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STRATEGIC MANAGEMENT

AN INTEGRATED APPROACH

THEORY & CASES

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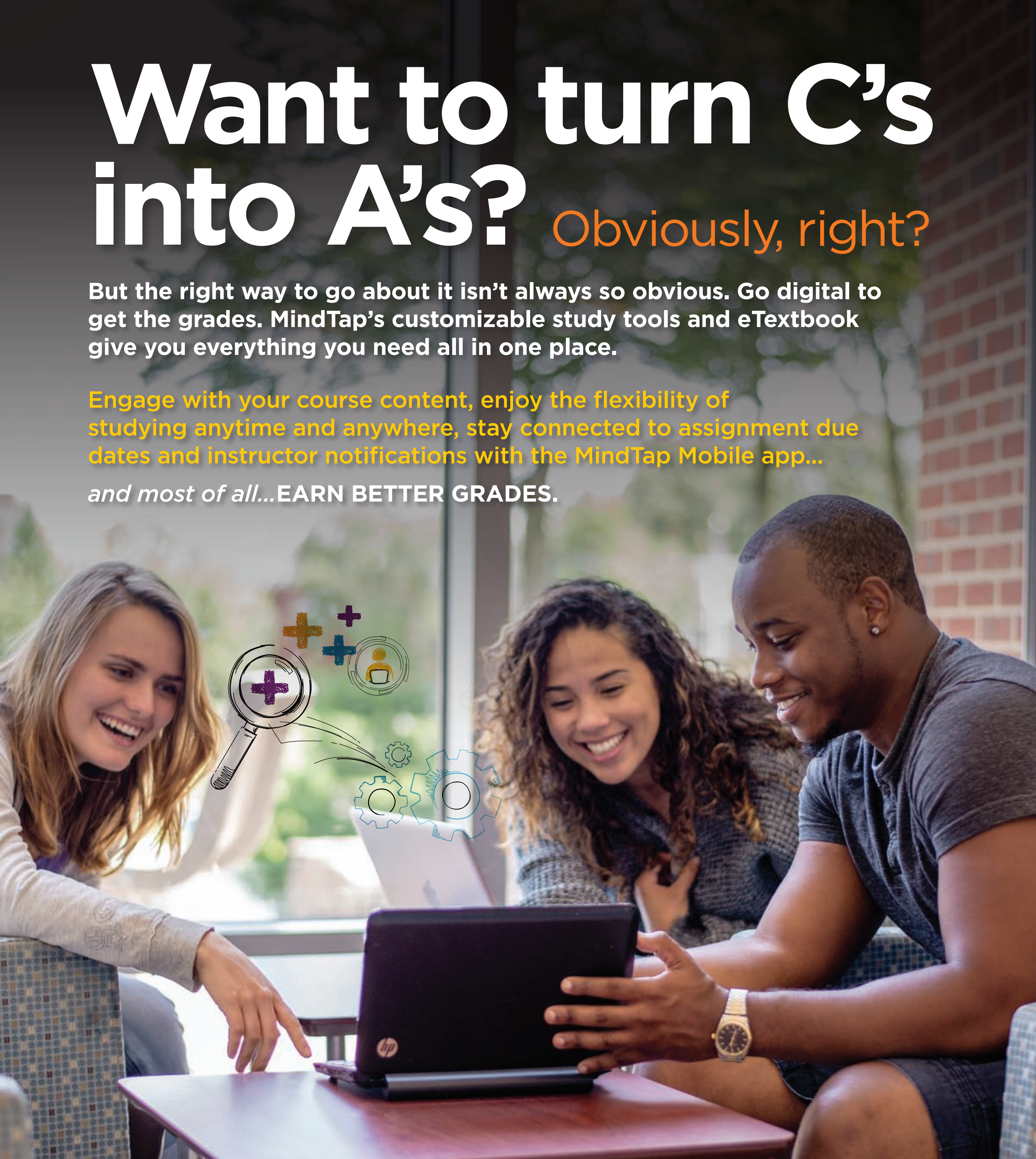
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STRATEGIC MANAGEMENT

12e

AN INTEGRATED APPROACH

THEORY & CASES

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PREFACE

Consistent with our mission to provide students with the most current and up-to-date account of the changes taking place in the world of strategy and management, there have been some significant changes in the 12th edition of *Strategic Management: An Integrated Approach*.

First, our new co-author, Melissa Schilling has taken on a major role in this edition. Melissa is a Professor of Management and Organization at the Leonard Stern School of Business at New York University, where she teaches courses on strategic management, corporate strategy, and technology and innovation management. She has published extensively in top-tier academic journals and is recognized as one of the leading experts on innovation and strategy in high-technology industries. We are very pleased to again have Melissa on the book team. Melissa made substantial contributions to the prior edition, and that continues with this edition. She has revised several chapters and written seven high-caliber case studies. We believe her input has significantly strengthened the book.

