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6 STRATEGY

LEARNING OBJECTIVES

After Reading this Chapter You Should Be Able to:

1. Define *strategy*.
2. Explain why the goal of strategy is to attain superior performance.
3. Describe what is meant by *competitive advantage*.
4. Explain how business-level strategy can lead to competitive advantage.
5. Explain how operations strategy can lead to competitive advantage.
6. Explain how corporate-level strategy can lead to competitive advantage.

Superior Performance and Competitive Advantage

Business-Level Strategy
Competitive Theme: Differentiation or Low Cost?
Segmenting the Market
Choosing Segments to Serve
Segmentation and Strategy
The Low Cost-Differentiation Frontier

Implementing Business-Level Strategy
Configuring the Value Chain
Competitive Advantage and Strategic Fit

Competitive Tactics
Tactical Pricing Decisions
Tactical Product Decisions

Corporate-Level Strategy
Focus on a Single Business
Vertical Integration
Diversification
International Expansion

In Conclusion: Why Does It Matter?

Management Challenges

Management Portfolio

Closing Case: Google's Quest for Competitive Advantage

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Pile Them High and Sell Them Cheap! Wal-Mart has succeeded by selling general merchandise at a low price in self-service stores that have minimal fixtures and fittings. The company also tightly controls inventory to reduce inventory holding costs.

Wal-Mart is the largest business enterprise on the planet. The company has over 5,000 stores, sales of over $300 billion, and 1.8 million employees. Established in 1962 by the legendary Sam Walton, Wal-Mart made its name by selling general merchandise at everyday low prices. For years Wal-Mart has been more profitable than competitors such as Target and Kmart. The company achieved this by pursuing strategies that lowered its costs, which enabled Wal-Mart to offer low prices and still make healthy profits.[1] To lower costs, Sam Walton's stores were self-service rather than full-service operations, which reduced the number of employees and thus labor costs. The design of the stores was basic, which further reduced costs. Because the early Wal-Mart stores were based in small Southern towns, Sam Walton found it difficult to get suppliers to deliver directly to his stores inexpensively. So he built the first of many Wal-Mart distribution centers. Each distribution center supplied stores within a 300-mile radius. Wal-Mart could now purchase inventory from suppliers in larger lots, storing it at the distribution centers. In return for larger orders, the suppliers lowered prices, which further shrank Wal-Mart's cost structure.

Over the years Walton and his successors also invested in information systems to track what was being sold in the stores daily. Wal-Mart was one of the first retailers in the country to require that all products sold in its stores have bar codes and was the first to install bar code scanners in all checkout stands and link the checkout stands to a centralized computer system. Information gathered by these systems let Wal-Mart manage its inventory more efficiently than rivals. As a result, the company carried less inventory, reducing the amount of space it had to devote to storage and the amount of capital tied up in inventory sitting in distribution centers or stores, all of which took further costs out of Wal-Mart's operations.

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strategy
An action managers take to attain a goal of an organization.

The story of Wal-Mart illustrates how the strategies of an enterprise can enable it to gain a competitive advantage over its rivals. In the last chapter we looked at the planning systems managers use to select strategies. In this chapter we discuss the different strategies managers can choose from. A **strategy** is an action managers take to attain a goal of an organization. In Wal-Mart's case the strategies were directed toward lowering costs. Wal-Mart's emphasis on low cost is an example of what we call a *business-level strategy,* which is the basic theme a company emphasizes to compete effectively with its rivals. However, many of the strategies that have enabled Wal-Mart to lower its costs were undertaken at the operating level of the company. This brings us to a key message of this chapter: *Business-level strategy is implemented through operations and organization.* For Wal-Mart's managers deciding to pursue a low-cost strategy was the easy part. Putting that strategy into effect was hard work and required a set of actions at the operating level—essentially *operating strategies.* As we will see, executing strategy also requires putting the right *organization* in place.

By the early 1990s Wal-Mart had been so successful at driving down costs that it had become the largest retailer in the United States. But now Sam Walton's successor as CEO, David Glass, faced another problem: Wal-Mart's growth opportunities in the United States were limited. What could the company do to continue growing? The answer Glass came up with was twofold. First, Wal-Mart increased the size of its stores so it could start selling groceries in addition to general merchandise. Wal-Mart reasoned that its state-of-the-art distribution and information systems would let the company lower the costs of selling groceries just as it had cut the costs of selling general merchandise. Second, Wal-Mart decided to start expanding internationally. As a result, by 2005 some 26 percent of Wal-Mart's sales came from groceries, and 17 percent of sales were generated from nine countries outside the United States.

Wal-Mart's diversification into the grocery business and international expansion are both examples of *corporate-level strategy,* which is primarily concerned with deciding which businesses and national markets a firm should be competing in. Until the early 1990s Wal-Mart's business was general merchandise retailing, and it operated in one national market, the United States. Since then it has entered the grocery business and nine additional markets, including Mexico, Germany, and the United Kingdom. Wal-Mart, in short, has pursued the corporate-level strategies of diversification and international expansion.

In this chapter we discuss both business-level strategy and corporate strategy. We show what must be done if a firm is to establish a competitive advantage over rivals. We also discuss how a competitive advantage is necessary for a firm to attain its performance goals. We begin by looking at the nature of those performance goals and the concept of competitive advantage. Then we examine the different strategic options managers can choose from.

// Superior Performance and Competitive Advantage

The overriding goal of most organizations is superior performance. For the business firm, superior performance has a clear meaning: It is the ability to generate high profitability and increase profits over time (see Figure 6.1).[2] A central task of managers is to pursue strategies that enable their firm to attain superior performance, measured by profitability and profit growth. This is easier said than done! A principal reason is that firms must compete against rivals for scarce resources. Wal-Mart's success is exemplary precisely because it has been able to outperform rivals such as Kmart and Target over the long haul.

competitive advantage
Advantage obtained when a firm outperforms its rivals.

In general, a business firm is more likely to attain high profitability and solid profit growth if it can outperform its rivals in the marketplace—if it can stay ahead in the race for consumer dollars. When a firm outperforms its rivals, we say that it has a **competitive advantage**. At the most basic level, competitive advantage comes from two sources: (1) the ability of the firm to *lower costs* relative to rivals and (2) the ability to *differentiate* its product offering from that of rivals.[3] As we will see shortly, the business-level strategies a firm can pursue are aimed at lowering costs and better differentiating its products.

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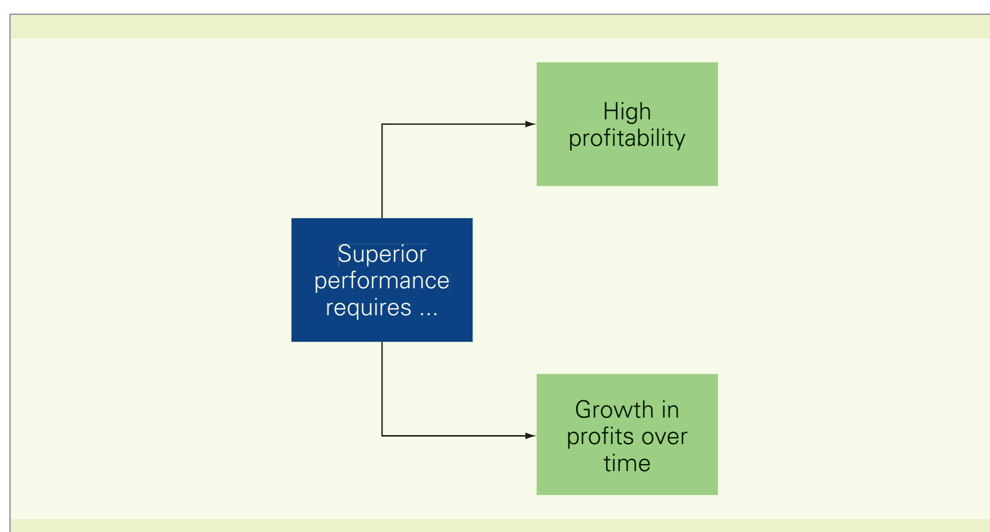

FIGURE 6.1
Superior Performance

If a firm has lower costs than its rivals, other things being equal, it will outperform them. It can charge the same price as its rivals and be more profitable. Alternatively, it might use its low costs to charge less, gain market share, and increase its profits faster than rivals. Or it can do some combination of these two things. Dell Computer, for example, has a competitive advantage over rivals due to its lower cost structure. It has used this low cost structure to cut prices for personal computers, gain market share, and increase its profits faster than rivals. Moreover, due to its low cost structure, Dell can still make good profits at low price points where its rivals lose money.

If a firm has successfully differentiated its products from those of rivals by attributes such as superior design, quality, reliability, after-sales service, and so on, it should also be able to outperform its rivals. It can charge more than rivals but still register significant sales and earn high profits. Alternatively, it can charge a similar price as less differentiated rivals but use the superior appeal of its products to gain market share and increase its profits faster than rivals. Or it can do some combination of these two things. The high-end department store retailer Nordstrom, for example, has differentiated its product offering from that of rivals by the quality of its merchandise and by its superior in-store customer service. This differentiation has let Nordstrom charge more than rivals while capturing more demand and growing its profits faster than rivals over time.

