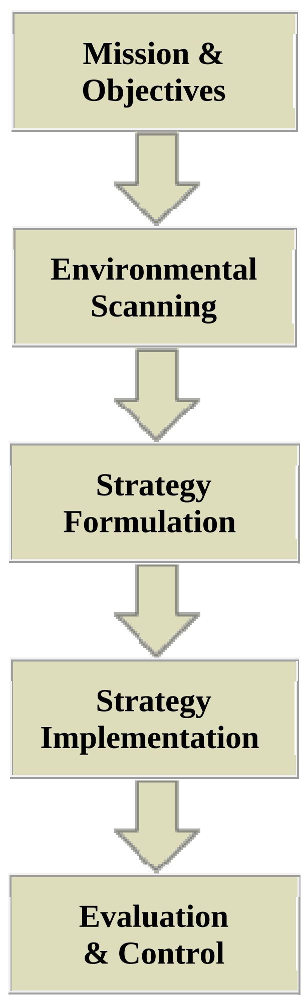
The Strategic Planning Process

In today's highly competitive business environment, budget-oriented planning or forecast-based planning methods are insufficient for a large corporation to survive and prosper. The firm must engage in **strategic planning** that clearly defines objectives and assesses both the internal and external situation to formulate strategy, implement the strategy, evaluate the progress, and make adjustments as necessary to stay on track.

A simplified view of the strategic planning process is shown by the following diagram:

The Strategic Planning Process



Mission and Objectives

The mission statement describes the company's business vision, including the unchanging values and purpose of the firm and forward-looking visionary goals that guide the pursuit of future opportunities.

Guided by the business vision, the firm's leaders can define measurable financial and strategic objectives. Financial objectives involve measures such as sales targets and earnings growth. Strategic objectives are related to the firm's business position, and may include measures such as market share and reputation.

Environmental Scan

The environmental scan includes the following components:

- Internal analysis of the firm
- Analysis of the firm's industry (task environment)
- External macroenvironment (PEST analysis)

The internal analysis can identify the firm's strengths and weaknesses and the external analysis reveals opportunities and threats. A profile of the strengths, weaknesses, opportunities, and threats is generated by means of a SWOT analysis

An industry analysis can be performed using a framework developed by Michael Porter known as Porter's five forces. This framework evaluates entry barriers, suppliers, customers, substitute products, and industry rivalry.

Strategy Formulation

Given the information from the environmental scan, the firm should match its strengths to the opportunities that it has identified, while addressing its weaknesses and external threats.

To attain superior profitability, the firm seeks to develop a competitive advantage over its rivals. A competitive advantage can be based on cost or differentiation. Michael Porter identified three industry-independent generic strategies from which the firm can choose.

Strategy Implementation

The selected strategy is implemented by means of programs, budgets, and procedures. Implementation involves organization of the firm's resources and motivation of the staff to achieve objectives.

The way in which the strategy is implemented can have a significant impact on whether it will be successful. In a large company, those who implement the strategy likely will be different people from those who formulated it. For this reason, care must be taken to communicate the strategy and the reasoning behind it. Otherwise, the implementation might not succeed if the strategy is misunderstood or if lower-level managers resist its implementation because they do not understand why the particular strategy was selected.

Evaluation & Control

The implementation of the strategy must be monitored and adjustments made as needed.

Evaluation and control consists of the following steps:

1. Define parameters to be measured
2. Define target values for those parameters
3. Perform measurements
4. Compare measured results to the pre-defined standard
5. Make necessary changes

The Business Vision and Company Mission Statement

While a business must continually adapt to its competitive environment, there are certain core ideals that remain relatively steady and provide guidance in the process of strategic decision-making. These unchanging ideals form the **business vision** and are expressed in the company **mission statement**.

In their 1996 article entitled *Building Your Company's Vision*, James Collins and Jerry Porras provided a framework for understanding business vision and articulating it in a mission statement.

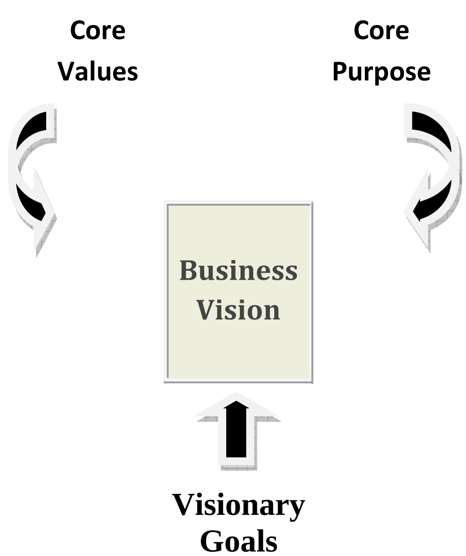
The mission statement communicates the firm's core ideology and visionary goals, generally consisting of the following three components:

1. **Core values** to which the firm is committed
2. **Core purpose** of the firm
3. **Visionary goals** the firm will pursue to fulfill its mission

The firm's core values and purpose constitute its core ideology and remain relatively constant. They are independent of industry structure and the product life cycle.

The core ideology is not created in a mission statement; rather, the mission statement is simply an expression of what already exists. The specific phrasing of the ideology may change with the times, but the underlying ideology remains constant.

The three components of the business vision can be portrayed as follows:



Core Values

The core values are a few values (no more than five or so) that are central to the firm. Core values reflect the deeply held values of the organization and are independent of the current industry environment and management fads.

One way to determine whether a value is a core value to ask whether it would continue to be supported if circumstances changed and caused it to be seen as a liability. If the answer is that it would be kept, then it is core value. Another way to determine which values are core is to imagine the firm moving into a totally different industry. The values that would be carried with it into the new industry are the core values of the firm.

Core values will not change even if the industry in which the company operates changes. If the industry changes such that the core values are not appreciated, then the firm should seek new markets where its core values are viewed as an asset.

For example, if innovation is a core value but then 10 years down the road innovation is no longer valued by the current customers, rather than change its values the firm should seek new markets where innovation is advantageous.

The following are a few examples of values that some firms has chosen to be in their core:

- excellent customer service
- pioneering technology
- creativity
- integrity
- social responsibility

Core Purpose

The core purpose is the reason that the firm exists. This core purpose is expressed in a carefully formulated mission statement. Like the core values, the core purpose is relatively unchanging and for many firms endures for decades or even centuries. This purpose sets the firm apart from other firms in its industry and sets the direction in which the firm will proceed.

The core purpose is an idealistic reason for being. While firms exist to earn a profit, the profit motive should not be highlighted in the mission statement since it provides little direction to the firm's employees. What is more important is *how* the firm will earn its profit since the "how" is what defines the firm.

Initial attempts at stating a core purpose often result in too specific of a statement that focuses on a product or service. To isolate the core purpose, it is useful to ask "why" in response to first-pass, product-oriented mission statements. For example, if a market research firm initially states that its purpose is to provide market research data to its customers, asking "why" leads to the fact that the data is to help customers better understand their markets. Continuing to ask "why" may lead to the revelation that the firm's core purpose is to assist its clients in reaching their objectives by helping them to better understand their markets.

The core purpose and values of the firm are not selected - they are discovered. The stated ideology should not be a goal or aspiration but rather, it should portray the firm as it really is. Any attempt to state a value that is not already held by the firm's employees is likely to not be taken seriously.

Visionary Goals

The visionary goals are the lofty objectives that the firm's management decides to pursue. This vision describes some milestone that the firm will reach in the future and may require a decade or more to achieve. In contrast to the core ideology that the firm discovers, visionary goals are selected.

These visionary goals are longer term and more challenging than strategic or tactical goals. There may be only a 50% chance of realizing the vision, but the firm must believe that it can do so. Collins and Porras describe these lofty objectives as "Big, Hairy, Audacious Goals." These goals should be challenging enough so that people nearly gasp when they learn of them and realize the effort that will be required to reach them.

Most visionary goals fall into one of the following categories:

- **Target** - quantitative or qualitative goals such as a sales target or Ford's goal to "democratize the automobile."
- **Common enemy** - centered on overtaking a specific firm such as the 1950's goal of Philip-Morris to displace RJR.
- **Role model** - to become like another firm in a different industry or market. For example, a cycling accessories firm might strive to become "the Nike of the cycling industry."
- **Internal transformation** - especially appropriate for very large corporations. For example, GE set the goal of becoming number one or number two in every market it serves.

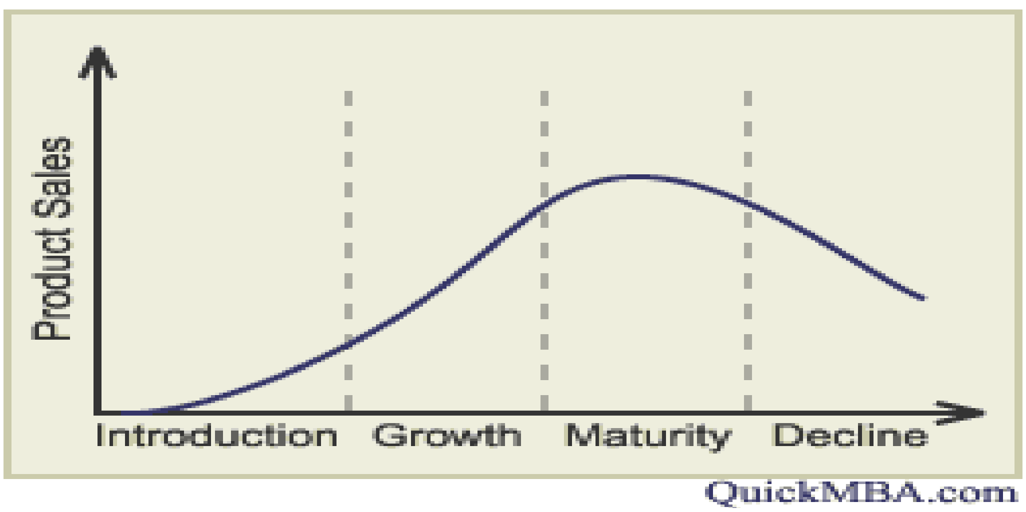
While visionary goals may require significant stretching to achieve, many visionary companies have succeeded in reaching them. Once such a goal is reached, it needs to be replaced; otherwise, it is unlikely that the organization will continue to be successful. For example, Ford succeeded in placing the automobile within the reach of everyday people, but did not replace this goal with a better one and General Motors overtook Ford in the 1930's.

The Product Life Cycle(Marketing)

A new product progresses through a sequence of stages from introduction to growth, maturity, and decline. This sequence is known as the **product life cycle** and is associated with changes in the marketing situation, thus impacting the marketing strategy and the marketing mix.

The product revenue and profits can be plotted as a function of the life-cycle stages as shown in the graph below:

Product Life Cycle Diagram



Introduction Stage

In the introduction stage, the firm seeks to build product awareness and develop a market for the product. The impact on the marketing mix is as follows:

- **Product** branding and quality level is established, and intellectual property protection such as patents and trademarks are obtained.
- **Pricing** may be low penetration pricing to build market share rapidly, or high skim pricing to recover development costs.
- **Distribution** is selective until consumers show acceptance of the product.
- **Promotion** is aimed at innovators and early adopters. Marketing communications seeks to build product awareness and to educate potential consumers about the product.

Growth Stage

In the growth stage, the firm seeks to build brand preference and increase market share.

- **Product** quality is maintained and additional features and support services may be added.
- **Pricing** is maintained as the firm enjoys increasing demand with little competition.
- **Distribution** channels are added as demand increases and customers accept the product.
- **Promotion** is aimed at a broader audience.

Maturity Stage

At maturity, the strong growth in sales diminishes. Competition may appear with similar products. The primary objective at this point is to defend market share while maximizing profit.

- **Product** features may be enhanced to differentiate the product from that of competitors.
- **Pricing** may be lower because of the new competition.
- **Distribution** becomes more intensive and incentives may be offered to encourage preference over competing products.
- **Promotion** emphasizes product differentiation.

Decline Stage

As sales decline, the firm has several options:

- Maintain the product, possibly rejuvenating it by adding new features and finding new uses.
- Harvest the product - reduce costs and continue to offer it, possibly to a loyal niche segment.
- Discontinue the product, liquidating remaining inventory or selling it to another firm that is willing to continue the product.

The marketing mix decisions in the decline phase will depend on the selected strategy. For example, the product may be changed if it is being rejuvenated, or left unchanged if it is being harvested or liquidated. The price may be maintained if the product is harvested, or reduced drastically if liquidated.

Market Share(Marketing)

Sales figures do not necessarily indicate how a firm is performing relative to its competitors. Rather, changes in sales simply may reflect changes in the market size or changes in economic conditions.

The firm's performance relative to competitors can be measured by the proportion of the market that the firm is able to capture. This proportion is referred to as the firm's **market share** and is calculated as follows:

Market Share = Firm's Sales / Total Market Sales

Sales may be determined on a value basis (sales price multiplied by volume) or on a unit basis (number of units shipped or number of customers served).

While the firm's own sales figures are readily available, total market sales are more difficult to determine. Usually, this information is available from trade associations and market research firms.

Reasons to Increase Market Share

Market share often is associated with profitability and thus many firms seek to increase their sales relative to competitors. Here are some specific reasons that a firm may seek to increase its market share:

- **Economies of scale** - higher volume can be instrumental in developing a cost advantage.
- **Sales growth in a stagnant industry** - when the industry is not growing, the firm still can grow its sales by increasing its market share.
- **Reputation** - market leaders have clout that they can use to their advantage.
- **Increased bargaining power** - a larger player has an advantage in negotiations with suppliers and channel members.

Ways to Increase Market Share

The market share of a product can be modeled as:

Share of Market = Share of Preference x Share of Voice x Share of Distribution

According to this model, there are three drivers of market share:

- Share of preference - can be increased through product, pricing, and promotional changes.
- Share of voice - the firm's proportion of total promotional expenditures in the market. Thus, share of voice can be increased by increasing advertising expenditures.
- Share of distribution - can be increased through more intensive distribution.

From these drivers we see that market share can be increased by changing the variables of the marketing mix.

- **Product** - the product attributes can be changed to provide more value to the customer, for example, by improving product quality.
- **Price** - if the price elasticity of demand is elastic (that is, > 1), a decrease in price will increase sales revenue. This tactic may not succeed if competitors are willing and able to meet any price cuts.
- **Distribution** - add new distribution channels or increase the intensity of distribution in each channel.
- **Promotion** - increasing advertising expenditures can increase market share, unless competitors respond with similar increases.

Reasons Not to Increase Market Share

An increase in market share is not always desirable. For example:

- If the firm is near its production capacity, an increase in market share might necessitate investment in additional capacity. If this capacity is underutilized, higher costs will result.
- Overall profits may decline if market share is gained by increasing promotional expenditures or by decreasing prices.
- A price war might be provoked if competitors attempt to regain their share by lowering prices.
- A small niche player may be tolerated if it captures only a small share of the market. If that share increases, a larger, more capable competitor may decide to enter the niche.
- Antitrust issues may arise if a firm dominates its market.

In some cases it may be advantageous to *decrease* market share. For example, if a firm is able to identify certain customers that are unprofitable, it may drop those customers and lose market share while improving profitability.

The Marketing Mix

(The 4 P's of Marketing)

The major marketing management decisions can be classified in one of the following four categories:

- Product
- Price
- Place (distribution)
- Promotion

These variables are known as the **marketing mix** or the **4 P's of marketing**. They are the variables that marketing managers can control in order to best satisfy customers in the target market. The marketing mix is portrayed in the following diagram:

The Marketing Mix

The firm attempts to generate a positive response in the target market by blending these four marketing mix variables in an optimal manner.

Product

The product is the physical product or service offered to the consumer. In the case of physical products, it also refers to any services or conveniences that are part of the offering.

Product decisions include aspects such as function, appearance, packaging, service, warranty, etc.

Price

Pricing decisions should take into account profit margins and the probable pricing response of competitors. Pricing includes not only the list price, but also discounts, financing, and other options such as leasing.

Place

Place (or placement) decisions are those associated with channels of distribution that serve as the means for getting the product to the target customers. The distribution system performs transactional, logistical, and facilitating functions.

Distribution decisions include market coverage, channel member selection, logistics, and levels of service.