Second, a number of chapters have been extensively revised. In the 11th edition, Chapter 5, "Business-Level Strategy," was rewritten from scratch. In addition to the standard material on Porter's generic strategies, this chapter now includes discussion of *value innovation* and *blue ocean strategy* following the work of W. C. Kim and R. Mauborgne. Chapter 6, "Business-Level Strategy and the Industry Environment," was also extensively rewritten and updated to clarify concepts and bring it into the 21st century. For the 12th edition, we significantly revised and updated Chapter 3, building discussion of resources and competitive advantage around Jay Barney's popular VRIO model. We also combined Chapters 12 and 13 into a single chapter on implementing strategy through organization. We think this more streamlined approach greatly strengthens the book and enhances readability, particularly for students.

Third, the examples and cases contained in each chapter have been revised. Every chapter has a new *Opening Case* and a new *Closing Case*. There are also many new *Strategy in Action* features. In addition, there has been significant change in the examples used in the text to illustrate content. In making these changes, our goal has been to make the book relevant for students reading it in the second decade of the 21st century.

Fourth, we have a substantially revised selection of cases for this edition. All of the cases are either new to this edition or are updates of cases that adopters have indicated they like to see in the book. For this edition, we made the decision to use only our own cases. Over the years, it has been increasingly difficult to find high-quality, third-party cases, while we have received consistently positive feedback about the quality of cases that we have written; so we decided that from this point forward we would only use our own cases. We have also received feedback that many professors like to use shorter cases, instead of or in addition to the longer cases normally included in our book. Consequently, in this edition of the book we have included 30 cases, 20 of which are the traditional long-form cases, and 10 of which are shorter cases. Many of the cases are current as of 2015. We have made an effort to include cases that have high name recognition with students, and that they will enjoy reading and working on. These include cases on Boeing, Staples, Trader Joe's, Tesla Motors, Uber, Google, Microsoft, and 3M.

Practicing Strategic Management: An Interactive Approach

We have received a lot of positive feedback about the usefulness of the end-of-chapter exercises and assignments in the Practicing Strategic Management sections of our book. They offer a wide range of hands-on and digital learning experiences for students. We are thrilled to announce that we have moved some of these elements into the MindTap digital learning solution to provide a seamless learning experience for students and instructors. We have enhanced these features to give students engaging, multimedia learning experiences that teach them the case analysis framework and provide them multiple opportunities to step into the shoes of a manager and solve real-world strategic challenges. For instructors, MindTap offers a fully customizable, all-in-one learning suite including a digital gradebook, real-time data analytics, and full integration into your LMS. Select from assignments including:

- **Cornerstone to Capstone Diagnostic** assesses students' functional area knowledge and provides feedback and remediation so that students are up to speed and prepared for the strategic management course material.
- **Multimedia Quizzes** assess students' basic comprehension of the reading material to help you gauge their level of engagement and understanding of the content.
- **Directed Cases** engage students by presenting businesses facing strategic challenges, placing concepts in real-world context, and making for great points of discussion. As they complete these activities, students receive instruction and feedback that teaches them the case analysis methodology and helps them build critical thinking and problem-solving skills.
- **Experiential Exercises** are based on the "Practicing Strategic Management" assignments in the end-of-chapter materials in previous editions. They have been updated for the MindTap and challenge students to work in teams using the YouSeeU app in our one-of-a-kind collaborative environment to solve real-world managerial problems and begin to experience firsthand what it's like to work in management.
- **Branching Activities** present challenging problems that cannot be solved with one specific, correct answer. Students are presented with a series of decisions to be made based upon information they are given about a company and are scored according to the quality of their decisions.
- **Case Analysis Projects** are delivered in our online collaborative environment via the YouSeeU app so that students can work together synchronously to complete their comprehensive case analysis projects, papers, and presentations. Offered in conjunction with robust cases written exclusively by Charles Hill and Melissa Schilling, these activities challenge students to think and act like tomorrow's strategic leaders. Use our default activity, written by seasoned strategic management instructors, or customize the project to suit your class.
- **Strategy Sign-On** projects are back by popular demand. They are designed to provide students the opportunity to explore the latest data through digital research activities. Students first research a company that is facing a strategic management problem, and students then follow the company throughout the semester and complete various case analysis assignments.

It is not our intention to suggest that *all* of these exercises should be used for *every* chapter. Strategic management is taught at both undergraduate and graduate levels, and therefore we offer a variety of pedagogically designed activities with numerous challenge levels so that instructors can customize MindTap to best suit their teaching style and the objectives of the course.

We have found that our interactive approach to teaching strategic management appeals to students. It also greatly improves the quality of their learning experience. Our approach is more fully discussed in the *Instructor's Resource Manual*.

Strategic Management Cases

The 30 cases that we have selected for this edition will appeal, we are certain, to students and professors alike, both because these cases are intrinsically interesting and because of the number of strategic management issues they illuminate. The organizations discussed in the cases range from large, well-known companies, for which students can do research to update the information, to small, entrepreneurial businesses that illustrate the uncertainty and challenge of the strategic management process. In addition, the selections include many international cases, and most of the other cases contain some element of global strategy. Refer to the Contents for a complete listing of the cases.

