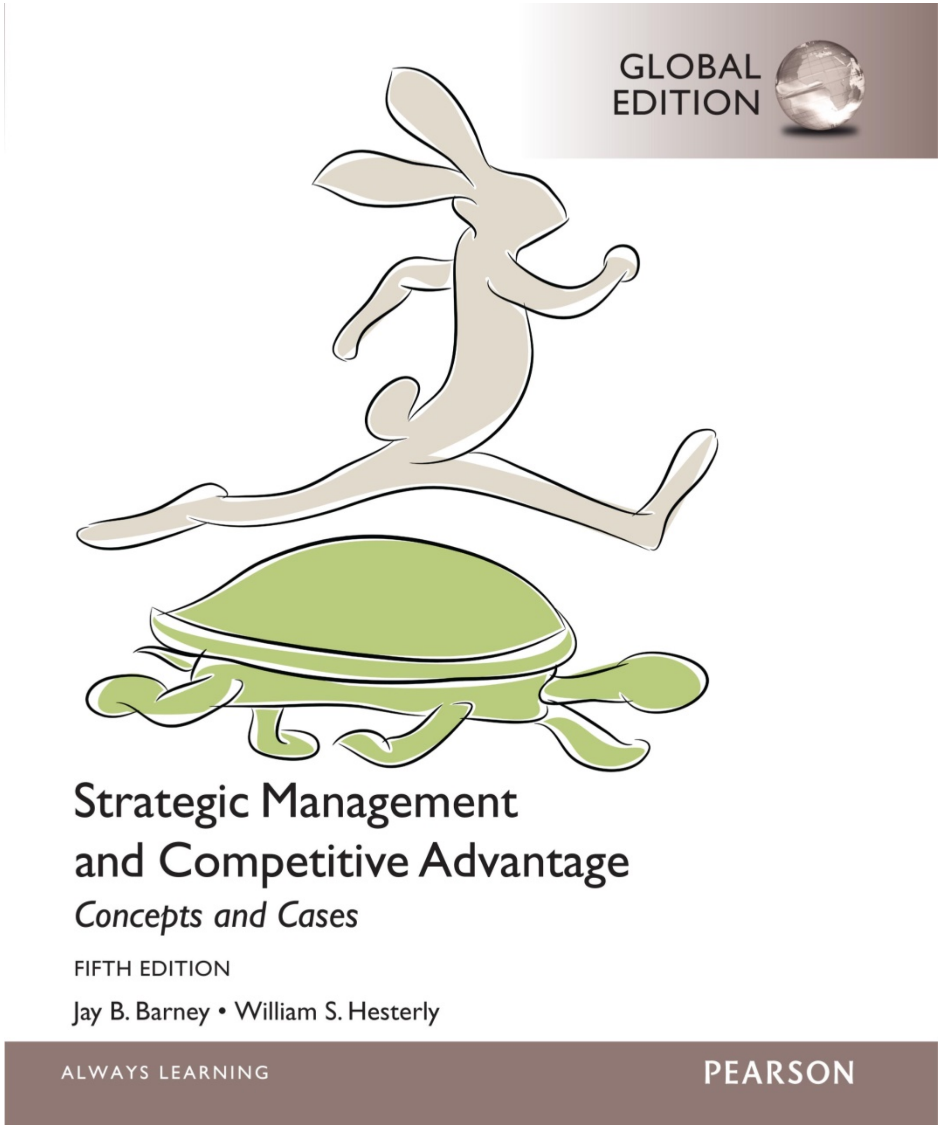


Chapter 1

What Is Strategy and the Strategic Management Process?

Walt Disney Company

1984 Profits: $242 Million

Theme Park Operations: 77 percent of profits

Consumer Products: 22 percent of profits

Filmed Entertainment: 1 percent of profits

Walt Disney Company

Hired Michael Eisner - 1984

1. Increased admission prices at theme parks
   1984 - $186 m   1989 - $787 m

2. Focused on movie studios (character development)
   1984 - $2.42 m   1994 - $845 m

3. Diversified into television (ABC), hotels, retail stores, sport team, cruise line, publishing, consumer products, licensing, etc.   (Huey & McGowan, 1995)

Market Cap: 1984 = $2 billion   1994 = $28 billion

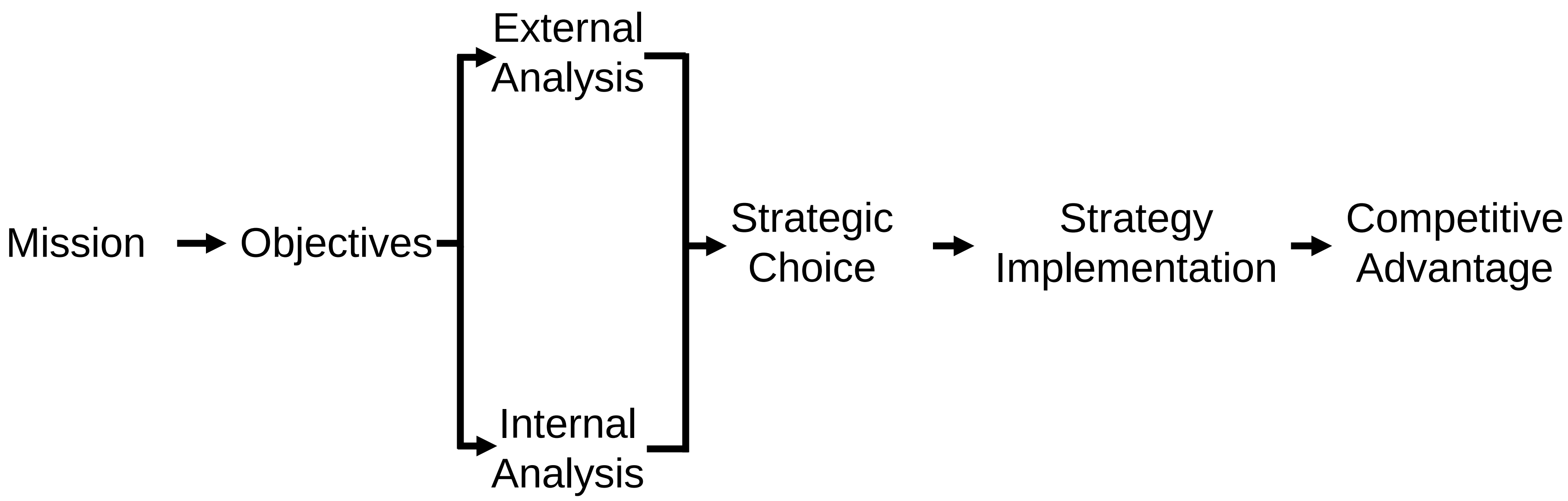
Definition of Strategy

Strategy: **A firm's theory about how to gain competitive advantages**

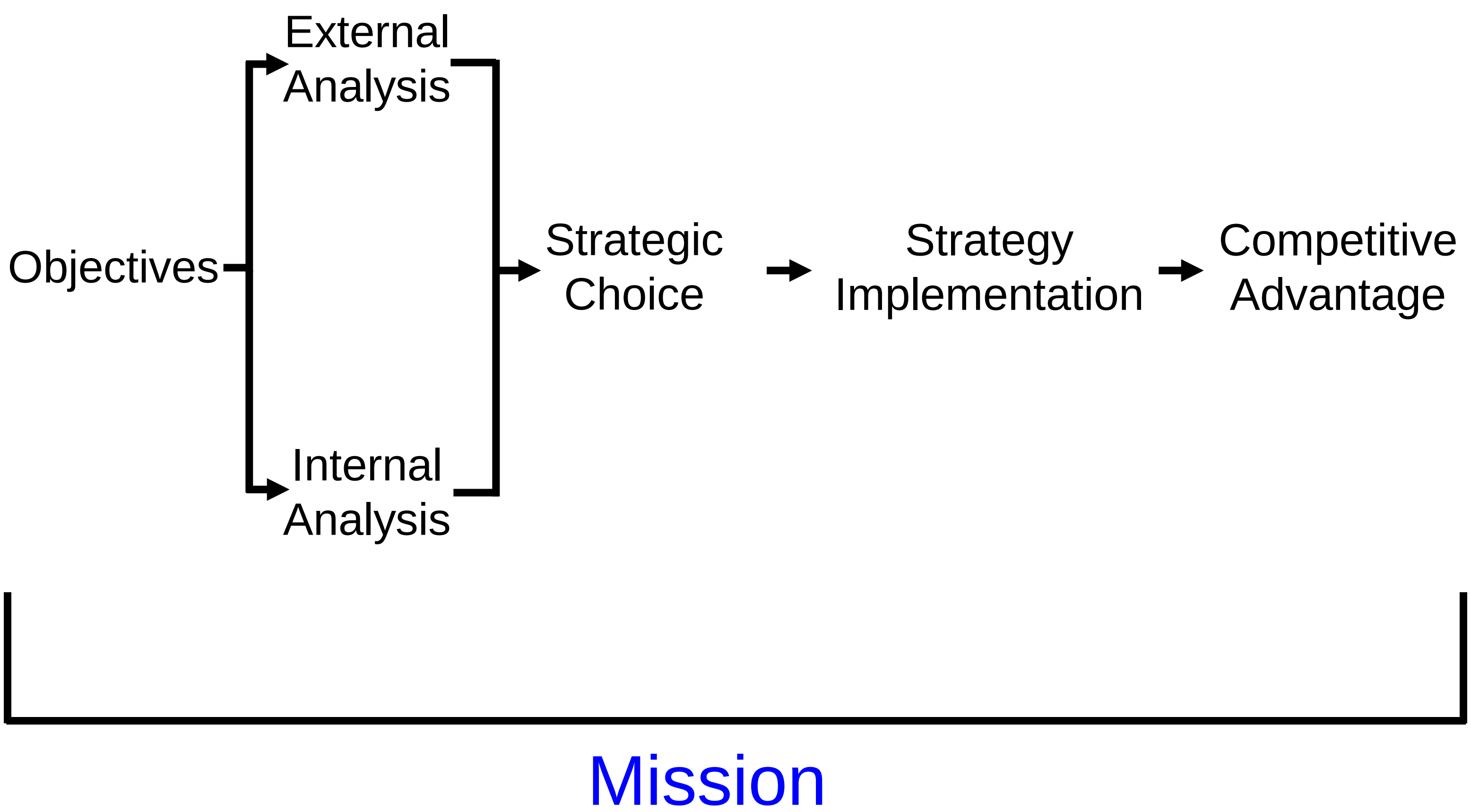
Eisner's theory may have been:

People will pay a premium price for extraordinary entertainment. We have the necessary resources to create extraordinary entertainment. Therefore, let's redeploy our resources in a different way and offer something extraordinary to people.

The Strategic Management Process



The Strategic Management Process



The Strategic Management Process

Objectives:

- specific, measurable targets
  - the things a firm needs to ‘do’ to achieve its mission
- should influence other elements in the strategic management process

Example: Steelcon’s mission & objectives

The Strategic Management Process

External and Internal Analysis

Systematic Examination
of the Environment

External Analysis

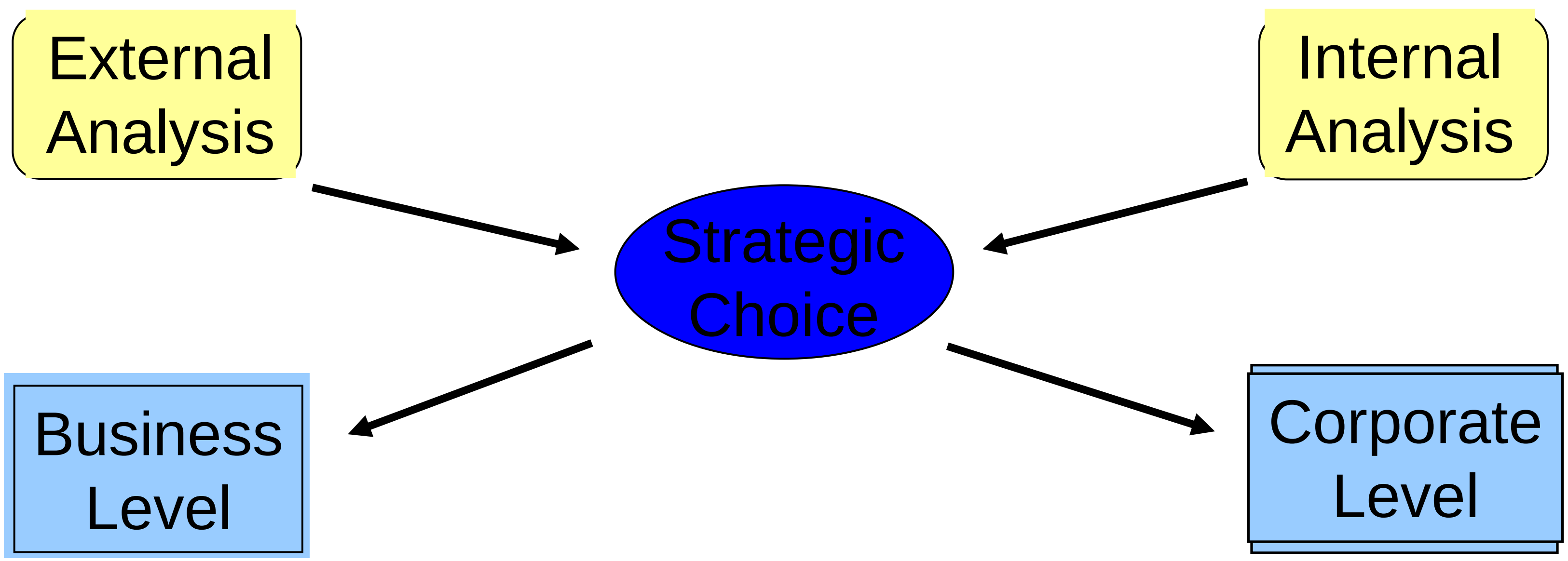
- interest rates
- demographics
- social trends
- technology

Internal Analysis

- human resources (knowledge)
- manufacturing abilities
- technology

The Strategic Management Process

Strategic Choice



- positioning a business
- which businesses?

Example: Stanley Black & Decker

The Strategic Management Process

Strategy Implementation

- *how* strategies are carried out
- *who* will do *what*
- organizational structure and control
  - who reports to whom
  - how does the firm hire, promote, pay, etc.

The Strategic Management Process

Strategy Implementation

- every strategic choice has strategy implementation implications
- strategy implementation is just as important as strategy formulation

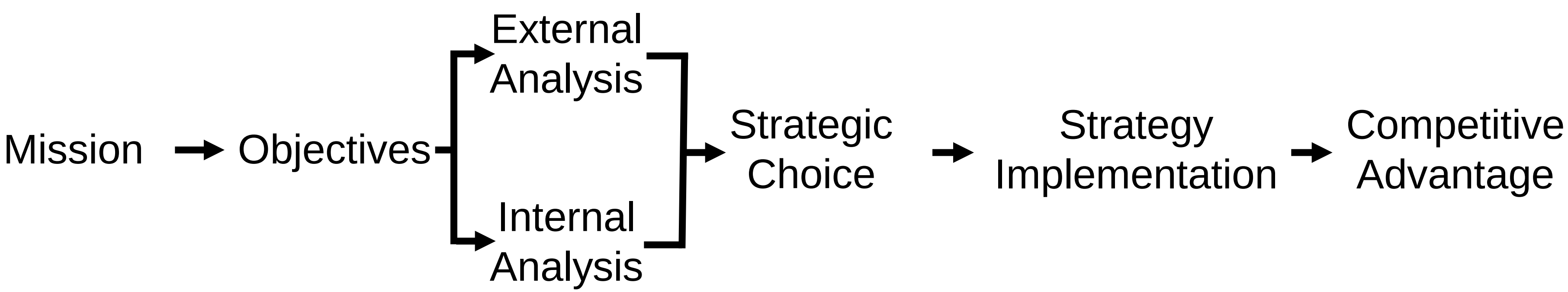
A Strategy Is Only As Good As Its Implementation

Example: Gen. Lee at Gettysburg

The Strategic Management Process

Competitive Advantage

Definition: the ability to create more economic value than competitors



- all other elements of the strategic management process are aimed at achieving competitive advantage

Competitive Advantage

The Ability to Create More Economic Value Than Competitors

- there must be something different about a firm's offering vis-à-vis competitors' offerings
- if all firms' strategies were the same, no firm would have a competitive advantage
- competitive advantage is the result of doing something different and/or better than competitors

Competitive Advantage

Two Types of Difference

1) Preference for the firm's output
   - people choose the firm's output over others'
   - people are willing to pay a premium

Example: Nordstrom

2) Cost advantage vis-à-vis competitors
   - lower costs of production/distribution

Example: Wal-Mart

Competitive Advantage

The Strategic Management Process

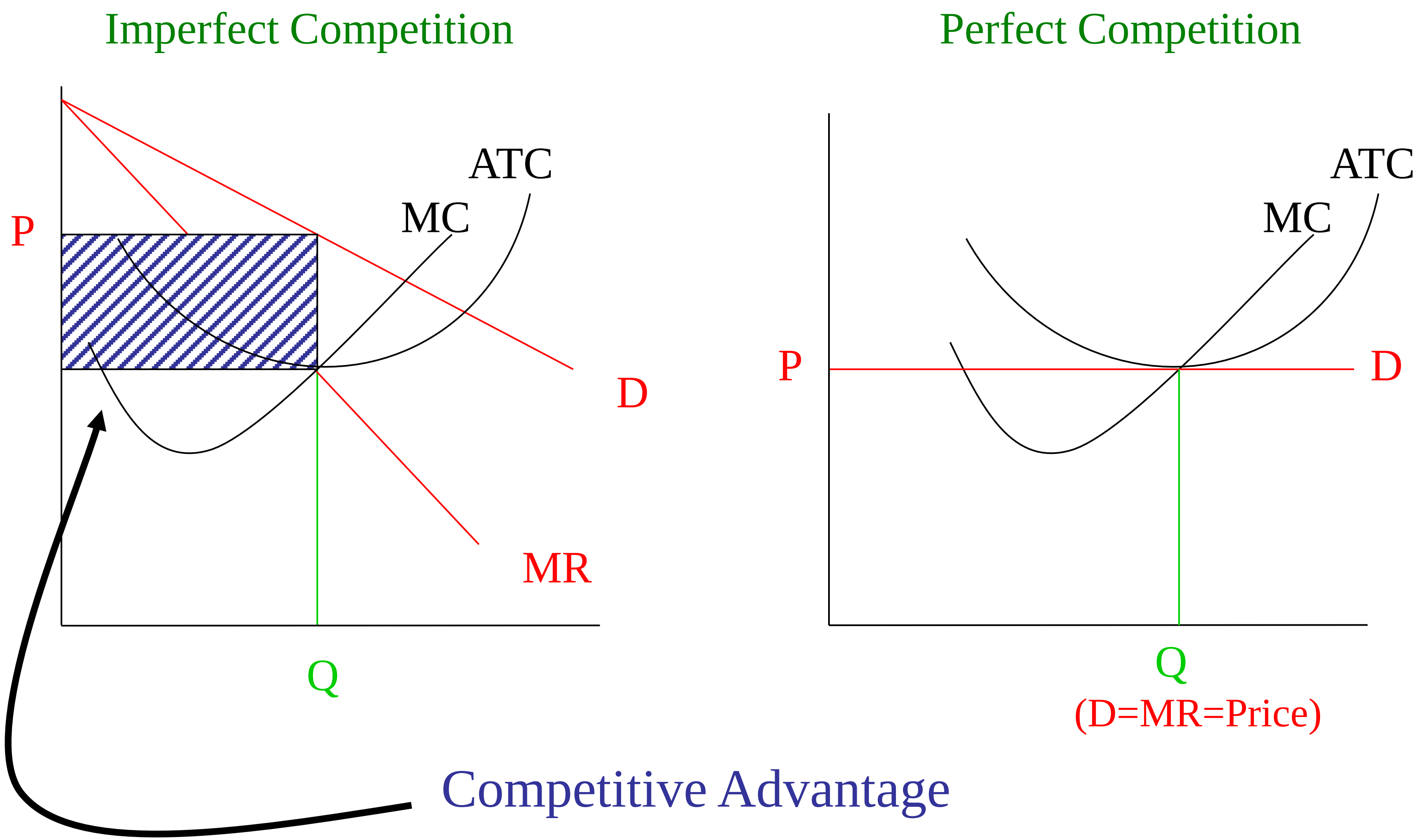
External Analysis
Internal Analysis → Strategic Choice → Strategy Implementation → Competitive Advantage

- identify and exploit differences that may lead to competitive advantage

Examples: Apple's iPod, iPad

Competitive Advantage

Economic Models



Competitive Advantage

Temporary & Sustainable

- competitive advantage typically results in high profits
- profits attract competition
- competition limits the duration of competitive advantage in most cases

Therefore,

- most competitive advantage is temporary
  - competitors imitate the advantage or offer something better

Competitive Advantage

Temporary & Sustainable

Some competitive advantages are sustainable if:

- competitors are unable to imitate the source of advantage
- no one conceives of a better offering

Of course,

- in time, even sustainable competitive advantage may be lost

Competitive Advantage

Competitive Parity

- the firm’s offerings are ‘average’
- people do not have a preference for the firm’s offering
- the firm does not have a cost advantage over others
- some things that may lead to competitive parity may still be critical to success

Competitive Advantage

Competitive Disadvantage

- people may have an aversion to the firm's offering
- the firm may have a cost disadvantage
- a firm may have outdated technology/equipment
- a firm may have a negative reputation

Example: Wal-Mart's Labor & Location Policies

Competitive Advantage

Measuring Competitive Advantage

Superior Economic Performance Is Viewed as Evidence of Competitive Advantage

- it is rather easy to see the evidence of competitive advantage
- measuring the source of the advantage per se is typically impossible
    - it’s difficult to ‘measure’ technology

Competitive Advantage

Measuring Competitive Advantage

Two Classes of Measures:

1) Accounting Measures
    - ROA, ROS, ROE, etc. that exceed industry averages
2) Economic Measures
    - earning a return in excess of the cost of capital

Competitive Advantage

Competitive Advantage		Economic Returns
Advantage	→	Above Normal • exceeding expectations
Parity	→	Normal • meeting expectations
Disadvantage	→	Below Normal • failing expectations

Competitive Advantage & The Strategic Management Process

Emergent vs. Intended Strategies

- the strategic management process leads managers to *intended* strategies

However,

- conditions often change or new information becomes available
- managers respond and adopt *emergent* strategies

Example: Honda Motorcycles

The Strategic Management Process

Summary

Firms could achieve competitive parity and survive

- they would face a flat demand curve
- their cost structure would be the industry average
- they would need to adapt their strategy over time just to survive
- they would fail if they didn't adapt their strategy

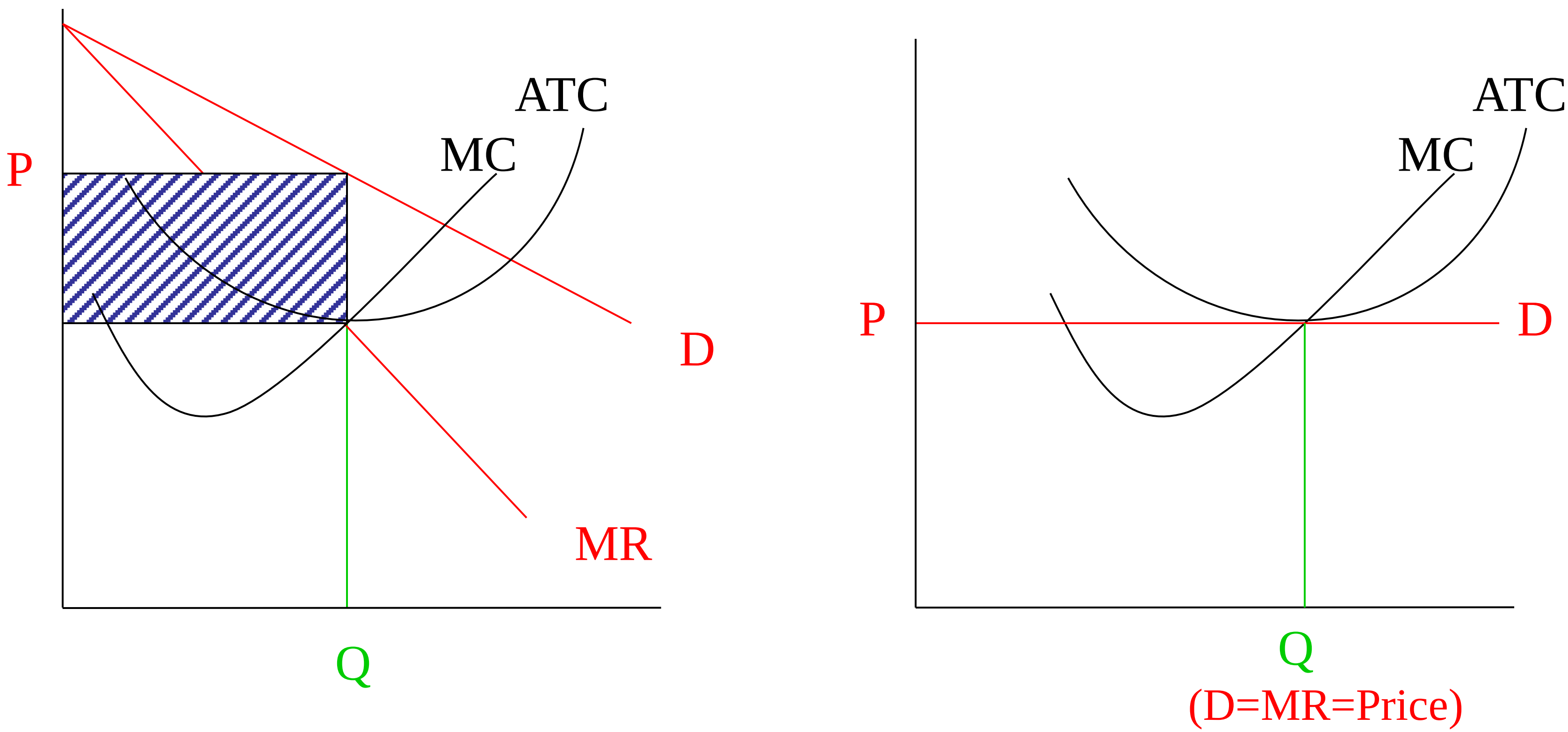
The Strategic Management Process

Summary

This course is not about mere survival, it is about thriving—achieving competitive advantage

- the strategic management process helps managers achieve competitive advantage
- competitive advantage depends on differences
- strategy is about discovering and exploiting these differences

The Strategic Management Process



Thriving!

Surviving

The Strategic Management Process

Applying Strategy to Your Career

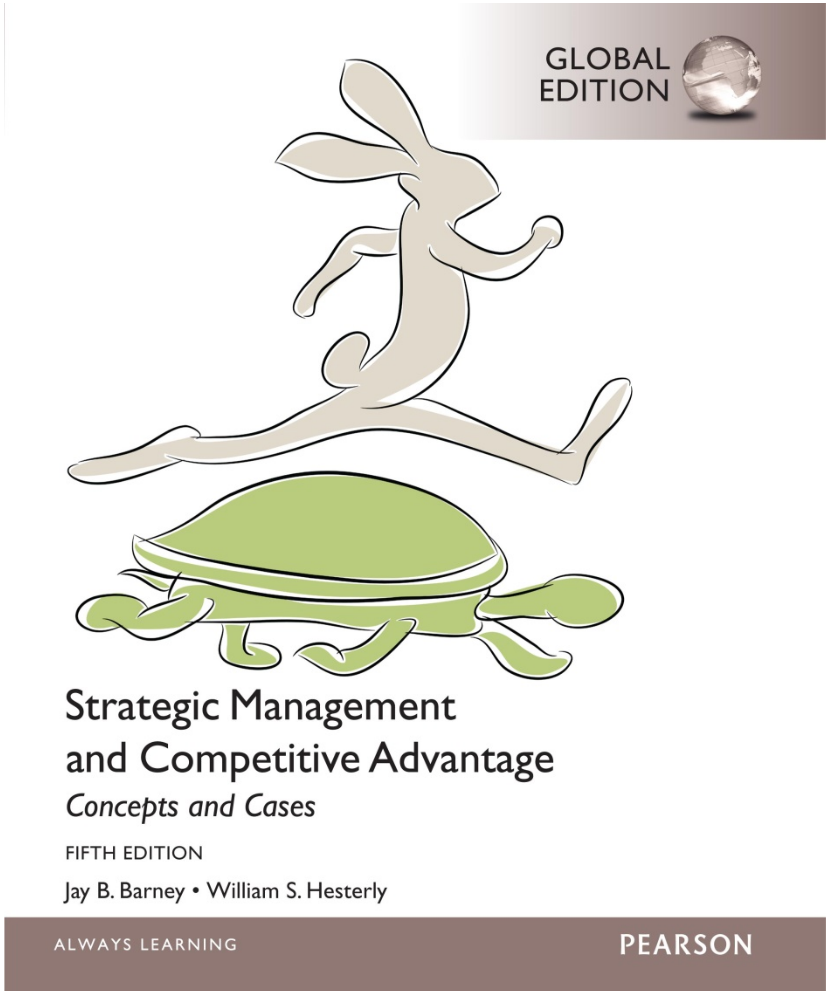
- a solid understanding of strategy concepts will help set you apart from other job candidates
- you can use the process to identify and exploit difference between you and others
- you can use the process to determine if you want to stay with a company

The Strategic Management Process & Competitive Advantage

Strategy Matters!

