PART 1

Introduction

1 What Is Strategy

CHAPTER 1

What Is Strategy

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Why Study Business Strategy?

Over the past hundred years, the world economy has slowly converged on a single approach to how goods and services are produced and sold–call it market capitalism. Not all countries follow this model–there are a few holdouts. But over time more and more have adopted it as the way to manage their economies. Countries can follow different versions of market capitalism: the United States has one, China has another, Russia a third and France a fourth. But all now share a commitment to the individual firm as the primary institution that makes the system work.

A key underlying principle of market capitalism is competition among firms in a product market. Firms - like IBM, Toyota, Apple, Carrefour, and Lenovo–compete for customers by trying to provide the best product, compared to rivals, at a particular price. In every market, some firms succeed and others fail. But in the hope of success, and in spite of the threat of failure, men and women in capitalist societies are continually driven to compete with new products or ideas, whether in existing or new businesses. The system works because the churning of firms and products in the market, driven by competition, improves

on average how well the people in a country live materially. And so the global economy moves forward.

This book addresses the question of what makes a firm successful. The approach focuses on how firms succeed by attracting customers and at the same time making superior profits, which are necessary to sustain operations and satisfy investors. How the firm does this is called its strategy, a concept which means both where a business is positioned in its market and how it manages to compete within that position.

Since every firm competes in a market, every firm has a strategy, whether explicit or not. Some strategies are simply more profitable than others. This is true no matter what industry the firm is in, or what broader conditions—social or economic—the firm faces.

For example, Wal-Mart competes at the low end of the mass merchandizing market, selling low-price goods. At the same time, Wal-Mart's costs are very low. So even though it offers relatively cheap products, the company does well financially. Target sells slightly fancier merchandise than Wal-Mart and so is more upscale. The question is: Which company is more profitable (in terms of its return on sales)—Wal-Mart at the low end or Target with its higher-value products?. It turns out that Target has higher profitability because on average it offers value to its customers more efficiently. The sources of Target's achievement are the assets, practices, and contracts it has designed and executed consistently. If Wal-Mart could imitate these sources of Target's productivity, there would be horse-race in higher value mass merchandising, leading to lower prices. But so far, because of both inertia and uncertainty in the demand for Target's products, Wal-Mart has remained pretty much at the low end.

We usually put the word *competitive* before strategy to emphasize the persistent rivalry a firm faces in its markets. Because this competition is frequently head-to-head (e.g., Coke versus Pepsi, Intel versus AMD, Boeing versus Airbus), it is sometimes seen as warfare, especially in sales. But overgeneralizing military analogies, however interesting and motivating they may be (e.g., Sun Tzu's teachings, the observe, orient, decide, and act or OODA loop), can be dangerous.[1]

fn 1

Unlike armies, firms have customers. Because they compete for customer accounts, firms don't act like soldiers fighting a battle. For example, competing firms do not confront each other directly, which means that there is no face-to-face contact where one firm tries to kill the other. Customer purchasing decisions determine success and failure, not arms and munitions. It is important to know the competition very well, but attention to the customer comes first. *In fact, without a customer, a firm produces nothing of value at all.*

So, ultimately, the goal of every business is to gain and sustain an advantage over rivals. This means achieving a strong market position and protecting this position from attack by other firms. A strong position produces superior financial returns in the short term, but over time competition will erode these returns by pushing prices down. So both a good *offense*—a strong position—and a good *defense*—effective protection from rivalry—are necessary in the long term, and neither is sufficient. When both exist, the firm is said to have a **sustainable competitive advantage**.

The ultimate proof of a successful strategy is superior profitability, as shown in a firm's financial reports. Financial reports are the scorecard that measures how well a firm performs. Investors pore over these reports in order to decide where to put their money, and managers are rewarded when performance improves. So it is foolish to talk about strategy without paying close attention to how well a firm is doing financially compared to its competitors.

What Defines a Successful Strategy?

No single position in a market is necessary for business success. Some companies compete effectively at the high end of the market by providing superior value to customers through an appealing design, superior functionality, brand equity, or other characteristics. Apple is a good example (see the sidebar on the iPod). Other firms succeed because of their low costs. Wal-mart in mass market merchandising and Nucor in steel are representative of this category.

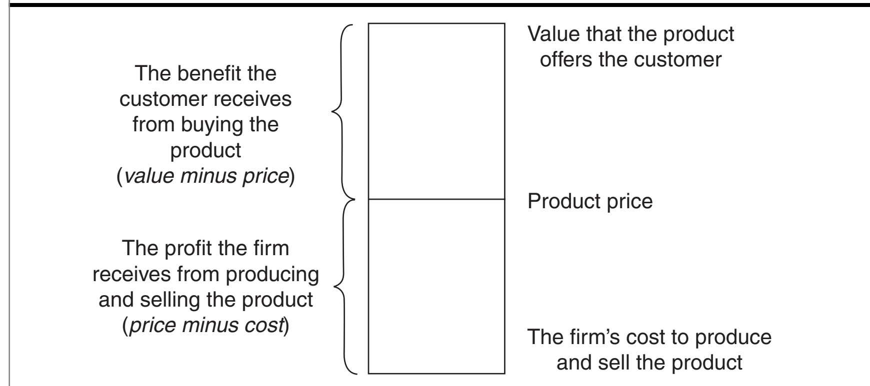
But high value and low cost are the two endpoints of the market. Can a firm succeed somewhere in the middle of this spectrum? The answer is absolutely yes, as the Target example shows. Another good illustration is Dannon Yogurt in the 1990s. Dannon offered the best combination of value offered to the customer and low marginal cost, even as it was flanked on one side of the market by more upscale competitors and on the other side by firms with lower costs.[2] In fact, a firm can succeed anywhere in the market as long as its product attracts enough customers and the firm can sell it at a low enough cost to achieve superior profitability.

