STRATEGIC MANAGEMENT

THIRD EDITION

CONCEPTS AND CASES

JEFFREY DYER • PAUL GODFREY • ROBERT JENSEN • DAVID BRYCE

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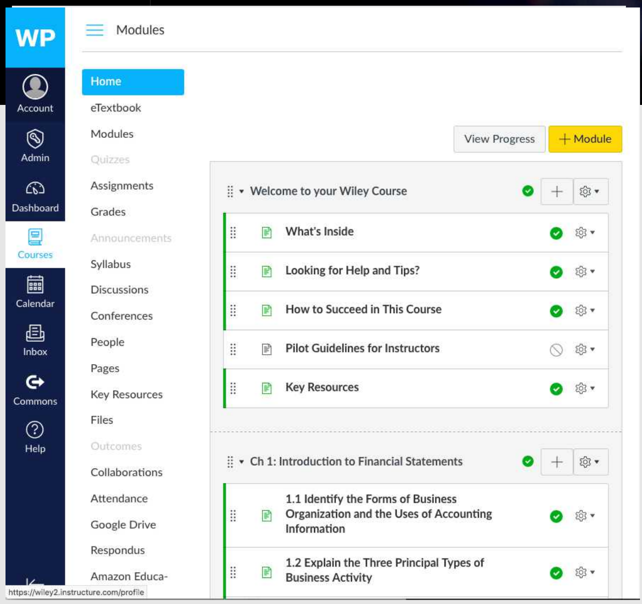

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JEFF DYER (Ph.D., UCLA, 1993) is the Horace Beesley Professor of Strategy at the Marriott School, BYU, where he serves as Chair of the Department of Organizational Leadership and Strategy. Before joining BYU, Dr. Dyer was a professor at the University of Pennsylvania's Wharton School, where he maintains an adjunct professor position and continues to teach Executive MBAs. Dr. Dyer has considerable consulting experience, having spent 5 years working as a strategy consultant and manager at Bain & Company, where he consulted with such clients as Baxter International, Kraft, Maryland National Bank, and First National Stores. Since then he has been a consultant, speaker, or trainer for a variety of companies, including Adobe, AT&T, Cisco, General Electric, General Mills, Gilead Sciences, Harley-Davidson, Hewlett Packard, Intel, Johnson & Johnson, and Sony. Dyer is the only strategy scholar in the world to have published at least six times in the *Harvard Business Review* and six times in *Strategic Management Journal*, the top academic journal in the strategy field. In 2012, he was ranked the world's #1 "most influential" management scholar among scholars who completed their Ph.D.s after 1990. This ranking, published in *Academy of Management Perspectives*, was based upon an equal weighting of academic citations (academic influence) and non-".edu" Google searches (business influence). His book *The Innovator's DNA* is a business bestseller and has been published in 13 languages, and his new book, *The Innovator's Method*, has already hit top 10 business bestseller lists.

PAUL C. GODFREY (Ph.D., Washington, 1994) currently serves as the William and Roceil Low Professor of Business Strategy in the Marriott School of Management at Brigham Young University. Paul teaches classes to BYU undergraduates, as well as MBA and Executive MBA students. He was honored in 2013 with the Marriott School's Teaching Award, and in 2017 with the school's research award. His research has appeared in the *Academy of Management Review*, the *Strategic Management Journal*, the *Journal of Business Ethics*, and the *Journal of Management Inquiry*. He has recently published a book on eliminating poverty with Stanford University Press. He has also co-edited two other books and served as a special issue editor for two academic journals. He currently serves as Associate Academic Director of the Economic Self-Reliance Center at the Marriott School. He currently consults with a variety of for-profit and not-for-profit organizations. Paul received his MBA and Ph.D. degrees from the University of Washington and a Bachelor of Science degree in Political Science from the University of Utah.

ROBERT J. JENSEN (Ph.D., Wharton, 2006) is an associate professor of Strategy and International Business and is a Whitman Faculty and Peery Research Fellow at the Marriott School of Management, Brigham Young University. He received his Ph.D. from the Wharton School, University of Pennsylvania. He has published in many of the top management journals including *Strategic Management Journal, Organization Science, Management Science*, and the *Journal of International Business Studies*. His professional awards include the McKinsey & Company/SMS Best Conference Paper prize, honorable mention, a finalist for the Blackwell Best Dissertation Prize from the Academy of Management, as well as the William H. Newman Best Paper from a Dissertation award, and runner up for the Booz Allen Hamilton/SMS Ph.D. fellowship. His work was honored as the best paper published in *Competitiveness Review* in 2009 and his papers have been selected seven times for the best paper proceedings of the Academy of Management. His research interests include leveraging knowledge assets through transfer and replication including the problems of overcoming the stickiness, or difficulty, of such transfers. He also researches the boundaries of the firm in extreme locations such as the Bottom of the Pyramid including the rise of hybrid organizations in such locations. He is also currently working on a study of the factors, both student, faculty, and course content factors, that impact student success in management classes, particularly in online settings, and which professor characteristics and routines can best be replicated in that medium.