To help students learn how to effectively analyze and write a case study, we continue to include a special section on this subject. It has a checklist and an explanation of areas to consider, suggested research tools, and tips on financial analysis. Additionally, the MindTap learning activities include Directed Cases that ask students to complete the steps and offer in-depth explanations to guide them through the process, as well as case-based Branching Activities that place students in the shoes of a manager and require them to move through strategic decisions; students are assessed on the quality of their analysis in making their choices, and the activity concludes with a discussion question for you to implement in class.

We feel that our entire selection of cases is unrivaled in breadth and depth.

Teaching and Learning Aids

Taken together, the teaching and learning features of *Strategic Management* provide a package that is unsurpassed in its coverage and that supports the integrated approach that we have taken throughout the book.

- **Instructor Website.** Access important teaching resources on this companion website. For your convenience, you can download electronic versions of the instructor supplements from the password-protected section of the site, including Instructor's Resource Manual, Comprehensive Case Notes, Cognero Testing, Word Test Bank files, PowerPoint® slides, and Video Segments and Guide. To access these additional course materials and companion resources, please visit www.cengagebrain.com.
- The **Instructor's Resource Manual.** For each chapter, we provide a clearly focused synopsis, a list of teaching objectives, a comprehensive lecture outline, teaching notes for the Ethical Dilemma feature, suggested answers to discussion questions, and comments on the end-of-chapter activities. Each Opening Case, Strategy in Action boxed feature, and Closing Case has a synopsis and a corresponding teaching note to help guide class discussion.
- **Case Teaching Notes.** These include a complete list of case discussion questions, as well as comprehensive teaching notes for each case, which give a complete analysis of case issues.
- **Cognero Test Bank.** A completely online test bank allows the instructor the ability to create comprehensive, true/false, multiple-choice, and essay questions for each chapter in the book. The mix of questions has been adjusted to provide fewer fact-based or simple memorization items and to provide more items that rely on synthesis or application.

- **PowerPoint Presentation Slides.** Each chapter comes complete with a robust PowerPoint presentation to aid with class lectures. These slides can be downloaded from the text website.
- **Cengage Learning Write Experience 3.0.** This new technology is the first in higher education to offer students the opportunity to improve their writing and analytical skills without adding to your workload. Offered through an exclusive agreement with Vantage Learning, creator of the software used for GMAT essay grading, Write Experience evaluates students' answers to a select set of writing assignments for voice, style, format, and originality.
- **Video Segments.** A collection of 13 BBC videos have been included in the MindTap Learning Path. These new videos are short, compelling, and timely illustrations of today's management world. Available on the DVD and Instructor website, and detailed case write-ups including questions and suggested answers appear in the Instructor's Resource Manual and Video Guide.
- **MindTap**. MindTap is the digital learning solution that helps instructors engage students and help them become tomorrow's strategic leaders. All activities are designed to teach students to problem-solve and think like management leaders. Through these activities and real-time course analytics, and an accessible reader, MindTap helps you turn cookie cutter into cutting edge, apathy into engagement, and memorizers into higher-level thinkers.
- **Micromatic Strategic Management Simulation** (for bundles only). The Micromatic Business Simulation Game allows students to decide their company's mission, goals, policies, and strategies. Student teams make their decisions on a quarter-by-quarter basis, determining price, sales and promotion budgets, operations decisions, and financing requirements. Each decision round requires students to make approximately 100 decisions. Students can play in teams or play alone, compete against other players or the computer, or use Micromatic for practice, tournaments, or assessment. You can control any business simulation element you wish, leaving the rest alone if you desire. Because of the number and type of decisions the student users must make, Micromatic is classified as a medium-to-complex business simulation game. This helps students understand how the functional areas of a business fit together, without being bogged down in needless detail, and provides students with an excellent capstone experience in decision making.
- **Smartsims** (for bundles only). MikesBikes Advanced is a premier strategy simulation providing students with the unique opportunity to evaluate, plan, and implement strategy as they manage their own company while competing online against other students within their course. Students from the management team of a bicycle manufacturing company make all the key functional decisions involving price, marketing, distribution, finance, operations, HR, and R&D. They formulate a comprehensive strategy, starting with their existing product, and then adapt the strategy as they develop new products for emerging markets. Through Smartsims' easy-to-use interface, students are taught the cross-functional disciplines of business and how the development and implementation of strategy involves these disciplines. The competitive nature of MikesBikes encourages involvement and learning in a way that no other teaching methodology can, and your students will have fun in the process!

ACKNOWLEDGMENTS

This book is the product of far more than three authors. We are grateful to our Senior Product Manager, Scott Person; our Content Developer, Tara Singer; our Content Project Manager, Kim Kusnerak; and our Marketing Manager, Emily Horowitz, for their help in developing and promoting the book and for providing us with timely feedback and information from professors and reviewers, which allowed us to shape the book to meet the needs of its intended market. We also want to thank the departments of management at the University of Washington and New York University for providing the setting and atmosphere in which the book could be written, and the students of these universities who react to and provide input for many of our ideas. In addition, the following reviewers of this and earlier editions gave us valuable suggestions for improving the manuscript from its original version to its current form:

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Richard G. Brandenburg, *University of Vermont*

