services which are valued by the final consumer. In other words, it is value activities and linkages between them which are the source of competitive advantage for the organization.

The approach can be described as follows:

- The organization should be aggregated into the various value activities which underpin the production and delivery of its products or services.
- Identify those value activities which critically underpin the organization's competitive position. These are the critical success factors.
- The concept of value must be assessed from the view-point of the final consumer of the product or services.
- Identify those factors which sustain the competitive position through each of the critical factors. These are the value drivers or cost drivers.
- Competitive advantage is likely to be sustained by the linkages which have been made between value activities and also within the wider value system of suppliers, channels or customers. It is the planning of these linkages which can either provide distinctive cost advantages or become the basis on which the organization's products or services are differentiated from the competitors'.

Core competencies analysis

Identifying the values perceived by the market place is the basic issue in the differentiation strategy. This is the basic link between the creation of value by the value activities, and the establishing of competitive advantages. When a company has real

proficiency in performing a competitively important value chain activity, it is said to have a core competence.

Examples of core competence might include mastery of a particular process technology either for products or services, a particularly successful management approach, in-depth understanding of how to satisfy particular segment of customers, the ability to manufacture a high-quality product at a low cost, the capability to develop new products in a more or less continuing stream, or know-how in creating and operating a system for filling customer orders accurately and swiftly..

GLOBAL
professional
publishing

CHAPTER 5 Strategic Formulation

Strategy outlines the fundamental steps an organization intends to take in order to achieve a set of objectives. Management develops a strategy by evaluating options available to the organization and choosing one or more of the options.

Strategies exist at different levels in an organization and are classified according to the scope of their coverage, as discussed previously. Strategies that address what businesses an organization will be in and how resources will be allocated among those businesses are called *corporate strategies.* Corporate strategies are established at the highest levels of the organization and involve a long-range time horizon. *Business (competitive) strategies* focus on how to compete in a given business. The scope of a business strategy is narrower than a corporate strategy and generally applies to a strategic business unit (SBU). A third level of strategy is functional strategies, which are narrower in scope than business strategies.

Functional strategies are concerned with the activities of the different functional areas, such as production, finance, marketing, and personnel. Usually functional strategies are for a relatively short time-normally one year or less. Although functional strategies must support corporate and business unit strategies, they are primarily concerned with "how-to" issues.

Functional area strategies, which are designed to improve the internal operations or condition of an organization, frequently hold the key to success for longer-range corporate strategies. For example, a functional information systems strategy that is designed to link all retail stores with central purchasing and inventory control could be the necessary precursor for extensive expansion. Functional strategies are used not only to support corporate and business unit strategies but also to upgrade strengths and to eliminate weaknesses. Corporate and business strategies are described in this chapter.

There are numerous distinctly identifiable basic strategies that an organization may choose to follow. Which of these is most appropriate naturally depends on several factors, such as the mission and long-range objectives, the growth rates of the related

markets, and the competitive position of the company. The most appropriate strategy may, and often does, change from time to time. The purpose of this chapter is to introduce and define the different possible strategy alternatives at both the corporate level and the business level. The selection of the most appropriate strategy for a given set of situations cannot be made until the specifics of the situation have been determined and evaluated. This is described in subsequent chapters of this book.

In choosing corporate and business unit strategies, most organizations have a wide variety of options. Exhibit 5.1 summarizes the alternatives available to most organizations. As can be seen, corporate strategy options fall into one of five basic categories: (1) stable growth, (2) growth, (3) harvesting, (4) defensive, or (5) a combination of the previous four. Business (competitive) strategy options fall into one of three basic categories: (1) overall cost leadership, (2) differentiation, or (3) focus. Each of these strategy options is described at length in the following sections.

Exhibit 5.1: Corporate and Business Strategy Alternatives

I. Corporate Strategy Alternatives
A. Stable Growth Strategy
B. Growth Strategy
    1. Concentration Strategy
        a Market Development
        b. Product Development
        c Horizontal Integration
2. Vertical Integration
3. Diversification
        a. Concentric Diversification
        b. Conglomerate Diversification
C. Harvesting Strategies
D. Defensive Strategies
        a. Turnaround
        b. Divestment
        c. Liquidation
        d. Filing for Bankruptcy
        e. Becoming a Captive
E. Combination Strategies
    a. Simultaneous
    b. Combination
II. Business (competitive) Strategy Alternatives
A. Overall Cost Leadership
B. Differentiation of Product/Service
C. Focus of Product/Service

Corporate strategy alternatives

Again, corporate strategy is concerned with which businesses an organization will be in and how its resources will be distributed among those businesses.

Stable growth strategies

A stable growth strategy can be characterized as follows:

- The organization is satisfied with its past performance and decides to continue to pursue the same or similar objectives.
- Each year the level of achievement expected is increased by approximately the same percentage.
- The organization continues to serve its customers with basically the same products or services.

A stable growth strategy is a relatively low-risk strategy and is quite effective for successful organizations in an industry that is growing and in an environment that is not volatile. For many organizations, stable growth is probably the most effective strategy. Some of the reasons for the use of a stable growth strategy are:

- Management may not wish to take the risk of greatly modifying its present strategy. Change threatens those people who employ previously learned skills when new skills are required. It also threatens old positions of influence. Furthermore, the management of a successful organization quite frequently assumes that strategies that have proved to be successful in the past will continue to be successful in the future.
- Changes in strategy require changes in resource allocations. Changes in patterns of resource allocation in an established organization are difficult to achieve and frequently require long periods.
- Too-rapid growth can lead to situations in which the organization's scale of operations outpaces its administrative resources. Inefficiencies can quickly occur. • The organization may not keep up with or be aware of changes that may affect its product and market.

Generally, organizations that pursue a stable growth strategy concentrate on one product/ service. They grow by maintaining their share of the steadily increasing market, by slowly increasing their share of the market, by adding new product(s)/ service(s) (but only after extensive marketing research), or by expanding their market coverage geographically. Many organizations in the public utility, transportation, and insurance industries follow a stable growth strategy. In fact, for many industries and for many organizations, stable growth is the most logical and appropriate strategy.

Growth strategies

Organizations pursuing a *growth strategy* can be described as follows:

- They do not necessarily grow faster than the economy as a whole but do grow faster than the markets in which their products are sold.
- They tend to have larger-than-average profit margins.
- They attempt to postpone or even eliminate the danger of price competition in their industry.
- They regularly develop new products, new markets, new processes, and new uses for old products.
- Instead of adapting to changes in the outside world, they tend to adapt the outside world to themselves by creating something or a demand for something that did not exist before.

Organizations pursuing growth strategies, however, are not confined to growth industries. They can be found in industries with relatively fixed markets and established product lines.

Why does an organization decide to pursue a growth strategy? While there is no single reason, several different possibilities exist:

- Growth has been ingrained in Americans as "the path of success." Since childhood, many Americans have held the dream of starting and growing their own businesses. This has always been, and still is, viewed as the quickest way to get rich.
- Managers are often given bonuses, salary increases, and continued employment for achieving growth in sales and profits. For example, it is not unusual for a bonus based on growth in profits to be written into a top-level manager's employment contract.
- Managers who did not start, and may not even own, a significant interest in the company want to be remembered as having made significant contributions to the company. More often than not, making "significant contributions" is interpreted as having expanded the company.
- Pressures from investors and others with a financial interest in the company stress growth. Stockholders, security analysts, and bankers like to invest in and support growth-oriented companies.
- A belief exists that the company must grow if it is to survive. In certain volatile industries, an organization does not have the option of remaining stable if it is to survive.

Several different generic strategies fall in the growth category. The most frequently encountered and clearly identifiable of the growth strategies are discussed in the following sections.

Concentration strategy

A concentration strategy focuses on a single product/service or on a small number of closely related products/ services and involves increasing sales, profits, or market share faster than it has increased in the past. Several factors might influence an organization to pursue a concentration strategy. Some of these include:

- Lack of a full product line in the relevant market (product line gap)
- Absent or inadequate distribution system to or within the relevant market (distribution gap).
- Less than full usage in the market (usage gap).
- Competitor's sales (competitive gap).

Some of the actions available to an organization in filling these gaps include the following:

- Filling out the existing product line (e.g., new sizes, options, styles, or colors could be offered for the existing product line).
- Developing new products in the existing product line (e.g., Cherry Coke was a new product in an existing product line).
- Expanding distribution into new geographic areas either nationally or internationally.
- Expanding the number of distribution outlets in a geographic area. Expanding shelf space and improving the location and displays of the product in present distribution outlets.
- Encouraging nonusers to use the product and light users to use it more frequently through the use of advertising, promotions, and special pricing campaigns.
- Penetrating competitors' positions through pricing strategies, product differentiation, and advertising.
- Basically, there are three general approaches to pursuing a concentration strategy: market development, product development, and horizontal integration.

Market development

The thrust under a market development approach is to expand the markets of the current business. This can be done by gaining a larger share of the current market,

expanding into new geographic areas, or attracting new market segments. Coca-Cola has continued to follow a market development strategy since its inception. It amassed its impressive market share through large-scale advertising programs and has continued to expand into new geographic areas.

Product development

The thrust under a product development approach is to alter the basic product or service or to add a closely related product or service that can be sold through the current marketing channels. Successful product development strategies often capitalize on the favorable reputation of the company or related products. The cell phone makers' introduction of smart phones is an example of a product development strategy.

Horizontal integration

Horizontal integration occurs when an organization adds one or more businesses that produce similar products or services and that are operating at the same stage in the product-marketing chain. Almost all horizontal integration is accomplished by buying another organization in the same business.

One concern with employing horizontal integration is that such a strategy eliminates the competition that has existed between the two organizations and may result in legal ramifications. In the 1950 Celler-Kefauver amendment to Section 7 of the Clayton Act, Congress prohibited mergers that substantially lessened competition or that tended to create a monopoly in any field of business in any section of the country. Some of the factors that are examined by the Antitrust Division of the U.S. Department of Justice in determining the legality of a merger are (1) the level of concentration in the industry (e.g., the market shares of the leading organizations and the increase in concentration that will be caused by the proposed merger), (2) whether the merger will give the resulting organization a competitive advantage over other organizations in the industry, (3) whether entry into the industry is difficult, (4) whether there has been a trend of mergers within the industry, (5) the economic power of the merged organizations, (6) whether demand for the industry's products is growing, and finally (7) whether there is danger that the merger will trigger others.

A concentration strategy offers an organization several advantages. First, the organization already has much of the knowledge and many of the resources necessary to compete in the market place. A second advantage is that a concentration strategy allows the organization to focus its attention on doing a small number of things extremely well. One does not have to look very far to find examples of companies that have failed because they spread their talents and resources in too many different directions. The major drawback to a concentration strategy is

that it places all or most of the organization's resources in the same basket. If the market for the organization's product/service declines, then the organization is in trouble. This is an especially important concern when one considers that it has been estimated 80 percent of today's products will have disappeared from the market 10 years from now, while an estimated 80 percent of the products that will be sold in the next decade are as yet unknown. Several factors outside the control of any single organization can cause a decline in the demand for a product/service. The increasing instability of consumer preferences, the growing intensity and sophistication of competition, technological change, and changes in government policy pose a risk for any organization concentrating on a single product/service.

Regardless of the risk associated with a concentration strategy, many organizations have been very successful in pursuing a concentration strategy.

Vertical integration

Vertical integration is a growth strategy that involves extending an organization's present business in two possible directions. The acquisition of a shoe retailer by a shoe manufacturer is an example of vertical integration. Vertical integration is typified by a merger or acquisition involving companies that are in the same industry but at different levels in the supply chain. In other words, one of the companies supplies inputs for the other. *Forward integration* moves the organization into distributing its own products or services. *Backward integration* moves an organization into supplying some or all of the products or services used in producing its present products or services.

Several factors, including the following, might cause an organization to pursue either forward or backward integration:

- Backward integration gives an organization more control over the cost, availability, and quality of the raw materials it uses.
- When suppliers of an organization's products or services have large profit margins, the organization can convert a cost-center into a profit-center by integrating backward.
- Forward integration gives an organization control over sales and distribution channels, which can help in eliminating inventory buildups and production slowdowns.
- When the distributors of an organization's products or services have large markups, the organization may increase its own profits by integrating forward.
- Some organizations use either forward or backward integration in hopes of benefiting from the economies of scale available from the creation of nationwide sales and marketing organizations and the construction

of larger manufacturing plants. These economies of scale may result in lower overall costs and thus increased profits.

- Some organizations use either backward or forward integration to increase their size and power in a particular market or industry in order to gain some degree of monopolistic control.

Vertical integration is a reasonable and rational strategy in certain situations. However, organizations should adopt a vertical integration strategy with caution, because integrated organizations have become associated with mature and less profitable industries. At the same time, escape from these industries is particularly difficult for a large, vertically integrated organization.

Diversification

Diversification occurs when an organization moves into areas that are clearly differentiated from its current businesses. The reasons for embarking on a diversification strategy can be many and varied, but one of the most frequently encountered is to spread the risk so the organization is not totally subject to the whims of any one given product or industry. A second reason to diversify is that management may believe the move represents an unusually attractive opportunity, especially when compared with other possible growth strategies. Possible reasons for this attractiveness could be that the markets for current products and services are saturated or, if current markets are not saturated, that the profit potential of diversification looks greater than that of expanding the current business. A third reason to diversify is that the new area may be especially intriguing or challenging to management. A fourth reason why diversification can be attractive is to balance out seasonal and cyclical fluctuations in product demand.

Most diversification strategies can be classified as either concentric diversification or conglomerate diversification. *Concentric diversification* occurs when the diversification is in some way related to, but clearly differentiated from, the organization's current business. *Conglomerate diversification* occurs when the firm diversifies into an area(s) totally unrelated to the organization's current business.

Concentric diversification

The basic difference between a concentric diversification strategy and a concentration strategy is that a concentric diversification strategy involves expansion into a related, but distinct, area whereas concentration involves expansion of the current business. Concentric diversification involves adding products or services that lie within the organization's know-how and experience in terms of technology employed, product line, distribution system, or customer base.

A concentric diversification strategy can have several advantages. The most obvious is that it allows the organization to build on its expertise in a related area.

It also can have the advantage of spreading the organization's risks. Organizations that do branch out but stick very close to their knitting outperform the others.

Conglomerate diversification

Conglomerate diversification is a growth strategy that involves adding new products or services that are significantly different from the organization's present products or services. Conglomerate diversification can be pursued internally or externally. Most frequently, however, it is achieved through mergers, acquisitions, or joint ventures, which are described later in this chapter.

A great many organizations prefer the conglomerate diversification strategy. The reasons for following such a strategy are also numerous. Some of the more important ones follow:

- Supporting some strategic business units (SBUs) with the cash flow from other SBUs during a period of development or temporary difficulties.
- Using the profits of one SBU to cover expenses in another SBU without paying taxes on the profits from the first SBU.
- Encouraging growth for its own sake or to satisfy the values and ambitions of management or the owners.
- Taking advantage of unusually attractive growth opportunities.
- Distributing risk by serving several different markets.
- Improving the overall profitability and flexibility of the organization by moving into industries that have better economic characteristics than those of the acquiring organization.
- Gaining better access to capital markets and better stability or growth in earnings.
- Increasing the price of an organization's stock.
- Reaping the benefits of synergy. *Synergy* results from a conglomerate merger when the combined organization is more profitable than the two organizations operating independently.

In choosing a conglomerate diversification strategy, an organization should proceed with caution and not diversify merely to be diversified. Conglomerate diversification brings with it bigness and the difficult management problems associated with bigness. Evidence shows that conglomerate firms which limit their diversification to three or four major business categories are generally more successful than those that don't.

There is little doubt that the right diversification strategy, whether concentric or conglomerate, can produce profitable results. However, experience, supported by research, tends to favor concentric diversification over conglomerate diversification especially when the diversification involves the sharing of activities (such as distribution

channels) and the transferring of skills among the old and new businesses.

Vehicles for implementing growth strategies

Corporations may utilize the growth strategies of either concentration or diversification through the internal development of new products and services or through external acquisitions, mergers, and joint ventures. Although the research is not yet conclusive, firms that grow through acquisitions apparently do not perform financially as well as firms that grow through internal means. Some of the more common examples of external growth strategies are mergers, acquisitions, joint ventures, and alliances.

Internal growth vs. merger or acquisition

When a company expands its current market share, its markets, or its products through the use of internal resources, *internal growth (*or *organic growth)* takes place. A *merger* occurs when two or more companies combine into one company. In an acquisition, one company clearly acquires another; in a merger, neither participant acquires the other, but rather both companies merge together, combining operations. An *acquisition* occurs when one company purchases the assets of another and absorbs them into its own operations.

Whether it is wiser to grow through internal development of new activities or through acquisition or merger depends on many factors. Internal growth is generally slower and less traumatic for the organization. It usually takes place over an extended period, allowing time to adjust to the change. Of course, if an organization is in a particular hurry to enter an area, the shorter time required by an acquisition or a merger might be considered an advantage. Growth through acquisitions or mergers can also help avoid or eliminate many barriers to entry, such as patents, costly promotions, and broad recognition. Although exceptions exist, internal growth is generally less risky than an acquisition or a merger. This is because growth, through internal means, is incremental and can be terminated at almost any time. Thus, if an organization determines that an expansion is not working out, the project can be dropped. On the other hand, growth through acquisition or merger is not incremental, and it requires a total financial commitment from the start.

Generally speaking, internal growth strategies work well for companies following a concentration strategy via product or market development. Almost all horizontal integration is achieved through acquisitions or mergers. Growth through vertical integration can be obtained by internal means or by acquisition or merger. The best method is entirely dependent on the situation. Growth through concentric diversification is similar to growth through vertical integration, because it can be successfully realized either by internal means or by acquisition or merger. Entry into new, unrelated businesses (conglomerate diversifica-

tion) is usually more successful through acquisition than through internal growth. The main problem with trying to develop new businesses through internal means is that the organization usually does not possess the core skills required. Because of this, it is usually better to enter an unrelated business through an acquisition or a merger. Exhibit 5.2 summarizes the appropriateness of growth through internal versus external (acquisition or merger) means.

Exhibit 5.2: Desirability of Internal Growth vs. Growth through Acquisitions or Mergers

Growth Strategy	*Generally Preferred Method of Growth*
Concentration:	
Product Development	Internal
Market Development	Internal
Horizontal Integration	Acquisition or Merger
Vertical Integration	Internal, or Acquisition or Merger
Concentric Diversification	Internal, or Acquisition or Merger
Conglomerate Diversification	Acquisition or Merger

Reasons for mergers and acquisitions

Organizations seek mergers and acquisitions for many reasons. One of the primary reasons is the potential benefit that can accrue to the stockholders of both companies. For example, if the earnings of two companies are valued differently in the stock market (i.e., they have different price-earnings ratios), a merger or acquisition can increase the market value of the stock of both organizations. This result is achieved if the acquiring company reports an increase in its earnings per share and if the multiple applied to its earnings rises as a result of the merger or acquisition.

Other reasons for mergers and acquisitions include the following:

- Providing a better utilization of existing manufacturing facilities.
- Selling in the same channels as existing channels to make the existing sales organization more productive.
- Getting the services of a proven management team to strengthen or succeed the existing staff.
- Smoothing out cyclical trends in present products or services.
- Evening out seasonal trends in present products or services.
- Providing new volume to replace static or shrinking volume in present products or services.

- Providing new products or services and better margins of profit in order to supplement older products or services still selling well but at increasingly competitive levels.
- Entering a new and growing field.
- Securing or protecting sources of raw materials or components used in its manufacturing process (vertical integration).
- Effecting savings in income and excess-profits taxes.
- Broadening the opportunities for using the managerial ability of the acquiring organization's personnel or its resources.
- Providing an avenue for the selling of the organization's stock. This is an especially important reason for an organization whose stock is not publicly traded and is held by a small number of individuals. Selling out to a publicly owned organization facilitates the sale of the acquired company's stock.
- Providing resources for expanding the organization.
- Reducing tax obligations. In many situations the owner of a business may sell it and make substantial savings both in income taxes and in estate and inheritance taxes.
- Providing for management succession and the perpetuation or continuation of the business. Frequently, family owned businesses or smaller businesses have few people capable of carrying on the business if the principal manager dies or is incapacitated. Merging with or being acquired by a larger organization helps to ensure the continuity of the organization.

Still, the primary reason for large mergers and acquisitions is the potential benefits that can accrue to the stockholders of both companies.

Carrying out mergers and acquisition

Mergers and acquisitions (M&As) can be carried out in either a friendly or a hostile environment. *Friendly M&As* are accomplished when the stockholders and management of both organizations agree that the combination will benefit both firms and then work together to ensure its success. On the other hand, *hostile* (or, as they are frequently called, *takeover) M&As* result when the organization to be acquired (also sometimes called the *target company)* resists the attempt. Takeover attempts are often bitterly resisted by the management of the target organization, because, if the takeover attempt is successful, the acquiring organization normally replaces the management of the target company. Takeover M&As usually come as a surprise to the target company. Generally, three conditions can make an organization a likely candidate for a takeover. First, the organization's stock may be selling for less than book value. Second, the organization may have a large cash surplus. Finally, the organization may be performing poorly, compared to

its competitors. In recent years, many companies have been installing anti-takeover devices in corporate charters and bylaws and taking other defensive measures against hostile takeovers. Some of these measures include staggered terms for board members and stipulations requiring approval by two-thirds of the stockholders for a merger that is not approved by the board of directors.

Several methods are available for carrying out M&As. One, the *tender offer, is* a well-publicized bid made by one organization for all or a prescribed amount of the stock of another organization. Tender offers are generally higher than the current trading price of the target company's stock. Another option is for one company to purchase stock of the target organization in the open market. The acquiring company can also purchase the assets of the target company. Finally, the two firms may agree to an exchange of stock. In agreeing to an exchange of stock, organizations use one of the following four yardsticks for determining the value of the stock: (1) book value per share, (2) earnings per share, (3) market price per share, or (4) dividends per share.

Guidelines for successfully implementing M&As

The following 10 guidelines are beneficial in successfully implementing M&As. The first four guidelines are critical and apply to any and all M&As. If any one of them is violated, then the chances of a successful acquisition or merger are very small.

1. Pinpoint and spell out the objectives.
2. Specify the gains for the stockholders of both organizations.
3. Ensure that the management of the acquired company is or at least can be made competent.
4. Seek to ensure that the acquiring company's resources fit or mesh with the resources of the target company. This results in synergy.
5. Involve the chief executive officers of both the acquiring and the target organization in the entire merger program.
6. Clearly define the business of the acquiring company (organizational purpose).
7. Determine the strengths, weaknesses, and other key performance factors of both the acquiring and target organizations.
8. Create a climate of mutual trust by anticipating problems and discussing them early with the target company.
9. Make the right advances. Avoid clumsy overtures, thoughtless actions, and carelessly voiced sentiments.
10. In assimilating a newly acquired company, exercise a minimum of control over it. Maintain, and if possible improve, the status of the newly acquired management team.

On the other hand, several factors need to be avoided to ensure a successful acquisition or merger. These factors include:

- Paying too much.
- Straying too far afield.
- Marrying disparate corporate cultures.
- Counting on key managers staying
- Assuming that a boom market will not crash
- Swallowing too large a company.

Lessons learned from corporate M&As are that they work under the right circumstances. The ability to understand those circumstances and choose the correct conditions for an acquisition or merger is a skill greatly needed by top management.