DAVID J. BRYCE (Ph.D., Wharton, 2003) is Associate Professor of Organizational Leadership and Strategy at the Marriott School of Management and has been an adjunct Associate Professor of Management at the Wharton School where he has taught strategy in the MBA program for executives. David earned a Ph.D. in strategy and applied economics from the Wharton School and is author on a number of thought-leading articles for senior executives, including articles in the *Harvard Business Review*. He conducts research in the area of corporate strategy and has published in top academic journals such as

Management Science and *Organization Science*. For more than 20 years, he has served as consultant on important strategic challenges to executives of start-ups, mid-market companies, and major corporations, including Eli Lilly, Prudential, Procter & Gamble, Microsoft, Johnson & Johnson, and the LG Group. He has worked with clients on enterprise strategy, new market entry, branding, pricing, positioning, and growth. He has also conducted many strategy-oriented leadership training sessions over the past 10 years within the Fortune 50, including extensively at Microsoft. Prior to his academic career, he held partner, vice president, and other senior positions at several global management consulting firms.

Why does the world need another strategy textbook? The answer is that we simply have not been able to find a textbook that we felt fully met the needs of our students. What are those needs? First, we wanted to write a textbook that would engage students' interest using numerous practical examples and tools that would help them actually *do* analysis to answer key strategic questions.

For example, leading firms and strategy consulting firms have tools to teach strategists how to actually conduct a "5 Forces" analysis, calculate a scale or experience curve, or conduct a net promoter score analysis. We wanted to provide those tools. We also wanted to create interactive learning tools that would connect with a new generation of learners. This meant we needed to provide interactive digital learning experiences such as the "white board" animated videos that we have created to support our textbook. When students are more engaged, they learn more—and they enjoy it more! Not surprisingly, this increases student satisfaction with the course and the professor.

As we looked at how we could create an enjoyable and engaging strategy course learning experience, we realized as an author group that we were somewhat uniquely qualified to create that type of experience. Why? Because we collectively have over 13 years of full-time management consulting experience at top consulting firms.

Why does this matter? Because we have practical experience *applying* strategy concepts and tools to real companies—practical experience that we have embedded in this textbook. Perhaps just as important, we know how to write to a management audience, having published three books targeting a practitioner audience, seven articles in *Harvard Business Review*, and another four articles in *Sloan Management Review*. Perhaps most important is the fact that we've tested the text, cases, video animations, and strategy tools with large groups of business students at BYU and Wharton over the past 10 years—with remarkable results. Average student satisfaction ratings have been 6.6/7.0 across multiple instructors for strategy courses using our materials. The bottom line is that we see better student satisfaction and higher teaching ratings because of using this material. In just the past year, we have class tested *Strategic Management* at over 40 institutions with over 900 students. In exit surveys, 76 percent of students rated the experience as positive or very positive. A few of their quotes are in the margin below.

Key Course Differentiators

Because this is a strategy book, we should tell you that our strategy in writing this book is to offer unique value. The key differentiators of this book can be summarized with the acronym **TACT**—**T**ext, **A**nimated Executive Summary Videos, **C**ases, and **T**ools.

Text. Each of our chapters is written in an accessible *Harvard Business Review* style with lots of practical examples, and each chapter is roughly 20 percent shorter than the chapters of the average strategy textbook. You can assign the whole chapter (not just a few pages) and feel confident that your students will not perceive it as a waste of time. This is not to say that we haven't included core strategy concepts, frameworks, and theories. They are all there.

Animated Executive Summary Videos. In WileyPLUS each chapter is accompanied by at least one 8–10 minute animated video that brings the content to life. Today's students love to learn through interactive technology, and student response to our animated videos has been positively off the charts. Research shows that student recall increases by more than 15 percent when material is presented with a white board animation versus a typical talking head lecture.[1] These animated videos allow you to

MY FAVORITE ASPECT WAS THE EXAMPLES USED TO EXPLAIN THE CONCEPTS. IT REALLY HELPED ME UNDERSTAND THE MATERIAL.

–BILL BOCHICCHIO, STUDENT, VILLANOVA UNIVERSITY

THE WHITEBOARD ANIMATIONS WERE VERY ENTERTAINING AND HELPED EXPLAIN SOME OF THE CONCEPTS IN REAL LIFE SITUATIONS.

–CAMERON LANDRY, STUDENT, MCNEESE STATE UNIVERSITY

[1] Study by Richard Wiseman. Available at http://www.sparkol.com/blog/how-scribe-videos-increase-your-students-learning-by-15/

flip the classroom. When students view the videos before class, they get the core concepts in a memorable way. Then you have more time to discuss questions and help them deeply understand and synthesize the concepts and tools. In WileyPLUS, we also provide strategy in your career videos that will help students tie what they are learning to the workplace and decipher how strategy affects their current and future career plans. This brings a new level of relevance to the study of strategy.

THE CASES WERE MY FAVORITE PART—UNDERSTANDING REAL WORLD EXAMPLES HELPED PUT THINGS INTO PROPER PERSPECTIVE.

