Strategic Management Summary (Lectures + Literature)

Lecture 1

Fundamentals of Strategic Management – Strategic management and strategic competitiveness (Chapter 1)

Strategic Management is about understanding how a firm (as a whole) can build and maintain a competitive advantage over rivals.

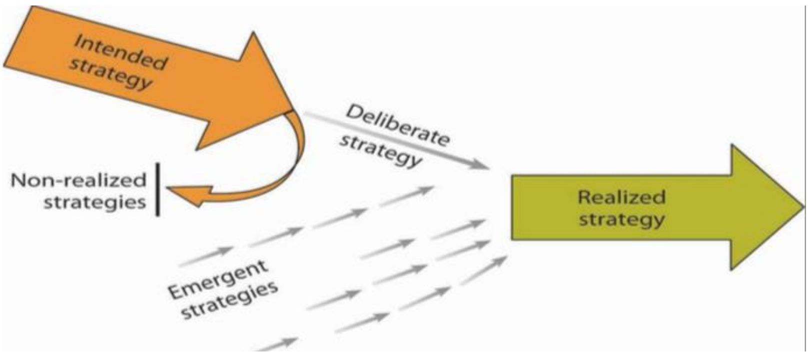
Strategy = set of integrated and coordinated set of commitments and action to exploit core competencies and gain a competitive advantage.

Four views on strategy:

1. **Strategy as a plan**
    a. Strategy is a conscious, rational, purposeful course of action
    b. Based on a clear mission and objectives that all agree on
    c. Company has ample data and analytical power to optimally decide investments
    d. Company has distinct **formulation** and **implementation** phases

    e. Company with a better *planning system* would have competitive advantage over rivals (because they would presumably have more solid basis for resource allocation and coordination)
        1. Loads of data, wicked power of analyses, revealing how to best allocate resources, confers ability to keep folks aligned and running

2. **Strategy as a pattern**
    a. Strategy as party conscious and purposeful and partly serendipitous
    b. A mission and objectives that set context, but are a bit elastic
    c. As people and the environment interact, deviation from plans are possible
    d. Formulation and implementation might not be linear



If strategy is a pattern, you combine good planning but have enough space to **alter** the plan and implement creative ideas to gain competitive advantage over rivals. This allows for resource allocation, coordination and creative action.
Some planning is needed and possible. However, stuff can happen
→ Strategy becomes evident *ex post*

3. **Strategy as a position**
    a. Example: Difference between Cathay Pacific and Easy Jet: Both companies decide in which industries to compete in; both decide to take on a different strategy: Differentiation vs. Cost Leadership

    b. Strategy is about where to position your company: where to compete and how?

c. Theories believe that whether a company has competitive advantage over others is a matter over **positioning** (positioning determines above-average or average returns)
d. Positioning determines above-average or average returns

	Low Cost	**Product / Service Uniqueness**
Broad (Industry wide)	Cost Leadership	Differentiation
Narrow (Market Segment)	Focus cost leadership	Focus Differentiation

Strategy as an exercise in niche selection and then defend niche;

4. Strategy as a **perspective**
   a. Example**:** Dell vs. Apple: Customization vs. Consumer experience/ Design

   b. Strategy responses to the **identity** which finds material expression (outcome in the products of the companies)
   c. Company gains competitive advantage over others on how much outsiders **identify** with the products of the company
   d. *Strategy is identity*
      i. Company's identity affects learning (influences direction company takes on in life)
      ii. Company's identity is seen by all identically
      iii. Company's identity can be managed in response to changes in context

The process of strategic management to achieve sustainable competitive advantage requires awareness of all *four* strategy *perspectives*.

Strategic competitiveness = achieved when a firm successfully formulates and implements a value-creating strategy.

SM is a process of maintaining a dynamic fit between the **firm's external environment** & the **internal resources** and capabilities for a **competitive advantage that is sustainable**.
With the strategic management process, firms can adapt to (disruptive/discontinuous) environmental change.

Example: Airbus and Boeing:
- *Boing is highly competitive; earned above average returns*
- *Both airbus and boing pursue a different diversification strategy*

Example: VW and Airbus:
- *Threat of increasing world population*

A firm has a **competitive advantage** when it implements a strategy competitors are unable to duplicate or find too costly to try to imitate.
However, not competitive advantage is permanent. The <u>speed</u> with which competitors can copy determines the duration of the competitive advantage.

Above average returns are returns in excess of what an investor expects to earn from other investments with similar amount of risk. **Risk** is an <u>investor's uncertainty</u> about economic gains/losses resulting from an investment.