Joint ventures and alliances

A *joint venture* occurs when two or more organizations pool their resources for a given project or a business product. There are a number of reasons why a joint venture may be attractive to the respective participants:

- By pooling their resources, the organizations may be capable of doing things that they could not do separately.
- By joining with another firm or firms, the companies share the risks of the venture.
- Certain government-sponsored projects have aggressively encouraged joint ventures for the purpose of involving minority businesses.
- International companies are often encouraged by host countries to enter into joint ventures with local companies.

A joint venture can be on either a temporary or a permanent basis. For example, a construction company might enter into a temporary joint venture with another construction company for purposes of erecting a specific building. On the other hand, two or more companies might enter into a permanent arrangement, such as jointly owning a business.

Joint ventures are especially popular between firms in different countries. What makes joint ventures so attractive in the international setting is that both the host firm and the entering firm benefit. Under a joint venture, the host firm does not have to fear that foreigners are taking over, and the entering firm is afforded much more confidence that its products and services will be accepted. An additional benefit for both parties is that less individual investment is required. It is not surprising that joint ventures in

the international setting work best when the cultures and economic conditions of the different partners are similar.

There are a variety of arrangements for joint development and alliances (also called *strategic alliances*). Strategic alliances are collaborative arrangements with other companies aimed at joining forces to achieve mutually beneficial strategic outcomes. Some may be very formalized inter-organizational relationships, others may be loose arrangements of cooperation between organizations, with no shareholding or ownership involved. Extremely popular in international undertakings because of financial and political-legal constraints, joint ventures are a convenient way for a privately owned and a publicly owned (state-owned) corporation to work together.

The reason why these different forms of alliances might occur are likely to be concerned with the assets involved in the alliances. The form of alliances is likely to be influenced by:

- Asset management - the extent to which assets do or do not need to be managed jointly.
- Asset separability - the extent to which it is possible to separate the assets involved between the parties involved.
- Asset appropriability - the extent to which there is a risk of one or other of the parties involved appropriating the assets involved for themselves.

Harvesting strategies

Most products and services eventually reach a point where future growth appears doubtful or not cost-effective. This may be because of new competition, changes in consumer preferences, or some other similar factor. When this occurs, organizations often attempt to "harvest" as much as they can from the product/ service.

The usual approach is to limit additional investment and expenses and to maximize short-term profit and cash flow. Ideally, organizations using a harvesting strategy will maintain market share at least over the short run. A harvesting strategy should be considered under the following conditions:

- The product/service is in a saturated or declining market.
- The current market share of the product/service is small, and it is not cost-effective to try to increase it.
- The profit prospects are not especially attractive.
- The organization has more attractive uses for any freed-up resources.
- A decrease in expenses and investment will not cause a sharp decline in sales.
- The product/service is not a major contributor of sales, stability, or prestige to the organization.

Naturally, the more of the above characteristics that are present, the more likely that the product/service is a candidate for harvesting.

Defensive strategies

Defensive strategies, sometimes referred to as *retrenchment strategies,* are used when *a* company wants or needs to reduce its operations. Most often, defensive strategies are used to reverse a negative trend or to overcome a crisis or problem situation. Consequently, defensive strategies usually are chosen as a short-term solution or because no better alternative exists. Specific reasons for using defensive strategies include:

- The company is having financial problems. These problems can stem from the fact that all or only certain parts of the organization are doing poorly.
- The company forecasts hard times ahead. This can be caused by such factors as new competitors entering the market, new products, or changes in government regulations.
- Owners either get tired of the business or have an opportunity to profit substantially by selling.

Defensive strategies include turnaround, divestment, liquidation, filing for bankruptcy, and becoming a captive.

Turnaround

A *turnaround strategy is* designed to reverse a negative trend and get the organization back on the track to profitability. Turnaround strategies usually try to reduce operating costs, either by cutting "excess fat" and operating more efficiently or by reducing the size of operations. Specific actions that can be taken to operate more efficiently include eliminating or cutting back employee compensation and/or benefits, replacing higher-paid employees with lower-paid employees, leasing rather than buying equipment, reducing expense accounts, and even cutting back marketing efforts. Examples of ways to reduce the size of operations include eliminating low-margin or unprofitable products, selling buildings or equipment, laying off employees, and dropping low-margin customers. Companies that employ a turnaround strategy are usually forced into it and do so with the hope that it will be only a temporary measure until things improve.

Divestment

Divestment involves selling off a part of the business, which can be a SBU, a product line, or a division. Divestment is a frequently used strategy when either

GLOBAL professional publishing

harvesting or turnaround strategies are not successful. There are many reasons why an organization may adopt a divestment strategy, but probably the most frequently encountered one is that a previous diversification did not work out. Sometimes a company's situation has deteriorated to the point that the only chance for survival is to sell major components and thereby raise sufficient capital to put the remaining parts of the business on firm footing. Sometimes companies successfully fend off an unfriendly takeover attempt by buying up large blocks of stock. This often leaves the company with unacceptably high levels of debt. The solution is to sell some of the company's assets. A final reason for engaging in divestment is government antitrust action-or fear of such action.

Often, the decision to divest a SBU is very difficult for management to make. Divestment is frequently interpreted as a sign of failure or even mismanagement. This is especially true when a divestment decision is faced by the same management team that either started up or acquired the SBU in question. For this reason, many divestment strategies are immediately preceded or instigated by changes in top management.

Liquidation

Liquidation occurs when an entire company is either sold or dissolved. The decision to sell or dissolve may come by choice or force. When liquidation comes by choice, it can be because the owners are tired of the business or are near retirement. Similarly, the chance to "get rich quick" has lured many owners of small, privately held organizations into selling. In other situations, management may have a negative view of the organization's future potential and, therefore, desire to sell while the business can still fetch a good price.

When an organization is forced to sell out, or to liquidate its assets, the decision often occurs because of a deteriorated financial condition. Obviously, such circumstances leave the seller in a weak bargaining position. Liquidation of assets is usually a last-resort measure and generally is forced by an organization's financial backers.

Filing for Bankruptcy

Filing for bankruptcy under Chapter 11 of the Federal Bankruptcy Act has recently emerged as a type of defensive strategy. Chapter 11 of the act allows a company to protect itself from creditors and from enforcement of executory contracts, which legally are those not yet completed, including labor contracts. The reasoning behind Chapter 11 is that a company should have an opportunity to rehabilitate itself and avoid insolvency. The degree of financial soundness that may prevent a company from filing bankruptcy under Chapter 11 is established by the bankruptcy court on an individual case-by-case basis. A prime factor used

by several companies in the decision to file for bankruptcy under Chapter 11 is the desire to void current labor contracts that management feels are "onerous and burdensome" to the point of threatening the solvency of the company. Another reason for filing for bankruptcy under Chapter 11 is to protect the company from lawsuits.

Most companies that file for bankruptcy under Chapter 11 eventually return to normal operation. Some return in a different form, while others return in the same business but under a new name.

Becoming a captive

Becoming a captive of another organization occurs when an independently owned organization allows another organization's management to make certain decisions for it in return for a guarantee that the managing organization will buy a certain amount of the captive's product or service. More often than not, such arrangements are made between a small to medium-sized manufacturer or supplier and a larger retailer. A captive organization may give up decisions in the areas of sales, marketing, product design, and even personnel. A company can make a conscious decision to do business as a captive, or it can become a captive over a period of time (the company does more and more business with one other company until it no longer has a choice about becoming a captive). Although becoming a captive can work out well for both parties, it usually occurs either by default or because of a long and gradual increase in the dependence of one company on another. Once a company has become a captive, it is very difficult to break away from the controlling company.

Combination strategies

Most multibusiness organizations use some type of combination strategy, especially when they are serving several different markets. Certain types of strategies lend themselves to combination with other strategies. For example, a divestment strategy in one area of an organization is normally used in combination with one or more strategies in other areas. Combination strategies, which can be either simultaneous or sequential, are the norm. The following are just a few of the possible combination strategies:

Simultaneous

1. Divesting an SBU, product line, or division while adding other SBUs, product lines, or divisions.
2. Using a turnaround strategy in certain areas or products while pursuing a growth strategy in other areas or products.
3. Using a harvesting strategy on certain products and growth strategies on other products.

Sequential

1. Employing a growth strategy for a specified time and then using stable growth for a specified time.
2. Using a turnaround strategy and then employing a growth strategy when conditions improve.

Business (competitive) strategy alternatives

As previously noted, corporate strategies identify which businesses the organization intends to be in and how the resources will be allocated among those businesses. Business strategies outline how each business will compete within its respective industry. For purposes of this discussion, an industry is defined as "the group of firms producing products [or services] that are close substitutes for each other.

By nature, business strategies tend to be much less generic than corporate strategies. This is because most business strategies must be fitted to a unique business situation in terms of the organizations position in the industry and the competition. Although all business strategies are tailored in some degree to a specific situation, it is nevertheless possible to categorize most business strategies according to four generic strategic types: *low-cost leadership, broad differentiation, focused (or niche) cost leadership,* and *focused (or niche) differentiation.*

Overall cost leadership

The idea behind an overall cost leadership strategy is to be able to produce and deliver the product or service at a lower cost than the competition. Cost leadership is usually attained through a combination of experience and efficiency. More specifically, cost leadership requires close attention to production methods, overhead, marginal customers, and overall cost minimization in such areas as sales and research and development (R&D). Some of the reasons why a cost leadership strategy can be attractive are as follows:

- It can give the firm above-average returns even in the face of strong competitive forces.
- It can defend the firm against rivalry from competitors because it is difficult for competitors to force the firm out on the basis of price.
- It can defend the firm against powerful buyers because buyers can exert pressure only to drive prices down to the level of the next most efficient competitor.
- It can defend the firm against powerful suppliers by providing flexibility to

deal with input cost increases.

- The factors contributing to a low-cost position can provide substantial barriers to entry (such as expensive production equipment).
- It can put the firm in a favorable position to fend against substitutes from the firm's competitors.

Achieving an overall low-cost position usually requires that the company develop some unique advantage or advantages over its competitors. Examples include a high market share, favorable access to raw materials, use of state-of-the-art equipment, or special design features which make the product easy to manufacture.

Differentiation

A differentiation strategy requires that an organization create a product or service that is recognized industrywide as being unique, thus permitting the organization to charge higher-than-average prices. Differentiation can take many forms, such as design or brand image, technology, customer service, or dealer network. The basic purpose of a differentiation strategy is to gain the brand loyalty of customers and a resulting lower sensitivity to price.

Following a differentiation strategy does not imply that the business should have little concern for costs but, rather, that the major competitive advantage sought is through differentiation. Differentiation has several potential advantages:

- It can provide protection against competition because of brand loyalty by customers and their resulting willingness to support higher prices for brand items.
- It can increase margins because of the ability to charge a higher price.
- Through higher margins, it can provide flexibility for dealing with supplier power (such as raising the cost of raw materials).
- It can mitigate buyer power because there are no comparable alternatives.
- It can provide entry barriers for competitors as a result of customer loyalty and the need for a competitor to overcome the product or service uniqueness.
- Because of customer loyalty, it can put the company in a favorable position to fend against substitutes from competitors.

Depending on what is required to achieve differentiation, a company may or may not find it necessary to incur relatively high costs. For example, if high-quality materials or extensive research is necessary, the resulting product or service may be priced relatively high. When this is the case, the idea is that the uniqueness of the product or service will create a willingness on the part of the customers to pay the premium price. While such a strategy can be very profitable, it may or may not preclude gaining a high share of

the market. For example, Rolex demands a very high price for its watches and makes a profit, but it has a very small market share.

Focused Low-Cost Leadership

A strategic position that enables a firm to be a low-cost leader in a narrow segment of the market is known as focused cost leadership. JetBlue, a recent entry into the commercial airline market, is a focused low-cost competitor that serves a small subset of commercial travelers who are price sensitive. Using a variation on Southwest Airline's early business model, JetBlue managed during its first few years of operation to keep its operating costs per airline seat mile lower than even Southwest's. It is the most profitable commercial U.S. airline. Fuel costs and weather-related operational difficulties hurt profits in 2008 and 2009; however, JetBlue still has the lowest operating costs of the major airlines.

Focused differentiation

When unique products are targeted to a particular market segment or arena, the positioning strategy is called *focused differentiation*. By definition, the greater the differentiation, the smaller the market segment to which a product will appeal: As quality is continually improved or luxury features added, fewer customers can afford the higher prices. In the bicycle industry, for example, Montague focuses on a small, specialized segment of the market that demands unique product features. Trek Bicycles also started as a focused differentiator. However, it now offers products in numerous segments and is moving toward a broad-based differentiator. Trek's products boast high quality and demand price premiums over products from Pacific Cycle, and, because it only sells products through independent bicycle dealers, are still classified as a focused differentiator.

Likewise, Mercedes Benz imports into the U.S. only its most expensive top-of-the-line models in each product category. In the U.S., therefore, Mercedes is a focused differentiator that markets only to the most affluent customers. Even more focused are such companies as Porsche and Ferrari.

Porter's generic strategies can be graphically depicted in Exhibit 5.3.

Exhibit 5.3: Porter's generic strategies

	Competitive Advantage		
Competitive Scope		*Low Cost*	*Product Uniqueness*
	Broad (industry)	Cost Leadership	Differentiation
	Narrow (niche)	Focus Strategy (cost)	Focus Strategy (differentiation)

Integrated positions

Organizations that are able to combine both cost leadership with differentiation will become out-performers. On the other hand, failure to adopt either one of the strategies will result in being "stuck-in-the-middle", which will end up losing competitiveness.

It is in fact very difficult for any firm to initially offer both a differentiated product demanding higher prices and still maintain a lower cost structure than competitors. It is hard to escape the fact that the tradeoffs required to achieve a superior level on one dimension make it hard to succeed on the other. However, as firms perfect their initial position, the tradeoff choices may not be as stark. Some firms are eventually able to achieve an integrated position—one in which elements of one position support a strong standing in the other. And while it is typically unwise for a firm to aim to excel at both low cost and differentiation, the competitive reality is that if a firm excels on one dimension it still must be really good on the other dimension. For instance, a company that sells very unique products must also have good cost controls in place. Similarly, a firm that competes on price (or low cost), should also seek attributes that differentiate its products beyond price alone.

The key to employing a successful business unit strategy is knowing which strategies work under which conditions. Each of the three strategies has certain associated risks. Each requires different skills and resources and different organizational settings to be successfully implemented. Exhibit 5.4 summarizes some of the specific requirements for each strategy.

Exhibit 5.4: Skills, Resources, and Organizational Requirements of Business Unit Strategies

Generic Strategy	Commonly Required Skills and Resources	Common Organizational Requirements
Overall cost Leadership	Sustained capital investment and access to capital. Process engineering skills. Intense supervision of labor. Products designed for ease in manufacture. Low-cost distribution system.	Tight cost control. Frequent, detailed control reports. Structured organization and responsibilities. Incentives based on meeting strict quantitative targets.

Generic Strategy	Commonly Required Skills and Resources	Common Organizational Requirements
Differentiation	Strong marketing abilities. Product engineering. Creative flair. Strong capability in basic research. Corporate reputation for quality of technological leadership. Long tradition in the industry or unique combination of skills drawn from other businesses. Strong cooperation from channels.	Strong coordination among functions in R&D, product development, and marketing. Subjective measurement and incentives instead of quantitative measures. Amenities to attract highly skilled labor, scientists, or creative people.
Focus	Combination of the above policies directed at the particular strategic target.	Combination of the above policies directed at the particular strategic target.

GLOBAL professional publishing

GLOBAL
professional
publishing

CHAPTER 6 Strategic Choice

Whatever strategic choices the organization makes, the choice must fit in with the overall organizational goals and objectives, the prevailing trend and state of the external environment, as well as with the rest of the organizational components. This whole balancing act is to ensure that there is strategic fit between the strategy and the rest of the internal external environment of the organization.

Business portfolio matrices

One methodology developed to assist in the strategy evaluation and selection process is known as *corporate portfolio analysis.* The analysis suggests that organizations should have a mix of products to spread the risks. The key aim of portfolio planning is to identify the strength and weaknesses of each of the products and to also identify the state of growth or decline in each of those markets.

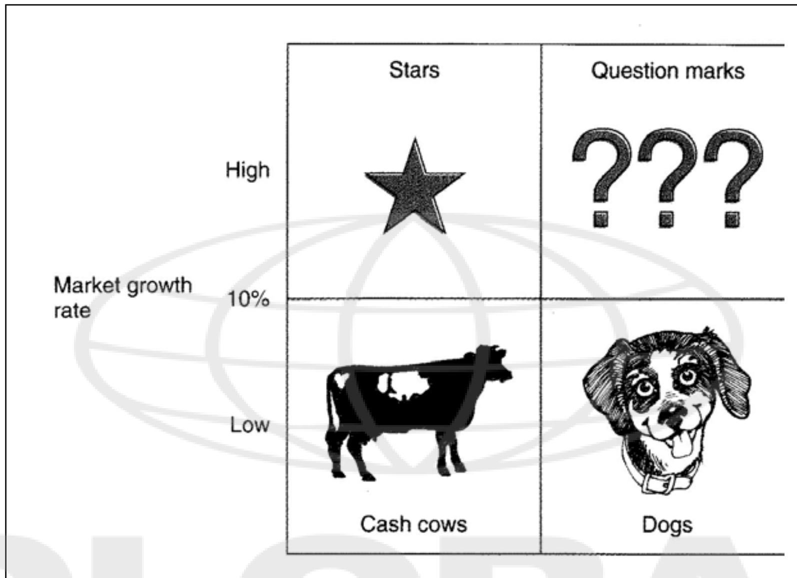
Two of the more popular approaches to corporate portfolio analysis are the Boston Consulting Group's Growth-Share Matrix and the GE's planning grid.

Boston Consulting Group's growth-share matrix

Developed by the Boston Consulting Group (BCG), the growth-share matrix postulates that all except the smallest and simplest organizations are composed of more than one business. These *businesses* in an organization are called its corporate portfolio. The BCG approach proposes that a separate strategy be developed for each of these largely independent units.

In order to visually display an organization's portfolio, BCG developed a four-quadrant grid, as shown in Exhibit 6.1.

Exhibit 6.1: The Boston Consulting Group's Growth-Share Matrix



The horizontal axis indicates the market share of the business relative to its major competitor and characterizes the strength of the organization in that business. The market share for any particular year is calculated as follows:

$$\text{Relative Market Share (RMS) (current year)} = \frac{\text{Business Unit Sales (current year)}}{\text{Leading Competitor's Sales (current year)}}$$

The vertical axis indicates the percent of growth in the market in the current year and characterizes the attractiveness of the market for the business unit. The market growth rate (MGR) is calculated as follows:

$$\text{Market Growth Rate (current year)} = \frac{\text{Total Market (current year)- Total Market (previous year)}}{\text{Total Market (previous year)}} \times 100$$

The lines that divide the matrix into fur quadrants are somewhat arbitrary set. A high market growth rate is taken to be over 10 percent. The demarcation between high and low relative market share is set at 1.5. This means that, if a particular business unit's current sales are 1.5 times or greater than its leading competitor's sales, then it is considered to have a high relative market share. These lines of demarcation are not absolutes and can be modified to fit the particular needs of an organization. Some current users of the BCG recommend using 0.8 or even as little as 0.5 for the line

of demarcation on relative market share. Furthermore, in actual practice the market growth rate axis is plotted on a linear scale whereas the relative market share is plotted on a logarithmic scale.

The following steps are generally followed in using the growth-share matrix in strategy evaluation and selection:

1. Divide the company into its business units. Many organizations perform this step when they establish strategic business units (SBUs). On the matrix, a circle is used to depict individual business units.
2. Determine the business unit's relative size within the total organization. Relative size can be measured in terms of assets employed in the business unit as a percentage of the total assets or in terms of sales of the business unit as a percentage of total sales. On the matrix, the area in the circle indicates the business unit's relative size.
3. Determine the market growth rate for each business unit.
4. Determine the relative market share of each business unit.
5. Develop a graphical picture of the company's overall portfolio of businesses.
6. Select a strategy for each business unit based on its position in the company's overall portfolio of businesses.

BCG describes the four quadrants of the growth-share matrix as follows:

1. *Cash cows* have low market growth and high market share. Because of high market share, profits and cash generation should be high. The low rate of growth means that the cash demands should be low. Thus, large cash surpluses are normally generated by cash cows. They provide the cash to meet company needs and are thus the foundation of the company.

2. *Dogs* have low market share and low market growth. The former normally implies poor profits. Because the growth rate is low, investments to increase market share are often prohibitive. Unfortunately, the cash required to maintain a competitive position often exceeds the cash generated. Thus, dogs often become cash traps. Generally, dogs are harvested or divested.

3. *Question marks* have low market share and high market growth rate. Their cash needs are high because of their growth, and the cash generated is low because of their market share. Because growth is high, one strategy for a question mark is to make the necessary investments to gain market

share and become a star. When the market growth rate slows, the unit can then become a cash cow. Another strategy is to divest the question marks that management feels cannot be developed into stars.

4. *Stars* have high growth and high market share. Because of the high growth and high market share, stars use and generate large amounts of cash. Stars generally represent the best profit and investment opportunities. Obviously, the best strategy for stars is to make the necessary investments to maintain or improve their competitive position.

Strategy selection using the growth-share matrix assumes that the primary objectives of the organization are growth and profitability. The advantage of multibusiness organizations is that they can transfer cash from business units that are highly profitable but have low growth potential to other units that have high growth and high profit potential. Strategy selection among the various business units is designed to produce a balanced portfolio in terms of the generation and uses of cash.

Thus, relative market share and the market growth rate are the two fundamental parameters that influence strategy selection. Relative market share determines the rate at which the business unit generates cash. A business unit with a relatively high share of the market compared to its competitors should have higher profit margins and thus higher cash flows. On the other hand, the market growth rate has a twofold influence on strategy selection. First, the market growth rate influences the ease of gaining market share. In slow-growth markets, increases in market share generally come from decreases in a competitor's market share. Second, the market growth rate determines the level of opportunity for investment. Growth markets provide an opportunity for plowing cash back into the business unit and compounding the return on investment. This opportunity can also present problems because the faster a business unit grows, the more cash it needs to finance the growth. Of course, businesses do have external sources of cash, such as debt and equity financing, but the BCG approach assumes that external debt would have to be met ultimately through internal cash flows.

BCG uses market share to determine the strategic choice for individual business units. The four major strategic choices identified are:

1. Increase market share.
2. Hold market share.
3. Harvest.
4. Divest.

Exhibit 6.2 identifies the strategic choices for business units in each quadrant of the growth-share matrix.

Exhibit 6.2: Strategic Choices Using Growth-Share Matrix

Market growth rate		Relative market share: High	1.5	Relative market share: Low
	High	**Stars** Increase of hold market share		**Question marks** Increase market share, market or divest
	10%			
	High	**Cash cows** Hold market share		**Dogs** Harvest/Divest Liquidation

The growth-share matrix can also be used to prepare a portfolio display for the organization at different times (present, three to five years ago, and forecast in three to five years). This gives management a picture of what the results of its strategic choices have been and might be.