Promotion

Promotion decisions are those related to communicating and selling to potential consumers. Since these costs can be large in proportion to the product price, a break-even analysis should be performed when making promotion decisions. It is useful to know the value of a customer in order to determine whether additional customers are worth the cost of acquiring them.

Promotion decisions involve advertising, public relations, media types, etc.

A Summary Table of the Marketing Mix

The following table summarizes the marketing mix decisions, including a list of some of the aspects of each of the 4Ps.

Summary of Marketing Mix Decisions

Product	Price	Place	Promotion
Functionality	List price	Channel members	Advertising
Appearance	Discounts	Channel motivation	Personal selling
Quality	Allowances	Market coverage	Public relations
Packaging	Financing	Locations	Message
Brand	Leasing options	Logistics	Media
Warranty		Service levels	Budget
Service/Support			

Price Elasticity of Demand(Economics)

The price elasticity of demand measures the responsiveness of quantity demanded to a change in price, with all other factors held constant.

Definition

The price elasticity of demand, E_d is defined as the magnitude of:

$$\frac{\text{proportionate change in quantity demanded}}{\text{proportionate change in price}}$$

Since the quantity demanded decreases when the price increases, this ratio is negative; however, the absolute value usually is taken and E_d is reported as a positive number.

Because the calculation uses proportionate changes, the result is a unitless number and does not depend on the units in which the price and quantity are expressed.

As an example calculation, take the case in which a product's E_d is reported to be 0.5. Then, if the price were to increase by 10%, one would observe a decrease of approximately 5% in quantity demanded.

In the above example, we used the word "approximately" because the exact result depends on whether the initial point or the final point is used in the calculation. This matters because for a linear demand curve the price elasticity varies as one moves along the curve. For small changes in price and quantity the difference between the two results often is negligible, but for large changes the difference may be more significant. To deal with this issue, one can define the *arc* price elasticity of demand. The arc elasticity uses the average of the initial and final quantities and the average of the initial and final prices when calculating the proportionate change in each. Mathematically, the arc price elasticity of demand is defined as:

$$\frac{\dfrac{Q2 - Q1}{(Q1 + Q2) / 2}}{\dfrac{P2 - P1}{(P1 + P2) / 2}}$$

where

Q1 = Initial quantity
Q2 = Final quantity
P1 = Initial price
P2 = Final price

Elastic versus Inelastic

<u>E > 1</u>
In this case, the quantity demanded is relatively elastic, meaning that a price change will cause an even larger change in quantity demanded. The case of E_d = infinity is referred to as perfectly elastic. In this theoretical case, the demand curve would be horizontal. For products having a high price elasticity of demand, a price increase will result in a revenue decrease since the revenue lost from the resulting decrease in quantity sold is more than the revenue gained from the price increase.

<u>E < 1</u>
In this case, the quantity demanded is relatively inelastic, meaning that a price change will cause less of a change in quantity demanded. The case of E_d = 0 is referred to as perfectly inelastic. In this theoretical case, the demand curve would be vertical. For products whose quantity demanded is inelastic, a price increase will result in a revenue increase since the revenue lost by the relatively small decrease in quantity is less than the revenue gained from the higher price.

<u>E = 1</u>
In this case, the product is said to have unitary elasticity; small changes in price do not affect the total revenue.

Factors Affecting the Price Elasticity of Demand

- Availability of substitutes: the more possible substitutes, the greater the elasticity. Note that the number of substitutes depends on how broadly one defines the product.
- Degree of necessity or luxury: luxury products tend to have greater elasticity. Some products that initially have a low degree of necessity are habit forming and can become "necessities" to some consumers.
- Proportion of the purchaser's budget consumed by the item: products that consume a large portion of the purchaser's budget tend to have greater elasticity.
- Time period considered: elasticity tends to be greater over the long run because consumers have more time to adjust their behavoir.
- Permanent or temporary price change: a one-day sale will elicit a different response than a permanent price decrease.
- Price points: decreasing the price from $2.00 to $1.99 may elicit a greater response than decreasing it from $1.99 to $1.98.

Environmental Scanning

PEST Analysis

A scan of the external macro-environment in which the firm operates can be expressed in terms of the following factors:

- **P**olitical
- **E**conomic
- **S**ocial
- **T**echnological

The acronym **PEST** (or sometimes rearranged as "STEP") is used to describe a framework for the analysis of these macroenvironmental factors. A PEST analysis fits into an overall environmental scan as shown in the following diagram:

Environmental Scan

↓

External Analysis | Internal Analysis

↓ | ↓

Macro | Micro

↓ | ↓

P.E.S.T | Opportunity & Threats | Strength & Weaknesses

Political Factors

Political factors include government regulations and legal issues and define both formal and informal rules under which the firm must operate. Some examples include:

- tax policy
- employment laws
- environmental regulations
- trade restrictions and tariffs
- political stability

Economic Factors

Economic factors affect the purchasing power of potential customers and the firm's cost of capital. The following are examples of factors in the macroeconomy:

- economic growth
- interest rates
- exchange rates
- inflation rate

Social Factors

Social factors include the demographic and cultural aspects of the external macroenvironment. These factors affect customer needs and the size of potential markets. Some social factors include:

- health consciousness
- population growth rate
- age distribution
- career attitudes
- emphasis on safety

Technological Factors

Technological factors can lower barriers to entry, reduce minimum efficient production levels, and influence outsourcing decisions. Some technological factors include:

- R&D activity
- automation
- technology incentives
- rate of technological change

SWOT Analysis

A scan of the internal and external environment is an important part of the strategic planning process. Environmental factors internal to the firm usually can be classified as strengths (**S**) or weaknesses (**W**), and those external to the firm can be classified as opportunities (**O**) or threats (**T**). Such an analysis of the strategic environment is referred to as a **SWOT analysis**.

The SWOT analysis provides information that is helpful in matching the firm's resources and capabilities to the competitive environment in which it operates. As such, it is instrumental in strategy formulation and selection. The following diagram shows how a SWOT analysis fits into an environmental scan:

SWOT Analysis Framework

```
              Environmental Scan
             /                  \
    Internal Analysis      External Analysis
          / \                     / \
Strengths   Weaknesses   Opportunities   Threats
                      |
                 SWOT Matrix
```

Strengths

A firm's strengths are its resources and capabilities that can be used as a basis for developing a competitive advantage. Examples of such strengths include:

- patents
- strong brand names
- good reputation among customers
- cost advantages from proprietary know-how
- exclusive access to high grade natural resources
- favorable access to distribution networks

Weaknesses

The absence of certain strengths may be viewed as a weakness. For example, each of the following may be considered weaknesses:

- lack of patent protection
- a weak brand name
- poor reputation among customers
- high cost structure
- lack of access to the best natural resources
- lack of access to key distribution channels

In some cases, a weakness may be the flip side of a strength. Take the case in which a firm has a large amount of manufacturing capacity. While this capacity may be considered a strength that competitors do not share, it also may be a considered a weakness if the large investment in manufacturing capacity prevents the firm from reacting quickly to changes in the strategic environment.

Opportunities

The external environmental analysis may reveal certain new opportunities for profit and growth. Some examples of such opportunities include:

- an unfulfilled customer need
- arrival of new technologies
- loosening of regulations
- removal of international trade barriers

Threats

Changes in the external environmental also may present threats to the firm. Some examples of such threats include:

- shifts in consumer tastes away from the firm's products
- emergence of substitute products
- new regulations
- increased trade barriers

The SWOT Matrix

A firm should not necessarily pursue the more lucrative opportunities. Rather, it may have a better chance at developing a competitive advantage by identifying a fit between the firm's strengths and upcoming opportunities. In some cases, the firm can overcome a weakness in order to prepare itself to pursue a compelling opportunity.

To develop strategies that take into account the SWOT profile, a matrix of these factors can be constructed. The SWOT matrix (also known as a **TOWS Matrix**) is shown below:

SWOT / TOWS Matrix

	Strengths	**Weaknesses**
Opportunities	S-O strategies	W-O strategies
Threats	S-T strategies	W-T strategies

- **S-O strategies** pursue opportunities that are a good fit to the company's strengths.
- **W-O strategies** overcome weaknesses to pursue opportunities.
- **S-T strategies** identify ways that the firm can use its strengths to reduce its vulnerability to external threats.
- **W-T strategies** establish a defensive plan to prevent the firm's weaknesses from making it highly susceptible to external threats.

Porter's Five Forces

A MODEL FOR INDUSTRY ANALYSIS

The model of pure competition implies that risk-adjusted rates of return should be constant across firms and industries. However, numerous economic studies have affirmed that different industries can sustain different levels of profitability; part of this difference is explained by industry structure.

Michael Porter provided a framework that models an industry as being influenced by five forces. The strategic business manager seeking to develop an edge over rival firms can use this model to better understand the industry context in which the firm operates.

Diagram of Porter's 5 Forces

SUPPLIER POWER
Supplier concentration
Importance of volume to supplier
Differentiation of inputs
Impact of inputs on cost or differentiation
Switching costs of firms in the industry
Presence of substitute inputs
Threat of forward integration
Cost relative to total purchases in industry

BARRIERS TO ENTRY
Absolute cost advantages
Proprietary learning curve
Access to inputs
Government policy
Economies of scale
Capital requirements
Brand identity
Switching costs
Access to distribution
Expected retaliation
Proprietary products

RIVALRY

THREAT OF SUBSTITUTES
-Switching costs
-Buyer inclination to substitute
-Price-performance trade-off of substitutes

BUYER POWER
Bargaining leverage
Buyer volume
Buyer information
Brand identity
Price sensitivity
Threat of backward integration
Product differentiation
Buyer concentration vs. industry
Substitutes available
Buyers' incentives

DEGREE OF RIVALRY
-Exit barriers
-Industry concentration
-Fixed costs/Value added
-Industry growth
-Intermittent overcapacity
-Product differences
-Switching costs
-Brand identity
-Diversity of rivals
-Corporate stakes

I. Rivalry

In the traditional economic model, competition among rival firms drives profits to zero. But competition is not perfect and firms are not unsophisticated passive price takers. Rather, firms strive for a competitive advantage over their rivals. The intensity of rivalry among firms varies across industries, and strategic analysts are interested in these differences.

Economists measure rivalry by indicators of industry concentration. The Concentration Ratio (CR) is one such measure. The Bureau of Census periodically reports the CR for major Standard Industrial Classifications (SIC's). The CR indicates the percent of market share held by the four largest firms (CR's for the largest 8, 25, and 50 firms in an industry also are available). A high concentration ratio indicates that a high concentration of market share is held by the largest firms - the industry is concentrated. With only a few firms holding a large market share, the competitive landscape is less competitive (closer to a monopoly). A low concentration ratio indicates that the industry is characterized by many rivals, none of which has a significant market share. These *fragmented* markets are said to be competitive. The concentration ratio is not the only available measure; the trend is to define industries in terms that convey more information than distribution of market share.

If rivalry among firms in an industry is low, the industry is considered to be disciplined. This discipline may result from the industry's history of competition, the role of a leading firm, or informal compliance with a generally understood code of conduct. Explicit *collusion* generally is illegal and not an option; in low-rivalry industries competitive moves must be constrained informally. However, a maverick firm seeking a competitive advantage can displace the otherwise disciplined market.

When a rival acts in a way that elicits a counter-response by other firms, rivalry intensifies. The intensity of rivalry commonly is referred to as being cutthroat, intense, moderate, or weak, based on the firms' aggressiveness in attempting to gain an advantage.

In pursuing an advantage over its rivals, a firm can choose from several competitive moves:

- Changing prices - raising or lowering prices to gain a temporary advantage.
- Improving product differentiation - improving features, implementing innovations in the manufacturing process and in the product itself.
- Creatively using channels of distribution - using vertical integration or using a distribution channel that is novel to the industry. For example, with high-end jewelry stores reluctant to carry its watches, Timex moved into drugstores and other non-traditional outlets and cornered the low to mid-price watch market.
- Exploiting relationships with suppliers - for example, from the 1950's to the 1970's Sears, Roebuck and Co. dominated the retail household appliance market. Sears set high quality standards and required suppliers to meet its demands for product specifications and price.

The intensity of rivalry is influenced by the following industry characteristics:

1. **A larger number of firms** increases rivalry because more firms must compete for the same customers and resources. The rivalry intensifies if the firms have similar market share, leading to a struggle for market leadership.

2. **Slow market growth** causes firms to fight for market share. In a growing market, firms are able to improve revenues simply because of the expanding market.
3. **High fixed costs** result in an economy of scale effect that increases rivalry. When total costs are mostly fixed costs, the firm must produce near capacity to attain the lowest unit costs. Since the firm must sell this large quantity of product, high levels of production lead to a fight for market share and results in increased rivalry.
4. **High storage costs or highly perishable products** cause a producer to sell goods as soon as possible. If other producers are attempting to unload at the same time, competition for customers intensifies.
5. **Low switching costs** increases rivalry. When a customer can freely switch from one product to another there is a greater struggle to capture customers.
6. **Low levels of product differentiation** is associated with higher levels of rivalry. Brand identification, on the other hand, tends to constrain rivalry.
7. **Strategic stakes are high** when a firm is losing market position or has potential for great gains. This intensifies rivalry.
8. **High exit barriers** place a high cost on abandoning the product. The firm must compete. High exit barriers cause a firm to remain in an industry, even when the venture is not profitable. A common exit barrier is asset specificity. When the plant and equipment required for manufacturing a product is highly specialized, these assets cannot easily be sold to other buyers in another industry. Litton Industries' acquisition of Ingalls Shipbuilding facilities illustrates this concept. Litton was successful in the 1960's with its contracts to build Navy ships. But when the Vietnam war ended, defense spending declined and Litton saw a sudden decline in its earnings. As the firm restructured, divesting from the shipbuilding plant was not feasible since such a large and highly specialized investment could not be sold easily, and Litton was forced to stay in a declining shipbuilding market.
9. **A diversity of rivals** with different cultures, histories, and philosophies make an industry unstable. There is greater possibility for mavericks and for misjudging rival's moves. Rivalry is volatile and can be intense. The hospital industry, for example, is populated by hospitals that historically are community or charitable institutions, by hospitals that are associated with religious organizations or universities, and by hospitals that are for-profit enterprises. This mix of philosophies about mission has lead occasionally to fierce local struggles by hospitals over who will get expensive diagnostic and therapeutic services. At other times, local hospitals are highly cooperative with one another on issues such as community disaster planning.
10. **Industry Shakeout.** A growing market and the potential for high profits induces new firms to enter a market and incumbent firms to increase production. A point is reached where the industry becomes crowded with competitors, and demand cannot support the new entrants and the resulting increased supply. The industry may become crowded if its growth rate slows and the market becomes saturated, creating a situation of excess capacity with too many goods chasing too few buyers. A shakeout ensues, with intense competition, price wars, and company failures.

BCG founder Bruce Henderson generalized this observation as the Rule of Three and Four: a stable market will not have more than three significant competitors, and the largest competitor will have no more than four times the market share of the smallest. If this rule is true, it implies that:

- If there is a larger number of competitors, a shakeout is inevitable
- Surviving rivals will have to grow faster than the market
- Eventual losers will have a negative cash flow if they attempt to grow
- All except the two largest rivals will be losers
- The definition of what constitutes the "market" is strategically important.

Whatever the merits of this rule for stable markets, it is clear that market stability and changes in supply and demand affect rivalry. Cyclical demand tends to create cutthroat competition. This is true in the disposable diaper industry in which demand fluctuates with birth rates, and in the greeting card industry in which there are more predictable business cycles.

II. Threat Of Substitutes

In Porter's model, substitute products refer to products in other industries. To the economist, a threat of substitutes exists when a product's demand is affected by the price change of a substitute product. A product's price elasticity is affected by substitute products - as more substitutes become available, the demand becomes more elastic since customers have more alternatives. A close substitute product constrains the ability of firms in an industry to raise prices.

The competition engendered by a Threat of Substitute comes from products outside the industry. The price of aluminum beverage cans is constrained by the price of glass bottles, steel cans, and plastic containers. These containers are substitutes, yet they are not rivals in the aluminum can industry. To the manufacturer of automobile tires, tire retreads are a substitute. Today, new tires are not so expensive that car owners give much consideration to retreading old tires. But in the trucking industry new tires are expensive and tires must be replaced often. In the truck tire market, retreading remains a viable substitute industry. In the disposable diaper industry, cloth diapers are a substitute and their prices constrain the price of disposables.