Strategy is often the difference between:

- success and failure, between mediocrity and excellence
- a great manager and average managers
- stumbling through life and moving ahead with purpose



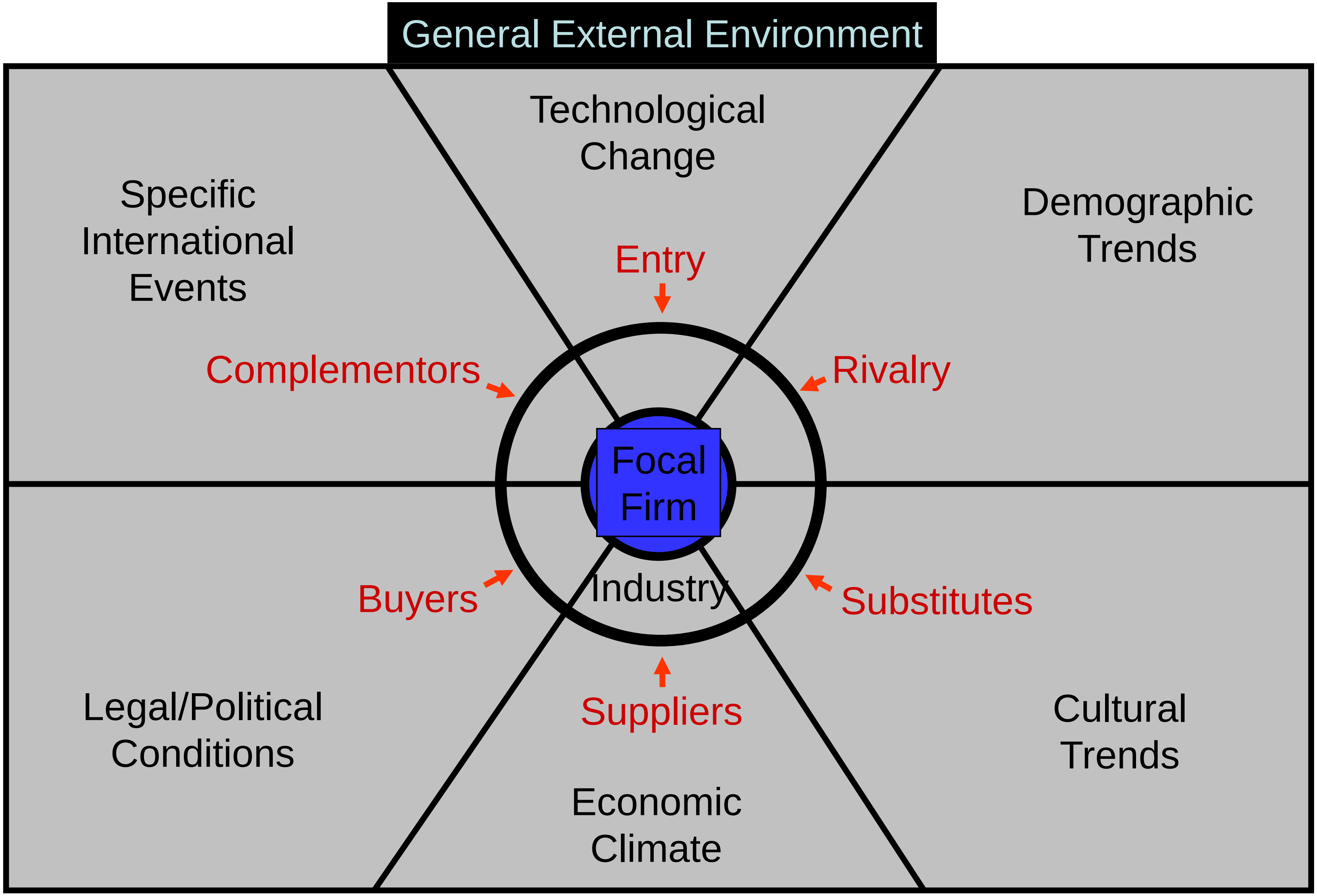
Chapter 2

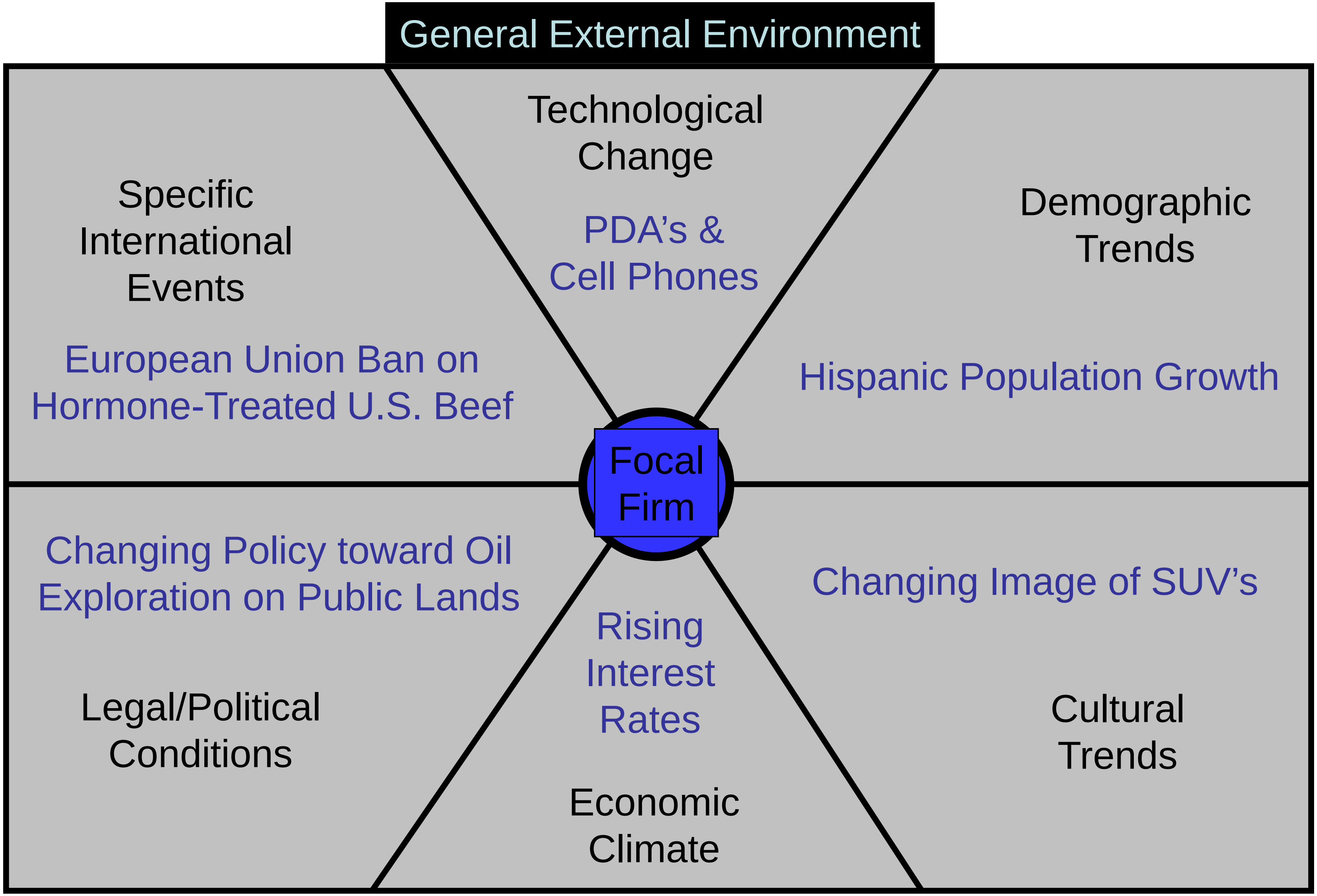
Evaluating a Firm's External Environment

Why External Analysis?

External analysis allows firms to:

- discover threats and opportunities
- see if above normal profits are likely in an industry
- better understand the nature of competition in an industry
- make more informed strategic choices


General External Environment
Technological Change
Specific International Events
Demographic Trends
Entry
Complementors
Rivalry
Focal Firm
Industry
Buyers
Substitutes
Suppliers
Legal/Political Conditions
Cultural Trends
Economic Climate

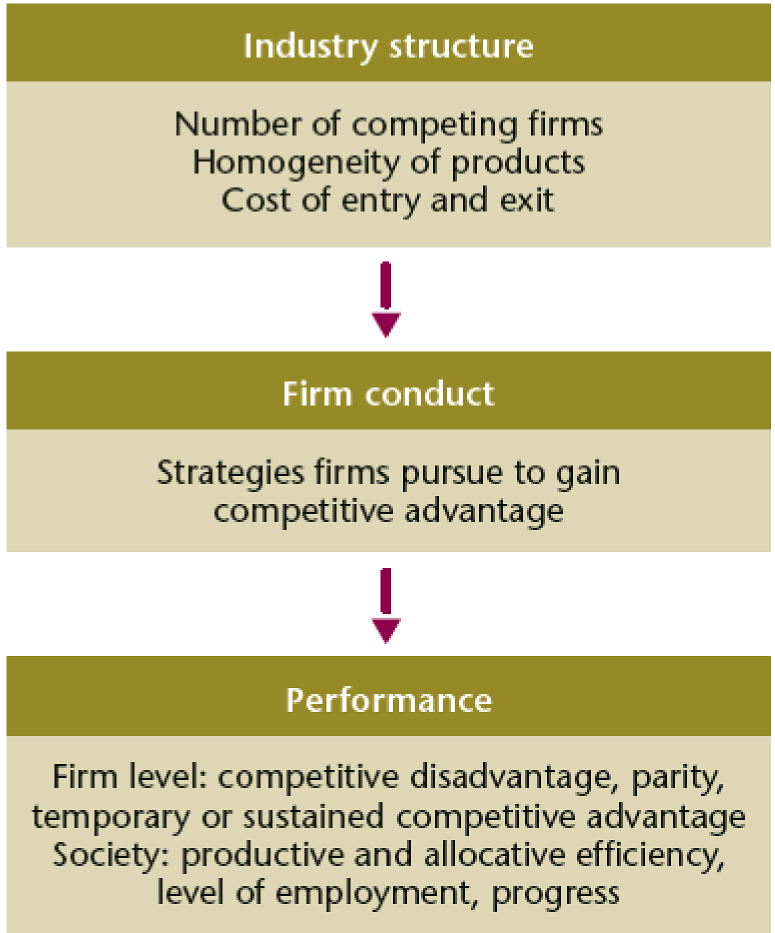

General External Environment
Technological Change
PDA's & Cell Phones
Specific International Events
European Union Ban on Hormone-Treated U.S. Beef
Demographic Trends
Hispanic Population Growth
Focal Firm
Changing Policy toward Oil Exploration on Public Lands
Legal/Political Conditions
Rising Interest Rates
Economic Climate
Changing Image of SUV's
Cultural Trends

Industry Analysis

The Structure–Conduct–Performance Model

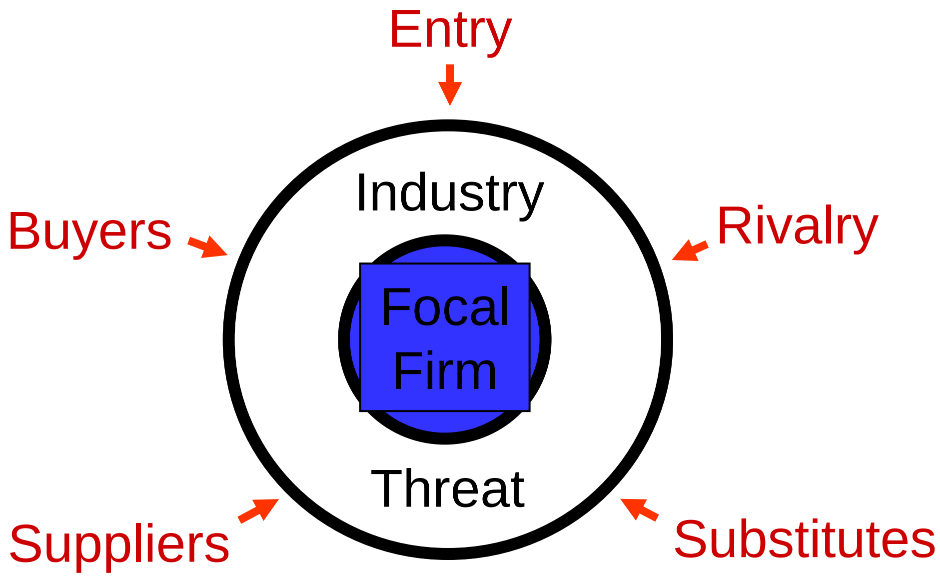
- originally developed to spot anti-competitive conditions for anti-trust purposes
- came to be used to assess the possibilities for above normal profits for firms within an industry
- model of environmental threats was developed from this economic tradition

The Structure–Conduct–Performance Model



Industry Analysis

The Model of Environmental Threats



Higher Threat ⟶ Lower Average Profits

Model of Environmental Threats

Threat from New Competition

- If firms can easily enter the industry, any above normal profits will be bid away quickly.

- Barriers to entry lower the threat of entry.

- Barriers to entry make an industry more attractive.
    - This is true whether the focal firm is already in the industry or thinking about entering.

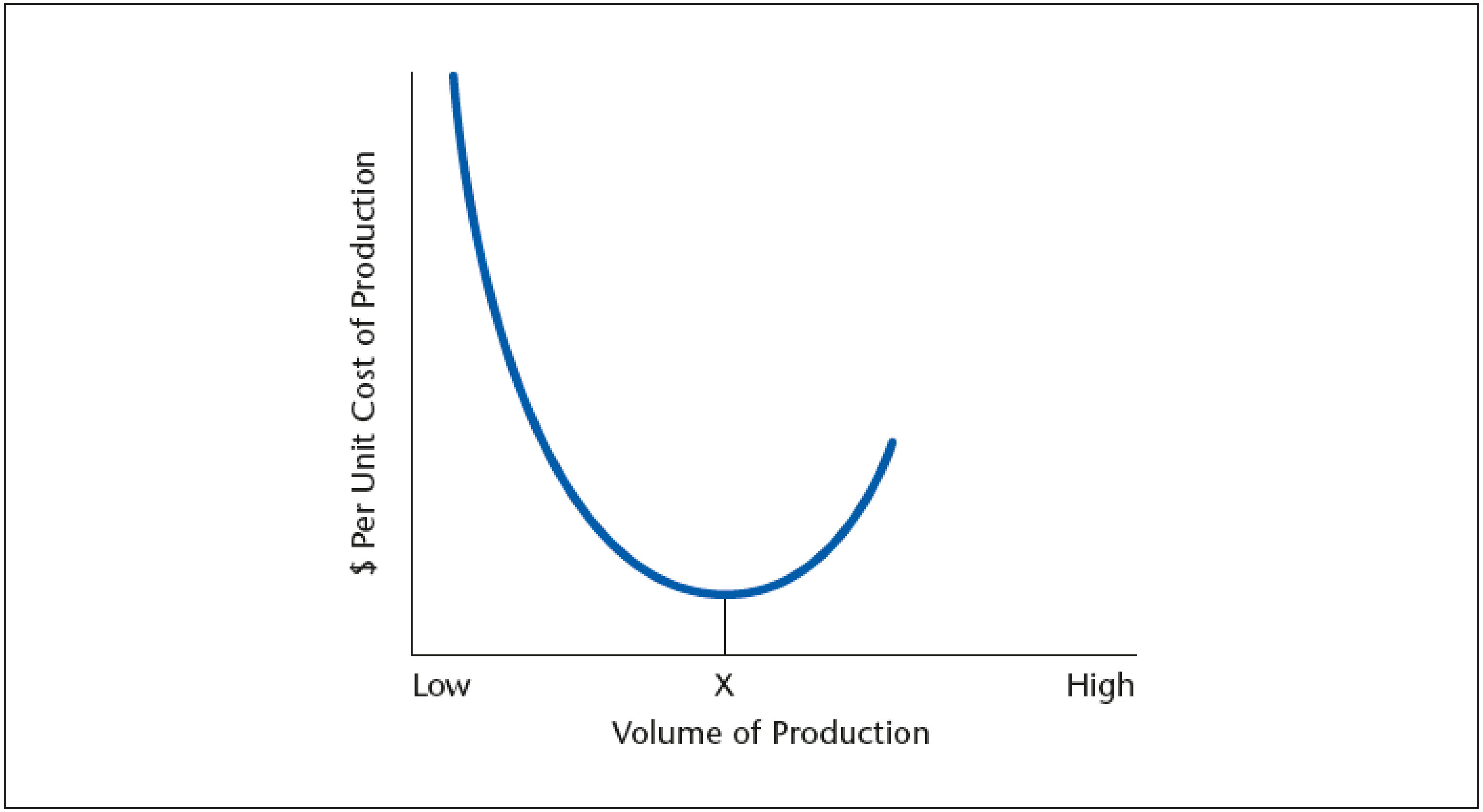
Model of Environmental Threats contd.

Threat of New Competition

Barriers to Entry:

- Economies of scale—firm that can’t produce the minimum efficient scale will be at a disadvantage.
- Product differentiation—entrants are forced to overcome customer loyalties to existing products.
- Cost advantages independent of scale—incumbents may have learning advantages, and so on.
- Government policies—governments may impose trade restrictions and/or grant monopolies.

Economies of Scale and the Cost of Production



Model of Industry Competition

Threat from Existing Competitors

- Attributes of an Industry That Increase the Threat of Direct Competition:
  - large numbers of competitors
  - slow or declining growth
  - high fixed costs and/or high storage costs
  - low product differentiation
  - industry capacity added in large increments

Model of Industry Competition

Threat of Substitute Products

- Substitutes fill the same need but in a different way.
  - Coke and Pepsi are rivals, milk is a substitute for both.
- Substitutes create a price ceiling because consumers switch to the substitute if prices rise.
- Substitutes will likely come from outside the industry—be sure to look.

Model of Industry Competition

Threat of Supplier Leverage

- Powerful suppliers can “squeeze” (lower profits) the focal firm.

Industry conditions that facilitate supplier power:

- small number of firms in supplier’s industry
- highly differentiated product
- lack of close substitutes for suppliers’ products
- supplier could integrate forward
- focal firm is an insignificant customer of supplier

Model of Industry Competition

Threat from Buyers Influence

- Powerful buyers can “squeeze” (lower profits) the focal firm by demanding lower prices and/or higher levels of quality and service.

Industry conditions that facilitate buyer power:

- small number of buyers for focal firm’s output
- lack of a differentiated product
- the product is significant to the buyer

Model of Industry Competition

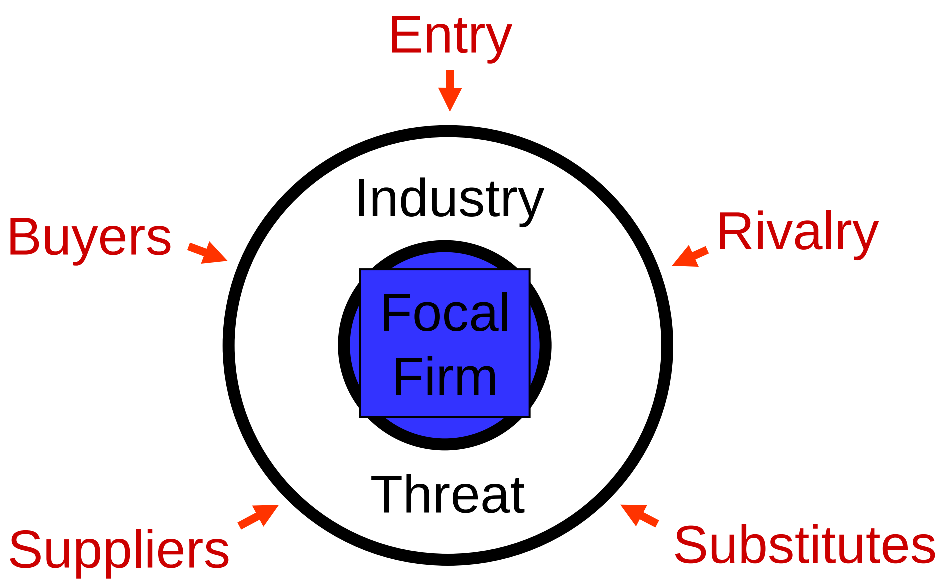
Threat from Buyers Influence

Indicators of the threat of buyers influence:

- Buyers operate in a competitive market—they are not earning above normal profits.
- Buyers can vertically integrate backward.
- Many small buyers can be united around an issue to act as a block.

Example: Monsanto's Life Sciences Strategy

Model of Industry Competition



If all threats are high → expect normal profits

If all threats are low → expect above normal profits

Most industries are somewhere between the extremes.

Complementors As Another Force

Complementors Increase the Value of the Focal Firms Product

- Customers perceive more value in the focal firm’s product when it is combined with the complementor’s product.

- Complementors may be found outside the focal firm’s industry.

Example: Goodyear Tires on Corvette

Responding to Environmental Threats

Neutralizing Threats

- Most firms cannot unilaterally change the threats in an industry.
- By altering relationships in an industry, firms may reduce threats and/or create opportunities, thereby increasing profits.

Examples: Regional Healthcare System, Building Contractor, and the Bakery

Exploiting Industry Structure Opportunities

Generic Industry Structures

- At any point in time, the structure of most industries fits into one of four generic categories.
- Each industry structure presents opportunities that may be exploited.
- Firms can choose to exploit an industry structure, continue business as usual, or exit the industry.

Exploiting Industry Structure Opportunities

Fragmented Industry Structure

Industry Characteristics	Opportunity
• large number of small firms • no dominant firms • no dominant technology • commodity type products • low barriers to entry • few, if any, economies of scale	Consolidation • buy competitors • build market power • exploit economies of scale

Exploiting Industry Structure Opportunities

Emerging Industry Structure

Industry Characteristics

- new industry based on break through technology or product
- no product standard has been reached
- no dominant firm has emerged
- new customers come from non-consumption not from competitors

Opportunity

- first mover advantages
  - technology
  - locking-up assets
  - creating switching costs

Exploiting Industry Structure Opportunities

Mature Industry Structure

Industry Characteristics

- slowing growth in demand
- technology standard exists
- increasing international competition
- industry-wide profits declining
- industry exit is beginning

Opportunities

- refine current products
- improve service
- process innovation

Exploiting Industry Structure Opportunities

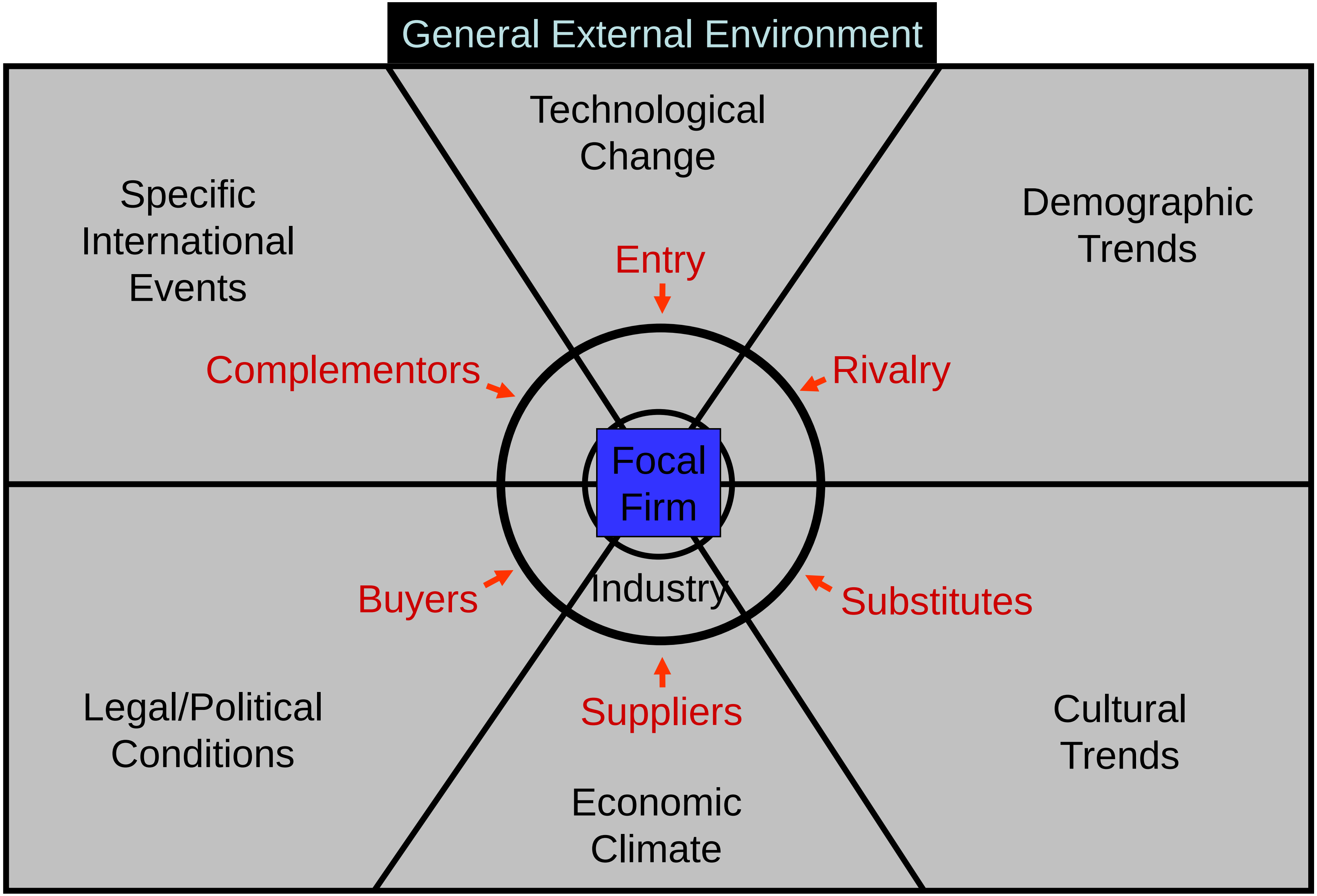
Declining Industry Structure

Industry Characteristics

- industry sales have sustained pattern of decline
- some well-established firms have exited
- firms have stopped investing in maintenance

Opportunities

- market leadership
- niche
- harvest
- divest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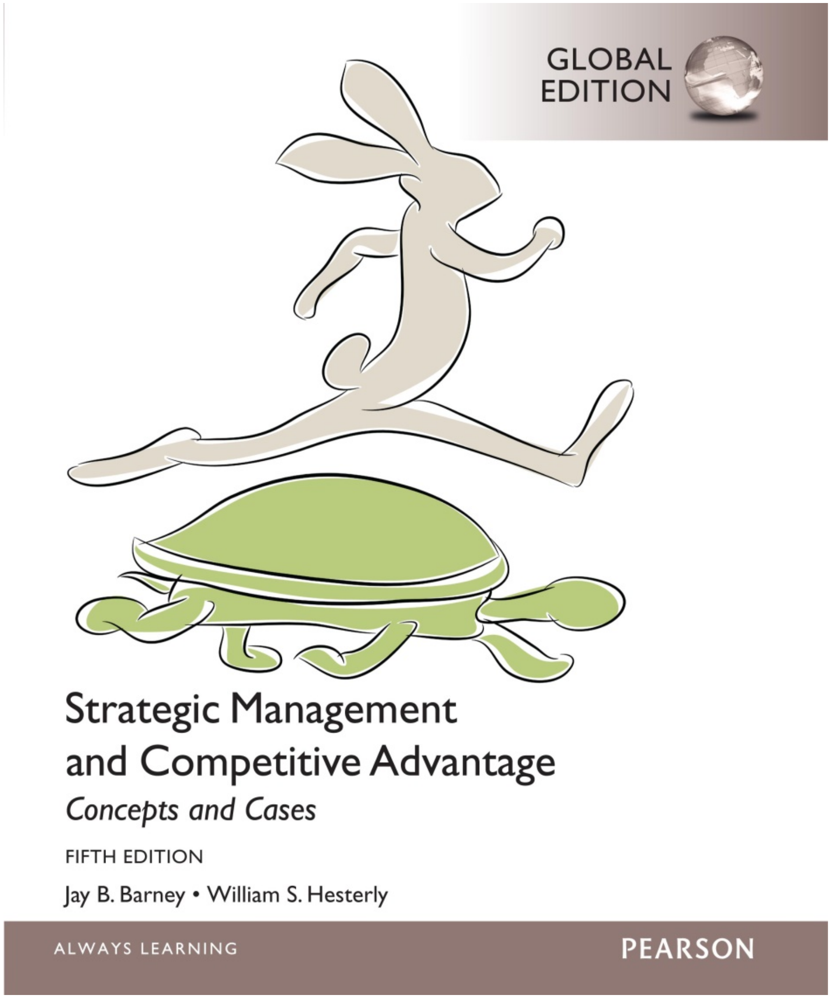
Economic Climate

Summary

External Analysis:

- takes time and effort
- should include consideration of international markets
- helps firms recognize threats and opportunities
- provides assessment of likely levels of industry profitability (normal, above, below)
- can be applied at the individual level to professional and personal environments



Chapter 3

Evaluating a Firm's Internal Capabilities

What Does Internal Analysis Tell Us?

Internal analysis provides a comparative look at a firm’s capabilities.

- What are the firm’s strengths?
- What are the firm’s weaknesses?
- How do these strengths and weaknesses compare to competitors?

Why Does Internal Analysis Matter?

Internal analysis helps a firm:

- determine if its resources and capabilities are likely sources of competitive advantage

- establish strategies that will exploit any sources of competitive advantage

The Theory Behind Internal Analysis

The Resource-Based View

- developed to answer the question: Why do some firms achieve better economic performance than others?
- used to help firms achieve competitive advantage and superior economic performance
- assumes that a firm’s resources and capabilities are the primary drivers of competitive advantage and economic performance

The Resource-Based View

Resources and Capabilities

Resources:

- tangible and intangible assets of a firm
  - » tangible: factories, products   intangible: reputation
- used to conceive of and implement strategies

Capabilities:

- a subset of resources that enable a firm to take full advantage of other resources
  - » marketing skill, cooperative relationships

The Resource-Based View

Resources and Capabilities

Firm Assets:	Are these resources or capabilities?
Machinery	?
Collective Product Design Skill	?
Recruiting Skill	?
Engineering Skill of Individuals	?
Mineral Deposits	?

The Resource-Based View

Four Categories of Resources

- Financial (cash, retained earnings)
- Physical (plant and equipment, geographic location)
- Human (skills and abilities of individuals)
- Organizational (reporting structures, relationships)

The Resource-Based View

Two Critical Assumptions of the RBV

- Resource Heterogeneity
  - » Different firms may have different resources.
- Resource Immobility
  - » It may be costly for firms without certain resources to acquire or develop them.
  - » Some resources may not spread from firm to firm easily.

The Resource-Based View

What do these assumptions really mean?

- if one firm has resources that are valuable and other firms don’t, and…
- if other firms can’t imitate these resources without incurring high costs, then…
- the firm possessing the valuable resources will likely gain a sustained competitive advantage

The Resource-Based View

Resource Heterogeneity

- Heterogeneity of resources typically occurs as the result of “bundling” the resources and capabilities of a firm.
- Managers of a firm could take resources that seem homogeneous and “bundle” them to create heterogeneous combinations.
- Competitive advantage typically stems from several resources and capabilities “bundled” together.

The Internal Analysis Tool

The VRIO Framework

Four Important Questions:

- Value
- Rarity
- Imitability
- Organization

The VRIO Framework

If a firm has resources that are:

- valuable,
- rare, and
- costly to imitate, and…
- the firm is organized to exploit these resources,

then the firm can expect to enjoy a sustained competitive advantage.

The VRIO Framework

Applying the Tool

- A resource or bundle of resources is subjected to each question to determine the competitive implication of the resource.
- Each question is considered in a comparative sense (competitive environment).

Applying the VRIO Framework

The Question of Value

- In theory: Does the resource enable the firm to exploit an external opportunity or neutralize an external threat?
- The practical: Does the resource result in an increase in revenues, a decrease in costs, or some combination of the two? (Levi's reputation allows it to charge a premium for its Docker's pants)

Applying the VRIO Framework

The Question of Rarity

- If a resource is not rare, then perfect competition dynamics are likely to be observed (i.e., no competitive advantage, no above normal profits).
- A resource must be rare enough that perfect competition has not set in.
- Thus, there may be other firms that possess the resource, but still few enough that there is scarcity (several pharmaceuticals sell cholesterol-lowering drugs, but the drugs are still scarce—look at prices).

Applying the VRIO Framework

Valuable and Rare

If a firm's resources are:	The firm can expect:
Not Valuable	Competitive Disadvantage
Valuable, but Not Rare	Competitive Parity
Valuable and Rare	Competitive Advantage (at least temporarily)

Applying the VRIO Framework

The Question of Imitability

- The temporary competitive advantage of valuable and rare resources can be sustained only if competitors face a cost disadvantage in imitating the resource.
  - » Intangible resources are usually more costly to imitate than tangible resources. (Harley-Davidson's styles may be easily imitated, but its reputation cannot.)

Applying the VRIO Framework

The Question of Imitability

- If there are high costs of imitation, then the firm may enjoy a period of sustained competitive advantage.
  - » A sustained competitive advantage will last only until a duplicate or substitute emerges.
    - ◆ If a firm has a competitive advantage, others will attempt to imitate it. **(Razor scooters were a big hit and others quickly imitated them.)**

Applying the VRIO Framework

The Question of Imitability

Costs of Imitation

Unique Historical Conditions (Caterpillar)

- first mover advantages
- path dependence

Applying the VRIO Framework

The Question of Imitability

Costs of Imitation

Causal Ambiguity (Southwest Airlines: HR)

- Causal links between resources and competitive advantage may not be understood.
- Bundles of resources fog these causal links.

Applying the VRIO Framework

The Question of Imitability

Costs of Imitation

Social Complexity (WordPerfect)

- The social relationships entailed in resources may be so complex that managers cannot really manage them or replicate them.

Applying the VRIO Framework

The Question of Imitability

Costs of Imitation

Patents

- Patents may be a two-edged sword.
- Offer a period of protection if the firm is able to defend its patent rights.
- Required disclosure may actually decrease the cost of imitation, and the timing.