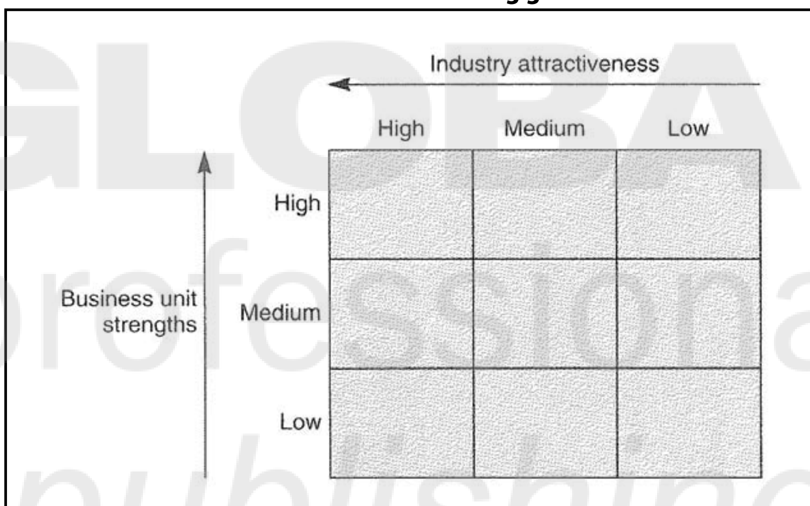
GE's planning grid

General Electric (GE) was a pioneer in the development of corporate portfolio analysis. GE's approach was inspired by its need to develop a method of evaluating the plans of its different business units in order to fund the plans with the greatest potential for success. GE felt that a wide variety of factors needed to be identified and assessed in order to develop an effective display of its business units. The two dimensions chosen to evaluate business units were business strengths (BS) and industry attractiveness (IA). Exhibit 6.3 shows the matrix used by GE. In order to arrive at a rating of low, medium, or high for business unit strengths, a number of factors are considered. These factors include the size of the business unit, growth rate of the business unit, market share held, profitability, competitive position, image, and quality of the management and employees of the business unit. Industry attractiveness is also judged on a number of factors-size of market, market growth rate, industry profitability, competitive structure, and pricing practices. Industry attractiveness is rated as either low, medium, or high. The choice of factors and the weight assessed for each factor may vary from business

GLOBAL professional publishing

unit to business unit. This approach requires the organization to identify and assess both critical external factors and critical internal factors. Critical external factors are not directly controllable by the organization but help determine the overall attractiveness of the industry in which the business unit operates. After identifying and assessing these critical external factors, the management of the organization must make a decision on whether the industry has a low, medium, or high attractiveness. Critical internal factors, or critical success factors as they are frequently called, are generally controllable by the organization and help determine the business unit's strengths. Again, management must make a decision on whether the business unit's strengths are low, medium, or high. Considerable expertise and experience are required if the rating process is to be effective. The rating process is valuable because it requires the management of an organization to examine the critical external and critical success factors and judge where a particular business unit stands in relationship to these factors.

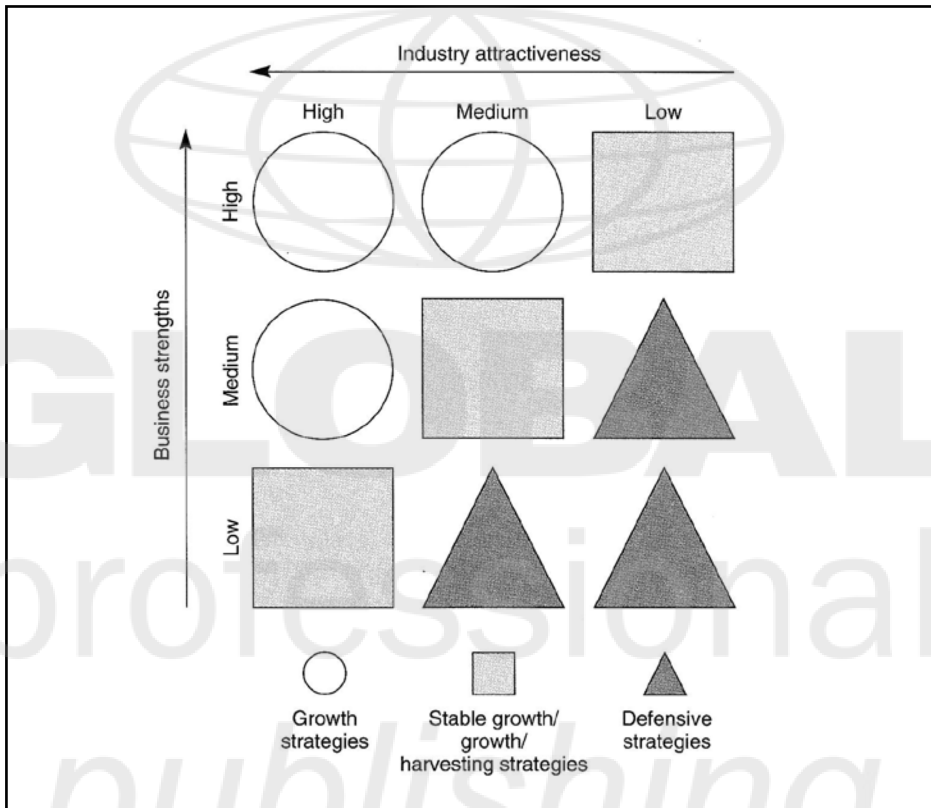
Exhibit 6.3: GE Planning grid



An overall view of the corporate portfolio can be gained by placing each of the business units on the matrix. Because of the scarcity of money and other resources, most organizations must become selective and limit their investments to those business units that are strong can provide an attractive payoff. In addition, they must use some business units to finance the growth of others. Exhibit 6.4 describes the corporate strategies that would be pursued for each cell of the matrix. Generally, when a business unit is high on industry attractiveness and business unit strengths, the strategy is to invest heavily and pursue a growth strategy. When industry attractiveness and business unit strengths are low, the strategy would normally be one of the defensive strategies.

In the intermediate positions, the strategy generally involves concentrating resources on the most attractive business units that have unique competence. This implies that stable growth, growth, and harvesting strategies would be used in the business units falling in the intermediate positions.

Exhibit 6.4 Strategy Options Using the Planning Grid Precautions and Assumptions in the Use of the Growth-Share Matrix and Planning Grid



Several potential difficulties with the use of the growth-share matrix have been widely described. One difficulty is in determining market share in complex industries. Another area of concern involves the concept of "shared experience." Under the BCG approach, dogs are generally harvested, divested, or liquidated. However, valuable experience may be gained in a low-profit business unit (dog) that can help lower costs in a related but more profitable business unit (star or cash cow). Both the planning grid and the BCG growth-share matrix assume that business units are independent. General Electric used the term *strategic business unit(SBU)* to apply to groupings of products or services with interdependent prices, similar competitors, similar customer groups,

and the potential for sharing research and development, manufacturing, or marketing experience. When these interdependencies cross business units (i.e., a dog and a cow share production or distribution facilities), neither matrix is appropriate.

Several difficulties with the use of the planning grid have also been identified. First, because it is often difficult to identify and agree on a standard list of critical external and critical success factors to be used by all business units in an organization, inconsistencies in the classification of business units can develop. It has also been argued that when applying the grid to business units that different managers do not agree and categorize a business unit as medium because they cannot reconcile diverging opinions.

Competitive strategy formulation

Another approach to evaluating and selecting corporate and business unit strategies has been proposed by Michael E. Porter and is known as competitive strategy formulation. Porter contends that every firm competing in an industry has a competitive strategy, whether it is explicit or implicit. He further contends that competitive strategy formulation involves the consideration of four key factors: (1) company strengths and weaknesses; (2) industry opportunities and threats; (3) personal values of the key managers; and (4) broader societal expectations, such as government policy, social concerns, and evolving mores. The outline of questions in Exhibit 6.5 gives an approach to developing an optimal competitive strategy.

Exhibit 6.5: Process for Formulating a Competitive Strategy

A. What is the Business Doing Now?

1. Identification

   What is the implicit or explicit current strategy?

2. Implied Assumptions

   What assumptions about the company's relative position, strengths and weaknesses, competitors, and industry trends must be made for the current strategy to make sense?

B. What Is Happening in the Environment?

1. Industry Analysis

   What are the key factors for competitive success and the important industry opportunities and threats?

2. Competitor Analysis

   What are the capabilities and limitations of existing and potential competitors, and their probable future moves?

3. Societal Analysis

   What important governmental, social, and political factors will present opportunities or threats?

4. Strengths and Weaknesses

   Given an analysis of industry and competitors, what are the company's strengths and weaknesses *relative to present and future competitors?*

C. What Should the Business Be Doing?

1. Tests of Assumptions and Strategy

   How do the assumptions embodied in the current strategy compare with the analysis in B above?

2. Strategic Alternatives

   What are the feasible strategic alternatives given the analysis above? (Is the current strategy one of these?)

3. Strategic Choice

   Which alternative best relates the company's situation to external opportunities and threats?

Life-cycle approach

The life cycle approach to strategy evaluation and selection classifies business units in an organization by industry maturity and by competitive position, resulting in the matrix shown in Exhibit 6.6.

The life cycle approach postulates that industries can be grouped into the following stages of maturity:

- Embryonic--characterized by rapid growth, rapid changes in technology, pursuit of new customers, and fragmented and changing shares of market.
- Growth--characterized by rapid growth; but customers, market share, and technology are better known and entry into the industry is more difficult.
- Mature--characterized by stability in known customers, technology, and market shares. The industry can, however, still be competitive.
- Aging (declining)--characterized by falling demand, declining number of competitors, and, in many such industries, a narrowing of the product line..

The determination of a business unit's competitive position using the life cycle approach calls for a qualitative decision based on multiple criteria, such as breadth of product line, market share, movement in market share, and changes in technology. The life cycle approach maintains that, as these criteria change over time, a business unit

either gains or loses competitive advantage and can be classified as being dominant, strong, favorable, tenable, or weak.

After a business unit has been positioned in the matrix, a strategy can be formulated for each business unit. At the corporate level, resources are normally allocated among business units on a competitive basis. Business units are screened or ranked on such criteria as desirability of certain maturities, strength of competitive position, ability to produce positive cash flows in the short or long term, rates of return on investment or net assets, and degree of risk. This screening enables top management to decide which business units are to receive what resources.

Exhibit 6.6: Life Cycle Matrix

		Industry maturity			
		Embryonic	Growth	Mature	Aging
Competitive position	Dominant				
	Strong				
	Favorable				
	Tenable				
	Weak				

Profit impact of market strategy (PIMS) analysis

The Strategic Planning Institute (SPI) develops and manages the Profit Impact of Market Strategy (PIMS) database. The PIMS database consists of strategic data that includes financial data, information on customers, competitors, quality, and structure. These data are provided to SPI by client corporations, which contribute data on their business. The database contains the experiences of over 3,000 strategic business units operating across all industries, offering many different types of products and services in regional, national, and international markets.

GLOBAL professional publishing

Nine basic PIMS proposition on business strategy

1. Business situations generally behave in a regular and predictable manner.
2. All business situations are basically alike in obeying the same "laws of the marketplace".
3. The "laws of the marketplace" determine about 80% of the observed variance in operating results across different businesses.
4. There are nine identifiable major strategic influences on profitability and net cash flow.
5. The operation of the nine major strategic influences is complex.
6. Product characteristics don't matter.
7. The expected impacts of strategic business characteristics tend to assert themselves over time.
8. Business strategies are successful if their "fundamentals" are good, unsuccessful if they are unsound.
9. Most clear strategy signals are robust.

The research data indicated that business situations in general behave in a regular and predictable manner, the manners being predictable by the "laws of the market place" that operate in business situations. On the basis of observable characteristics of the market and of the strategies employed by the business itself and its competitors, it is generally possible to estimate the approximate results (within 3-5 points of after-tax R.O.I.) of most business (close to 90%) over a moderately long period. The implication is that business situations can be understood by an empirical scientific approach, therefore the process of formulating business strategy is becoming an applied science.

The data further indicated that all business situations, despite the many differences in culture, product, or profitability, are basically alike in obeying the same "laws of the marketplace". Thus this further support the concept of the applied science of business strategy, in which trained strategists can usefully function in any and all businesses.

The research indicated that the "laws of the marketplace" determine about 80% of the observed variance in operating results across different businesses. This means that the characteristics of the served market and its competitors constitute about 80% of the reasons for success or failure, and management skill or luck only 20%. The implication here is that doing the right thing seems to be much more important than doing it well, and that being in the right business in the right way is 80% of the story; and operating that business in a skillful or lucky way only count for 20%.

Regarding the nine major strategic influences on profitability and net cash flow, they account for most of the 80% of the determination of business success or failure. In the order of importance, they are as follows:

1. Capital investment intensity - exhibiting an inverse relationship. Businesses that are mechanized or automated or stock-intensive generally show lower returns on investment and sales than businesses that are not.
2. Productivity - exhibiting a direct relationship. Businesses producing high value added per employee are more profitable.
3. Share of served market - exhibiting a direct relationship. A business's share of its served market (both absolute and relative) has a positive impact on its profit and net cash flow.
4. Growth rate of market served - exhibiting a direct relationship. The faster the market growth, the greater the profits.
5. Perceived product or service quality - exhibiting a direct relationship. Quality as defined by the customers' evaluation of the business's product or service package, as compared to that of competitors, generally has a favorable impact on all measures of financial performance.
6. Innovation and differentiation - exhibiting a direct relationship. Especially relevant to market leader who has a strong market share to begin with. Otherwise impact is usually less obvious.
7. Vertical integration (make as opposed to buy) - exhibiting a direct relationship in mature or stable markets, but an inverse relationship elsewhere.
8. Relative cost control (cost push) - exhibiting a direct relationship. Depends on whether the business is positioned to pass on inclusive costs.
9. Current strategic effort - exhibiting a direct relationship in the long term, but an inverse relationship in the short term

A key interpretation of these data is that there is no absolute definition of a good or poor management team. The only distinction is the outcome. A good management team can improve the profitability of a strong strategic position or minimize the damage of a weak one; while a poor team does the opposite.

The operation of the nine major strategic influences is complex. Sometimes they offset each other, in which case it is the net effect that matters, and sometimes they reinforce each other, in which case a cumulative effect occurs. Therefore frequently the effect of a strategic factor reverses, depending on other factors.

As the data suggests that the key driving force is the "law of the market place", it implies that product characteristics on their own don't matter as far as the success or failure of the organizations is concerned. What matters are the characteristics of the business.

The expected impacts of strategic business characteristics tend to assert themselves over time. If the `fundamentals' change, profitability and net cash flow will move in the direction of the norm for the new position. If the actual performance deviates from the expected norm, it will tend to move back toward that norm.

Therefore, the implication is that business strategies are successful only if their "fundamentals" are good. The strategies will be unsuccessful if they are unsound. A good strategy is one that can confidently be expected to have good consequences, and the "laws of the market place" are a reliable source of confidence in estimating both the cost of making a given strategic move and the benefit of having made it.

Finally, where a particular strategic move for a business is clearly indicated to be a good idea (in other words, the cost-benefit projections clearly look favorable), that signal is usually quite robust.

Companies pay to participate in PIMS. The data they submit and reports they receive give them reliable information for strategy evaluation and selection. Obviously, however, merely because a strategy has worked for another business in similar situations does not mean that the strategy is appropriate for all businesses in that same situation. The major impact of PIMS has been its findings that the two major drivers of increased return on equity are *quality* and *market share.*

GLOBAL
professional
publishing

GLOBAL
professional
publishing

CHAPTER 7

Strategic Implementation Issues

Strategy implementation is defined as the way in which a company created the organizational arrangements that allow it to put its strategic plan into operation most efficiently and to achieve its objectives. Strategy is implemented through organizational design. Organizational design involves selecting the combination of organizational structure and control systems that lets a company pursue its strategy most efficiently. Different kinds of structure and control systems provide strategic planners with alternative means of pursuing different strategies because they offer the company and the people within it a variety of different ways to act.

Designing organizational structures

After formulating a company's strategy, management must make designing the structure its next priority, for strategy can only be implemented through organizational structure. The activities of organizational personnel are meaningless unless some type of structure is used to assign people to tasks and connect the activities of different people or functions. The terms used to describe the characteristics of organizational structure are differentiation and integration. *Differentiation* is the way in which a company allocates people and resources to organizational tasks.

First, management chooses how to distribute decision-making authority in the organization; these are *vertical differentiation* choices. Second, it chooses how to divide labor in the organization and group organizational tasks; these are *horizontal differentiation* choices. Integration is the means by which a company seeks to coordinate people and functions to accomplish organizational tasks. These means include the use of integrating mechanisms and the whole apparatus of organizational control. In short, differentiation refers to the way in which a company divides itself up into parts, and

integration refers to the way in which the parts are then combined. Together the two processes determine how an organizational structure will operate and how successfully managers will be able to implement their chosen strategies.

Implementation framework

The implementation of strategies broadly involves the management of operations and the management of resources.

Operations management includes the planning of operations as well as the organizing and the controlling of the operations.

Operational plans are the short-term element of the organization's overall plan. They are concerned with the day to day running of the organization, and thus the aim of operational planning and control is to provide effective and efficient performance of specific tasks.

The inputs to operational planning are budgets. The budgets provide the frameworks on which operations planning are based. A budget is a financial plan to control *future* operations and results. Budgeting facilitates control and communication and also provides motivation to employees. The process of budgeting forces a company to establish goals, determine the resources necessary to achieve those goals, and anticipate future difficulties in their achievement. A budget is also a control tool because it establishes standards and facilitates comparison of actual and budgeted performance. Thus, it motivates good performance by highlighting the work of effective managers. Moreover, the nature of budgeting fosters communication of goals to company subunits and coordination of their efforts. Budgeting activities must be coordinated because they are interdependent.

The features and applications of budgets that are of key relevance to operation planning include the usage of budgets for:

- Target setting.
- Continuous monitoring.
- Responsibility assignment.
- Identification of resource limitation in the short term.
- Providing capacity planning in the long term.

The implementation of operational plans require regulatory procedures to focus and guide behaviors:

- Relevant training and development.
- Appropriate incentives and rewards.
- Change in routines and practices.

- Adapting correct management style.
- Setting up appropriate organizational structures.

With regards to the management of resources, a key area is the planning of how resources will have to be reallocated given the implementation of the chosen strategy. The focus is split into two levels: the corporate level and the operating level.

At the corporate level, the problem is the allocation of resources between different parts of the organization or between the different business units. At the operating level, the problem is the provision and allocation of resources between departments, functions or projects.

Achieving synergy

One of the goals to be achieved in strategy implementation is synergy among functions and business units, which is why corporations commonly reorganize after an acquisition. The search is for synergy, the concept under which 2 + 2 = 5, that will allow two businesses to generate more profits together than they could separately. The acquisition or development of additional product lines often is justified on the basis of achieving some advantages of scale in one or more of a company's functional areas. Synergy may derive from superior financial strength, potential cost savings, and leveraging of capabilities.

Six types of synergy are identified, which often affect the success of strategy implementation.

- *Market synergy*. Common distribution channels and sales force create synergies. A complete line of related products increases the productivity of the sales force. Common advertising and promotions can have multiple returns for the same dollar spent.
- *Operating synergy*. The greater utilization of facilities and personnel, the spreading of overhead, and large-lot purchasing create operating synergies.
- *Investment synergy*. The joint use of plant, common raw materials inventories, transfer of R&D among products, common tooling and machinery, and increased access to sources of capital create investment synergies.
- *Management synergy*. Competent management often is a scarce commodity, so the addition of new products or businesses can enhance overall performance if management finds the new problems to be similar to the ones it has successfully overcome earlier with its current products or businesses. When acquiring another firm, for example, the acquiring firm's

management knows the types of people to appoint to key jobs, the ratios to examine, and the time to intervene in activities.

- *Cost synergy.* It results in cost reduction. It manifests itself in many ways, for example, in recycling of by-products or in the design, production, marketing, and sales of a line of products by the same company.
- *Technological synergy.* It is the transfer of technology among applications. For example, technology developed for military purposes often has civilian commercial uses.

These synergies are not automatic. In order to achieve them, a corporation must not only encourage a supportive culture, but also develop an implementation program reorganizing and combining its operations.

Monitor and control

Monitor and control is needed in the implementation of strategies to prevent strategic drifts.

Strategic drifts occur when the strategic development of the organization becomes out of line with the changing environment. This happens easily because of the tendency for organization to prefer incremental changes in terms of the existing organizational paradigm, rather than focusing the change on the environmental forces.

Strategic drift is deceptive because change is seen to be taking place, and certain evidence of improvement is visible. However, unless the strategic implementation is properly monitored and controlled with respect to the correct parameters, the organization will eventually face demise.

Operations strategy

An operations strategy formulates a long-term plan for using enterprise resources to reach strategic objectives. It aims to close the tactical gap between business strategy and implementation. Typical operations strategy issues include:

- Capacity requirements: amount, timing, and type.
- Facilities: size, location, and specialization.
- Technology: equipment, automation, and linkages.
- Vertical integration: extent of use of outside suppliers.
- Workforce: skill level, wage policies, employment security.
- Quality: defect prevention, monitoring, and intervention.

- Production planning/materials control: sourcing policies, centralization, decision rules.
- Organization: structure, control/reward systems, role of staff groups.

Four basic operations strategies were identified: cost, quality, speed of delivery, and flexibility. These four strategies translate directly into characteristics used to direct and measure business performance.

A cost strategy

A *cost strategy* is successful when the enterprise is the low-cost producer. However, the product (e.g., a commodity) tends to be undifferentiated in these cases, the market is often very large, and the competition tends to be intense because of the possibility of high-volume sales. Within every industry, there is usually a segment of the market that buys strictly on the basis of low cost. To successfully compete in this niche, a firm must be the low-cost producer. But even doing this does not always guarantee profitability and success. Products sold strictly on the basis of cost are typically commodity-like in nature. In other words, customers cannot distinguish the products of one firm from those of another. As a result, customers use cost as the primary determinant for making a purchase. However, this segment of the market is frequently very large and many companies are lured by the potential for significant profits, which they associate with the large unit volumes of product. As a consequence, competition in this segment is fierce—and so is the failure rate. After all, there can only be one low-cost producer, which usually establishes the selling price in the market.

A quality strategy

Quality can be divided into two categories: product quality and process quality. The level of quality in a product's design will vary as to the market segment it is aimed for. Obviously, a child's first two-wheel bicycle is of significantly different quality than the bicycle of a world-class cyclist. One advantage of offering higher-quality products is that they command higher prices in the marketplace. The goal in establishing the proper level of product quality is to focus on the requirements of the customer. Overdesigned products with too much quality will be viewed as being prohibitively expensive. Underdesigned products, on the other hand, will lose customers to products that cost a little more but are perceived by the customers as offering much greater benefits. Process quality is critical in every market segment. In general, customers want products without defects. Thus, the goal of process quality is to produce error-free products through *total quality management (TQM).*

A speed strategy

Another market niche considers speed of delivery to be an important determinant in its purchasing decision. Here, the ability of a firm to provide dependable and fast delivery allows it to charge a premium price for its products.

A flexibility strategy

Flexibility, from a strategic perspective, refers to the ability of a company to offer a wide variety of products to its customers. Flexibility is also a measure of how fast a company can convert its process(es) from making an old line of products to producing a new product line. Product variety is often perceived by the customer to be a dimension of' speed of delivery.

Management by objectives (MBO)

Management by Objectives (MBO) is an organizationwide approach that can help ensure purposeful action toward desired objectives. It links organizational objectives and individual behavior. Because it is a system that links plans with performance, MBO is a powerful implementation technique.