fn 2

A good offense starts with an emphasis on the transaction with the customer. The transaction can be broken into two parts: (1) the value of the product to the customer less the price of the product (the bigger the difference, the more customers buy); and (2) the price of the product minus its cost to the firm (the bigger the difference, the more money the firm makes) (see Figure 1.1). Every successful strategy focuses on both of these parts. Some firms emphasize value first (Apple Computer), some cost first (Nucor), and some the combination of value and cost (Dannon Yogurt).

Figure 1

FIGURE 1.1 | The Transaction with the Customer



What about defense? Some firms succeed by focusing on preempting the competition. They do this by swamping the market in the early stages of industry development and then by defending their dominant positions aggressively. A highly illustrative example is Microsoft. A lot has been written about how Microsoft came to dominate PC operating systems, much of it based on antitrust cases in the United States and Europe that began in 1994 and 2000, respectively. These cases focused more on how the company defended its dominant market position than on whether the position was superior to that of competitors. To understand how Microsoft sustained its dominance, we therefore need to lay out how firms protect their market positions from competitors.

A market position can be defended in two ways. The first is to induce high rates of **customer retention** by keeping customers from defecting to rivals. The simple way to do this is to make defection expensive. The higher the **switching costs** a customer must incur in moving to a new product, the longer it is likely to stay with the current product. The second way is making certain that competition for customers is low. This can be accomplished by **preventing imitation**. Imitation is deterred when (1) copying the dominant firm's product is difficult and expensive and (2) the costs of entry into the market are high. Microsoft used both of these defenses—high switching costs and high copying/entry costs—to become dominant in PC operating software.

We study strategy to learn both how businesses develop strong market positions and how they defend these positions once they are built. These two pillars of sustainable competitive advantage are the goal of strategic thinking in any ambitious company. Their combination in a strategy model is a formidable tool for improving financial performance over the long haul.

The Apple iPod

In October 2001, Apple introduced a portable MP3 player called the iPod, a product that almost immediately dominated its market. What has made the iPod so successful? How does Apple maintain its dominance over its competitors in this market? Apple did not invent MP3 technology, nor was the iPod the first MP3 player. In fact, the idea for the iPod did not even originate at Apple. The concept of a player coupled with an online source for music was developed by an independent consultant. Apple hired him and then built a design team around him. Steve Jobs, Apple's CEO, was deeply involved in the iPod's design, much of which was coordinated with a suite of vendors. These included PortalPlayer, which provided the system-on-a-chip core processing unit; Toshiba, which produced the product's original tiny hard drive; and Samsung, which manufactured the memory chip that protects against skips. Apple does not even assemble the iPod; the pieces are put together by Inventec, a Taiwanese firm. So Apple really doesn't do much more than design and market the product, along with managing the whole value chain of partners.

When it was introduced, the first iPod could play more songs and was smaller and lighter than competing MP3 players—but it cost much more: $399 for a 5G disk drive. The iPod's major innovations were its cool design, a 1.8-inch hard drive that held roughly 1,000 songs, and a scroll wheel that allowed the user to choose and manipulate the playlist more effectively than competing machines. The iPod also could download songs from multiple online sources, such as Napster and iTunes.

After the iPod's initial success, Apple moved quickly to expand and improve the product line. A second generation of iPods was introduced in 2002 at lower prices. The scroll wheel technology was enhanced, and the iPod could now link to both Apple computers and Windows-based PCs. Apple launched a third generation in April 2003, and a fourth generation appeared in 2004 with greater disk capacity and extended battery life. Apple also expanded the product line with the iPod mini, the iPod U2, the iPod shuffle, and the iPod Photo. Apple's product variations covered the product space almost completely.

To broaden its distribution channels, in January 2004 Apple formed a partnership with HP to sell HP iPods through retail electronics stores. Further, many companies introduced products to support the iPod. These included docking stations for cars, hookups with home audio systems, microphones for voice recording, holders for bicycles, and upscale speaker systems.

In late 2004, the iPod commanded over 80 percent of the market. Dell, Sony, iRiver, Rio, and Creative introduced competing players, each with innovative features. But none of these could overcome Apple's dominant position.

Why was Apple so successful? Obviously Apple pursued the high end of the market, emphasizing value and not price. Apple bet rightly that the look and feel of the iPod plus its larger storage capacity would overcome any sticker shock. The product's value lay in its aesthetics, its technology (disk storage capacity, scroll wheel), the presence of complementary products (music download sites, speaker systems, docking stations), and probably Apple's brand, which had been enhanced by the increasing popularity of the iMac computer.