– PHILIP SIEKMANN, STUDENT, PENNSYLVANIA COLLEGE OF TECHNOLOGY

Cases. We will admit that differentiating cases isn't easy, but we think we've done a few things to make using our cases easier. Our cases offer new, shortened, and updated "classic" cases on familiar companies (e.g., Walmart, Coke and Pepsi, Intel, Southwest, Nike, etc.). If you build your course around these cases, you'll experience very low switching costs moving to our book. We've also written cases on companies and topics that millennials gravitate to such as Tesla, Uber, Facebook, ESPN, Amazon, skype, Samsung, and the AT&T-Apple alliance.

We also provide brief Case Notes and PowerPoint presentations to summarize key take-aways for each case.

I LIKED THE EXAMPLES AND THEIR OVERALL RELEVANCE. I ALSO LIKED THE STRATEGIC TOOLS AND THE EXPLANATIONS.

–DAVID GRANTHAM, STUDENT, KENNESAW STATE UNIVERSITY

Tools. Almost every chapter will offer a "Strategy Tool" to teach students how to apply a theory, framework, or concept. Students will feel like they have learned how to ***do*** something—actually conduct analysis that will help with strategic decisions. Some of these tools are used in Fortune 500 companies and in strategy consulting firms such as Bain, BCG, and McKinsey when they do strategy analysis for clients. For example, the book shows the student how to assess the attractiveness of an industry, how to calculate and use scale or experience curve, how to create a net promoter score to assess whether a differentiation strategy is working, and how to decide whether to "make" versus "buy." Many of the end-of-chapter cases integrate the strategy tool into the case so you can easily have students apply the tool as they analyze the case. Our students tell us that these tools help them feel that they are acquiring useful analytical skills to help them in making strategic decisions.

I FOUND IT TO BE A VERY EASY READ. IT WAS ONE OF THE FEW BUSINESS TEXTBOOKS THAT I ENJOYED READING WHICH MADE LEARNING EASIER AND MORE FUN.

–TAYLOR LEE, STUDENT, SAN JOSE STATE UNIVERSITY

We think the combination of well-conceived and executed Text, Animated Executive Summary Videos, Cases, and Tools can dramatically improve student satisfaction with your strategy course. Indeed, a random sample of strategy professors who reviewed our text book preferred it over their current textbooks by almost 4:1. That's a pretty powerful endorsement.

So, does the world need another strategy text? We answer "yes," and we offer one that provides students with a well-designed, engaging, and learning-rich combination of TACT: Text, Animated Executive Summary Videos, Cases, and Tools. We've also found that when our students enjoy their courses, we enjoy teaching much more.

What's New in Edition 3?

When you open the book, you'll see much that's new, from new color schemes to layouts. There's more that's new, however, than just cosmetics; we've taken time to respond to feedback from users of the first edition, sharpened our ties to the overarching framework of our book, and provided new updates and cases. Let's look at each of these in turn:

User Feedback. While we continue to get rave reviews for the second edition, we also received some very insightful critique. We've heard feedback that some of our models don't mesh well with other readings strategy faculty use. As a result, we've updated Chapter 3 to eliminate confusion around the company diamond model and the strategy diamond many faculty use. We've continued to polish the Strategy and Your Career sidebars, and we created a set of videos in WileyPLUS with the authors answering frequently asked questions about strategy careers.

Sharper Focus. We approach strategy—the search for competitive advantage—as the answer to four critical questions: Where should we compete? Why do we win with customers? How do we deliver unique value to win with customers? How will we win over time, or sustain our competitive advantage? Several chapters now include a specific section that details *new thinking* about the answers to these four questions. For example, we explore the idea that "where you compete" is less at the industry level and more at the "job-to-be-done" level. We also discuss new thinking that suggests unique value is less about cost versus differentiation and more about cost *and* differentiation—meaning that companies are increasingly offering differentiated products at a lower price. We have created five new video animations that instructors can use to illustrate this new thinking in a way that is easy for students to understand.

New Content and Cases. We've updated a number of chapter opening vignettes. In Chapter 9, for example, we replaced Lincoln Electric with Huawei, the Chinese telecom giant that has expanded into making smartphones to compete directly with Apple and Samsung around the globe. In Chapter 10, we now introduce the chapter content with a case on "voice wars," highlighting the emerging battle between personal digital voice assistants like Alexa, Google, and Siri. In the third edition, we've updated a number of existing cases in our library and have added cases on Facebook and the 2016 election, ESPN, EcoLab and Vivint Smart Home. We continue to write new cases in between each edition to keep the companies fresh and give instructors new material. Similar to our case library, our animation library will continue to grow. You'll soon see new "tool" animations on how to solve a business problem and how to present a business solution.

If you are a current user of our book, let us say "Thank You!" for your support and your wonderful feedback. If you are thinking about adopting our text, we'd encourage you to give our total offering (text, animations, cases, PowerPoints, tools) a very serious look. This edition keeps all that was great about the first edition—an approachable text that helps students understand and use real-world strategy tools to supplement strategy models—and builds on those strengths to offer a text that better meets your needs, emphasizes a simple framework to help students see an overarching vision of strategy, and content that builds on the latest and greatest strategic moves by companies.