The MBO process involves the following features:

1. Establishing and communicating organizational goals and objectives. MBO goals may be set in terms of qualitative and quantitative measures (such as sales dollars).
2. Setting individual objectives (through superior-subordinate interaction) that will help implement organizational objectives.
3. Self-directives, highly personalized supervision, and encouragement to the individual to operate as a whole person within the context of the organization.
4. Developing an action plan of activities needed to achieve the objectives
5. Periodically (at least quarterly) reviewing performance as it relates to the objectives and including the results in the annual performance appraisal.

MBO managers believe that employees are committed to achieving objectives, working hard to receive the rewards of achievement, and striving for self-actualization. The MBO view is that employees enjoy work, need little supervision, seek responsibility, and are imaginative problem solvers. The hallmark of MBO is the mutual setting of goals by the superior and the subordinate as a basis for performance evaluation. MBO requires top management participation and commitment to the program, integration of the

objectives for all sub-units into a compatible system directed toward accomplishment of overall goals, provision for regular reporting of performance, and free and honest communication between superior and subordinates. Subordinates must make careful assessments of their abilities and their interests, and managers must "coach" subordinates rather than dictate their proper goals. Both sides must maintain flexibility to accommodate unforeseen changes, and the review and analysis of results before setting the next round of goals is a vital part of the process. One of the weaknesses of MBO is that emphasis on quantitative factors may cause employees to focus on ends rather than means. Thus, MBO may jeopardize the quality of the organization's output.

This technique also provides an opportunity to connect the objectives of people at each level to those at the next higher level. Therefore MBO ties together corporate, business, and functional objectives and the strategies developed to achieve them.

Although corporate MBO programs have yielded mixed results, they generally tend to support the belief that MBO should result in higher levels of performance than would be achieved by approaches that do not include performance goals, relevant feedback, and joint supervisor-subordinate goal setting.

One of the real benefits of MBO is that it can reduce the amount of internal politics in a large corporation. Political actions often cause conflict and divide the very people and groups who should be working together to implement strategy. People are less likely to jockey for position if the company's mission and objectives are clear and they know that the reward system is based not on game playing, but on achieving clearly communicated, measurable objectives.

Total quality management (TQM) concept

Total quality management (TQM) is a system for creating competitive advantage by focusing the organization on what is important to the customer. It is a comprehensive approach to quality. It treats the pursuit of quality as a basic organizational function that is as important as production or marketing. TQM is the continuous pursuit of quality in every aspect of organizational activities through a philosophy of doing it right the first time, employee training and empowerment, promotion of teamwork, improvement of processes, and attention to satisfaction of customers, both internal and external. One of the basic tenets of TQM is doing it right the first time. Thus, errors should be caught and corrected at the source.

The ultimate objective for any business organization is to maximize profits. The achievement of profit maximization is directly linked to the value the customer perceived in the output products or services. The higher the perceived value, the more the customers will be willing to pay, and the higher the profits will be.

While most people would associate increase value with the additions of features or attributes of the products or services, many managers now understand that

perceived value could also be increased if the customer satisfaction with the existing product or services is increased. Meeting the specific needs of the customers is the key measure of satisfaction, and customer perceived quality of the products or services is often associated with this same measure of satisfaction.

As such we can define quality as "meeting customers' agreed requirements, formal and informal, at lowest cost, first time, every time." This definition of quality encompasses five concepts central to the understanding of quality management.

First, there is the concept of customers. Customers can be internal customers as well as external customers. Internal interactions must be dealt with in the same quality spirit as if the interaction is external. Second, there is the concept of the agreed requirements. Quantitative specifications (usually for products) as well as qualitative specifications (usually for services) provide the basic parameters for the measurement and the assessment of quality achievements.

Third, there is the concept of formality and informality. Informal agreements, expectations, or attitudes are as important as formal business-like specifications when considering the development and maintenance of a sustained quality image. TQM advocates replacement of the traditional hierarchal structure with teams of people from different specialties. This change follows from TQM's emphasis on empowering employees and teamwork. Employees should have proper training, necessary information, and the best tools; be fully engaged in the decision process; and receive fair compensation. If such empowered employees are assembled in teams of individuals with required skills, they will be more effective than people performing their tasks separately in a rigid structure.

Fourth, there is the concept of incurring the lowest cost. There must be no unnecessary loss or waste in the time, effort, or material in the production and delivery of the products and services. Finally, there is the concept of getting it right first time, every time. It implies a policy of never falling below the agreed requirements under any circumstances.

This concept of quality adequately serve the two basic aims and objectives of business operations, namely to make the best use of limited resources, and to meet the customer's needs.

Benchmarking is one tool for implementing TQM.

Under certain circumstances, these objectives are more than just mere options available to managers to either accept or reject. They may be critical to the success of the organization.

Consider a product that has reached the maturity stage of its product life cycle. At the maturity stage, the production cost of the product would already be at the lowest level, and direct competitions and substitution products are in abundance. The only generic competitive strategy available to such a product would be the strategy of differentiation. Perceived quality may be the only means of differentiation available

to sustain the product on the market. Thus in this case, quality is no longer a matter of choice, but rather a matter of survival.

If having a quality focus is so important to the success and survival of any operations, then the total quality management concept is the means of ensuring quality standards at all times.

TQM is a management philosophy that views the organization pro-actively and as a single total system, and managing it so that in itself it becomes a quality organization. As a quality organization, the understanding is that it will invariably produce quality goods and services for the customers. One of the main reasons TQM can be used as a strategic weapon is that the cumulative improvement from a company's TQM efforts cannot readily be copied by competitors.

An illustration of the philosophy may again be best done through a hypothetical scenario. Let us assume an organization that is producing at a 50% rate of sub-quality standard of output.

A simple quality decision might be to just recall the sub-standard 50% as rejects. This way, quality standard for the customer is maintained at all times and the quality criteria as far as the customers are concerned, is satisfied. But now the organization must built in a 50% product write-off into their profit equation. And if their profit margin is not very high, then the organization will run into serious trouble.

A basic quality management action might be to locate the cause of the problem, and to eliminate the cause to the problem using the appropriate management skills. In time, that particular cause to the specific problem will no longer exist. However, organizations are integral dynamic systems. With such complex systems, there are many complex and interrelated parts all affecting one another. As such, there are many different factors that could in time give rise to many other quality problems. If management only wait until a quality problem is identified, and then react to eliminate the cause, it could well end up to be very time consuming as well as very costly in the long run. Moreover, this option is to react after the problem events. If the impact of the problems encountered are too serious, the organization may not have the ability to react and recover.

TQM is simply a management philosophy of managing organizations towards becoming a healthy and quality focused organizations with tendency of producing quality products and services. The simple understanding is that if an organization itself can be organized into a "quality organization", then the quality standard of the organization's output can be assured.

The implication here, however, is that since the concept is TQM, the philosophy must extend to all levels of the organization for it to succeed. In other words, the concept of total quality management is workable only if the entire organization, from top management to the lowest ranks of the organization, adopts quality as a way of life and as a philosophy of work.

When the culture and the philosophy of all the people within the organization are focused on quality, then invariably, their output will be of quality standard.

Management of change

With the strategic progress of any organization, change is inevitable. The environment is constantly changing, and the implementation of new strategies will also affect change. It is therefore important to understand the nature of change as well as to understand the management of change. Moreover, change give rise to conflicts, and management will also need to understand how to manage conflicts, too.

In the context of the strategic management of organizations, there are many causes which force change. In general, the forces can be categorized into people (management and staff), technology, and competition.

The concept of strategic fit implies that the strategy of any organization must match the changing environment. Change within the organization may be as a result of management response to the changing environment, or it may be a proactive decision as a response to a chosen strategy. Thus organizational change may include structural or size change, technical (process) change, product change, management style change, or personnel/behavior change.

Turbulence is the degree of unpredictability in the environment. Corresponding degree of change may thus be described as either anticipatory, reactive, or crisis. Note also the difference between incremental change and strategic change in terms of the degree of change.

The process of change may be best understood using the three stage model, or force field analysis. The three stage model identifies the three stages of unfreezing, changing and re-freezing as steps of the process. The force field analysis suggests that there is an inter-playing of restraining and driving forces that keep things as they are, and that change seek to impose imbalances on these forces, while the resistance and inertia seek an equilibrium balance of these forces.

It is worth noting that while there is a natural resistance to change, it is not always a bad thing. Resistance can be constructive, and can lead to creativity through the search for new solution. Therefore, resistance should be managed, not avoided or overcome.

Management should be careful in distinguishing the symptoms of resistance from the cause of resistance. Symptoms will include indifference, passive resistance or active resistance. Indifference is evident in apathy, lack of interests, or inaction. Passive resistance can be seen in refusal to learn or working to rule, and active resistance give rise to deliberate spoiling or errors, sabotage, absenteeism or strikes.

The cause for resistance could come from uncertainty, self-interests, conflicting perceptions, or feelings of loss.

Management should actively develop strategies to manage the resistance. The approach to the management of resistance should include looking at the pace of change, the manner of change, and the scope of change.

The successful management of change must take a holistic view of the organization and involve top management support. Participation by those affected by the change should be encouraged, and open communication fostered.

To manage resistance to change, management could adopt any of the following options:

- Education and communication - open communication and training programmers designed to increase awareness. This is the most effective way to deal with the fear of unknown. However, this option requires a very high element of trust.
- Participation and involvement - collaborative design of change. Very appropriate if resistance is due to lack of awareness. However, note the time factor involved as this option is usually very time consuming.
- Facilitation and support - giving a message of care. Very effective in combating security problem or fear of unknown. However, as this option involve providing emotional support and attentiveness, specific problem solving skills training may be required.
- Negotiation and agreement - can be useful if significant loss are anticipated and yet lack the power to impose or to resist. Common results are labor contracts or mutual goal setting.
- Manipulation and cooptation - this option relies on the manipulation of information, resources and favors to overcome resistance. Cooptation may involve including members of resisting groups in the design and implementation of the change whether their ideas are valued or not. This presents a situation in which firms are simultaneously competitors in one market and collaborators in another. This option may involve political behaviors.
- Coercion - usually the best outcome for this option is only compliance and not commitment. Very likely to lead to affected attitudes and adverse consequences in the long run.

GLOBAL professional publishing

GLOBAL
professional
publishing

CHAPTER 8

Strategic Evaluation and Control

In this chapter, we consider the integration mechanisms that companies use to coordinate the structure, as well as the control systems through which they monitor and evaluate corporate, divisional, and functional performance. The control process ensures that the company is achieving what it set out to accomplish. It compares performance with desired results and provides the feedback necessary for management to evaluate results and take corrective action as needed. This process can be viewed as a five-step feedback model.

1. Determine what to measure: Top managers and operational managers need to specify the implementation processes and results that will be monitored and evaluated. The processes and results must be measurable in a reasonably objective and consistent manner. The focus should be on the most significant elements in a process those that account for the highest proportion of expense or the greatest number of problems. Measurements must be found for all important areas regardless of difficulty. Because quality often is hard to measure, this step is crucial for implementing a Total Quality Management program.
2. Establish standards of performance: Standards used to measure performance are detailed expressions of strategic objectives. They are *measures* of acceptable performance results. Each standard usually includes a *tolerance range,* which defines acceptable deviations. Standards can be set not only for final output, but also for intermediate stages of production.
3. Measure actual performance: Measurements must be made at predetermined times.

4. Compare actual performance with the standard: If actual results are within the desired tolerance range, the measurement process stops here.
5. Take corrective action: If actual results fall outside the desired tolerance range, action must be taken to correct the deviation. The following must be determined:
   a. Is the deviation only a chance fluctuation?
   b. Are the processes being carried out incorrectly?
   c. Are the processes appropriate to the achievement of the desired standard? Action must be taken that will not only correct the deviation, but also will prevent its recurrence.

Research indicates that top management often performs the first two steps better than the last three follow-through steps. Top management tends to establish a control system and then delegate implementation of this system to others, which can have unfortunate results.

Evaluation and control in strategic management

The strategic management model at the beginning of each chapter shows evaluation and control information being fed back and assimilated into the entire management process. Such information consists of performance data and activity reports (gathered in Step 3). If undesired performance is the result of inappropriate use of strategic management processes, operational managers must know about it. They can then correct the employee activity without involving top management. However, if undesired performance results from the processes themselves, both top managers and operational managers must know about it. They must then develop new implementation programs or procedures.

An implemented strategy gives strategic managers a series of questions to use in the evaluation. Management usually initiates such a strategy review when a *planning gap* appears between a company's financial objectives and the expected results of current activities. Answering this set of questions (or a similar set), should give a manager a good idea of where the problem originated and what must be done to solve it.

There are three types of control: strategic, tactical, and operational..

Strategic control deals with the basic strategic direction of the corporation in terms of its relationship with its environment. It focuses on the organization as a whole and might emphasize long-term measures (one year or more), such as return on investment and changes in shareholder value. Strategic control measures may be categorized as

concerning either external effectiveness or internal efficiency. *Flexibility* overlaps these categories. It relates to effectiveness and efficiency. Thus, an organization must be externally flexible in responding to changing customer needs and internally flexible in reordering its structural arrangements, retraining employees, etc.

Measures such as cycle time, waste, productivity are internal efficiency measures.

Tactical control, in contrast, deals primarily with carrying out the strategic plan. It emphasizes the implementation of programs and might use medium-range measures (considering six months to a year), such as market share in particular product categories. Operational control deals with near-term (considering today to six months) corporate activities and focuses on what might be going on now to achieve near- and long-term success. An example of an operational control is the use of *statistical process control*, or SPC, to provide immediate feedback to workers to enable them to minimize defects in the production process.

There is also a hierarchy of control. At the *corporate level*, control focuses on maintaining a balance among the various activities of the corporation as a whole. Strategic and tactical controls are most important. Overall annual profitability is key. At the *divisional level*, control is concerned primarily with maintenance and improvement of competitive position. Tactical control dominates. Market share and unit costs are watched carefully on a monthly and quarterly basis. At the *functional level*, the role of control becomes one of developing and enhancing function-based distinctive competencies. The number of sales calls completed, the number of customer complaints, and the number of defects are watched daily and weekly. Because of their short-term time horizons, operational and tactical controls are the most important types at this level, with only slight concern for strategic control.

To help achieve organizational objectives, strategic managers have an obligation to ensure that the entire hierarchy of controls are integrated and working properly. According to W. Edwards Deming, 85% of product defects are caused by the system within which the worker must perform and only 15% can be directly traced to the worker. Unfortunately, during the past several decades top management has almost forgotten the importance of strategic control. It often shifted control to the tactical and operational levels and led to short-term crisis management.

Measuring performance

The measures to be used to assess performance depends on the organizational unit to be appraised and the objectives to be achieved. The objectives established in the strategy formulation stage of the strategic management process (regarding profitability, market share, and cost reduction, among others) should certainly be used to measure corporate performance during strategy implementation.

Some measures, such as return on investment (ROI), are appropriate for evaluating the corporation's or division's ability to achieve a profitability objective. This type of measure, however, is inadequate for evaluating other corporate objectives such as social responsibility or employee development. Even though profitability is the major objective for a corporation, ROI can be computed only *after* profits are totaled for a period. It tells what happened after the fact—not what is happening or what *will* happen. A firm therefore needs to develop measures that predict likely profitability. These are referred to as steering or feed-forward controls because they measure variables that influence future profitability. One example of this type of control is the use of control charts in Statistical Process Control (SPC). In SPC, workers and managers maintain charts and graphs detailing quality and productivity on a daily basis.

Managers may establish controls to focus either on activities that generate the performance (behavior) or on actual performance results (output). Behavior controls specify *how* something is to be done through policies, rules, standard operating procedures, and orders from a superior. Output controls specify *what* is to be accomplished by focusing on the end result of the behaviors through the use of objectives and performance targets or milestones. Behavior and output controls are not interchangeable. Behavior controls (such as following company procedures, making sales calls to potential customers, and getting to work on time) are most appropriate for situations in which results are hard to measure and a clear cause-effect connection exists between activities and results.

Output controls (such as sales quotas, specific cost reduction or profit objectives, and surveys of customer satisfaction) are most appropriate for situations in which there are specific agreed-upon output measures and there is no clear cause-effect connection between activities and results. Generally, output measures serve the control needs of the corporation as a whole, whereas behavior measures serve the individual manager."

Measures of corporate performance

The most commonly used measure of corporate performance (in terms of profits) is ROI. It is simply the result of dividing net income before taxes by total assets. Although there are several advantages to the use of ROI, there are also several distinct limitations. Although ROI gives the impression of objectivity and precision, it can be easily manipulated.

Other popular profit measures are earnings per share (EPS) and return on equity (ROE). Earnings per share also has several deficiencies as an evaluation of past and future performance. Because alternative accounting principles are available, EPS can have several different but equally acceptable values, depending on the principle selected for its computation. Moreover, EPS is based on accrual income involving both the near-term and delayed conversion of income to cash thereby ignoring the time value of

money. Return on equity also has its share of limitations because it also is derived from accounting-based data. In addition, there is some evidence that EPS and ROE may be unrelated to a company's stock price. Because of these and other limitations, EPS and ROE by themselves are inadequate measures of corporate performance.

Value-added measures

Because any one measure is hound to have some shortcomings, C.W. Hofer recommends the use of value-added measures in evaluating a corporation's performance. Value added is the difference between dollar sales and the cost of raw materials and purchased parts. Return on value added (ROVA) is a measure that divides net profits before tax by value added and converts the quotient to a percentage. Hofer argues that ROVA might be a better measure of corporate performance in various industries than other measures currently in use. Value added is a useful way to apply Porter's value chain concept. Unfortunately, the major disadvantage of using value added is that the necessary figures aren't readily available. In the United States, value added can't be calculated from traditional financial reports because of the allocation of direct labor costs, indirect costs, and overhead costs to the total cost of goods manufactured. Nevertheless, authorities on the subject argue that combining value-added measures with traditional performance measures creates a more complete and realistic picture of a corporation's performance.

Shareholder value

Because of the belief that accounting-based numbers such as return on investment, return on equity, and earnings per share aren't reliable indicators of a corporation's economic value, many corporations are using shareholder value as a better measure of corporate performance and strategic management effectiveness. Shareholder value may be defined as the present value of the anticipated future stream of cash flows from the business plus the value of the company if liquidated. Based on the argument that the purpose of a company is to increase shareholder wealth, shareholder value analysis concentrates on cash flow as the primary measure of performance. The value of a corporation thus is the value of its cash flows discounted to their present value, using the cost of capital as the discount rate. So long as the returns from a business exceed its cost of capital, the business will create value and be worth more than the capital invested in it.

Economic value added (EVA)

Economic value added (EVA), also called *residual income (RI)*, has become an extremely popular shareholder value method of measuring corporate and divisional performance and may eventually replace ROI as the standard performance measure. EVA equals

income in excess of a minimum desired return. That is, EVA = income - (cost of capital x capital assets). Thus, it is measured in dollars.

EVA represents the business unit's true economic profit; that is, the return that could have been obtained on the best alternative investment of similar risk. Hence, the EVA measures the managerial benefit obtained by using resources in a particular way. It is useful for determining whether a segment of a business is increasing shareholder value. EVA measures the difference between the pre-strategy and post-strategy value of the business. If the difference, discounted by the cost of capital is positive, the strategy is generating value for shareholders. Among the many companies using the new measure are Coca-Cola, AT&T, Quaker Oats, and CSX. EVA is after-tax operating profit minus the total annual cost of capital. Unlike ROI, one of EVA's most powerful properties is its strong relationship to stock price. Managers can improve a company's or business unit's EVA by (1) earning more profit without using more capital, (2) using less capital, and (3) investing capital in high-return projects.

Evaluation of top management

Through its strategy, audit, and compensation committees, a board of directors may evaluate the job performance of the CEO and the top management team. Of course, the board is concerned primarily with overall profitability as measured quantitatively by return on investment, return on equity, earnings per share, and shareholder value. The absence of short-run profitability certainly is a factor contributing to the firing of any CEO, but the board also will be concerned with other factors .

Members of the compensation committees of today's boards of directors generally agree that measuring a CEO's ability to establish strategic direction, build a management team, and provide leadership is more important in the long run than are a few quantitative measures. The board should evaluate top management not only on typical output-oriented quantitative measures, but also on behavioral measures—factors relating to its strategic management practices. Unfortunately, less than 30% of companies systematically evaluate their CEOs' performance.

The specific measures used by a board to evaluate its top management should be based on the objectives agreed on earlier by both groups. If better relations with the local community and improved safety practices in work areas were selected as objectives for the year (or for five years), progress toward meeting them should be evaluated. In addition, other factors that tend to lead to profitability might be included, such as market share, product quality, and investment intensity.

Management audits

Utilized by various consulting firms as a way to measure performance, audits of corporate activities are frequently suggested for use by boards of directors and by

managers alike. Management audits have been developed to evaluate activities such as corporate social responsibility, functional areas such as the marketing department, and divisions such as the international division—and the corporation itself in a strategic audit. To be effective, the strategic audit should parallel the corporation's strategic management process.

Measures of divisional and functional performance

Companies use a variety of techniques to evaluate and control performance in divisions, SBUs, and functional areas. If a corporation is organized by SBU or division, it will use many of the same performance measures (ROI or EVA, for instance) that it uses to assess overall corporation performance. When it can isolate specific functional units, such as R&D, the corporation may develop responsibility centers. It also may use typical functional measures such as market share and sales per employee (marketing), unit costs and percentage of defects (operations), percentage of sales from new products and number of patents (R&D), and turnover and job satisfaction (HRM).

During strategy formulation and implementation, top management approves a series of programs and supporting operating budgets submitted by its business units. During evaluation and control, management contrasts actual expenses with planned expenditures and assesses the degree of variance, typically each month. In addition, top management probably will require periodic statistical reports that summarize data about key factors, such as the number of new customer contracts, volume of received orders, and productivity, among others.

Investment decisions under ROI And RI

The decision whether to use ROI or RI as a measure of divisional performance affect financial managers' investment decisions. Under the ROI method, division managers tend to accept only the investments whose returns exceed the division's ROI; otherwise, the division's overall ROI would decrease. Under the RI method, on the other hand, division managers would accept an investment as long as it earns a rate in excess of the minimum required rate of return. The addition of such an investment will increase the division's overall RI.

Control and business unit strategy

The strategy chosen by an SBU should influence the type of controls chosen. High-performing SBUs following a cost leadership competitive strategy tend to use output controls, such as piece rate or straight commission. This approach is logical because costs usually can be easily determined. In contrast, high-performing SBUs following a differentiation competitive strategy tend to use behavior controls, such as salaried compensation. Factors such as creative flair, strong R&D, and innovative product development are extremely important to this strategy but are difficult to quantify.

Responsibility centers

Control systems can be established to monitor specific functions, projects, or divisions. For example, budgets typically are used to control the financial indicators of performance in conjunction with responsibility centers. A responsibility center is a unit that can be evaluated separately from the rest of the corporation. Each responsibility center is headed by a manager who is responsible for its performance, has its own budget, and is evaluated on its use of budgeted resources. The center uses resources (measured in terms of costs or expenses) to produce a service or a product (measured in terms of volume or revenues). The type of responsibility center used is determined by the way the corporation's control system measures these resources and services or products. There are five major types of responsibility centers.

1. Standard cost centers: Primarily used in manufacturing facilities, standard (or expected) costs are computed for each operation on the basis of historical data. In evaluating the center's performance, its total standard costs are multiplied by the units produced; the result is the expected cost of production, which is then compared to the actual cost of production.