While the treat of substitutes typically impacts an industry through price competition, there can be other concerns in assessing the threat of substitutes. Consider the substitutability of different types of TV transmission: local station transmission to home TV antennas via the airways versus transmission via cable, satellite, and telephone lines. The new technologies available and the changing structure of the entertainment media are contributing to competition among these substitute means of connecting the home to entertainment. Except in remote areas it is unlikely that cable TV could compete with free TV from an aerial without the greater diversity of entertainment that it affords the customer.

III. Buyer Power

The power of buyers is the impact that customers have on a producing industry. In general, when buyer power is strong, the relationship to the producing industry is near to what an economist terms a **monopsony** - a market in which there are many suppliers and one buyer. Under such market conditions, the buyer sets the price. In reality few pure monopsonies exist, but frequently there is some asymmetry between a producing industry and buyers. The following tables outline some factors that determine buyer power.

Buyers are Powerful if:	**Example**
Buyers are concentrated - there are a few buyers with significant market share	DOD purchases from defense contractors
Buyers purchase a significant proportion of output - distribution of purchases or if the product is standardized	Circuit City and Sears' large retail market provides power over appliance manufacturers
Buyers possess a credible backward integration threat - can threaten to buy producing firm or rival	Large auto manufacturers' purchases of tires
Buyers are Weak if:	**Example**
Producers threaten forward integration - producer can take over own distribution/retailing	Movie-producing companies have integrated forward to acquire theaters
Significant buyer switching costs - products not standardized and buyer cannot easily switch to another product	IBM's 360 system strategy in the 1960's
Buyers are fragmented (many, different) - no buyer has any particular influence on product or price	Most consumer products
Producers supply critical portions of buyers' input - distribution of purchases	Intel's relationship with PC manufacturers

IV. Supplier Power

A producing industry requires raw materials - labor, components, and other supplies. This requirement leads to buyer-supplier relationships between the industry and the firms that provide it the raw materials used to create products. Suppliers, if powerful, can exert an influence on the producing industry, such as selling raw materials at a high price to capture some of the industry's profits. The following tables outline some factors that determine supplier power.

Suppliers are Powerful if:	**Example**
Credible forward integration threat by suppliers	Baxter International, manufacturer of hospital supplies, acquired American Hospital Supply, a distributor
Suppliers concentrated	Drug industry's relationship to hospitals
Significant cost to switch suppliers	Microsoft's relationship with PC manufacturers
Customers Powerful	Boycott of grocery stores selling non-union picked grapes
Suppliers are Weak if:	**Example**
Many competitive suppliers - product is standardized	Tire industry relationship to automobile manufacturers
Purchase commodity products	Grocery store brand label products
Credible backward integration threat by purchasers	Timber producers relationship to paper companies
Concentrated purchasers	Garment industry relationship to major department stores
Customers Weak	Travel agents' relationship to airlines

V. Barriers to Entry / Threat of Entry

It is not only incumbent rivals that pose a threat to firms in an industry; the possibility that new firms may enter the industry also affects competition. In theory, any firm should be able to enter and exit a market, and if free entry and exit exists, then profits always should be nominal. In reality, however, industries possess characteristics that protect the high profit levels of firms in the market and inhibit additional rivals from entering the market. These are ***barriers to entry***.

Barriers to entry are more than the normal equilibrium adjustments that markets typically make. For example, when industry profits increase, we would expect additional firms to enter the market to take advantage of the high profit levels, over time driving down profits for all firms in the industry. When profits decrease, we would expect some firms to exit the market thus restoring a market equilibrium. Falling prices, or the expectation that future prices will fall, deters rivals from entering a market. Firms also may be reluctant to enter markets that are extremely uncertain, especially if entering involves expensive start-up costs. These are normal accommodations to market conditions. But if firms individually (collective action would be illegal collusion) keep prices artificially low as a strategy to prevent potential entrants from entering the market, such **entry-deterring pricing** establishes a barrier.

Barriers to entry are unique industry characteristics that define the industry. Barriers reduce the rate of entry of new firms, thus maintaining a level of profits for those already in the industry. From a strategic perspective, barriers can be created or exploited to enhance a firm's competitive advantage. Barriers to entry arise from several sources:

1. **Government creates barriers.** Although the principal role of the government in a market is to preserve competition through anti-trust actions, government also restricts competition through the granting of monopolies and through regulation. Industries such as utilities are considered natural monopolies because it has been more efficient to have one electric company provide power to a locality than to permit many electric companies to compete in a local market. To restrain utilities from exploiting this advantage, government permits a monopoly, but regulates the industry. Illustrative of this kind of barrier to entry is the local cable company. The franchise to a cable provider may be granted by competitive bidding, but once the franchise is awarded by a community a monopoly is created. Local governments were not effective in monitoring price gouging by cable operators, so the federal government has enacted legislation to review and restrict prices.

   The regulatory authority of the government in restricting competition is historically evident in the banking industry. Until the 1970's, the markets that banks could enter were limited by state governments. As a result, most banks were local commercial and retail banking facilities. Banks competed through strategies that emphasized simple marketing devices such as awarding toasters to new customers for opening a checking account. When banks were deregulated, banks were permitted to cross state boundaries and expand their markets. Deregulation of banks intensified rivalry and created uncertainty for banks as they attempted to maintain market share. In the late 1970's, the strategy of banks shifted from simple marketing tactics to mergers and geographic expansion as rivals attempted to expand markets.

2. **Patents and proprietary knowledge serve to restrict entry into an industry.** Ideas and knowledge that provide competitive advantages are treated as private property when patented, preventing others from using the knowledge and thus creating a barrier to entry. Edwin Land introduced the Polaroid camera in 1947 and held a monopoly in the instant photography industry. In 1975, Kodak attempted to enter the instant camera market and sold a comparable camera. Polaroid sued for patent infringement and won, keeping Kodak out of the instant camera industry.
3. **Asset specificity inhibits entry into an industry.** Asset specificity is the extent to which the firm's assets can be utilized to produce a different product. When an industry requires highly specialized technology or plants and equipment, potential entrants are reluctant to commit to acquiring specialized assets that cannot be sold or converted into other uses if the venture fails. Asset specificity provides a barrier to entry for two reasons: First, when firms already hold specialized assets they fiercely resist efforts by others from taking their market share. New entrants can anticipate aggressive rivalry. For example, Kodak had much capital invested in its photographic equipment business and aggressively resisted efforts by Fuji to intrude in its market. These assets are both large and industry specific. The second reason is that potential entrants are reluctant to make investments in highly specialized assets.
4. **Organizational (Internal) Economies of Scale.** The most cost efficient level of production is termed **Minimum Efficient Scale** (MES). This is the point at which unit costs for production are at minimum - i.e., the most cost efficient level of production. If MES for firms in an industry is known, then we can determine the amount of market share necessary for low cost entry or cost parity with rivals. For example, in long distance communications roughly 10% of the market is necessary for MES. If sales for a long distance operator fail to reach 10% of the market, the firm is not competitive.

   The existence of such an economy of scale creates a barrier to entry. The greater the difference between industry MES and entry unit costs, the greater the barrier to entry. So industries with high MES deter entry of small, start-up businesses. To operate at less than MES there must be a consideration that permits the firm to sell at a premium price - such as product differentiation or local monopoly.

Barriers to exit work similarly to barriers to entry. Exit barriers limit the ability of a firm to leave the market and can exacerbate rivalry - unable to leave the industry, a firm must compete. Some of an industry's entry and exit barriers can be summarized as follows:

Easy to Enter if there is:	Difficult to Enter if there is:
• Common technology • Little brand franchise • Access to distribution channels • Low scale threshold	• Patented or proprietary know-how • Difficulty in brand switching • Restricted distribution channels • High scale threshold
Easy to Exit if there are:	**Difficult to Exit if there are:**
• Salable assets • Low exit costs • Independent businesses	• Specialized assets • High exit costs • Interrelated businesses

DYNAMIC NATURE OF INDUSTRY RIVALRY

Our descriptive and analytic models of industry tend to examine the industry at a given state. The nature and fascination of business is that it is not static. While we are prone to generalize, for example, list GM, Ford, and Chrysler as the "Big 3" and assume their dominance, we also have seen the automobile industry change. Currently, the entertainment and communications industries are in flux. Phone companies, computer firms, and entertainment are merging and forming strategic alliances that re-map the information terrain. Schumpeter and, more recently, Porter have attempted to move the understanding of industry competition from a static economic or industry organization model to an emphasis on the interdependence of forces as dynamic, or *punctuated equilibrium*, as Porter terms it.

In Schumpeter's and Porter's view the dynamism of markets is driven by innovation. We can envision these forces at work as we examine the following changes:

Top 10 US Industrial Firms by Sales 1917 - 1988

	1917	1945	1966	1983	1988
1	US Steel	General Motors	General Motors	Exxon	General Motors
2	Swift	US Steel	Ford	General Motors	Ford
3	Armour	Standard Oil -NJ	Standard Oil -NJ (Exxon)	Mobil	Exxon
4	American Smelting	US Steel	General Electric	Texaco	IBM
5	Standard Oil -NJ	Bethlehem Steel	Chrysler	Ford	General Electric
6	Bethlehem Steel	Swift	Mobil	IBM	Mobil
7	Ford	Armour	Texaco	Socal (Oil)	Chrysler
8	DuPont	Curtiss-Wright	US Steel	DuPont	Texaco
9	American Sugar	Chrysler	IBM	Gulf Oil	DuPont
10	General Electric	Ford	Gulf Oil	Standard Oil of Indiana	Philip Morris

10 Largest US Firms by Assets, 1909 and 1987

	1909	1987
1	US STEEL	GM (Not listed in 1909)
2	STANDARD OIL, NJ (Now, EXXON #3)	SEARS (1909 = 45)
3	AMERICAN TOBACCO (Now, American Brands #52)	EXXON (Standard Oil trust broken up in 1911)
4	AMERICAN MERCANTILE MARINE (Renamed US Lines; acquired by Kidde, Inc., 1969; sold to McLean Industries, 1978; bankruptcy, 1986	IBM (Ranked 68, 1948)
5	INTERNATIONAL HARVESTER (Renamed Navistar #182); divested farm	FORD (Listed in 1919)

6	ANACONDA COPPER (acquired by ARCO in 1977)	MOBIL OIL
7	US LEATHER (Liquidated in 1935)	GENERAL ELECTRIC (1909= 16)
8	ARMOUR (Merged in 1968 with General Host; in 1969 by Greyhound; 1983 sold to ConAgra)	CHEVRON (Not listed in 1909)
9	AMERICAN SUGAR REFINING (Renamed AMSTAR. In 1967 =320) Leveraged buyout and sold in pieces)	TEXACO (1909= 91)
10	PULLMAN, INC (Acquired by Wheelabrator Frye, 1980; spun-off as Pullman-Peabody, 1981; 1984 sold to Trinity Industries)	DU PONT (1909= 29)

GENERIC STRATEGIES TO COUNTER THE FIVE FORCES

Strategy can be formulated on three levels:

- corporate level
- business unit level
- functional or departmental level.

The business unit level is the primary context of industry rivalry. Michael Porter identified three generic strategies (*cost leadership*, *differentiation*, and *focus*) that can be implemented at the business unit level to create a competitive advantage. The proper generic strategy will position the firm to leverage its strengths and defend against the adverse effects of the five forces.

Competitive Advantage

When a firm sustains profits that exceed the average for its industry, the firm is said to possess a **competitive advantage** over its rivals. The goal of much of business strategy is to achieve a sustainable competitive advantage.

Michael Porter identified two basic types of competitive advantage:

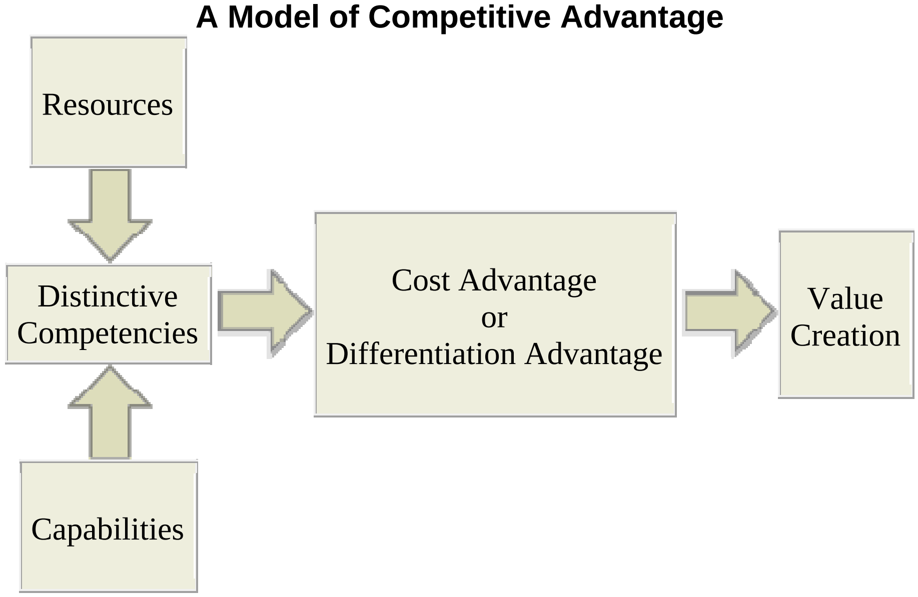
- cost advantage
- differentiation advantage

A competitive advantage exists when the firm is able to deliver the same benefits as competitors but at a lower cost (cost advantage), or deliver benefits that exceed those of competing products (differentiation advantage). Thus, a competitive advantage enables the firm to create superior value for its customers and superior profits for itself.

Cost and differentiation advantages are known as *positional advantages* since they describe the firm's position in the industry as a leader in either cost or differentiation.

A *resource-based view* emphasizes that a firm utilizes its resources and capabilities to create a competitive advantage that ultimately results in superior value creation. The following diagram combines the resource-based and positioning views to illustrate the concept of competitive advantage:

A Model of Competitive Advantage



Resources and Capabilities

According to the resource-based view, in order to develop a competitive advantage the firm must have resources and capabilities that are superior to those of its competitors.

Without this superiority, the competitors simply could replicate what the firm was doing and any advantage quickly would disappear.

Resources are the firm-specific assets useful for creating a cost or differentiation advantage and that few competitors can acquire easily. The following are some examples of such resources:

- Patents and trademarks
- Proprietary know-how
- Installed customer base
- Reputation of the firm
- Brand equity

Capabilities refer to the firm's ability to utilize its resources effectively. An example of a capability is the ability to bring a product to market faster than competitors. Such capabilities are embedded in the routines of the organization and are not easily documented as procedures and thus are difficult for competitors to replicate.

The firm's resources and capabilities together form its **distinctive competencies**. These competencies enable innovation, efficiency, quality, and customer responsiveness, all of which can be leveraged to create a cost advantage or a differentiation advantage.

Cost Advantage and Differentiation Advantage

Competitive advantage is created by using resources and capabilities to achieve either a lower cost structure or a differentiated product. A firm positions itself in its industry through its choice of low cost or differentiation. This decision is a central component of the firm's competitive strategy.

Another important decision is how broad or narrow a market segment to target. Porter formed a matrix using cost advantage, differentiation advantage, and a broad or narrow focus to identify a set of generic strategies that the firm can pursue to create and sustain a competitive advantage.

Value Creation

The firm creates value by performing a series of activities that Porter identified as the value chain. In addition to the firm's own value-creating activities, the firm operates in a *value system* of vertical activities including those of upstream suppliers and downstream channel members.

To achieve a competitive advantage, the firm must perform one or more value creating activities in a way that creates more overall value than do competitors. Superior value is created through lower costs or superior benefits to the consumer (differentiation).

Porter's Generic Strategies

If the primary determinant of a firm's profitability is the attractiveness of the industry in which it operates, an important secondary determinant is its position within that industry. Even though an industry may have below-average profitability, a firm that is optimally positioned can generate superior returns.