Applying the VRIO Framework

Value, Rarity, and Imitability

If a firm's resources are:	The firm can expect:
Valuable, Rare, but not Costly to Imitate	Temporary Competitive Advantage
Valuable, Rare, and Costly to Imitate	Sustained Competitive Advantage (if Organized appropriately)

Applying the VRIO Framework

The Question of Organization

- A firm’s structure and control mechanisms must be aligned so as to give people ability and incentive to exploit the firm’s resources.
- Examples: formal and informal reporting structures, management controls, compensation policies, relationships, and so on
- These structure and control mechanisms complement other firm resources—taken together, they can help a firm achieve sustained competitive advantage. (3M Company)

The VRIO Framework

Valuable?	Rare?	Costly to Imitate?	Exploited by Organization?	Competitive Implications
No			No	Disadvantage
Yes	No			Parity
Yes	Yes	No		Temporary Advantage
Yes	Yes	Yes	Yes	Sustained Advantage

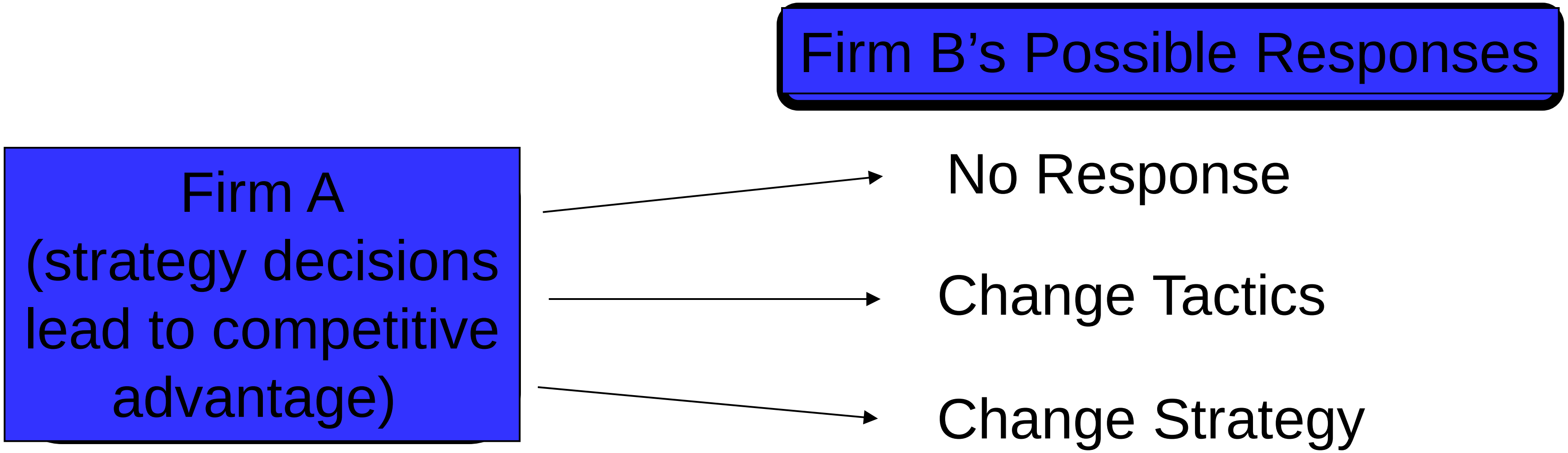
The VRIO Framework

Valuable?	Rare?	Costly to Imitate?	Exploited by Organization?	Competitive Implications	Economic Implications
No			No	Disadvantage	Below Normal
Yes	No			Parity	Normal
Yes	Yes	No		Temporary Advantage	Above Normal
Yes	Yes	Yes	Yes	Sustained Advantage	Above Normal

Competitive Dynamics of Resource Imitation

Competitive Dynamics:

- the strategic decisions and actions of firms in response to the strategic decisions and actions of other firms



Competitive Dynamics

“No Action” Response (Rolex $\longrightarrow$ Casio)

A firm may decide to take no action because:

- the other firm is serving a different market
- a response may hurt its own competitive advantage
- it does not have the resources and capabilities to mount an effective response
- it wants to reduce or manage rivalry in the market through tacit collusion

Competitive Dynamics

“Change” Responses

Tactics (Tide)

- specific *actions*
  - » tweaking product characteristics
- usually imitated so quickly that there is no advantage
- a “leap frog” move may create advantage

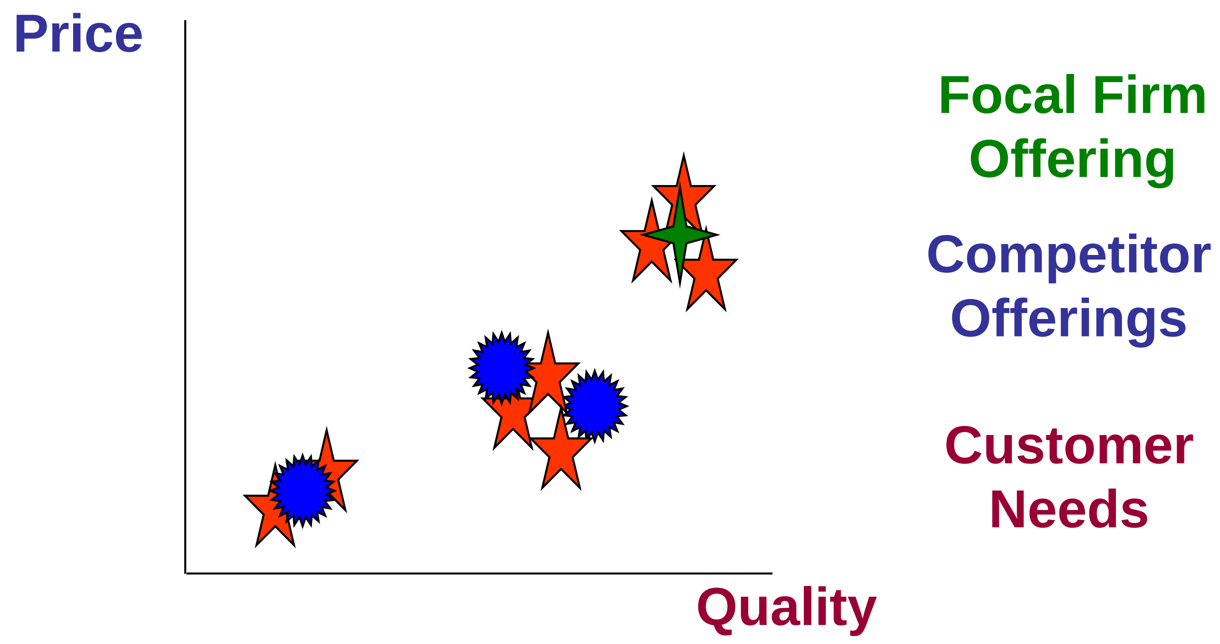
Strategy (Monsanto)

- a fundamental change in a firm’s theory
- may be necessary if current strategy becomes obsolete
- a mimetic change may achieve parity, but not advantage

Competitive Dynamics

Imitation will seldom lead to competitive advantage

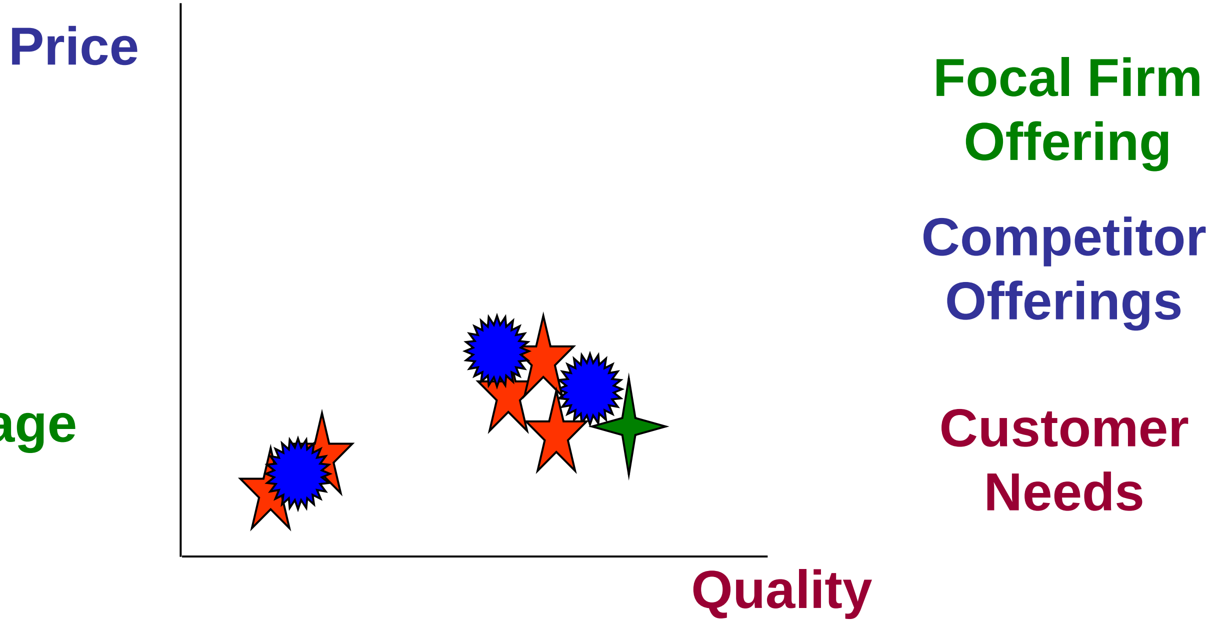
- Firms should use resources and capabilities to fill unique competitive space.



Competitive Dynamics

Similar strategies *may* lead to competitive advantage.

- Some firms can achieve competitive advantage even if they are second movers.



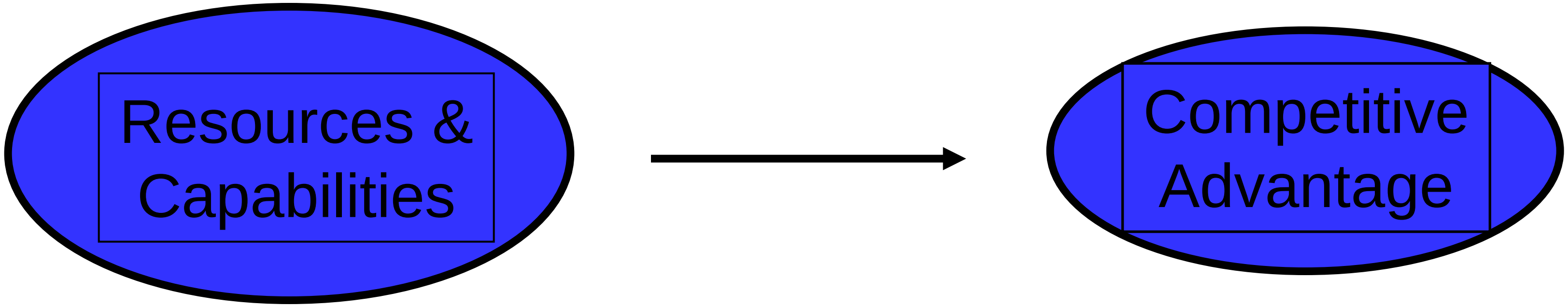
» higher quality/ lower cost offering may lead to advantage

Internal Analysis

Assumes:

- Determinates of economic performance are firm-level characteristics (resources and capabilities).
    - » Firms may be different (heterogeneity).
    - » Differences may be enduring (immobility).
- Competitive advantage stems from resources and capabilities that meet the VRIO criteria.

The Resource-Based View



- Valuable
- Rare
- Costly to Imitate
- Organized to Exploit

CA will be sustained if:

- other firms' costs of imitation are greater than benefit of imitation
- the firm is organized to exploit advantages

Internal Analysis

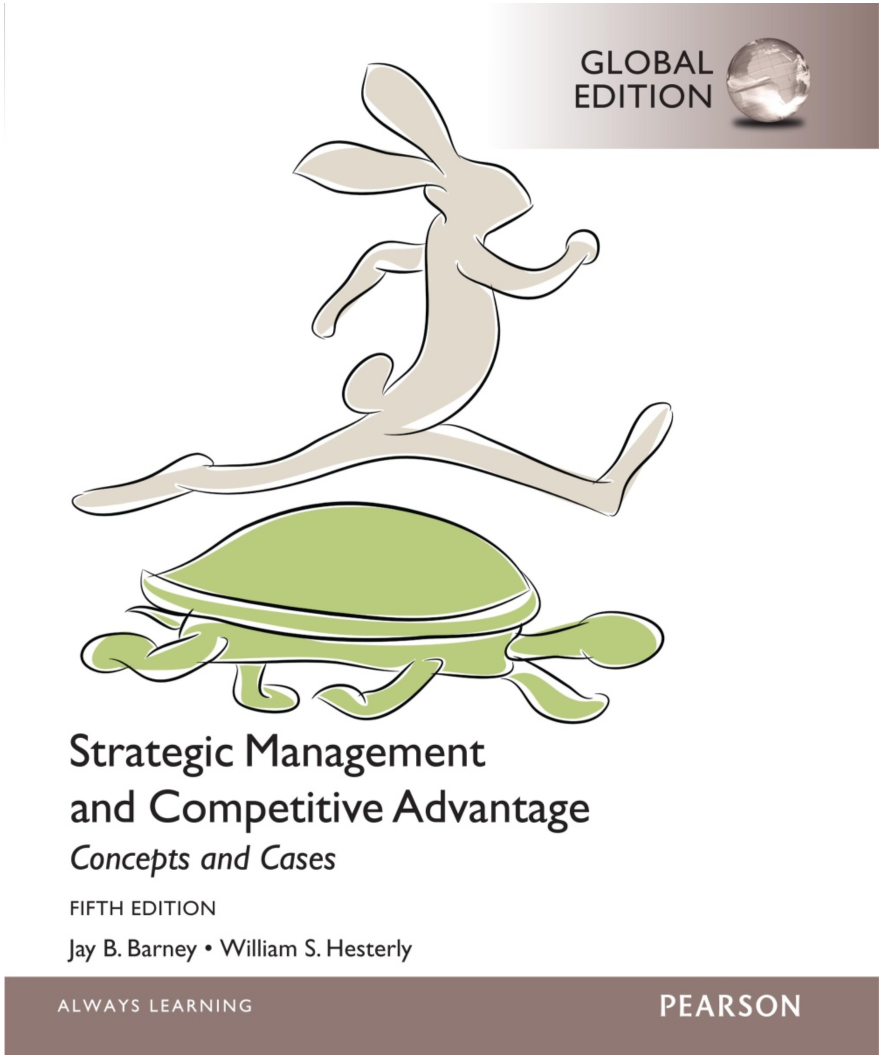
Tells us:

- what the firm *should* do, given the relative strengths and weaknesses of resources and capabilities

Managers' Job:

- bundle resources and capabilities to achieve competitive advantage

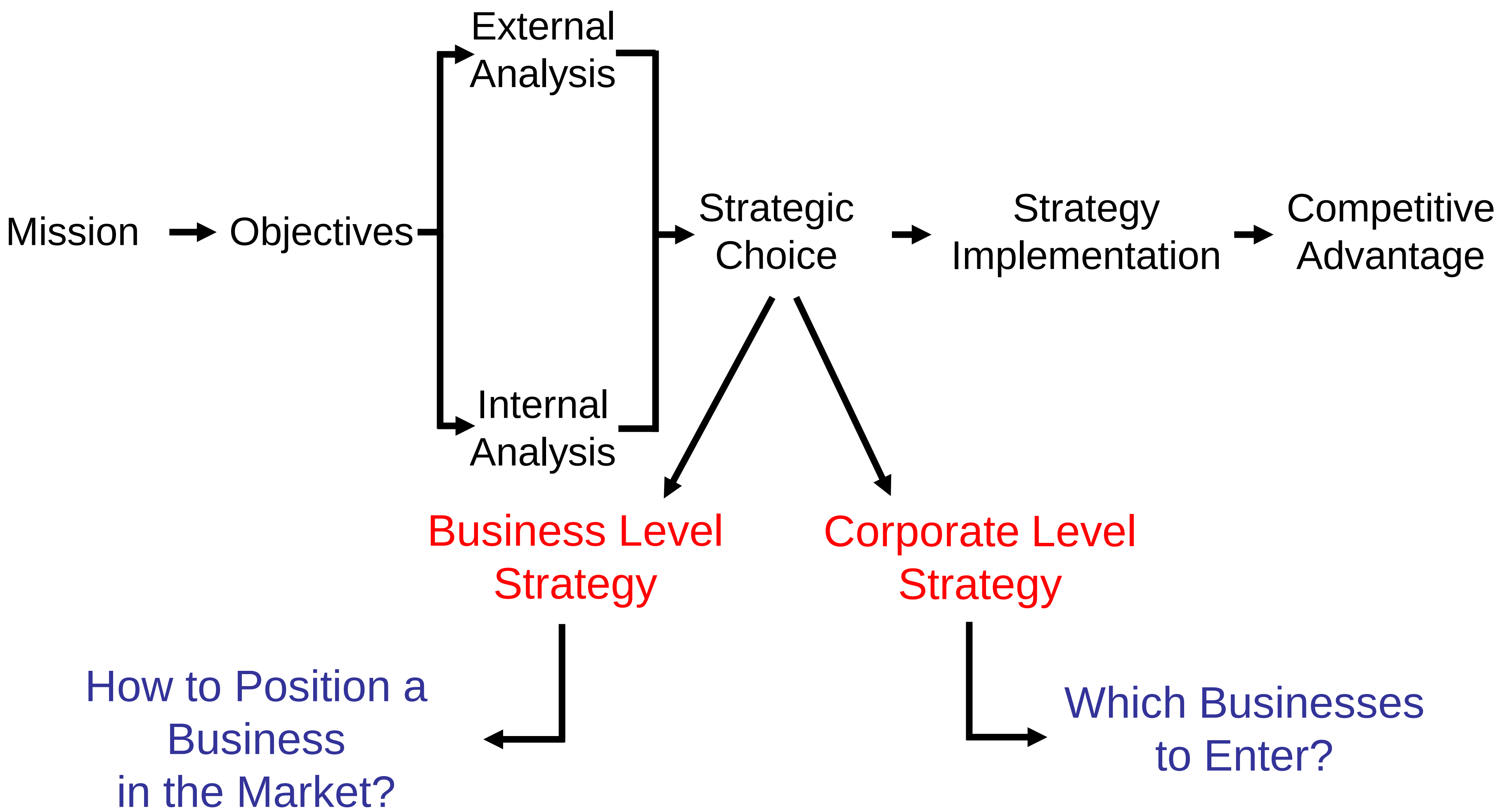
VRIO Framework Helps Managers Recognize Sources of Competitive Advantage



Chapter 4

Cost Leadership

The Strategic Management Process



Business Level Strategies

Two Generic Business Level Strategies

Cost Leadership:

- generate economic value by having lower costs than competitors

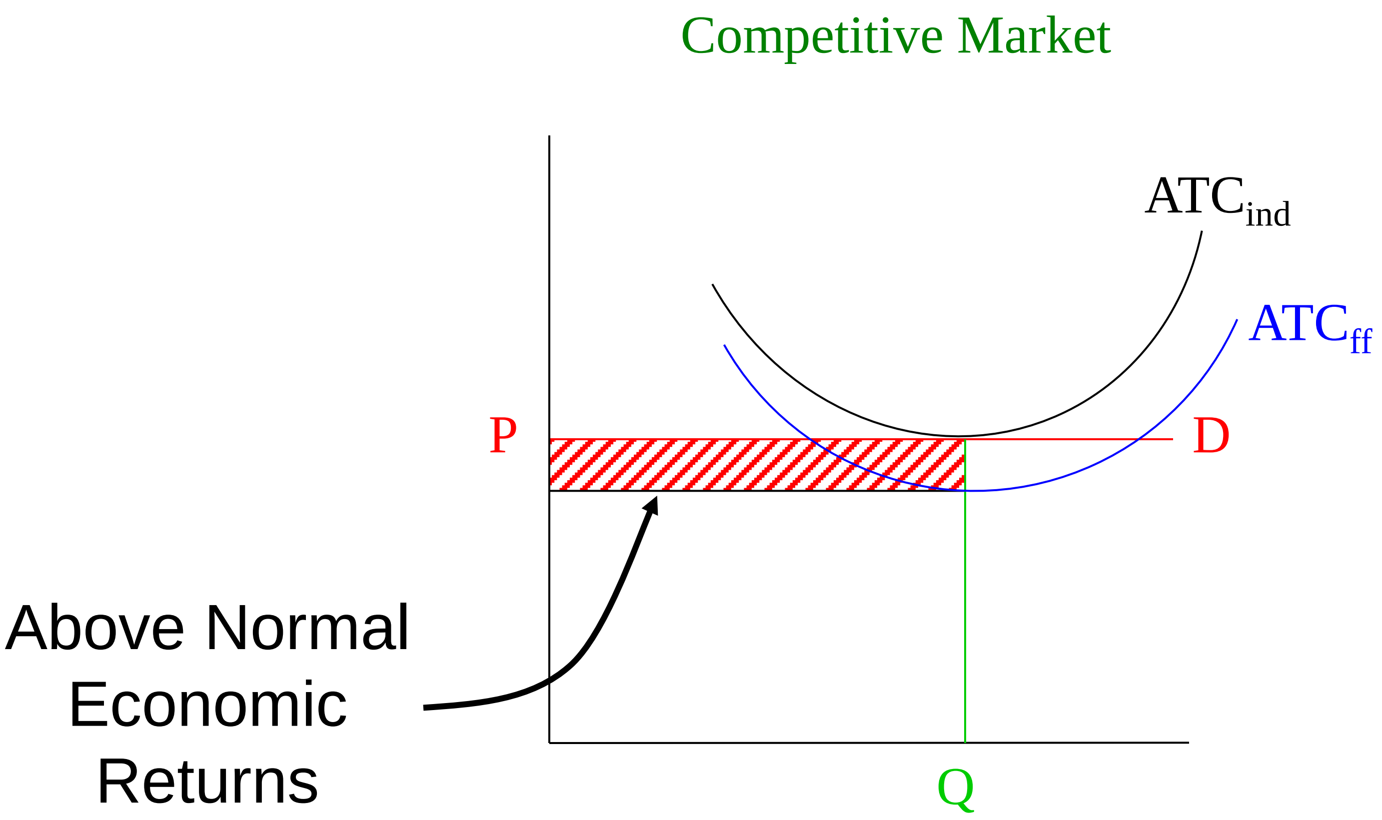
Example: Wal-Mart

Product Differentiation:

- generate economic value by offering a product that customers prefer over competitors' product

Example: Harley-Davidson

Why Cost Leadership Matters



Understanding Cost Advantage

Managers need to understand *who* has the cost advantage in their market.

- it could be the focal firm
  - develop a strategy to exploit the advantage
- it could be a competitor
  - develop a strategy to either capture the advantage or compete on some other basis

Sources of Cost Advantage

Economies of Scale

- average cost per unit falls as quantity increases—until the minimum efficient scale is reached
- are a cost advantage because competitors may not be able to match the scale because of capital requirements (barrier to entry)
- international expansion may allow a firm to have enough sales to justify investing in additional capacity to capture economies of scale

Sources of Cost Advantage

Diseconomies of Scale

- are an advantage for those who do not have diseconomies of scale
- occur when firms become too large and bureaucratic
- are a risk of international expansion

Example: Nucor Steel

Sources of Cost Advantage

Learning Curve Economies

- A firm gets more efficient at a process with experience.
- The more complicated/technical the process, the greater the experience advantage.
- International expansion may propel a firm down the experience curve because of higher volumes.

Example: Fuel Injectors

Sources of Cost Advantage

Differential Low-Cost Access to Productive Inputs

- may result from:
  - history—being in the right place at the right time
  - being first into a market—esp. foreign markets
  - natural endowment—owning a mineral deposit
  - locking up a source—buying all of its output

Example: Quantity Carpet Buys

Sources of Cost Advantage

Technology Independent of Scale

- may allow small firms to become cost competitive
- advantage typically accrues to the "owner" of the technology—may or may not be the ones who actually use the technology
- size of the advantage depends both on how valuable and protectable the technology is

Example: Vegetable Inspection

Sources of Cost Advantage

Policy Choices

- Firms get to choose how they will serve the market.
    - We'll offer level of quality that is inexpensive to produce.
- Firms can make policy choices that give people incentives to reduce cost at every opportunity.

Example: Southwest Airlines

Cost Leadership and Competitive Advantage

A source of cost advantage will lead to competitive advantage if that source is:

- Valuable
- Rare
- Costly to Imitate
- Organized (Implemented Appropriately)

Value of a Cost Advantage

Entry

- increases capital requirements for entrants

Buyers

- lowers incentives for buyers to vertically integrate

Rivalry

- competitors rationally avoid price competition

Substitutes

- limits attractiveness of substitutes

Suppliers

- increases importance of the focal firm to the supplier

Rareness of a Cost Advantage

The rareness of a source of cost advantage depends heavily on the industry life cycle:

Generally…

	Emerging		Mature
Economies of Scale	Not Rare	→	Rare
Diseconomies of Scale	Rare	→	Rare
Learning Curve Economies	Rare	→	Not Rare
Differential Input Access	Rare	→	Rare
Technology	Rare	→	Not Rare
Policy Choices	Rare	→	Rare

Imitability of Sources of Cost Advantage

Conditions largely determine if a source of cost advantage will be costly to imitate.

Low Cost Conditions

Unbalanced Industry Capacity and Demand

Non-Proprietary Technology

Highly Observable Technology

Transactional Exchange

(A cost advantage can be easily imitated.)

Imitability of Sources of Cost Advantage

High Cost Conditions

Balanced Industry Capacity and Demand

Path Dependence (Historical Uniqueness)

Protected Technology

Highly Unobservable Technology (Causal Ambiguity)

Relational Exchange (Social Complexity)

(A cost advantage cannot be easily imitated.)

Implementing a Cost Leadership Strategy

A strategy is only as good as its implementation.

Strategy is implemented through organizational structure and control:

- structure: 1) the division of management responsibilities, and 2) the establishment of reporting relationships
- control: policies intended to influence behavior—align the interests of the individual with the interests of the organization

Organizational Structure

Three Organizational Structures

Simple

Functional

Multi-Divisional

Organizational Structure

Simple Structure

Owner / Manager

- Owner/Manager makes all major decisions directly and monitors all activities.
- Difficult to maintain this structure as the firm grows in size and complexity.

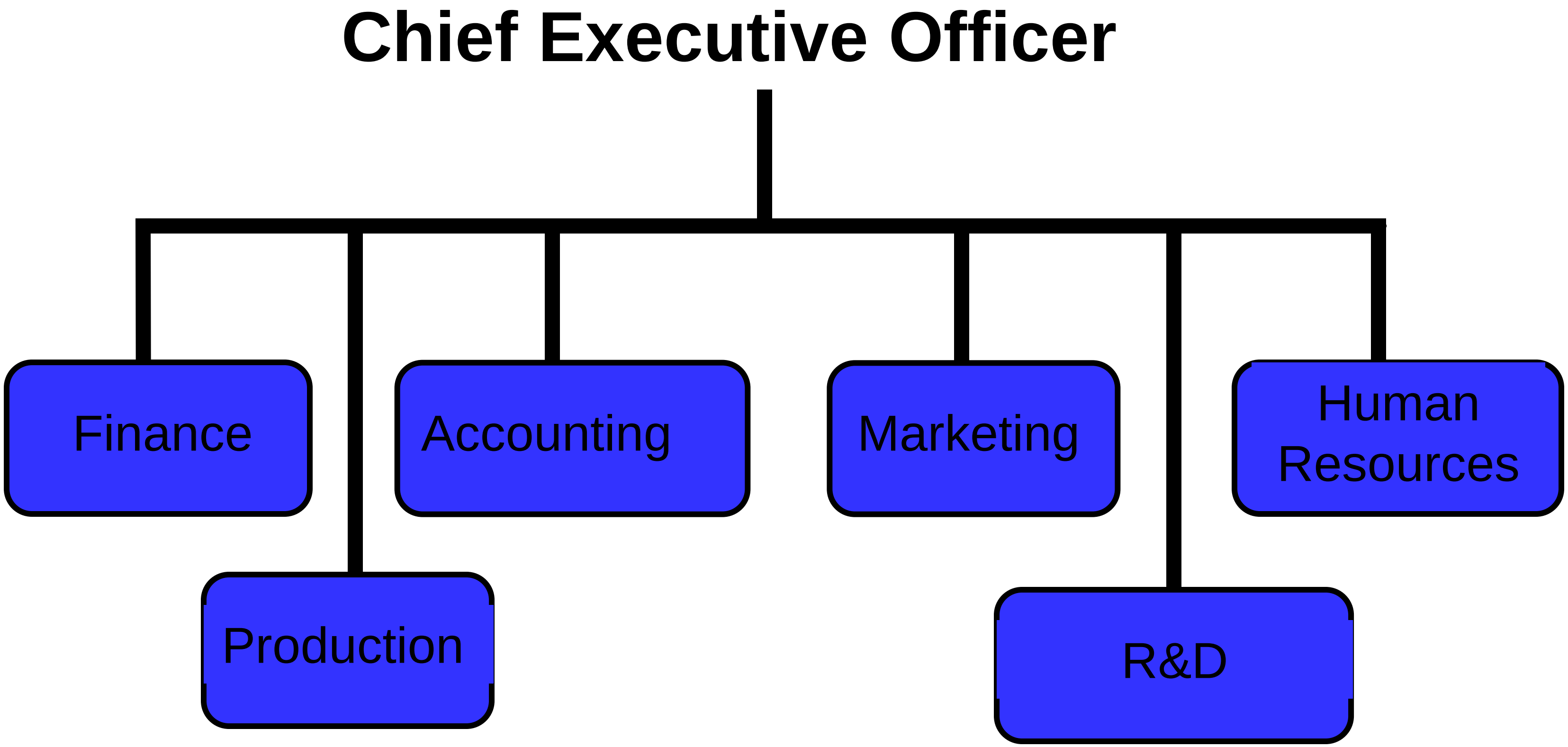
Organizational Structure

Functional Structure (U-Form: Unitary)

- divides management responsibilities by function
  - marketing
  - finance
  - accounting
  - procurement
  - production
  - R&D
  - HR
  - logistics
  - and so on
- CEO is the only executive with enterprise-wide perspective.
- CEO is responsible for strategy and coordination of functions.