2. Revenue centers: Production, usually in terms of unit or dollar sales, is measured without consideration of resource costs (e.g., salaries). The center is thus judged in terms of effectiveness rather than efficiency. The effectiveness of a sales region, for example, is determined by the comparison of its actual sales to its projected or previous year's sales. Profits are not considered because sales departments have limited influence over the cost of the products they sell.

3. Expense centers: Resources are measured in dollars without consideration of service or product costs. Thus budgets will be prepared for *engineered* expenses (costs that can be calculated) and for *discretionary* expenses (costs that can be only estimated). Typical expense centers are administrative, service, and research departments. They cost an organization money, but they contribute only indirectly to revenues.

4. Profit centers: Performance is measured in terms of the difference between revenues (which measure production) and expenditures (which measure resources). A profit center typically is established whenever an organizational unit controls both its resources and its products or services. By having such centers, a company can be organized into divisions of separate product lines. The manager of each division is given autonomy to the extent that profits remain at a satisfactory (or better) level.

5. Investment centers: Because many divisions in large manufacturing corporations use significant assets to make their products, their asset bases should be factored into the performance evaluation. Thus focusing only on profits, as in the case of profit centers, is insufficient. An investment center's performance is measured in terms of the difference between its resources and its services or products. For example, if two divisions in a corporation make identical profits but one division has a capital investment of $3 million in a plant and the other has a capital investment of $1 million in a plant, the smaller plant obviously is more efficient: it provides shareholders with a better return on their investment.

The most widely used measure of investment center performance is return on investment (ROI). Another measure, called *economic value added (EVA)* or *residual income*, or *after-capital charge* is obtained by subtracting an interest charge from net income. This interest charge could be based on the interest the corporation is actually paying to lenders for the assets being used. It could also be based on the amount of income that could have been earned if the assets had been invested somewhere else. Even though the residual income method is superior to ROI because it takes into account the cost of capital, it never attained ROI's popularity.

Most single-business corporations, such as Apple Computer, tend to use a combination of cost, expense, and revenue centers. In these corporations, most managers are functional specialists and manage against a budget, and total profitability is integrated at the corporate level. Dominant product companies, such as Anheuser-Busch, which have diversified into a few small businesses but which still depend on a single product line for most of their revenue and income, generally use a combination of cost, expense, revenue, and profit centers. Multidivisional corporations such as General Electric tend to emphasize investment centers—although in various units throughout a corporation other types of responsibility centers also are used. One problem with using responsibility centers, however, is that they sometimes complicate the calculations necessary for the kind of value chain analysis that looks for synergistic linkages among units.

Benchmarking

Benchmarking is the continual process of measuring products, services, and practices against the toughest competitors or those companies recognized as industry leaders. An increasingly popular program, benchmarking is based on the concept that reinventing something that someone else is already using makes no sense. It involves openly learning how others do something and imitating or perhaps even improving on their techniques. The benchmarking process usually involves the following steps.

- Identify the area or process to be examined. It should be an activity that has the potential to determine a business unit's competitive advantage.
- Find behavioral and output measures of the process and obtain measurements.
- Select an accessible set of competitors and best-in-class companies against which to benchmark. These companies may be in completely different industries but perform similar activities.
- Calculate the differences among the company's performance measurements and those of the best-in-class company. Determine *why* the differences exist.
- Develop tactical programs for closing performance gaps.
- Implement the programs, measures the results, and compare the results with those of the best-in-class company.

Discovery-driven planning

In conventional planning, the correctness of a plan is generally judged by how close projections come to outcomes. In *discovery-driven planning*, it is assumed that plan parameters may change because new information is revealed; therefore the plan is subject to change. With conventional planning, it is considered appropriate to fund the entire project as the expectation is that one can predict a positive outcome. In discovery-driven planning, funds are released based on the accomplishment of key milestones or checkpoints, at which point additional funding can be made available predicated on reasonable expectations for future success. Conventional project management tools, such as stage-gate models or the use of financial tools to assess innovation have been found to be flawed in that they are not well suited for the uncertainty of innovation-oriented projects Innovative growth that involves the development of an innovative new product or service can be attained by establishing and systematically testing project assumptions at progressively more challenging checkpoints, learning from the outcomes, and changing direction as appropriate. If the results live up to your assumptions, you release more funds until you get to the next checkpoint. If they don't, you alter the project or kill it. Ego, corporate politics, and a desire to recoup some kind of return on investment almost guarantee that good money will be thrown after bad. The important thing is that you're embedding learning into the planning process."

Strategic information systems

Before performance measures can have any impact on strategic management, they must first be communicated to the people responsible for formulating and implementing strategic plans. Strategic information systems—computer-based or manual, formal or informal—can perform this function to serve the information needs

of top management. One of the main reasons given for the bankruptcy of International Harvester was the inability of the corporation's top management to determine precisely its income by major class of similar products. Because of this inability, management kept trying to fix ailing businesses and was unable to respond flexibly to major changes and unexpected events. In contrast, one of the key reasons for the success of Toys 'R' Us has been management's use of the company's sophisticated information system to control purchasing decisions.

Critical success factors (CSFs), also called *key success factors (KSFs*), are the things that must go well to ensure a corporation's success. Typically, they are the 20% of the factors that determine 80% of the corporation's or business unit's performance. Critical success factors should be:

- Important to achieving overall corporate goals and objectives.
- Measurable and controllable by the organization to which they apply.
- Relatively few in number—not everything can be critical.
- Expressed as things that must be done.
- Applicable to all companies in the industry with similar objectives and strategies.
- Hierarchical in nature—some CSFs will pertain to the overall corporation, whereas others will be more narrowly focused, say, in one functional area.

The CSFs provide a starting point for developing an information system. Such an information system will thus pinpoint the principal areas that need attention .

At the divisional or SBU level, the information system should support, reinforce, or enlarge business-level strategy with a decision support component. An SBU pursuing a strategy of overall cost leadership could use its information system to help reduce costs either by the improvement of labor productivity or the utilization of other resources, such as inventory or machinery.

The choice of business-level strategy will thus dictate the type of information system that the SBU needs both to implement and to control strategic activities.

The information systems will be constructed differently to monitor different activities because the two types of business-level strategies have different critical success factors.

Problems in measuring performance

Performance measurement is crucial to evaluation and control. The lack of quantifiable objectives or performance standards and the inability of the information system to provide timely, valid information are two obvious control problems. Without objective and timely measurements, making operational, let alone strategic, decisions would be extremely difficult. Nevertheless, the use of timely, quantifiable standards

doesn't guarantee adequate performance. The very act of monitoring and measuring performance may cause side effects that interfere with overall corporate performance. Among the most frequent negative side effects are short-term orientation and goal displacement.

Short-term orientation

In many situations top executives do not analyze either the long-term implications of present operations on the strategy they have adopted or the operational impact of a strategy on the corporate mission. Long-run evaluations are not conducted because executives (1) may not realize their importance, (2) may believe that short-run considerations are more important than long-run considerations, (3) may not be personally evaluated on a long-term basis, or (4) may not have the time to make a long-run analysis. There is no real justification for the first and last "reasons." If executives realize the importance of long-run evaluations, they make the time to conduct those evaluations. Even though many chief executives point to immediate pressures from the investment community and to short-term incentive and promotion plans to support the second and third reasons, the evidence doesn't always support their claims.

Many accounting-based measures do, however, encourage a short-term emphasis. One of the limitations of ROI as a performance measure is its short-term nature. In theory, ROI is not limited to the short run, but in practice applying this measure to long-term performance often is difficult. Moreover, because managers can manipulate both the numerator (earnings) and the denominator (investment), an ROI figure may be meaningless. Advertising, maintenance, and research efforts may be reduced. Mergers may be undertaken that will do more for this year's earnings (and next year's paycheck) than for the corporation's future profits.

Efforts to compensate for these distortions tend to create a burdensome accounting control system, which stifles creativity and flexibility and leads to even more questionable "creative accounting" practices.

Goal displacement

Monitoring and measuring performance (if not carefully done) can actually result in a decline in overall corporate performance. Goal displacement is the confusion of means with ends and occurs when activities originally intended to help managers attain corporate objectives become ends in themselves—or are adapted to meet ends other than those for which they were intended. Two types of goal displacement are behavior substitution and suboptimization.

Behavior substitution

Managers tend to focus more of their attention on those behaviors that are clearly measurable than on those that are not. Employees receive little or no reward for

cooperation and initiative. However, easy-to-measure activities might have little or no relationship to the desired performance. Rational people, nevertheless, tend to work for the rewards that a system has to offer. Therefore workers will tend to substitute behaviors that are recognized and rewarded for those behaviors that are ignored, without regard to their contribution to goal accomplishment. A U.S. Navy quip sums up this situation: "What you inspect is what you get." If the evaluation and control system of an auto plant rewards the meeting of quantitative goals and pays only lip service to qualitative goals, consumers can expect to get a large number of poorly built cars.

The most frequently mentioned problem process partially distorts the realities of the job. Objectives are set for areas in which the measurement of accomplishments is relatively easy, such as ROI, increased sales, or reduced cost. But these might not always be the most important areas. This problem becomes crucial in professional, service, or staff activities for which quantitative measurement is difficult. For example, if a divisional manager is achieving all the quantifiable objectives set but, in so doing, alienates the workforce, the result could be a long-term, significant drop in the division's performance. If promotions are based strictly on measurable short-term performance results, this manager is likely to be promoted or transferred before the employees' negative attitudes result in complaints to the personnel office, strikes, or sabotage. The law governing the effect of measurement on behavior seems to be that *quantifiable measures drive out nonquantifiable measures.*

Suboptimization

The emphasis in large corporations on developing separate responsibility centers may create some problems for the corporation as a whole. To the extent that a division or functional unit views itself as a separate entity, it might refuse to cooperate with other units or divisions if cooperation could in some way negatively affect its performance evaluation. The competition between divisions to achieve a high ROI may result in one division's refusal to share its new technology or work-process improvements. One division's attempt to optimize the accomplishment of its goals may cause other divisions to fall behind and thus negatively affect overall corporate performance. One common example of this type of suboptimization occurs when a marketing department approves an early shipment date to a customer as a means of getting an order. That commitment forces manufacturing to work overtime to get the order out, raising production costs and reducing manufacturing's overall efficiency. Although marketing might achieve its sales goal, the corporation as a whole might not achieve its expected profitability.

Guidelines for proper control

In designing a control system, top management needs to remember that controls should follow strategy. That is, unless controls ensure the proper use of a strategy

achieve objectives, dysfunctional side effects are likely to undermine completely the implementation of that strategy. The following guidelines are recommended.

1. Controls should involve only the minimum amount of information needed to give a reliable picture of events. Too many controls create confusion. Focus on that 20% of the factors that determine 80% of the results.
2. Controls should monitor only meaningful activities and results, regardless of measurement difficulty. If cooperation between divisions is important to corporate performance, some form of qualitative or quantitative measure should be established to monitor cooperation.
3. Controls should be timely so that corrective action can be taken before it is too late. Steering controls, or controls that monitor or measure the factors influencing performance, should be stressed so that advance notice of problems is given.
4. Controls should be long term as well as short term because emphasizing only short-term measures is likely to lead to a short-term managerial orientation.
5. Controls should pinpoint exceptions, with only those activities or results that fall outside a predetermined tolerance range being identified for attention.
6. Controls should be used to reward meeting or exceeding standards rather than to punish failure to meet standards. Heavy punishment of failure will typically result in goal displacement. Managers will falsify reports and lobby for lower standards.

Surprisingly, the best managed companies often have few formal objective controls. They focus on measuring critical success factors and control other factors by means of the corporate culture. When the firm's culture complements and reinforces its strategic orientation, there is little need for an extensive formal control system. The stronger the culture and the more it was directed toward the marketplace, the less need was there for policy manuals, organization charts, or detailed procedures and rules. In these companies, people way down the line know what they are supposed to do in most situations because the handful of guiding values is crystal clear.

Strategic incentive management

To ensure congruence between the needs of the corporation as a whole and the needs of its employees as individuals, management and the board of directors should develop an incentive program that rewards desired performance. Research confirms the conventional wisdom that, when pay is tied to performance, it motivates higher productivity, and strongly affects both absenteeism and work quality. Studies of

compensation plans in all types of companies—manufacturing and service, large and small, growing and declining, in stable and turbulent markets—showed that the higher the percentage of management's compensation that is linked to performance, the greater is the company's profitability. Corporations therefore have developed various types of incentives for executives that range from stock options to cash bonuses. Unfortunately, research consistently reveals that CEO compensation is related more to the size of the corporation than to the size of its profits. The gap between CEO compensation and corporate performance is most noticeable in those corporations with widely dispersed stock ownership and no dominant shareholder group to demand performance-based pay.

The following three approaches are tailored to help match measurements and rewards with explicit strategic objectives and time frames.

1. Weighted-factor method: This method is particularly appropriate for measuring and rewarding the performance of top SBU managers and group-level executives when performance factors and their importance vary from one SBU to another. The measurements used by one corporation might contain the following variations: the performance of high-growth SBUs measured in terms of market share, sales growth, designated future payoff, and progress on several future-oriented strategic projects; the performance of low-growth SBUs, in contrast, measured in terms of ROI and cash generation; and the performance of medium-growth SBUs measured for a combination of these factors.

2. Long-term evaluation method: This method compensates managers from achieving objectives set over a multi-year period. An executive is promised some company stock or "performance units" (convertible into money) in amounts to be based on long-term performance. An executive committee, for example, might set a particular objective in terms of growth in earnings per share during a five-year period. Awards would be contingent on the corporation's meeting that objective within the designated time limit. Any executive who leaves the corporation before the objective is met receives nothing. The typical emphasis on stock price makes this approach more applicable to top management than to business unit managers.

3. Strategic-funds method: This method encourages executives to look at developmental expenses differently from current operating expenses. The accounting statement for a corporate unit enters strategic funds as a separate entry below the current ROI. Distinguishing between funds consumed in the generation of current revenues and funds invested in the future of the business is possible. Hence the manager can be evaluated on

both a short- and a long-term basis and has an incentive to invest strategic funds in the future.

An effective way to achieve the desired strategic results through a reward system is to combine the weighted-factor, long-term evaluation, and strategic-funds approaches. To do so, *first*, segregate strategic funds from short-term funds, as is done in the strategic-funds method. *Second*, develop a weighted-factor chart for each SBU. *Third*, measure performance on the basis of the pretax profit indicated by the strategic-funds approach, the weighted factors, and the long-term evaluation of SBU and corporate performance. General Electric and Westinghouse are two of the firms that use a version of these measures.

A guide to performance measurement and non-financial indicators – The need for a range of performance measures

Organizational control is the process whereby an organization ensures that it is pursuing strategies and actions which will enable it to achieve its goals. The measurement and evaluation of performance are central to control and mean posing 4 basic questions:

- What has happened?
- Why has it happened?
- Is it going to continue?
- What are we going to do about it?

The first question can be answered by performance measurement. Management will then have to hand far more useful information than it would otherwise have in order to answer the other three questions. By finding out what has actually been happening, senior management can determine with considerable certainty which direction the company is going in and, if all is going well, continue with the good work. Or, if the performance measurements indicate that there are difficulties on the horizon, management can then lightly effect a touch on the tiller or even alter course altogether with plenty of time to spare.

As to the selection of a range of performance measures which are appropriate to a particular company, this selection ought to be made in the light of the company's strategic intentions which will have been formed to suit the competitive environment in which it operates and the kind of business that it is. For example, if technical leadership and product innovation are to be the key source of a manufacturing company's competitive advantage, then it should be measuring its performance in this

GLOBAL professional publishing

area relative to its competitors. But if a service company decides to differentiate itself in the marketplace on the basis of quality of service, then, amongst other things, it should be monitoring and controlling the desired level of quality.

Whether the company is in the manufacturing or the service sector, in choosing an appropriate range of performance measures it will be necessary however to balance them, to make sure that one dimension or set of dimensions of performance is not stressed to the detriment of others. The mix chosen will in almost every instance be different. While most companies will tend to organize their accounting systems using common accounting principles, they will differ widely in the choice, or potential choice, of performance indicators.

Authors from differing management disciplines tend to categories the various performance indicators that are available as follows::

- competitive advantage – flexibility
- financial performance – resource utilization
- quality of service – innovation

These six generic performance dimensions fall into two conceptually different categories. Measures of the first two reflect the success of the chosen strategy, i.e. ends or results. The other four are factors that determine competitive success, i.e. means or determinants.

Another way of categorizing these sets of indicators is to refer to them either as upstream or as downstream indicators, where, for example, improved quality of service upstream leads to better financial performance downstream.

Exhibit 8.1: Upstream Determinants and Downstream Results

Performance Dimensions	Types of Measures
Competitiveness	Relative market share and position Sales growth, Measures re customer base
Financial Performance .	Profitability, Liquidity, Capital Structure, Market Rations, etc
Quality of Service	Reliability, Responsiveness, Appearance, Cleanliness, Comfort, Friendliness, Communication, Courtesy, Competence, Access, Availability, Security etc.
Flexibility	Volume Flexibility, Specification and Speed of Delivery Flexibility

Performance Dimensions	Types of Measures
Resource Utilization	Productivity, Efficiency, etc.
Innovation	Performance of the innovation process, Performance of individual innovations, etc.

Who does the analysis?

Whether the indicators are of the financial variety or of the non-financial sort, usually it is the functional managers themselves who prepare their own indicators from data generated from within their own departments.

Financial vs. Non-financial

In many companies, the familiar cry "everything here is viewed in terms of the bottom line!" can be heard. In this sort of corporate environment, financial indicators remain the fundamental management tool and could be said to reflect the capital market's obsession with profitability as almost the sole indicator of corporate performance. Opponents of this approach suggest that it encourages management to take a number of actions which focus on the short term at the expense of investing for the long term. It results in such action as cutting back on R & D revenue expenditure in an effort to minimize the impact on the costs side of the current year's P & L, or calling for information on profits at too frequent intervals so as to be sure that targets are being met, both of which actions might actually jeopardize the company's overall performance rather than improve it.

In general terms, the opponents of "the bottom line school" state that because of the pre-eminence of money measurement in the commercial world, the information derived from the many stages preceding the preparation of the annual accounts, such as budgets, standard costs, actual costs and variances, are actually just a one dimensional view of corporate activity. Increasingly, over the past decade, they have been emphasizing that executives should come to realize the importance of the non-financial type of performance measurement.

Research in support of this approach has come up with new dictums for the workplace : "the less you understand the business, the more you rely on accounting numbers" and "the nearer you get to operations, the more non-financial performance indicators you realize could be valuable aids to better management"; or "graphs and bars carry much more punch than numbers for the non-financial manager".

But there is still a lot of resistance. Executives tend to avoid using multiple indicators because they are difficult to design and sometimes difficult to relate, one to another. They have a strong preference for single indicators of performance which are

well tried and which produce ostensibly unambiguous signals. But the new school lays great emphasis on the fact that multiple indicators are made necessary by the sheer complexity of corporate activity.

The case for non-financial performance indicators

If senior managers place too much emphasis on managing by the financial numbers, the organization's long term viability becomes threatened. That is, to provide corporate decision makers with solely financial indicators is to give them an incomplete set of management tools.

The essential case is twofold; that firstly not every aspect of corporate activity can be expressed in terms of money and secondly that if managers aim for excellence in their own aspects of the business, then the company's bottom line will take care of itself.

So what do non-financial indicators relate to ? They relate to the following functions:

- manufacturing and production
- sales and marketing
- people
- research and development
- the environment

Whether the company is a manufacturer or a service provider, to be successful its management should be concerned to ensure that:

- products move smoothly and swiftly through the production cycle
- warranty repairs are kept to a minimum and turned round quickly
- suppliers' delivery performance is constantly monitored
- quality standards are continually raised
- sales orders, shipments and backlog are kept to a minimum
- there is overall customer satisfaction
- labor turnover statistics are produced in such a way as to identify managerial weaknesses
- R &D costs do not escalate
- the accounting and finance departments really understand the business

Looking at each of these areas in turn, the following non-exhaustive list of performance measures is relevant. No one indicator should be over emphasized and no one indicator should reign supreme for long in the corporate consciousness of executives or management gurus.

1. Manufacturing and production indicators

The sheer volume, variety and complexity of managerial issues surrounding the production process makes this area of corporate activity a particularly rich one for non-financial indicators. Performance indicators can be devised for all operational areas.

Non-financial indicators, depending on the exact nature of the production process, might include the following:

- indicators deriving from time and motion studies
- production line efficiency
- ability to change the manufacturing schedule when the marketing plan changes
- reliability of component parts of the production line
- production line repair record
- keeping failures of finished goods to a minimum
- ability to produce against the marketing plan
- product life cycle

Indicators concerned with controlling production quality - right first time

- measurement of scrap
- tests for components, sub-assemblies and finished products
- fault analysis
- "most likely reasons" for product failures
- actual failure rates against target failure rates
- complaints received against the quality assurance testing program
- annualized failures as a % of sales value
- failures as a % of units shipped
- various indicators of product / service quality
- various indicators of product / service reliability

Indicators concerned with the purchasing department's external relationships with its suppliers

- inventory levels and timing of deliveries
- "just in time" inventory control measurements
- stock turnover ratio
- weeks stocks held
- suppliers delivery performance
- analysis of stock-outs
- parts delivery service record

- % of total requests supplied in time
- % supplied with faults

Indicators of sales delivery and service

- shipments vs. first request date
- average no. of days shipments late
- response time between enquiry and first visit

2. Sales and marketing

- measurements based on "staying close to the customer"
- complaints re manuals
- complaints re packaging / ease of opening
- quality of packaging materials
- customer satisfaction analysis
- price of products comparisons
- check on unsuccessful visit reports
- monitoring repeated lost sales by individual salesmen
- sales commission analysis
- monitoring of enquiries and orders
- sales per 100 customers
- "strike rate" - turning enquiries into orders
- analysis of sales by product line
- by geographical area
- by individual customer
- by salesmen
- matching sales orders against sales shipments - the trend from the mismatch
- backlog of orders analysis
- flash reports on sales
- publication of sales teams performance internally
- analysis of basic salaries and sales commissions
- share of the market against competitors
- share of new projects in the industry
- new product / service launch analysis
- time to turn round repairs
- delays in delivering to customers (customer goodwill)
- value of warranty repairs to sales over the period

3. People

- head count control

- head count by responsibility
- mix of staff analysis
- mix of business analysis vs. staff personnel needs
- skilled vs. non skilled
- management numbers vs. operations staff
- own labor / outside contractor analysis
- workload activity analysis
- vacancies existing and expected
- labor turnover
- labor turnover vs. local economy
- % of overtime worked to total hours worked
- absence from work
- staff morale
- cost of recruitment
- number of applicants per advert
- number of employees per advertising campaign
- staff evaluation techniques
- evaluation of staff development plans
- monitoring of specific departments, e.g. accounting
- speed of reporting to internal managers vs. HQ
- accuracy of reporting as measured by misallocations and mispostings
- monitoring of departments performance long term
- pay and conditions vs. competition

4. Research and development

- evaluation vs. basic R&D objectives, strategic objectives and project objectives
- product improvement against potential market acceptance
- R&D against technical achievement criteria, against cost and markets
- R&D priority vs. other projects
- R&D vs. competition
- R&D technical milestones
- analysis of market needs over the proposed product / service life of R&D outcome
- top management audit of R&D projects
- major program milestones
- failure rates of prototypes
- control by visibility - releases, e.g. definition release, design release, trial release, manufacturing release, first shipment release, R&D release

5. Environment

- work place environment yardsticks
- cleanliness
- tidiness
- catering facilities vs. competition
- other facilities vs. competition

Many executives will talk freely in terms of quality and standards, of "just in time" inventory control, and of other performance measurement yardsticks and may be quite knowledgeable about them, but when questioned as to the exact nature of the non-financial measurements that they actually have in place in the company will be hard-pressed to tell the researcher what the company is in fact measuring on an on-going basis. There is a lot of lip service paid to these measures, as opposed to those of a purely financial nature, which are of course to a great extent the product of regulation and company law. So, much remains to be done to broadcast the merits of non-financial performance measurement indicators.