Also, the time was ripe for a consumer electronics innovation. Stereo music systems were long past their prime, and the

PC market was mature. Finally, Apple's innovations—expanding the product line and adding more value at each price point—undoubtedly attracted more customers and kept competitors off guard. This ongoing cycle of growth and innovation was essential in Apple's effort to make the iPod the market standard.

The chart below shows the iPod's remarkable rise from early 2003 until the end of 2004. The break between the spring and summer of 2004 is an obvious inflection point. In the last quarter of 2004, the iPod accounted for 46 percent of Apple's revenues.

To sustain sales growth, Apple had to lower its price on the original iPod and introduce cheaper models (the nano and shuffle). From 2005 to 2007, revenues per iPod decreased substantially. At the end of its fiscal year in 2007, Apple reported an average price of $161, down from $202 in 2005. Were the cheaper players as profitable as the more expensive models? Apple does not publish these numbers and guards them very carefully, so it is impossible to know. However, in general, cheaper consumer products have lower margins. So Apple now needs more new products, like the iPhone, to maintain the company's growth rate.

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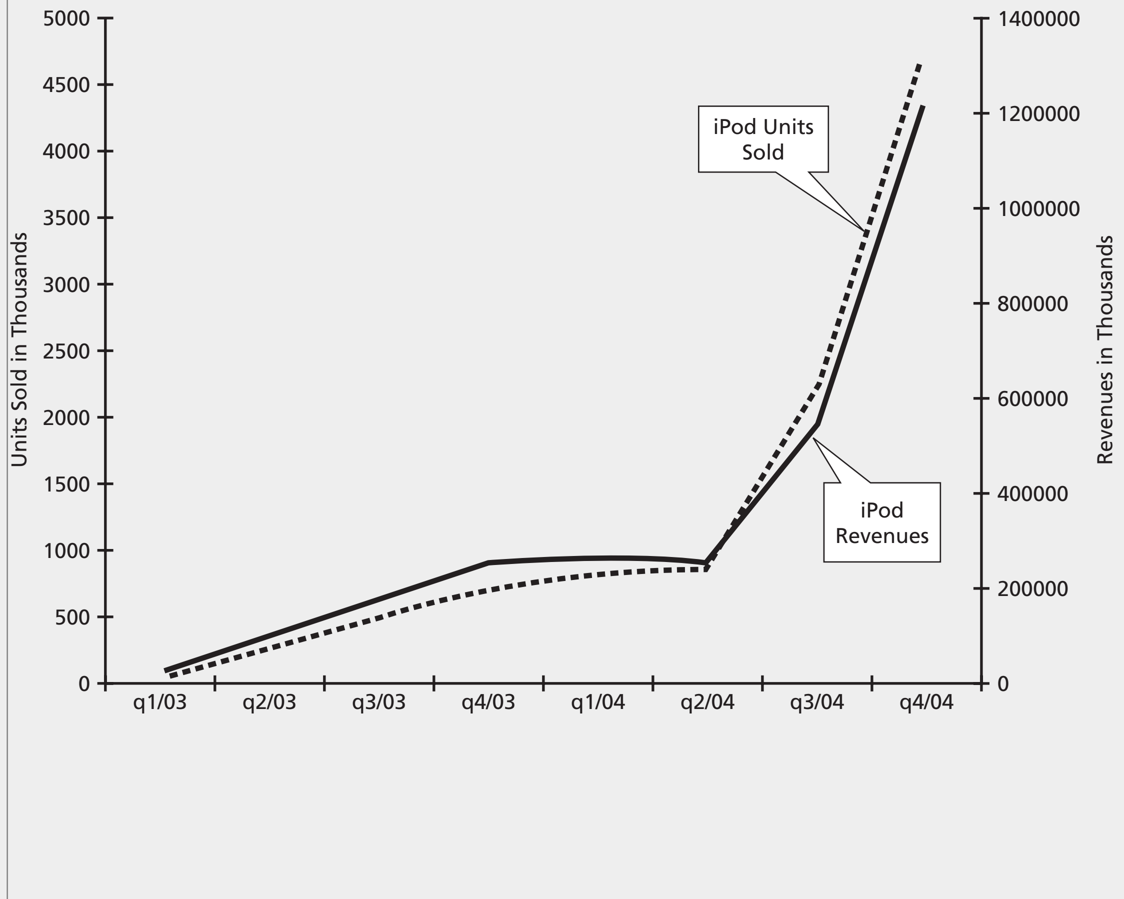

How Important Is Strategy, Really?

To get a sense of the importance of business strategy, we need to understand the full range of factors that affect a firm's profitability. Three types of factors have an impact: (1) macroeconomic forces, such as exchange rates, tax policy, regulation, and the ups and downs of the economy; (2) **industry forces,** such as competition and buyer and supplier power; and finally (3) characteristics of the business itself. Of these three types, research has shown that the firm's unique characteristics are frequently the most important.[3]

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It would be foolish to ignore the effect that the macroeconomic factors have on business profits. When global markets are growing, as they were in the 1990s, firms in many industries make more money simply because demand is strong and products can be sold at higher prices. Sometimes one country can affect the fortunes of an entire region. The rise of China, for example, has been a boon to many companies in Korea, Japan, Taiwan, and the rest of Asia. In contrast, when global markets are weak, prices drop and profits fall. Profits also rise and fall with shifts in the national economy. Regulation and taxes also limit how much money firms can make.