A firm positions itself by leveraging its strengths. Michael Porter has argued that a firm's strengths ultimately fall into one of two headings: cost advantage and differentiation. By applying these strengths in either a broad or narrow scope, three generic strategies result: *cost leadership*, *differentiation*, and *focus*. These strategies are applied at the business unit level. They are called generic strategies because they are not firm or industry dependent. The following table illustrates Porter's generic strategies:

Porter's Generic Strategies

Target Scope	*Advantage*	
	Low Cost	**Product Uniqueness**
Broad (Industry Wide)	**Cost Leadership Strategy**	**Differentiation Strategy**
Narrow (Market Segment)	**Focus Strategy** (low cost)	**Focus Strategy** (differentiation)

Cost Leadership Strategy

This generic strategy calls for being the low cost producer in an industry for a given level of quality. The firm sells its products either at average industry prices to earn a profit higher than that of rivals, or below the average industry prices to gain market share. In the event of a price war, the firm can maintain some profitability while the competition suffers losses. Even without a price war, as the industry matures and prices decline, the firms that can produce more cheaply will remain profitable for a longer period of time. The cost leadership strategy usually targets a broad market.

Some of the ways that firms acquire cost advantages are by improving process efficiencies, gaining unique access to a large source of lower cost materials, making optimal outsourcing and vertical integration decisions, or avoiding some costs altogether. If competing firms are unable to lower their costs by a similar amount, the firm may be able to sustain a competitive advantage based on cost leadership.

Firms that succeed in cost leadership often have the following internal strengths:

- Access to the capital required to make a significant investment in production assets; this investment represents a barrier to entry that many firms may not overcome.
- Skill in designing products for efficient manufacturing, for example, having a small component count to shorten the assembly process.
- High level of expertise in manufacturing process engineering.
- Efficient distribution channels.

Each generic strategy has its risks, including the low-cost strategy. For example, other firms may be able to lower their costs as well. As technology improves, the competition may be able to leapfrog the production capabilities, thus eliminating the competitive advantage. Additionally, several firms following a focus strategy and targeting various narrow markets may be able to achieve an even lower cost within their segments and as a group gain significant market share.

Differentiation Strategy

A differentiation strategy calls for the development of a product or service that offers unique attributes that are valued by customers and that customers perceive to be better than or different from the products of the competition. The value added by the uniqueness of the product may allow the firm to charge a premium price for it. The firm hopes that the higher price will more than cover the extra costs incurred in offering the unique product. Because of the product's unique attributes, if suppliers increase their prices the firm may be able to pass along the costs to its customers who cannot find substitute products easily.

Firms that succeed in a differentiation strategy often have the following internal strengths:

- Access to leading scientific research.
- Highly skilled and creative product development team.
- Strong sales team with the ability to successfully communicate the perceived strengths of the product.
- Corporate reputation for quality and innovation.

The risks associated with a differentiation strategy include imitation by competitors and changes in customer tastes. Additionally, various firms pursuing focus strategies may be able to achieve even greater differentiation in their market segments.

Focus Strategy

The focus strategy concentrates on a narrow segment and within that segment attempts to achieve either a cost advantage or differentiation. The premise is that the needs of the group can be better serviced by focusing entirely on it. A firm using a focus strategy often enjoys a high degree of customer loyalty, and this entrenched loyalty discourages other firms from competing directly.

Because of their narrow market focus, firms pursuing a focus strategy have lower volumes and therefore less bargaining power with their suppliers. However, firms pursuing a differentiation-focused strategy may be able to pass higher costs on to customers since close substitute products do not exist.

Firms that succeed in a focus strategy are able to tailor a broad range of product development strengths to a relatively narrow market segment that they know very well.

Some risks of focus strategies include imitation and changes in the target segments. Furthermore, it may be fairly easy for a broad-market cost leader to adapt its product in order to compete directly. Finally, other focusers may be able to carve out sub-segments that they can serve even better.

A Combination of Generic Strategies
- Stuck in the Middle?

These generic strategies are not necessarily compatible with one another. If a firm attempts to achieve an advantage on all fronts, in this attempt it may achieve no advantage at all. For example, if a firm differentiates itself by supplying very high quality products, it risks undermining that quality if it seeks to become a cost leader. Even if the quality did not suffer, the firm would risk projecting a confusing image. For this reason, Michael Porter argued that to be successful over the long-term, a firm must select only one of these three generic strategies. Otherwise, with more than one single generic strategy the firm will be "stuck in the middle" and will not achieve a competitive advantage.

Porter argued that firms that are able to succeed at multiple strategies often do so by creating separate business units for each strategy. By separating the strategies into different units having different policies and even different cultures, a corporation is less likely to become "stuck in the middle."

However, there exists a viewpoint that a single generic strategy is not always best because within the same product customers often seek multi-dimensional satisfactions such as a combination of quality, style, convenience, and price. There have been cases in which high quality producers faithfully followed a single strategy and then suffered greatly when another firm entered the market with a lower-quality product that better met the overall needs of the customers.

Generic Strategies and Industry Forces

These generic strategies each have attributes that can serve to defend against competitive forces. The following table compares some characteristics of the generic strategies in the context of the Porter's five forces.

Generic Strategies and Industry Forces

Industry Force	*Generic Strategies*		
	Cost Leadership	**Differentiation**	**Focus**
Entry Barriers	Ability to cut price in retaliation deters potential entrants.	Customer loyalty can discourage potential entrants.	Focusing develops core competencies that can act as an entry barrier.
Buyer Power	Ability to offer lower price to powerful buyers.	Large buyers have less power to negotiate because of few close alternatives.	Large buyers have less power to negotiate because of few alternatives.
Supplier Power	Better insulated from powerful suppliers.	Better able to pass on supplier price increases to customers.	Suppliers have power because of low volumes, but a differentiation-focused firm is better able to pass on supplier price increases.
Threat of Substitutes	Can use low price to defend against substitutes.	Customer's become attached to differentiating attributes, reducing threat of substitutes.	Specialized products & core competency protect against substitutes.
Rivalry	Better able to compete on price.	Brand loyalty to keep customers from rivals.	Rivals cannot meet differentiation-focused customer needs.

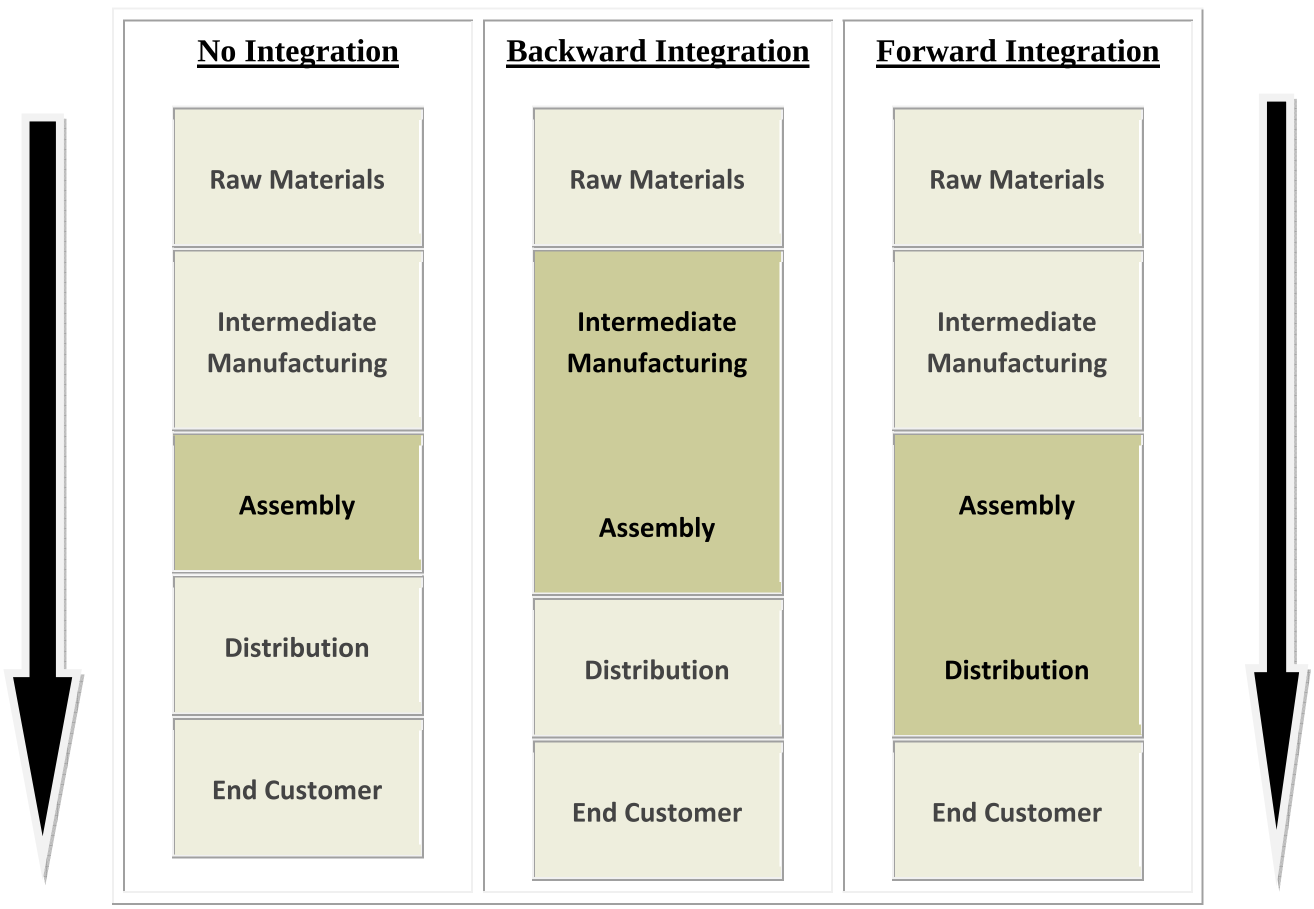
Vertical Integration

The degree to which a firm owns its upstream suppliers and its downstream buyers is referred to as **vertical integration**. Because it can have a significant impact on a business unit's position in its industry with respect to cost, differentiation, and other strategic issues, the vertical scope of the firm is an important consideration in corporate strategy.

Expansion of activities downstream is referred to as *forward integration*, and expansion upstream is referred to as *backward integration.*

The concept of vertical integration can be visualized using the value chain. Consider a firm whose products are made via an assembly process. Such a firm may consider backward integrating into intermediate manufacturing or forward integrating into distribution, as illustrated below:

Example of Backward and Forward Integration



Two issues that should be considered when deciding whether to vertically integrate is cost and control. The cost aspect depends on the cost of market transactions between firms versus the cost of administering the same activities internally within a single firm. The second issue is the impact of asset control, which can impact barriers to entry and which can assure cooperation of key value-adding players.

The following benefits and drawbacks consider these issues.

Benefits of Vertical Integration

Vertical integration potentially offers the following advantages:

- Reduce transportation costs if common ownership results in closer geographic proximity.
- Improve supply chain coordination.
- Provide more opportunities to differentiate by means of increased control over inputs.
- Capture upstream or downstream profit margins.
- Increase entry barriers to potential competitors, for example, if the firm can gain sole access to a scarce resource.
- Gain access to downstream distribution channels that otherwise would be inaccessible.
- Facilitate investment in highly specialized assets in which upstream or downstream players may be reluctant to invest.
- Lead to expansion of core competencies.

Drawbacks of Vertical Integration

While some of the benefits of vertical integration can be quite attractive to the firm, the drawbacks may negate any potential gains. Vertical integration potentially has the following disadvantages:

- Capacity balancing issues. For example, the firm may need to build excess upstream capacity to ensure that its downstream operations have sufficient supply under all demand conditions.
- Potentially higher costs due to low efficiencies resulting from lack of supplier competition.
- Decreased flexibility due to previous upstream or downstream investments. (Note however, that flexibility to coordinate vertically-related activities may increase.)
- Decreased ability to increase product variety if significant in-house development is required.
- Developing new core competencies may compromise existing competencies.
- Increased bureaucratic costs.

Factors Favoring Vertical Integration

The following situational factors tend to favor vertical integration:

- Taxes and regulations on market transactions
- Obstacles to the formulation and monitoring of contracts.
- Strategic similarity between the vertically-related activities.
- Sufficiently large production quantities so that the firm can benefit from economies of scale.
- Reluctance of other firms to make investments specific to the transaction.

Factors Against Vertical Integration

The following situational factors tend to make vertical integration less attractive:

- The quantity required from a supplier is much less than the minimum efficient scale for producing the product.
- The product is a widely available commodity and its production cost decreases significantly as cumulative quantity increases.
- The core competencies between the activities are very different.
- The vertically adjacent activities are in very different types of industries. For example, manufacturing is very different from retailing.
- The addition of the new activity places the firm in competition with another player with which it needs to cooperate. The firm then may be viewed as a competitor rather than a partner

Alternatives to Vertical Integration

There are alternatives to vertical integration that may provide some of the same benefits with fewer drawbacks. The following are a few of these alternatives for relationships between vertically-related organizations:

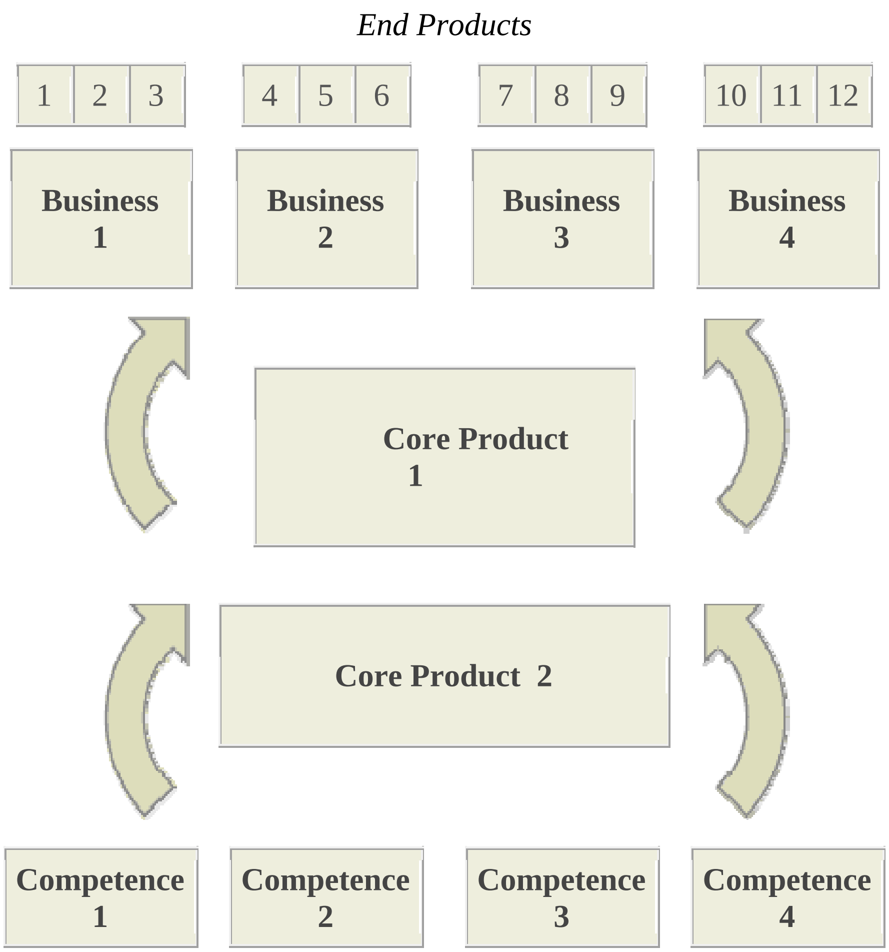
- long-term explicit contracts
- franchise agreements
- joint ventures
- co-location of facilities
- implicit contracts (relying on firms' reputation)

Core Competencies

In their 1990 article entitled, *The Core Competence of the Corporation*, C.K. Prahalad and Gary Hamel coined the term **core competencies**, or the collective learning and coordination skills behind the firm's product lines. They made the case that core competencies are the source of competitive advantage and enable the firm to introduce an array of new products and services.

According to Prahalad and Hamel, core competencies lead to the development of core products. Core products are not directly sold to end users; rather, they are used to build a larger number of end-user products. For example, motors are a core product that can be used in wide array of end products. The business units of the corporation each tap into the relatively few core products to develop a larger number of end user products based on the core product technology. This flow from core competencies to end products is shown in the following diagram:

Core Competencies to End Products



The intersection of market opportunities with core competencies forms the basis for launching new businesses. By combining a set of core competencies in different ways and matching them to market opportunities, a corporation can launch a vast array of businesses.