Instructor Resources

Companion Website. The *Strategic Management* Website at http://www.wiley.com/college/dyer contains myriad tools and links to aid both teaching and learning, including resources listed here.

Teaching Notes. The Teaching Notes offer helpful teaching ideas. They offer chapter-by-chapter text highlights, learning objectives, chapter outlines, and answers to end-of-chapter material.

Case Notes. Written for each case presented with *Strategic Management*, each Case Note includes a brief case summary, learning objectives for the instructor, learning outcomes for the students, and a brief teaching plan with questions and answers. In addition, we've provided a matrix showing alternative teaching approaches for each case.

Test Bank. This comprehensive Test Bank contains over 100 questions per chapter. The multiple-choice, fill-in, and short-essay questions vary in degree of difficulty. All questions are tagged with learning objectives, Bloom's Taxonomy categories, and AACSB Standards. The *Computerized Test Bank* allows instructors to modify and add questions to the master bank and to customize their exams. In addition, a *Respondus Test Bank* is available for use with learning management systems.

PowerPoint Presentation Slides. This robust set of slides for chapters and cases can be accessed on the instructor companion site. Lecture notes accompany most slides. A set of slides without lecture notes is available on the student companion site.

Practical Application Guide. This brief manual, authored by Sheri B. Schulte, University of Akron, provides an introduction to a "flipped classroom" approach of teaching

Strategic Management. It contains practical exercises linking to key topics throughout the text. Each exercise is accompanied by facilitator's instructions, questions for classroom discussion and follow up, and suggested answers.

WileyPLUS

WileyPLUS is a research-based online environment for effective teaching and learning.

WileyPLUS builds students' confidence because it takes the guess-work out of studying by providing students with a clear roadmap: what to do, how to do it, if they did it right. Students will take more initiative so you'll have greater impact on their achievement in the classroom and beyond.

WileyPLUS for Instructors

WileyPLUS enables you to:

- Assign automatically graded homework, practice, and quizzes from the chapters, cases, animations, and test bank.
- Track your students' progress in an instructor's grade book.
- Access all teaching and learning resources, including an online version of the text, and student and instructor supplements, in one easy-to-use website. These include animated executive summary videos, additional cases, teaching notes, and full-color PowerPoint slides.
- Create class presentations using Wiley-provided resources, with the ability to customize and add your own materials.

WileyPLUS for Students

In WileyPLUS, students will find various helpful tools, such as an ebook, animations, videos, additional cases, a virtual Career Center, and flashcards.

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Brief Contents

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ADDITIONAL CASES CAN BE FOUND IN WILEYPLUS

CHAPTER **1**

What Is Business Strategy?

LEARNING OBJECTIVES

Studying this chapter should provide you with the knowledge to:

1. Define business strategy, including the importance of competitive advantage, the four choices that are critical to strategy formulation, and the strategic management process.
2. Summarize the information that the company's mission and thorough external and internal analysis provide to guide strategy.
3. Discuss how strategies are formulated and implemented in order to achieve objectives.
4. Explain who is responsible for, and who benefits from, good business strategy.

Strategy at Apple

STANCA SANDA/Alamy Stock Photo

In 2000, Apple Computer held a loyal customer base but was limping along as a relatively minor player in the personal computer market. Launched by Steve Jobs and Steve Wozniak, Apple was one of the pioneers in the industry. Unlike other PC makers that relied on Microsoft's operating system and application software, Apple wrote its own operating system software and much of its application software, which was known as being easy to use. In fact, Apple was the first to introduce software on a low cost personal computer with drop-down menus and a graphical user interface that allowed customers to easily complete a task, such as dragging a file to the trash to delete it. However, Apple's investment in unique software led to high-priced computers and created files that were originally incompatible with those of Microsoft's Windows operating system and Office software suite. As a result, Apple rarely achieved more than about a 5 percent share of the computer market.[1]

That all changed in 2001, however, when Apple entered an entirely new market with the launch of an MP3 portable music player called the iPod. Apple's MP3 player was not the first on the market. A company called Rio had offered an MP3 player for a couple of years before iPod's entry into the market. But iPod quickly took market share from the Rio, for three primary reasons:

1. iPod had a mini hard drive that allowed it to hold 500 songs, as opposed to the roughly 15 songs the Rio could hold using flash memory.
2. iPod was the first to introduce a "fly wheel" navigation button—the round button that was easy to use and allowed users to quickly scroll through menus and songs.
3. iPod was backed with Apple's name and an innovative design.[2]

These advantages helped iPod quickly move to industry leadership, despite the fact that an iPod cost 15 to 25 percent more than a Rio.[3] At the time the iPod was launched, it was difficult for most consumers to access digital downloads of songs legally. Initially, the iPod was snapped up only by a relatively small group of users, mostly teenagers and college students, who were illegally downloading songs through Napster and other free downloading sites.