Industry conditions also have an influence on profits. Some industries grow quickly (MP3 players, video games) as others grow slowly (toasters, lawn mowers). Likewise, customers will buy everything firms can produce in one industry, while companies in other industries struggle to sell their products. Some industries can be relatively cheap to enter and are overrun with competition (cattle ranching, money market funds), while the cost of entering other industries is prohibitive (automobiles, aluminum). Even within industries that are hard to enter, firms can fight fiercely for a share of the market (Coke versus Pepsi) or live and let live (the global cement industry). The strength of buyers and suppliers also affects firm performance. The more powerful they are, the more they limit how much money firms can make. In combination, then, these industry forces—competition, entry, buyers, and suppliers—as well as other factors such as substitute products (skis versus snowboards) constrain profits.

Interestingly, in many industries the most important influence on the firm's performance is the firm itself. Firms in the same industry can differ substantially in their resources and capabilities, leading to wide variation in profitability independent of macroeconomic and industry factors. As the examples above (Target, Apple) showed, establishing a successful market position is essential for competitive advantage. Once established, the position must be defended from other firms to prevent price competition, which drives profits down.

The Origins of Strategy

Where did strategy come from as a field of study? Although military theorists such as von Clausewitz and political philosophers such as Machiavelli offer interesting insights about stratagems and the use of power, many other sources of models and frameworks are available. The seven basic sources of thinking about strategy are the following:

- Strategic planning tools.
- Industrial economics.
- Evolutionary economics.
- Case studies of exemplary companies.
- Business and industry history.
- Economic and organizational sociology.
- Institutional economics.

Each of these touches on the question of why some firms are more successful than others. But none provides a wholly satisfying answer. Only viewed as a whole can they give us a reasonable framework for understanding competitive advantage.

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Strategy has evolved in part from planning tools for top managers.[4] Although strategic planning can improve performance markedly, it does not actually determine the array of investments managers choose from. Indeed planning is neither necessary nor sufficient for higher performance. As long as a firm invests in projects that have a higher value than those of competitors, it need not have a formal strategic plan to be successful. However, planning models frequently capture key challenges and therefore can be very useful in identifying strategic problems. Without effective planning, a successful firm in a changing market can lose its advantage very quickly.

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Planning tools without an underlying economic logic lose their benefit very quickly. The most salient discipline that provides these tools is industrial economics.[5] A dominant tradition in industrial economics, developed at Harvard in the 1950s, holds that industry forces, such as the degree of concentration in market shares, constrain what a firm can do. This is the so-called structure-conduct-performance paradigm, which is the basis of Michael Porter's famous book, *Competitive Strategy*.[6] A more recent approach in economics is game theory. Game theory also looks at the behavior of firms in an industry but only in terms of direct competitive interaction. Both these approaches to strategy assume that managers make decisions rationally. This may be true some of the time, but casual observation makes it hard to argue that it is true all the time.

A third tradition in economics that applies to strategy but does not rely on rational decision making is evolutionary economics. Some of the work in this discipline focuses on the evolution of practices within firms and some focuses on the evolution of industries. Much of what is understood about how firms develop capabilities and how industries move through the stages of a life cycle is based on this tradition.[7]

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While neither industrial nor evolutionary economics alone is enough to encompass the discipline of strategy, each makes critical contributions. In this book they are combined with mainstream strategic analysis to cover the key topics for understanding competitive advantage.

A fourth building block of strategy analysis consists of in-depth case studies of exemplary companies.[8] Cases capture the challenges behind the investment decisions that create successful market positions and protect them from competition. Although cases cannot completely explain how a company competes, they provide important insights, especially by showing how firms develop innovations that competitors can't imitate. The concept of a distinctive competence or capability has been derived from case studies and is critical for understanding competitive advantage.

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Business and industry histories have also added significantly to strategy.[9] Because of their scope and detail, firm histories deepen the empirical base from which strategic concepts are formed. By describing competitive behavior over time, historians show how successful market positions have emerged.[10]

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The contributions of economic and organizational sociology to strategy are found in four areas.[11] First, analyses of industry trends, especially rates of firm failure, have shown the relative importance of firm size and age for survival. Second, the internal structures and processes of firms have been analyzed for their relative efficiency and potential for generating innovations. Third, the development of networks of organizations has been analyzed as a strategic resource. Fourth, advantages associated with geographical location have been identified. These contributions are important pieces of the strategy domain.

fn 11

The final building block of strategy is institutional economics, which focuses on the effective governance of the firm's boundaries.[12] Governing the firm's boundary through vertical integration, outsourcing, and partnering is critical for strategy execution and has become important in global industries over the past 30 years. Boundary decisions and the firm's market position are closely tied to each other since where the firm places its boundaries depends crucially on what activities it needs to control in order to succeed with customers.