Balanced scorecard

A problem with just assessing performance with financial measures like profit, ROI and Economic Value Added (EVA) is that the financial measures are "backward looking."' In other words, today's financial measures tell you about the accomplishments and failures of the past. An approach to performance measurement that also focuses on what managers are doing today to create future shareholder value is the Balanced Scorecard.

Essentially, a Balanced Scorecard is a set of performance measures constructed for four dimensions of performance. As indicated in Figure 3, the dimensions are financial, customer, internal processes, and learning and growth. Having financial measures is critical even if they are backward looking. After all, they have a great effect on the evaluation of the company by shareholders and creditors. Customer measures examine the company's success in meeting customer expectations. Internal process measures examine the company's success in improving critical business processes. And learning and growth measures examine the company's success in improving its ability to adapt, innovate, and grow. The customer, internal processes, and learning and growth measures are generally thought to be predictive of *future* success (i.e., they are not backward looking).

A variety of potential measures for each dimension of a Balanced Scorecard are indicated in Exhibit 8.2. After reviewing these measures, note how "balance" is achieved:

- Performance is assessed across a *balanced set of dimensions* (financial, customer, internal processes, and innovation).
- *Quantitative* measures (e.g., number of defects) are balanced with *qualitative* measures (e.g., ratings of customer satisfaction).
- There is a balance of *backward-looking* measures (e.g., financial measures like growth in sales) and *forward-looking* measures (e.g., number of new patents as an innovation measure).

Exhibit 8.2: Balanced scorecard

	Description	**Measures**
Financial	Is the company achieving its financial goals?	Operating income Return on assets Sales growth Cash flow from operations Reduction of administrative expense
Customer	Is the company meeting customer expectations?	Customer satisfaction Customer retention New customer acquisition Market share On-time delivery Time to fill orders
Internal Processes	Is the company improving critical internal processes?	Defect rate Lead time Number of suppliers Material turnover Percent of practical capacity
Learning and Growth	Is the company improving its ability to innovate?	Amount spent on employee training Employee satisfaction Employee retention Number of new products New product sales as a percent of total sales Number of patents

Examples of balanced scorecard measures by industry

Industry	***Financial Dimension***	***Customer Dimension***	***Internal Business Process Dimension***	***Learning and Growth Dimension***
Airlines	Return on assets	Frequent flier program participation rates	Percentage of on-time takeoffs and arrivals	Labor contract length
Consumer retail banks	Ratio of assets to debt	Number of new accounts opened	Number of new branches	Hours of employee training completed
Accounting, consulting, and law firms	Profit margin	Client retention rate	Percentage of projects completed on time	Certification and education levels of professionals
Computer manufacturers	Sales growth from new products	Number of corporate customers	Number of product defects	Percentage of factory employees who completed quality control training
Supermarkets	Inventory turnover	Customer satisfaction	Product spoilage rates	Employee turnover rates

There are numerous web resources that you can log on to learn more about the balanced score card and performance evaluations. For example, managers frequently look to industry "best practices" or examples of successful implementations at other firms when developing measurement programs. The following list below provides valuable resources for evaluating performance and business decision making across a wide range of industries.

- **The Balanced Scorecard Institute (www.balancedscorecard.org).** The Balanced Scorecard Institute is an independent educational institute that provides training and guidance to assist government agencies and

companies in applying best practices in balanced scorecard (BSC) and performance measurement for strategic management and transformation. Their website provides background information about implementing the balanced scorecard and the proper selection of nonfinancial measures. It also provides several examples of past successes.

- **American Productivity and Quality Center (www.apqc.org).** The American Productivity & Quality Center (APQC), an internationally recognized nonprofit organization, provides expertise in benchmarking and best practices research. APQC helps organizations adapt to rapidly changing environments, build new and better ways to work, and succeed in a competitive marketplace. It has a membership of over 450 prestigious global firms including 3M, AT&T, Cisco Systems, and Ernst & Young. The objective of this collaborative center is to "Understand how innovative organizations create succession management programs to identify and cultivate potential leaders who will provide a sustainable business advantage." The Best Practices and Free Resources links lead to many useful resources.
- **Management Help (www.managementhelp.org).** This website offers a robust "library" of decision-making tools and library resources. The site offers many resources on such topics as strategic planning, performance measurement, employee development, and make-or-outsource decisions. It also includes online discussion groups, decision-making guidance, and free reference material.
- **Performance Measurement Association (www.performanceportal.org).** This website, a home to the United Kingdom's Performance Measurement Association, covers references to valuable articles, a free newsletter, and insight into current trends in performance measurement. It is representative of the types of professional associations that managers join to share ideas and continue the development of their personal and managerial skills.

GLOBAL professional publishing

CHAPTER 9

Crafting Global Strategy

Today's global economy requires new thinking about the company's mission and strategy. Whether small or large, startups or well established, low or high technology, manufacturing or service, companies are pressured to adapt to this global reality. Success in global markets often requires different skills and capabilities than those needed in domestic markets. Changes in organizational structure, managerial processes, and control systems are also necessary.

Reasons for rising internationalization of business

International trade has always been an integral part of the economic enterprise. Companies have found opportunities for growth and profitability in new markets-outside their home base. There are several reasons for increased international operations:

Capitalizing on growth opportunities

Companies in diverse industries such as telecommunication, tobacco, personal computer (PC), cosmetics and hygiene, fast food, pharmaceutical, software, and biotechnology have ventured into international markets with success. U.S. companies in mature, declining, and growth industries have focused on growth opportunities in overseas markets.

GLOBAL professional publishing

Taking advantage of cost differences

There are differences in resource endowments among regions of the world and among countries. Prudent companies take advantage of these differences.

Gaining economies of scale and making a profit

Technological advances have reduced the costs of communication and transportation, and made it easier for companies to target wider markets. Similarly, advances in manufacturing technologies have allowed companies to "mass customize" some of their products. This has helped companies meet the needs of customers in different markets while making a profit

Protecting the company's home base market

Some international operations represent a defensive move to counteract the penetration of foreign producers of the company's home markets.

Global industries

The analysis of a competition in an industry requires consideration of the economics of the characteristics of competitors. However, in a global industry, the analysis is not limited to one market, but extends to all markets (geographic or national) taken together. Michael E. defines a global industry as "one in which the strategic positions of competitors in major geographic or national markets are fundamentally affected by their overall global positions." Thus, an industry becomes global because it perceives a net strategic advantage to competing in a coordinated way in many national markets.

Internationalization leads to four key changes in the structure of industries:

- Barriers to entry decline and, as a result, it becomes easier for foreign companies to penetrate national markets.
- Concentration declines as a result of entry by foreign producers. Concentration shows the amount of market share controlled by the top four or eight producers in the industry. A low concentration ratio indicates a highly competitive industry.
- Competition intensifies as a result of internationalization. Moreover, the diversity of competitors rises with internationalization. This happens because companies from different countries enter the industry and compete by using different strategies.
- Consumer buying power rises with increased internationalization. The entry of companies with different strategies gives consumers many new options from which to choose.

GLOBAL professional publishing

Michael E. Porter suggests that industries form a continuum, ranging from "multidomestic" to truly "global industries." This is an important distinction, because it affects the way the company competes and creates a competitive advantage.

In a multidomestic industry, each country (or a small number of countries) is treated differently. A company's competitive strategies in these countries (or regions) are independent. Retailing, insurance, and consumer package goods are prime examples of multidomestic industries. These industries exhibit great variations in their structures and bases of competition. These variations reflect the diversity of national culture, socioeconomic variables, and political regimes. Because of these variations, little coordination can be achieved on a global scale.

A global industry exhibits considerable similarities across its different segments. Competing in a global industry requires coordination of the company's activities. That is, what a company does in one market affects its actions in other markets.

International strategic choices

Many aspiring companies have failed in their bid to "internationalize" their operations. One reason is the tendency to view the company's international or global effort as an "add on" to its existing strategies. Some companies approach international markets as a mere extension of their domestic markets. Assumptions of these types can be deadly. Other companies have copied their industry leader's international strategy. This, too, can cause failure. Whether the company should compete using one of the above four models depends on many factors, especially the desired extent and type of international participation. This section focuses on this important factor.

Mapping the company's international strategy involves three steps:

- Determining the company's preparedness for international operations.
- Selecting the company's mode of entry into different markets or countries.
- Developing the organizational structure that supports the chosen strategy.

Determining the company's preparedness for international operations

This phase requires attention to two important areas: (1) analysis of the company's internationalization drivers and potential and (2) determining the extent of the company's readiness for international operations. Results from these analyses complement one another and are useful in selecting the company's international strategy.

Analyzing the industry's internationalization drivers and potential

This phase of the analysis requires identifying the industry-related factors that encourage internationalization. These factors relate to market conditions, competitive forces in the target industry and market, and government regulations. Executives typically consider several variables within each area 6

Market factors

These variables refer to the attractiveness of the industry as a target market. In particular, internationalization is attractive when:

- Market needs do not vary considerably from one country to another. Although diversity of needs offers opportunities to exploit, similarity of needs can facilitate production and marketing activities, lower costs, and reduce risks.
- Customers are not widely dispersed globally. When customers are widely dispersed, serious coordination problems may arise.
- The company can build on its well-known brands or its advertising campaigns. Internationalization is attractive when the company's brand names are well known, and these require little effort to position them in local markets. Similarly, when advertising themes or campaigns can be used in new markets, the cost of internationalization is reduced.
- International distribution channels exist. In this case, access to international markets will be easier and less costly.

Competitive factors

Two issues deserve attention here:

- The extent to which the company's key rivals have internationalized their operations. As mentioned, internationalization can be used to defend the company's market. When rivals internationalize their operations, they can achieve economies of scale and increase their ability to create new products. Sometimes, this may prompt some companies to internationalize their own operations to remain internationally viable.
- Competitive interdependence among countries. If success in one market requires participation in other markets, international entry is desirable. This interdependence can be a potent source of innovation and economies of scale.

Government regulations

Here, managers need to examine several factors:

- To what extent do national trade policies protect domestic producers? If trade policies are designed to protect domestic producers, the attractiveness of the target industry as an international arena is diminished.
- To what extent is the industry's (or country's) technical standards compatible with the company's engineering and manufacturing skills? If the standards are compatible with the company's products, the attractiveness of the industry is enhanced.
- What is the nature and extent of marketing regulations in the countries under consideration? If different regulations exist, they may increase cost, require customization, and serve as an entry barrier. These regulations reduce the attractiveness of an industry as an international opportunity.

Evaluating a company's international preparedness demands an analysis of its structure, managerial process, culture, and people. Managers should ask several questions:

- How will the company's increased international participation affect its mission and competitive approach? How will internationalization influence the company's ability to achieve its goals?
- To what extent does the company have an international identity? Has it always defined itself as a domestic competitor, or does it have some international recognition?
- What is the level of existing international expertise in the company? Who among the senior executives has international expertise? Does the company value international expertise in hiring, evaluating, and promoting its executives? Does the company hire foreign nationals?
- How will the internationalization process affect the company's structure, authority lines, and communication flows?
- If the company had some previous international activities, to what extent has it coordinated those operations with its domestic operations? To what extent are the existing international operations themselves coordinated? For instance, does the company develop and use global budgets? Does it use global performance reviews?
- If the company has some previous international experience, to what extent does the current structure accommodate the needs of international and domestic operations?

Considering the mode of entry

Several approaches can be used to enter foreign markets. These approaches require different levels of international experience and financial investments.

Initially, the company may rely on *exporting* activities to gain a foothold in an international market. Next, with increased international expertise, the company may use *licensing* agreements to broaden its market reach. Alternatively, the company may engage in *franchising* by authorizing others to use its products, services, and logos in new markets. The company may enter a *joint venture* with foreign partner(s).

Exporting

Exporting represents an initial stage in a company's international participation. Exporting has many advantages, including:

- Offering the company an opportunity to learn and develop appropriate familiarity with international markets.
- Helping the company reduce business risk by providing a broader customer base that serves as a hedge against unfavorable domestic markets.
- Enabling the company to achieve economies of scale because of increased production volume.
- Not requiring major initial startup costs, making this option feasible for even small and startup companies.

The factors that stimulate or impede a company's exporting activities fall into two types: external and internal. External factors relate to the company's competitive setting. Internal factors pertain to the company's unique skills and attitudes of its executives about exporting. Both external and internal factors play a major role in the company's decision to export.

External stimuli and impediments

Several external factors encourage a company to export, especially:

- Poor domestic economic conditions, such as a recession.
- Intense competitive conditions in the firm's major industry.
- Government support through tax incentives or other means.

However, several other external factors may discourage exporting by limiting the attractiveness of the target markets. These factors include:

GLOBAL professional publishing

- The existence of strong trade barriers in foreign markets, such as quotas or tariffs.
- The intensity of competition in the target market.
- Poor demand in the target market.
- Poor profit potential in the target market.

Internal stimuli and impediments

Several internal factors can influence the company's decision to export. These include managerial beliefs, attitudes, and practices. Managerial beliefs that encourage exporting include:

- A belief that exporting can contribute positively to the company's growth and profitability.
- A belief that the risks and costs associated with exporting are offset by benefits from this activity.
- A belief that exporting is more profitable than purely domestic operations.
- A belief that the initial exporting effort does not depend on the incentives offered by the government.
- A belief that the company has a unique product or a distinct competitive advantage.

Unfortunately, sometimes the company holds beliefs that can handicap exporting activities. These beliefs develop from limited international exposure. They include:

- The belief that the risks associated with exporting are greater than any potential gains.
- The belief that initiating exporting activities are very costly.
- The belief that the company will encounter major difficulties in initiating its exporting programs.
- The belief that exporting is suitable only for very well-established large companies.

Managerial beliefs about exporting should be examined to determine their accuracy. Further, to be a successful exporter, the company should:

- Obtain qualified export counseling and develop an international marketing plan before starting an export business.
- Secure a commitment from top management to overcome the initial financial requirements of exporting.

- Take sufficient care in selecting overseas distributors. Establish a basis for profitable operations and orderly growth. Devote continuing attention to the export business when the U.S. market booms.
- Treat international distributors on an equal basis with domestic counterparts.
- Differentiate its marketing approach. The company should not assume that a given market technique and product will automatically be successful in all countries.
- Be willing to modify products to meet regulations or cultural preferences of other countries.
- Print service, sales, and warranty material in locally understood languages.
- Provide readily available servicing for the product. A product without the necessary service support can acquire a bad reputation quickly.

Licensing and other contractual agreements

In addition to exporting, the company can use licensing as a means of entering foreign markets. Thus, for a fee, the company transfers one or more of its intangible assets (such as a trade secret, patent, or trademark) to foreign companies. Licensing has been widely used in many industries, such as civilian aircraft manufacturing, PC, semiconductors, electronics, and hotels.

Several factors encourage companies to engage in licensing agreements:

- Licensing diffuses the technology and establishes it as the industry's dominant standard. Licensing encourages others to use its technology so it can control the market or preempt rival technologies. For example, with the use of licensing agreements, Microsoft's Windows became a worldwide success.
- Royalties generated from licensing are a major source of revenue on products already considered mature in the domestic markets.
- The company may use cross-licensing to obtain information about other technologies, products, or processes. For instance, a company may allow another company to use its technology in return for access to that company's new technology.
- International licensing keeps the company's technology or trademark in use.
- Sometimes the R&D activities of a company generate products or technologies that fall outside the company's mission. In this case, the company uses licensing to make use of its technology, without assuming the risks associated with its marketing.

- For users, licensing can speed up access to vital technological innovation. It can also help fill voids in these companies' technological programs.

As a mode of entry into foreign markets, licensing offers a company three advantages:

- It helps the company overcome trade barriers, without much cost or equity investment.
- It allows the company to overcome limits on investments imposed by other countries or governments.
- It may encourage the company to adapt its technology for local markets, thereby reviving it for use in other countries or applications.

Still, there are several shortcomings for licensing as a mode of entry. For example, the income generated from licensing may not match the income that can be gained by using other modes of entry. There is also the possibility that licensing can create a competitor for the company, as happened with U.S. companies' experience with Japanese and Korean companies. After gaining access to U.S. technology through licensing, Japanese companies offered products that became substitutes to U.S.-made products.

Franchising

This approach is fast becoming a popular mode of entering foreign markets. In franchising, a company authorizes other companies to do business in a specific manner. Soft-drink and fast-food companies have used franchising to expand internationally.

Franchising has many advantages for both the franchisors and franchisees. For franchisors, it offers a quick way of entering foreign markets, thus expanding their operations and achieving higher profitability. For franchisees, it gives them access to a successful business concept and reduces business risk.

Despite the increasing popularity of international franchising, companies frequently face major problems, including red tape by host governments, high duties imposed by host countries, monetary uncertainties, logistical problems, lack of control over the franchisees, patent or trademark protection, and imitation by local companies.

International joint ventures

International joint ventures (IJVs) are an important mode of entry to foreign markets. IJVs can help companies overcome trade barriers, achieve economies of scale, facilitate the acquisition of managerial and technological skills, secure access to raw materials, and reduce the risks associated with complex projects. Companies participate in IJVs

to minimize the cost of operations, improve their competitive position, and learn new skills.

Despite an impressive record of achievements, IJVs are risky. Many IJVs fail because of: ineffective managerial decisions about the type, scope, duration, and administration of IJVs, the careless selection of partners, and the company's failure to link IJVs to their strategy.

Several factors encourage the use of international joint ventures, including:

- The company's major industry is experiencing technological volatility. In this case, an IJV allows the company to reduce the costs and risks associated with developing new technologies. These reasons may explain why companies in the pharmaceutical industry have been among the most active in IJVs.
- High demand uncertainty also favors the use of IJVs. An IJV helps reduce uncertainty by sharing knowledge and resources.
- Significant entry barriers exist in the target foreign market.
- There is a need for major economies of scale. Specifically, potential savings in production, distribution, and marketing are important for gaining or sustaining a strong competitive position.
- The company has expertise in international operations. Companies with extensive international business expertise are more likely to succeed than companies without IJV experience.

Despite their growing popularity, IJVs are considered a risky strategic option. A major contributor to this high rate of failure is the poor selection of IJV partners. To minimize the risks associated with IJVs, executives should consider the following issues in selecting prospective partners.

- How do partners define their current business? How do they intend to change their business concept if they are contemplating such a change? How does the IJV fit into the partners' current and future business definitions?
- How critical is the proposed IJV to the partners' goals, mission, and strategy?
- Who is championing the IJV in the future partner firm? What are their expectations of the venture? What is their track record?
- What is the partner's international expertise?
- How compatible are the managerial styles and organizational systems of the partners?

Another factor that contributes to the high rate of IJV failure is disagreements among partners on the scope of the venture. Success demands agreement on the scope and objectives of the IJV, the legal form, the contributions of the partners to the venture,

the management, the venture's relationship with the parent company, the life span of the venture, and the conditions under which the IJV will be disbanded. These issues require careful and diligent negotiations.

Still, despite good intentions, additional factors may cause IJVs to fail. For example:

- Partners may delay the transfer of technology to the IJV and cause its failure.
- Organizational or national cultural clashes among IJV managers and employees may cause the venture to fail.
- Differing management styles and disagreements on goals or policies may lead to failure.
- The venture may be initiated during poor economic conditions, or local authorities may respond negatively to the venture.

Wholly owned subsidiaries

Establishing a wholly owned subsidiary is generally the most costly method of serving a foreign market. Companies doing this have to bear the full costs and risks associated with setting up overseas operations (in contrast with joint ventures, where the costs and risks are shared, or licensing, where the licensee bears most of the costs and risks). Despite this considerable disadvantage, however, two clear advantages are associated with setting up a wholly owned subsidiary.

First, when a company's competitive advantage is based on control over a technological competence, a wholly owned subsidiary is normally the preferred entry mode because it reduces the risk of losing control over that competence. For this reason, many high-tech companies prefer to set up wholly owned subsidiaries overseas rather than enter into joint ventures or licensing arrangements. Thus wholly owned subsidiaries tend to be the favored entry mode in the semiconductor, electronics, and pharmaceutical industries. Second, a wholly owned subsidiary gives a company the kind of tight control over operations in different countries that is necessary if a company is going to pursue a global strategy. When the pressures for global integration are high, it may pay a company to configure its value chain in such a way that value-added at each stage is maximized. Thus a national subsidiary may specialize in manufacturing only part of the product line or certain components of the end product, exchanging parts and products with other subsidiaries in the company's global system. Establishing such a global manufacturing system necessarily requires a high degree of control over the operations of national affiliates. Different national operations have to be prepared to accept centrally determined decisions about how they should produce, how much they should produce, and how their output should be priced for transfer between operations. Licensees or joint—venture partners are unlikely to accept such a subservient role.

Global strategic alliances

The term *global strategic alliances* refers to cooperative agreements between potential or actual multinational competitors. Alliances range from formal joint ventures, in which two or more multinational companies have an equity stake, to short-term contractual agreements in which two companies may agree to cooperate on a particular problem (such as developing a new product). Critics warn that global strategic alliances, like formal joint ventures, give competitors a low-cost route to gain new technology and market access. On the other hand, strategic alliances can be to the advantage of both parties. However, in order for this to occur, alliances must be structured so that (1) a company does not unintentionally give away proprietary technology to its alliance partner and (2) a company learns important skills from its alliance partner. Alliances can be seen as a way of sharing the high fixed costs and high risks associated with new product development or with the opening up of new markets. Further, an alliance can be seen as a way of bringing together complementary skills and assets that neither company could easily develop on its own.

Exhibit 9.1: Advantages and disadvantages of different entry modes

Entry mode	**Advantage**	**Disadvantage**
Exporting	Ability to realize global scale economies	High transport costs Tariff barriers Problems with local marketing agents
Licensing	Low development costs and risks	Difficulties achieving global strategic coordination Lack of control over technology
Franchising	Low development costs and risks	Difficulties achieving global strategic coordination Problems of quality control
International joint ventures (IJV)	Access to local partner's knowledge Sharing of development costs and risks Political acceptability	Difficulties achieving global strategic coordination Lack of control over technology

Entry mode	Advantage	Disadvantage
Wholly owned subsidiaries	Protection of technology Establishment of tight control necessary for achieving global strategic coordination	Assumption by company of all development costs and risk
Global Strategic alliances	A low-cost market access and access to proprietary technology	High-tech giveaways

Having discussed the different modes of entry, a question now arises: How can a company choose an appropriate mode of entry? The next section answers this important question.

Choice of entry mode

Three sets of variables jointly impact a company's choice of entry mode: environmental, strategic, and transactional variables. Exhibit 9.2 summarizes these variables.

Environmental variables

These variables relate to the competitive pressure and the environmental conditions that exist in the markets under consideration. Four variables deserve attention: country risk, location familiarity, demand conditions, and competitive conditions.