Apple recognized that to grow the market for iPods, it needed to help consumers legally access songs to play on their iPods. As a result, Apple developed software called iTunes, allowing customers to legally download songs. One main reason iTunes was able to provide legal downloads before its competitors was because Steve Jobs, as CEO of both Apple and Pixar (the animation movie production company), understood that music companies, like movie companies, were concerned about people pirating their products. So Apple worked with the music companies to sell songs that had been digitized using software that prevented customers from copying the songs to more than a few computers. iTunes was designed to be easy to use with the iPod. Customers now could easily and legally access songs simply by connecting their iPods to their computers and letting the software do the rest. Even a technology-challenged grandparent could do it.[4]

But Apple wasn't done with its music player strategy. Apple's experience in the computer business was that other companies could make similar products, often at lower prices. Indeed, while Apple and IBM were the pioneers of the personal computer industry and dominated it during the early years, lower-priced competitors such as Dell, Hewlett-Packard, Lenovo, and ASUS eventually came to dominate the market. Apple realized it needed to prevent easy imitation of its music offering. So it created proprietary software called Fairplay that restricted the use of music downloaded from iTunes to iPods only. That meant consumers couldn't buy a lower-priced MP3 player and use it with iTunes because it was incompatible. If they wanted to use a different MP3 player, they would have to download and pay for music a second time.[5] Now Apple has bundled an MP3 player into the iPhone, which makes it move convenient for customers because they don't have to carry two devices.

To top it off, Apple did something that no other maker of computers, music players, or any other electronic device company had done. It opened its own stores to sell Apple products. This required that Apple learn how to operate retail stores. The Apple Stores helped Apple create a direct link to its customers, making it easier for consumers to learn about and try out Apple products—and get their products serviced.

As a result of Apple's strategic initiatives, it has built a very secure market position in music players, currently holding over 70 percent of that market.[6] But the battle isn't over. Amazon has entered the industry, offering music buyers unrestricted use of its songs with a subscription to Amazon Music Unlimited. Moreover, other competitors offering music via subscription include eMusic, Pandora.com, and Spotify. Users can listen to any song they want for a small monthly subscription fee. The $17 billion music industry is so large that it will continue to attract new competitors who want to dethrone Apple.

How did Apple enter the music industry and within 10 years become the dominant seller of both songs and music players? How did Pandora, a start-up, succeed in the music industry while former giant Sony (maker of the Walkman and Discman) struggled? For that matter, why is any company successful? Understanding the series of actions taken by Apple to achieve a dominant position in the online music business will go a long way toward understanding business strategy—*a company's dynamic plan to gain, and sustain, competitive advantage in its markets*. In this chapter, we'll help you get started by answering some basic questions. We begin with the most obvious: "What is a business strategy?"

business strategy A plan to achieve competitive advantage that involves making four inter-related strategic choices: (1) markets to compete in; (2) unique value the firm will offer in those markets; (3) the resources and capabilities required to offer that unique value better than competitors; and (4) ways to sustain the advantage by preventing imitation.

competitive advantage When a firm generates consistently higher profits compared to its competitors.

market The industry, customer segment, or geographic area that a company competes in.

unique value The reason a firm wins with customers or the value proposition it offers to customers, such as a low cost advantage or differentiation advantage or both.

What Is Business Strategy?

The word *strategy* comes from the Greek word *strategos*, meaning, "the art of the general." In other words, the origin of strategy comes from the art of war, and, specifically, the role of a general in a war. In fact, there is a famous treatise titled *The Art of War* that is said to have been authored by Sun Tzu, a legendary Chinese general. In the art of war, the *goal* is to win—but that is not the strategy. Can you imagine the great general Hannibal saying something like, "Our strategy is to beat Rome!" No, Hannibal's goal was to defeat Rome. His strategy was to bring hidden strengths against the weaknesses of his enemy at the point of attack—which he did when he crossed the Alps to attack in a way that his enemies did not believe he could. He achieved an advantage through his strategy.

In similar fashion, a company's **business strategy** is defined as a company's dynamic plan to gain and sustain **competitive advantage** in the marketplace. This plan is based on the theory its leaders have about how to succeed in a particular **market**. This theory involves predictions about which markets are attractive and how a company can offer **unique value** to customers in those markets in a way that won't be easily imitated by competitors. This theory then gets translated into a plan to gain competitive advantage. This plan must be dynamic to respond to new information that comes as customers, competitors, and technologies change. Apple's theory of how to gain a competitive advantage in the music download business was to create cool and easy-to-use MP3 players and smartphones that could easily—and legally—download digital songs from a computer through the iTunes store. Apple sought to sustain its advantage by making it difficult for competitor MP3 players or phones to download songs from the iTunes store. The Apple Stores contributed to Apple's advantage by providing a direct physical link to customers that competitors couldn't match. In this particular instance, Apple's plan to gain, and sustain, competitive advantage worked. But there have been other times, such as with the Apple Newton Message Pad (the first handheld computer that Apple sold as a *personal digital assistant*), that Apple's approach to gaining and sustaining competitive advantage did not work. Sometimes strategies are successful and sometimes they are not.