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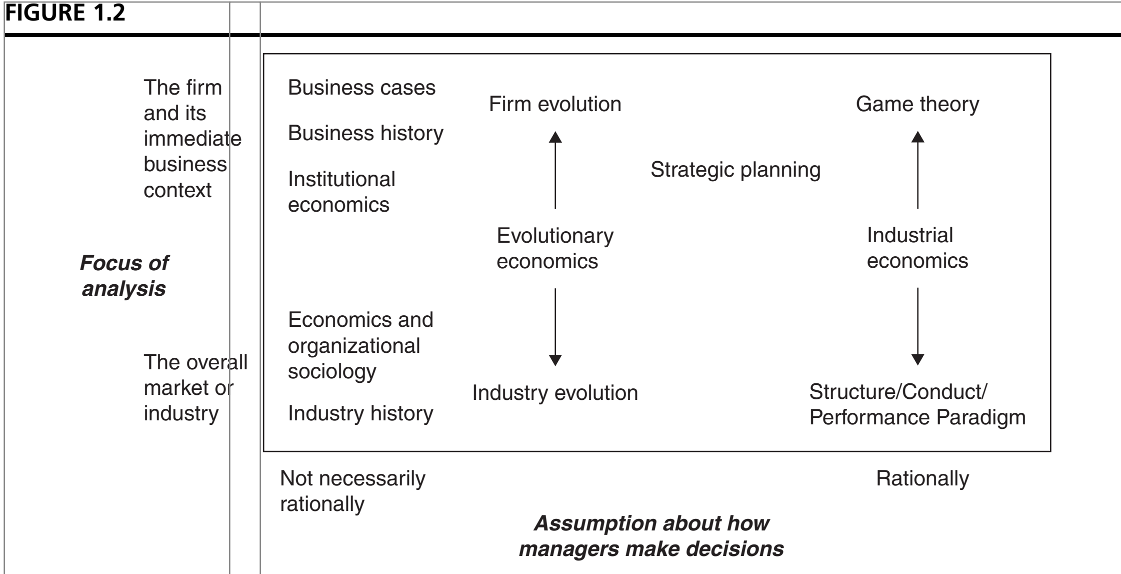
A useful way of organizing these fields is the following chart:[13]

fn 13

Figure 2

FIGURE 1.2



The vertical axis here represents whether the building block of strategic analysis focuses on the firm and its immediate context or on overall industry forces. The horizontal dimension reflects whether the building block assumes that managers make decisions rationally or not. Clearly an understanding of both the industry and the firm are needed to analyze the firm's strategy, and managers can be both highly rational and less than rational as they make strategic choices.

This book therefore covers all of these approaches to strategy as a field of study. The following sections elaborate on several of these strategy topics in greater detail. Each is the focus of a single chapter later in the book.

Strategic Planning and Strategy Execution

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It is often thought that strategy has two stages: **formulation** and **implementation**.[14] Formulation means that managers gather data on the firm's markets and the firm itself, set financial and operating goals, and decide what strategy the firm should follow. Then, in the implementation stage, managers develop and invest in projects to build or buy the assets that are necessary for the strategy to be successful. But do all firms go through these steps? No, they don't.

Not all businesses "formulate" a strategy per se. That is, in some firms managers do not have a well-developed formal process to make decisions on goals or the means to achieve them. *Nonetheless, even without a formulation process, the business competes in a market and therefore has a strategy.*

So in this book, instead of discussing formulation and implementation, we differentiate between strategic planning and strategy execution and discuss them separately. The reason is that distinguishing between planning and execution is closer to what firms actually do.

As a management practice, strategic planning is more specific than strategy formulation (see Chapter 2). Planning models describe in detail the process for developing a business strategy and linking it to operational programs and investments. Strategic planning overlays the financial reporting system by detailing the logic behind cash flow forecasts. Moreover, an effective plan moves the business closer to choosing the best set of projects for improving performance, given the business's market position and competition. The following sidebar presents a representative planning format and its purposes.

Some firms go through a strategic planning process carefully in order to gain more control over their investment decisions. This was a major motivation behind the implementation of strategic planning methods at General Electric in the late 1960s. In fact, because it increases control, planning can be thought of as part of strategy execution, turning the sequential process of formulation and implementation on its head.[15]

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In addition to greater control, firms benefit from strategic planning since it helps them to solve problems and develop innovations. Discussions in a planning process can range across a large number of strategic and operating issues, some of which are not well understood or known. Airing these issues often stimulates the development of creative ways to resolve them.

Planning sessions are also sometimes useful for generating innovative ideas to move the firm in a new strategic direction, whether it is a novel technology, market, or way of organizing. For example, when Royal Dutch Shell used scenarios in its strategic planning, it discovered a radically new approach to predicting market trends. This approach led to a change in the company's investments in refinery capacity, greatly reducing exposure to shifts in demand.[16]

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But a firm doesn't need a plan to have a strategy. Every business executes whatever strategy it has, whether the goals of the firm are stated or not. Strategy execution is ongoing, necessary, and in fact inevitable.[17] Although managers may not articulate (or may not be able to articulate) what determines the firm's cash flows, the factors that determine the firm's profitability can still be identified through careful analysis. As these factors become apparent, the strategy of the business can be apprehended.

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Strategy execution essentially entails the continuous development, maintenance, and improvement of the resources and capabilities that

The Strategic Planning Framework

A strategic plan at the business level typically has the following elements:

- A mission statement that defines the business's scope of business and strategic intent.
- An analysis of the business's industry and market position relative to competitors and a statement of assumptions regarding the competitive environment, frequently involving significant risks
- A statement of the business's financial and operating goals.
- The strategic initiatives necessary to achieve these goals.
- The specific programs necessary to achieve each strategic initiative.