Without core competencies, a large corporation is just a collection of discrete businesses. Core competencies serve as the glue that bonds the business units together into a coherent portfolio.

Developing Core Competencies

According to Prahalad and Hamel, core competencies arise from the integration of multiple technologies and the coordination of diverse production skills. Some examples include Philip's expertise in optical media and Sony's ability to miniaturize electronics.

There are three tests useful for identifying a core competence. A core competence should:

1. provide access to a wide variety of markets, and
2. contribute significantly to the end-product benefits, and
3. be difficult for competitors to imitate.

Core competencies tend to be rooted in the ability to integrate and coordinate various groups in the organization. While a company may be able to hire a team of brilliant scientists in a particular technology, in doing so it does not automatically gain a core competence in that technology. It is the effective coordination among all the groups involved in bringing a product to market that results in a core competence.

It is not necessarily an expensive undertaking to develop core competencies. The missing pieces of a core competency often can be acquired at a low cost through alliances and licensing agreements. In many cases an organizational design that facilitates sharing of competencies can result in much more effective utilization of those competencies for little or no additional cost.

To better understand how to develop core competencies, it is worthwhile to understand what they do not entail. According to Prahalad and Hamel, core competencies are not necessarily about:

- outspending rivals on R&D
- sharing costs among business units
- integrating vertically

While the building of core competencies may be facilitated by some of these actions, by themselves they are insufficient.

The Loss of Core Competencies

Cost-cutting moves sometimes destroy the ability to build core competencies. For example, decentralization makes it more difficult to build core competencies because autonomous groups rely on outsourcing of critical tasks, and this outsourcing prevents the firm from developing core competencies in those tasks since it no longer consolidates the know-how that is spread throughout the company.

Failure to recognize core competencies may lead to decisions that result in their loss. For example, in the 1970's many U.S. manufacturers divested themselves of their television manufacturing businesses, reasoning that the industry was mature and that high quality, low cost models were available from Far East manufacturers. In the process, they lost their core competence in video, and this loss resulted in a handicap in the newer digital television industry.

Similarly, Motorola divested itself of its semiconductor DRAM business at 256Kb level, and then was unable to enter the 1Mb market on its own. By recognizing its core competencies and understanding the time required to build them or regain them, a company can make better divestment decisions.

Core Products

Core competencies manifest themselves in core products that serve as a link between the competencies and end products. Core products enable value creation in the end products. Examples of firms and some of their core products include:

- 3M - substrates, coatings, and adhesives
- Black & Decker - small electric motors
- Canon - laser printer subsystems
- Matsushita - VCR subsystems, compressors
- NEC - semiconductors
- Honda - gasoline powered engines

The core products are used to launch a variety of end products. For example, Honda uses its engines in automobiles, motorcycles, lawn mowers, and portable generators.

Because firms may sell their core products to other firms that use them as the basis for end user products, traditional measures of brand market share are insufficient for evaluating the success of core competencies. Prahalad and Hamel suggest that *core product share* is the appropriate metric. While a company may have a low brand share, it may have high core product share and it is this share that is important from a core competency standpoint.

Once a firm has successful core products, it can expand the number of uses in order to gain a cost advantage via economies of scale and economies of scope.

Implications for Corporate Management

Prahalad and Hamel suggest that a corporation should be organized into a portfolio of core competencies rather than a portfolio of independent business units. Business unit managers tend to focus on getting immediate end-products to market rapidly and usually do not feel responsible for developing company-wide core competencies. Consequently, without the incentive and direction from corporate management to do otherwise, strategic business units are inclined to underinvest in the building of core competencies.

If a business unit does manage to develop its own core competencies over time, due to its autonomy it may not share them with other business units. As a solution to this problem, Prahalad and Hamel suggest that corporate managers should have the ability to allocate not only cash but also core competencies among business units. Business units that lose key employees for the sake of a corporate core competency should be recognized for their contribution.

The Value Chain

To analyze the specific activities through which firms can create a competitive advantage, it is useful to model the firm as a chain of value-creating activities. Michael Porter identified a set of interrelated generic activities common to a wide range of firms. The resulting model is known as the **value chain** and is depicted below:

Primary Value Chain Activities

Inbound Logistics	>	Operations	>	Outbound Logistics	>	Marketing & Sales	>	Service

The goal of these activities is to create value that exceeds the cost of providing the product or service, thus generating a profit margin.

- **Inbound logistics** include the receiving, warehousing, and inventory control of input materials.
- **Operations** are the value-creating activities that transform the inputs into the final product.
- **Outbound logistics** are the activities required to get the finished product to the customer, including warehousing, order fulfillment, etc.
- **Marketing & Sales** are those activities associated with getting buyers to purchase the product, including channel selection, advertising, pricing, etc.
- **Service** activities are those that maintain and enhance the product's value including customer support, repair services, etc.

Any or all of these primary activities may be vital in developing a competitive advantage. For example, logistics activities are critical for a provider of distribution services, and service activities may be the key focus for a firm offering on-site maintenance contracts for office equipment.

These five categories are generic and portrayed here in a general manner. Each generic activity includes specific activities that vary by industry.

Support Activities

The primary value chain activities described above are facilitated by support activities. Porter identified four generic categories of support activities, the details of which are industry-specific.

- **Procurement** - the function of purchasing the raw materials and other inputs used in the value-creating activities.
- **Technology Development** - includes research and development, process automation, and other technology development used to support the value-chain activities.
- **Human Resource Management** - the activities associated with recruiting, development, and compensation of employees.
- **Firm Infrastructure** - includes activities such as finance, legal, quality management, etc.

Support activities often are viewed as "overhead", but some firms successfully have used them to develop a competitive advantage, for example, to develop a cost advantage through innovative management of information systems.

Value Chain Analysis

In order to better understand the activities leading to a competitive advantage, one can begin with the generic value chain and then identify the relevant firm-specific activities. Process flows can be mapped, and these flows used to isolate the individual value-creating activities.

Once the discrete activities are defined, linkages between activities should be identified. A linkage exists if the performance or cost of one activity affects that of another. Competitive advantage may be obtained by optimizing and coordinating linked activities.

The value chain also is useful in outsourcing decisions. Understanding the linkages between activities can lead to more optimal make-or-buy decisions that can result in either a cost advantage or a differentiation advantage.

The Value System

The firm's value chain links to the value chains of upstream suppliers and downstream buyers. The result is a larger stream of activities known as the *value system*. The development of a competitive advantage depends not only on the firm-specific value chain, but also on the value system of which the firm is a part.

Industry Concentration(Economics)

The concentration of firms in an industry is of interest to economists, business strategists, and government agencies. Here, we discuss two commonly-used methods of measuring industry concentration: the Concentration Ratio and the Herfindahl-Hirschman Index.

Concentration Ratio (CR)

The concentration ratio is the percentage of market share owned by the largest *m* firms in an industry, where *m* is a specified number of firms, often 4, but sometimes a larger or smaller number. The concentration ratio often is expressed as CR_m, for example, CR_4.

The concentration ratio can be expressed as:

$$CR_m = s_1 + s_2 + s_3 + \dots \dots + s_m$$

where s_i = market share of the i^{th} firm.

If the CR_4 were close to zero, this value would indicate an extremely competitive industry since the four largest firms would not have any significant market share.

In general, if the CR_4 measure is less than about 40 (indicating that the four largest firms own less than 40% of the market), then the industry is considered to be very competitive, with a number of other firms competing, but none owning a very large chunk of the market. On the other extreme, if the CR_1 measure is more than about 90, that one firm that controls more than 90% of the market is effectively a monopoly.

While useful, the concentration ratio presents an incomplete picture of the concentration of firms in an industy because by definition it does not use the market shares of all the firms in the industry. It also does not provide information about the distribution of firm size. For example, if there were a significant change in the market shares among the firms included in the ratio, the value of the concentration ratio would not change.

Herfindahl-Hirschman Index (HHI)

The Herfindahl-Hirschman Index provides a more complete picture of industry concentration than does the concentration ratio. The HHI uses the market shares of all the firms in the industry, and these market shares are squared in the calculation to place more weight on the larger firms. If there are *n* firms in the industry, the HHI can be expressed as:

$$HHI = s_1^2 + s_2^2 + s_3^2 + \dots \dots + s_n^2$$

where s_i is the market share of the i^{th} firm.

Unlike the concentration ratio, the HHI will change if there is a shift in market share among the larger firms.

The Herfindahl-Hirschman Index is calculated by taking the sum of the squares of the market shares of every firm in the industry. For example, if there were only one firm in the industry, that firm would have 100% market share and the HHI would be equal to 10,000 -- the maximum possible value of the Herfindahl-Hirschman Index. On the other extreme, if there were a very large number of firms competing, each of which having nearly zero market share, then the HHI would be close to zero, indicating nearly perfect competition.

The U.S. Department of Justice uses the HHI in guidelines for evaluating mergers. An HHI of less than 1000 represents a relatively unconcentrated market, and the DOJ likely would not challenge a merger that would leave the industry with an HHI in that range. An HHI between 1000 and 1800 represents a moderately concentrated market, and the DOJ likely would closely evaluate the competitive impact of a merger that would result in an HHI in that range. Markets having an HHI greater than 1800 are considered to be highly concentrated; there would be serious anti-trust concerns over a proposed transaction that would increase the HHI by more than 100 or 200 points in a highly concentrated market.

Other Considerations in Using Industry Concentration Measures

One should be aware that these measures are influenced by the definition of the relevant market. For example, the automotive industry is not the same as the market for sport utility vehicles. One also must consider the geographic scope of the market, for example, national markets versus local markets.

Hierarchical Levels of Strategy

Strategy can be formulated on three different levels:

- corporate level
- business unit level
- functional or departmental level.

While strategy may be about competing and surviving as a firm, one can argue that products, not corporations compete, and products are developed by business units. The role of the corporation then is to manage its business units and products so that each is competitive and so that each contributes to corporate purposes.

Consider Textron, Inc., a successful conglomerate corporation that pursues profits through a range of businesses in unrelated industries. Textron has four core business segments:

- Aircraft - 32% of revenues
- Automotive - 25% of revenues
- Industrial - 39% of revenues
- Finance - 4% of revenues.

While the corporation must manage its portfolio of businesses to grow and survive, the success of a diversified firm depends upon its ability to manage each of its product lines. While there is no single competitor to Textron, we can talk about the competitors and strategy of each of its business units. In the finance business segment, for example, the chief rivals are major banks providing commercial financing. Many managers consider the business level to be the proper focus for strategic planning.

Corporate Level Strategy

Corporate level strategy fundamentally is concerned with the selection of businesses in which the company should compete and with the development and coordination of that portfolio of businesses.

Corporate level strategy is concerned with:

- Reach - defining the issues that are corporate responsibilities; these might include identifying the overall goals of the corporation, the types of businesses in which the corporation should be involved, and the way in which businesses will be integrated and managed.
- Competitive Contact - defining where in the corporation competition is to be localized. Take the case of insurance: In the mid-1990's, Aetna as a corporation was clearly identified with its commercial and property casualty insurance products. The conglomerate Textron was not. For Textron, competition in the insurance markets took place specifically at the business unit level, through its subsidiary, Paul Revere. (Textron divested itself of The Paul Revere Corporation in 1997.)
- Managing Activities and Business Interrelationships - Corporate strategy seeks to develop synergies by sharing and coordinating staff and other resources across business units, investing financial resources across business units, and using business units to complement other corporate business activities. Igor Ansoff introduced the concept of synergy to corporate strategy.
- Management Practices - Corporations decide how business units are to be governed: through direct corporate intervention (centralization) or through more or less autonomous government (decentralization) that relies on persuasion and rewards.

Corporations are responsible for creating value through their businesses. They do so by managing their portfolio of businesses, ensuring that the businesses are successful over the long-term, developing business units, and sometimes ensuring that each business is compatible with others in the portfolio.

Business Unit Level Strategy

A strategic business unit may be a division, product line, or other profit center that can be planned independently from the other business units of the firm.

At the business unit level, the strategic issues are less about the coordination of operating units and more about developing and sustaining a competitive advantage for the goods and services that are produced. At the business level, the strategy formulation phase deals with:

- positioning the business against rivals
- anticipating changes in demand and technologies and adjusting the strategy to accommodate them
- influencing the nature of competition through strategic actions such as vertical integration and through political actions such as lobbying.

Michael Porter identified three generic strategies (*cost leadership*, *differentiation*, and *focus*) that can be implemented at the business unit level to create a competitive advantage and defend against the adverse effects of the five forces.

Functional Level Strategy

The functional level of the organization is the level of the operating divisions and departments. The strategic issues at the functional level are related to business processes and the value chain. Functional level strategies in marketing, finance, operations, human resources, and R&D involve the development and coordination of resources through which business unit level strategies can be executed efficiently and effectively.

Functional units of an organization are involved in higher level strategies by providing input into the business unit level and corporate level strategy, such as providing information on resources and capabilities on which the higher level strategies can be based. Once the higher-level strategy is developed, the functional units translate it into discrete action-plans that each department or division must accomplish for the strategy to succeed.

Horizontal Integration

The acquisition of additional business activities at the same level of the value chain is referred to as **horizontal integration**. This form of expansion contrasts with vertical integration by which the firm expands into upstream or downstream activities. Horizontal growth can be achieved by internal expansion or by external expansion through mergers and acquisitions of firms offering similar products and services. A firm may diversify by growing horizontally into unrelated businesses.

Some examples of horizontal integration include:

- The Standard Oil Company's acquisition of 40 refineries.
- An automobile manufacturer's acquisition of a sport utility vehicle manufacturer.
- A media company's ownership of radio, television, newspapers, books, and magazines.

Advantages of Horizontal Integration

The following are some benefits sought by firms that horizontally integrate:

- Economies of scale - acheived by selling more of the same product, for example, by geographic expansion.
- Economies of scope - achieved by sharing resources common to different products. Commonly referred to as "synergies."
- Increased market power (over suppliers and downstream channel members)
- Reduction in the cost of international trade by operating factories in foreign markets.

Sometimes benefits can be gained through customer perceptions of linkages between products. For example, in some cases synergy can be achieved by using the same brand name to promote multiple products. However, such extensions can have drawbacks, as pointed out by Al Ries and Jack Trout in their marketing classic, *Positioning*.

Pitfalls of Horizontal Integration

Horizontal integration by acquisition of a competitor will increase a firm's market share. However, if the industry concentration increases significantly then anti-trust issues may arise.

Aside from legal issues, another concern is whether the anticipated economic gains will materialize. Before expanding the scope of the firm through horizontal integration, management should be sure that the imagined benefits are real. Many blunders have been made by firms that broadened their horizontal scope to achieve synergies that did not exist, for example, computer hardware manufacturers who entered the software business on the premise that there were synergies between hardware and software. However, a connection between two products does not necessarily imply realizable economies of scope.

Finally, even when the potential benefits of horizontal integration exist, they do not materialize spontaneously. There must be an explicit horizontal strategy in place. Such strategies generally do not arise from the bottom-up, but rather, must be formulated by corporate management.

Mergers and Acquisitions(Finance)

A **corporate merger** is the combination of the assets and liabilities of two firms to form a single business entity. In everyday language, the term **acquisition** tends to be used when a larger firm absorbs a smaller firm, and **merger** tends to be used when the combination is portrayed to be between equals. In a merger of firms that are approximate equals, there often is an exchange of stock in which one firm issues new shares to the shareholders of the other firm at a certain ratio. For the sake of this discussion, the firm whose shares continue to exist (possibly under a different company name) will be referred to as the acquiring firm and the firm whose shares are being replaced by the acquiring firm will be referred to as the target firm.

Excluding any synergies resulting from the merger, the total post-merger value of the two firms is equal to the pre-merger value. However, the post-merger value of each individual firm likely will be different from the pre-merger value because the exchange ratio of the shares probably will not exactly reflect the firms' values with respect to one another. The exchange ratio is skewed because the target firm's shareholders are paid a premium for their shares.

Synergy takes the form of revenue enhancement and cost savings. When two companies in the same industry merge, such as two banks, combined revenue tends to decline to the extent that the businesses overlap in the same market and some customers become alienated. For the merger to benefit shareholders, there should be cost saving opportunities to offset the revenue decline; the synergies resulting from the merger must be more than the initial lost value.