In general, when a firm has a competitive advantage it derives from one or more distinctive competencies. A **distinctive competency** is a unique strength that rivals lack (we discussed the sources of unique strengths in Chapter 2). For example, Dell Computer has a unique strength in using the Internet to coordinate a globally dispersed supply chain to such an extent that the firm holds only two days of inventory at its assembly plants. Because inventory is a major source of costs in the personal computer business, and most of Dell's rivals operate with as much as 30 days of inventory on hand, Dell's distinctive competency in supply chain management helps explain the firm's low cost structure.[4] Nordstrom, in contrast, has a distinctive competency in customer service. Nordstrom's salespeople are the best in the industry at respectfully helping customers purchase clothes that make them look good. Because customer service gives Nordstrom a differential advantage, it can charge higher prices than rivals for the same basic merchandise.

distinctive competency
A unique strength that rivals lack.

When a firm outperforms its rivals for a long time, we say that it has a sustainable competitive advantage. A **sustainable competitive advantage** arises from a distinctive competency that rivals cannot easily match or imitate.[5] For example, rivals find it hard to copy Dell's distinctive competency in supply chain management. Dell's strength here is based on the ability to take orders that flow into its Web site from customers and communicate those instantly via the Internet to its suppliers, wherever in the world they might be located. Rivals like Hewlett-Packard would like to do the same thing, but they cannot because unlike Dell, which sells directly to consumers via its Web site, Hewlett-Packard sells mostly through retailers. Thus Hewlett-Packard lacks the real-time information about sales that Dell has, and thus HP cannot execute supply chain

sustainable competitive advantage
A distinctive competency that rivals cannot easily match or imitate.

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barrier to imitation
Factors that make it difficult for a firm to imitate the competitive position of a rival.

You Won't Find This at Wal-Mart.
A Nordstrom shoe salesman helps a customer find the perfect fit. Superior customer service is one way Nordstrom differentiates itself from rivals. Nordstrom even has "personal shoppers"—dedicated salespeople assigned to important customers. In contrast, Wal-Mart is a self-service store.

management techniques based on access to such information.

A distinctive competency is difficult for rivals to match or imitate when it is protected from copying by a **barrier to imitation**. Barriers to imitation include intellectual property rights (such as patents, trademarks, and copyrights) and processes that are embedded deep within a firm and not easy for rivals to see or copy.[6] For example, a barrier to imitation that makes it difficult for rivals to create products similar to Microsoft Office, the company's suite of productivity programs, is the copyright Microsoft has on the computer code that makes up the Office programs, which rivals cannot directly copy without breaking copyright law. Similarly, 3M has a distinctive competency in innovation that has enabled the company to generate 30 percent of its sales from differentiated products introduced within the last five years. Rivals find this competency difficult to imitate because it is based on *processes* for generating new product ideas and taking those ideas from conception through market introduction. These processes are embedded deep within the organization and not easy to observe. There is, in other words, no code book or book of blueprints a rival can purchase to learn how to operate like 3M.

legacy constraints
Prior investments in a particular way of doing business that are difficult to change and limit a firm's ability to imitate a successful rival.

Legacy constraints can also make it difficult for rivals to imitate a firm's distinctive competency. **Legacy constraints** arise from prior investments in a particular way of doing business that are difficult to change and limit a firm's ability to imitate a successful rival. Hewlett-Packard, for example, has invested in reaching consumers for personal computers through retail channels. This is a legacy constraint that makes it difficult for Hewlett-Packard to adopt quickly the direct selling model that Dell uses—that would require HP to walk away from long-established relationships with retailers. If HP were to do that, it would undoubtedly lose significant sales in the short run as it transitioned its business from selling through retailers to selling direct.

In sum, to achieve superior performance, a firm must have a competitive advantage, which allows a firm to achieve lower costs than rivals and better differentiate its product offering. A competitive advantage is typically based on one or more distinctive competencies or unique strengths that the firm has relative to rivals (see Figure 6.2). That competitive advantage will

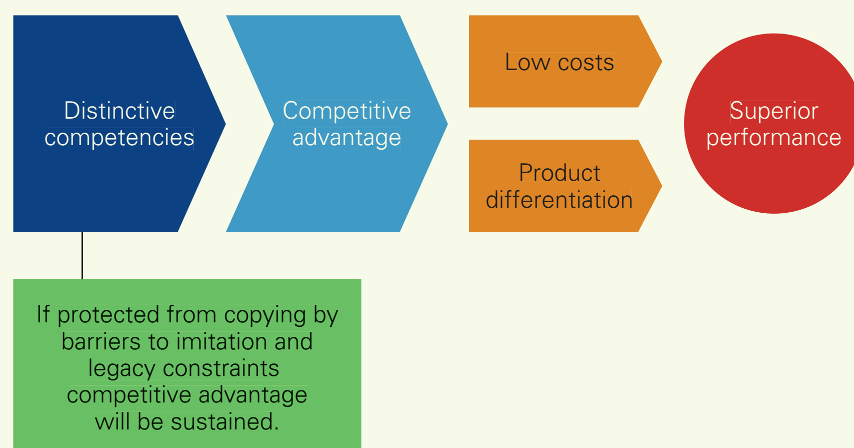

FIGURE 6.2
Competitive Advantage

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be more sustainable if it is difficult for rivals to copy or imitate the firm's distinctive competencies. Barriers to imitation and legacy constraints are important factors that make it difficult for rivals to copy a firm's distinctive competencies.

For managers, the key task is to figure out what they must do to build a distinctive competency in one or more activities to gain a competitive advantage over rivals. Moreover, it is clearly preferable that competency be difficult for rivals to imitate due to barriers to imitation and rivals' legacy constraints. In such circumstances the firm's advantage will be more sustainable. Indeed, without barriers to imitation or legacy constraints rivals will quickly copy any new products or processes that managers develop, and any competitive advantage that derives from those products or processes will be transitory.

// Business-Level Strategy

To build a sustainable competitive advantage managers need a good grasp of business-level strategy. A firm's **business-level strategy** is the basic theme that a company emphasizes to compete effectively with rivals in an industry. A firm's business-level strategy encompasses three related choices: the competitive theme that managers emphasize, how to segment the market within an industry, and which segments to serve.

business-level strategy
Strategy concerned with deciding how a firm should compete in the industries in which it has elected to participate.

// COMPETITIVE THEME: DIFFERENTIATION OR LOW COST?

Basic business-level strategy is concerned with making the choice between low cost and differentiation. We have already noted that these are two distinct ways of gaining a competitive advantage. So basic are these two strategic orientations that Michael Porter, who wrote one of the classic books on competitive strategy, has referred to them as "generic strategies".[7]

Low-Cost Strategy A **low-cost strategy** is concerned with giving consumers value for money and focusing managerial energy and attention on doing everything possible to lower the costs of the organization. Wal-Mart, Dell Inc., and Southwest Airlines are all examples of firms that have pursued a low-cost strategy. All three enterprises focus on offering basic goods and services at a reasonable price, and they try to produce those goods and services as efficiently as possible. Thus Wal-Mart's stores have minimal fixtures and fittings, are self-service rather than full-service, and sell merchandise at a discounted price. Unlike its rivals, Dell does not invest heavily in R&D to produce leading-edge computers. Rather, it sells good machines at a discounted price. Similarly, Southwest Airlines provides its customers with minimal in-flight service in an attempt to lower costs and thus support inexpensive ticket prices.

low-cost strategy
Focusing managerial energy and attention on doing everything possible to lower the costs of the organization.

The successful pursuit of a low-cost strategy lets a firm charge less than its rivals and still make profits. Moreover, firms that charge lower prices might also be able to gain market share—as Dell, Wal-Mart, and Southwest Airlines have all done—which allows them to realize **economies of scale** (cost advantages derived from a large sales volume) and reap further cost reductions. Thus firms that successfully pursue a low-cost strategy can set up a value cycle similar to that illustrated in Figure 6.3, which lets them consolidate their cost advantage over time.

economies of scale
Cost advantages derived from a large sales volume.

Differentiation Strategy A **differentiation strategy** is concerned with increasing the value of a product offering in the eyes of consumers. A product can be differentiated by superior reliability (it breaks down less often or not at all), better design, superior functions and features, better point-of-sale service, better after-sales service and support, better branding, and so on. Thus a Rolex watch is differentiated from a Timex watch by superior design, functions, features, and reliability; a Toyota car is differentiated from a General Motors car by superior reliability (new Toyota cars have fewer defects than new GM cars); Nordstrom differentiates itself from Wal-Mart by the quality of its products (such as Armani suits), numerous in-store sales personnel that can help even the most fashion-challenged individual dress well, and a store design that creates a luxurious shopping atmosphere.

differentiation strategy
Increasing the value of a product offering in the eyes of consumers.

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Cost Cutters By relentlessly taking steps to lower costs Chairman Michael Dell and CEO Kevin Rollins have made Dell Inc. the most profitable enterprise in the personal computer industry. In the early 2000s Dell took advantage of its low-cost position to launch a price war and gain market share from its rivals.

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If consumers value a differentiated product offering over that sold by rivals, a differentiation strategy will give the firm a competitive advantage so it can capture more consumer demand. For example, Starbucks has successfully differentiated its product offering from that of rivals such as Tully's by the excellent quality of its coffee-based drinks; the quick, efficient, and friendly service its baristas offer customers; the comfortable atmosphere created by the design of its stores; and its strong brand image. This differentiation has given Starbucks more of the market for coffee-based drinks.