As a practice the strategic planning process should also do the following:

- Act as a tool for management decision making.
- Communicate the organization's strategy without jargon and in a format that is conceptually coherent.
- Generate commitment from employees and motivate their actions.
- Motivate the organization's systems of financial and operating control, including its metrics.
- Be reviewed regularly and in response to unexpected and significant market changes.

are central to the business's market position. This book examines five elements of execution:

- Task design
- Incentives and compensation.
- Control and coordination systems.
- The degree of consistency among the firm's activities.
- The practices related to innovation and the firm's culture.

Each of these contributes towards building the capabilities necessary for achieving a competitive advantage (see Chapter 6).

Effective strategy execution requires that each of these elements reinforces the others. For example, as the three largest major U.S. airlines—American, United, and Delta—attempt to reposition themselves in the market to compete with low-cost carriers such as Southwest, Airtran and JetBlue, they face challenges in all the elements of strategy execution. Compensation contracts must be changed; coordination systems must be altered to promote efficiency; the airline's policies and activities must be redesigned to lower costs; and a host of cultural and human resource issues must be confronted as traditional practices are eliminated. As the airlines shift their market positions, the five elements of strategy execution are paramount.

Industry Analysis

Firms create industries, not the reverse. However, once created, industries can have powerful effects on how well firms perform. The best known and most useful framework for understanding these effects is Michael Porter's five forces framework.[18] These forces–competition, buyers, suppliers, products based on substitute technologies, and the potential for the entry of new firms–all influence how a firm transacts with its customers. For this reason, as mentioned above, every firm must know its industry very well and understand how its forces affect its market position and those of its competitors.

fn 18

The logic underlying industry effects can be appreciated using the value-price-cost representation of the firm's transaction with the customer, as shown in Figure 1.1. An example is powerful buyers. A strong buyer typically wants the firm's product to deliver more value at a lower price. In many cases, providing higher value will force the firm to increase its costs, which combined with a lower price will reduce the firm's profits. Another example is the influence exerted by a potent supplier. Here the firm's costs are driven up as the supplier raises its price. The supplier may also lower the value it offers the firm, which may reduce the value the firm can provide its own customers. Finally, both competition and the threat of entry can drive down prices, benefiting customers but also lowering the firm's profits. In some circumstances, competitors may implicitly or explicitly collude to keep prices from falling. But these situations require special conditions and quite a bit of coordination.

Are all firms in an industry affected equally by industry forces? The answer is no–some have figured out how to protect themselves. They do so by raising switching costs to lower buyer power or by protecting their core technologies and practices from imitation to reduce competition or by partnering with suppliers to mitigate the effects of their power. These are all on the *defense* side of business strategy. So understanding the logic behind industry forces increases the firm's ability to defend its market position and therefore preserve its profits.

Strategy over Time: Growth and Innovation

As new challenges emerge, a firm's strategy must shift to meet them. To compete successfully, a firm must change its size and shape by adding or eliminating products, activities, and people. Without adaptation, profitability declines as new products invade the market with higher value or competitors invest in more efficient processes that allow lower prices. Consequently, successful firms grow over the industry life cycle by maintaining a high level of productivity through innovation (see the

Toyota sidebar). These innovations involve changes in both the determinants of customer value and firm cost as the industry matures.

fn 19

An important concept that captures a firm's ability to grow in the face of change is its dynamic capability.[19] In essence, companies have a dynamic capability when they respond in an effective way repeatedly to changes in the market. Part of this capability involves how accurately managers perceive market trends and part of it entails how efficiently the firm's assets and practices can be transformed to meet new market needs. Both accurate perception and efficient transformation are necessary for a dynamic capability to emerge.

Outsourcing, Vertical Integration, and Strategic Alliances

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Outsourcing is currently a hot topic for businessmen, politicians, and journalists, primarily because of the rise in the past decade of China and India as sources of low-cost labor. Instead of continuing to carry out an activity, like manufacturing or software development, inside the organization, an increasing number of firms have outsourced the activity to companies to take advantage of their lower costs.[20] If the quality of the product manufactured or the software developed is the same as before, the firm benefits from reduced costs. However, if this is not so, then management must make a trade-off: Which is more important—lower cost or higher quality?

This kind of trade-off obviously has an impact on the firm's market position. If the firm's customers are quality sensitive, then poorer quality goods due to outsourcing will lead to a loss of market share. But since the firm makes more money on each sale, because of its lower costs, its overall profits may not decline.

Many companies decide that outsourcing is not worth it and bring the activity back inside the organization. This is the reverse of outsourcing, which can be called "insourcing" or, more commonly, vertical integration. In fact, there is a venerable tradition of analysis regarding vertical integration decisions and, for the most part, the models developed are highly applicable to outsourcing decisions as well.

Strategic alliances between firms are one way firms try to get lower costs but keep quality high. Alliances can be seen as a mixture of both outsourcing and vertical integration. The firms do not own each other, but to a degree they try to achieve the benefits of ownership to improve the joint performance. They accomplish this trick by developing sophisticated methods of control and coordination. An excellent example is the global alliance between Wal-Mart and Procter & Gamble, which helps these firms to reduce costs and improve delivery times.