Steven Braund, *University of Hull*

Philip Bromiley, *University of Minnesota*

Geoffrey Brooks, *Western Oregon State College*

Jill Brown, *Lehigh University*

Amanda Budde, *University of Hawaii*

Lowell Busenitz, *University of Houston*

Sam Cappel, *Southeastern Louisiana University*

Charles J. Capps III, *Sam Houston State University*

Don Caruth, *Texas A&M Commerce*

Gene R. Conaster, *Golden State University*

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Catherine M. Daily, *Ohio State University*

Robert DeFillippi, *Suffolk University Sawyer School of Management*

Helen Deresky, *SUNY—Plattsburgh*

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John Fahy, *Trinity College, Dublin*

Patricia Feltes, *Southwest Missouri State University*

Bruce Fern, *New York University*
Mark Fiegener, *Oregon State University*
Chuck Foley, *Columbus State Community College*
Isaac Fox, *Washington State University*
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Scott R. Gallagher, *Rutgers University*
Eliezer Geisler, *Northeastern Illinois University*
Gretchen Gemeinhardt, *University of Houston*
Lynn Godkin, *Lamar University*
Sanjay Goel, *University of Minnesota—Duluth*
Robert L. Goldberg, *Northeastern University*
James Grinnell, *Merrimack College*
Russ Hagberg, *Northern Illinois University*
Allen Harmon, *University of Minnesota—Duluth*
Ramon Henson, *Rutgers University*
David Hoopes, *California State University—Dominguez Hills*
Todd Hostager, *University of Wisconsin—Eau Claire*
David Hover, *San Jose State University*
Graham L. Hubbard, *University of Minnesota*
Miriam Huddleston, *Harford Community College*
Tammy G. Hunt, *University of North Carolina at Wilmington*
James Gaius Ibe, *Morris College*
W. Grahm Irwin, *Miami University*
Homer Johnson, *Loyola University—Chicago*
Jonathan L. Johnson, *University of Arkansas Walton College of Business Administration*
Marios Katsioloudes, *St. Joseph's University*
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Joanna Mulholland, *West Chester University of Pennsylvania*

James Muraski, *Marquette University*
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Paul R. Reed, *Sam Houston State University*
Rhonda K. Reger, *Arizona State University*
Malika Richards, *Indiana University*
Simon Rodan, *San Jose State*
Stuart Rosenberg, *Dowling College*
Douglas Ross, *Towson University*
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Joseph A. Schenk, *University of Dayton*
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Leonard Sholtis, *Eastern Michigan University*
Pradip K. Shukla, *Chapman University*
Mel Sillmon, *University of Michigan—Dearborn*
Dennis L. Smart, *University of Nebraska at Omaha*
Barbara Spencer, *Clemson University*
Lawrence Steenberg, *University of Evansville*
Kim A. Stewart, *University of Denver*
Ted Takamura, *Warner Pacific College*
Scott Taylor, *Florida Metropolitan University*
Thuhang Tran, *Middle Tennessee University*
Bobby Vaught, *Southwest Missouri State*
Robert P. Vichas, *Florida Atlantic University*
John Vitton, *University of North Dakota*
Edward Ward, *St. Cloud State University*
Kenneth Wendeln, *Indiana University*
Daniel L. White, *Drexel University*
Edgar L. Williams, Jr., *Norfolk State University*
Donald Wilson, *Rochester Institute of Technology*
Jun Zhao, *Governors State University*

Charles W. L. Hill
Melissa A. Schilling
Gareth R. Jones

DEDICATION

To my daughters Elizabeth, Charlotte, and Michelle

— Charles W. L. Hill

For my children, Julia and Conor

— Melissa A. Schilling

For Nicholas and Julia and Morgan and Nia

— Gareth R. Jones

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1

INTRODUCTION TO STRATEGIC MANAGEMENT

Chapter 1 Strategic Leadership: Managing the Strategy-Making Process for Competitive Advantage

Chapter 2 External Analysis: The Identification of Opportunities and Threats

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CHAPTER 1

STRATEGIC LEADERSHIP: MANAGING THE STRATEGY-MAKING PROCESS FOR COMPETITIVE ADVANTAGE

LEARNING OBJECTIVES

1.1 Explain what is meant by "competitive advantage"

1.2 Discuss the strategic role of managers at different levels within an organization

1.3 Identify the primary steps in a strategic planning process

1.4 Discuss the common pitfalls of planning, and how those pitfalls can be avoided

1.5 Outline the cognitive biases that might lead to poor strategic decisions, and explain how these biases can be overcome

1.6 Discuss the role strategic leaders play in the strategy-making process

OPENING CASE

The Rise of Lululemon

In 1998, self-described snowboarder and surfer dude Chip Wilson took his first yoga class. The Vancouver native loved the exercises, but hated doing them in the cotton clothing that was standard yoga wear at the time. For Wilson, who had worked in the sportswear business and had a passion for technical athletic fabrics, wearing cotton clothes to do sweaty, stretchy, power yoga exercises seemed inappropriate. Thus the idea for Lululemon was born.

Wilson's vision was to create high-quality, stylishly designed clothing for yoga and related sports activities using the very best technical fabrics. He built a design team, but outsourced manufacturing to low-cost producers in South East Asia. Rather than selling clothing through existing

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retailers, Wilson elected to open his own stores. The idea was to staff the stores with employees who were themselves passionate about exercise, and could act as ambassadors for healthy living through yoga and related sports such as running and cycling.