Having differentiated their product, the issue facing managers is how best to translate the competitive advantage that comes from successful differentiation into sustained high profitability and profit growth. Complicating the issue is the fact that differentiation often (but not always) raises the cost structure of the firm. It costs Starbucks quite a lot, for example, to purchase, roast, and brew premium coffee, to train its baristas, and to furnish its stores.

One option managers have is to raise prices to reflect the differentiated nature of the product offering and cover any increase in costs (see Figure 6.4). This is an option that many pursue. It can by itself enhance profitability so long as prices increase more than costs. For example, the Four Seasons chain has luxurious hotels. It costs a lot to provide that luxury, but Four Seasons also charges high prices for its rooms, and the firm is profitable as a result.

However, greater profitability and profit growth can also come from the increased demand associated with successful differentiation, which allows the firm to use its assets more efficiently and thereby simultaneously realize lower costs from scale economies.

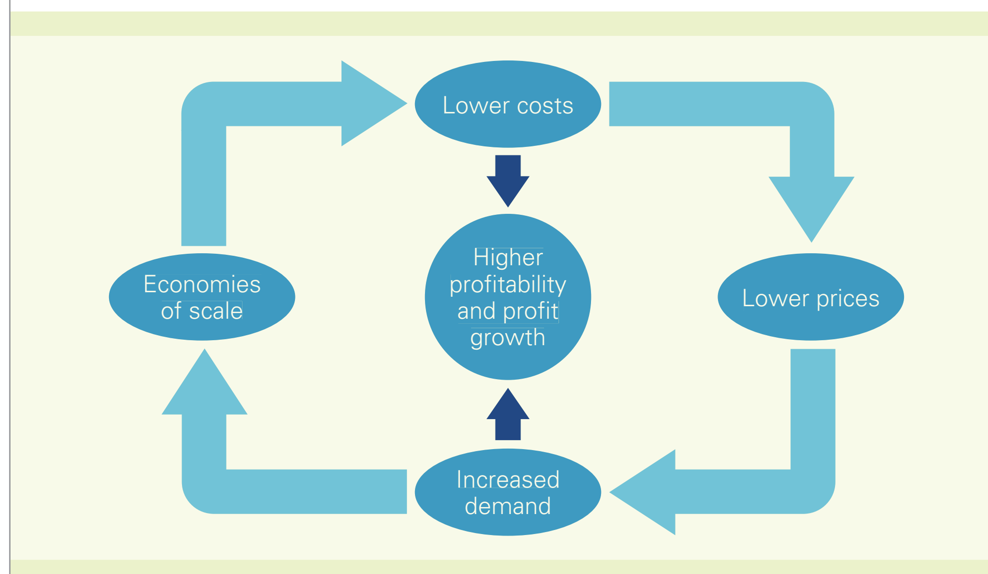

FIGURE 6.3
The Low-Cost Value Cycle

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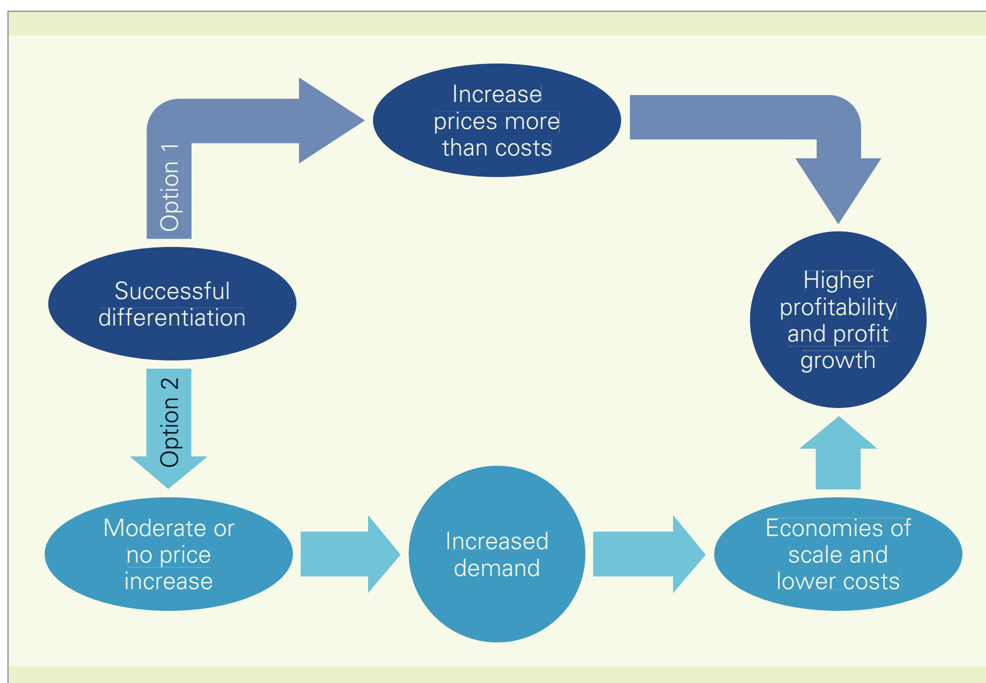

FIGURE 6.4
Options for Exploiting Differentiation

This leads to another option: The successful differentiator can also hold prices constant (or increase prices only slightly), sell more, and boost profitability through scale economies (see Figure 6.4).[8] Thus successful differentiation by Starbucks raises the volume of traffic in each Starbucks store, thereby increasing the productivity of employees in the store (they are always busy) and the productivity of the capital invested in the store itself. So each store realizes scale economies from greater volume, which lowers the average costs at each store. Spread that across the 6,000 stores that Starbucks operates, and you have potentially huge cost savings that translate into higher profitability. Add this to the enhanced demand that comes from successful differentiation, which in the case of Starbucks enables the firm not only to sell more from each store but also to open more stores, and profit growth will also accelerate.

// SEGMENTING THE MARKET

Markets are characterized by different types of consumers. Some are wealthy, some are not; some are old, some are young; some are influenced by popular culture, some never watch TV; some care deeply about status symbols, other do not; some place a high value on luxury, some on value for money. Markets can be segmented by a variety of factors, common examples being the income, demographics, preferences, and tastes of consumers. Moreover, different enterprises can segment the same market in different ways, and various approaches might be reasonable. Take the retail market for apparel: Wal-Mart's clothing department targets lower-income, value-conscious consumers looking for basic clothing; Chico's targets value-conscious, middle-income and middle-aged women with an eye for fashion; Abercrombie & Fitch targets the casual fashion-conscious youth market; Brooks Brothers' targets middle- and upper-income male business executives with a taste for stylish formal business attire; Eddie Bauer targets middle- and upper-income consumers who are looking for stylish casual clothing with an outdoor theme; Victoria's Secret targets…well, never mind! These different approaches all represent different ways of segmenting the market—by value preferences, income, age, tastes, and so on.

There is no single best way of segmenting a market; but in terms of attaining a competitive advantage, some approaches to segmentation make more sense. At a minimum, a segment

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must have enough demand to be served profitably. There are no apparel retailers, for example, who target a segment consisting of sedentary old white males who like to dress in the baggy athletic clothing favored by rap musicians; there are not enough potential consumers in that segment to make it profitable to serve.

Beyond this commonsense notion, there may be value in segmenting the market in a unique way that distinguishes the firm from rivals. Costco, the fast-growing discount warehouse store, targets relatively affluent value-conscious consumers. We tend to think of warehouse stores as offering merchandise at a deep discount from normal prices (they are pursuing a low-cost strategy). Costco indeed does that; but the merchandise the firm sells can be high-end, from Polo brand shirts that would normally retail for $70, which Costco might offer for $40, to $40,000 diamond rings that Costco sells for $25,000. As one Costco executive told this author, "We can offer Polo shirts at a deep discount and our customer will recognize the value and snap them up, buying 10 at a time. Wal-Mart could do the same thing, and their customers wouldn't recognize the value, and they would not be able to sell them."[9] Costco attracts a different type of customer because it has segmented the market differently than Wal-Mart. Costco's product offering reflects its managers' decisions about how best to segment the market.

Generalizing from the Costco example, segmenting the market in a unique but economically viable way can be a good starting point in the quest to build a sustainable competitive advantage. It is not necessary to segment the market uniquely, however. Toyota has segmented the automobile market conventionally (according to income and age), but it still has a competitive advantage. When segmenting the market, managers must have a clear idea of the consumers they are trying to serve, what the needs of those consumers are, and how the business is going to serve those needs.

// CHOOSING SEGMENTS TO SERVE

Having decided how to segment the market, managers must decide which segments to serve. Some enterprises focus on a few segments or just one. Others serve a broad range of segments. In the automobile industry, Toyota has brands that address the entire market: Scion for budget-constrained, young, entry-level buyers; Toyota for the middle market; and Lexus for the luxury end of the market. In each of these segments Toyota pursues a differentiation strategy; it tries to differentiate itself from rivals in the segment by the excellent reliability and high perceived quality of its offerings. In contrast, Porsche focuses exclusively on the top of the market, targeting wealthy middle-aged male consumers who have a passion for the speed, power, and engineering excellence associated with its range of sports cars. Porsche is clearly pursuing a differentiation strategy with regard to these segments, although it emphasizes a different type of differentiation than Toyota. When managers decide to serve a limited number of segments, or just one segment, we say that they are pursuing a **focus strategy**. When they decide to serve the entire market, they are pursuing a **broad market strategy**.

focus strategy
Serving a limited number of segments.

broad market strategy
Serving the entire market.