Strategies are more likely to be successful when the plan explicitly takes into account four factors:

1. Where to compete, or the attractiveness of a market or customer segment in the targeted markets
2. How to offer unique value relative to the competition in the targeted markets
3. What resources or capabilities are necessary to deliver that unique value
4. How to sustain a competitive advantage once it has been achieved

The goal of the strategic plan is to create competitive advantage. First, let's examine the goal.

Competitive Advantage

What exactly do we mean when we use the term *competitive advantage*?[7] In the sports world, it is usually obvious when a team has a competitive advantage over another team: The better team wins the game by having a higher score. The ability to consistently win is based on attracting and developing better players and coaches, and by employing strategies to exploit the weaknesses of opponents. In the business world, the scoring is measured by looking at the profits (as a percentage of invested capital) generated by each firm. We describe the most common ways of measuring profits in *Strategy in Practice: Measuring American Home Products' Competitive Advantage*.

Just as in sports, where an inferior team may outscore a superior team on a given day, it may be possible for an inferior company to outscore a superior company in a particular quarter, or perhaps even a year. Competitive advantage requires that a firm *consistently* outperform its rivals in generating above-average profits. A firm has a competitive advantage when it can consistently generate above-average profits through a strategy that competitors are unable to imitate or find too costly to imitate. **Above-average profits** are profit returns in excess of what an investor expects from other investments with a similar amount of risk. *Risk* is an investor's uncertainty about the profits or losses that will result from a particular investment. For example, investors suffer a lot of uncertainty (and, hence, risk) when they put their money into a start-up company that is trying to launch products based on a new technology, such as a solar power company. There is much less risk in investing in a stable firm with a long history of profitability, such as a utility company that supplies power to customers who have few, if any, alternative sources of power.[9]

above-average profits Returns in excess of what an investor expects from other investments with a similar amount of risk.

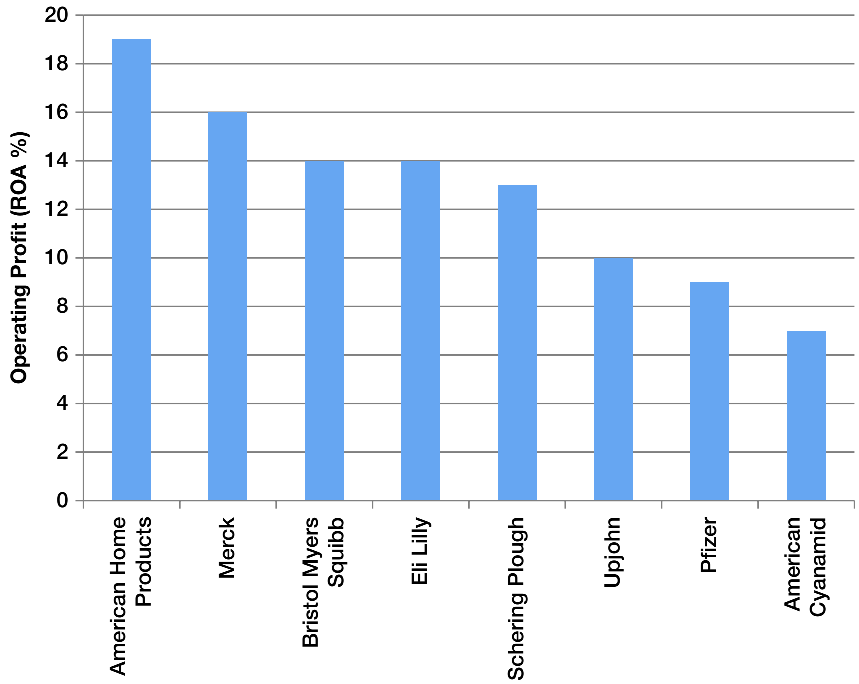
Many organizations work to achieve objectives other than profit. For example, universities, many hospitals, government agencies, not-for-profit organizations, and social entrepreneurs play important roles in making our economy work and our society a better place to live. These organizations do not measure their success in terms of profit rates, but they still use many of the tools of strategic management to help them succeed (see Chapter 14). For these organizations, success might be measured using tangible outcomes such as the number of degrees granted, patient health and satisfaction measures, people served, or some other measure of an improved society.

The primary source of a company's competitive advantage can come from several areas of its operations. For example, the diamond company De Beers has an advantage that comes from paying lower costs for its diamonds than other companies do, because De Beers owns its own

Strategy in Practice

Measuring American Home Products' Competitive Advantage

To see which firms in an industry are most successful, we typically compare their return on assets (ROA), a calculation of operating profits divided by total assets, or their return on equity (ROE), which is operating profits divided by total stockholders' equity. The company that consistently generates the highest returns for its investors, in terms of ROA or ROE, wins the game. For example, from 1971 to 2000, the pharmaceutical company American Home Products averaged 19 percent ROA, compared to competitor American Cyanamid's 7 percent. American Home Products' ROA was higher than American Cyanamid's every year for 30 years. This is evidence that during this time period, American Home Products had a competitive advantage over American Cyanamid.[8] American Home Products' advantage over American Cyanamid has frequently been attributed to its ability to develop more blockbuster drugs (through more effective research and development) and to quickly get those drugs to market through a larger and more effective sales force.