Organizational Structure

Functional Structure



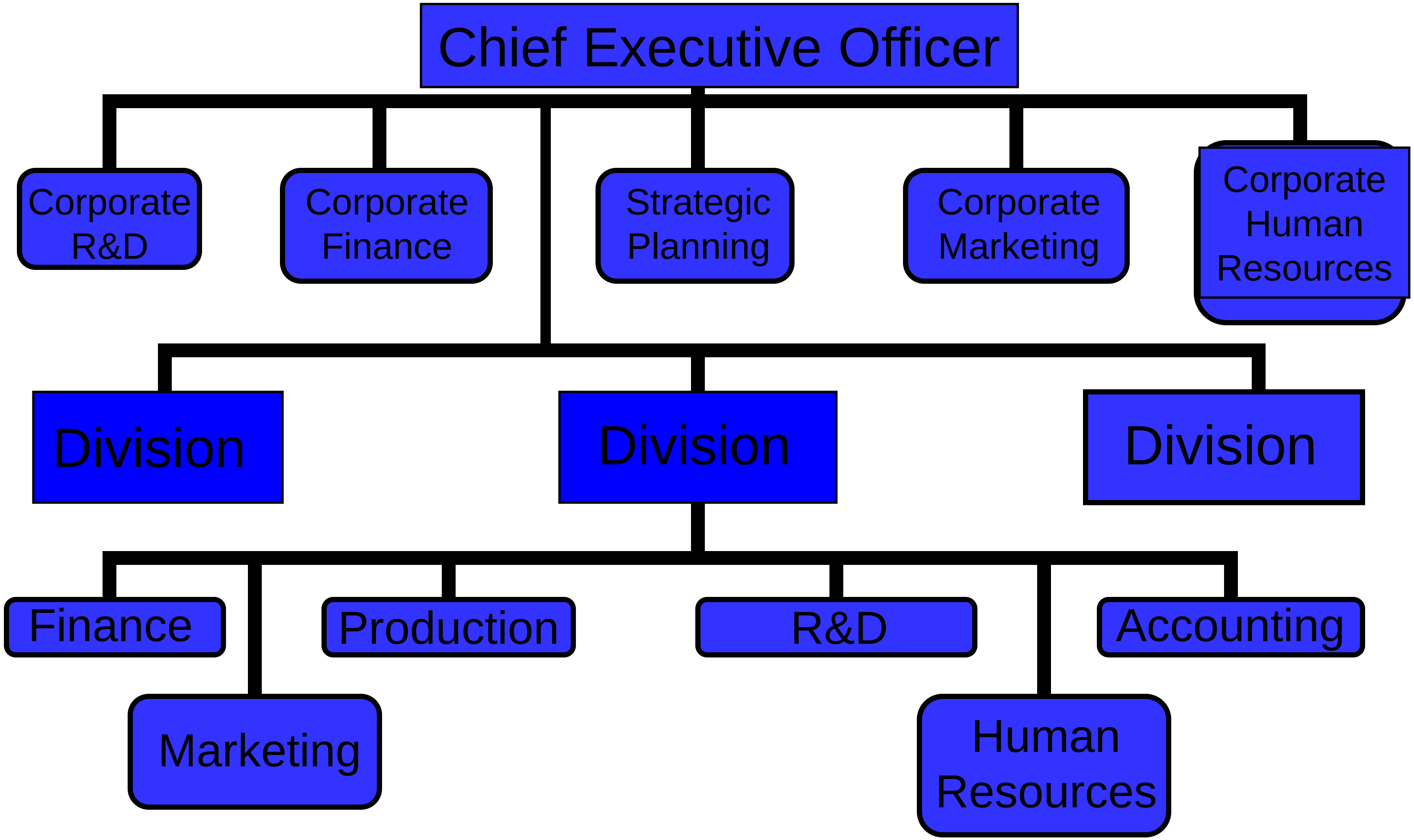
Organizational Structure

Multi-Divisional Structure (M-Form)

- Functions are replicated in each division as appropriate.
- This structure makes sense when the firm is involved in more than one business or has grown large enough to justify geographic divisions.
- CEO has strategic responsibility with the help of vice presidents, and so on—information is filtered through layers.
- CEO balances coordination and competition among divisions.

Organizational Structure

Multi-Divisional Structure (M-Form)



Organizational Structure

The Functional Structure and Cost Leadership

- specialization within functions facilitates cost reduction
- CEO can use this structure to:
    - ensure best cost reduction practices are shared among divisions
    - allow and encourage decision-making by those who are in the best positions to do so—those close to decisions
    - ensure that functions are coordinating efforts in pursuit of a common strategy

Organizational Controls

policies intended to influence behavior by aligning the interests of the individual with the interests of the organization

Management Controls

Formal

- budgeting policies
- credit policies
- spending policies
- travel policies
- purchasing policies

Informal

- culture
- attitudes
- leadership styles

Organizational Controls

Compensation Policies

- stock options
- bonuses based on:
  - cost reduction
  - financial performance
- nonmonetary awards
  - vacations
  - parking places
  - office decor

Compensation Policies Should Reinforce Formal and Informal Management Controls

Organizational Controls

Organizational Controls and Cost Leadership

- Management controls and compensation policies can be focused on cost reduction.
    - supply contracts that stipulate cost reductions over time
    - tight credit policies
    - austere travel policies (e.g., no first class)
    - bonuses tied to cost reduction targets

Example: Wal-Mart and Southwest Airlines

Summary

Business Level Strategy

Cost Leadership

Cost Advantages

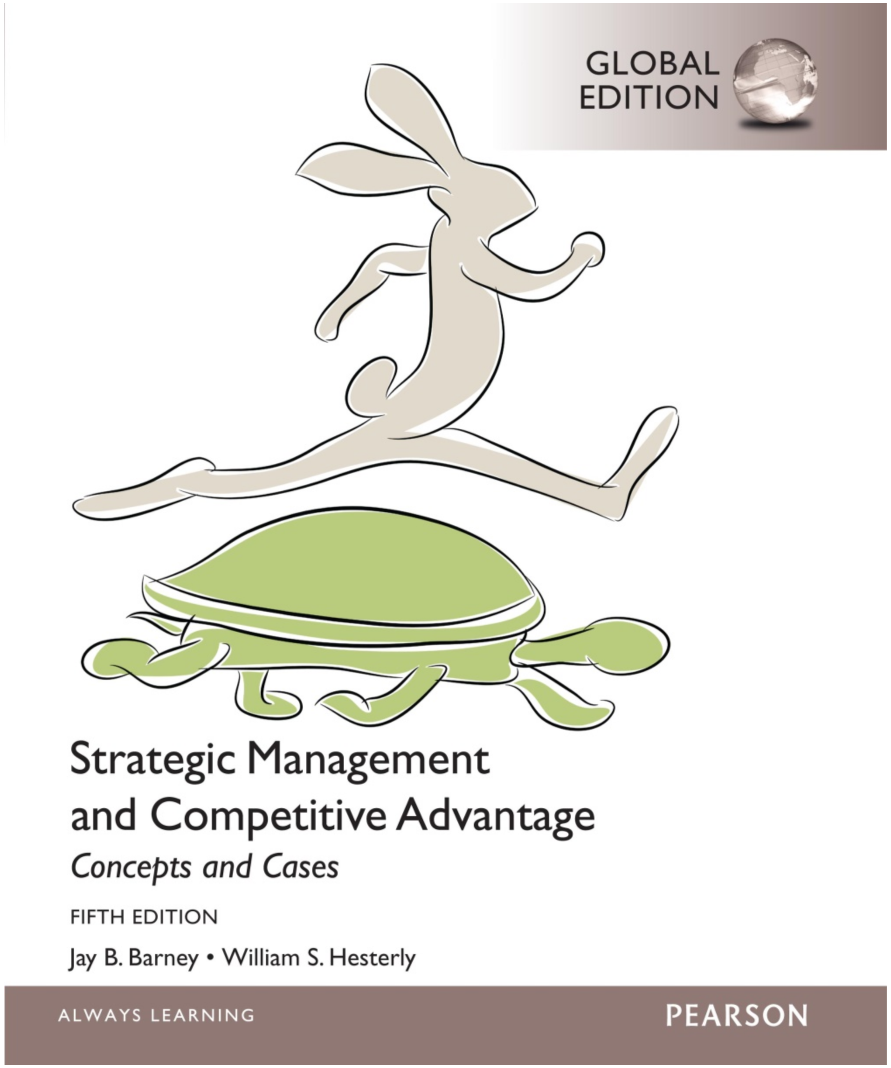
- Economies of Scale
- Diseconomies of Scale
- Learning Curve Economies
- Differential Input Access
- Technology
- Policy Choices

Product Differentiation

Competitive Advantage Depends on Meeting VRIO Criteria

Emphasis on Organization (Implementation)

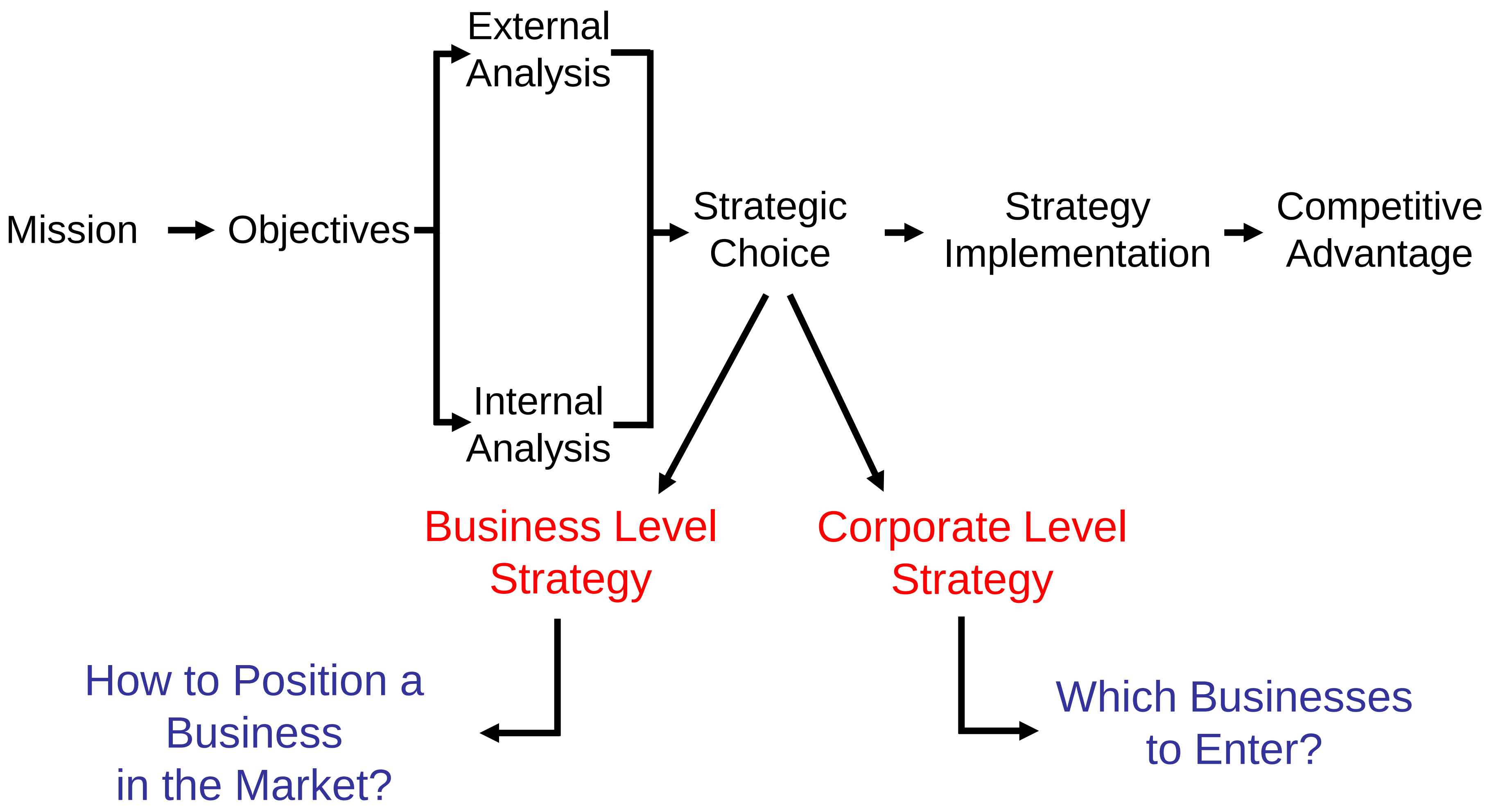
Structure and Control



Chapter 5

Product Differentiation

The Strategic Management Process



Business Level Strategies

Two Generic Business Level Strategies

Cost Leadership:

- generate economic value by having lower costs than competitors

Example: Wal-Mart

Product Differentiation:

- generate economic value by offering a product that customers prefer over competitors' product

Example: Harley-Davidson

Product Differentiation

A business level strategy intended to:

- increase the perceived value of the focal firm's products and/or services relative
  to the value of competitor's products and/or services

- create a customer preference for the focal firm's products and/or services

Bases of Differentiation

A base of differentiation must fill some customer need:

- image
- hunger
- comfort
- cleanliness
- beauty
- status
- style
- taste
- safety
- quality
- service
- accuracy
- furthering a cause
- reliability in use
- nostalgia
- belonging

A differentiated product fills one or more needs better than the products of competitors.

Bases of Differentiation

Almost anything can be a base of differentiation.

- The wide range of customer needs can be filled by a wide range of bases of differentiation.
  - tangible thing (product features, location, etc.)
  - intangible concept (reputation, a cause, an ideal, etc.)
  - limited only by managerial creativity

Example: Fred Smith and FedEx

Bases of Differentiation

Three Categories

1) Product Attributes
    - exploiting the actual product
2) Firm—Customer Relationships
    - exploiting relationships with customers
3) Firm Linkages
    - exploiting relationships within the firm and/or relationships with other firms

Bases of Differentiation

Product Attributes

- Product Features—the shape of a golf club head
- Product Complexity—multiple functions on a watch
- Timing of Introduction—being the first to market
- Location—locating next to a freeway exit

Bases of Differentiation

Firm–Customer Relationships

- Customization—creating a unique diamond bracelet for a customer
- Consumer Marketing—creating brand loyalty to a soap through image advertising
- Reputation—sponsoring the local homeless shelter to engender positive community response

Bases of Differentiation

Firm Linkages

- Linkages among Functions in the Firm—using a circuit board designed in one division in other divisions
- Linkages with other Firms—a sporting goods store sponsors a benefit race by donating running shoes and receives free radio advertising in return
- Product Mix—a furniture store begins to sell home gym equipment, computers, and lawn mowers

Bases of Differentiation

Firm Linkages

- Distribution Channels—a doughnut shop begins to sell its doughnuts through gas stations
- Service and Support—an oil change shop begins to offer pick up and delivery of cars in an office building's parking garage

Competitive Advantage

A product differentiation strategy must meet the VRIO criteria…

Is it *V*aluable?

Is it *R*are?

Is it costly to *I*mitate?

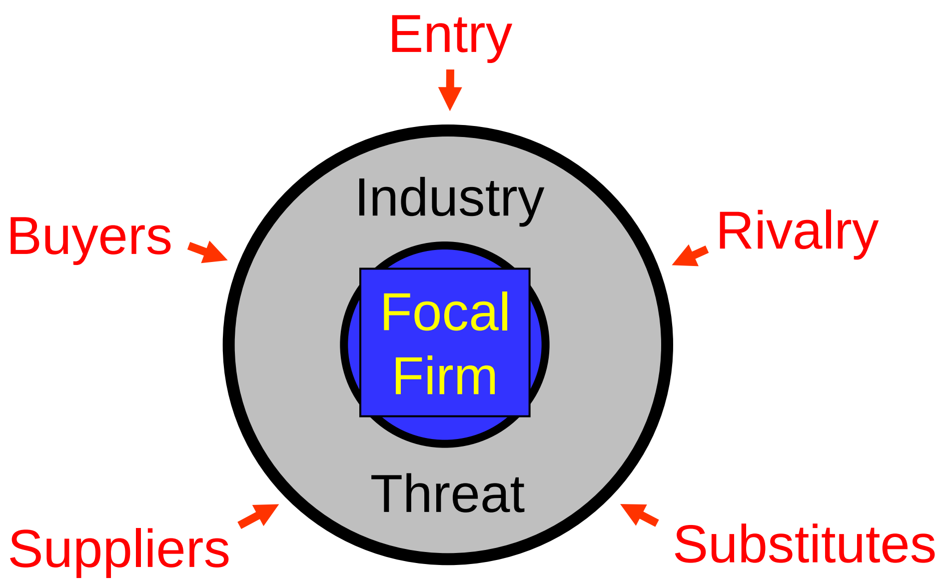
Is the firm *O*rganized to exploit it?

…if it is to create competitive advantage.

The Value of Product Differentiation

Neutralizing Threats

Toyota protected from Hyundai



Chrysler's Crossfire

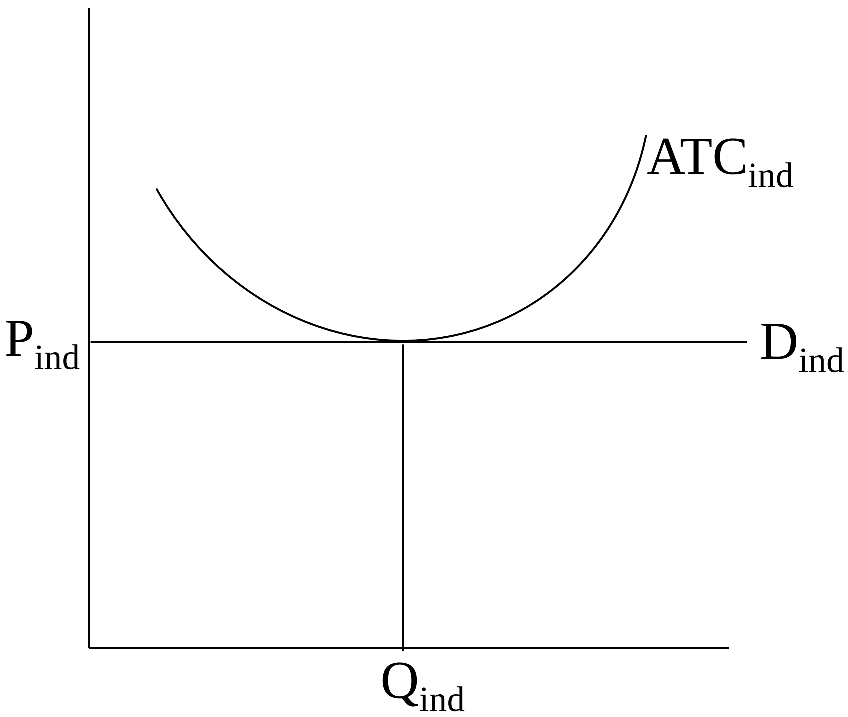
Allen Edmonds & Cole Hahn

Ruth's Chris Steak House

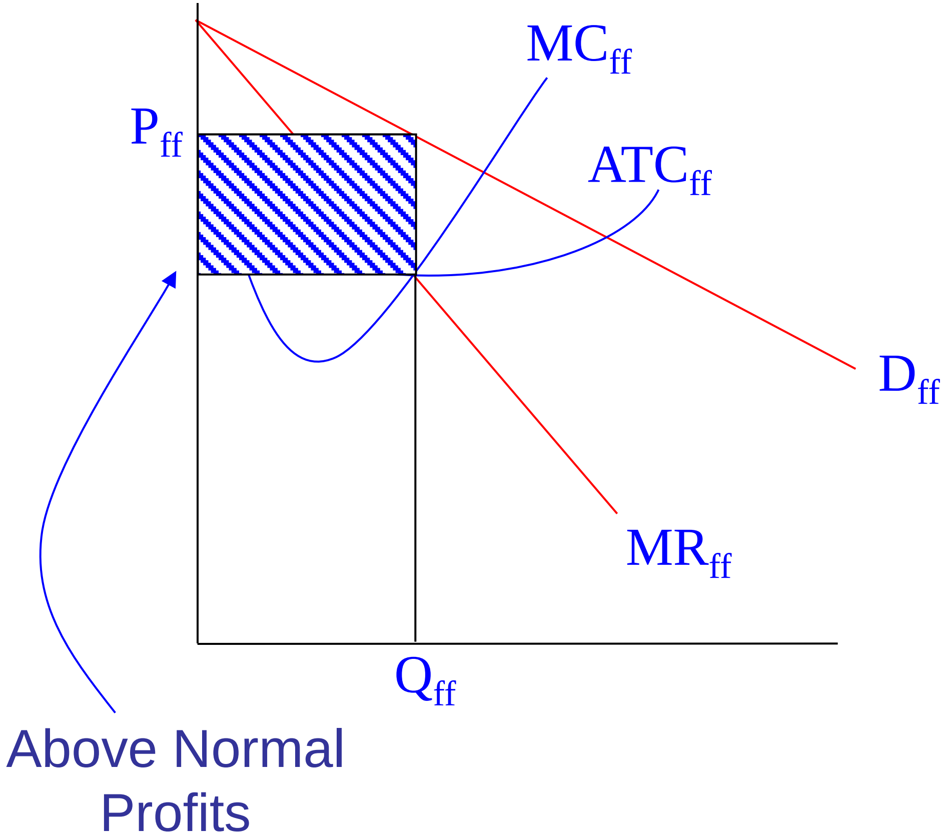
Home vs. Photo Shop Printing of Digital Pictures

The Value of Product Differentiation

Focal Firm with No Differentiated Product



Focal Firm with Differentiated Product



The Value of Product Differentiation

Exploiting Industry-Type Opportunities

Fragmented Industry

Branding: commodity ⟶ differentiated product

Example: Kellogg's Corn Flakes

Emerging Industry

First mover advantages: captures market share

Example: Motorola Cell Phones

The Value of Product Differentiation

Exploiting Industry-Type Opportunities

Mature Industry

Refining product or adding services

Example: Ford's emphasis on service

Declining Industry

Exploiting niches: serving those with strong needs

Example: NEWT at the Royal Hawaiian

The Value of Product Differentiation

Exploiting Other Opportunities

Trends or Fads

- spinners
- surf clothing

Social Causes

- themed credit cards
- animal safe clothing

Government Policy

- Toyota Prius
- airport x-ray machines

Economic Conditions

- outplacement agencies
- check cashing services

Rareness of Product Differentiation

By definition, we assume rareness

- if a product is differentiated, it is rare enough
- customer preferences are evidence of a differentiated product
    - increased volume of purchases
    - and/or a premium price

Imitability of Product Differentiation

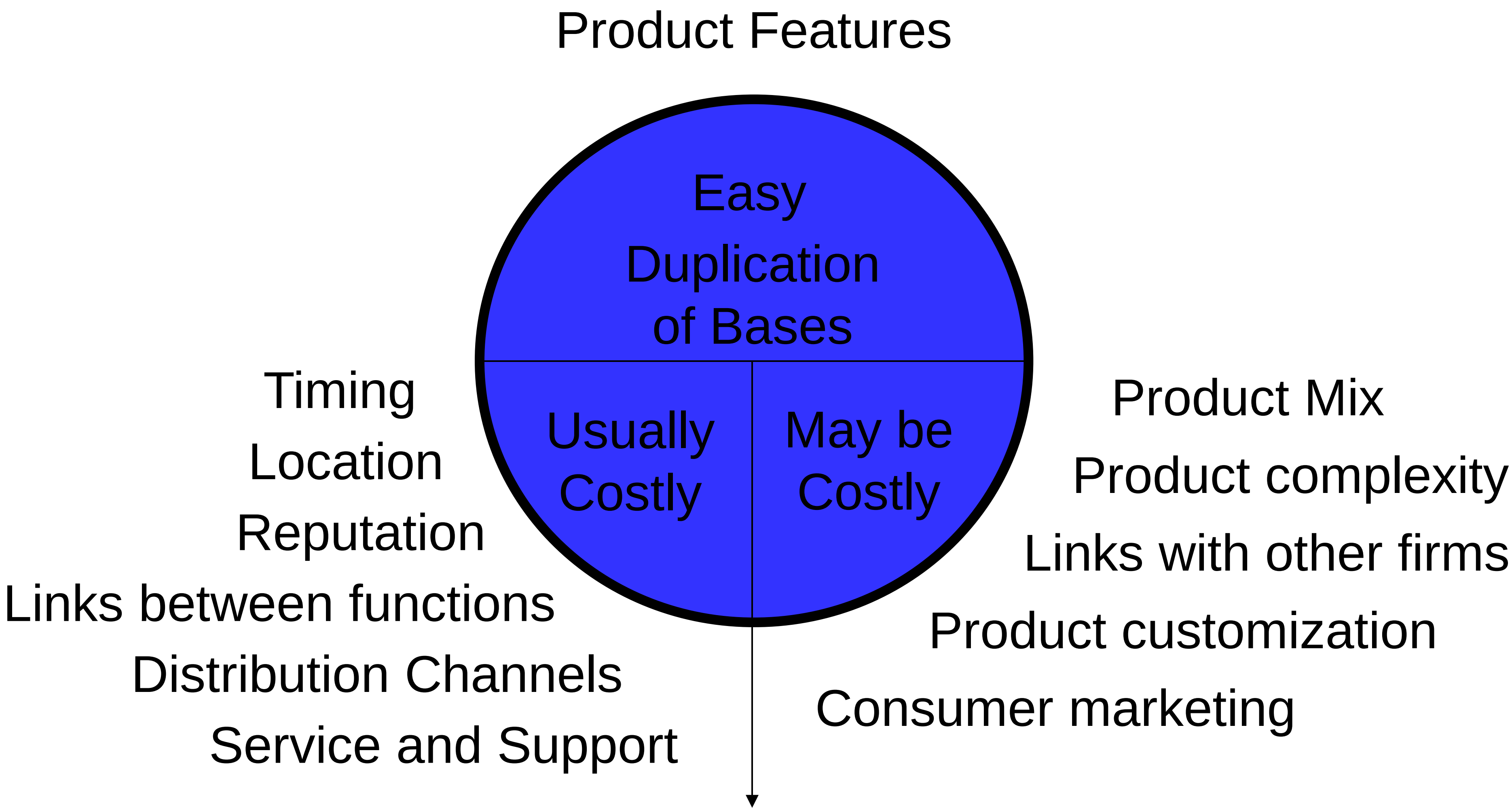
Logic of costs of imitation

- If would-be imitators face a cost disadvantage of imitation, they will rationally choose not to imitate.

Sources of costs of imitation

- historical uniqueness
- causal ambiguity
- social complexity

Imitability of Product Differentiation



Imitability of Product Differentiation

Substitutes

- Some substitutes may be obvious.
- Some substitutes may not be obvious.
- If no substitutes are obvious, then we would conclude that imitation through substitution will be costly—at least for the present time.
- If a base of differentiation is valuable, others will attempt to imitate it through duplication and/or substitution.

Organizing for Product Differentiation

Organizational Structure

- U-Form with cross-functional teams

Management Controls

- flexibility
- broad guidelines
- creativity encouraged

Compensation Policies

Reward:

- cross-functional cooperation
- creativity
- risk taking

Example: Ford Taurus Cross-Functional Teams

Cost Leadership and Product Differentiation

Can a firm pursue both simultaneously?

No

- Use of structure, management control, and compensation policies are nearly opposites.

Example: Rolex

Yes

- Firms can do both because some bases of differentiation also lend themselves to low cost.
- Structure, controls, and policies are not opposites.

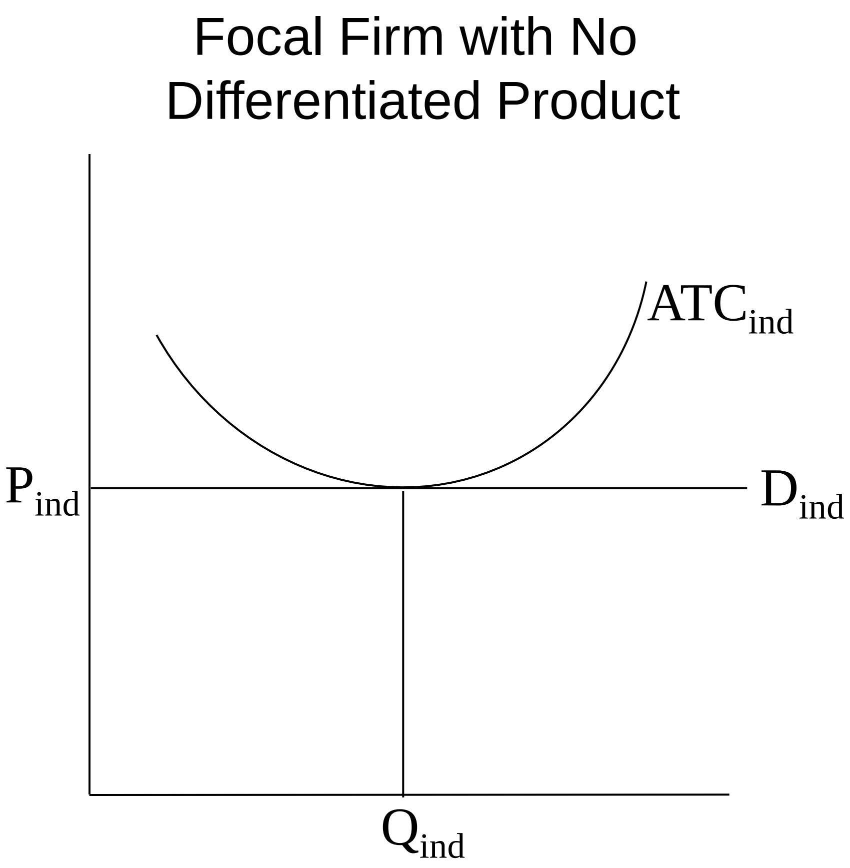
Example: Toyota

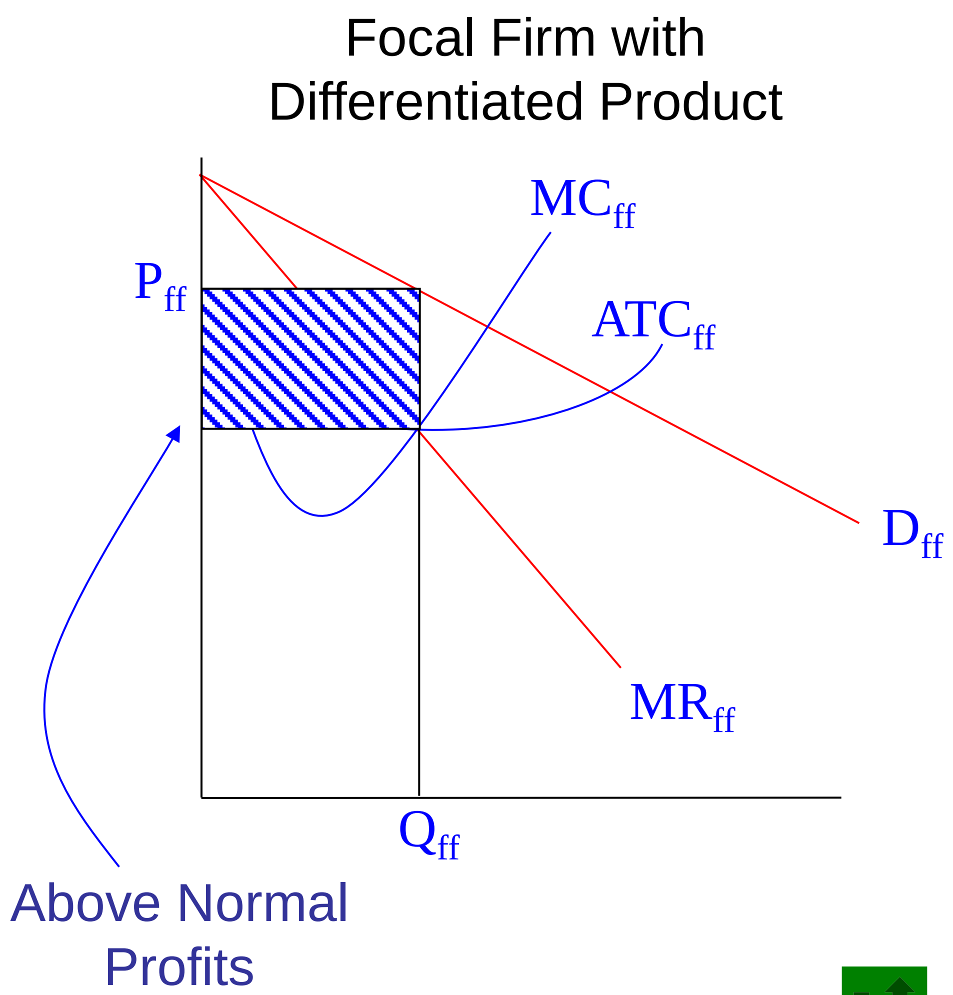
Summary

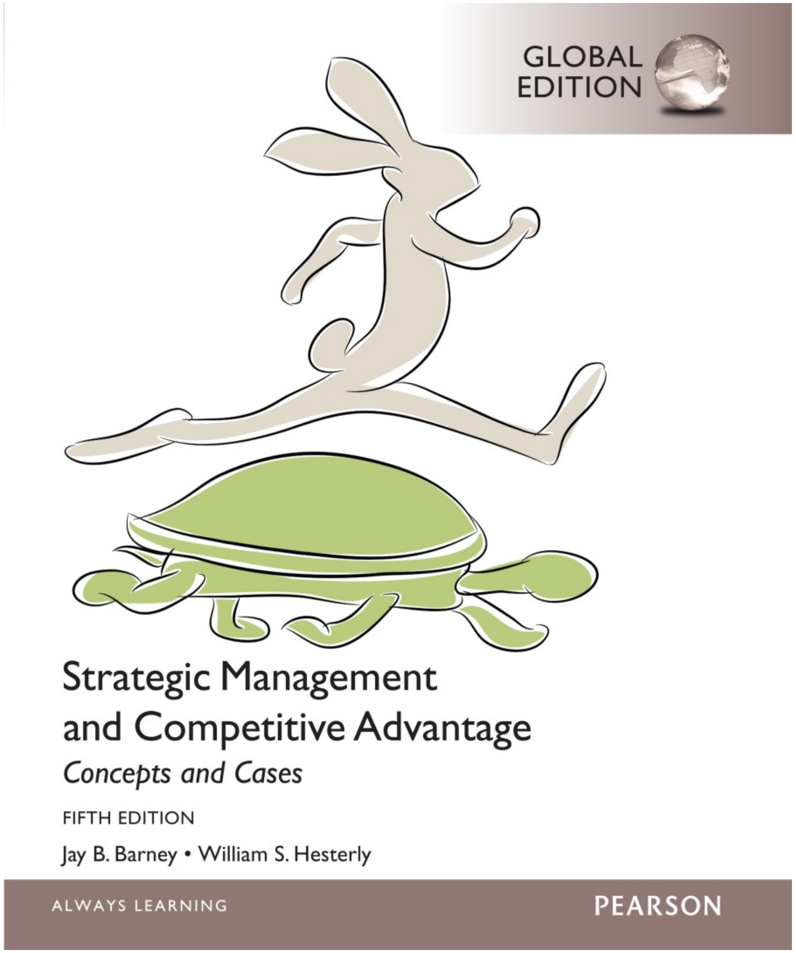
- Product differentiation creates customer preferences.
- Preferences allow firms to make above normal profits.
- Almost anything can be a base of differentiation.
- Bases of product differentiation that meet the VRIO criteria may generate competitive advantage.
- A product differentiation strategy is only as good as its implementation.