// SEGMENTATION AND STRATEGY

We have suggested that there are three dimensions to business-level strategy: the competitive theme managers emphasize (low cost or differentiation), the way they choose to segment the market, and the segments they serve. Taken together, these dimensions allow a variety of different ways to compete in an industry. Figure 6.5 summarizes two of these dimensions—competitive theme and segments served. Also included in Figure 6.5 are some illustrative examples chosen from the U.S. retail industry.

Broad low-cost and broad differentiation strategies aim to serve many segments in an industry and strive for either a low-cost or a differentiated position. Focused low-cost and focused differentiation strategies focus on one or a few specific segments and strive to attain a low-cost or differentiation position *relative to that segment.* However, Figure 6.5 does not capture the full richness of business-level strategy. Various businesses may segment the

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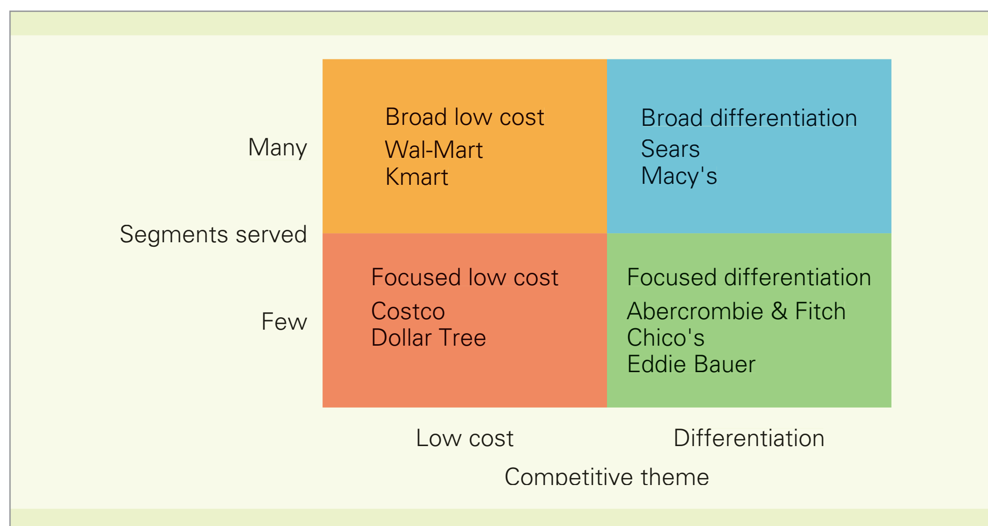

FIGURE 6.5
Types of Business-Level Strategy

market differently and focus on disparate segments. Although Costco and Dollar Tree are both shown as focused low-cost businesses in the retail industry, they compete in very different spaces. All of the merchandise in a Dollar Tree store is priced at a dollar or less. Dollar Tree sells a lot of small household items at deep discounts to low-income consumers. In contrast, as already noted, Costco sells higher-end items at a deep discount to middle- and high-income value-conscious consumers. Costco customers do not usually enter Dollar Tree stores and vice versa.

// THE LOW COST–DIFFERENTIATION FRONTIER

So far we have suggested that low-cost positions and differentiated positions are two different ways of gaining competitive advantage. The enterprise that is striving for the lowest costs does everything it can to cut costs out of its operations, whereas the enterprise striving for differentiation necessarily has to bear higher costs to achieve that differentiation. Put simply, a firm cannot simultaneously be Wal-Mart and Nordstrom, Porsche and Kia, or Rolex and Timex. Managers must choose between these basic ways of attaining competitive advantage.

However, presenting the choice between differentiation and low costs in these terms is something of a simplification. In practice, the strategic issue facing managers is what position to choose on a continuum that is anchored at one end by very low costs and at the other by a very high level of differentiation. To understand this issue, look at Figure 6.6. Its convex curve illustrates what is known as an *efficiency frontier.*[10] The efficiency frontier shows all the different positions a firm can adopt with regard to differentiation and low cost assuming that its internal operations are configured efficiently to support a particular position. (Note that the horizontal axis in Figure 6.6 is reverse scaled—moving along the axis to the right implies lower costs.) For an enterprise to reach the efficiency frontier—to have a competitive advantage and achieve superior performance—it must have unique strengths or distinctive competencies that rivals inside the frontier lack and that enable it to operate efficiently.

The efficiency frontier has a convex shape because of *diminishing returns*: When a firm already has significant differentiation built into its product offering, increasing differentiation by a relatively small amount requires significant additional costs. The converse also holds: When a firm already has a low cost structure, it has to give up a lot of differentiation in its product offering to get additional cost reductions.

The efficiency frontier shown in Figure 6.6 is for the U.S. retail apparel business (Wal-Mart sells more than apparel, but that need not concern us here). As you can see, Nordstrom and Wal-Mart are both shown on the frontier, implying that both organizations have configured their internal operations efficiently. However, they have adopted different

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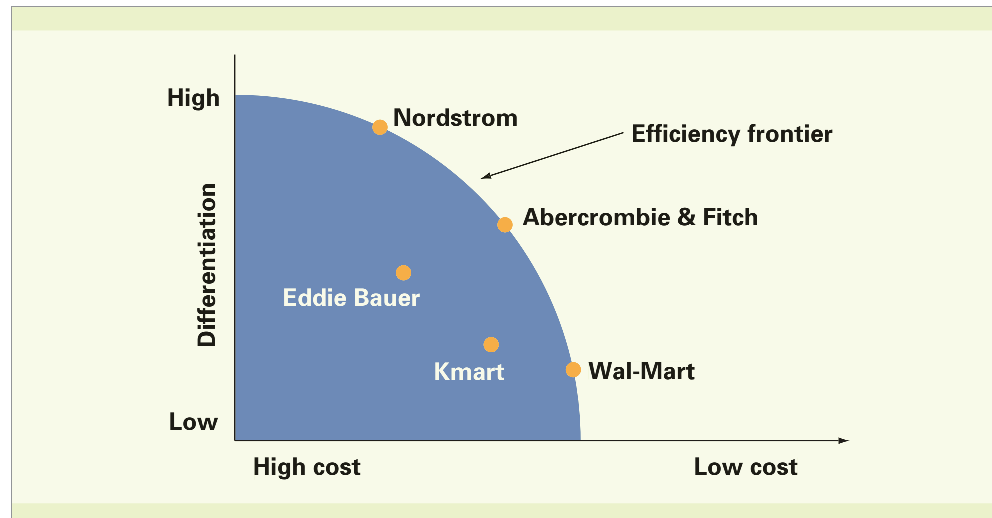
FIGURE 6.6

The Efficiency Frontier in Retail Apparel



strategic positions. Nordstrom has high differentiation and high costs (it is pursuing a differentiation strategy), whereas Wal-Mart has low costs and low differentiation (it is pursuing a low-cost strategy). These are not the only viable positions in the industry. We have also shown Abercrombie & Fitch on the frontier. Abercrombie & Fitch offers higher-quality apparel than Wal-Mart, sold in a more appealing store format; but its offering is nowhere near as differentiated as that of Nordstrom, and it is positioned between Wal-Mart and Nordstrom. This midlevel position, offering moderate differentiation at a higher cost than Wal-Mart, makes sense because there is a large enough segment of consumers that demand this kind of offering.

Often multiple positions on the low cost–differentiation continuum are viable in the sense that they have enough demand to support an offering. The strategic task for managers is to identify a viable position in the industry and then configure the enterprise's internal operations as efficiently as possible, to enable the firm to reach the frontier. Not all firms can do this. Only firms that can get to the frontier have a competitive advantage.

Not all positions on an industry's efficiency frontier are equally as attractive. At some positions there may not be sufficient demand to support a product offering. At other positions too many competitors may be going after the same consumers (the competitive space might be too crowded), and the resulting competition might drive prices down below levels that are acceptable.

In Figure 6.6 Kmart is shown inside the frontier. Kmart is trying to position itself in the same space as Wal-Mart, but its internal operations are not efficient. Indeed, the company was operating under bankruptcy protection in the early 2000s (it is now out of bankruptcy). Also shown in Figure 6.6 is the Redmond, Washington-based clothing retailer Eddie Bauer, which is owned by Spiegel. Like Kmart, Eddie Bauer is not currently run efficiently relative to its rivals, and its parent company is operating under bankruptcy protection.

Value Innovation

Using Innovation to offer more value at a lower cost than competitors

Value Innovation The efficiency frontier in an industry is not static; it is continually being pushed outward by the efforts of managers to improve their firms' performance.[11] The companies that push out the efficiency frontier can offer more value to their customers (through enhanced differentiation) at lower cost than their rivals—a process sometimes referred to as *value innovation.*[12] Dell Computer has achieved value innovation in the personal computer industry (see Figure 6.7). In the 1980s when other computer firms were selling through retailers, Michael Dell pioneered the practice of selling direct. By the mid-1990s Dell was selling over the Internet, and today 85 percent of its home PCs are sold this way. A great advantage of this strategy for customers is that they can customize their PCs, mixing and matching components to get just what they want. Thus by adopting a direct selling business model, Dell differentiated itself from competitors, offering its customers more value.