The first store, opened in Vancouver, Canada, in 2000, quickly became a runaway success, and other stores followed. In 2007, the company went public, using the capital raised to accelerate its expansion plans. By late 2014, Lululemon had over 290 stores, mostly in North America, and sales in excess of $1.7 billion. Sales per square foot were estimated to be around $1,800—more than four times that of an average specialty retailer. Lululemon's financial performance was stellar. Between 2007 and 2104, average return on invested capital–an important measure of profitability–was 31%, far outpacing that of other well-known specialty retailers, while earnings per share grew by a staggering 3,183% (see Table 1.1).

How did Lululemon achieve this? It started with a focus on an unmet consumer need: the latent desire among yoga enthusiasts for high-quality, stylish, technical athletic wear. Getting the product offering right was a central part of the company's strategy. An equally important part of the strategy was to stock a limited supply of an item. New colors and seasonal items, for example, get a 3- to 12-week lifecycle, which keeps the product offerings feeling fresh. The goal is to sell gear at full price, and to condition customers to buy it when they see it, rather than wait, because if they do it may soon be "out of stock." The company only allows product returns if the clothes have not been worn and still have the price tags attached. The scarcity strategy has worked. Lululemon never holds sales, and its clothing sells for a premium price. For example, its yoga pants are priced from $78 to $128 a pair, whereas low-priced competitors like Gap Inc.'s Athleta sell yoga pants on their websites for $25 to $50.

To create the right in-store service, Lululemon hires employees who are passionate about fitness. Part of the hiring process involves taking prospective employees to a yoga or spin class. Some 70% of store managers are internal hires; most started on the sales floor and grew up in the culture. Store managers are given funds to repaint their stores, any color, twice a year. The interior design of each store is largely up to its manager. Each store is also given $2,700 a year for employees to contribute to a charity or local event of their own choosing. One store manager in Washington, D.C., used the funds to create, with regional community leaders, a global yoga event in 2010. The result, Salutation Nation, is now an annual event in which over 70 Lululemon stores host a free, all-level yoga practice at the same time.

Employees are trained to eavesdrop on customers, who are called "guests." Clothes-folding tables are placed on the sales floor near the fitting rooms rather than in a back room so that employees can overhear complaints. Nearby, a large chalkboard lets customers write suggestions or complaints that are sent back to headquarters. This feedback is then incorporated into the product design process.

Table 1.1 Lululemon's Financial Performance

	Lululemon	Gap Inc.	Urban Outfitters	Abercrombie & Fitch
Average ROIC 2007–2014	31%	21%	19%	14%
EPS Growth 2007–2014	3183%	295%	274%	15%

Despite the company's focus on providing a quality product, it has not all been clear sailing. In 2010, Wilson caused a stir when he emblazoned the company's tote bags with the phrase "Who is John Galt?" the opening line from Ayn Rand's 1957 novel, *Atlas Shrugged*. *Atlas Shrugged* has become a libertarian bible, and the underlying message that Lululemon supported Rand's brand of unregulated capitalism did not sit well with many of the stores' customers. After negative feedback, the bags were quickly pulled from stores. Wilson himself stepped down from day-to-day involvement in the company in January 2012 and resigned his chairman position in 2014.

In early 2013, Lululemon found itself dealing with another controversy when it decided to recall black yoga pants that were too sheer, and effectively "see through," when stretched due to the lack of "rear-end coverage." In addition to the negative fallout from the product itself, some customers report being mistreated by employees who demanded that customers put the pants on and bend over to determine whether the clothing was see-through enough to warrant a refund. One consequence of this PR disaster was the resignation of then CEO Christine Day. The company is also facing increasing competition from rivals such as Gap's Athleta Urban Outfitters' Without Walls, and Nike Stores. Notwithstanding these challenges, most observers in the media and financial community believe that the company can handle these issues and should be able to continue on its growth trajectory.

Sources: D. Mattoili, "Lululemon's Secret Sauce," *The Wall Street Journal*, March 22, 2012; C. Leahey, "Lululemon CEO: How to Build Trust Inside Your Company," *CNN Money*, March 16, 2012; T. Hsu, "'Pantsgate' to Hurt Lululemon Profit: Customer Told to Bend Over," *latimes.com*, March 21, 2013; C. O'Commor, "Billionaire Founder Chip Wilson Out at Yoga Giant Lululemon," *Forbes*, January 9, 2012; B. Weishaar, "No-moat Lululemon faces increasing competition but is regaining its customer base," *Morningstar*, December 17, 2014.

OVERVIEW

Why do some companies succeed, whereas others fail? Why has Lululemon been able to persistently outperform most other specialty retailers? In the airline industry, how has Southwest Airlines managed to keep increasing its revenues and profits through both good times and bad, whereas rivals such as United Airlines have had to seek bankruptcy protection? What explains the persistent growth and profitability of Nucor Steel, now the largest steelmaker in the United States, during a period when many of its once-larger rivals disappeared into bankruptcy?