To calculate the minimum value of synergies required so that the acquiring firm's shareholders do not lose value, an equation can be written to set the post-merger share price equal to the pre-merger share price of the acquiring firm as follows:

$$\frac{\text{(pre-merger value of both firms + synergies)}}{\text{post-merger number of shares}} = \text{pre-merger stock price}$$

The above equation then can be solved for the value of the minimum required synergies.

The success of a merger is measured by whether the value of the acquiring firm is enhanced by it. The practical aspects of mergers often prevent the forecasted benefits from being fully realized and the expected synergy may fall short of expectations.

Positioning(Marketing)

As Popularized by Al Ries and Jack Trout

In their 1981 book, *Positioning: The Battle for your Mind*, Al Ries and Jack Trout describe how **positioning** is used as a communication tool to reach target customers in a crowded marketplace. Jack Trout published an article on positioning in 1969, and regular use of the term dates back to 1972 when Ries and Trout published a series of articles in *Advertising Age* called "The Positioning Era." Not long thereafter, Madison Avenue advertising executives began to develop positioning slogans for their clients and positioning became a key aspect of marketing communications.

Positioning: The Battle for your Mind has become a classic in the field of marketing. The following is a summary of the key points made by Ries and Trout in their book.

Information Overload

Ries and Trout explain that while positioning begins with a product, the concept really is about positioning that product in the mind of the customer. This approach is needed because consumers are bombarded with a continuous stream of advertising, with advertisers spending several hundred dollars annually per consumer in the U.S. The consumer's mind reacts to this high volume of advertising by accepting only what is consistent with prior knowledge or experience.

It is quite difficult to change a consumer's impression once it is formed. Consumers cope with information overload by oversimplifying and are likely to shut out anything inconsistent with their knowledge and experience. In an over-communicated environment, the advertiser should present a simplified message and make that message consistent with what the consumer already believes by focusing on the perceptions of the consumer rather than on the reality of the product.

Getting Into the Mind of the Consumer

The easiest way of getting into someone's mind is to be first. It is very easy to remember who is first, and much more difficult to remember who is second. Even if the second entrant offers a better product, the first mover has a large advantage that can make up for other shortcomings.

However, all is not lost for products that are not the first. By being the first to claim a unique position in the mind the consumer, a firm effectively can cut through the noise level of other products. For example, Miller Lite was not the first light beer, but it was the first to be positioned as a light beer, complete with a name to support that position. Similarly, Lowenbrau was the most popular German beer sold in America, but Beck's Beer successfully carved a unique position using the advertising,

"You've tasted the German beer that's the most popular in America. Now taste the German beer that's the most popular in Germany."

Consumers rank brands in their minds. If a brand is not number one, then to be successful it somehow must relate itself to the number one brand. A campaign that pretends that the market leader does not exist is likely to fail. Avis tried unsuccessfully for years to win customers, pretending that the number one Hertz did not exist. Finally, it began using the line,

"Avis in only No. 2 in rent-a-cars, so why go with us? We try harder."

After launching the campaign, Avis quickly became profitable. Whether Avis actually tried harder was not particularly relevant to their success. Rather, consumers finally were able to relate Avis to Hertz, which was number one in their minds.

Another example is that of the soft-drink 7-Up, which was No. 3 behind Coke and Pepsi. By relating itself to Coke and Pepsi as the "Uncola", 7-Up was able to establish itself in the mind of the consumer as a desirable alternative to the standard colas.

When there is a clear market leader in the mind of the consumer, it can be nearly impossible to displace the leader, especially in the short-term. On the other hand, a firm usually can find a way to position itself in relation to the market leader so that it can increase its market share. It usually is a mistake, however, to challenge the leader head-on and try to displace it.

Positioning of a Leader

Historically, the top three brands in a product category occupy market share in a ratio of 4:2:1. That is, the number one brand has twice the market share of number two, which has twice the market share of number three. Ries and Trout argue that the success of a brand is not due to the high level of marketing acumen of the company itself, but rather, it is due to the fact that the company was first in the product category. They use the case of Xerox to make this point. Xerox was the first plain-paper copier and was able to sustain its leadership position. However, time after time the company failed in other product categories in which it was not first.

Similarly, IBM failed when it tried to compete with Xerox in the copier market, and Coca-Cola failed in its effort to use Mr. Pibb to take on Dr. Pepper. These examples support the point that the success of a brand usually is due to its being first in the market rather than the marketing abilities of the company. The power of the company comes from the power of its brand, not the other way around.

With this point in mind, there are certain things that a market leader should do to maintain the leadership position. First, Ries and Trout emphasize what it should not do, and that is boast about being number one. If a firm does so, then customers will think that the firm is insecure in its position if it must reinforce it by saying so.

If a firm was the first to introduce a product, then the advertising campaign should reinforce this fact. Coca-Cola's "the real thing" does just that, and implies that other colas are just imitations.

Another strategy that a leader can follow to maintain its position is the multibrand strategy. This strategy is to introduce multiple brands rather than changing existing ones that hold leadership positions. It often is easier and cheaper to introduce a new brand rather than change the positioning of an existing brand. Ries and Trout call this strategy a single-position strategy because each brand occupies a single, unchanging position in the mind of the consumer.

Finally, change is inevitable and a leader must be willing to embrace change rather than resist it. When new technology opens the possibility of a new market that may threaten the existing one, a successful firm should consider entering the new market so that it will have the first-mover advantage in it. For example, in the past century the New York Central Railroad lost its leadership as air travel became possible. The company might have been able to maintain its leadership position had it used its resources to form an airline division.

Sometimes it is necessary to adopt a broader name in order to adapt to change. For example, Haloid changed its name to Haloid Xerox and later to simply Xerox. This is a typical pattern of changing *Name 1* to an expanded *Name 1 - Name 2*, and later to just *Name 2*.

Positioning of a Follower

Second-place companies often are late because they have chosen to spend valuable time improving their product before launching it. According to Ries and Trout, it is better to be first and establish leadership.

If a product is not going to be first, it then must find an unoccupied position in which it can be first. At a time when larger cars were popular, Volkswagen introduced the Beetle with the slogan "Think small." Volkswagen was not the first small car, but they were the first to claim that position in the mind of the consumer.

Other positions that firms successfully have claimed include:

- age (Geritol)
- high price (Mobil 1 synthetic engine lubricant)
- gender (Virginia Slims)
- time of day (Nyquil night-time cold remedy)
- place of distribution (L'eggs in supermarkets)
- quantity (Schaefer - "the one beer to have when you're having more than one.")

It most likely is a mistake to build a brand by trying to appeal to everyone. There are too many brands that already have claimed a position and have become entrenched leaders in their positions. A product that seeks to be everything to everyone will end up being nothing to everyone.

Repositioning the Competition

Sometimes there are no unique positions to carve out. In such cases, Ries and Trout suggest repositioning a competitor by convincing consumers to view the competitor in a different way. Tylenol successfully repositioned aspirin by running advertisements explaining the negative side effects of aspirin.

Consumers tend to perceive the origin of a product by its name rather than reading the label to find out where it really is made. Such was the case with vodka when most vodka brands sold in the U.S. were made in the U.S. but had Russian names. Stolichnaya Russian vodka successfully repositioned its Russian-sounding competitors by exposing the fact that they all actually were made in the U.S., and that Stolichnaya was made in Leningrad, Russia.

When Pringle's new-fangled potato chips were introduced, they quickly gained market share. However, Wise potato chips successfully repositioned Pringle's in the mind of consumers by listing some of Pringle's non-natural ingredients that sounded like harsh chemicals, even though they were not. Wise potato chips of course, contained only "Potatoes. Vegetable oil. Salt." As a resulting of this advertising, Pringle's quickly lost market share, with consumers complaining that Pringle's tasted like cardboard, most likely as a consequence of their thinking about all those unnatural ingredients. Ries and Trout argue that is usually is a lost cause to try to bring a brand back into favor once it has gained a bad image, and that in such situations it is better to introduce an entirely new brand.

Repositioning a competitor is different from comparative advertising. Comparative advertising seeks to convince the consumer that one brand is simply better than another. Consumers are not likely to be receptive to such a tactic.

The Power of a Name

A brand's name is perhaps the most important factor affecting perceptions of it. In the past, before there was a wide range of brands available, a company could name a product just about anything. These days, however, it is necessary to have a memorable name that conjures up images that help to position the product.

Ries and Trout favor descriptive names rather than coined ones like Kodak or Xerox. Names like DieHard for a battery, Head & Shoulders for a shampoo, Close-Up for a toothpaste, People for a gossip magazine. While it is more difficult to protect a generic name under trademark law, Ries and Trout believe that in the long run it is worth the effort and risk. In their opinion, coined names may be appropriate for new products in which a company is first to market with a sought-after product, in which case the name is not so important.

Margarine is a name that does not very well position the product it is describing. The problem is that it sounds artificial and hides the true origin of the product. Ries and Trout propose that "soy butter" would have been a much better name for positioning the product as an alternative to the more common type of butter that is made from milk.

While some people might see soy in a negative light, a promotional campaign could be developed to emphasize a sort of "pride of origin" for soy butter.

Another everyday is example is that of corn syrup, which is viewed by consumers as an inferior alternative to sugar. To improve the perceptions of corn syrup, one supplier began calling it "corn sugar", positioning it as an alternative to cane sugar or beet sugar.

Ries and Trout propose that selecting the right name is important for positioning just about anything, not just products. For example, the Clean Air Act has a name that is difficult to oppose, as do "fair trade" laws. Even a person's name impacts his or her success in life. One study showed that on average, schoolteachers grade essays written by children with names like David and Michael a full letter grade higher than those written by children with names like Hubert and Elmer.

Eastern Airlines was an example of a company limited by its name. Air travel passengers always viewed it as a regional airline that served the eastern U.S., even though it served a much wider area, including the west coast. Airlines such as American and United did not have such a perception problem. (Eastern Airlines ceased operations in 1991.)

Another problem that some companies face is confusion with another company that has a similar name. Consumers frequently confused the tire manufacturer B.F. Goodrich with Goodyear. The Goodyear blimp had made Goodyear tires well-known, and Goodyear frequently received credit by consumers for tire products that B.F. Goodrich has pioneered. (B.F. Goodrich eventually sold its tire business to Uniroyal.)

Other companies have changed their names to something more general, and as a result create confusion with other similar-sounding companies. Take for instance The Continental Group, Inc. and The Continental Corporation. Few people confidently can say which makes cans and which sells insurance.

The No-Name Trap

People tend use abbreviations when they have fewer syllables than the original term. GE is often used instead of General Electric. IBM instead of International Business Machines. In order to make their company names more general and easier to say, many corporations have changed their legal names to a series of two or three letters. Ries and Trout argue that such changes usually are unwise.

Companies having a broad recognition may be able to use the abbreviated names and consumers will make the translation in their minds. When they hear "GM", they think "General Motors". However, lesser known companies tend to lose their identity when they use such abbreviations. Most people don't know the types of business in which companies named USM or AMP are engaged.

The same applies to people's names as well. While some famous people are known by their initials (such as FDR and JFK), it is only after they become famous that they begin using their initials. Ries and Trout advise managers who aspire for name recognition to use an actual name rather then first and middle initials. The reason that initials do not lead to recognition is that the human mind works by sounds, not by spellings.

Most companies began selling a single product, and the name of the company usually reflected that product. As the successful firms grew in to conglomerates, their original names became limiting. Ries and Trout advise companies seeking more general names to select a shorter name made of words, not individual letters. For example, for Trans World Airlines, they favored truncating it simply to Trans World instead removing all words and using the letters TWA.

The Free-Ride Trap

A company introducing a new product often is tempted to use the brand name of an existing product, avoiding the need to build the brand from scratch. For example, Alka-Seltzer named a new product Alka-Seltzer Plus. Ries and Trout do not favor this strategy since the original name already in positioned in the consumer's mind. In fact, consumers viewed Alka-Seltzer Plus simply as a better Alka-Seltzer, and the sales of Alka-Seltzer Plus came at the expense of Alka-Seltzer, not from the market share of the competition.

Some firms have built a wide range of products on a single brand name. Others, such as Procter & Gamble have selected new names for each new product, carefully positioning the product in a different part of the consumer's mind. Ries and Trout maintain that a single brand name cannot hold multiple positions; either the new product will not be successful or the original product bearing the name will lose its leadership position.

Nonetheless, some companies do not want their new products to be anonymous with an unrecognized name. However, Ries and Trout propose that anonymity is not so bad; in fact, it is a resource. When the product eventually catches the attention of the media, it will have the advantage of being seen without any previous bias, and if a firm prepares for this event well, once under the spotlight the carefully designed positioning can be communicated exactly as intended. This moment of fame is a one-shot event and once it has passed, the product will not have a second chance to be fresh and new.

The Line Extension Trap

Line extensions are tempting for companies as a way to leverage an existing popular brand. However, if the brand name has become near generic so that consumers consider the name and the product to be one and the same, Ries and Trout generally do not believe that a line extension is a good idea.

Consider the case of Life Savers candy. To consumers, the brand name is synonymous with the hard round candy that has a hole in the middle. Nonetheless, the company introduced a Life Savers chewing gum. This use of the Life Savers name was not consistent with the consumer's view of it, and the Life Savers chewing gum brand failed. The company later introduced the first brand of soft bubble gum and gave it a new name: Bubble Yum. This product was very successful because it not only had a name different from the hard candy, it also had the the advantage of being the first soft bubble gum.

Ries and Trout cite many examples of failures due to line extensions. The consistent pattern in these cases is that either the new product does not succeed, or the original successful product loses market share as a result of its position being weakened by a diluted brand name.

When Line Extensions Can Work

Despite the disadvantages of line extensions, there are some cases in which it is not economically feasible to create a new brand and in which a line extension might work. Some of the cases provided by Ries and Trout include:

- *Low volume product* - if the sales volume is not expected to be high.
- *Crowded market* - if there is no unique position that the product can occupy.
- *Small ad budget* - without strong advertising support, it might make sense to use the house name.
- *Commodity product* - an undifferentiated commodity product has less need of its own name than does a breakthrough product.
- *Distribution by sales reps* - products distributed through reps may not need a separate brand name. Those sold on store shelves benefit more from their own name.

Positioning Has Broad Applications

The concept of positioning applies to products in the broadest sense. Services, tourist destinations, countries, and even careers can benefit from a well-developed positioning strategy that focuses on a niche that is unoccupied in the mind of the consumer or decision-maker.

Ansoff Matrix

To portray alternative corporate growth strategies, Igor Ansoff presented a matrix that focused on the firm's present and potential products and markets (customers). By considering ways to grow via existing products and new products, and in existing markets and new markets, there are four possible product-market combinations. Ansoff's matrix is shown below:

Ansoff Matrix

	Existing Products	New Products
Existing Markets	**Market Penetration**	**Product Development**
New Markets	**Market Development**	**Diversification**

Ansoff's matrix provides four different growth strategies:

- **Market Penetration** - the firm seeks to achieve growth with existing products in their current market segments, aiming to increase its market share.
- **Market Development** - the firm seeks growth by targeting its existing products to new market segments.
- **Product Development** - the firms develops new products targeted to its existing market segments.
- **Diversification** - the firm grows by diversifying into new businesses by developing new products for new markets.

Selecting a Product-Market Growth Strategy

The **market penetration** strategy is the least risky since it leverages many of the firm's existing resources and capabilities. In a growing market, simply maintaining market share will result in growth, and there may exist opportunities to increase market share if competitors reach capacity limits. However, market penetration has limits, and once the market approaches saturation another strategy must be pursued if the firm is to continue to grow.

Market development options include the pursuit of additional market segments or geographical regions. The development of new markets for the product may be a good strategy if the firm's core competencies are related more to the specific product than to its experience with a specific market segment. Because the firm is expanding into a new market, a market development strategy typically has more risk than a market penetration strategy.