Product differentiation principles can be applied to your personal and professional lives.

The Value of Product Differentiation

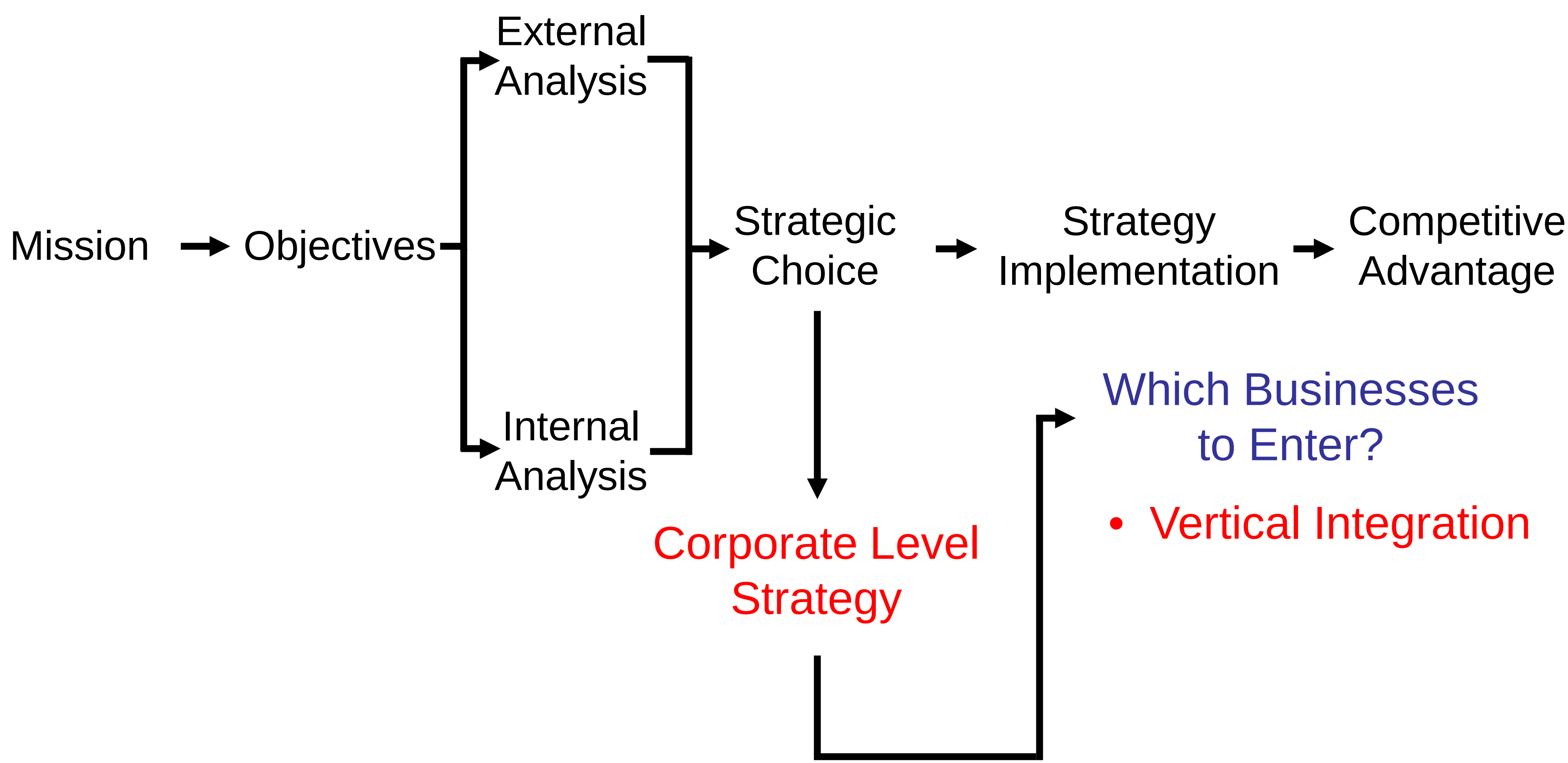






Chapter 6
Vertical Integration

The Strategic Management Process



Logic of Corporate Level Strategy

Corporate level strategy should create value:

1) such that the value of the corporate whole increases

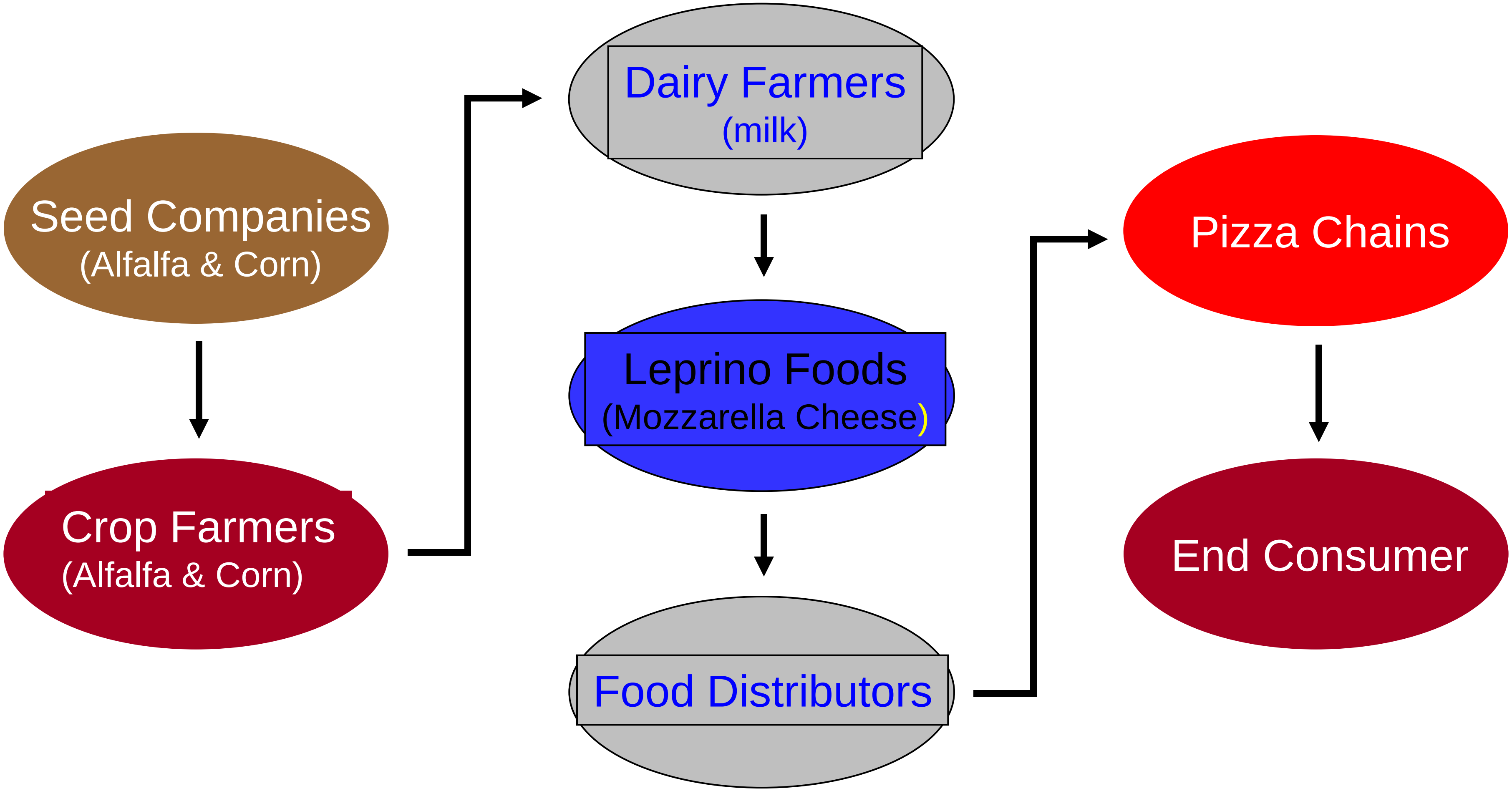
2) such that businesses forming the corporate whole are worth more than they would be under independent ownership

3) that equity holders cannot create through portfolio investing

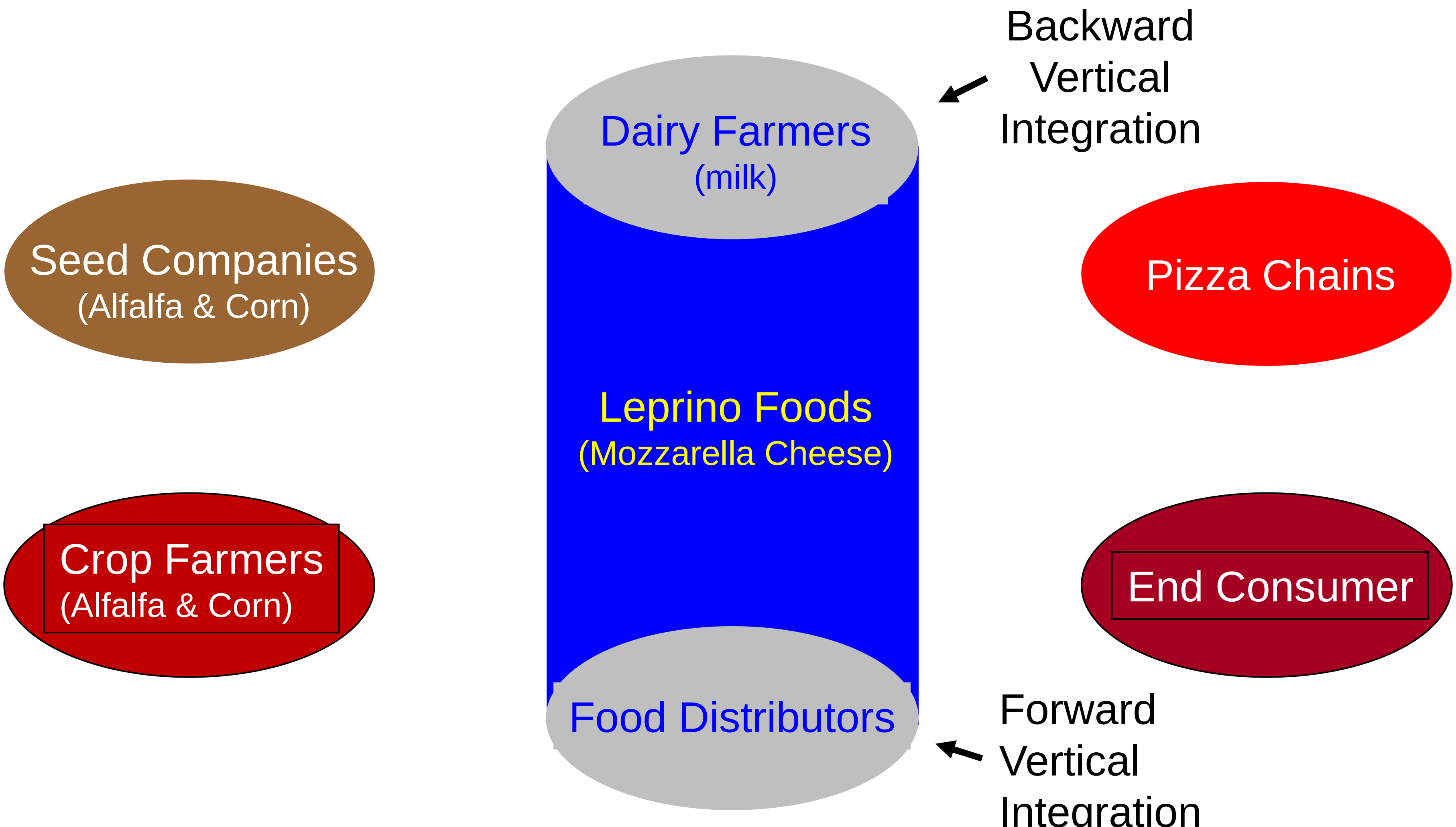
- A corporate level strategy should create synergies that are not available in equity markets.
  - vertical integration = value chain economies

What Is Vertical Integration?

Where your pizza comes from



What Is Vertical Integration?

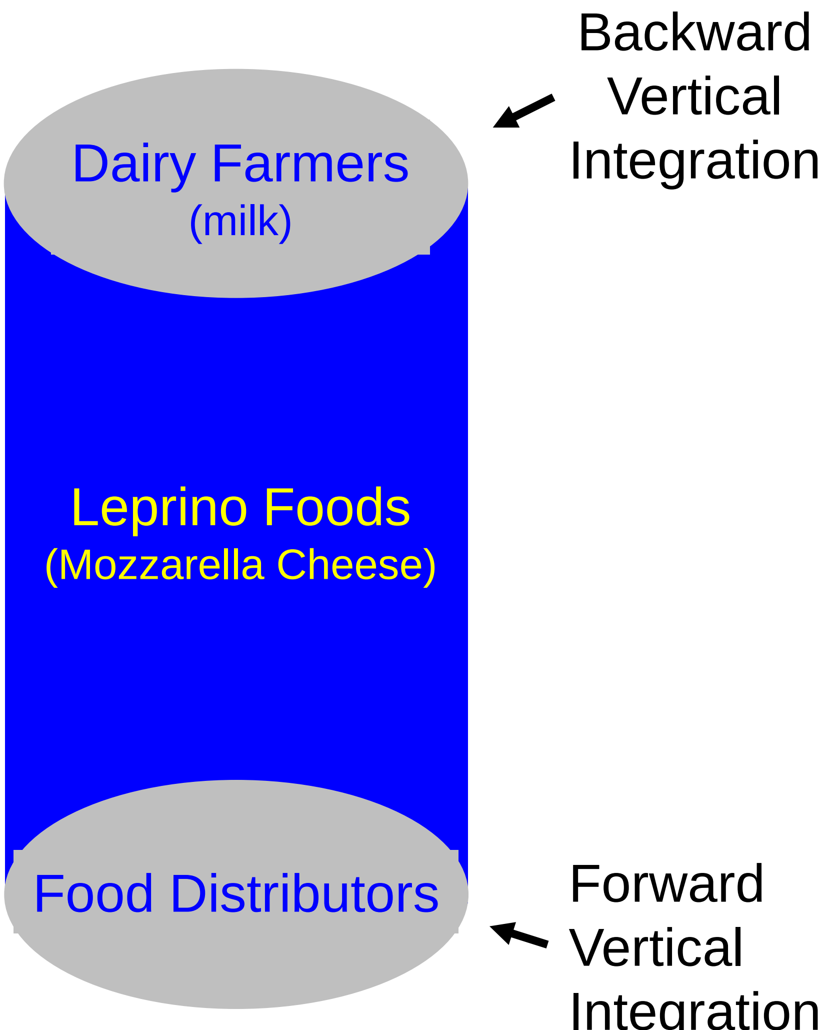


Value Chain Economies

The Logic of Value Chain Economies

- The focal firm is able to create synergy with the other firm(s).
    - cost reduction
    - revenue enhancement

- The focal firm is able to capture above normal economic returns (avoid perfect competition).



Competitive Advantage

If a vertical integration strategy meets the VRIO criteria…

Is it *V*aluable?

Is it *R*are?

Is it costly to *I*mitate?

Is the firm *O*rganized to exploit it?

…it may create competitive advantage.

Value of Vertical Integration

Market vs. Integrated Economic Exchange

- Markets and integrated hierarchies are “forms” in which economic exchange can take place.
- Economic exchange should be conducted in the form that maximizes value for the focal firm.
  - Thus, firms assess which form is likely to generate more value.

Integration makes sense when the focal firm can capture more value than a market exchange provides.

Value of Vertical Integration

Three Value Considerations

Leverage Capabilities	Manage Opportunism	Exploit Flexibility
• firm capabilities may be sources of competitive advantage in other businesses • if not, then don't integrate exchange	• opportunism may be checked by internalizing (TSI) • internalizing must be less costly than opportunism	• internalizing is usually less flexible • flexibility is prized when uncertainty is high

Rarity of Vertical Integration

Integration vs. Non-Integration

- A firm’s integration strategy may be rare because the firm integrates or because the firm does not integrate.
    - Thus, the question of rareness does not depend on the number of forms observed.
- A firm’s integration strategy is rare or common with respect to the value created by the strategy.

Example: Toyota’s Choice Not to Integrate Suppliers

Imitability of Vertical Integration

Form vs. Function

- The form, *per se*, is usually not costly to imitate.
- The value-producing function of integration may be costly to imitate, if:
    - the integrated firm possesses resource combinations that are the result of:
        - historical uniqueness
        - causal ambiguity
        - social complexity
    - small numbers prevent further integration
    - capital requirements are prohibitive

Imitability of Vertical Integration

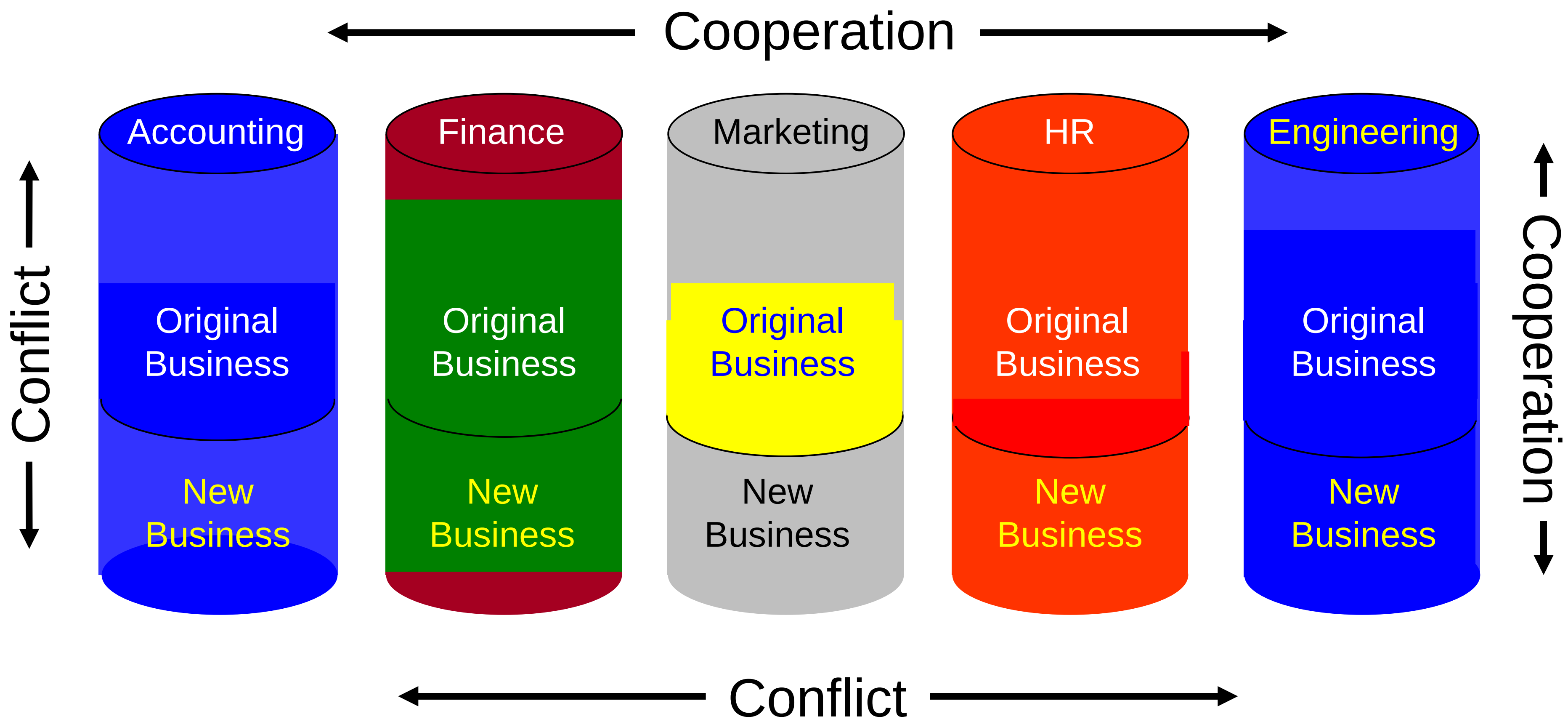
Modes of Entry

- Acquisition and internal development are alternative modes of entry into vertical integration.
    - Thus, one firm may acquire a supplier while a competitor could imitate that strategy through internal development.
    - In both cases, the boundaries of the firm would encompass the new business.
- Strategic alliances can be viewed as a substitute for vertical integration—without the costs of ownership.

Organizing Vertical Integration

Functional Structure (U-Form)

CEO's Role



Organizing Vertical Integration

Management Controls

What needs to be “controlled” in a vertically integrated firm?

- managers’ efforts to achieve the desired value chain economies
  - cooperation and competition among and between functions
  - the integration of new businesses into the existing business
  - time horizon of managers

Organizing Vertical Integration

Management Controls

Budgets

- separating strategic and operational budgets
  - strategic: inputs and outputs
  - operational: outputs

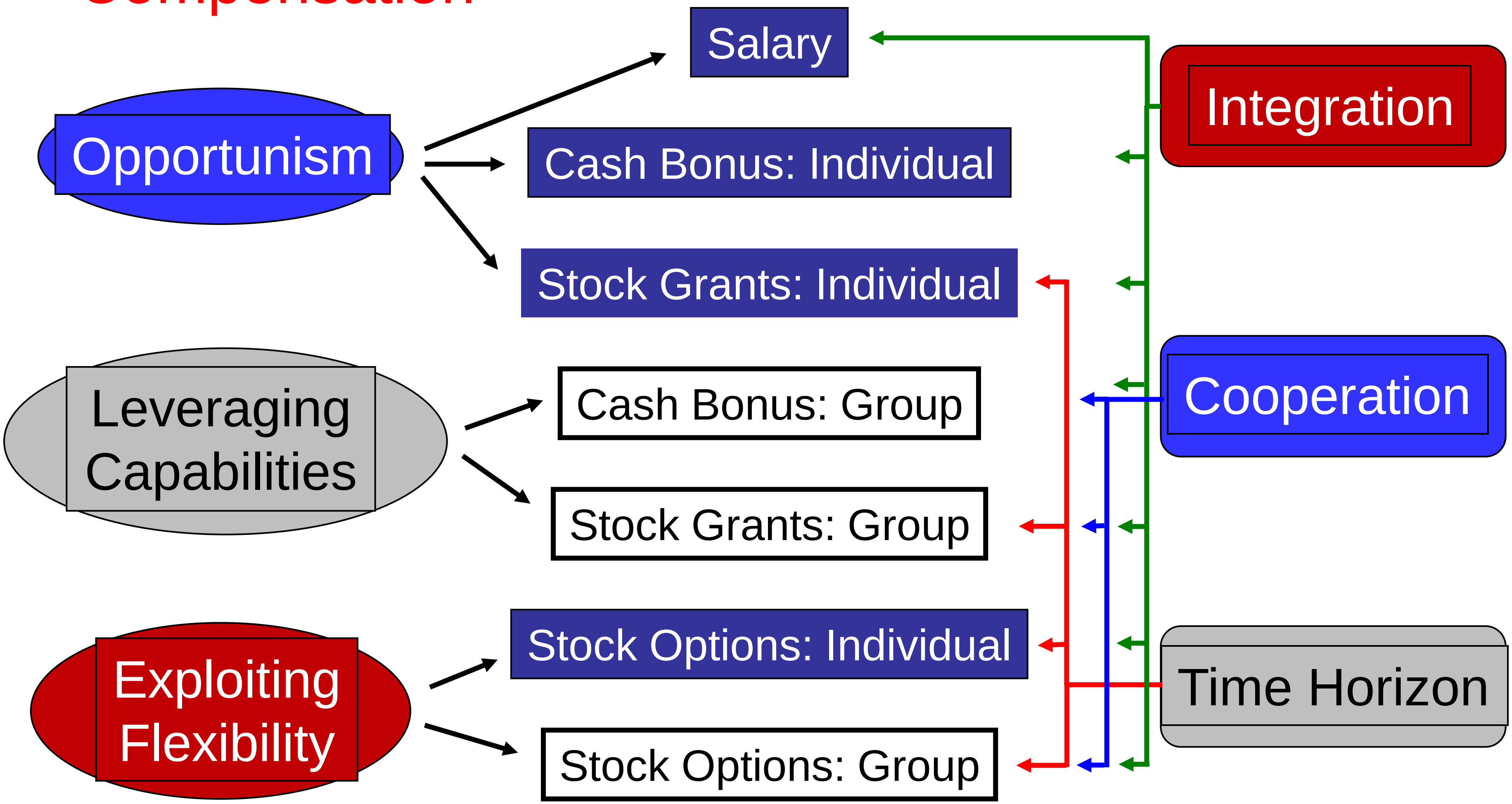
Board Committees

- provide oversight and direction to managers
- help ensure that strategic direction is maintained

These mechanisms focus management attention on achieving value chain economies.

Organizing Vertical Integration

Compensation



Summary

Vertical Integration…

- makes sense when value chain economies can be created and captured
- may allow a firm to leverage capabilities
- may be a response to the threat of opportunism and uncertainty
- as a form of exchange *per se*, is not rare nor costly to imitate

Summary

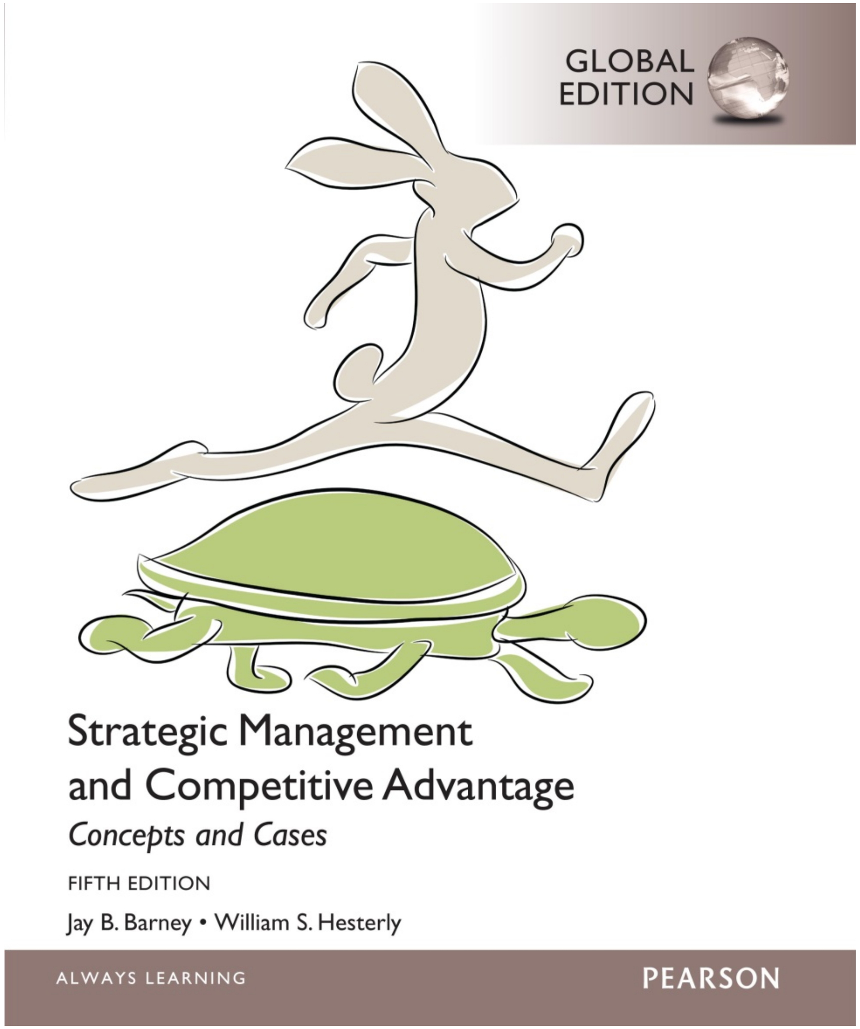
Vertical Integration…

- is an important consideration in the decision to expand internationally (range of possibilities)

- makes sense when done for the right reasons, under the right circumstances

- can be a costly mistake if done wrong

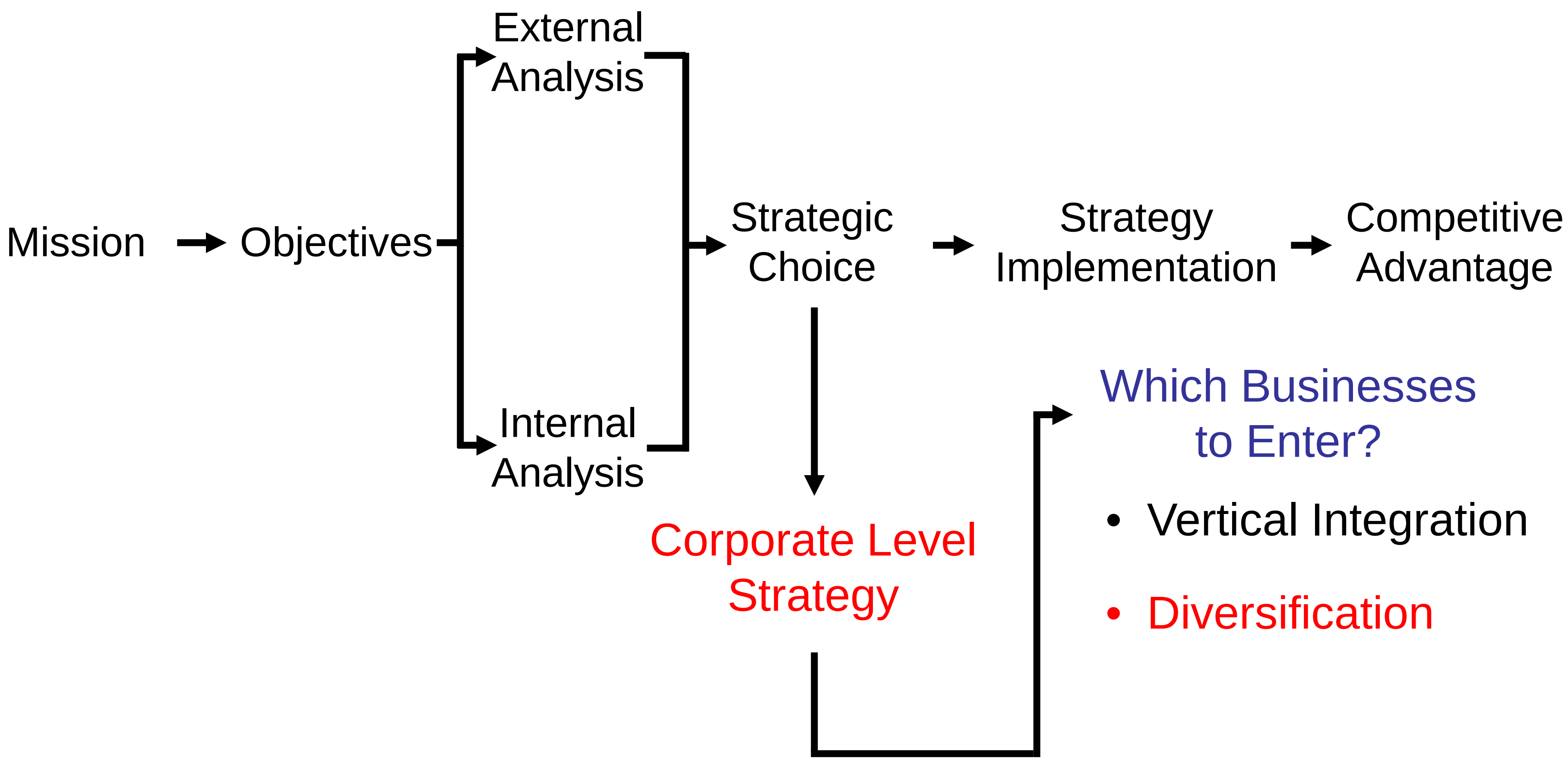
Ownership is costly—integrate only when the benefits outweigh the costs of integration!