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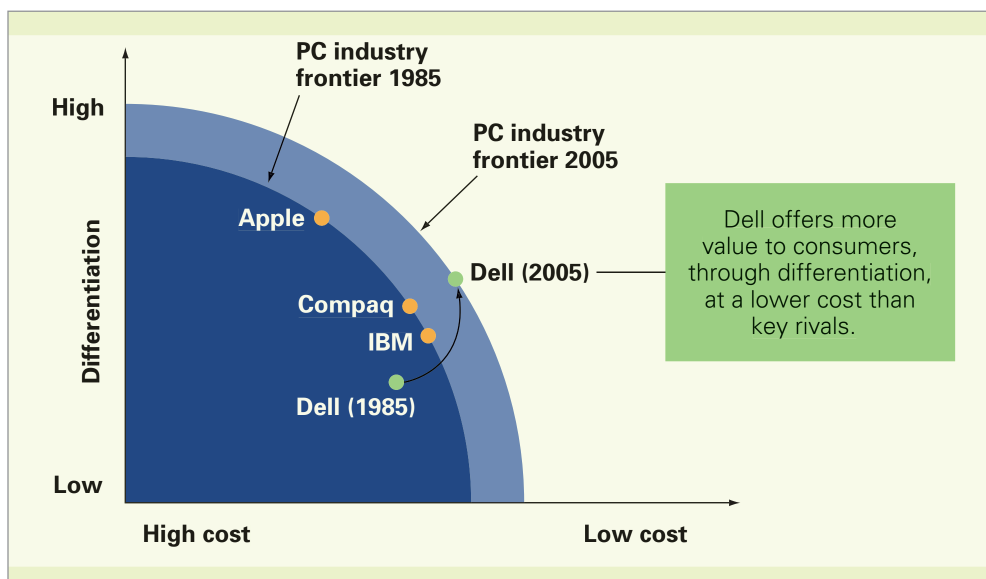

FIGURE 6.7
Pushing out the Efficiency Frontier through Value Innovation

The direct selling strategy has also had far-reaching implications for Dell's costs. Because it sells direct, Dell can build to order. Unlike competitors, it does not have to fill a retail channel with inventory. Moreover, Dell can use the Internet to feed real-time information about order flow to its suppliers so they have up-to-the-minute information about demand trends for the components they produce, along with volume expectations for the upcoming 4–12 weeks. Dell's suppliers use this information to adjust their own production schedules, manufacturing just enough components for Dell's needs and shipping them by the most appropriate mode to arrive just in time for production. Dell's ultimate goal is to drive all inventories out of the supply chain apart from those actually in transit between suppliers and Dell, effectively replacing inventory with information. Although it has not yet achieved this goal, it has driven down inventory to the lowest level in the industry. Dell has about two days of inventory on hand, compared to 20–30 at competitors such as Hewlett-Packard and Gateway. This is a major source of competitive advantage in the computer industry, where component costs account for 75 percent of revenues and the value of components falls by 1 percent per week due to rapid obsolescence. Thus by pioneering online selling of PCs, and by using information systems to coordinate its supply chain, Dell Computer has attained new levels of operational efficiency.

In essence, Dell has built new distinctive competencies, and in doing so has pushed out the efficiency frontier in the personal computer industry. Dell now offers more differentiation (the ability to customize a PC when placing an order on the Web) at lower cost than its rivals can offer. In industry after industry this is how competition proceeds: Firms compete by developing superior competencies that enable them to push out the efficiency frontier, stranding rivals at a competitive disadvantage. It follows that a central strategic task of managers is to look for ways of improving operating efficiency and enhancing value through differentiation in order to take the enterprise to a new level of excellence.

// Implementing Business-Level Strategy

We have just seen that reaching the efficiency frontier in an industry, given managers' choice of strategic position, requires efficient operations. Moreover, in the long run sustaining a competitive advantage requires managers to continually improve operational efficiency, thereby pushing out the efficiency frontier and staying ahead of rivals in a race that has no end. To grasp this we need to dig a little deeper into the nature of operations and consider how operational excellence can help an enterprise build distinctive competencies and thus lower costs or better differentiate its product offering. We return to operational strategy in Chapter 7, when we discuss some of these issues in more depth.

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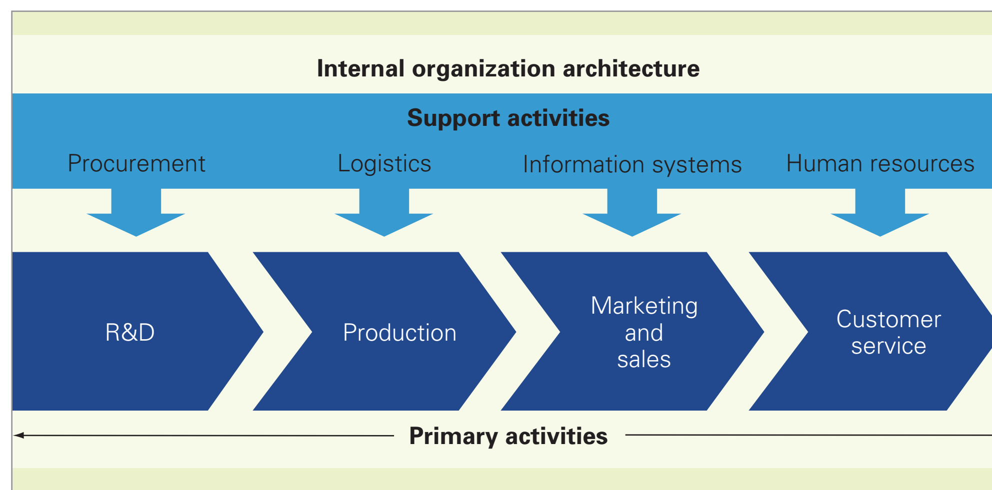
FIGURE 6.8
The Value Chain



// CONFIGURING THE VALUE CHAIN

The operations of a firm can be thought of as a value chain composed of a series of distinct activities including production, marketing and sales, logistics, R&D, human resources, information systems, and the firm's infrastructure. We can categorize these activities, or operations, as *primary activities* and *support activities* (see Figure 6.8).[13] We use the term *value chain* because each activity adds value to the product offering. These operations are embedded within the internal organization architecture of a firm, which includes the organization structure, controls, incentives, culture, and people of the enterprise. Organization architecture provides the context within which operations take place.

Primary Activities
Actives having to do with the design, creation, and delivery of the product; its marketing; and its support and after sales service.

Primary Activities Primary activities have to do with the design, creation, and delivery of the product; its marketing; and its support and after-sale service. Following normal practice, in the value chain illustrated in Figure 6.8 the primary activities are divided into four functions: research and development, production, marketing and sales, and customer service.

Research and development (R&D) is concerned with the design of products and production processes. Although we think of R&D as being associated with the design of physical products and production processes in manufacturing enterprises, many service companies also undertake R&D. Banks compete with each other by developing new financial products and new ways of delivering those products to customers. Online banking and smart debit cards are two examples of new product development in the banking industry. Through superior product design, R&D can increase the functionality of products, which makes them more attractive to consumers (increasing differentiation). Alternatively, R&D may result in more efficient production processes, thereby cutting production costs. Either way, the R&D function can help create a competitive advantage.

Production creates a good or service. For physical products, when we talk about production we generally mean manufacturing. Thus we can talk about the production of an automobile. For services such as banking or health care, production typically occurs when the service is delivered to the customer (such as when a bank originates a loan for a customer). For a retailer such as Wal-Mart, production includes selecting the merchandise, stocking the store, and ringing up sales at cash registers. Production can help a firm create competitive advantage through efficiency or greater differentiation.

The marketing and sales functions can help a firm attain a differentiated or low-cost position in several ways. Through brand positioning and advertising, marketing can affect consumers' perceptions of how differentiated a firm's product offering is. If consumers have a favorable impression of a firm's products, the firm can charge more or expand sales volume. For example, Ford produces a high-value version of its Ford Expedition SUV. Sold as the

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Lincoln Navigator and priced around $10,000 higher, the Navigator has the same body, engine, chassis, and design as the Expedition. But through skilled advertising and marketing, supported by some fairly minor features changes (such as more accessories and the addition of a Lincoln-style engine grille and nameplate), Ford has fostered the perception that the Navigator is a luxury SUV. This marketing strategy has increased the perceived differentiation of the Navigator relative to the Expedition, and Ford can charge a higher price for the car.

Marketing and sales can also create value by discovering consumer needs and communicating them back to the R&D function of the company, which can then design products that better match those needs. For example, the allocation of research budgets at Pfizer, the world's largest pharmaceutical company, is determined by the marketing function's assessment of the potential market size associated with solving unmet medical needs. Thus Pfizer is currently directing significant funds to R&D efforts aimed at finding treatments for Alzheimer's disease, principally because marketing has identified the treatment of Alzheimer's as a major unmet medical need.

Caption t/k

The role of a firm's service activity is to provide after-sale service and support. This function can create a perception of superior differentiation in the minds of consumers by solving customer problems and supporting customers after they have purchased the product. Caterpillar, the U.S.-based manufacturer of heavy earth-moving equipment, can get spare parts to any point in the world within 24 hours, thereby minimizing the amount of downtime its customers have to suffer if their Caterpillar equipment malfunctions. This is an extremely valuable capability in an industry where downtime is expensive. It has helped increase the value that customers associate with Caterpillar products and thus the price that Caterpillar can charge.