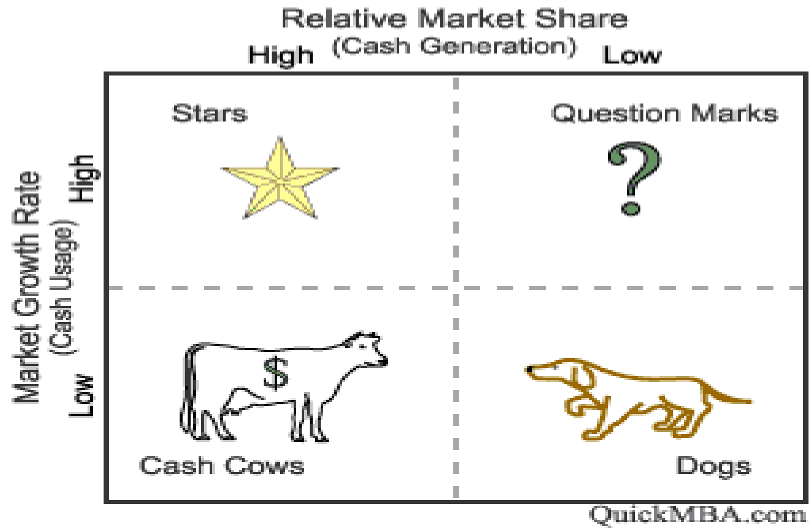
A **product development** strategy may be appropriate if the firm's strengths are related to its specific customers rather than to the specific product itself. In this situation, it can leverage its strengths by developing a new product targeted to its existing customers. Similar to the case of new market development, new product development carries more risk than simply attempting to increase market share.

Diversification is the most risky of the four growth strategies since it requires both product and market development and may be outside the core competencies of the firm. In fact, this quadrant of the matrix has been referred to by some as the "suicide cell". However, diversification may be a reasonable choice if the high risk is compensated by the chance of a high rate of return. Other advantages of diversification include the potential to gain a foothold in an attractive industry and the reduction of overall business portfolio risk.

BCG Growth-Share Matrix

Companies that are large enough to be organized into strategic business units face the challenge of allocating resources among those units. In the early 1970's the Boston Consulting Group developed a model for managing a portfolio of different business units (or major product lines). The **BCG growth-share matrix** displays the various business units on a graph of the market growth rate vs. market share relative to competitors:

BCG Growth-Share Matrix



Resources are allocated to business units according to where they are situated on the grid as follows:

- **Cash Cow** - a business unit that has a large market share in a mature, slow growing industry. Cash cows require little investment and generate cash that can be used to invest in other business units.
- **Star** - a business unit that has a large market share in a fast growing industry. Stars may generate cash, but because the market is growing rapidly they require investment to maintain their lead. If successful, a star will become a cash cow when its industry matures.
- **Question Mark (or Problem Child)** - a business unit that has a small market share in a high growth market. These business units require resources to grow market share, but whether they will succeed and become stars is unknown.
- **Dog** - a business unit that has a small market share in a mature industry. A dog may not require substantial cash, but it ties up capital that could better be deployed elsewhere. Unless a dog has some other strategic purpose, it should be liquidated if there is little prospect for it to gain market share.

The BCG matrix provides a framework for allocating resources among different business units and allows one to compare many business units at a glance. However, the approach has received some negative criticism for the following reasons:

- The link between market share and profitability is questionable since increasing market share can be very expensive.
- The approach may overemphasize high growth, since it ignores the potential of declining markets.
- The model considers market growth rate to be a given. In practice the firm may be able to grow the market.

These issues are addressed by the GE / McKinsey Matrix, which considers market growth rate to be only one of many factors that make an industry attractive, and which considers relative market share to be only one of many factors describing the competitive strength of the business unit.

GE / McKinsey Matrix

In consulting engagements with General Electric in the 1970's, McKinsey & Company developed a nine-cell portfolio matrix as a tool for screening GE's large portfolio of strategic business units (SBU). This business screen became known as the **GE/McKinsey Matrix** and is shown below:

GE / McKinsey Matrix

		Business Unit Strength		
		High	Medium	Low
Industry Attractiveness	High			
	Medium			
	Low			

The GE / McKinsey matrix is similar to the BCG growth-share matrix in that it maps strategic business units on a grid of the industry and the SBU's position in the industry. The GE matrix however, attempts to improve upon the BCG matrix in the following two ways:

- The GE matrix generalizes the axes as "Industry Attractiveness" and "Business Unit Strength" whereas the BCG matrix uses the market growth rate as a proxy for industry attractiveness and relative market share as a proxy for the strength of the business unit.
- The GE matrix has nine cells vs. four cells in the BCG matrix.

Industry attractiveness and business unit strength are calculated by first identifying criteria for each, determining the value of each parameter in the criteria, and multiplying that value by a weighting factor. The result is a quantitative measure of industry attractiveness and the business unit's relative performance in that industry.

Industry Attractiveness

The vertical axis of the GE / McKinsey matrix is industry attractiveness, which is determined by factors such as the following:

- Market growth rate
- Market size
- Demand variability
- Industry profitability
- Industry rivalry
- Global opportunities
- Macroenvironmental factors (PEST)

Each factor is assigned a weighting that is appropriate for the industry. The industry attractiveness then is calculated as follows:

$$
\begin{aligned}
\text{Industry attractiveness} = \; & \text{factor value}_1 \times \text{factor weighting}_1 \\
& + \text{factor value}_2 \times \text{factor weighting}_2 \\
& \;\;. \\
& \;\;. \\
& \;\;. \\
& + \text{factor value}_N \times \text{factor weighting}_N
\end{aligned}
$$

Business Unit Strength

The horizontal axis of the GE / McKinsey matrix is the strength of the business unit. Some factors that can be used to determine business unit strength include:

- Market share
- Growth in market share
- Brand equity
- Distribution channel access
- Production capacity
- Profit margins relative to competitors

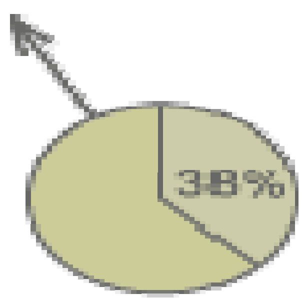
The business unit strength index can be calculated by multiplying the estimated value of each factor by the factor's weighting, as done for industry attractiveness.

Plotting the Information

Each business unit can be portrayed as a circle plotted on the matrix, with the information conveyed as follows:

- Market size is represented by the size of the circle.
- Market share is shown by using the circle as a pie chart.
- The expected future position of the circle is portrayed by means of an arrow.

The following is an example of such a representation:



The shading of the above circle indicates a 38% market share for the strategic business unit. The arrow in the upward left direction indicates that the business unit is projected to gain strength relative to competitors, and that the business unit is in an industry that is projected to become more attractive. The tip of the arrow indicates the future position of the center point of the circle.

Strategic Implications

Resource allocation recommendations can be made to grow, hold, or harvest a strategic business unit based on its position on the matrix as follows:

- **Grow** strong business units in attractive industries, average business units in attractive industries, and strong business units in average industries.
- **Hold** average businesses in average industries, strong businesses in weak industries, and weak business in attractive industies.
- **Harvest** weak business units in unattractive industries, average business units in unattractive industries, and weak business units in average industries.

There are strategy variations within these three groups. For example, within the harvest group the firm would be inclined to quickly divest itself of a weak business in an unattractive industry, whereas it might perform a phased harvest of an average business unit in the same industry.

business unit in the same industry.

While the GE business screen represents an improvement over the more simple BCG growth-share matrix, it still presents a somewhat limited view by not considering interactions among the business units and by neglecting to address the core competencies leading to value creation. Rather than serving as the primary tool for resource allocation, portfolio matrices are better suited to displaying a quick synopsis of the strategic busines

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Global Strategic Management

During the last half of the twentieth century, many barriers to international trade fell and a wave of firms began pursuing global strategies to gain a competitive advantage. However, some industries benefit more from globalization than do others, and some nations have a comparative advantage over other nations in certain industries. To create a successful global strategy, managers first must understand the nature of global industries and the dynamics of global competition.

Sources of Competitive Advantage from a Global Strategy

A well-designed global strategy can help a firm to gain a competitive advantage. This advantage can arise from the following sources:

- **Efficiency**
    - Economies of scale from access to more customers and markets
    - Exploit another country's resources - labor, raw materials
    - Extend the product life cycle - older products can be sold in lesser developed countries
    - Operational flexibility - shift production as costs, exchange rates, etc. change over time
- **Strategic**
    - First mover advantage and only provider of a product to a market
    - Cross subsidization between countries
    - Transfer price
- **Risk**
    - Diversify macroeconomic risks (business cycles not perfectly correlated among countries)
    - Diversify operational risks (labor problems, earthquakes, wars)
- **Learning**
    - Broaden learning opportunities due to diversity of operating environments
- **Reputation**
    - Crossover customers between markets - reputation and brand identification

Sumantra Ghoshal of INSEAD proposed a framework comprising three categories of strategic objectives and three sources of advantage that can be used to achieve them. Assembling these into a matrix results in the following framework:

Strategic Objectives	*Sources of Competitive Advantage*		
	National Differences	**Scale Economies**	**Scope Economies**
Efficiency in Operations	Exploit factor cost differences	Scale in each activity	Sharing investments and costs
Flexibility	Market or policy-induced changes	Balancing scale with strategic & operational risks	Portfolio diversification
Innovation and Learning	Societal differences in management and organization	Experience - cost reduction and innovation	Shared learning across activities

The Nature of Competitive Advantage in Global Industries

A global industry can be defined as:

- An industry in which firms must compete in all world markets of that product in order to survive.
- An industry in which a firm's competitive advantage depends on economies of scale and economies of scope gained across markets.

Some industries are more suited for globalization than are others. The following drivers determine an industry's globalization potential.

1. **Cost Drivers**
    - Location of strategic resources
    - Differences in country costs
    - Potential for economies of scale (production, R&D, etc.) Flat experience curves in an industry inhibits globalization. One reason that the facsimile industry had more global potential than the furniture industry is that for fax machines, the production costs drop 30%-40% with each doubling of volume; the curve is much flatter for the furniture industry and many service industries. Industries for which the larger expenses are in R&D, such as the aircraft industry, exhibit more economies of scale than those industries for which the larger expenses are rent and labor, such as the dry cleaning industry. Industries in which costs drop by at least 20% for each doubling of volume tend to be good candidates for globalization.
    - Transportation costs (value/bulk or value/weight ratio) => Diamonds and semiconductors are more global than ice.

2. **Customer Drivers**
    - Common customer needs favor globalization. For example, the facsimile industry's customers have more homogeneous needs than those of the furniture industry, whose needs are defined by local tastes, culture, etc.
    - Global customers: if a firm's customers are other global businesses, globalization may be required to reach these customers in all their markets. Furthermore, global customers often require globally standardized products.
    - Global channels require a globally coordinated marketing program. Strong established local distribution channels inhibits globalization.
    - Transferable marketing: whether marketing elements such as brand names and advertising require little local adaptation. World brands with non-dictionary names may be developed in order to benefit from a single global advertising campaign.

3. **Competitive Drivers**
    - Global competitors: The existence of many global competitors indicates that an industry is ripe for globalization. Global competitors will have a cost advantage over local competitors.
    - When competitors begin leveraging their global positions through cross-subsidization, an industry is ripe for globalization.

4. **Government Drivers**
    - Trade policies
    - Technical standards
    - Regulations

The furniture industry is an example of an industry that did not lend itself to globalization before the 1960's. Because furniture has a high bulk compared to its value, and because furniture is easily damaged in shipping, transport costs traditionally were high. Government trade barriers also were unfavorable. The Swedish furniture company IKEA pioneered a move towards globalization in the furniture industry. IKEA's furniture was unassembled and therefore could be shipped more economically. IKEA also lowered costs by involving the customer in the value chain; the customer carried the furniture home and assembled it himself. IKEA also had a frugal culture that gave it cost advantages. IKEA successfully expanded in Europe since customers in different countries were willing to purchase similar designs. However, after successfully expanding to several countries, IKEA ran into difficulties in the U.S. market for several reasons:

- Different tastes in furniture and a requirement for more customized furniture.
- Difficult to transfer IKEA's frugal culture to the U.S.
- The Swedish Krona increased in value, increasing the cost of furniture made in Sweden and sold in the U.S.
- Stock-outs due to the one to two month shipping time from Europe
- More competition in the U.S. than in Europe

Country Comparative Advantages

Competitive advantage is a firm's ability to transform inputs into goods and services at a maximum profit on a sustained basis, better than competitors. **Comparative** advantage resides in the factor endowments and created endowments of particular regions. Factor endowments include land, natural resources, labor, and the size of the local population.

In the 1920's, Swedish economists Eli Hecksher and Bertil Ohlin developed the factor-proportions theory, according to which a country enjoys a comparative advantage in those goods that make intensive use of factors that the country has in relative abundance.

Michael E. Porter argued that a nation can create its own endowments to gain a comparative advantage. Created endowments include skilled labor, the technology and knowledge base, government support, and culture. Porter's Diamond of National Advantage is a framework that illustrates the determinants of national advantage. This diamond represents the national playing field that countries establish for their industries.

Types of International Strategy: Multi-domestic vs. Global

Multi-domestic Strategy

- Product customized for each market
- Decentralized control - local decision making
- Effective when large differences exist between countries
- Advantages: product differentiation, local responsiveness, minimized political risk, minimized exchange rate risk

Global Strategy

- Product is the same in all countries.
- Centralized control - little decision-making authority on the local level
- Effective when differences between countries are small
- Advantages: cost, coordinated activities, faster product development

A fully multi-local value chain will have every function from R&D to distribution and service performed entirely at the local level in each country. At the other extreme, a fully global value chain will source each activity in a different country.

Philips is a good example of a company that followed a multidomestic strategy. This strategy resulted in:

- Innovation from local R&D
- Entrepreneurial spirit
- Products tailored to individual countries
- High quality due to backward integration

The multi-domestic strategy also presented Philips with many challenges:

- High costs due to tailored products and duplication across countries
- The innovation from the local R&D groups resulted in products that were R&D driven instead of market driven.
- Decentralized control meant that national buy-in was required before introducing a product - time to market was slow.

Matsushita is a good example of a company that followed a global strategy. This strategy resulted in:

- Strong global distribution network
- Company-wide mission statement that was followed closely
- Financial control
- More applied R&D
- Ability to get to market quickly and force standards since individual country buy-in was not necessary.

The global strategy presented Matsushita with the following challenges:

- Problem of strong yen
- Too much dependency on one product - the VCR
- Loss of non-Asian employees because of glass ceilings

A third strategy, which was appropriate to Whirlpool is one of mass customization, discussed below.

Global Cost Structure Analysis

In 1986, Whirlpool Corporation was considering expanding into Europe by acquiring Philips' Major Domestic Appliance Division. From the framework of customers, costs, competitors, and government, there were several pros and cons to this proposed strategy.

Pros

- Internal components of the appliances could be the same, offering economies of scale.
- The cost to customize the outer structure of the appliances was relatively low.
- The appliance industry was mature with low growth. The acquisition would offer an avenue to continue growing.

Cons

- Fragmented distribution network in Europe.
- Different consumer needs and preferences. For example, in Europe refrigerators tend to be smaller than in the U.S., have only one outside door, and have standard sizes so they can be built into the kitchen cabinet. In Japan, refrigerators tend to have several doors in order to keep different compartments at different temperatures and to isolate odors. Also, because houses are smaller in Japan, consumers desire quieter appliances.
- Whirlpool already was the dominant player in a fragmented industry.

Since Philip's had a relatively small market share in the European appliance market, one must analyze the cost structure to determine if the acquisition would offer Whirlpool a competitive advantage. With the acquisition, Whirlpool would be able to cut costs on raw materials, depreciation and maintenance, R&D, and general and administrative costs. These costs represented 53% of Whirlpool's cost structure. Compared to most other industries, this percentage of costs that could benefit from economies of scale is quite large. It would be reasonable to expect a 10% reduction in these costs, an amount that would decrease overall cost by 5.3%, doubling profits. Such potential justifies the risk of increasing the complexity of the organization.

Because of the different preferences of consumers in different markets, a purely global strategy with standard products was not appropriate. Whirlpool would have to adapt its products to local markets, but maintain some global integration in order to realize cost benefits. This strategy is known as "mass customization."

Whirlpool acquired Philips' Major Domestic Appliance Division, 47% in 1989 and the remainder in 1991. Initially, margins doubled as predicted. However, local competitors responded by better tailoring their products and cutting costs; Whirlpool's profits then began to decline. Whirlpool applied the same strategy to Asia, but GE was outperforming Whirlpool there by tailoring its products as part of its multi-domestic strategy.