In this book, we view outsourcing, vertical integration, and alliances as elements of strategy execution. The reason is that the firm

Toyota: Investment in Growth and Innovation Dominates the Competition

Toyota has risen from the ravages of postwar Japan in the late 1940s to become the most successful auto company in the world today. The accompanying figure shows the extent to which Toyota has come to dominate its competitors in terms of productivity over the 30-year period from the late 1960s to the late 1990s.[22] For comparison purposes, the figure also shows the technical efficiency trend for General Motors, the worst performer in the industry. Other firms fall in between Toyota and GM.

What made Toyota such a formidable competitor? Obviously, autos are a relatively mature industry and have not changed much in basic design for roughly 50 years. So Toyota could not have prospered through a design breakthrough. Rather, Toyota is able to design and produce more attractive and higher quality cars at a lower cost than anyone else. The chart shows that Toyota has done this steadily over 40 years. What is Toyota's secret?

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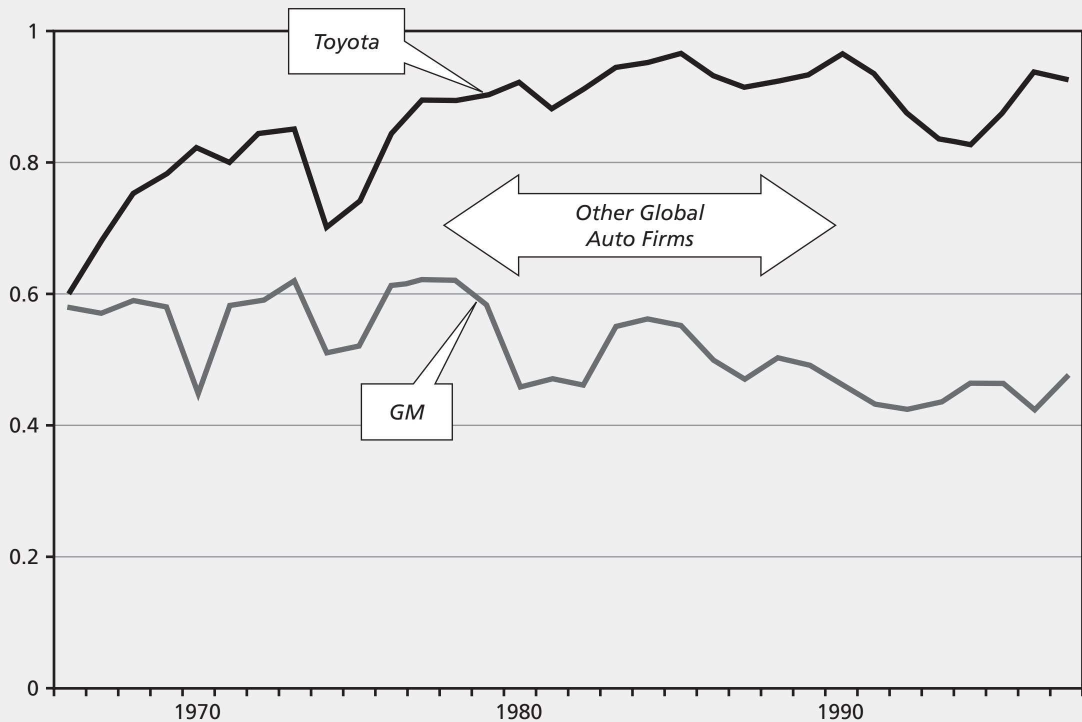

A large part of the answer is the Toyota production system. Developed by Taichi Ohno, Toyota's chief of production after World War II, this system evolved through trial and error by following a number of basic principles. Primary among these were just-in-time production processes, so that inventory within the plant was cut to the barest minimum, and a rule (called *jidoka*) that allowed worker to stop the assembly line whenever an error was found. The goals of the system, pursued relentlessly, were

highest quality, lowest cost, and shortest lead time. Toyota's suppliers integrated their production processes and logistics into this system and adopted its principles. A fundamental tenet underlying Toyota's method was a focus on solving problems scientifically so that they stayed solved. By following these principles, the production system evolved into the most powerful and widely adopted manufacturing model in the world.

At the same time that Toyota has improved its technical efficiency, it seems clear that General Motors' ability to produce high-quality cars at low cost has declined. GM's example shows that a firm can destroy its capabilities as well as build them. The key to understanding the changing fortunes of car companies is therefore how well they manage their investments in growth and innovation: Those that understand the importance of these investments succeed and those that seem to disinvest in innovation become weaker.

must first identify what market position it wants to achieve and defend before it can decide how to make trade-offs between quality and cost. When vertical integration and outsourcing decisions are made in a strategic vacuum, management begins to lose control of the company.

Global Strategy

The popular press has emphasized the increasing globalization of many industries. Is the world becoming "flat" in the sense of more integrated?[21] Or is it becoming more fragmented as nations build comparative advantages in specific industries (China in discrete manufacturing, Italy in fashion, Denmark in wind power)? Or are both trends valid? The answers to these questions have important implications for how firms compete internationally and thus are crucial for strategy development.