Country risk

Managers should evaluate four risks before selecting an entry mode:

- Political risks, such as political instability. Political risk is the risk that a foreign government may act in a way that will reduce the value of the company's investment. Political risk may be reduced by making foreign operations dependent on the domestic parent for technology, markets, and supplies.
- Ownership and control risks, such as the potential for expropriation.
- Operational risks, such as local price controls.
- Transfer risks, which relate to exchange rates and currency issues.

In general, if risk is high, the company should select an entry mode that demands commitment of limited resources such as exporting or licensing.

Location familiarity

As mentioned, companies should understand the economic, social, technological, and cultural values of their potential markets.

However, understanding these variables takes years, even decades. If the company does not have great familiarity with the market, it should consider a mode of entry that does not require significant resource commitments such as franchising or exporting.

Demand conditions

If the market is uncertain because of declining demand or a recession, the company should use a mode of entry that requires low resource commitments.

Competitive conditions

These conditions determine the attractiveness of the market as well as the strategy the company should use. When the competition is fierce or volatile, the company should use an entry mode that requires limited resource commitments, such as franchising.

Strategic variables

These variables reflect the strategic thrust of the company. Three variables are especially important to selecting the mode of entry.

The extent of national differences

Companies vary considerably in their understanding of different markets. Similarly, different entry modes require different degrees of market expertise and familiarity. If the company emphasizes achieving tight integration among its units, it is beneficial for the company to utilize an entry mode (such as having a subsidiary) that facilitates this coordination. If the company aims to pursue different markets without tight integration, then licensing, franchising, or joint ventures can be used.

Extent of economies of scale

Another issue for managers to consider is the potential for savings from the increased volume of operations. Both technical and nontechnical sources of economies should be evaluated. If the multidomestic strategy is followed, some economies are realized. Global strategy requires the widespread coordination of the company's operations. Greater control is needed to achieve such economies. The FDI option is better suited for this purpose.

Concentration

As the concentration ratio rises, the need for FDI may increase. Concentration means that a few companies control most industry sales. As concentration rises, the industry moves closer and closer to oligopoly or even monopoly. Success hinges on tightly coordinating corporate goals and the competitive mission pursued in the industry. This is best achieved when the FDI is followed.

Transaction variables

These variables relate to the costs-both fixed and variable-associated with different entry modes. Two variables are important.

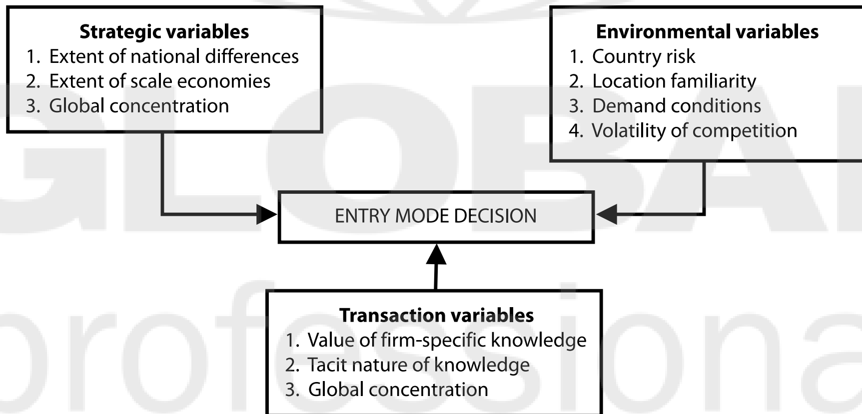
Value of firm-specific knowledge

Companies may gain a competitive advantage from the unique skills they develop in their operations. Companies have an obvious incentive to protect these skills by making them proprietary. Licensing can leak information to other companies and reduce the company's advantage. Franchising has a similar effect. These modes also fail to protect the company against potential opportunism. For example, once a foreign company gains access to the company's technology, it might imitate it and produce a substitute technology. Opportunistic behavior should be considered in selecting an entry mode.

GLOBAL professional publishing

Exhibit 9.2: Determinants of Mode of International Entry

Entry Mode	Control	Resource Commitment	Dissemination Risk
Exporting	High	High	Medium
Licensing	Low	Low	High
Franchising	Low	Low	High
International joint venturing	Medium	Medium	Medium
Wholly owned subsidiary	High	High	Low
Global strategic alliances	Medium	Medium	Medium



Establishing a subsidiary can overcome some of the problems just mentioned, but it also creates other risks. Therefore, the company must compare the profits generated from having a subsidiary with the risks and costs of exporting, licensing, or franchising. The higher the profits and the greater the need for control over firm-specific knowledge, the greater the need for FDI.

Tacit knowledge

A company's skills and capabilities are tangible or intangible. Tangible skills are visible in the company's technological resources. However, intangible or tacit knowledge resides in the minds and experiences of the company's employees and managers. It resides also in the work routines people follow in their jobs. This knowledge often

determines the speed and quality of a company's decisions. Therefore, the company should determine the effect of tacit knowledge on the mode of entry.

The company should also ask: How important is tacit knowledge for success? Answering this question is difficult because there are no precise tools that help the company with the right answer. Obviously, managers' past experiences can be helpful in discussing this issue. When the company's need to retain its tacit knowledge is high, it should not use licensing or franchising. Instead, the company should seriously consider the FDI option.

Selecting the mode of entry is an important step in designing the company's international strategy. Obviously, a company may use several modes of entry simultaneously as it ventures into different markets. For instance, it may use franchising in one market, exporting in another, and FDI in yet another market.

Configurations of international operations

Having selected the modes of entry, executives need to consider two interrelated issues: the selection of generic international strategies and the organization structure needed for these activities.

Generic international strategies

As with domestic strategic choices, companies need to consider both corporate and business-level international strategies. Moreover, they should ensure consistency between these strategies.

International corporate strategies

The choice of the international corporate strategies centers on comparing the multidomestic, global, and transnational options. Managers should consider each option's advantages and disadvantages in terms of coordination and responsiveness.

- *The multidomestic strategy* is rooted in the belief that national markets differ significantly in their structure, demographics, key success factors, and key players. These variations demand greater differentiation in the competitive strategies used in different countries. Thus, competition in one market occurs independently from competition elsewhere. For example, under this model, a company's competitive strategy in Saudi Arabia may differ significantly from that used in Thailand or Mexico. Therefore, there will be little coordination among these different strategies. .

- *Global strategy* means that the company will focus on exploiting similarities among countries in order to create a competitive advantage. It will serve a particular business by offering the same products throughout its markets. Therefore, the company may forgo some of the benefits of the multidomestic strategy in order to achieve economies of scale. A global strategy requires the standardization of operations, the use of tight controls, and the pursuit of a uniform market approach worldwide. It also demands a common managerial philosophy to ensure successful execution.

- *Transnational strategy* focuses on achieving both efficiency and local responsiveness. A key feature of the transnational model is its focus on organizational resources as a means of creating a competitive advantage. The company is viewed as a collection of resources, tangible (such as machines) or intangible (such as reputation in particular markets). Tangible and intangible resources can be exploited to position the company in different international markets. Accordingly, each unit plays a central role in developing and using organizational resources to compete successfully and enhance the competitive position of other units in the company.

International generic business strategies

At the business level, the company can pursue a strategy of low cost, differentiation, or both. These strategies can be achieved in a narrowly or broadly defined market. There are five such options, as discussed below.

- *Global cost leadership*. Global cost leadership can be achieved through product standardization and global sourcing and distribution. TV set and PC producers have followed this strategy for years.
- *Global differentiation* is achieved by building brand name familiarity (e.g., Toyota) or exploiting unique technological differences in operations.
- *Global segmentation* requires determining and targeting a few attractive segments on a worldwide scale. This approach is viable if a company wishes to specialize by focusing on particular customer groups. It is also useful when the company attempts to build its name recognition and gain expertise in international operations and then expand the scope of those operations.
- *Protected markets* require the company to locate and target those segments that enjoy government protection. Often, these markets are considered important for national growth. However, because success

in these industries may require expertise and resources not available domestically, the government may offer necessary legal protection.

- *National responsiveness* means that the company will focus on a few segments in order to capitalize on differences among countries. However, to be viable, these segments should be sufficiently large to generate a profit.

It must be clear by now that managers face a major challenge in designing their company's international operations. On the one hand, they must determine the desired level of standardization in their operations. On the other hand, they should also consider the extent to which the company should be responsive to each market's need. This tension between standardization and responsiveness is at the heart of the strategic choices that companies make in their global operations. .

Organizational structure and international operations

Several factors impact the company's choice of the appropriate organizational structure for its international operations including:

- ***The company's experience in international markets***. *As* experience increases, managers' abilities to control operations improve. Managers acquire greater expertise in dealing with the unique circumstances of different subsidiaries, dealing with diverse economic and political systems, and understanding the specific mission of each subsidiary. Increased expertise can facilitate decentralization of the company's international operations.
- ***The number of products involved***. *As* the number of products in the company's international portfolio increases, complexity of operations rises. This complexity often begets complexity in the chosen organizational structure.
- ***Human resource issues also impact the selection of structure.*** The skills, expertise, and talents of managers and employees impact the company's selection of the organizational structure. Companies that hire skilled personnel can give subsidiaries greater autonomy.
- ***Cost of operations affects the choice of the structure***. Specifically, high costs of transportation, storage, or communication may favor the decentralization of international operations by locating them closer to the local market. However, the potential for achieving high economies of scale through coordination may encourage the centralization of these activities.
- ***Coordination and responsiveness affect the chosen structure.*** The design of an international strategy requires attention to coordinating

the subsidiaries' different activities. This coordination is essential for achieving economies. Coordination is also necessary because some subsidiaries develop cultures that differ from the corporate headquarters' culture. These cultures reflect the subsidiaries' unique focus, personnel, their cultural heritage, education, and experience. Coordination ensures consistency between the corporate and subsidiary missions, prevents conflicts, and ensures commitment to the corporate mission.

Responsiveness and standardization should be considered jointly with the scope of the company's global operations. When this analysis is performed, four options emerge.

When the company's operations are concentrated and the need for coordination is low, executives should also consider exporting their products. To achieve success, they should decentralize their marketing activities to respond to market needs.

- When operations are dispersed and the need for coordination is low, a multi-domestic strategy is desirable. This allows the company to respond to the needs of its different markets.
- When operations are concentrated and the need for coordination is high, a global strategy should be followed.
- When operations are dispersed and the need for coordination is high, the FDI option is suggested. Here, the company can also achieve extensive coordination among its subsidiaries. This requires evaluating and managing interdependencies among the subsidiaries.

Evaluating and managing interdependence

As the company increases its international operations, managing interdependencies among its different units becomes crucial. Managing interdependencies can yield many benefits.

- ***Cost reduction***. *By* sharing resources and eliminating redundancies, the company can achieve efficiency in its operations.
- ***Technological integrity***. This means that the company can keep critical know-how in-house, and use this technology for a competitive advantage. In other words, when technology integrity is achieved, the company's technology can be an important means for creating organizational capabilities that are not available to the competition.
- ***Sustaining a global infrastructure***. This means the company can develop essential services that can be used across several global markets. For example, the company can develop and maintain an organizationwide

GLOBAL professional publishing

competitive intelligence system. Data from this system can be used in predicting competitors behaviors.

Managing interdependence in the corporate portfolio also requires attention to "strategic variety." This refers to the unique administrative and managerial challenges managers face in integrating the international portfolio. Strategic variety arises from variations among businesses in mission, activities, and competitive challenges among units. It also results from the restrictions imposed by the host country's government. Strategic variety increases the complexity of the company's operations and the responsibilities of its senior executives. However, it can be successfully managed using the following approaches:

- The company can reduce complexity by forgoing additional investment opportunities.
- The company may selectively narrow the number of the units in their portfolio through divestment.
- The company may narrow the administrative burden associated with increased strategic variety through selective grouping of countries in their portfolio. Countries believed to be similar in their needs for administrative control are thus put together.
- Managing corporate-subsidiary relationships to reduce conflict, enhance autonomy, and increase coordination. Because of the importance of this issue, it is discussed next.

Managing the corporate-subsidiary relationship

On occasion, tension may develop between the corporate headquarters (HQ) and individual subsidiaries. This tension is reduced by having an effective organizational structure. Tension is further reduced when "due process" prevails in the relationship of the HQ with subsidiaries. This due process means that:

- The headquarters is familiar with the subsidiary's local situation.
- Two-way communication exists in the global strategy-making process. This means that the subsidiary managers have a say in the design of the strategy.
- The HQ is relatively consistent in making its decisions, such as resource allocations and rewards across subsidiaries.
- The subsidiaries can challenge and appeal the HQ's strategic decisions. Moreover, managers receive an explanation for the HQ's final strategic decisions.

Clearly, while the HQ needs to achieve coordination and integration, it cannot do this solely based on formal control systems. Indeed, the HQ must use both informal and formal controls. Informal controls require frequent interaction between the HQ and subsidiaries, negotiation of differences, and institution of "due process" as described above.

The importance of informal controls is likely to increase in the future. One reason is the growing size of subsidiaries and their control of important resources. This growth enhances the subsidiaries' bargaining positions. Also, over time, subsidiaries develop different cultures and values distinct from their HQ. Therefore, the HQ needs less formal rules and tools to create commitment to a common mission by its subsidiaries.

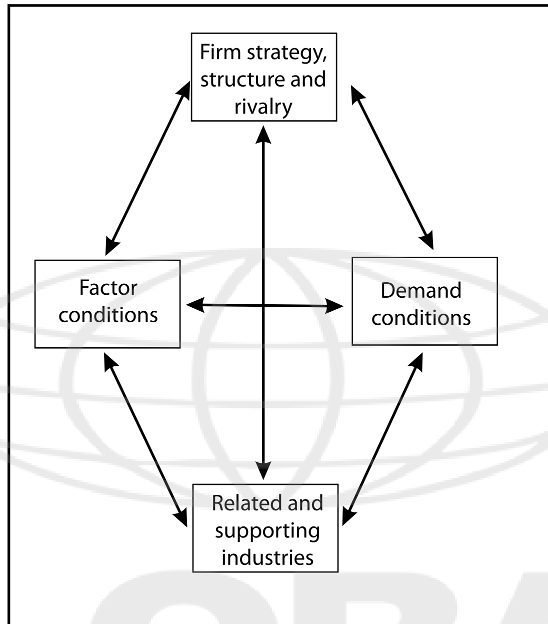
The role of national factors in global strategy

With increased international competition, the potential impact of the company's national origin on its competitive approach becomes an important issue. One might ask: Do certain national cultures enhance the competitive advantage of their international corporations?

Michael Porter identified a "diamond" framework for analyzing national competitiveness. The factors he identified as having effects on national competitiveness include the factor conditions, the demand conditions, the nature and characteristics of company strategies, structure and rivalry, and the state of the related and supporting industries (see Exhibit 9.3).

GLOBAL professional publishing

Exhibit 9.3: Porter's Diamond



The factors conditions describes the state of country's endowment of inputs. They include basic or natural inputs as well as advanced or created inputs. Factors for consideration include human resources factors (skills, price, motivation, industrial relations), physical or natural resources (land, minerals, climates), knowledge (scientific, technical, educational), capital (wealth, government investments), and infrastructure (transport, communication, housing).

It is argued that basic factors are unsustainable as competitive advantage but advanced factors on the other hand are vital for competitive success. Note also the different between generalized factors such as roads and specialized factors such as expertise in specialist areas.

The demand conditions describe the nature of the home demands for the particular products or services. The argument is that the nature of the home demands will "train" and develop the home industries to compete internationally.

In particular, the interests will be focused on the nature and the degree of market segmentation, the sophistication and standard of the local demands, the ability to anticipate local demands, and the flexibility and adaptability to rapid growth.

With regards to company structures, strategy and rivalry, strategy determines the approach to competition, structure determines the ability to compete, and home rivalry determines the readiness and training for international competition. All these factors can be influenced, and can either develop or deteriorate.

Finally, related and supporting industries are essential to support the competitiveness of a particular industry as they form the continuous value chain.

It is important to recognize that the above-mentioned variables interact and jointly influence a company's global success. Moreover, to succeed globally, companies should achieve consistency between their own strategies and national factors.

The CAGE framework – to choose foreign countries

Now that you have answered the *why* question of international strategy, you must move on to answer the *where* question. The CAGE framework can be used to measure the differences between countries and to help users understand which differences matter the most in their particular industry. The four components of the CAGE framework are cultural, administrative, geographic and economic differences. The CAGE framework can be used to accomplish specific objectives, namely: making differences more visible, understanding the liability of being a foreign entity in a local market, comparing foreign competitors, comparing markets, and assessing markets taking into account the impact of distance.

Generally, the greater the distance covered and the greater the value differences between the disconnected markets, the greater the profit potential that arises from arbitrage. However, greater distance also tends to be accompanied by greater entry costs and risks. Although most people tend to think of distance in geographic terms, in the area of international strategy distance can also be viewed in terms of culture, administrative heritage, and economics. This broader **CAGE** framework—Culture, Administrative, Geographic, and Economic—provides you with another way of thinking about location and the opportunities and concomitant risks associated with global arbitrage.

CAGE-related risks would be most relevant in industries in which language or cultural identity are important factors, the government views the products as staples or as essential to national security, or income or input costs are key determinants of product demand or cost. The PESTEL framework discussed in Chapter 3 addresses these broader cultural and socioeconomic factors. But CAGE asks you to look at countries and regions, try to assess the degree to which they are different or similar along many of the PESTEL dimensions, and then try to estimate the implications of such differences for a firm that wishes to move into a new geographic market.

Application of the CAGE framework requires managers to identify attractive locations based on raw material costs, access to markets or consumers, or other key decision criteria. For instance, a firm maybe most interested in markets with high consumer buying power, so it uses per capita income as the first sorting cue. This would

result in some type of ranking. Any international expansion strategy would still need to be backed up by the specific resources and capabilities possessed by the firm, regardless of how rosy the CAGE analysis paints the picture. Think of international expansion as a movement along a continuum from known markets to less-known markets; a firm can move to more CAGE-proximate neighbors before venturing into markets that are portrayed as very different from a CAGE-framework perspective. Each dimension of CAGE is described below.

Cultural distance

Culture happens to be the first facet of CAGE, in terms of the acronym, but it also can be the most practically perplexing facet for managers. Culture is sometimes referred to as the software of the mind, in that it has a sometimes invisible but indelible influence on people's values and behaviors. *Cultural distance,* then, has to do with the possible differences existing in relation to the way individuals from different countries observe certain values and behaviors.

A number of researchers have identified significant cultural differences among countries. Distinct cultural differences are observed around the following dimensions: power distance (the extent to which individuals accept the existence of inequalities between subordinates and superiors within a hierarchical structure); uncertainty avoidance (individuals' willingness to coexist with uncertainty about the future); individualism (how the individuals in a society value individualistic behaviors as opposed to collective ones); predominant values (regarding quantity or quality of life, that is, whether more importance is given to material aspects or a stronger emphasis is laid on interpersonal relationships); and long-term or short-term orientation (the focus on future rewards or the concern about the maintenance of the stability related to the past and the present).

Administrative distance

Administrative distance reflects the historical and present political and legal associations between trading partners; for example, colonial ties between trading partners, or participation in common trading blocs. This facet of CAGE asks you to examine whether there are historical or current political factors that might favor or impede a business relationship between a company and a new country market. NAFTA, for instance, decreased the administrative distance between U.S. firms and Mexico and Canada. Similarly, historical political hostilities between the United States and Cuba make it virtually impossible (and illegal) for most U.S. firms to do business there. Trade practices between countries can be significantly affected by laws and regulations enacted at the national or international level. Because they affect fundamental business practices, they often affect the competitive position of firms as well.

Geographic distance

How far apart are trading partners in physical terms: the size of the country, differences in climates, and nature of transportation and information networks? You can think *of geographic distance* as absolute, in terms of the miles or kilometers that separate a firm from another market or supplier. Technology and the Internet, however, has shrunk distance in terms of transportation time, and *now* with digital products and services, almost entirely eliminated geographic distance as a constraint of trade between some markets.

Economic distance

Finally, *economic distance* captures fundamental differences relating to income, the distribution of wealth, and the relative purchasing power of segments of a geographic market. This has been one of the biggest barriers, for instance, in the way of U.S. firms' success selling products in emerging markets. In global terms, this is the four billion people who live on less than $2 per day. The phrase "bottom of the pyramid" is used in particular by people developing new models of doing business that deliberately target that market, typically using new technology. An example of a product that *is* designed with the needs of the very poor in mind is that of a shampoo that works best with cold water. Such a product is marketed by Hindustan Lever (part of the Unilever family of firms).

GLOBAL professional publishing

Glossary

Acquisition Strategy by which one firm acquires another through stock purchase or exchange.

Acquisition premium Difference between current market value of a target firm and purchase price paid to induce its shareholders to turn its control over to new owners.

Agency problem Separation of its ownership from managerial control of a firm.

Agent Party, such as a manager, who acts on behalf of another party.

Ambidextrous structure Organizational structure for dynamic contexts in which project teams are organized as structurally independent units and encouraged to develop their own structures, systems, and processes.

Arena Area (product, service, distribution channels, geographic markets, technology, etc.) in which a firm participates.

Balanced scorecard Strategic management support system for measuring vision and strategy against business- and operating-unit-level performance. It uses multiple measures to evaluate managerial performance. These measures may be financial or nonfinancial, internal or external, and short-term or long-term. The scorecard allows a determination as to whether a manager is achieving certain objectives at the expense of others that may be equally or more important. There are four different perspectives: (1) the financial perspective, (2) the customer perspective, (3) the process perspective, and (4) the learning and growth perspective.

Barrier to entry Condition under which it is more difficult to join or compete in an industry.

Behavioral controls Practice of tying rewards to criteria other than simply financial performance, such as those broadly identified in the balanced scorecard.

Board of directors Group of individuals that formally represents the firm's shareholders and oversees the work of top executives.

Bootstrapping Process of finding creative ways to support a startup business financially until it turns profitable.

Business strategy Strategy for competing against rivals within a particular industry or industry segment.

Buyer power Degree to which firms in the buying industry are able to dictate terms on purchase agreements that extract some of the profit that would otherwise go to competitors in the focal industry.

CAGE framework Tool that considers the dimensions of culture, administration, geography, and economics to assess the distance created by global expansion.

Capabilities A firm's skill at using its resources to create goods and services; combination of procedures and expertise on which a firm relies to produce goods and services.

Causal ambiguity Condition whereby the difficulty of identifying or understanding a resource or capability makes it valuable, rare, and inimitable.

Codes of governance Ideal governance standards formulated by regulatory, market, and government institutions.

Coevolution Process by which diversification causes two or more interdependent businesses to adapt not only to their environment, but to each other.

Commoditization Process during industry evolution by which sales eventually come to depend less on unique product features and more on price.

Competitive advantage A firm's ability to create value in a way that its rivals cannot

Complementor Firm in one industry that provides products or services which tend to increase sales in another industry.

Conglomerate Corporation consisting of many companies in different businesses or industries.

Consortia Association of several companies and/or governments for some definite strategic purpose.

Contractual agreements An exchange of promises or agreement between parties that is often enforceable by the law.

Cooptation Situation in which firms are simultaneously competitors in one market and collaborators in another.

Core competence Capability which is central to a firm's main business operations and which allow it to generate new products and services.

Corporate governance The system by which owners of firms direct and control the affairs of the firm.