Globalizing Service Businesses

Service industries tend to have a flat experience curve and lower economies of scale. However, some economy of scale may be gained through knowledge sharing, which enables the cost of developing the knowledge over a larger base. Also, in some industries such as professional services, capacity utilization can better be managed as the scope of operations increases. On the customer side, because a service firm's customers may themselves be operating internationally, global expansion may be a necessity. Knowledge gained in foreign markets can used to better service customers. Finally, being global also enhances a firm's reputation, which is critical in service businesses.

High quality service products often depend on the service firm's culture, and maintaining a consistent culture when expanding globally is a challenge.

A good example of a service firm that experienced global expansion challenges is the management consulting firm Bain & Company, Inc. In consulting, a firm's most important strategic asset is its reputation, so a consistent firm culture is very important. Bain faced the following challenges, which depend on the firm's strategy and which affect the ability to maintain a consistent culture:

- Coordinating across offices and sharing knowledge
- Whether to hire locals or international staff
- How to compensate

Modes of Foreign Market Entry

An important part of a global strategy is the method that the firm will use to enter the foreign market. There are four possible modes of foreign market entry:

- Exporting
- Licensing (includes franchising)
- Joint Venture
- Foreign Direct Investment

These options vary in their degree of speed, control, and risk, as well as the required level of investment and market knowledge. The entry mode selection can have a significant impact on the firm's foreign market success.

Issues in Emerging Economies

In emerging economies, capital markets are relatively inefficient. There is a lack of information, the cost of capital is high, and venture capital is virtually nonexistent. Because of the scarcity of high-quality educational institutions, the labor markets lack well trained people and companies often must fill the void. Because of lacking communications infrastructure, building a brand name is difficult but good brands are highly valued because of lower product quality of the alternatives. Relationships with government officials often are necessary to succeed, and contracts may not be well enforced by the legal system.

When a large government monopoly (e.g. a state-owned oil company) is privatized, there often is political pressure in the country against allowing the firm to be acquired by a foreign entity. Whereas a very large U.S. oil company may prefer acquisitions, because of the anti-foreign sentiment joint ventures often are more appropriate for outside companies interested in newly privatized emerging economy firms.

Knowledge Management in Global Firms

There is much value in transferring knowledge and best practices between parts of a global firm. However, many barriers prevent knowledge from being transferred:

- Barriers attributable to the knowledge source
    - lack of motivation
    - lack of credibility

- Barriers attributable to the knowledge itself - ambiguity and complexity
- Barriers attributable to the knowledge recipient
  - lack of motivation (not invented here syndrome)
  - lack of absorptive capacity - need prerequisite knowledge to advance to next level
- Barriers attributable to the recipient's existing process - process rigidity
- Barriers attributable to the recipient's external environment and constraints

Furthermore, even when the transfer is successful, there often is a temporary drop in performance before the improvements are seen. During this period, there is danger of losing faith in the new way of doing things.

To facilitate knowledge transfer a firm can:

- Implement processes to systematically identify valuable knowledge and best practices.
- Create incentives to motivate both the knowledge source and recipient.
- Develop absorptive capacity in the recipient - cumulative knowledge
- Develop strong technical and social networks between parts of the firm that can share knowledge.

Country Management

Country managers must have the following knowledge:

- Knowledge of strategic management
- Firm-specific knowledge
- Country-specific knowledge
- Knowledge of the global environment

Country organizations can assume the role of implementor, contributor, strategic leader, or black hole, depending on the combination of importance of the local market and local resources.

Strategic Importance of Local Market	*Level of Local Resources & Capabilities*	
	Low	**High**
Low	Implementor	Contributor
High	Black Hole	Strategic Leader

The least favorable of these roles is the black hole, which is a subsidiary in a strategically important market that has few capabilities. A firm can find itself in this situation because of company traditions, ignorance of local conditions, unfavorable entry conditions, misreading the market, excessive reliance on expatriates, and poor external relations. To get out of a black hole a firm can form alliances, focus its investments, implement a local R&D organization, or when all else fails, exit the country.

Country managers assume different roles (*The New Country Managers*, John A. Quelch, Professor of Business Administration, Harvard Business School).

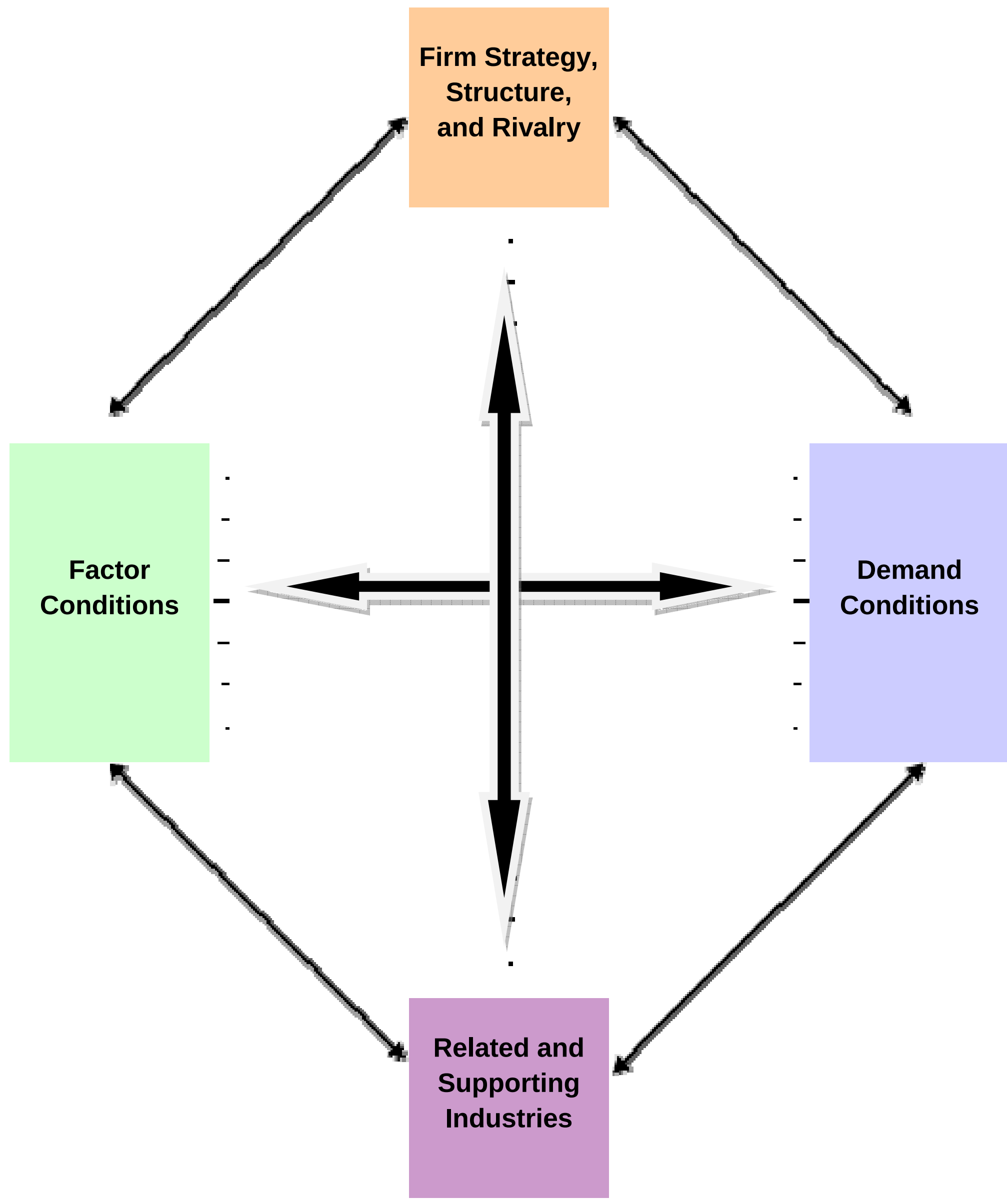
- International Structure: Country manager is a trader who implements policy.
- Multinational Structure: Country manager plays the role of a functional manager with profit and loss responsibilities.
- Transnational Structure: Country manager acts as a cabinet member (team player) since management control systems are standardized and decision-making power is shifted to the region manager. The country manager develops the lead market in his country and transfers the knowledge gained to other similar markets.
- Global Structure: Country manager acts as an ambassador and administrator. In a global firm there usually are business directors who oversee marketing and sales. The role of the country manager becomes one of a statesman. This person usually is a local with good government contacts.

Porter's Diamond of National Advantage

Classical theories of international trade propose that comparative advantage resides in the factor endowments that a country may be fortunate enough to inherit. Factor endowments include land, natural resources, labor, and the size of the local population.

Michael E. Porter argued that a nation can create new advanced factor endowments such as skilled labor, a strong technology and knowledge base, government support, and culture. Porter used a diamond shaped diagram as the basis of a framework to illustrate the determinants of national advantage. This diamond represents the national playing field that countries establish for their industries.

Porter's Diamond of National Advantage



The individual points on the diamond and the diamond as a whole affect four ingredients that lead to a national comparative advantage. These ingredients are:

1. the availability of resources and skills,
2. information that firms use to decide which opportunities to pursue with those resources and skills,
3. the goals of individuals in companies,
4. the pressure on companies to innovate and invest.

The points of the diamond are described as follows.

I. Factor Conditions

- A country creates its own important factors such as skilled resources and technological base.
- The stock of factors at a given time is less important than the extent that they are upgraded and deployed.
- Local disadvantages in factors of production force innovation. Adverse conditions such as labor shortages or scarce raw materials force firms to develop new methods, and this innovation often leads to a national comparative advantage.

II. Demand Conditions

- When the market for a particular product is larger locally than in foreign markets, the local firms devote more attention to that product than do foreign firms, leading to a competitive advantage when the local firms begin exporting the product.

- A more demanding local market leads to national advantage.

- A strong, trend-setting local market helps local firms anticipate global trends.

III. Related and Supporting Industries

- When local supporting industries are competitive, firms enjoy more cost effective and innovative inputs.

- This effect is strengthened when the suppliers themselves are strong global competitors.

IV. Firm Strategy, Structure, and Rivalry

- Local conditions affect firm strategy. For example, German companies tend to be hierarchical. Italian companies tend to be smaller and are run more like extended families. Such strategy and structure helps to determine in which types of industries a nation's firms will excel.

- In Porter's Five Forces model, low rivalry made an industry attractive. While at a single point in time a firm prefers less rivalry, over the long run more local rivalry is better since it puts pressure on firms to innovate and improve. In fact, high local rivalry results in less global rivalry.

- Local rivalry forces firms to move beyond basic advantages that the home country may enjoy, such as low factor costs.

The Diamond as a System

- The effect of one point depends on the others. For example, factor disadvantages will not lead firms to innovate unless there is sufficient rivalry.
- The diamond also is a self-reinforcing system. For example, a high level of rivalry often leads to the formation of unique specialized factors.

Government's Role

The role of government in the model is to:

- Encourage companies to raise their performance, for example by enforcing strict product standards.

- Stimulate early demand for advanced products.

- Focus on specialized factor creation.

- Stimulate local rivalry by limiting direct cooperation and enforcing antitrust regulations.

Application to the Japanese Fax Machine Industry

The Japanese facsimile industry illustrates the diamond of national advantage. Japanese firms achieved dominance is this industry for the following reasons:

- Japanese factor conditions: Japan has a relatively high number of electrical engineers per capita.

- Japanese demand conditions: The Japanese market was very demanding because of the written language.
- Large number of related and supporting industries with good technology, for example, good miniaturized components since there is less space in Japan.
- Domestic rivalry in the Japanese fax machine industry pushed innovation and resulted in rapid cost reductions.
- Government support - NTT (the state-owned telecom company) changed its cumbersome approval requirements for each installation to a more general type approval.

Foreign Market Entry Modes

The decision of how to enter a foreign market can have a significant impact on the results. Expansion into foreign markets can be achieved via the following four mechanisms:

- Exporting
- Licensing
- Joint Venture
- Direct Investment

Exporting

Exporting is the marketing and direct sale of domestically-produced goods in another country. Exporting is a traditional and well-established method of reaching foreign markets. Since exporting does not require that the goods be produced in the target country, no investment in foreign production facilities is required. Most of the costs associated with exporting take the form of marketing expenses.

Exporting commonly requires coordination among four players:

- Exporter
- Importer
- Transport provider
- Government

Licensing

Licensing essentially permits a company in the target country to use the property of the licensor. Such property usually is intangible, such as trademarks, patents, and production techniques. The licensee pays a fee in exchange for the rights to use the intangible property and possibly for technical assistance.

Because little investment on the part of the licensor is required, licensing has the potential to provide a very large ROI. However, because the licensee produces and markets the product, potential returns from manufacturing and marketing activities may be lost.

Joint Venture

There are five common objectives in a joint venture: market entry, risk/reward sharing, technology sharing and joint product development, and conforming to government regulations. Other benefits include political connections and distribution channel access that may depend on relationships.

Such alliances often are favorable when:

- the partners' strategic goals converge while their competitive goals diverge;
- the partners' size, market power, and resources are small compared to the industry leaders; and
- partners' are able to learn from one another while limiting access to their own proprietary skills.

The key issues to consider in a joint venture are ownership, control, length of agreement, pricing, technology transfer, local firm capabilities and resources, and government intentions.

Potential problems include:

- conflict over asymmetric new investments
- mistrust over proprietary knowledge
- performance ambiguity - how to split the pie
- lack of parent firm support
- cultural clashes
- if, how, and when to terminate the relationship

Joint ventures have conflicting pressures to cooperate and compete:

- Strategic imperative: the partners want to maximize the advantage gained for the joint venture, but they also want to maximize their own competitive position.

- The joint venture attempts to develop shared resources, but each firm wants to develop and protect its own proprietary resources.
- The joint venture is controlled through negotiations and coordination processes, while each firm would like to have hierarchical control.

Foreign Direct Investment

Foreign direct investment (FDI) is the direct ownership of facilities in the target country. It involves the transfer of resources including capital, technology, and personnel. Direct foreign investment may be made through the acquisition of an existing entity or the establishment of a new enterprise.

Direct ownership provides a high degree of control in the operations and the ability to better know the consumers and competitive environment. However, it requires a high level of resources and a high degree of commitment.

The Case of EuroDisney

Different modes of entry may be more appropriate under different circumstances, and the mode of entry is an important factor in the success of the project. Walt Disney Co. faced the challenge of building a theme park in Europe. Disney's mode of entry in Japan had been licensing. However, the firm chose direct investment in its European theme park, owning 49% with the remaining 51% held publicly.

Besides the mode of entry, another important element in Disney's decision was exactly where in Europe to locate. There are many factors in the site selection decision, and a company carefully must define and evaluate the criteria for choosing a location. The problems with the EuroDisney project illustrate that even if a company has been successful in the past, as Disney had been with its California, Florida, and Tokyo theme parks, future success is not guaranteed, especially when moving into a different country and culture. The appropriate adjustments for national differences always should be made.

Comparision of Market Entry Options

The following table provides a summary of the possible modes of foreign market entry:

Comparison of Foreign Market Entry Modes

Mode	Conditions Favoring this Mode	Advantages	Disadvantages
Exporting	Limited sales potential in target country; little product adaptation required Distribution channels close to plants High target country production costs Liberal import policies High political risk	Minimizes risk and investment. Speed of entry Maximizes scale; uses existing facilities.	Trade barriers & tariffs add to costs. Transport costs Limits access to local information Company viewed as an outsider
Licensing	Import and investment barriers Legal protection possible in target environment. Low sales potential in target country. Large cultural distance Licensee lacks ability to become a competitor.	Minimizes risk and investment. Speed of entry Able to circumvent trade barriers High ROI	Lack of control over use of assets. Licensee may become competitor. Knowledge spillovers License period is limited
Joint Ventures	Import barriers Large cultural distance Assets cannot be fairly priced High sales potential Some political risk Government restrictions on foreign ownership Local company can provide skills, resources, distribution network, brand name, etc.	Overcomes ownership restrictions and cultural distance Combines resources of 2 companies. Potential for learning Viewed as insider Less investment required	Difficult to manage Dilution of control Greater risk than exporting a & licensing Knowledge spillovers Partner may become a competitor.
Direct Investment	Import barriers Small cultural distance Assets cannot be fairly priced High sales potential Low political risk	Greater knowledge of local market Can better apply specialized skills Minimizes knowledge spillover Can be viewed as an insider	Higher risk than other modes Requires more resources and commitment May be difficult to manage the local resources.