Support Activities The support activities of the value chain provide inputs that allow the primary activities to occur (see Figure 6.8). In terms of attaining competitive advantage, they can be as important, if not more important, than the primary activities of the firm. The procurement function is responsible for purchasing inputs to the production process, including raw materials, partly finished products, and in the case of retailers, items for resale. Procurement can lower costs by getting the best deals and by leveraging buying power to lower the price paid for inputs. Procurement can also help increase differentiation by purchasing higher-quality inputs. The logistics function controls the transmission of physical materials through the value chain, from procurement through production and into distribution. The efficiency with which this is carried out can significantly reduce costs. As noted earlier, logistics is a major source of Wal-Mart's competitive advantage.

Support Activities
Activities that provide inputs that allow the primary activities to occur.

The human resources function can help create competitive advantage in a number of ways. It ensures that the company has the right mix of skilled people to perform its value creation activities effectively. Wal-Mart, for example, uses local managers to run Wal-Mart's stores and logistics operations in countries outside the United States. The thinking behind this is that local managers will have a better feel for the tastes and preferences of local customers than expatriate managers from the United States. Insofar as this improves the fit between Wal-Mart's merchandising and local tastes, it should result in higher sales. The human resources function also ensures that people are adequately trained, motivated, and compensated to perform their value creation tasks.

Information systems are the electronic systems for managing inventory, tracking sales, pricing products, selling products, dealing with customer service inquiries, and so on.

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Information systems, when coupled with the communications features of the Internet, can alter the efficiency and effectiveness with which a firm manages other activities in the value chain. Again, Wal-Mart's competitive advantage is based largely on its pioneering use of information systems to track store sales. This tracking capability means that Wal-Mart is almost never caught with too much or too little of a certain item. This reduces Wal-Mart's need to hold extensive buffer inventory, which reduces inventory costs, and makes sure that Wal-Mart never has to hold sales to unload excess inventory, keeping prices from having to be reduced.

Organization Architecture As already noted, the operations of the firm are embedded within the internal organization architecture of the enterprise, which includes the organization structure, incentives, control systems, people, and culture of the firm. In a real sense strategy is implemented through organization architecture. Because organization architecture is so important to strategy implementation and the attainment of competitive advantage, we discuss it in depth in Part 3 of this book. For now note that if a firm is to attain competitive advantage, its organization architecture must support its operations and enable it to successfully implement its strategy.

For example, if a firm is trying to become a low-cost industry player, it should have an organization architecture that focuses the attention of everyone within the enterprise on the need to drive down costs. Thus Wal-Mart operates with a very flat organization structure (there are few layers between the head office and individual stores). Unlike most other large national retailers, the company has no regional offices. It sees regional offices as an additional cost, so it has cut them out, preferring to manage the entire U.S. operations from its headquarters in Arkansas. Wal-Mart also has an organizational culture that emphasizes the need to contain costs. At important norm at Wal-Mart is that when senior managers travel from headquarters to visit stores, they should share hotel rooms and stay in budget hotels to save costs. Another norm is that they should return from each trip with enough ideas to cover the cost of the trip. These norms are designed to emphasize the importance of controlling costs. In other words, the organization architecture of Wal-Mart supports the company's strategy, which is to drive down costs, and its operations, which again are geared toward maximizing efficiency.

// COMPETITIVE ADVANTAGE AND STRATEGIC FIT

If a business enterprise is to attain superior performance, its business-level strategy (as captured by its desired strategic position on the efficiency frontier) must make sense given industry conditions (for example, there must be sufficient demand to support that strategic choice). Operations must be configured in a way that supports the strategy, and the internal organization architecture must support the operations and strategy of the firm. In other words, as illustrated in Figure 6.9, industry conditions, strategy, operations, and organization must all be consistent with each other, or *fit* each other, for competitive advantage to be attained and superior performance to occur. Moreover, the operations and organization of the firm must give it a distinctive competency in one or more activities of the value chain. Without unique and valuable skills, a firm will not be able to outperform rivals.

The issue of strategic fit is actually more complex than illustrated in Figure 6.9. The firm can influence industry conditions through its choice of strategy. For example, by launching a price war in their industry, a firm's managers can make the industry conditions they face more hostile, and that might require a fundamental change of strategy. Alternatively, through their choice of strategy managers can reduce the intensity of competition in their industry, making it more favorable. In addition, shifts in market conditions caused by new technologies, government action such as deregulation, demographics, or social trends can mean that the strategy of the firm no longer fits the industry. In such circumstances the firm must change its strategy, operations, and organization to fit the new reality. This can be an extraordinarily difficult challenge. We discuss the management of change in depth in Chapter 18.

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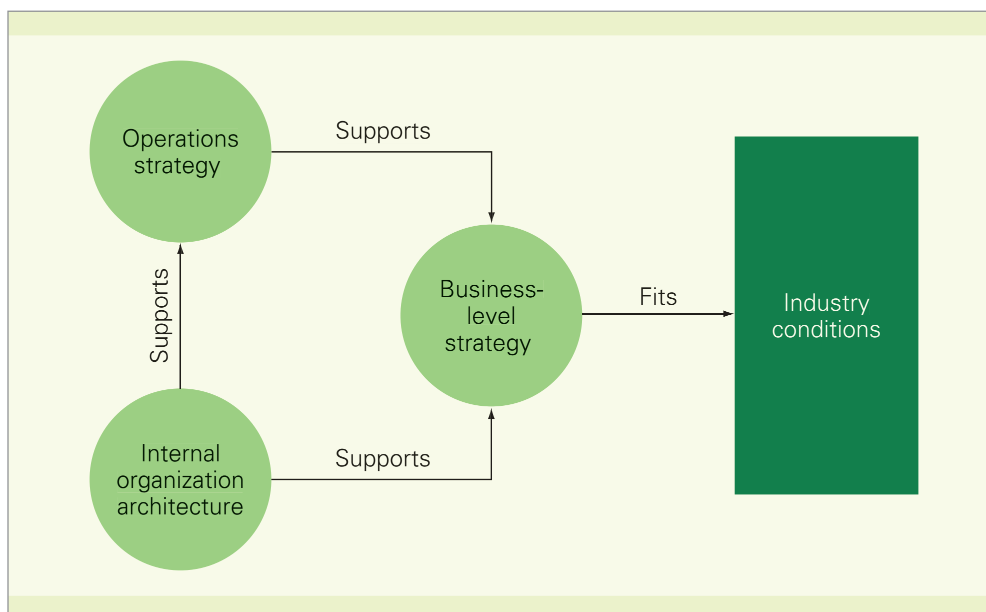

FIGURE 6.9
Strategic Fit

// Competitive Tactics

The **competitive tactics** of an enterprise are actions that managers take to try to outmaneuver rivals in the marketplace.[14] Whereas the business-level *strategy* of an enterprise represents its basic competitive theme and tends to be pursued for a long time, *tactics* are individual actions taken to gain advantage over rivals or even to inhibit rivals from emerging in the first place, thereby making it easier to attain competitive advantage. Competitive tactics can be short-term maneuvers or longer-term actions, but they are always about gaining a better market position relative to actual or potential rivals. Tactics include decisions about pricing and product offerings. We review some here to give you an idea of what tactics encompass.

competitive tactics
Actions that managers take to try to outmaneuver rivals in the market.

// TACTICAL PRICING DECISIONS

Managers can make a number of different tactical pricing decisions. Launching a *price war* to gain share from competitors is one example of a tactical pricing decision. This is what Dell Computer did in 2000–2001 when it took advantage of its low cost structure to drive down the prices of personal computers and gain share from its major rivals. A variant of this tactic is *price signaling,* such as cutting prices when new competitors enter the market to send a signal to potential rivals that they will have a tough fight if they wish to gain share. When discount airlines such as Jet Blue started to expand into profitable routes served by American Airlines, American responded by slashing prices. Not only did this make it more difficult for Jet Blue to gain a foothold; it also sent a signal to other discount airlines that American would not give up its market share easily. American's hope, of course, was that such actions would deter future entry.

Another common tactical pricing decision is *razor and razor blade pricing,* so called because it was pioneered by razor manufacturer Gillett. Gillett's idea was to price razors low (at cost) to sell them to consumers, then make money from the sale of blades, which were priced high. Today Hewlett-Packard uses this tactic in the market for ink jet printers and supplies. HP prices its ink jet printers low (some can be purchased for under $100) and makes little profit on these sales. However, the company charges a high price for ink cartridges for the printers (often over $30) and makes high profit margins on these. The strategy works because once consumers have purchased the ink jet printers they are tied into those products by high switching costs (the cost of buying a printer from another company) and so are likely to continue buying HP ink cartridges.

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Product Proliferation Walk into a supermarket and you will see dozens of different varieties of cereal; yet the industry is dominated by just four firms—Kellogg, General Mills, Post, and Quaker. Each manufacturer has proliferated its brands to occupy as much shelf space as it can, thereby shutting out competitors and creating an entry barrier.

// TACTICAL PRODUCT DECISIONS

As with pricing, managers can pursue a wide range of tactical product decisions to gain an advantage over rivals. One tactic, known as *product proliferation,* has been successfully pursued by the manufacturers of laundry detergent. Walk down the aisle of your local supermarket and you will see many different laundry detergent brands. Most of these brands are produced by just two firms, Unilever and Procter & Gamble. They produce a wide range of different brands to supply any variant of laundry detergent consumers might wish to buy—powdered detergent, liquid detergent, colorfast detergent, detergent with fabric softener, and so on—and thus occupy all of the shelf space in a supermarket, limiting the opportunities for market entry by new rivals. Thus product proliferation is an entry-deterring tactic; and to the extent that it has been successful, Unilever and Procter & Gamble can charge higher prices than would otherwise be the case, which improves their performance. A similar strategy has been pursued by manufacturers in the cereal industry.