Chapter 7

Corporate Diversification

The Strategic Management Process



Logic of Corporate Level Strategy

Corporate level strategy should create value:

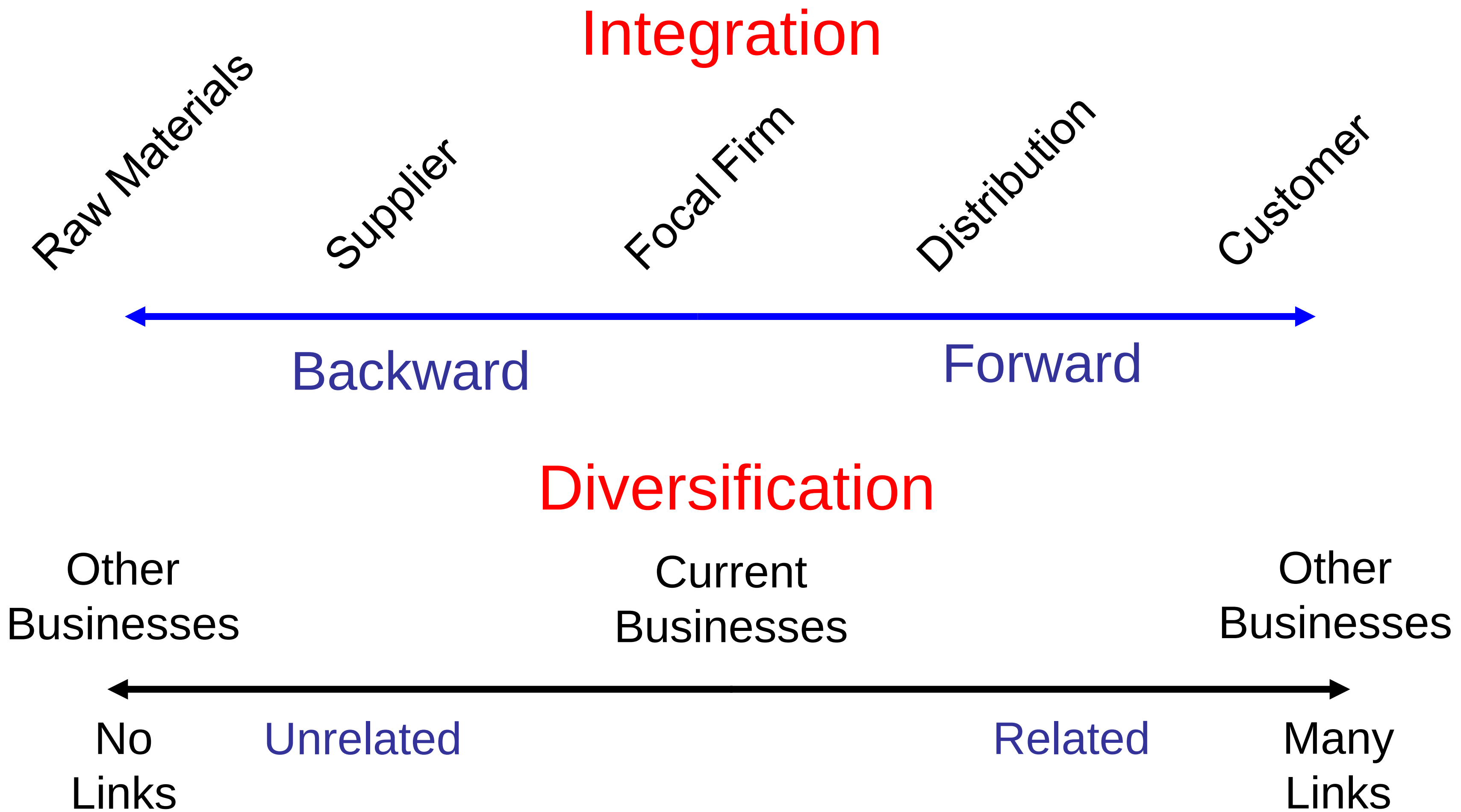
1) such that businesses forming the corporate whole are worth more than they would be under independent ownership

2) that equity holders cannot create through portfolio investing

Therefore,

- a corporate level strategy must create synergies
  - economies of scope—diversification

Integration and Diversification



Types of Corporate Diversification

At a general level…

Product Diversification:

- operating in multiple industries

Geographic Market Diversification:

- operating in multiple geographic markets

Product-Market Diversification

- operating in multiple industries in multiple geographic markets

Types of Corporate Diversification

At a more specific level…

Limited Diversification

- single business: > 95% of sales in single business
- dominant business: 70% to 95% in single business

Related Diversification

- related-constrained: all businesses related on most dimensions
- related-linked: some businesses related on some dimensions

Unrelated Diversification

- businesses are not related

Product and Geographic Diversification

Possibilities:

- single-business in one geographic area
- single-business in multiple geographic areas
- related-constrained in one or multiple geographic areas
- related-linked in one or multiple geographic areas
- unrelated in one or multiple geographic areas

Note:

- Relatedness usually refers to products.
- Seemingly unrelated products may be related on other dimensions.

Competitive Advantage

If a diversification strategy meets the VRIO criteria…

Is it *V*aluable?

Is it *R*are?

Is it costly to *I*mitate?

Is the firm *O*rganized to exploit it?

…it may create competitive advantage.

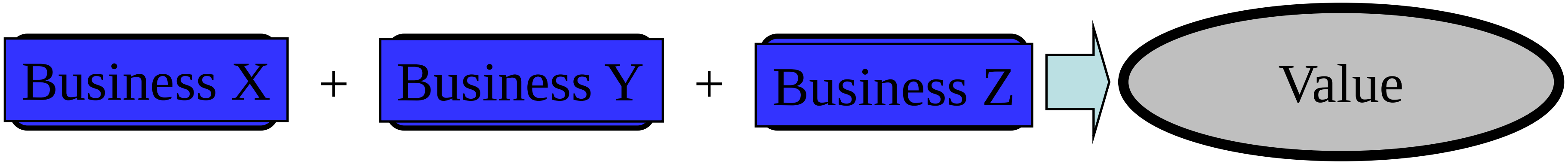
Value of Diversification

Two Criteria

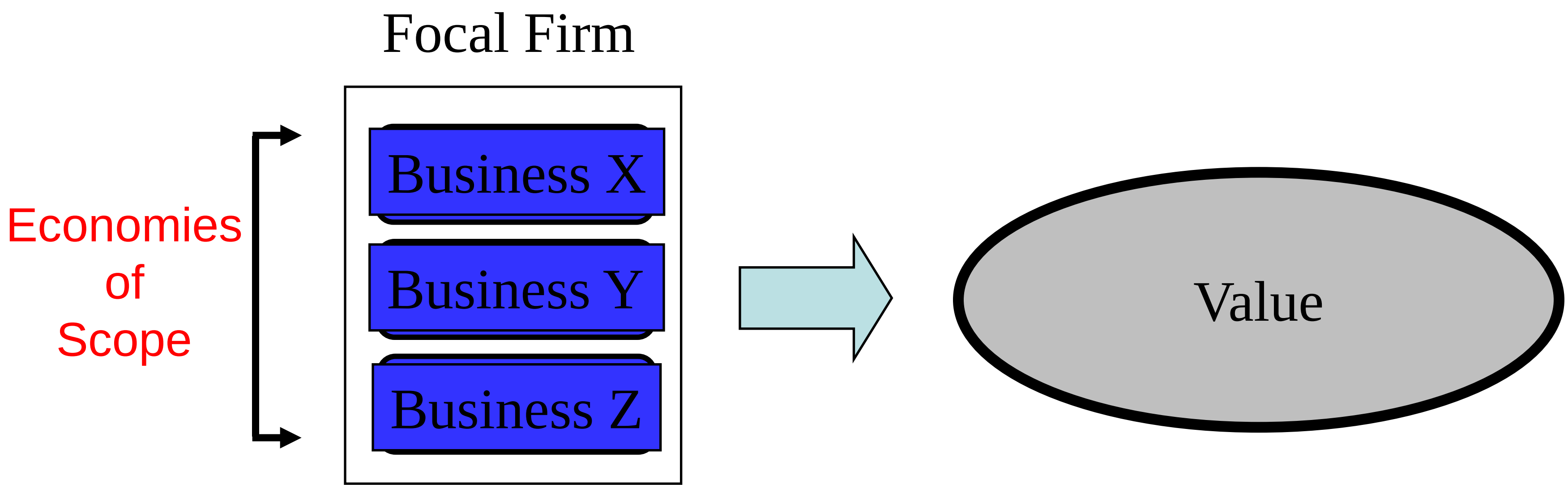
1) There must be some economy of scope.

2) The focal firm must have a cost advantage over outside equity holders in exploiting any economies of scope.

Value of Diversification



Independent: equity holder could buy shares of each firm



Combined: equity holder buys shares in one firm

Economies of Scope

Four Types

- Operational
- Financial
- Anticompetitive
- Managerialism

Economies of Scope

Operational Economies of Scope

Sharing Activities

- exploiting efficiencies of sharing business activities

Example: Frito-Lay's Trucking

Spreading Core Competencies

- exploiting core competencies in other businesses
  - competency must be strategically relevant

Example: Orbitz

Economies of Scope

Financial Economies of Scope

Internal Capital Market

- Premise: insiders can allocate capital across divisions more efficiently than the external capital market.
  - works only if managers have better information
  - may protect proprietary information
  - may suffer from escalating commitment

Example: Hanson Trust, PLC

Economies of Scope

Financial Economies of Scope

Risk Reduction

- counter cyclical businesses may provide decreased overall risk

however,

- individual investors can usually do this more efficiently than a firm

Example: Snow Skiis & Water Skiis

Economies of Scope

Financial Economies of Scope

Tax Advantages

- transfer pricing policy allows profits in one division to be offset by losses in another division
  - this is especially true internationally

- can be used to "smooth" income

Example: Ireland

Economies of Scope

Anticompetitive Economies of Scope

Multipoint Competition

- mutual forbearance
  - a firm chooses not to compete aggressively in one market to avoid competition in another market

Example: American Airlines and Delta: Dallas and Atlanta

Market Power

- using profits from one business to compete in another business
- using buying power in one business to obtain advantage in another business

Economies of Scope

Managerialism

- An economy of scope that accrues to managers at the expense of equity holders.
- Managers of larger firms receive more compensation (larger scope = more compensation).
    - Therefore, managers have an incentive to acquire other firms and become ever larger.
- Even though the incentive is there, it is difficult to know if managerialism is the reason for an acquisition.

Equity Holders and Economies of Scope

Most economies of scope cannot be captured by equity holders.

- Risk reduction can be captured by equity holders.

Managers should consider whether corporate diversification will generate economies of scope that equity holders can capture.

- If a corporate diversification move is unlikely to generate valuable economies of scope, managers should avoid it.

Rareness of Diversification

Diversification *per se* is not rare.

Underlying economies of scope *may* be rare.

- Relationships that allow an economy of scope to be exploited may be rare.
- An economy of scope may be rare because it is naturally or economically limited.
  - A soft drink bottler buys the only source of spring water available.
  - A hotel in a resort town creates a large water park, there are only enough customers to support one park.

Imitability of Diversification

Duplication of Economies of Scope

Less Costly-to-Duplicate	Costly-to-Duplicate
Employee Compensation	Core Competencies
Tax Advantages	Internal Capital Allocation
Risk Reduction	Multipoint Competition
Shared Activities*	Exploiting Market Power
(codified/tangible)	(tacit/intangible)

*may be costly depending on relationships

Imitability of Diversification

Substitution of Economies of Scope

Internal Development

- start a new business under the corporate whole
- avoids potential cross-firm integration issues

Strategic Alliances

- find a partner with the desired complementary assets
- less costly than acquiring a firm

Competitors may use these strategies to arrive at a position of diversification without buying another firm.

Summary

Corporate Strategy: In what businesses should the firm operate?

- An understanding of diversification helps managers answer that question.

Two Criteria:

1) economies of scope must exist

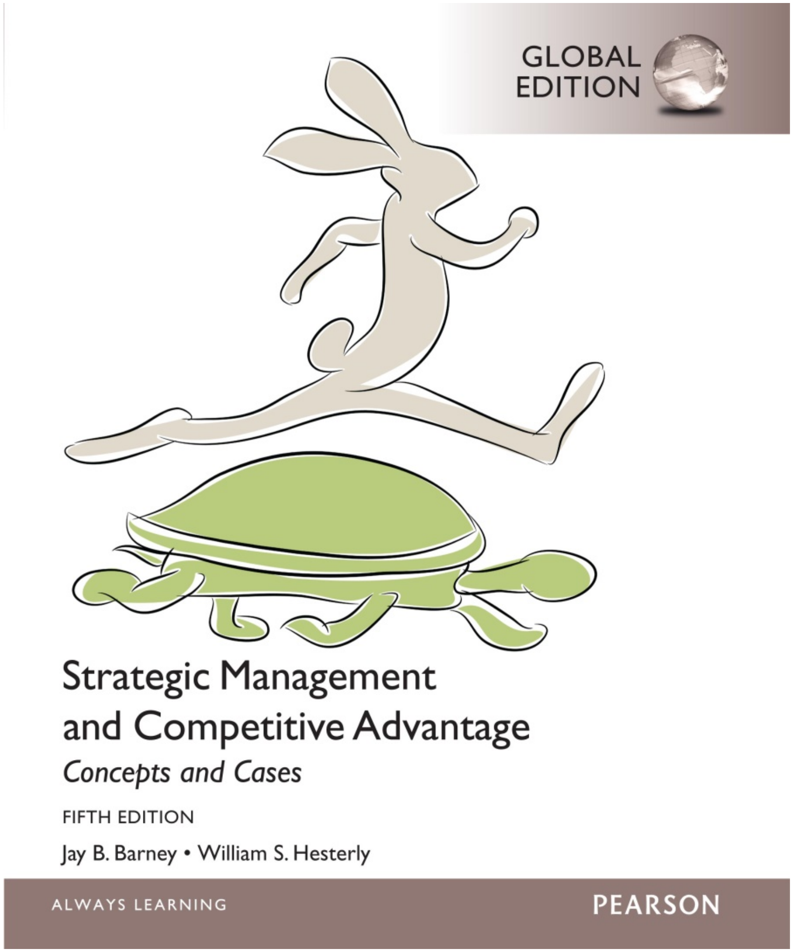
2) must create value that outside equity holders cannot create on their own

Summary

Economies of Scope

- a case of synergy—combined activities generate greater value than independent activities
- may generate competitive advantage if they meet the VRIO criteria

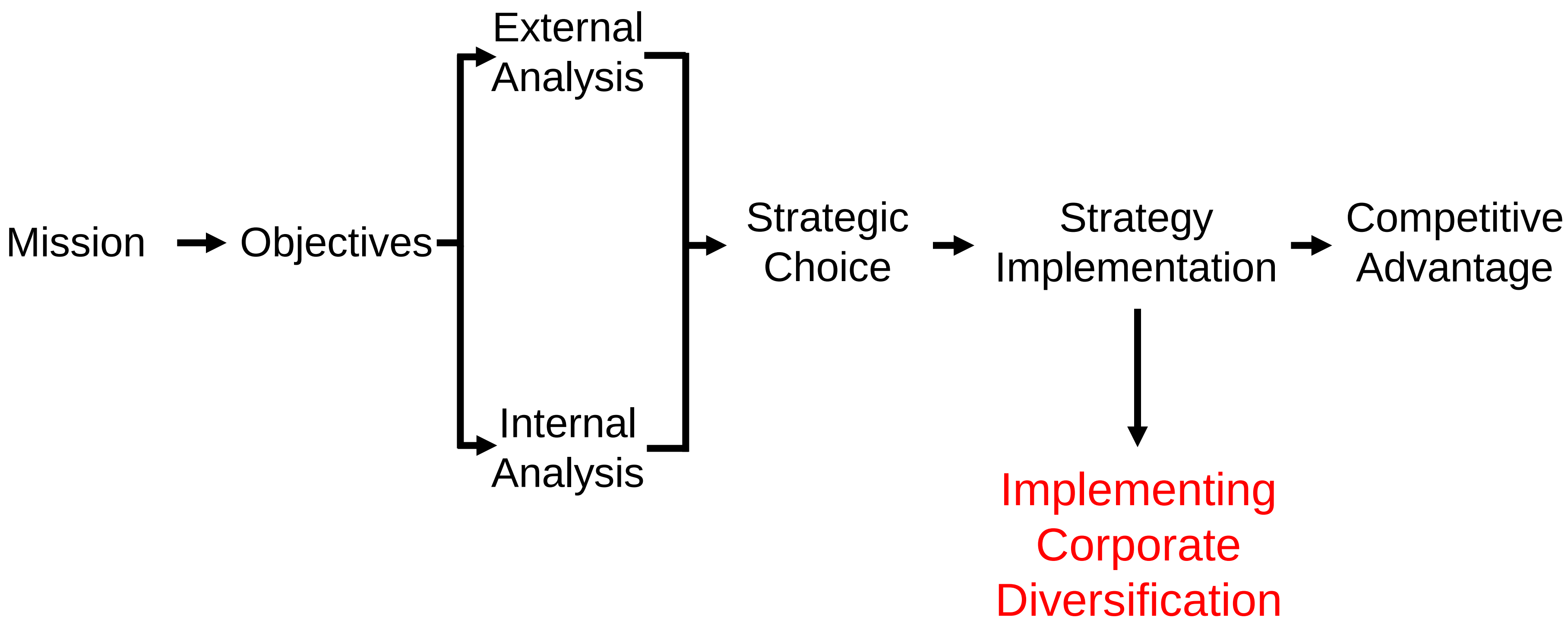
Firms should pursue diversification only if careful analysis shows that competitive advantage is likely!



Chapter 8

Organizing to Implement Corporate Diversification

The Strategic Management Process



Implementation Issues

How Information Flows

Where and By Whom Are Decisions Made

How to Influence the Behavior of People

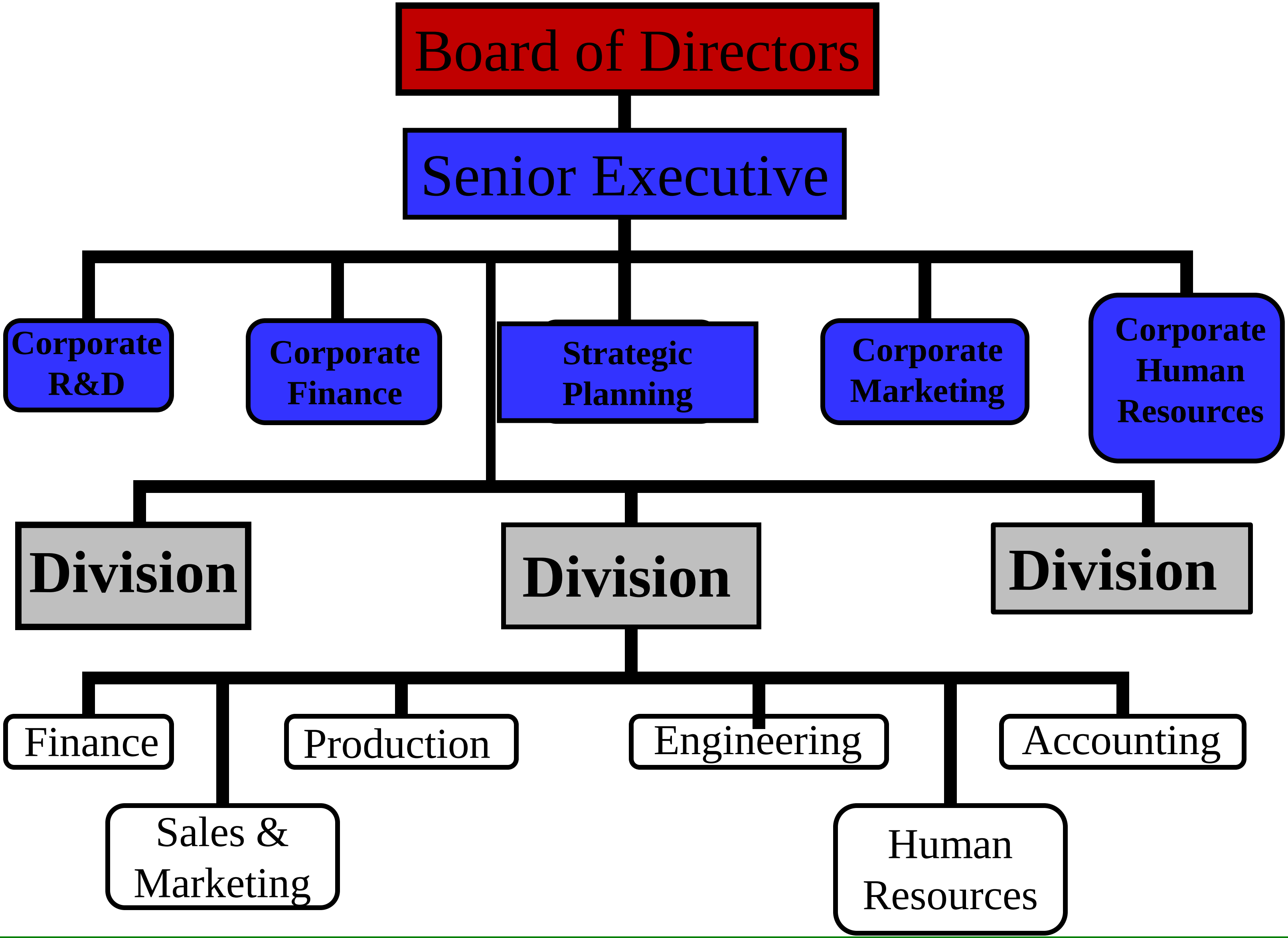
- **How can the interests of employees be aligned with the interests of the firm?**

The Need for Organizational Structure

Information Processing Requirements

- As organizations become larger and more complex, information processing requirements exceed individual capacity.
  - **bounded rationality**
  - **satisficing**
- Organizational structure divides information processing into manageable blocks (span of control).

M-Form Structure



The Agency Relationship

A Trade Off

M-Form Structure

Divides Information Processing Requirements Into Manageable Blocks → Divides Owners From Managers

Interests of Owners and Managers May Diverge

The Agency Relationship

Managing Agency

Principals

Monitors

Agents

Individual Shareholders

Institutional Shareholders

Board Of Directors

Dual Role

Senior Executives

Corporate Staff

Division General Managers

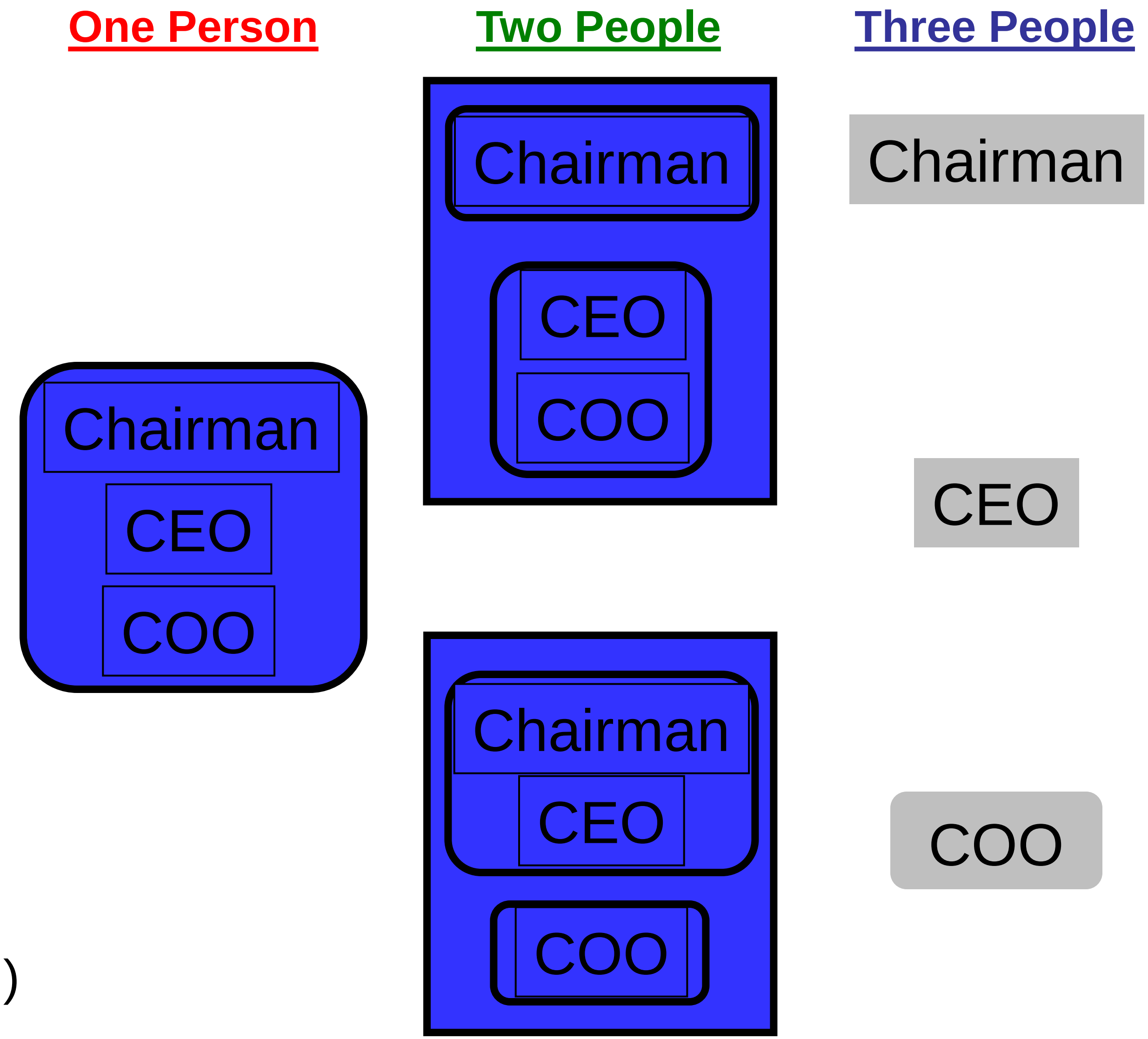
Shared Activity Managers

The Office of the President

Chairman
of the
Board
(monitoring)

Chief
Executive
Officer
(strategy formulation)

Chief
Operating
Officer
(strategy implementation)

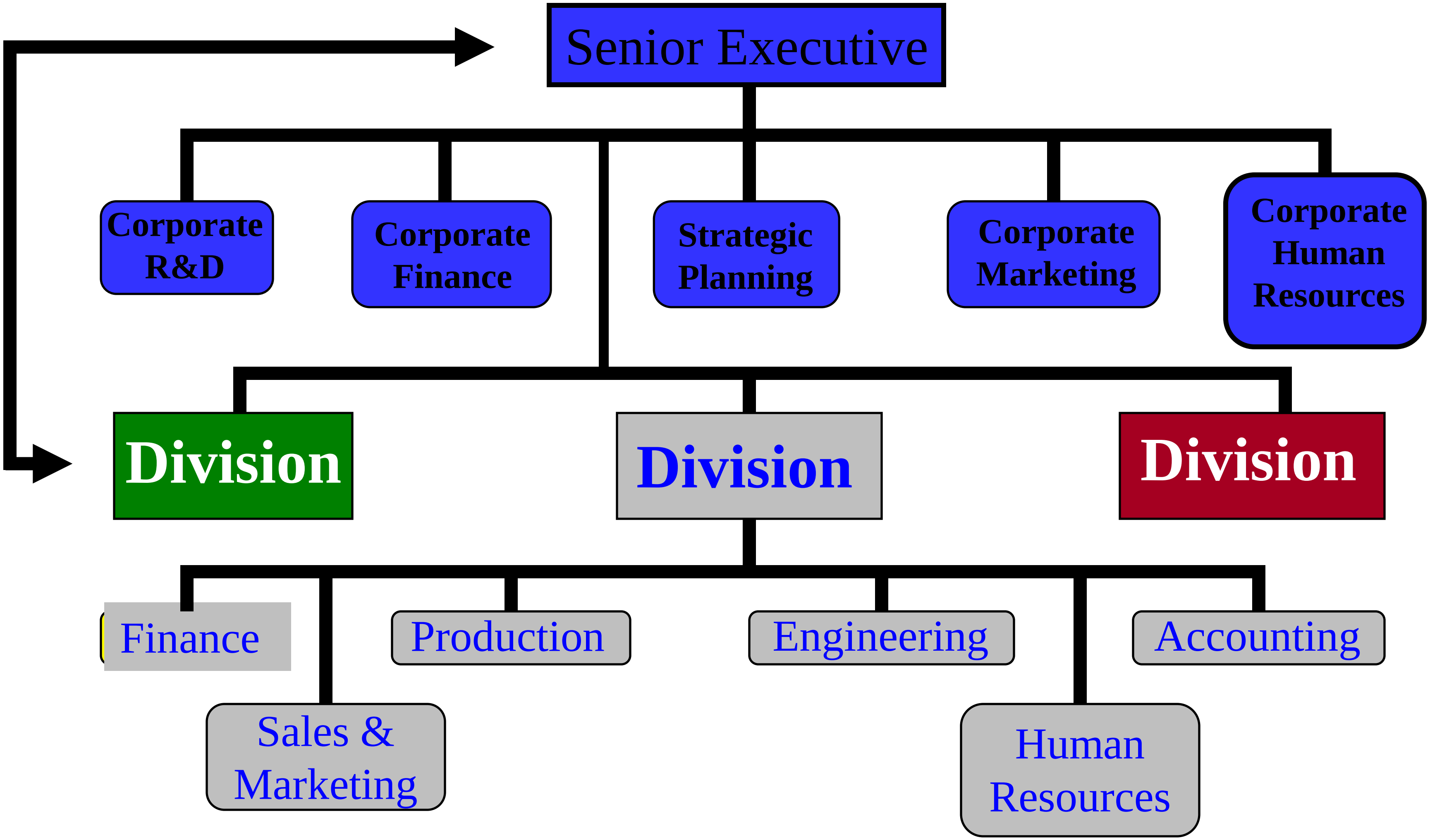


The Office of the President

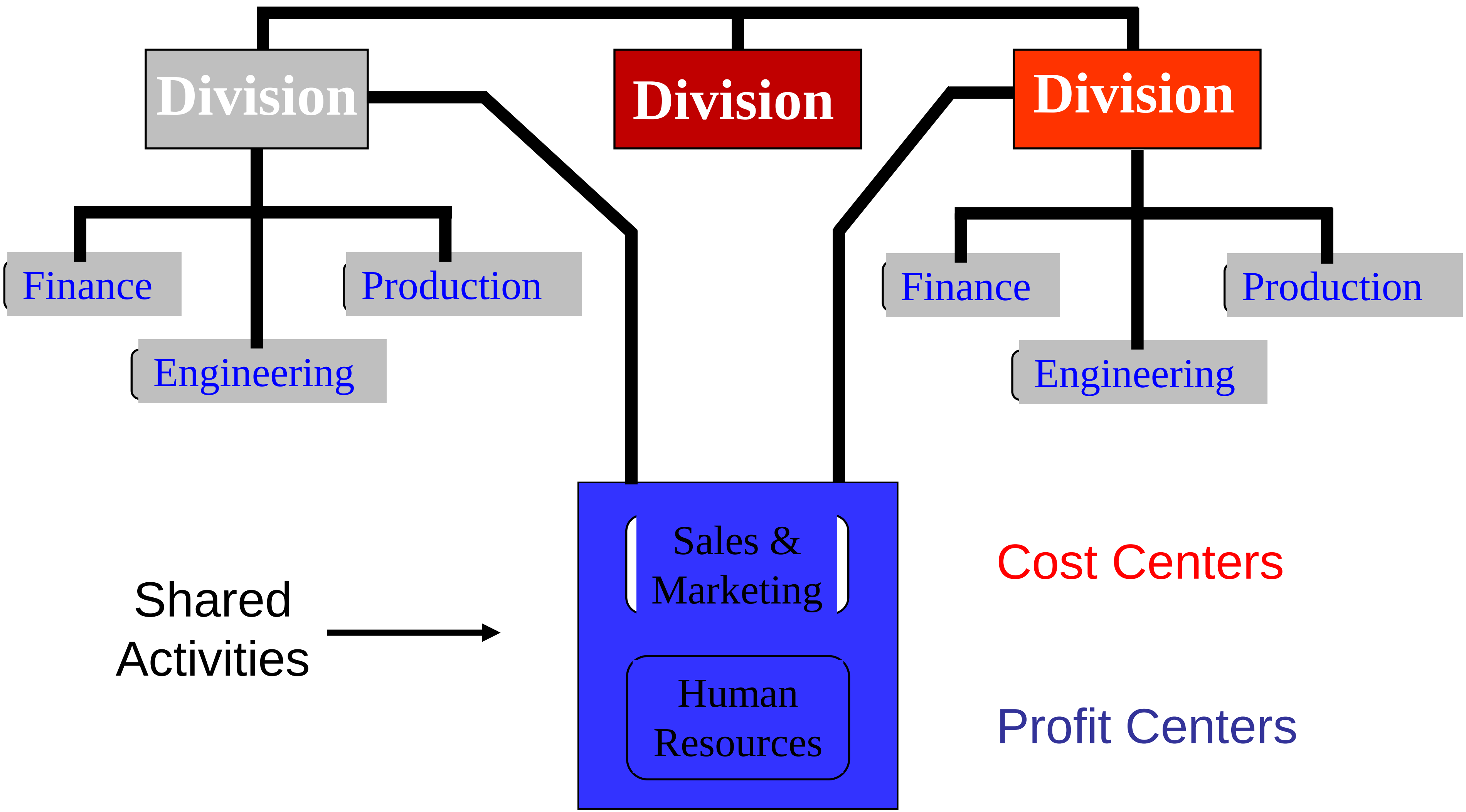
Information Filtering

- Information about the divisions’ businesses is filtered as it rises to the senior executive.
    - The senior executive can “manage” the information flow.
        - Information flow should not exceed the bounded rationality of managers at any level in the organization.
        - Information flow should be matched with decision-making authority.