In this book, we argue that the strategies that a company's managers pursue have a major impact on the company's performance relative to that of its competitors. A **strategy** is a set of related actions that managers take to increase their company's performance. For most, if not all, companies, achieving superior performance relative to rivals is the ultimate challenge. If a company's strategies result in superior performance, it is said to have a competitive advantage.

strategy
A set of related actions that managers take to increase their company's performance.

Lululemon's strategies produced superior performance from 2007 to 2014; as a result, Lululemon enjoyed a competitive advantage that was translated into stellar financial performance. As described in the Opening Case, Lululemon's strategies included focusing on a market niche where there was an unmet need for stylish, well-designed, high-quality athletic wear, satisfying that need through excellence in product design, and managing product inventory to limit supply, spur impulse purchases, and keep prices high. Lululemon's founder, Chip Wilson, clearly had a compelling strategic vision, and that vision was well executed.

This book identifies and describes the strategies that managers can pursue to achieve superior performance and provide their companies with a competitive advantage. One of its central aims is to give you a thorough understanding of the analytical techniques and skills necessary to formulate and implement strategies successfully. The first step toward achieving this objective is to describe in more detail what superior performance and competitive advantage mean and to explain the pivotal role that managers play in leading the strategy-making process.

Strategic leadership is about how to most effectively manage a company's strategy-making process to create competitive advantage. The strategy-making process is the process by which managers select and then implement a set of strategies that aim to achieve a competitive advantage. **Strategy formulation** is the task of selecting strategies. **Strategy implementation** is the task of putting strategies into action, which includes designing, delivering, and supporting products; improving the efficiency and effectiveness of operations; and designing a company's organizational structure, control systems, and culture. Lululemon was successful not just because managers formulated a viable strategy, but because that strategy was for the most part very well implemented.

strategic leadership
Creating competitive advantage through effective management of the strategy-making process.

strategy formulation
Selecting strategies based on analysis of an organization's external and internal environment.

strategy implementation
Putting strategies into action.

By the end of this chapter, you will understand how strategic leaders can manage the strategy-making process by formulating and implementing strategies that enable a company to achieve a competitive advantage and superior performance. Moreover, you will learn how the strategy-making process can sometimes go wrong, as it did at one point for Lululemon, and what managers can do to make this process more effective.

STRATEGIC LEADERSHIP, COMPETITIVE ADVANTAGE, AND SUPERIOR PERFORMANCE

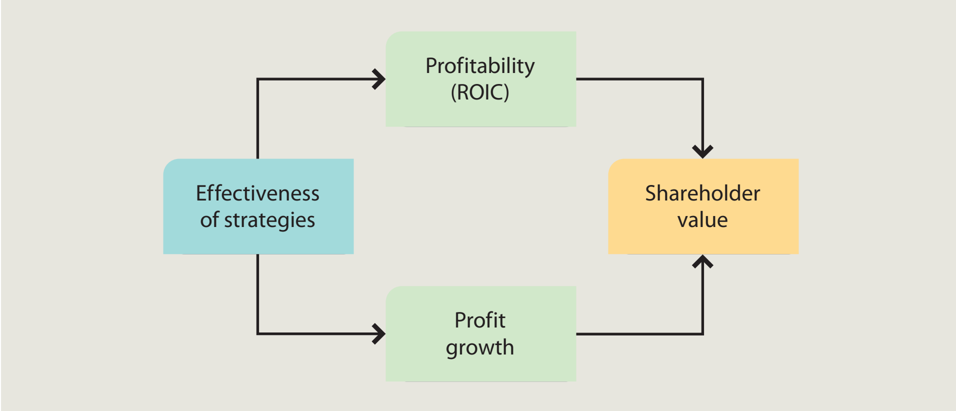
Strategic leadership is concerned with managing the strategy-making process to increase the performance of a company, thereby increasing the value of the enterprise to its owners, its shareholders. As shown in Figure 1.1, to increase shareholder value, managers must pursue strategies that increase the profitability of the company and ensure that profits grow (for more details, see the Appendix to this chapter). To do this, a company must be able to outperform its rivals; it must have a competitive advantage.

Superior Performance

Maximizing shareholder value is the ultimate goal of profit-making companies, for two reasons. First, shareholders provide a company with the risk capital that enables managers to buy the resources needed to produce and sell goods and services. **Risk capital** is capital that cannot be recovered if a company fails and goes bankrupt. For

risk capital
Equity capital invested with no guarantee that stockholders will recoup their cash or earn a decent return.

Figure 1.1 Determinants of Shareholder Value



example, when Lululemon went public in 2007, shareholders provided Chip Wilson's company with capital it used to build out its network of stores. Had Lululemon failed to execute, its shareholders would have lost their money—their shares would have been worthless. Thus, shareholders will not provide risk capital unless they believe that managers are committed to pursuing strategies that provide a good return on their capital investment. Second, shareholders are the legal owners of a corporation, and their shares therefore represent a claim on the profits generated by a company. Thus, managers have an obligation to invest those profits in ways that maximize shareholder value.