Profitability of Different Firms in the Pharmaceutical Industry

Source: Annual reports; 1973–1992.

diamond mines. Competitive advantage can also come from different functional areas within the company. Biotechnology pioneer Genentech's advantage comes primarily from research and development that has produced several blockbuster drugs; Toyota's advantage in automobiles has come primarily from its manufacturing operations (known as the Toyota Production System); Procter & Gamble's advantage in household products comes largely from its sales and marketing, and Nordstrom's advantage as a retailer comes largely from its merchandising and service.

strategic management process The process by which organizations formulate a plan and allocate resources to achieve competitive advantage that involves making four strategic choices: (1) markets to compete in, (2) unique value the firm will offer in those markets, (3) the resources and capabilities required to offer that unique value better than competitors, and (4) ways to sustain the advantage by preventing imitation.

The Strategic Management Process

The processes that firms use to develop a strategy can differ dramatically across firms. In some cases, executives do not spend significant time on strategy formulation, and strategies are often based only on recent experience and limited information. However, we propose that a better approach to the formulation of strategy is the **strategic management process** outlined in Figure 1.1. The strategic management process for formulating and implementing strategy involves thorough **external analysis** and **internal analysis**. Only after conducting an analysis of the company's external environment and its internal resources and capabilities are a firm's

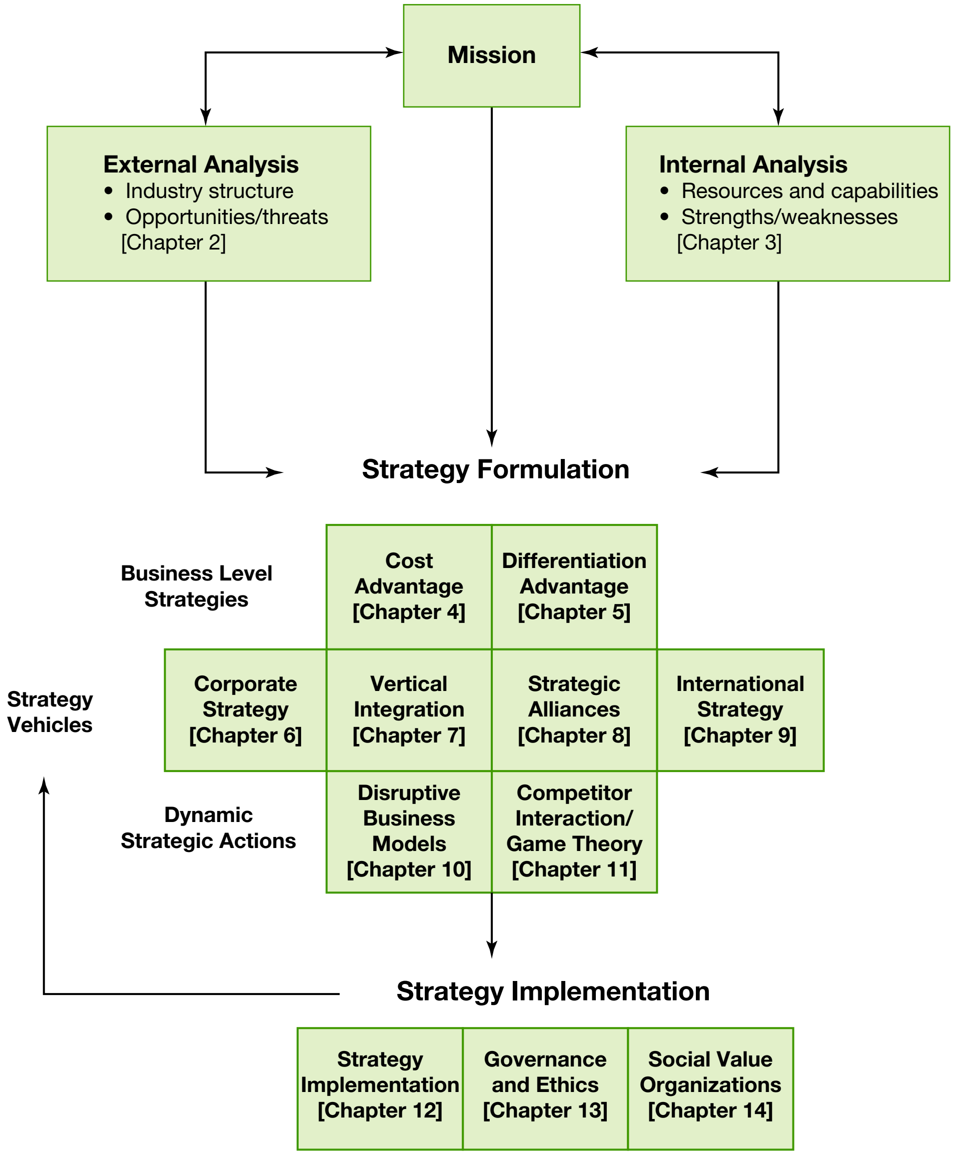


FIGURE 1.1 **The Strategic Management Process**

executives and managers able to identify the most attractive business opportunities and formulate a strategy for achieving competitive advantage.