On the other hand, **average returns** occur *without* competitive advantage. They equal to those an investor expects to earn from other investments with similar risk.

Returns are measured in:
- Accounting figures such as return on equity, return on sales
- Basis of stock market: monthly returns, stock price
- Measures of speed of growth (especially for small, new firms)

Strategic Management

<u>Strategic management process</u>
The SM process is the full set of commitments, decisions and actions required for a firm to achieve strategic competitiveness and earn above-average returns.

1. Analyze Inputs:
    a. External environment
    b. Internal organization
    c. Integrating internal and external resources
    → determine firm's resources, capabilities, core competencies = "strategic inputs"
    → formulate mission and vision; formulate strategy
2. Formulation
    a. Business-level strategy
    b. Competitive rivalry and competitive dynamics
    c. Corporate level strategy
    d. Strategic acquisition and restructuring
    e. International strategy
    f. Corporate strategy
3. Implementation
    a. Strategic leadership
    b. Corporate governance
    c. Organizational structure and controls
    d. Strategic entrepreneurship
    e. → transformation: Strategic renewal

The competitive landscape
Competition is increasing worldwide.
- No boundaries of industries
- Markets are volatile
- Financial capital is scarce
- Partnerships among firms
- Competitive scale, advertising budgets are not as advantageous as they were in the past
- Managers must adopt new mind-set: flexibility, speed, etc.
- ***Hypercompetition*** = inherent instability, change; results from dynamics of strategic manoeuvring among global and innovative combatants

The global economy
Global economy refers to an economy in which goods, services, people, skills, and ideas move freely across geographical borders.

- Advantages
    - Markets become larger
    - Immense influence on global economy
    - E.g. China: emerging market: countries near China also benefit (Taiwan, Hongkong)
    - MNC cover many markets

March of globalization
Globalization is the increasing *economic interdependence* among countries and their organizations as reflected in the flow of goods and services, financial capital and knowledge across country borders.
- *large numbers of firms competing* against one another in an increasing number of global economies
- increases the range of opportunities for companies competing in the current competitive landscape

Globalization has led to higher levels of performance standards (quality, cost, productivity, product introduction time, operational efficiency). These standards also affect companies in the domestic market.

Liability of foreignness = risks of participating outside a firm's domestic country in the global economy;
- Amount of time required to learn how to compete in new markets
- Over-diversification: difficult to adapt knowledge and practices

Technology and technological change
Technology-related trends and conditions can be placed into two categories:
1) **Technology diffusion and disruptive technologies**
2) **Information age and increasing knowledge intensity**

Technology diffusion and disruptive technologies
Technology diffusion = Speed at which new technologies become available and are used;
This rate has substantially increased over the last 15-20 years.

Perpetual innovation describes how rapidly and consistently new information-intensive technologies replace older ones.

Shorter product life cycles result from these rapid diffusions of new technologies. They place a competitive premium on being able to quickly introduce new, innovative goods and services into the marketplace.
The **speed to market** with innovative products may be the competitive edge of companies.
Another indicator is that now companies only need 12-18 months to gather information about their competitors' research and development and product decisions. In a competitive economy, firms can imitate competitors within a few days.

Disruptive technologies are technologies that destroy the value of an existing technology and create new markets.

Examples: IPod, Wifi, browser

Disruptive technologies can create a new industry or harm industry incumbents.

The information age
Changes in information technology drastically changed the economy. With IT, companies can effectively and efficiently access and use information. **IT** will continue with declining cost of information technology and increased accessibility.

The Internet also contributed to the **hypercompetition**.

Increasing knowledge intensity
Knowledge is the basis of technology and its application. In the 1980s, the basis of competition shifted from hard assets to intangible resources.

Getting insights in the customer buying behaviour helps the company to increase customer retention and therefore sales.

Knowledge is gained through *experience*, *observation* and *inference* and is an **intangible resource**. Firms have to capture intelligence and transform it into usable knowledge, and diffuse it rapidly throughout the company.

Knowledge processes – ways organizations create, absorb, transfer and transform knowledge

Strategic flexibility is a set of dynamic capabilities used to respond to various demands and opportunities existing in a dynamic and uncertain competitive environment. It involves coping with **uncertainty** and its accompanying **risks**. Therefore, firms should develop strategic flexibility in all areas of the business.

The I/O model of above-average return
The **I/O model** of above average returns explains the external environment's dominant influence on a firm's strategic actions. The industry / segment of industry in which a company chooses to compete has a *stronger influence on performance than do the choices managers* make inside the organizations.