Division General Managers



Shared Activity Managers



Management Controls

Three Issues

Evaluating Divisional Performance	Allocating Capital	Transferring Intermediate Products

Measurement:
- accounting
- economic value added (EVA)

Ambiguity:
- allocating costs and revenues

Playing Games:
- managers want to look good
- zero-based budgeting

Setting Prices:
- negotiation
- cost
- market-based
- dual pricing

Compensation Policies

Compensation Committee

In theory…

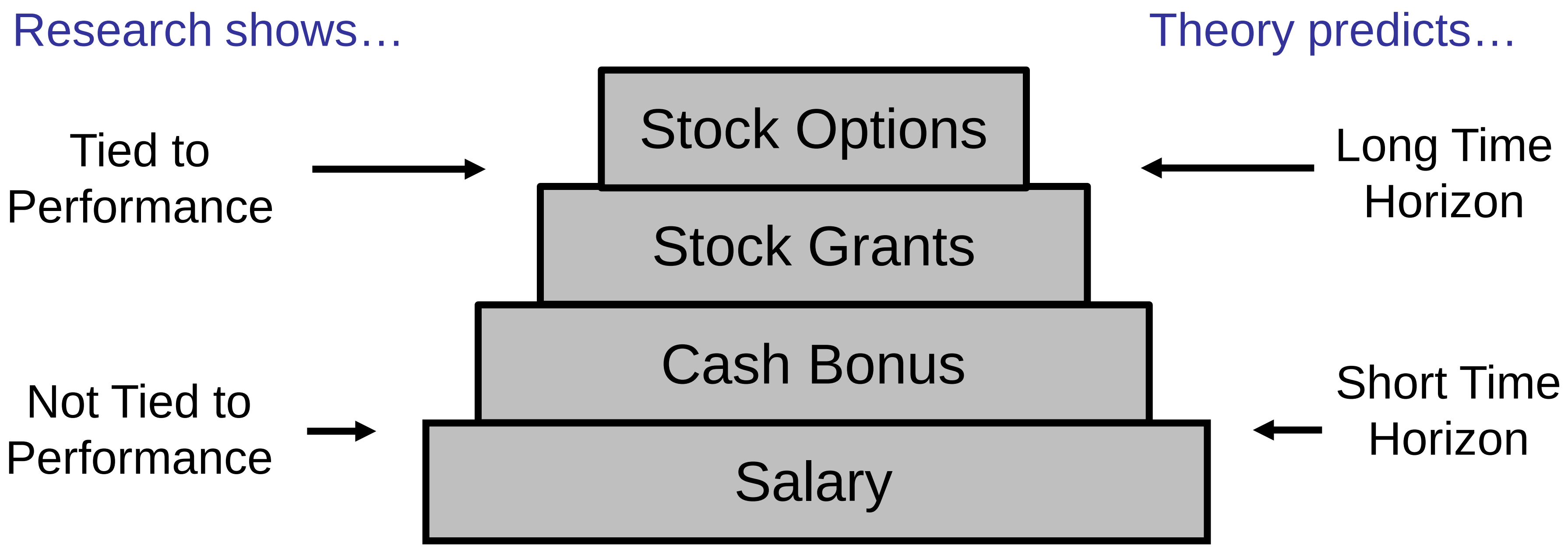
- represents interests of owners in setting compensation of top executive team
- sets compensation based on performance or market

In practice…

- sometimes appear to be beholden to executives
- compensation decisions often bear little relationship to performance

Compensation Policies

Aligning Incentives



Refocusing

Corporate level strategy may call for exiting a business.

- A conglomeration discount may exist.
  - The corporation may lack necessary skills.
  - Expected economies of scope may not exist.

- The corporation may need funds for core activities.

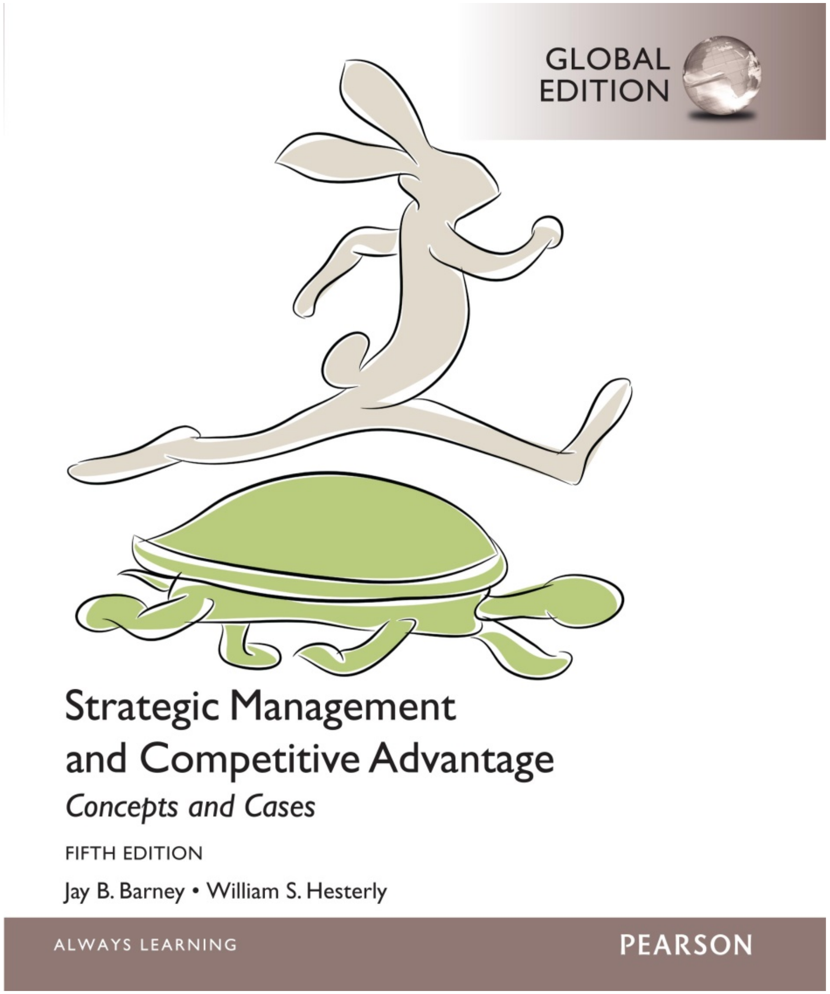
Summary

Successful implementation is a matter of:

- appropriately breaking information processing into manageable blocks
- aligning the interests of owners and managers

These can be accomplished through:

- Organizational Structure
- Management Controls
- Compensation Policies



Chapter 9

Strategic Alliances

The Strategic Management Process

External Analysis

Mission → Objectives → Strategic Choice → Strategy Implementation → Competitive Advantage

Internal Analysis

Corporate Level Strategy

Which Businesses to Enter?

- Vertical Integration
- Diversification
- Strategic Alliances
    - Mode of Entry

Strategic Alliances Defined

Strategic Alliance:

Any cooperative effort between two or more independent organizations to develop, manufacture, or sell products or services.

Motivation for Alliances

Create economic value by:

- accessing complementary resources and capabilities
- leveraging existing resources and capabilities

An alliance is an organizational form of exchange that:

- should produce a gain from trade due to some comparative or absolute advantage

Implication: Choose partners that are better at something than you are (complementary resources).

Motivation for Alliances

Gains from Trade

	Canada	Mexico
Wheat bushels/hr.	6	1
Bananas lbs./hr.	4	5

Exchange Rate:
1 bu. = 1 lb.

Canada: 2 hrs. = 6 bu. Wheat and 4 lbs. Banana, or
2 hrs. = 12 bu. Wheat

By trading, Canada can get:
6 bu. Wheat and 6 lbs. Bananas

A ½ hour gain from trade!

Motivation for Alliances

Gains from Trade

	Canada	Mexico
Wheat bushels/hr.	6	1
Bananas lbs./hr.	4	5

Exchange Rate:
1 bu. = 1 lb.

Mexico: 2 hrs. = 1 bu. Wheat and 5 lbs. Bananas, or
2 hrs. = 10 lbs. Bananas

By trading, Mexico can get:
5 bu. Wheat and 5 lbs. Bananas

A 4 hour gain from trade!

Three Types of Alliances

Nonequity Alliance

Contracts

- licensing
- supply and distribution agreements

Equity Alliance

Cross Equity Holdings

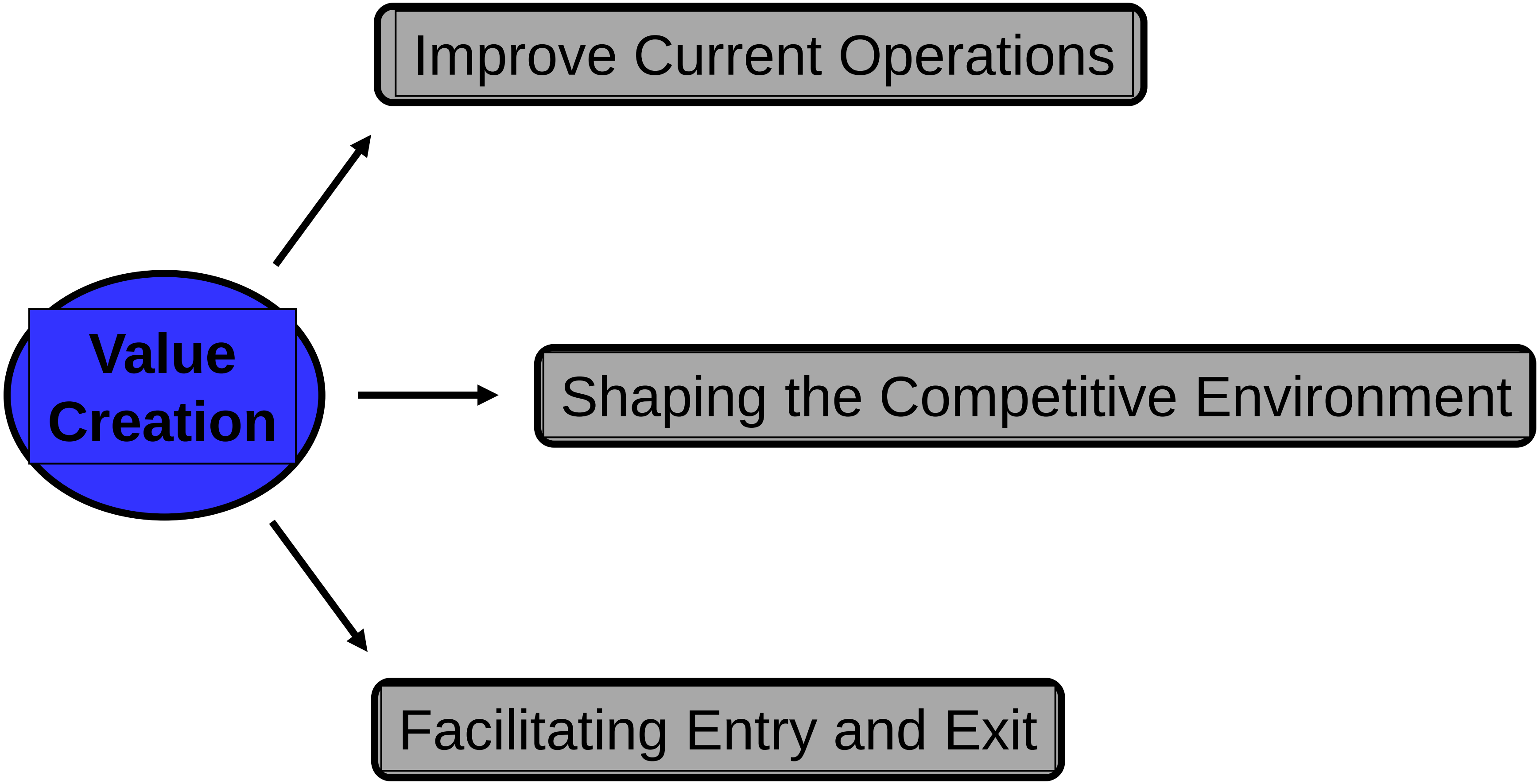
- partners own stakes in eachother

Joint Venture

Joint Equity Holdings

- independent firm is created

How Strategic Alliances Create Value



How Strategic Alliances Create Value

Improving Current Operations

Exploiting economies of scale

- A partner brings increased market share and/or manufacturing capacity.

Learning from partners

- A partner brings technology and/or market knowledge.

Risk and cost sharing

- A partner bears a portion of the risk and/or cost of the alliance.

How Strategic Alliances Create Value

Shaping the Competitive Environment

Facilitating technology standards

- Partners may agree on a standard and avoid a market battle for the standard.

Facilitating tacit collusion

- Partners may communicate within an alliance in subtle, legal ways whereas the same communication between competitors outside an alliance would be illegal.

How Strategic Alliances Create Value

Facilitating Entry and Exit

Low-cost entry into new industries

- A partner provides instant access and legitimacy.

Low-cost exit from industries

- A partner is an informed buyer.

Managing uncertainty

- Alliances may serve as “real options”.

Low-cost entry into new geographic markets

- Partners provide local market knowledge, access, and legitimacy with governments and customers.

Challenges to Value Creation and Allocation

Incentives to Misappropriate Value (Cheat)

An alliance is an exchange context in which:

- Partner inputs may be difficult to monitor.
- Actual value creation may be difficult to monitor.
- Value appropriation (allocating the value) may be:
  - difficult to monitor
  - subject to power dynamics

Challenges to Value Creation and Allocation

Three Forms of Misappropriating Value

- Adverse Selection → misrepresenting the value of inputs
- Moral Hazard → providing inputs of lesser value than promised
- Holdup → exploiting the transaction-specific investment of partners

Sustained Competitive Advantage

Are strategic alliances rare?

As a form of organizing economic exchange, NO!

However,

The sources of value creation within alliances
may be rare.

- Firms may form a combination of complementary resources within an alliance that is rare.
- The stock of such complementary resources may be limited so that first movers have a rare combination.

Sustained Competitive Advantage

Are strategic alliances costly to imitate?

As a form of organizing economic exchange, NO!

- The organizational form *per se* is easily duplicated.

However,

The resource combinations that create value in alliances may be very costly, if not impossible, to imitate if:

- he value creating combination depends on social complexity (trust), causal ambiguity, and/or historical uniqueness

Sustained Competitive Advantage

Are strategic alliances substitutable?

Substitutes for Strategic Alliances

Internal Development

If:

- no partner is available
- transaction-specific investment is high
- low uncertainty about the investment

Mergers & Acquisitions

If:

- there are no anti-trust issues
- low uncertainty about the investment
- firms can be integrated easily
- value of combined firms is not tied to independence

Organizing Strategic Alliances

Governance Responses to the Challenges of Value Creation and Allocation

Formal/Codified

Explicit Contracts & Legal Sanctions	Joint Ventures	Equity Investments
• creates mutual understanding • imposes costs for cheating • conflict resolution	• aligns interests of partners through ownership of independent firm • direct effect	• aligns interests of partners through ownership in each other • indirect effect

Organizing Strategic Alliances

Governance Responses to the Challenges of Value Creation and Allocation

Informal

Trust

- may allow partners to exploit opportunities that would be infeasible with other mechanisms

Firm Reputations

- the shadow of the future constrains cheating

Organizing Strategic Alliances

Governance Responses to the Challenges of Value Creation and Allocation

These responses are not mutually exclusive:

- Contracts may be used with equity investments and joint ventures along with firm reputation and trust.
- Reputation and trust come into play in every type of alliance.

Reputation and trust may be sources of competitive advantage because they are costly to imitate.

Summary

Successful alliance managers will:

- create alliances that will produce gains from trade—complementary resources
- identify the sources of value creation
- assess the likelihood of challenges to value creation and allocation
- adopt appropriate governance responses to the challenges to value creation and allocation

Summary

Alliances may generate competitive advantage if:

- combinations of complementary resources meet the VRIO criteria
- governance responses meet the VRIO criteria

The Big Challenge of Strategic Alliances: maximizing gains from trade while minimizing the threat of cheating

Prisoner's Dilemma Game

On each round of play each team can choose either Strategy A or Strategy B.

The objective is to maximize your payoff.

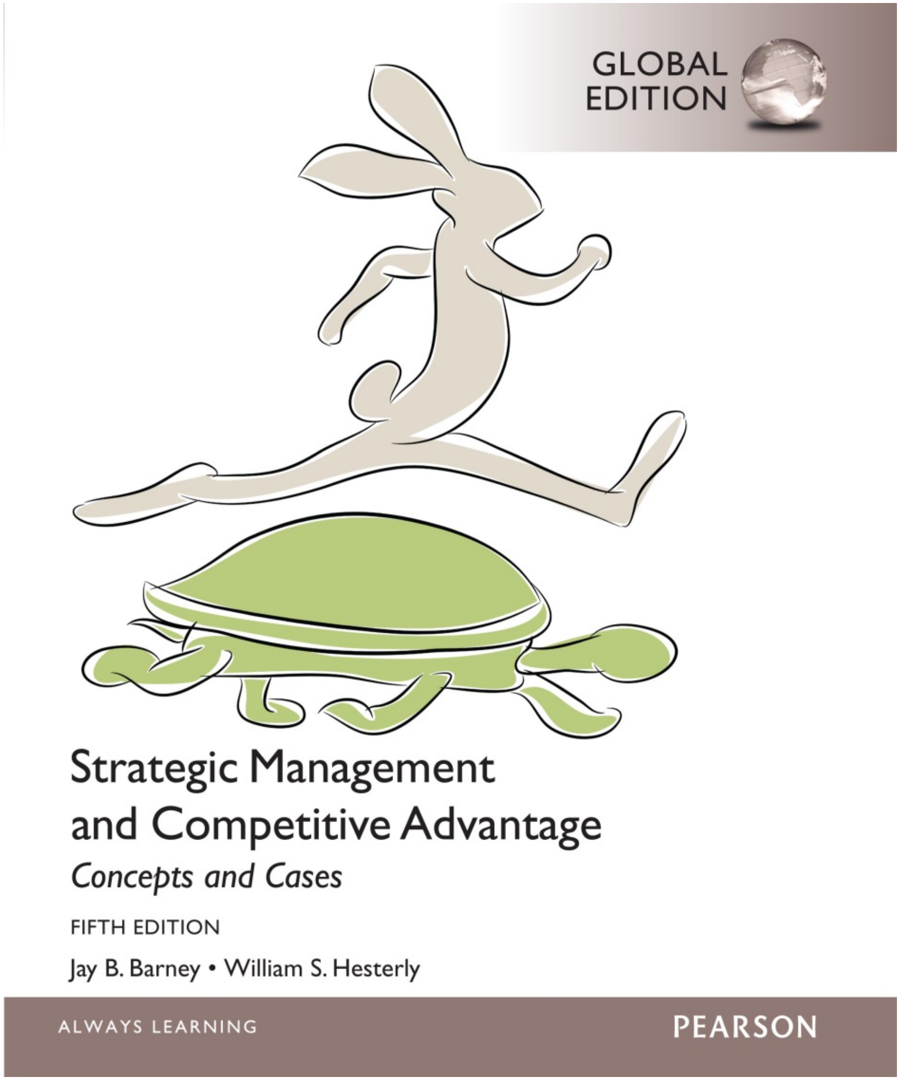
Payoff Matrix

Team I

Team II	Strategy A	Strategy B
Strategy A	I. $3,000 II. $3,000	I. $5,000 II. $-0-
Strategy B	I. $-0- II. $5,000	I. $1,000 II. $1,000

Payoff Schedule

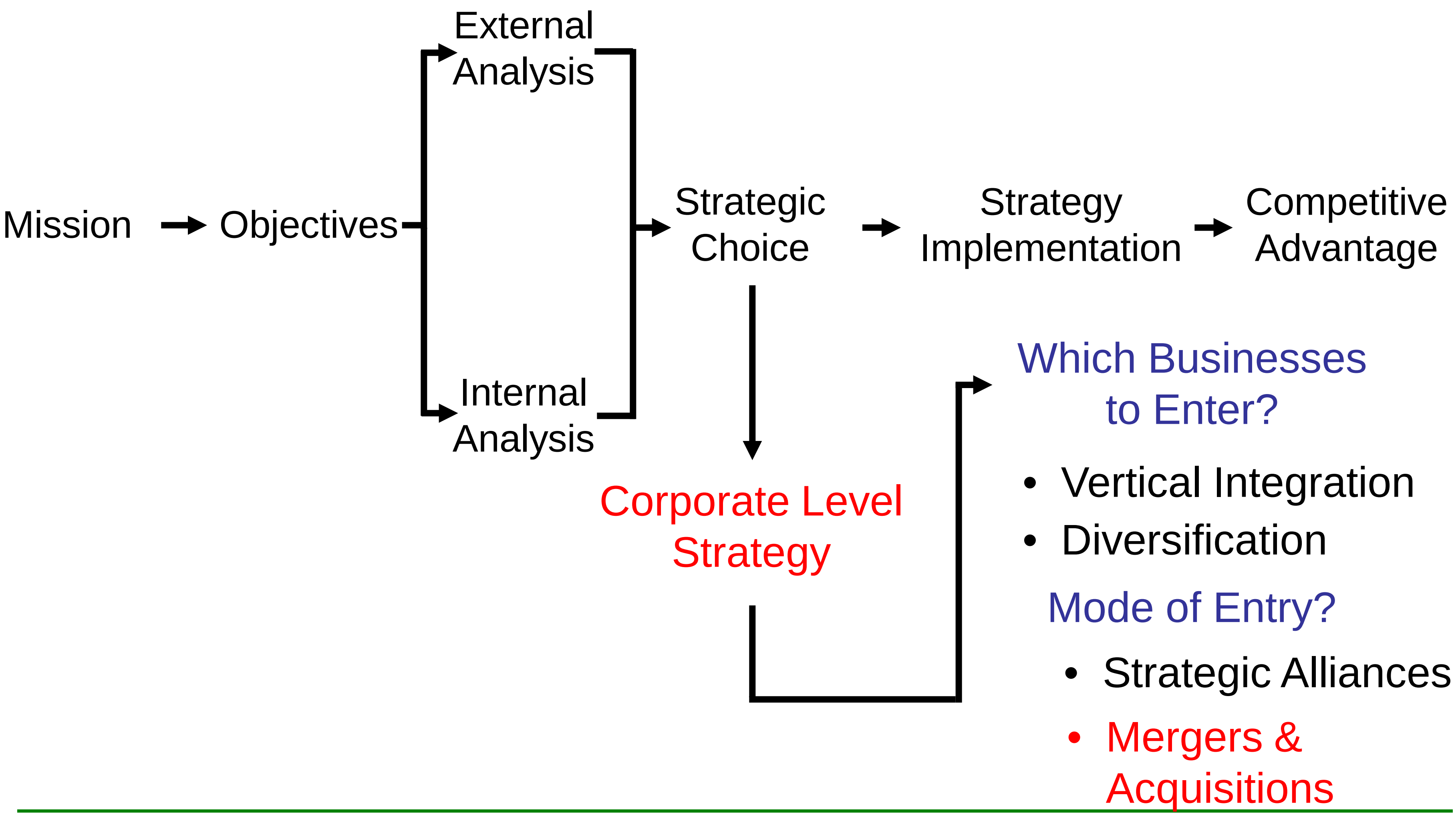
	Team I	Team II
Round 1	______________	______________
Round 2	______________	______________
Round 3	______________	______________
Round 4	______________	______________
Round 5	______________	______________
Round 6	______________	______________
Total	______________	______________



Chapter 10

Mergers and Acquisitions

The Strategic Management Process



Logic of Corporate Level Strategy Applies

Corporate level strategy should create value:

1) such that the value of the corporate whole increases

2) such that businesses forming the corporate whole are worth more than they would be under independent ownership

3) that equity holders cannot create through portfolio investing

Mergers and Acquisitions Defined

Mergers

- two firms are combined on a relatively co-equal basis

Acquisitions

- one firm buys another firm

- the words are often used interchangeably even though they mean something very different

- merger sounds more amicable, less threatening

Mergers and Acquisitions Defined

Mergers	Acquisitions
• parent stocks are usually retired and new stock issued	• can be a controlling share, a majority, or all of the target firm's stock
• name may be one of the parents' or a combination	• can be friendly or hostile
• one of the parents usually emerges as the dominant management	• usually done through a tender offer

Do Mergers and Acquisitions Create Value?

The Logic

Unrelated M&A Activity

- there would be no expectation of value creation due to the lack of synergies between businesses

- there might be value creation due to efficiencies from an internal capital market

- there might be value creation due to the exploitation of a conglomerate discount

- a corporate raider who buys and restructures firms

Mergers and Acquisitions Defined

Types of M&A Activity

FTC Categories

Related
- Vertical » suppliers or customers
- Horizontal » competitors
- Product Extension » complementary products
- Market Extension » complementary markets

Unrelated → Conglomerate » everything else

Do Mergers and Acquisitions Create Value?

The Logic

Related M&A Activity

- value creation would be expected due to synergies between divisions
  - economies of scale
  - economies of scope
    - transferring competencies
    - sharing infrastructure, and so on

Do Mergers and Acquisitions Create Value?

The Empirical Evidence

Research is based on stock market reaction to the announcement of M&A activity

- this reflects the market's assessment of the expected value of the merger or acquisition

- these studies look at what happens to the price of both the acquirer's stock and the target's stock

- thus, we can see who is capturing any expected value that may be created

Do Mergers and Acquisitions Create Value?

The Empirical Evidence

M&A Activity creates value, on average, as follows:

Acquiring Firms

- no value created

Target Firms

- value increases by about 25%

- related M&A activity creates more value than unrelated M&A activity

M&A activity creates value, but target firms capture it.

Do Mergers and Acquisitions Create Value?

Expected versus Operational Value

April 2000: Wells Fargo offers to acquire First Security Bank for about $3 billion

Expected

The Deal:

Stock values were:
Wells Fargo: $43.69
First Security: $15.50

0.355 shares of WF for each share of FS stock

Wells Fargo: down $0.25 to $39.50

First Security: up $1.19 to $13.38

Operational

	Stock Price	Market Cap.
12/1999	$40.44	$65.7 B
12/2000	$56.69	$95.2 B
12/2001	$43.60	$74.0 B
12/2002	$46.87	$82.0 B
12/2003	$58.89	$100.0 B
12/2004	$62.15	$105.0 B

Why Is M&A Activity So Prevalent?

If managers know that acquiring firms do not capture any value from M&A's, why do they continue to merge and acquire?

Survival

- avoid competitive disadvantage
- avoid scale disadvantages

Free Cash Flow

- cash generating, normal return investment

Why Is M&A Activity So Prevalent?

If managers know that acquiring firms do not capture any value from M&A's, why do they continue to merge and acquire?

Agency Problems

- Managers benefit from increases in size.
- Managers benefit from diversification.

Managerial Hubris

- Managers believe they can beat the odds.

Why Is M&A Activity So Prevalent?

If managers know that acquiring firms do not capture any value from M&A's, why do they continue to merge and acquire?

Above Normal Profits

- Some M&A activity does generate above normal profits (expected and operational over the long run).
- Proposed M&A activity may satisfy the logic of corporate level strategy.
- Managers may see economies that the market can't see.

Competitive Advantage

Can an M&A strategy generate sustained competitive advantage?

Yes, if managers' abilities meet VRIO criteria.