Corporate new-venturing New-venture creation by established firms.

Corporate renewal Outcome of successful strategic change in the context of an established business.

Corporate strategy Strategy for guiding a firm's entry and exit from different businesses, for determining how a parent company adds value to and manages its portfolio of businesses, and for creating value through diversification. It address what businesses a multiple-business-unit organization will be in and how resources will be allocated among those businesses.

Critical success factors (CSFs) Limited number (usually between 3 to 8) of characteristics, conditions, or variables that have a direct and serious impact on the effectiveness, efficiency, and viability of an organization, program, or project. Activities associated with CSF must be performed at the highest possible level of excellence to achieve the intended overall objectives; also called KEY SUCCESS FACTORS (KSFs).

Cross-subsidizing Practice by which a firm uses profits from one aspect of a product, service, or region to support other aspects of competitive activity.

Culture Core organizational values widely held and shared by an organization's members.

Differentiation Strategic position based on products or offers services with quality, reliability, or prestige that is discernibly higher than that of competitors and for which customers are willing to pay.

Differentiator Feature or attribute of a company's product or service (e.g., image, customization, technical superiority, price, quality, and reliability) that helps it beat its competitors in the marketplace.

Diseconomies of scope Condition under which the joint output of two or more products within a single firm results in increased average costs.

Diseconomy of scale Condition under which average total costs per unit of production increases at higher levels of input.

Disruptive technology Breakthrough product- or process-related technology that destroys the competencies of incumbent firms in an industry.

Distinctive competence Capability that sets a firm apart from other firms; something that a firm can do which competitors cannot.

Diversification Degree to which a firm conducts business in more than one arena.

Divestiture Strategy whereby a company sells off a business or division.

Due diligence Initial pre-closing screening, analysis, and negotiations for an acquisition.

Dynamic capabilities A firm's ability to modify, reconfigure, and upgrade resources and capabilities in order to strategically respond to or generate environmental changes.

Economic logic Means by which a firm will earn a profit by implementing a strategy.

Economy of scale Condition under which average total cost for a unit of production is lower at higher levels of output.

Economy of scope Condition under which lower total average costs result from sharing resources to produce more than one product or service.

Entrepreneurial process Integration of opportunity recognition, key resources and capabilities, and an entrepreneur and entrepreneurial team to create a new venture.

Entrepreneurship Recognition of opportunities and the use of resources and capabilities to implement innovative ideas fur new ventures.

Equity alliance Alliance in which one or more partners assumes a greater ownership interest in either the alliance or another partner.

Escalation of commitment Decision-making bias under which people are willing to commit additional resources to a failing course of action.

Ethnocentrism Belief in the superiority of one's own ethnic group or, more broadly, the conviction that one's own national, group, or cultural characteristics are "normal."

Exit barriers Barriers that impose a high cost on the abandonment of a market or product.

Exporting Foreign-country entry vehicle in which a firm uses an intermediary to perform most foreign marketing functions.

First mover The firm that is first to offer a new product or service a market.

Five-forces model Framework for evaluating industry structure according to the effects of rivalry, threat of entry, supplier power, buyer power, and the threat of substitutes.

Focused cost leadership Strategic position based on being a low-cost leader in a narrow market segment.

Focused differentiation Strategic position based on targeting products to relatively small segments.

Foreign direct investment (FDI) Foreign-country entry vehicle by which a firm commits to the direct ownership of a foreign subsidiary or division.

Functional strategies Strategy that deals with the activities of the functional areas of a business – production, finance, marketing, personnel, and the like.

Functional structure Form of organization revolving around specific value chain functions.

General resources Resource that can be exploited across a wide range of activities.

Generic strategies Strategic position designed to reduce the effects of rivalry, including *low-cost, differentiation, focused cost leadership, focused differentiation, and integrated positions.*

Geographic roll-up Strategy whereby a firm acquires many other firma in the same industry segment by in different geographic arenas in an attempt to create significant scale and scope advantages.

Geographic scope Breadth and diversity of geographic arenas in which a firm operates.

Globalization Evolution of distinct geographic product markets into a state of globally interdependent product markets.

Goals and objectives Combination of a broad indication of organizational intentions (goals) and specific, measurable steps (objectives) for reaching them.

Greenfield investment Form of FDI in which a firm starts a new foreign business from the ground up.

Guiding philosophy Thesis that establishes the values and beliefs of the organization about what is important in both life and business, how business should be conducted, its view of humanity, its role in society, the way the world works, and what is held to be inviolate.

High-end disruption Strategy that may result in huge new markets in which new players redefine industry rules to unseat the largest incumbents.

Horizontal alliance Alliance involving a focal firm and another firm in the same industry.

Horizontal scope Extent to which firm participates in related market segments or industries outside its existing value chain activities.

Hubris Exaggerated self-confidence that can result in managers' overestimating the value of a potential acquisition, having unrealistic assumptions about the ability to create synergies, and a willingness to pay too much for a transaction.

Implementation levers Mechanisms used by strategic leaders to help execute a firm's strategy.

Importing Internationalization strategy by which a firm brings a good, service, or capital into the home country from abroad.

Incentive alignment Use of incentives to align managerial self-interest with shareholders~

Industry life cycle Pattern of evolution followed by an industry inception to current and future states.

Initial public offering (IPO) First sale of a company's stock to the public market.

Innovator's dilemma When incumbents avoid investing in innovative and disruptive technologies because those innovations do not satisfy the needs of their mainstream and most profitable clients.

Institutional investors Pension or mutual fund that manages large suits of money for third-party investors.

Integrated position Strategic position in which elements of one position support strong standing in another.

International strategy Process by which a firm approaches its cross-border activities and those of competitors and plans to approach them in the future.

Intrinsic value Present value of a company's future cash flows from existing assets and businesses.

Joint venture Affiance in which two firms make equity investments in a third legal entity.

Key success factors (KSFs) The factors that all firms in an industry must possess in order to be a viable competitor. *See also* CRITICAL SUCCESS FACTOR (CSFs).

Knowing-doing gap Phenomenon whereby firms tend to be better at generating new knowledge than at creating new products based on that knowledge.

Learning curve Incremental production costs decline at a constant rate as production experience is gained; the steeper the learning curve, the more rapidly costs decline.

Level 5 hierarchy Model of leadership skills calling for a wide range of abilities, some of which are hierarchical in natures.

Long-range objectives Goals that specify the results desired in pursuing the organization's mission and normally extend beyond the current fiscal year of the organizations.

Long-tail When the selling of individual products that each have low sales volume add up to huge revenues.

Low-cost leadership Strategic position based on producing a good or offering a service while maintaining total costs that are lower than what it takes competitors to offer the same product or service.

Low-end disruption Strategy that appears at the low end of industry offerings, targeting the least desirable of incumbents' customers.

Managerialism Tendency of managers to make decisions based on personal self-interest rather than the best interests of shareholders.

Market for corporate control The idea that every public company is theoretically for sale. This puts some pressure on managers to perform; otherwise, their corporation can be taken over.

Market value Current market capitalization of a firm.

Matrix structure Form of organization in which specialists from functional departments are assigned to work for one or more product or geographic units.

Merger Consolidation or combination of two or more firms.

Minimum efficient scale (MES) The output level that delivers the lowest total average cost.

Mission Declaration of what a firm is and what it stands for—its fundamental values and purpose. Mission defines an organization's line or lines of business, identifies its products and services, and specifies the markets it serves at present and in a time frame of three to five years.

Monitoring Functioning of the board in exercising its legal and fiduciary responsibility to oversee executives' behavior and performance and to take action when it's necessary to replace management.

Multidivisional structure Form of organization in which divisions are organized around product or geographic markets and are often self-sufficient in terms of functional expertise.

Multipoint competition When a firm competes against another firm in multiple product markets or multiple geographic markets (or both).

Network structure Form of organization in which small, semiautonomous, and potentially temporary groups are brought together for specific purposes.

New-venture creation Entrepreneurship and the creation of a new business from scratch.

Nonequity alliance Alliance that involves neither the assumption of equity interest nor the creation of separate organizations.

Objective A statement of what is to be achieved.

Offshoring Moving a value chain activity or set of activities to another country, typically where key costs are lower.

Organizational culture The collective assumptions and beliefs held by an organization's employees that shape the behavior of individuals and groups in the organization.

Organizational structure Relatively stable arrangement of responsibilities, tasks, and people within an organization.

Outcome controls Practice of tying rewards to narrowly defined financial criteria.

Outsourcing Activity performed for a company by people other than its full-time employees.

Patching Process of remapping businesses in accordance with changing market conditions and restitches them into new internal business structures.

Peer-to-peer Where individual network members can engage in exchange with any other member of the network.

PESTEL analysis Tool for assessing the political, economic, sociocultural, technological, environmental, and legal contexts in which a firm operates.

Policies Guides to action for employees of the organization.

Portfolio planning Practice of mapping diversified businesses or products based on their relative strengths and market attractiveness.

Principal Party, such as a shareholder, who hires an agent to act on his or her behalf.

Profit pool Analytical tool that enables managers to calculate profits at various points along an industry value chain.

Purchase price Final price actually paid to the target firm's shareholders of an acquired company.

Purpose Defining the fundamental reason for the organization's existence.

Real-options Process of maximizing the upside or limiting the downside of an investment opportunity by uncovering and quantifying the options and discussion points embedded within it.

Related diversification Form of diversification in which the business units operated by a firm are highly related.

Relational quality Principle identifying four key elements (initial conditions, negotiation process, reciprocal experiences, outside behavior) in establishing and maintaining interorganizational trust.

Required performance improvements The increases in combined cash flow of the acquirer and target that are necessary to justify the acquisition premium.

Resources Inputs used by firms to create products and services.

Return on invested capital (ROIC) How effectively a company uses the money (borrowed or owned) invested in its operations.

Revenue-enhancement synergy When total sales are greater if two products are sold and distributed within one company than when they are owned by separate companies.

Reward system Bases on which employees are compensated and promoted.

R**ivalry** Intensity of competition within an industry.

Road show Series of presentations in which top management promotes an IPO to interested investors and analysts.

S-1 statement Legal document outlining a firm's financial position in preparation for an initial public stock offering.

GLOBAL professional publishing

Second mover (often fast follower) Second significant company to move into a market, quickly following the first mover.

Serial acquirers Company that engages in frequent acquisitions.

Short-range objectives Performance targets, normally of less than one year's duration, which management uses to measure progress toward the achievement of long-range objectives.

Social capital The advantage created through the characteristics of a person's network

Social network The collection of ties between people and the strength of those ties.

Specialized resources Resource with a narrow range of applicability.

Staging Timing and pace of strategic moves.

Stakeholder Individual or group with an interest in an organization's ability to deliver intended results and maintain the viability of its products and services.

Stereotyping Relying on a conventional or formulaic conception of another group based on some common characteristic.

Stock options Incentive device giving an employee the right to buy a share of company stock at a later date for a predetermined price.

Straddling Unsuccessful attempt to integrate both low-cost and differentiation positions.

Strategic alliance Relationship in which two or more firms combine resources and capabilities in order to enhance the competitive advantage of all parties.

Strategic business units (SBUs) Operating units in an organization each of which sells a distinct set of products or services to an identifiable group of customers in competition with a well-defined set of competitors.

Strategic change Significant changes in resource allocation choices, in the business and implementation activities that align the firm's strategy with its vision, or in its vision.

Strategic coherence Symmetric coalignment of the five elements of the firm's strategy, the congruence of functional-area policies with these elements, and the overarching fit of various businesses under the corporate umbrella.

Strategic group Subset of firms which, because of similar strategies, resources, and capabilities, compete against each other more intensely than with other firms in an industry.

Strategic leadership Task of managing an overall enterprise and influencing key organizational outcomes.

Strategic management Process by which top management determines the long-run direction and performance of the organization by ensuring that careful formulation, effective implementation, and continuous evaluation of the strategy takes place.

Strategic positioning Means by which managers situate a firm relative to its rivals.

Strategic purpose Simplified, widely shared mental model of the organization and its future, including anticipated changes in its environment.

Strategy The determination and evaluation of alternatives available to an organization for achieving its objectives and mission and the selection of the alternative to be pursued.

Strategy evaluation Establishing standards of performance, monitoring progress in strategy execution, and taking corrective actions to ensure continued commitment to strategy.

Strategy formulation The making of decisions to define an organization's philosophy and mission, establish objectives, and select the strategy to be used in achieving the objectives.

Strategy implementation Process of executing a strategy. It is the making of decisions with regard to matching strategy and organizational structure; and developing budgets, functional strategies, and motivational systems.

Succession planning Process of managing a well-planned and well-executed transition from one CEO to the next with positive outcomes for all key stakeholders.

Superordinate goal Overarching reference point for a host of hierarchical subgoals.

Supplier power Degree to which firms in the supply industry are able to dictate terms to contracts and thereby extract some of the profit that would otherwise be available to competitors in the focal industry.

Synergy Condition .under which the combined benefits of activities in two or more arenas are greater than the simple sum of those benefits.

Takeoff period Period during which a new product generates rapid growth and huge sales increases.

Threat of new entry Degree to which new competitors can enter an industry and intensify rivalry.

Threat of substitutes Degree to which products of one industry can satisfy the same demand as those of another.

Unrelated diversification Form of diversification in which the business units that a firm operates are highly dissimilar.

Value chain Total of primary and support value-adding activities by which a firm produces, distributes, and markets a product.

Value curve A graphical depiction of how a firm and major groups of its competitors are competing across its industry's factors of completion.

Value net model Map of a firm's existing and potential exchange relationships.

Vertical alliance Alliance involving a focal firm and a supplier or customer.

Vertical integration Diversification into upstream. and/or downstream industries.

Vertical scope The extent to which a firm is vertically integrated.

Vision Simple statement or understanding of what the firm will be in the future.

VRINE criteria Analytical framework suggesting that a firm with resources and capabilities which are valuable, rare, inimitable, nonsubstitutable, and exploitable will gain a competitive advantage.

Willingness to pay Principle of differentiation strategy by which customers are willing to pay more for certain product features.

Winner's curse Situation in which a winning M&A bidder must live with the consequences of paying too much for the target.

GLOBAL professional publishing

Index

3M 10
3M Corporation 17

A

ABN Amro 22
Acquisitions 91
    carrying out 92
Adelphia 26
Administrative distance 181
Alliances 94
Altria 22
American Productivity and Quality Center 156
Analysis
    competitive 29
    core competencies 79
    cost driver 79
    environmental 28, 29
Analyzers culture 69
Anglo American 23
appraisal, internal 29
Audits, resource and capability 62
Aviva 23

B

Balanced scorecard 153, 154
    measures 155
Balanced Scorecard Institute 155
Bankruptcy 97
Barclays 22
Bargaining power of
    buyers 46
    suppliers 46
Barriers to entry 44
Behavior substitution 142
Benchmarking 139
Black & Decker Corporation 15
Boston Consulting Group's Growth Share Matrix 105-106
Brainstorming 39
Business for Social Responsibility (BSR) 22
Business in the Community (BitC) 23, 24
Business portfolio matrices 105
Business strategy 19
Buyers, bargaining powers 46

C

CAGE framework 180
Capabilities 61, 68
    audits 62
Capacity
    expansion 48
    ambiguity 67
Change management 128
Chick-fil-a 8
Citigroup 22
Combination strategies 98
    sequential 99
    simultaneous 98
Competencies 61
Competitive
    positioning 99
    strategy 19
        alternatives 99
        formulation 81
Competitors
    analysis 52
    assessing 54
Complementors 48
Concentration strategy 85

Concentric diversification 88
Condition of facilities and equipment 58
Conglomerate diversification 89
Contractual agreements 164
Control
and business unit strategy 137
guidelines for 143
Core
competencies analysis 79
ratings 23
Corporate
Responsibility Index 23
social responsibility 21
basic indicators 24
best practice 24
strategy 19
Country risk 169
Cultural distance 181
Customer
appraisal 39
service 76

D

Defenders culture 69
Defensive strategies 96
becoming a captive 98
divestment 96
liquidation 97
turnaround 96
Delphi technique 39
Designing organizational structures 119
Differentiation 100, 119
Discovery-driven planning 140
Distinctive capabilities and competences 62
Diversification 88
Divestment 96
Dupont 17
Dynergy 26

E

eBay 15
Econometric modeling 40
Economic
distance 182
factors 33
value added (EVA) 135
Enron 26
Entry
barriers to 44
threat of 45
threat of new 44
Environment
external 28
information 29
Environmental
analysis 27-42
economic factors 33
environmental factors 35
forecasting 36
legal factors 35
political factors 33
scanning 36
sociocultural factors 34
technological factors 35
factors 35
forecasting 36
qualitative forecasting techniques 38
methods 39
Environment, analyze
internal 4
external 3
forecasting 36-38
legal factors 35
political factors 33
Equator Principles 22
Ethics and strategy 25
Evaluation
customer 39
of top management 136
Exit barriers 45
Exploitability 67

F

Financial
position 56
resources 76
Fixed costs 48
Focused differentiation 101
Ford 13
Forecasting, environmental 38
Franchising 165
Functional strategies 19, 81

G

General Electric (GE) 109
- *GE Planning Grid 109, 110*

Geographic distance 182
Global
- *cost leadership 174*
- *differentiation 174*
- *industries 158*
- *segmentation 174*
- *strategic alliances 168*
- *strategy 174*
  - *choice of entry mode 169*
  - *crafting 157–182*
  - *growth opportunities 157*
  - *national factors 178*
  - *strategic variables 170*

Goal displacement 142
Government regulations 161
Growth-share matrix 105, 106
- *strategic choices 109*

Growth strategies 84
- *alliances 94*
- *concentration strategy 85*
- *concentric diversification 88*
- *conglomerate diversification 89*
- *diversification 88*
- *horizontal integration 86*
- *joint ventures 94*
- *market development 85*
- *product development 86*
- *vehicles for implementing 90*
- *vertical integration 87*

Guiding philosophies
- *defining 5*
- *developing organizational policies 6*

H

Harvesting strategies 95
HealthSouth 26
Hewlett Packard 13
Hierarchy of strategies 18, 20
Hilton Hotels Corporation 16
Horizontal integration 86
Human resources 58, 76

I

Imitation 67
- *cost 67*

Implementation framework 120
Industrial attractiveness 50
Industry life cycle 48
- *stages 50, 51*

Inimitability 66, 67
Innovest 23
Integrated positions 102
Intel 8
Interdependence 176
Internal appraisal 55-80
- *coverage 56*
- *responsibility for 55*

Internal culture 69
- *analyzers culture 69*
- *defenders culture 69*
- *prospectors culture 69*
- *reactors culture 68*
- *strategy 68*

Internal structure 68
- *and strategy 68*

International
- *corporate strategies 173*
- *generic business strategies 174*
- *joint ventures 165*
- *operations*
  - *configurations 173*
  - *determining preparedness 159*
  - *organizational structure 175*
- *strategic choices 159*
- *strategies 173*

Internationalization 157
Investment decisions 137

J

Joint ventures 94
Jury of Expert Opinions 38

K

Key success factors (KSFs) 51

L

Legal factors 35
Licensing 164
Life-cycle approach 113
Liquidation 97
Long-range objectives 74

GLOBAL professional publishing

M

Management
and mission 12
audits 136
by objectives (MBO) 124
evaluation of top 136
Management Help 156
Market development 185
Marketing capability 57
Markets 76
Market strategy (PIMS) analysis 114
nine basic proposition on business strategy 115
Mary Kay Cosmetics 10
M&As
carrying out 92
implementing 93
reasons for 91
Merck 8, 10
Mergers 91
carrying out 92
Mission
and management 12
and stakeholders 12
changing 3
defining 9
statement, examples 10
uniting for 13
versus strategic mission 14
Morley Fund Managers 23
Multidomestic strategy 173

N

National responsiveness 175
Nonsubtitutability 66

O

Objectives 59
establishing organizational 16
mix of organizational 75
Operations strategy 122
Organizational
objectives 75
and SWOT analysis 75
establishing 17
examples 7
policies
examples 7
structure 58, 76
international operations 175
Overall cost leadership 99

P

Performance
measurement guide 133, 146
measures of 137
problems in measuring 141
Performance Measurement Association 156
PESTEL analysis 30
dimensions 31
Physical facilities 76
Political factors 33
Porter's
five forces model 43, 44
diamond 179
generic strategies 101
Problems in measuring performance 141
Product 76
development 86
differentiation 48
life cycle 52, 53
Productivity 77
Product/service
position 757
quality 57
Profitability 77
Property rights 67
Prospectors culture 69
Protected markets 174

Q

Qualitative forecasting techniques 38
brainstorming 39
customer evaluation 39
Delphi technique 39
jury of expert opinions 38
sales force polling 38
surveys and opinion polling 39
Quantitative forecasting techniques 39
econometric modeling 40
regression analysis 40
time-series analysis 40

R

Rarity 65
Reactors culture 69
Red Hat Linux 15
Regression analysis 40
Research and development 77
    capability 58
Resource audits 62
Resources 61, 68
    capabilities 60
Responsibility centers 138
RI 137
Rivalry among existing firms 48
ROI 137

S

Sales force polling 38
Scanning, environmental 36
Scenario planning 41
Scorecard, balanced 153
Shareholder value 135
Short-term orientation 142
Situational analysis 70
Social responsibility 77
Sociocultural factors 34
Sony 13
Stable growth strategies 83
Stakeholders and mission 12
Starbucks 11
Strategic
    alliances 95
    business unit (SBU) 4, 21
    choice 105-117
        business portfolio matrices 105
        competitive strategy formulation 112
        international 159
        life-cycle approach 114
        profit impact of market strategy (PIMS) analysis 114
    evaluation and control 2
    formulation 81
    implementation 2
    implementation issues 119-129
        achieving synergy 121
        change management 128
        designing organizational structures 119
        implementation framework 120
        management by objectives (MBO) 124
        monitor and control 122
        operations strategy 122
        total quality management (TQM) 125
    incentive management 1-26, 144
    information systems 140
    management evaluation and control 131-156
    management process 2
    planning 3
        bottom-up 20
        interactive approach 20
        top-down 20
    vision versus mission 15
Strategies 59
    combination 98
        sequential 99
        simultaneous 98
    functional 81
    growth 84
    hierarchy 20
    implementation 5
Strategy
    and ethics 25
    and internal structure 75
    business strategy alternatives 99
    competitive alternatives 99
    evaluation 2
    hierarchy 18
    identifying 18
    internal culture 68, 69
    selling 17
    turnaround 96
    visions 15
Suboptimization 143
Subsidiaries, managing relationship 177
Substitution 67
Suppliers bargaining powers 46
Surveys and opinion polling 39
SWOT analysis 70
    and organizational objectives 75
    factors 72
    step-by-step summary 73
Synergy 121

T

Tacit knowledge 172
Technological factors 34

Threat of
entry 44, 45
new entry 44
substitutes 47
Time-series analysis 40
Total quality management (TQM) concept 125
Trader Joe 10
Transnational strategy 174
Turnaround 96
Tyco 26

V

Value 65
Value-added measures 135
Value chain 61, 78
analysis 77
Vertical integration 87
VRINE criteria 63
causal ambiguity 67
exploitability 67
Imitation 67
inimitability 66, 67
nonsubstitutabflity 66
nonsubstitution 67
property rights 67
rarity 65
substitution 67
value 65

W

Walgreens 10
Wal-Mart 11, 13
Weaknesses 60
Wells Fargo 15
Wholly owned subsidiaries 167
World.com 26