Another common product strategy is known as *bundling.* The idea behind a bundling strategy is to tie together a set of related products and charge a single price for them, which is marginally lower than the price of each product when sold separately. This can appeal to consumers, who wish to pay only a single bill and deal with a single provider, and it can raise demand far beyond what could be attained if the firm sold each item separately. The cable company Comcast is currently pursuing this strategy. In additional to cable TV, Comcast now uses its cable into the home to provide high-speed Internet access via a cable modem, video on demand, digital video recording capabilities, and long-distance telephone service. By bundling these services together Comcast hopes to be able to gain market share and revenues from rivals that sell just one of these services.

// Corporate-Level Strategy

corporate-level strategy
Strategy concerned with deciding which industries a firm should compete in and how the firm should enter or exit industries.

So far we have been discussing strategy at the business level. Now it is time to consider **corporate-level strategy**, which is concerned with deciding what businesses and national markets an enterprise should participate in. The business options are to focus on a single business; vertically integrate into adjacent businesses, forming a supply chain from raw materials to consumers; and diversify into other businesses. The national market options are to focus on the firm's home market or expand internationally. Corporate-level strategy also encompasses decisions about *how* to enter new businesses and markets—whether through acquisitions and mergers or by establishing new ventures. As always, the goal of management in pursuing these strategies is to boost the overall performance of the enterprise measured by profitability and profit growth.

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// FOCUS ON A SINGLE BUSINESS

Focusing on a single business makes sense if a firm is growing rapidly, consuming all available capital resources and the time and energy of its managers. Almost all enterprises start out focusing on a single industry. So long as that business continues to grow, they are often advised to continue doing so. Expanding into other businesses becomes an option when the growth rate in the core business is decelerating, as can occur when the market the firm serves is saturated and overall industry growth has slowed down.

The strategic question managers must answer then is whether to enter new businesses or simply return the cash generated by the existing business to shareholders in the form of higher dividend payouts. This was the question managers at Microsoft were contemplating in 2004. The growth rate in the company's core software business had slowed down due to maturation of the personal computer market, but the company was generating huge cash flows (by mid-2004 it had some $64 billion in cash). Microsoft's managers had to decide whether to use that cash to fund additional diversification efforts (such as the company's move into the video game businesses with Xbox) or to return it to shareholders. Because they could not find enough profitable opportunities outside their existing business, they chose to return over $30 billion to shareholders in a huge special dividend payout. Basically Microsoft's managers were saying that they could not see opportunities for profitably redeploying those funds to other businesses, so they decided to let investors enjoy the fruits of their ownership of the company. Sometimes, however, managers may see opportunities for boosting the overall performance of a firm by vertically integrating into adjacent activities, diversifying into new businesses, or expanding internationally to enter new markets.

// VERTICAL INTEGRATION

Vertical integration involves moving *upstream* into businesses that supply inputs to the firm's core business or *downstream* into businesses that use the outputs of the firm's core business. An example of upstream vertical integration would be for Dell Computer to enter the memory chip business, making the memory chips that go into its personal computers (currently Dell purchases these chips from independent suppliers). An example of downstream vertical integration is the 2001 decision by Apple Computer to enter the retail business with its Apple Store. The stores sell Apple products and third-party products, and as of 2006 there were close to 150 of these stores.

vertical integration
Moving upstream into businesses that supply inputs to a firm's core business or downstream into businesses that use the outputs of the firm's core business.

Vertical integration makes sense if it improves the competitive position of the firm's core business. For this to be so, *vertical integration must enable the firm's core business either to lower its costs or to better differentiate its product offering.* Apple's entry into retailing, for example, is designed to provide better point-of-sales service to customers wishing to purchase an Apple product than can be had from independent stores. By helping to raise the overall level of differentiation associated with Apple's offering, the strategy is designed to strengthen Apple's competitive position.

Vertical Integration In 2001 Apple decided to start opening its own stores to sell Apple products, including Apple computers and iPods. This is an example of downstream vertical integration.

Although vertical integration might look good on paper, many enterprises that have vertically integrated upstream have found themselves locked into high-cost businesses that detract from their competitive advantage. A common problem is that in-house suppliers lack a strong incentive to drive down costs because they have a guaranteed buyer for their products—their own firm. As a result, over time in-house suppliers can become less efficient, making vertical integration a liability rather than an asset. General Motors,

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for example, was until recently highly vertically integrated, making many of the components that go into GM cars. Unfortunately for GM, high labor costs in its unionized in-house supply operations raised input costs above those enjoyed by rivals like Toyota, putting GM at a competitive disadvantage. In the late 1990s GM rectified this situation by selling its in-house suppliers, effectively *deintegrating.* This strategic action gave GM greater freedom to purchase components from independent suppliers that had a lower cost structure and could offer GM lower prices.

// DIVERSIFICATION

diversification
Entry into new business areas.

related diversification
Diversification into a business related to the existing business activities of an enterprise by distinct similarities in one or more activities in the value chain.

unrelated diversification
Diversification into a business not related to the existing business activities of an enterprise by distinct similarities in one or more activities in the value chain.

The strategy of **diversification** involves entry into new business areas. Microsoft's entry into the video game business with its Xbox offering is an example of diversification, as is General Electric's move into network broadcasting with the acquisition of NBC. The Microsoft case is an example of what is called **related diversification**: The new business is related to the existing business activities of the enterprise by distinct similarities in one or more activities in the value chain. The video game business is a software-based business, so Microsoft could use its established software engineering skills to develop both an operating system for the Xbox (which is actually based on Windows) and the video games themselves. The General Electric case is an example of **unrelated diversification**: The new business, NBC, was *not* related to the existing activities of the enterprise by similar value chain activities.[15]

As with vertical integration, the key to successful diversification is that it should increase the performance of one or more businesses beyond what could be achieved if each enterprise were an independent business in its own right.[16] If this does not happen, there is no value to different businesses being part of the same organization.

Leveraging Core Competencies One way in which diversified enterprises boost the performance of their constituent units is by leveraging valuable core competencies and applying them to a new line of business. Thus Microsoft used its valuable skills in software engineering to enter the video game business with Xbox. The aim here is to create a competitive advantage in the new business activity by leveraging the competencies that enabled the original business activity to gain a competitive advantage. A good example of a firm that has done this consistently for decades is 3M, which among other things leveraged its skills in adhesives, originally developed to hold the grit on sandpaper, to create new businesses. These new businesses have included masking tape, medical tape, and the ubiquitous Post-it notes.

economies of scope
Cost reductions associated with sharing resources across businesses.

Economies of Scope Another way of improving performance through diversification is to realize what are called **economies of scope**, which are the cost reductions associated with sharing resources across businesses.[17] Firms that can share resources across businesses have to invest proportionally less in the shared resource than companies that cannot share. For example, Procter & Gamble makes both disposable diapers and paper towels. Both of these paper-based products are valued for their ability to absorb liquid without disintegrating. Because both products need the same attribute—absorbency—Procter & Gamble can share the R&D costs associated with producing an absorbent paper-based product across the two businesses. Similarly, because both products are sold to the same customer set (supermarkets), P&G can use the same sales force to sell both products. In contrast, competitors that make just paper towels or just disposable diapers cannot achieve the same economies and will have to invest more in both R&D and maintaining a sales force. The net result is that other things being equal, P&G will have lower expenses and higher profitability than firms that lack the ability to share resources.

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Superior Internal Governance A final way in which diversification can improve the performance of the enterprise is through superior internal governance shills.[18] *Internal governance skills* are the ability of senior managers to elicit high levels of performance from the constituent businesses of a diversified enterprise. Senior managers can do this via organization architecture that creates incentives for the managers and employees running the businesses to work productively; by selecting highly skilled managers to run the constituent businesses; by coaching those managers, helping them to upgrade their managerial skills; by helping them to diagnose problems within their businesses and identify ways of improving performance; and by pushing managers to search for ways to improve the performance of their units.

Jack Welch, the longtime CEO of General Electric, was a master at internal governance. Welch said he spent 70 percent of his time on people issues and that his greatest contribution to General Electric was finding and coaching great managers and pushing those managers to improve the performance of their units and share best practices across businesses.

Internal Governance skills
The ability of senior managers to elicit high levels of performance from the constituent businesses of a diversified enterprise.

Diversification Failures Although diversification can improve the profitability and profit growth of an enterprise, the opposite can also be the case. There are many examples of diversification efforts that failed. In some cases these diversification effort involved the acquisition of an established business in another industry, as opposed to organic expansion like that of 3M or Microsoft's entry into the video game business. There are several problems with such diversification.[19] First, there is evidence that acquiring enterprises pay too much for the companies they acquire (they overvalue them). Second, acquiring firms often let acquired businesses continue to operate as stand-alone enterprises. Managers of the acquiring firm take no action to transfer core competencies, realize economies of scope, or improve performance through the application of superior governance skills. When no steps are taken to improve the performance of the acquired business, it is hardly surprising that the diversification move fails to improve performance.