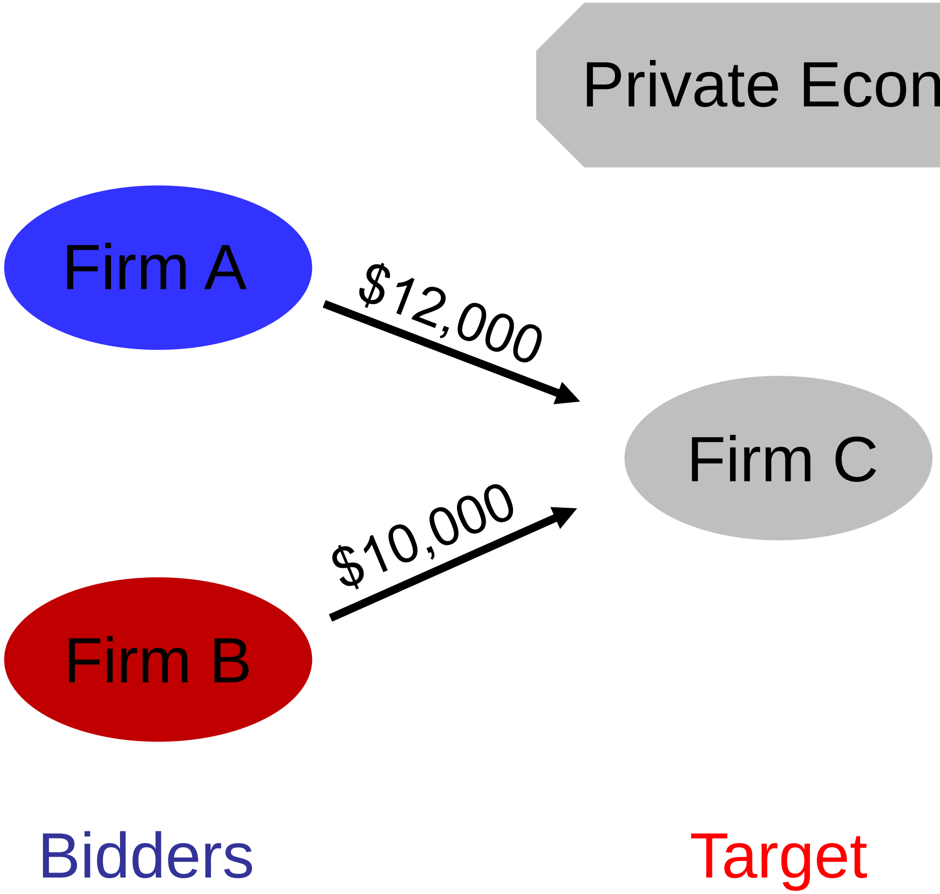
1. Managers may be good at recognizing and exploiting potentially value-creating economies with other firms.

2. Managers may be good at doing "deals".

3. Managers may be good at both.

Competitive Advantage

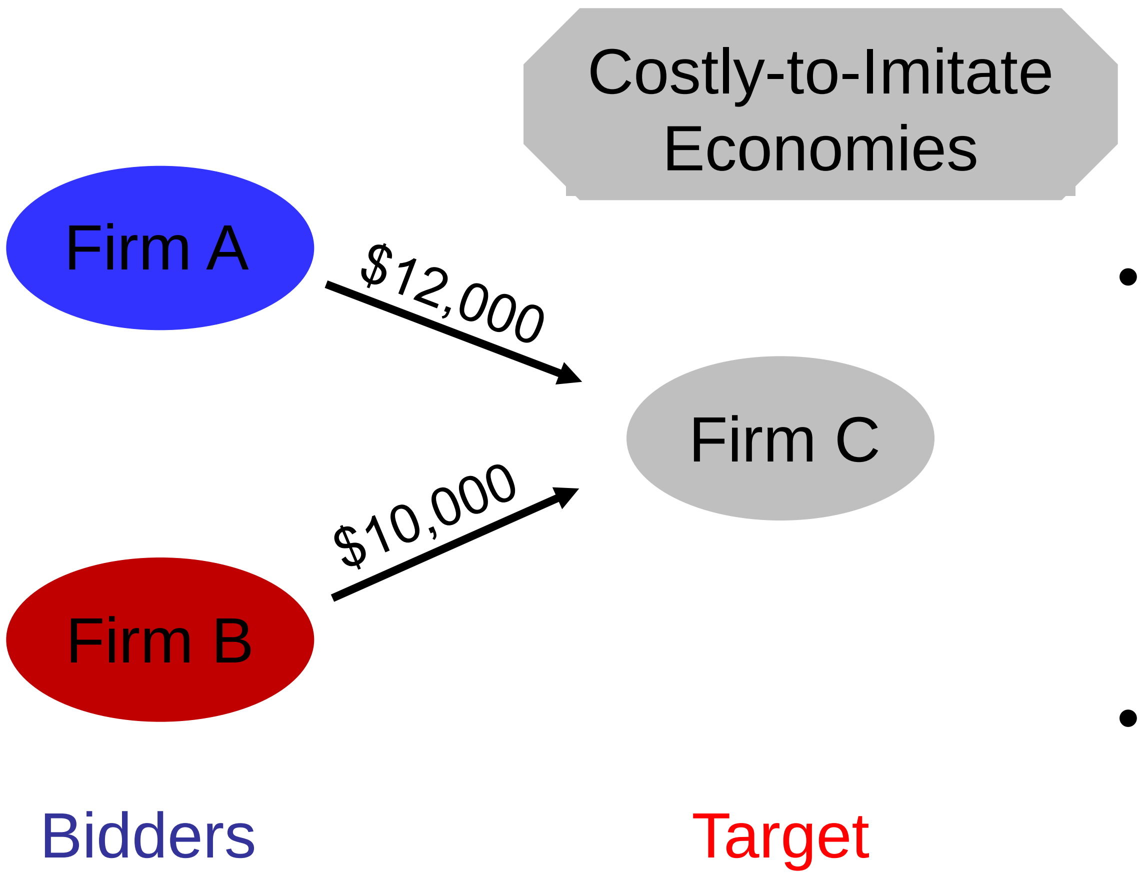
Recognizing and Exploiting Economies of Scope



- Firm C's recognized value is $10,000.
- Firm A sees value of $12,000 in Firm C.
- Firm A can earn a profit of $2,000 only if the economy remains private.

Competitive Advantage

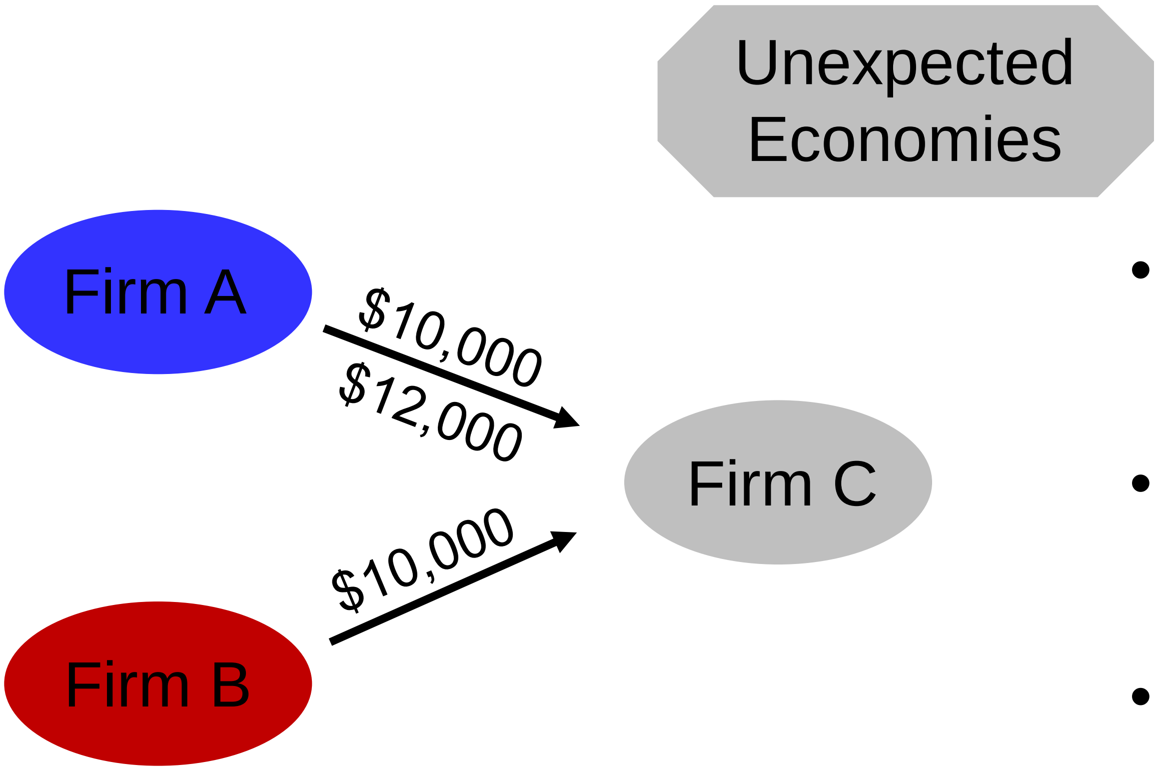
Recognizing and Exploiting Economies of Scope



- If the economy between A & C is costly to imitate, it doesn't matter if other firms know.
- Firm A can still earn a $2,000 profit.

Competitive Advantage

Recognizing and Exploiting Economies of Scope

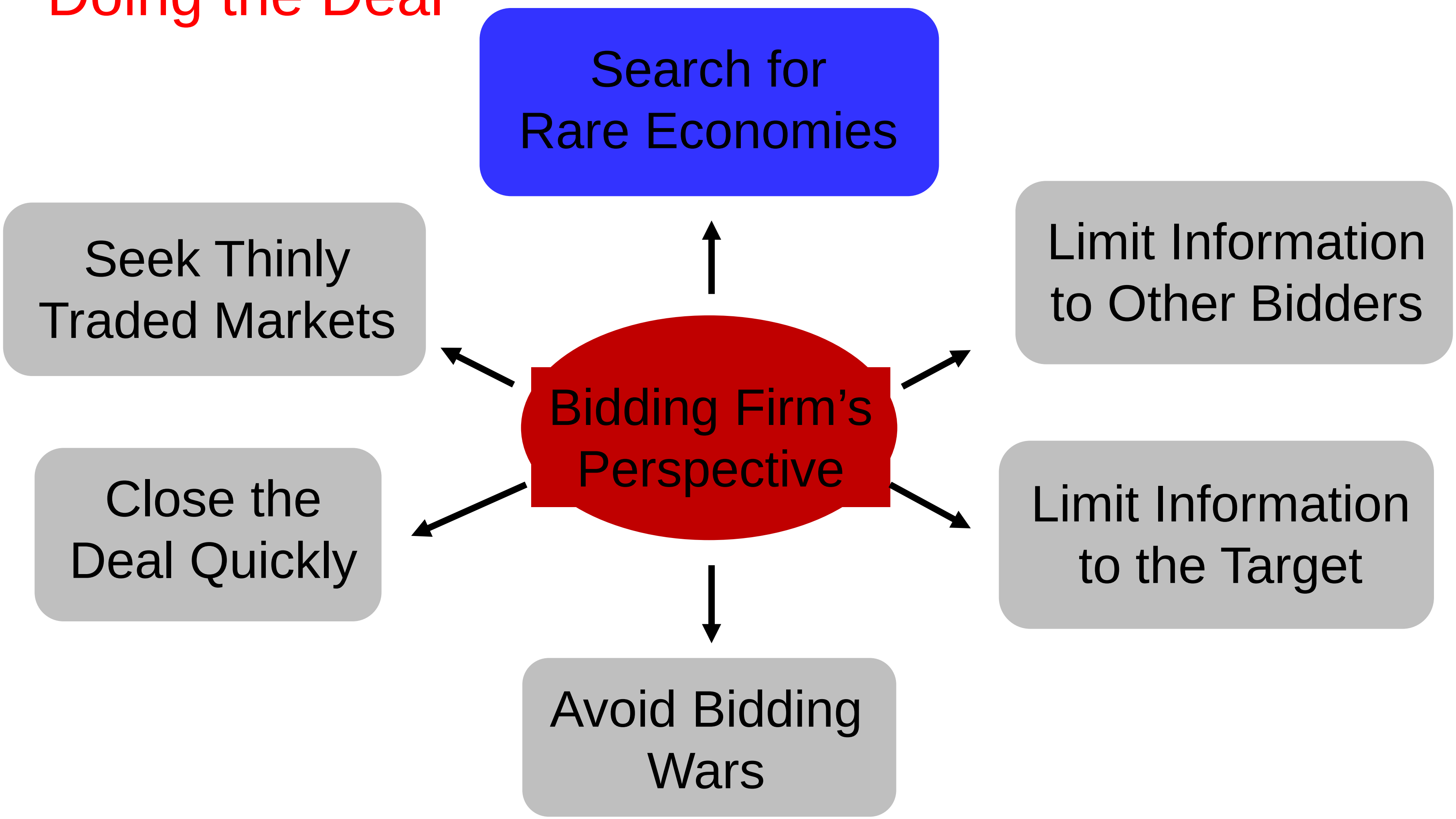


- Firm C has a market value of $10,000.
- Firm A buys Firm C for $10,000.
- Firm C turns out to be worth $12,000.

Bidders Target

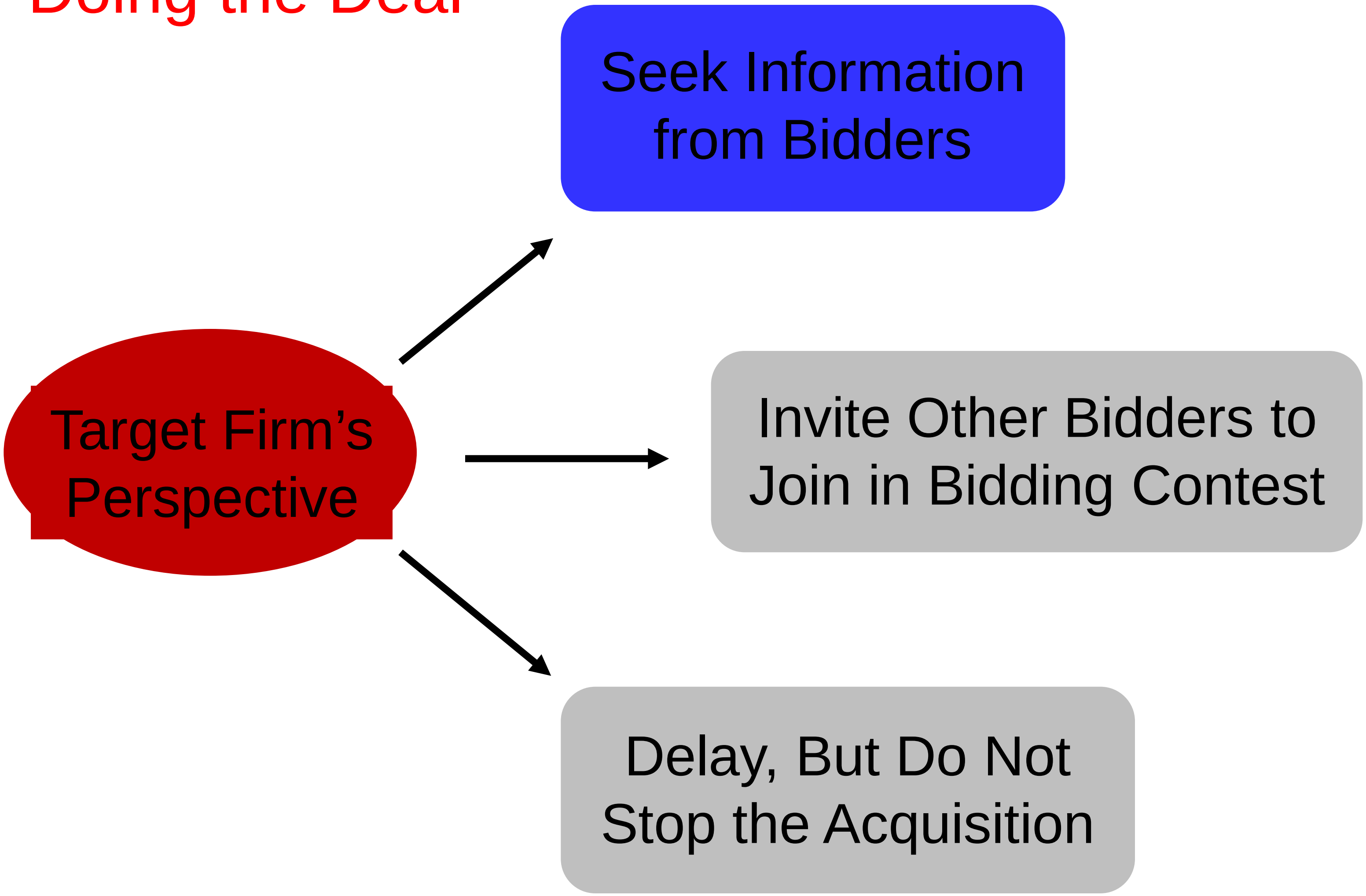
Competitive Advantage

Doing the Deal



Competitive Advantage

Doing the Deal



Implementation Issues

Structure, Control, and Compensation

M&A activity requires responses to these issues:

- M-form structure is typically used.
- Management controls and compensation policies are similar to those used in diversification strategies.

Managers must decide on the level of integration:

- Target firm may remain somewhat autonomous.
- Target firm may be completely integrated.

Implementation Issues

Cultural Differences

- High levels of integration require greater cultural blending.
- Cultural blending may be a matter of:
  - combining elements of both cultures
  - essentially replacing one culture with the other
- Integration may be very costly, often unanticipated.
- The ability to integrate efficiently may be a source of competitive advantage.

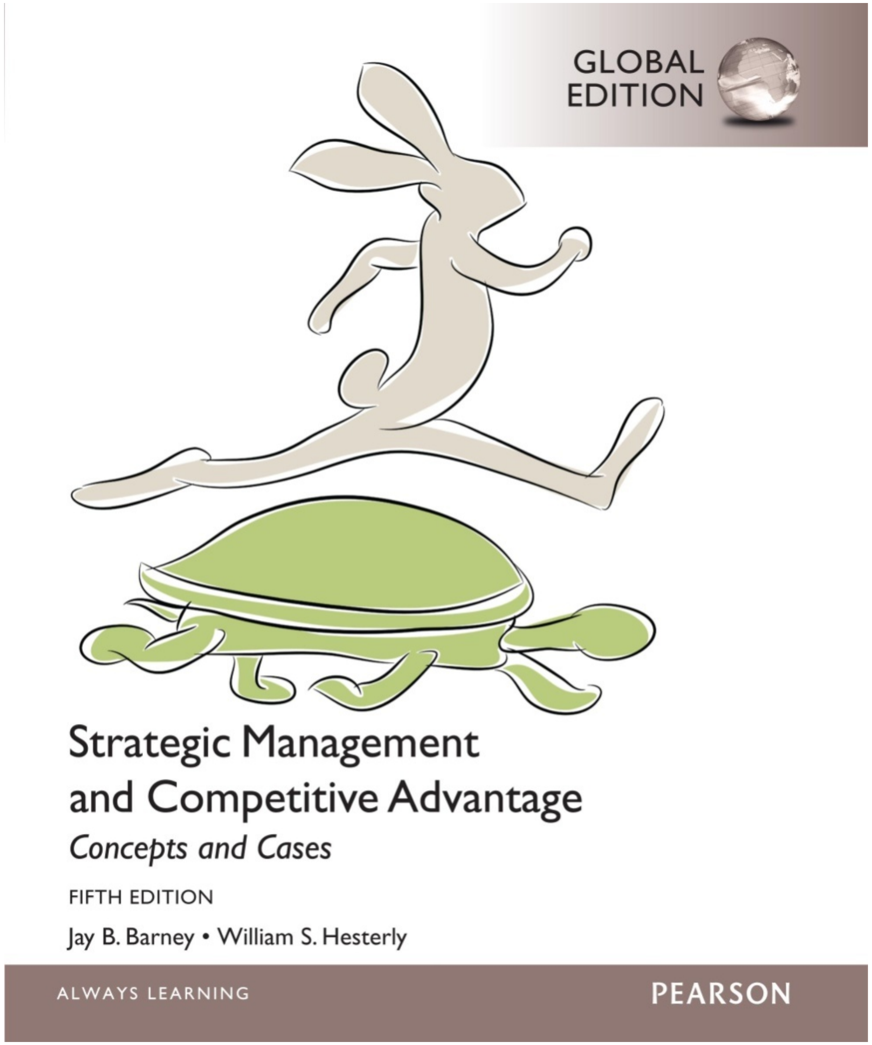
Summary

M&A activity is a mode of entry for vertical integration and diversification strategies.

A firm's M&A strategy should satisfy the logic of corporate level strategy.

M&A activity can create economic value at announcement, but target firms usually capture that value.

M&A activity can create value over the long term for the acquiring firm.



Chapter 11

International Strategies

Procter and Gamble

2013 Worldwide Revenues: $84.167 billion

Developing markets: 39%of revenues
(or ~$33 billion)

Impact of foreign exchange:
* Revenues down
* Profits affected by
devaluation of currency in Venezuela

Company has 121,000 employees working in more than 80 countries. Products sold in more than 180 countries.

Source: pg.com

Procter and Gamble contd.

Many products specific to certain markets

1. Bonus: laundry detergent—Asia

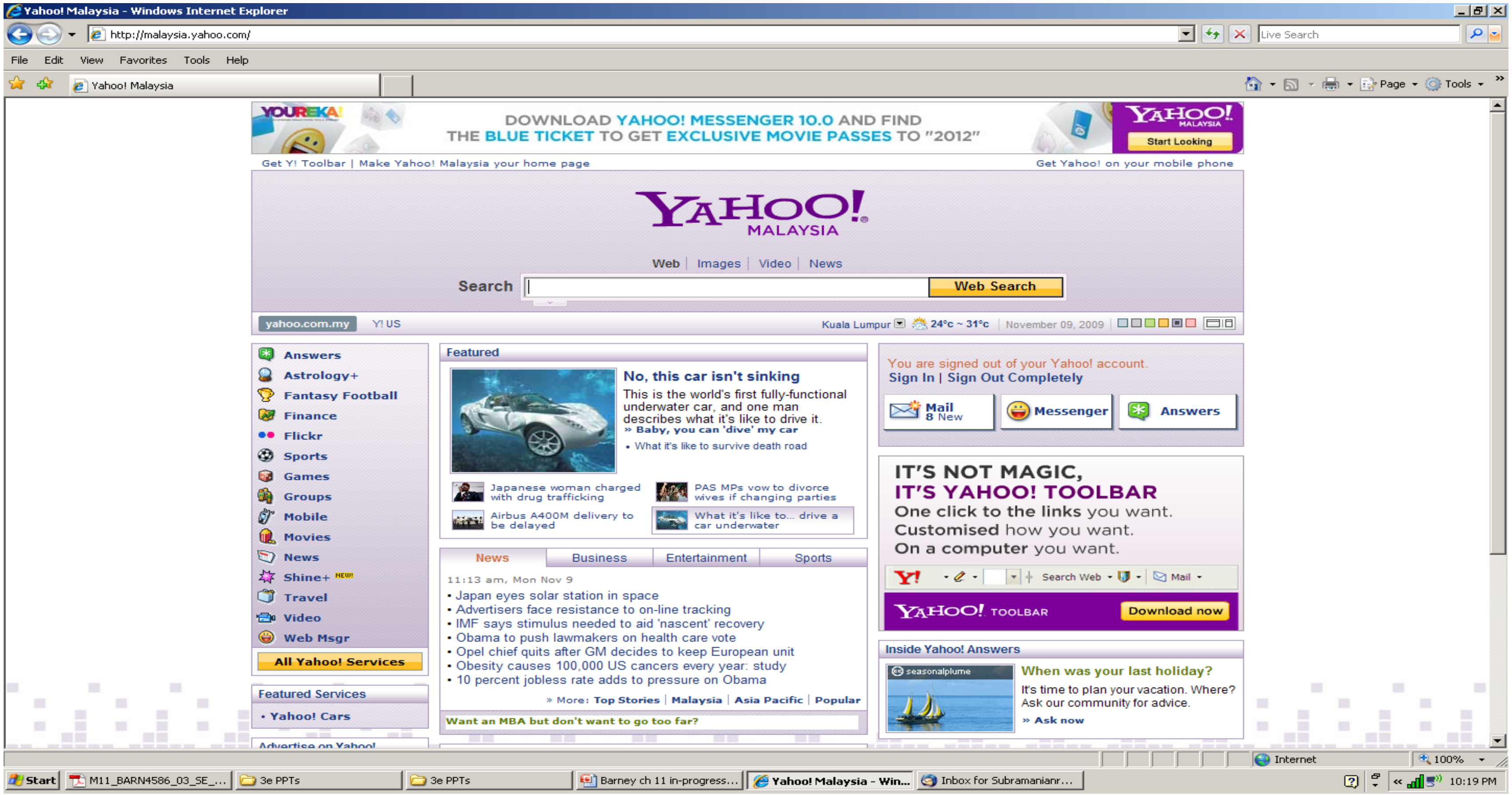
2. Dash: dishwashing detergent—
   Europe/Middle East/Africa

3. Tempo: facial tissue—Middle East/Africa/Asia

52 country-specific websites

Source: pg.com

Yahoo Malaysia's Web Page



International Strategies as a Special Case of Corporate Strategies

Firms can

- Vertically integrate
- Diversify
- Form strategic alliances
- Implement mergers and acquisitions

all across national borders

The Importance of International Activities to Companies

Percentage of Revenues from International Markets

- Colgate-Palmolive: 75% of revenues
- 3M: 64% of revenues
- General Electric: > 50% of revenues
- Johnson & Johnson: about 50% of revenues

Potential Sources of Economies of Scope in International Markets

1. Gain access to new customers for current products or services.
2. Gain access to low-cost factors of production.
3. Develop new core competencies.
4. Leverage current core competencies in new ways.
5. Manage corporate risk.

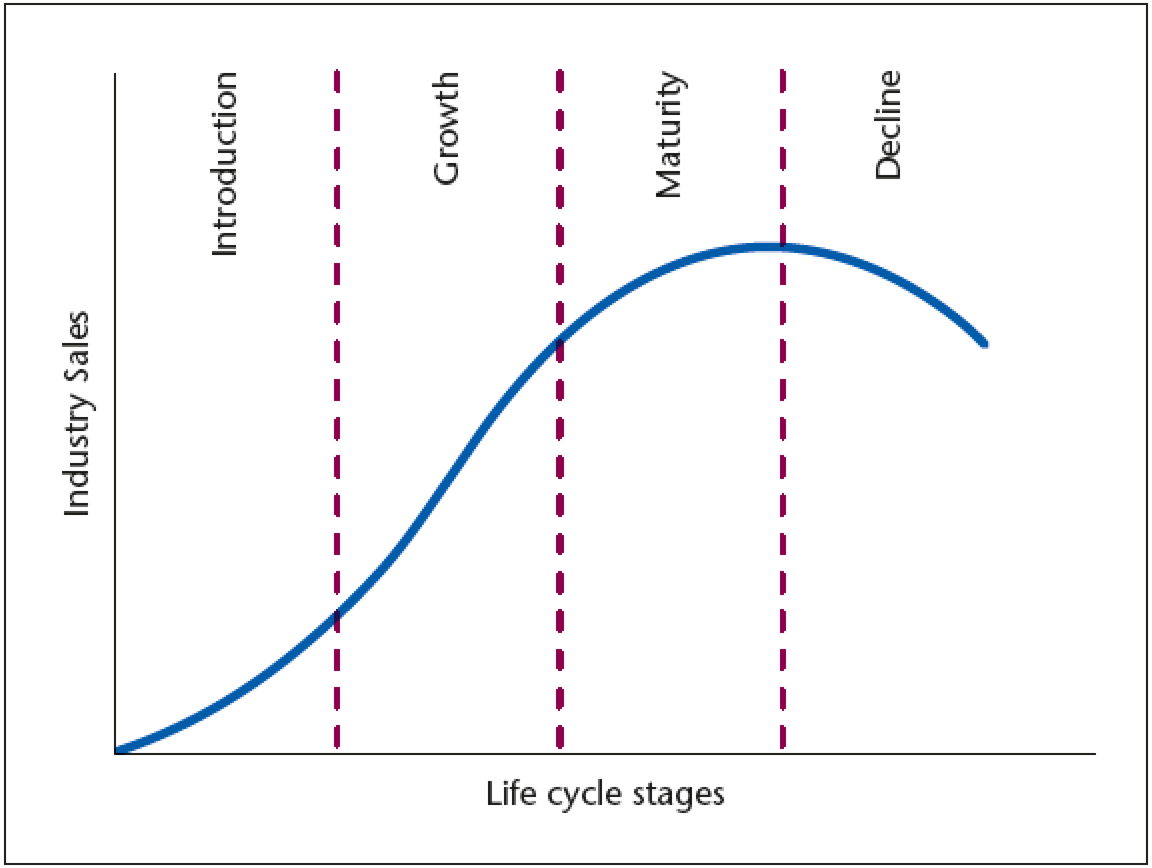
Per Capita GDP

Selected Countries

Top Ten Countries		Bottom Ten Countries	
Qatar	$86,008	Zimbabwe	$268
Luxembourg	82,441	Congo	330
Norway	53,738	Liberia	373
Singapore	51,226	Burundi	390
Brunei	50,199	Guinea-Bissau	486
United States	47,440	Sierra Leone	725
Switzerland	43,196	Niger	740
Ireland	42,110	Cent. African Rep.	740
Netherlands	40,558	Eritrea	748
Iceland	40,471	Afghanistan	760

Source: International Monetary Fund, 2008

The Product Life Cycle



Learning from International Operations

As a firm enters a new market:

- A disciplined learning mentality is imperative for success.
  - What resources and capabilities meet the VRIO criteria in the new market?
  - What can the firm learn from partners in the new market? (GM learned from Toyota in the NUMI alliance.)

Determinants of the Ability to Learn in International Markets

- the intent to learn
- the transparency of business partners
- receptivity to learning

The Local Responsiveness vs. International Integration Trade-off

Local Responsiveness

- nonstandard product
- high variance in tastes and preferences
- decentralized control
- focused on satisfying tastes and preferences

Example: Siemens

International Integration

- standardized product
- little variance in tastes and preferences
- centralized control
- focused on efficiency

Example: Sony

Managing Financial Risks

- Currency hedging
- Geographic diversification
  - spreading risk across several countries

Managing Political Risks

- Find a local partner
- Political neutrality
- Negotiation with governments
  - Foreign governments often have an interest in direct investment.

Example: Case International in Brazil

International Strategic Alliances

- Fiat-Tata Alliance (Italy/India)
  - ❑ Using Fiat's technology, Tata will manufacture and market automobiles in India.
- Microsoft-Nokia Alliance (USA/Finland)
  - ❑ Nokia will use Microsoft's Office software in its cell phones to compete with Blackberry. (This alliance was made prior to Microsoft's acquisition of Nokia's handset business in 2013.)
- Eli Lilly-Piramal Life Sciences Alliance (USA/India)
  - ❑ Piramal will be responsible for the design and development of Lilly's global clinical development program including human clinical trials.

Organizing Options for Firms Pursuing International Strategies

Market Governance	Intermediate Market Governance	Hierarchical Governance
Exporting	Licensing	Mergers
	Non-equity alliances	Acquisitions
	Equity alliances	Wholly owned subsidiaries
	Joint ventures	

Structural Options for Firms Pursuing International Strategies

Decentralized federation	Strategic and operational decisions are delegated to divisions/country companies.
Coordinated federation	Operational decisions are delegated to divisions/country companies; strategic decisions are retained at corporate headquarters.
Centralized hub	Strategic and operational decisions are retained at corporate headquarters.
Transnational structure	Strategic and operational decisions are delegated to those operational entities that maximize responsiveness to local conditions and international integration.

Source: C. A. Bartlett and S. Ghoshal (1989). *Managing Across Borders: The Transnational Solution*. Boston: Harvard Business School Press.