The central task of the *strategy formulation* process is specifying the high-level plan and set of actions the company will take in its quest to achieve competitive advantage. After the plan for creating competitive advantage is created, the final step is to develop a detailed plan to effectively *implement*, or put into action, the firm's strategy through specific activities.

The focus of the strategic management process should be to make four key strategic choices, as shown in Figure 1.2:

1. *Which markets will the company pursue?* A company's markets include the high-level industry and specific customer segments in which it competes and its geographic markets.
2. *What unique value does the company offer customers in those markets?* This is the firm's *value proposition*, the reason the company wins with a set of customers.[10]
3. *What resources and capabilities are required?* What does the company need to have and know how to do so that it can deliver its unique value better than competitors, and exactly how will the company deliver its unique value through an implementation plan?[11]
4. *How will the company capture value and sustain a competitive advantage over time?* Firms need to create *barriers to imitation* to keep other companies from delivering the same value.

external analysis Examining the forces that influence industry attractiveness, including opportunities and threats that exist in the environment.

internal analysis The analysis of a firm's resources and capabilities (its strength and weaknesses) to assess how effectively the firm is able to deliver the unique value (value proposition) that it hopes to provide to customers.

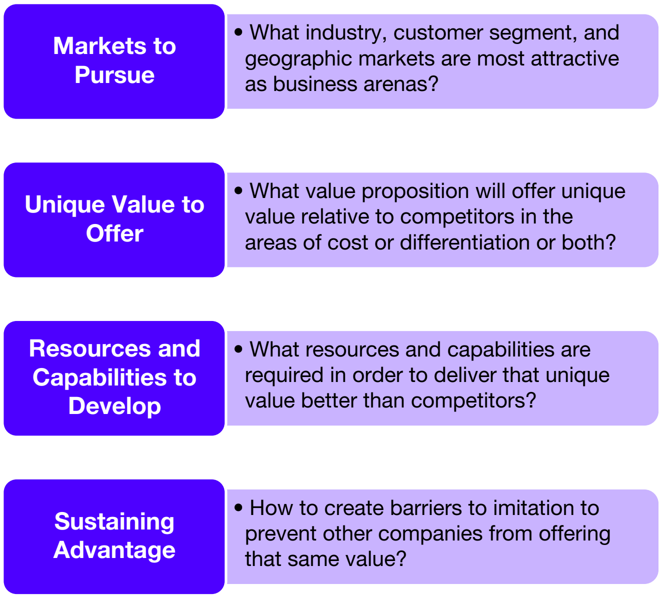


FIGURE 1.2 **Four Key Strategic Choices in Strategic Management**

Markets One of the first decisions a company must make is where to compete or which markets it will serve. Leaders must choose the *industries* a company competes in and the specific customer segments or needs it will address (the focus of Chapter 2) within those industries. For example, before iPod, Apple competed only in the computer industry. Its product markets included desktop and laptop computers. Launching iPod and iTunes took Apple into the music industry. Later, when Apple launched the iPhone, it entered the cell phone business. Apple targets the high-end customer segments within its industries. Its customers want the latest in technology, see themselves as innovators, appreciate design and elegance, and are not price sensitive.

It is also important to select *geographic markets* to serve. Apple competes on a worldwide basis, which allows it to spread heavy research and development costs across its many geographic markets. By contrast, Walmart started by focusing on rural markets, which allowed it to offer lower prices than the "mom and pop" retail stores in small towns.[12]

Unique Value After a company chooses the markets in which to compete, it then attempts to offer unique value in those markets. This is often referred to as a company's *value proposition*, or the value that it proposes to offer to customers. Companies typically try to achieve a competitive advantage by choosing between one of two *generic strategies* for offering unique value: *low cost* or *differentiation*. Companies such as Walmart, Ryanair, Taco Bell, and Kia attract customers by being cost leaders, offering products or services that are priced lower than competitor offerings. A firm that chooses a low-cost strategy (the focus of Chapter 4) focuses on reducing its costs below those of its competitors. Key sources of **cost advantage** include economies of scale, lower-cost inputs, or proprietary production know-how.

cost advantage An advantage that a firm has over its competitors in the activities associated with producing a product or service, thereby allowing it to produce the same product at lower cost.

A firm that chooses a **differentiation strategy** (the focus of Chapter 5) focuses on offering features, quality, convenience, or image that customers cannot get from competitors. Apple's unique value is offering iPods (music players), iPhones (smartphones), and iPads (tablets) that are well designed, innovative, easy to use, and have features that competing products don't have ("there's an App for that"). In similar fashion, Starbucks wins through differentiation by offering multiple blends of high-quality coffee in convenient locations.

differentiation strategy An advantage a firm has over its competitors by making a product more attractive by offering unique qualities in the form of features, reliability, and convenience that distinguish it from competing products.

The traditional answer to offering unique value is to be either a low-cost (low-price) provider or a differentiator. In fact, strategy professor Michael Porter, whose five forces analysis will be introduced later in this chapter, has cautioned that trying to do both simultaneously