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Since global strategy includes a geographical dimension that pertains to both competition among regions (think Silicon Valley) and nation states, it is more complex and in some periods more turbulent than strategy in local markets. Firms that compete internationally therefore can experience arduous strategic challenges. One of the most important of these challenges is separating the benefit the firm receives from geographical location from the benefit it receives from its own assets and practices. Both are variable over time, but the firm's unique characteristics are more under its control. This book lays out the basic frameworks for thinking about global strategy as competition within and across regions and nations.

Strategy in Single and Multibusiness Firms

The strategies of single and multibusiness firms require different types of analysis. Companies like Dell Computer, a firm engaged almost

exclusively in the assembly and sale of personal computers and therefore a single business, obviously face quite different challenges than diversified firms like GE, one of the largest companies in the world. Dell has one business, but GE is composed of six major segments, each of which contains a range of businesses. The GE spectrum stretches from home appliances to a major media unit (NBC/Universal) to financial services.

In contrast to a single business, which makes money by making and selling goods and services in one industry, a multibusiness firm owns and manages a portfolio of businesses and so competes in many industries. The firm's businesses may provide inputs to each other, including capital, technology, materials, and know-how. These inputs substitute for goods and services available in external markets. Multibusiness organizations may also provide their businesses with general management or entrepreneurial skills that help them compete more effectively.

A multibusiness firm continuously faces the question of why its business units are better off under its ownership than they would be if they were in some other multibusiness firm or spun off to be free-standing companies. This problem is partially solved by a well-articulated strategy indicating how the businesses gain from being managed together in the same organization. A strategy may point to how the firm should evolve by adding new companies that would improve the business mix and divesting units that detract from it. The challenges of business diversification and developing strategy in multibusiness firms are elaborated upon later in this book.

Corporate Governance

With the bankruptcies of Enron and WorldCom and the appearance of top management skullduggery at many other companies (Adelphia, Tyco, Quest, and Broadcomm are examples), corporate governance has become a major management issue. Interestingly, it is also a strategic issue since it affects both how firms make critical decisions and influences the value that investors place on firms. The focus of governance inquiries has been almost exclusively on the board of directors: its composition, rules, and behavior.

Two major governance issues have preoccupied regulators, investors, and analysts: 1) board policies that limit the influence of shareholders and 2) senior management compensation. The salience of the first issue has somewhat receded as corporate governance rankings have forced companies to change their policies (no one wants to be singled out as having poor governance). However, the debate over compensation remains highly contentious, even with new SEC rules regarding disclosure. This book lays out the concepts and research findings on this important topic.

Summary

In this chapter we have covered the basic motivations for studying business strategy. We discussed and analyzed a number of firms with superior strategies and presented major strategy topics. We defined the transaction with the customer in terms of the difference between customer value and firm cost, leading to a number of insights related to industry analysis, strategy execution, outsourcing, and global strategy. We discussed the difference between strategy in single business and multibusiness firms, as well as key current issues in corporate governance, and we described the origins of strategy as a field of study. All of the topics presented here will be dealt with in greater depth later in the book.

End Notes

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4. Arnaldo Hax and Nicolas Majluf, *The Strategy Concept and Process: A Pragmatic Approach* (Englewood Cliffs, NJ: Prentice Hall, 1995); and Charles Hofer and Dan Schendel, *Strategy Formulation: Analytical Concepts* (St. Paul, MN: West, 1978).
5. For summaries see Jean Tirole, *The Theory of Industrial Organization* (Cambridge, MA: MIT Press, 1988); F. Michael Scherer and David Ross, *Industrial Market Structure and Economic Performance* (Boston: Houghton Mifflin, 1990); Michael E. Porter, *Competitive Strategy: Techniques for Analyzing Industries and Competitors* (New York: Free Press, 1980); Adam Brandenburger and Barry Nalebuff, *Co-opetition* (New York: Doubleday, 1996); and Pankaj Ghemawat, *Games Businesses Play Cases and Models* (Cambridge, MA: MIT Press, 1997).
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8. See Joseph Bower, *Business Policy: Text and Cases,* 8th ed. (Burr Ridge, IL: McGraw-Hill-Irwin, 1995).

Au: Hofer and Schendel have not previously been referred to; please provide full reference.

9. See Alfred D. Chandler, *Strategy and Structure* (Cambridge, MA: MIT Press, 1962).
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11. For example, Glenn Carroll and Michael Hannan, *The Demography of Corporations and Industries* (Princeton, NJ: Princeton University Press, 1999); and Jay Galbraith, *Organization Design* (Reading, MA: Addison-Wesley, 1977).
12. See Oliver Williamson, *The Economic Institutions of Capitalism* (New York: Free Press, 1985).
13. This chart is based on Giovanni Gavetti and Daniel Levinthal, "The Strategy Field from the Perspective of Management Science: Divergent Strands and Possible Integration," *Management Science* 50 (2004), pp. 1309–18.
14. See Hofer and Schendel, *Strategy Formulation;* J. Galbraith and R. Kazanjian, *Strategy Implementation: Structure, Systems and Process,* 2nd ed. (St. Paul, MN: West, 1986); and Lawrence Hrebiniak, *Making Strategy Work* (Philadelphia, PA; Wharton School, 2005).
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17. See Jack Welch, *Winning* (New York: HarperCollins, 2005).
18. See Michael Porter, "The Five Competitive Forces That Shape Strategy," *Harvard Business Review*, January (2008), pp. 2–17.
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