Finally, even when proactive efforts are made to improve the performance of the newly acquired business, many unexpected problems stymie can attempts to do this. Often these problems stem from differences in organization architecture and cultures. After an acquisition, many acquired businesses experience high management turnover, possibly because their employees do not like the acquiring company's way of doing things.[20] Evidence suggests that the loss of management talent and expertise in the acquired enterprise can materially harm the performance of the acquired unit.[21]

// INTERNATIONAL EXPANSION

International expansion is the final corporate strategy we consider here. International expansion can be a good way to increase the performance of a firm. Historically managers have turned their attention to international expansion after their business has become established in its home market. More recently, however, with the emergence of global markets managers are starting to think about international expansion even at an early point in the development of their enterprise. Nowadays even some small enterprises have a global presence. We reviewed the reasons for expanding internationally in Chapter 3. Here we note briefly that international expansion can enlarge the market for a firm's products, thereby boosting profit growth; enable a firm to realize *scale economies* from serving a large global market, which can lower unit costs and boost profitability; enable a firm to realize *location economies* and increase profitability by basing different business activities where they can be performed most efficiently; and boost both profitability and profit growth by transferring skills between different national subsidiaries, a process known as *global learning.*

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IN CONCLUSION WHY DOES IT MATTER?

All organizations have to compete with rivals to obtain scarce resources and achieve their performance goals. For sustained high performance, an organization needs a competitive advantage over its rivals. A competitive advantage does not happen by accident. Gaining and sustaining a competitive advantage over the long haul requires managers to craft and then implement strategies that result in a fit between the products of the enterprise and competitive conditions in the markets in which the enterprise participates. Without the correct set of strategies at the corporate, business, operating, and organizational levels, performance will suffer, the enterprise will go into decline, and the job security, career prospects, and reputations of its managers will suffer. By the same token, successful careers are enjoyed by managers who establish a reputation for being able to craft and then effectively implement strategies.

Designing and implementing strategy is not the sole preserve of top managers. Although top managers may guide the strategy-making process, the strategies crafted and implemented by operating managers also play a key role in strategic success. It is crucially important, therefore, that even the lowest-level managers in an organization have a good grasp of strategy and understand their role in the process of building and sustaining a competitive advantage.

An interesting example was referred to several times in this chapter: Microsoft's entry into the video game business with its Xbox offering. The Xbox was not the result of a grand strategic vision crafted by Chairman Bill Gates and CEO Steve Balmer; it was the result of the actions of four engineers and their manager, who developed a prototype of the Xbox by their own initiative and on their own time, then successfully lobbied Gates and Balmer to devote resources to the commercialization of the product. To be able to pull off this kind of initiative, managers, whatever their level, must be able to articulate what the strategy should be. They cannot do that unless they understand the basics of strategy as laid out in this chapter.

Even if they are not pushing strategic initiatives, newly hired junior managers can still be surprised by how rapidly they are drawn into the strategy-making vortex of an enterprise. This is certainly true at Microsoft, where management interns have recounted, sometimes with a sense of wonder in their eyes at the possibilities, how they found themselves in a strategy session where their team was trying to articulate and defend the competitive strategy for its product offering to Bill Gates or Steve Balmer. "What a rush," one noted as he recounted the experience; "here I was, not even graduated yet, and I had to answer this blizzard of questions from Bill Gates, who was just ripping into our plan. Amazingly, at the end of the session, he told us to go ahead!"[22] The ability of this intern to hold his own in the strategy conversation was due to the fact that he understood what strategy was about, what was required to gain and sustain competitive advantage, and how to articulate that. This is a skill that managers must have if they are to be successful.

MANAGEMENT CHALLENGES

1. "The only goal of strategy is to maximize the profitability of the enterprise." Is this statement correct?
2. How would you characterize the business-level strategies of the following enterprises in the airline industry: Jet Blue, Maxjet (www.maxjet.com), and United Airlines? Can you plot the position that each enterprise aspires to on the efficiency frontier in the industry?
3. "Success in strategy is 10 percent inspiration and 90 percent perspiration." In the context of the material discussed in this chapter, what does this statement mean?

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4. Visit the Web site of the Boeing Corporation and familiarize yourself with the different activities of the organization. Then answer the following questions:
   a. What is the business-level strategy of Boeing's commercial jet aircraft business?
   b. What tactics is Boeing pursuing to raise entry barriers into the commercial jet aircraft business?
   c. What is the corporate-level strategy of Boeing? How might this strategy help the company increase the profitability of the entire enterprise?
5. Compare and contrast Toyota and General Motors. (You might want to visit the Web sites of both companies and review their financial performance using the data found at the Yahoo finance site, finance.yahoo.com.) Which company is on the efficiency frontier in the automobile industry, and which company is inside the frontier? How important are the following in explaining the differences between the two companies?
   a. Business-level strategy.
   b. Operating strategy.
   c. Corporate strategy.
   d. Competitive tactics.

THE MANAGEMENT PORTFOLIO

FOR THE ORGANIZATION YOU HAVE CHOSEN TO FOLLOW:

1. What is the business-level strategy of this firm? (For a multibusiness firm, focus on the largest business unit.)
2. Plot the position to which the firm aspires on the efficiency frontier. Also plot its actual position if that is different. If you think the firm is positioned inside the frontier, state why. If you think it is on the frontier, how did it get there?
3. What is the corporate-level strategy of the firm? In your opinion, does this strategy create additional value, boosting the profitability of the enterprise, or is it destroying value and lowering profitability? How did you reach your conclusion?

CLOSING CASE

GOOGLE'S QUEST FOR COMPETITIVE ADVANTAGE

In 1996 two computer science PhD students at Stanford University, Sergey Brin and Larry Page, were wondering how they could sort through the massive amount of information that was starting to appear on the Web to find specific and useful information on a topic. Although there were several different technologies, or search engines, available to search the Web for information, none of them seemed particularly useful to Brin and Page because they failed to distinguish between useful and trivial Web sites. Brin and Page decided to build a search engine that would not only examine the words on Web pages and then index them as other search engines did, but would also look at how and where these words were being used and at the number of other Web sites linked to a page. The goal was to have the search engine return a list of Web pages with the most useful appearing at the top.

The first version of their search engine, which relied on a proprietary algorithm developed by Brin and Page, was known as BackRub. BackRub soon created a buzz among other computer science students at Stanford; but it was the encouragement of a former Stanford student, David Filo, one of the founders of Yahoo! that persuaded Brin and Page to start their own company.

By December 1998 the beta version of Google's search engine had been up and running on the Web for months, answering over 10,000 search queries a day. From that point on growth was exponential. By December 2000 Google's

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index included more than 1.3 billion web pages, and the company was answering some 60 million search queries a day. By 2004 the number of Web pages indexed by Google exceeded 4 billion, and the search engine was handling more than 300 million queries a day. Google's technology quickly became pervasive. Soon most major Web portals were using Google's search engine technology, including Yahoo! and AOL. Estimates suggested that in 2003 some 75 percent of Internet searches were made using Google. What was most impressive about Google, however, was that unlike many other dot-com businesses of the 1990s, Google found a way to make money. In 2003 the company made $967 million in revenues and $105 million in net profits. In 2004 revenues surged to $3.19 billion and net income to $399 million.

Google Guys From small beginnings in 1996, Sergey Brin and Larry Page have built one of the largest and most profitable online enterprises in the world, Google.

To make money Google sells to advertisers the words that people put in when they search for something on the Web. This means that whoever bids the most for a particular term, say digital cameras, gets their link put at the top of a Google-generated list. Google distinguishes between independent search results and those that are paid for by listing "sponsored links" on its page. However, sponsors do not pay Google unless a user clicks through to them from a Google-generated link.

To determine the price to charge advertisers for a term, Google uses an automated bidding process known as a *Vickery second price auction.* Under this bidding methodology, winning bidders pay only one cent more than the bidder below them. Thus if there are three bids for the term "digital cameras"—say $1 a click, $0.50 a click, and $0.25 a click—the winner will pay $0.51 a click to Google.

In August 2004 Google went public, raising over $1.5 billion. With no debt and flush with cash, the company looked set to build on its lead in the search engine business. However, competitors were not sitting on the sidelines. In 2003 Yahoo! purchased a rival search engine company, Overture Services, for some $1.6 billion. In February 2004 Yahoo! replaced Google as the search engine on its site with a proprietary search engine based on Overture's technology. Microsoft too seems to have its sights set on Google. Microsoft is reportedly working on its own search engine technology, which it plans to integrate with its software, including Microsoft Office and Longhorn, the next version of the Windows operating system (due for release in 2007).

CASE DISCUSSION QUESTIONS

1. What business-level strategy is Google pursuing?
2. What value does Google create for customers and advertisers? How does this value translate into superior performance, measured by profitability and profit growth?
3. What are the sources of Google's competitive advantage? How secure are these advantages from imitation by competitors? What must Google do to keep the competitors at bay?
4. Do competitors such as Yahoo! and Microsoft potentially have assets and capabilities that give them an advantage over Google in the search engine business?[23]

ENDNOTES

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18. See, for example, Jones and Hill, *A Transaction Cost Analysis,* Strategic Management Journal, 9, (1988), pp. 159–72; Williamson, *Markets and Hierarchies* (New York: Free Press), pp. 132–75; and Hill, "The Role of Headquarters in the Multidivisional Firm."
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