That being said, as explained later in this book, managers must behave in a legal, ethical, and socially responsible manner while working to maximize shareholder value. Moreover, as we shall see, there is good evidence that the best way to maximize the *long-run* return to shareholders is to focus on customers and employees. Satisfying customer needs, and making sure that employees are fairly treated and work productively, typically translates into better financial performance and superior long-run returns for shareholders. Alternatively, ignoring customer needs, and treating employees unfairly, may boost short-run profits and returns to shareholders, but it will also damage the long-run viability of the enterprise and ultimately depress shareholder value. This is why many successful managers argue that if a company focuses on its customers, and creates incentives for its employees to work productivity, shareholder returns will take care of themselves.

shareholder value
Returns that shareholders earn from purchasing shares in a company.

By **shareholder value**, we mean the returns that shareholders earn from purchasing shares in a company. These returns come from two sources: (a) capital appreciation in the value of a company's shares and (b) dividend payments. For example, during 2014 a share of Microsoft increased in price from \$37.35 to \$46.73. Each share of Microsoft also paid a dividend of \$1.15 to its owners during 2014. Thus, in 2014, shareholders in Microsoft earned a return of 28.2%, 25.1% of which came from capital appreciation in the value of the share and 3.1% of which came in the form of a dividend payout.

profitability
The return a company makes on the capital invested in the enterprise.

One way to measure the **profitability** of a company is by its return on the capital invested in the enterprise.[1] The return on invested capital (ROIC) that a company earns is defined as its net profit over the capital invested in the firm (profit/capital invested). By net profit, we mean net income after tax. By capital, we mean the sum of money invested in the company: that is, stockholders' equity plus debt owed to creditors. So defined, *profitability is the result of how efficiently and effectively managers use the capital at their disposal to produce goods and services that satisfy customer needs.* A company that uses its capital efficiently and effectively makes a positive return on invested capital. Between 2007 and 2014, Lululemon earned an average **return on invested capital** (ROIC) of 31%, far above that of most other specialty retailers, which indicated that its strategies resulted in the very efficient and effective use of its capital.

A company's **profit growth** can be measured by the increase in net profit over time. A company can grow its profits if it sells products in rapidly growing markets, gains market share from rivals, increases sales to existing customers, expands overseas, or diversifies profitably into new lines of business. For example, between 2007 and 2012, Lululemon increased its net profits from $8 million to $280 million by rapidly growing the market for high-end, yoga-inspired clothing. Due to its dramatic profit growth, Lululemon's earnings per share increased from $0.06 to $1.91 over this period, resulting in appreciation in the value of each share in Lululemon.

profit growth
The increase in net profit over time.

Together, profitability and profit growth are the principal drivers of shareholder value (see the Appendix to this chapter for details). *To both boost profitability and grow profits over time, managers must formulate and implement strategies that give their company a competitive advantage over rivals*. This is what Lululemon achieved between 2007 and 2014. As a result, investors who purchased Lululemon shares on July 27, 2007, when it went public, and held on to them until December 31, 2014, saw the value of their shares increase from $14 to $55.79, a capital appreciation of almost 400%. By pursuing strategies that lead to high, sustained profitability and profit growth, Lululemon's managers rewarded shareholders for their decision to invest in the company.

One key challenge managers face is how best to simultaneously generate high profitability and increase profits. Companies that have high profitability but no profit growth will often be less valued by shareholders than companies that have both high profitability and rapid profit growth (see the Appendix for details). At the same time, managers need to be aware that if they grow profits but profitability declines, that too will be less highly valued by shareholders. What shareholders want to see, and what managers must try to deliver through strategic leadership, is *profitable growth*: that is, high profitability and sustainable profit growth. This is not easy, but some of the most successful enterprises of our era have achieved it—companies such as Apple, Google, and Lululemon.

Competitive Advantage and a Company's Business Model

Managers do not make strategic decisions in a competitive vacuum. Their company is competing against other companies for customers. Competition is a rough-and-tumble process in which only the most efficient, effective companies win out. It is a race without end. To maximize long-run shareholder value, managers must formulate and implement strategies that enable their company to outperform rivals—that give it a competitive advantage. A company is said to have a **competitive advantage** over its rivals when its profitability and profit growth are greater than the average of other companies competing for the same set of customers. The higher its profitability and profit growth relative to rivals, the greater its competitive advantage will be. A company has a **sustained competitive advantage** when its strategies enable it to maintain above-average profitability and profit growth for a number of years. This was the case for Lululemon between 2007 and 2014.

competitive advantage
The achieved advantage over rivals when a company's profitability is greater than the average profitability of firms in its industry.

sustained competitive advantage
A company's strategies enable it to maintain above-average profitability for a number of years.

business model
The conception of how strategies should work together as a whole to enable the company to achieve competitive advantage.

The key to understanding competitive advantage is appreciating how the different strategies managers pursue over time can create activities that fit together to make a company unique and able to consistently outperform them. A **business model** is managers' conception of how the set of strategies their company pursues work together as a congruent whole, enabling the company to gain a competitive advantage and achieve superior profitability and profit growth. In essence, a business model is a kind of mental model, or gestalt, of how the various strategies and capital investments a company makes fit together to generate above-average performance. A business model encompasses the totality of how a company will:

- Select its customers.
- Define and differentiate its product offerings.
- Create value for its customers.
- Acquire and keep customers.
- Produce goods or services.
- Increase productivity and lower costs.
- Deliver goods and services to the market.
- Organize activities within the company.
- Configure its resources.
- Achieve and sustain a high level of profitability.
- Grow the business over time.