It has four underlying assumptions:
1. The external environment is assumed to impose **pressures** and **constraints** that determine the strategies that would result in above-average returns
2. Most firms competing within an industry or within a segment of an industry are assumed to control similar resources to pursue similar strategies

3. Resources used to implement strategies are assumed to be highly mobile across firms, so any resource differences that might develop between firms will be short-lived
4. Organizational decision makers are assumed to be rational and committed to acting in the firm’s best interest → shown by their profit-maximizing behaviour

The I/O model challenges firms to find the **most attractive industry.** The model considers a firm’s strategy to be a set of commitments and actions flowing from the characteristics of the industry in which the firm decided to compete.

Five forces of competition: suppliers, buyers, competitive rivalry, product substitutes, potential entrants.

The model suggests that firms can either

- Produce standardized goods at costs below competitors (**cost leadership**)
- Produce differentiated goods for which customers are willing a premium (**differentiation)**

Firms can earn above-average returns by:

1. Study the external environment (especially industry environment) (about 20% of a firm’s profitability is explained by the industry in which it competes)

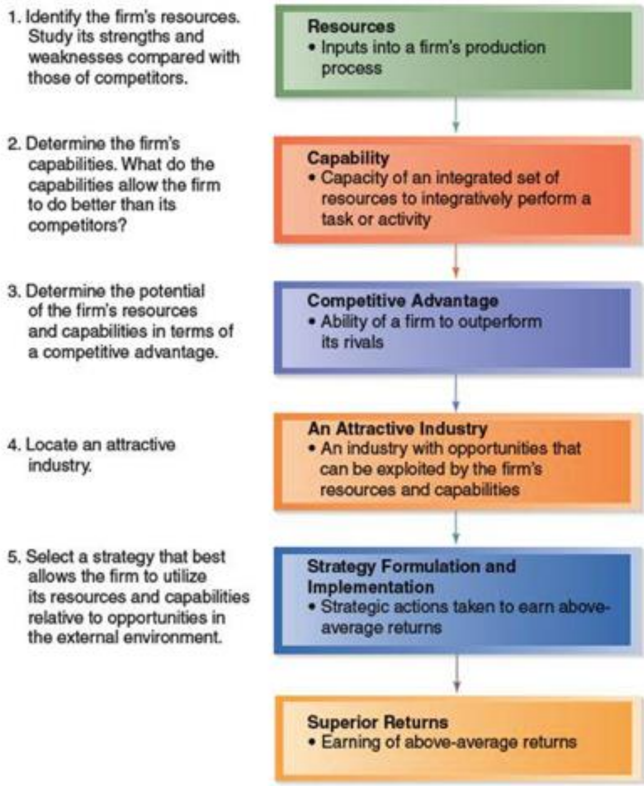
2. Locate an industry with high potential for above-average returns

3. Identify the strategy called for by the attractive industry

4. Develop /acquire assets and skills needed to implement the strategy

5. Use the firm’s strengths to implement strategy

The resource-based model of above average returns



This model assumes that each organization is a collection of **unique resources** and **capabilities.** This **uniqueness** is the basis for the firm's strategy and the reason for above-average returns.
Resources are inputs into a firm's production process, such as capital equipment, employees' skills, patents etc. There are three categories for resources:

1) Physical resources
2) Human resources
3) Organizational capital

Resources can be tangible or intangible (knowledge).
In order to earn above average returns, resources have to be formed into a **capability**, which is the set of resources to perform a task or an activity in an integrative manner. They evolve over time and must be managed dynamically in pursuit of above-average returns.

Core competencies are resources and capabilities that serve as a source of competitive advantage for a firm over its rivals. They are often visible in form of the organizational functions.

The resource model explains differences in performance by the firm's unique resources and capabilities and not by the industry's structural characteristics. Resources are not mobile across firms. The differences in resources and capabilities are the basis for competitive advantage.
Resources should be:

- **Valuable** when they allow a firm to take advantage of opportunities or neutralize threats in its external environment
- **Rare** when possessed by few current and potential competitors
- **Costly to imitate** when other firms either cannot obtain them or are at a cost disadvantage when obtaining them
- **Non-substitutable** when they have no structural equivalents

If this is met, resources and capabilities are transformed into core competencies.

Vision and mission

Vision

Vision is a picture of what the firm **wants to be** and, in broad terms, what it wants to **ultimately achieve**.

A vision statement is about the *ideal description* of an organization and gives shapes to its intended future. It reflects the firm's values and aspirations, and is long-lasting.

Mission

The vision is the **foundation for the firm's mission**. A **mission** specifies the **business** in which the firm intends to compete and the **customers** it intends to serve. It is more *concrete* than the vision.