The business model at discount stores such as Wal-Mart, for example, is based on the idea that costs can be lowered by replacing a full-service retail format for with a self-service format and a wider selection of products sold in a large-footprint store that contains minimal fixtures and fittings. These savings are passed on to consumers in the form of lower prices, which in turn grow revenues and help the company achieve further cost reductions from economies of scale. Over time, this business model has proved superior to the business models adopted by smaller, full-service, "mom-and-pop" stores, and by traditional, high-service department stores such as Sears. The business model—known as the self-service supermarket business model—was first developed by grocery retailers in the 1950s and later refined and improved on by general merchandisers such as Wal-Mart in the 1960s and 1970s. Subsequently, the same basic business model was applied to toys (Toys "R" Us), office supplies (Staples, Office Depot), and home-improvement supplies (Home Depot and Lowes).

Industry Differences in Performance

It is important to recognize that in addition to its business model and associated strategies, a company's performance is also determined by the characteristics of the industry in which it competes. Different industries are characterized by different competitive conditions. In some industries, demand is growing rapidly, and in others it is contracting. Some industries might be beset by excess capacity and persistent price wars, others by strong demand and rising prices. In some, technological change might be revolutionizing competition; others may be characterized by stable technology. In some industries, high profitability among incumbent companies might induce new companies to enter the industry, and these new entrants might subsequently depress prices and profits in the industry. In other industries, new entry might be difficult, and periods of high profitability might persist for a considerable time.

Thus, the different competitive conditions prevailing in different industries may lead to differences in profitability and profit growth. For example, average profitability might be higher in some industries and lower in other industries because competitive conditions vary from industry to industry.

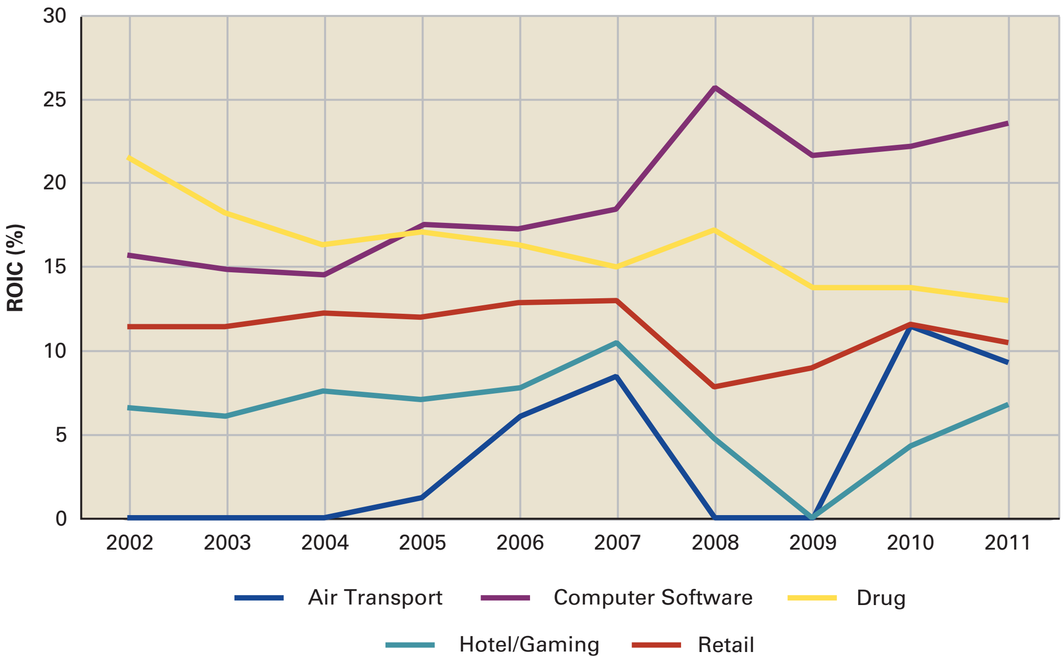
Figure 1.2 shows the average profitability, measured by ROIC, among companies in several different industries between 2002 and 2011. The computer software industry had a favorable competitive environment: demand for software was high and competition was generally not based on price. Just the opposite was the case in the air transport industry, which was extremely price competitive.

Exactly how industries differ is discussed in detail in Chapter 2. For now, it is important to remember that the profitability and profit growth of a company are determined by two main factors: *its relative success in its industry and the overall performance of its industry relative to other industries*.[2]

Performance in Nonprofit Enterprises

A final point concerns the concept of superior performance in the nonprofit sector. By definition, nonprofit enterprises such as government agencies, universities, and charities are not in "business" to make profits. Nevertheless, they are expected to use their resources efficiently and operate effectively, and their managers set goals to measure their performance. The performance goal for a business school might be to

Figure 1.2 Return on Invested Capital (ROIC) in Selected Industries, 2002–2011



Source: Value Line Investment Survey.