The CEO is responsible for the vision and mission formulation.
The vision and mission are critical aspects of the *strategic inputs* it requires to engage in *strategic actions* as the foundation for achieving strategic competitiveness and earning above-average returns. Thus, vision and mission should be **effective**.

Stakeholders

Stakeholders are the individuals and groups who can affect the firm's vision and mission, are affected by the strategic outcomes the firm achieves through its operations, and who have enforceable claims on the firm's performance.
In general, the more critical and valued a stakeholder's participation, the greater the firm's dependency on it. With greater dependence, stakeholders have more influence over firm's commitments, actions and decisions.

Classifications of stakeholders

1) Capital market stakeholders
    a. Shareholders
    b. Major suppliers of firm's capital
2) Product market stakeholders
    a. Customers, suppliers, host communities, unions
3) Organizational stakeholders
    a. Employees

Moreover, societal stakeholders (local/governmental parties) can also put pressure on the firm.

The firm has to manage all its stakeholders efficiently.

1. Identify stakeholders
2. Prioritize them (power = most important criterion)

Strategic leaders

Strategic leaders are people located in different parts of the firm using the strategic management process to help the firm reach its vision and mission. Typically, the CEO is the strategic leader but there are often other people helping implement the strategy.

Organizational culture also affects strategic leaders and is defined by a *complex set of ideologies*, *symbols* and *core values* that are **shared** throughout the firm and that influence how the firm conducts business. Organizational ethics influence the culture.

To anticipate possible outcomes of different decisions, strategic leaders can map out **profit pools** which entail total profits earned in an industry at all points along the value chain.

Lecture 2

The positioning literature versus the resource-based view **or:** Developing business strategies and change
(Chapter 2 – The external environment: Opportunities, threats, industry competition and competitor analysis)

The external environment can be divided into:

- **General (macro) environment**: Dimensions in the broader society that influence an industry
  - Comprises social, economic, political & technological dynamics of a time
  - Changes affect many industries
  - Cannot be controlled by firms directly
  - Divided into segments:
    - ***Demographic*** (population size, age structure, ethnic mix)
    - ***Economic*** (inflation, interest rates, budget deficits, GDP, saving rates)
    - ***Physical*** (natural resources, sustainable technologies, waste reduction)
    - ***Sociocultural*** (women in workforce, workforce diversity, shifts in work and career preferences)
    - ***Political/legal*** (antitrust laws, taxation laws, deregulation)
    - ***Technological*** (product innovations, applications of knowledge, communication technologies)
    - ***Global*** (most complex: political events, critical global markets, industrialized countries, different cultural and institutional attributes)
  - Analysis is focused on environmental trends

- **Industry environment**: Set of factors that directly influences a firm and its competitive actions and competitive responses
  - Threat of new entrants, power of suppliers, power of buyers, product substitutes, intensity of rivalry
  - Interaction of these forces determine industry's profit potential
  - Firm has to position itself within the industry where it can favourably influence these five factors
  - Analysis is focused on factors and conditions influencing an industry's profitability potential

- **Competitor environment**:
  - Competitor analysis/competitor intelligence: How firms gather information about competitors
  - Focused on predicting competitor's actions, responses and intentions
  - Affect single company

These three dimensions influence and are influenced by the firm's vision and mission.

Other segmentation:

- **Macro environment** – comprises social, economic, political and technological dynamics of a time
  - Changes affect many industries
- **Industry environment** – comprises competitors, regulators, analysts, buyers, suppliers
  - Changes in this layer affect company and peers
- **Micro environment** – comprises customers, debtors, creditors, suppliers, partners
  - Changes in this layer affect single company

External environment analysis

To cope with the rapidly changing environment and with the ambiguous and incomplete environmental data, firms engage in external environmental analysis. This analysis has four parts:

1. *Scanning*
   a. *Study of all segments in the general environment*
   b. *Identifying early signals of environmental changes and trends*
   c. *Reveal incomplete and ambiguous information*
2. *Monitoring*
   a. *Observe environmental changes to see if an important trend is emerging from among those spotted in scanning*
   b. *Detecting meaning through ongoing observations of environmental changes and trends*
   c. *Identify stakeholders as the foundation for serving their needs*
3. *Forecasting*
   a. *Developing projections of anticipated outcomes based on monitored changes and trends*
4. *Assessing*
   a. *Determining the timing and importance of environmental changes and trends for the firms' strategies and their management*
   b. *Specify the implications of the analysis conducted earlier*

Important objectives of studying the external environment, is to find ***opportunities*** *and* ***threats****. Opportunities can help the company achieve strategic competitiveness. Threats may hinder the company's efforts to achieve strategic competitiveness.*
*There are several sources to analyse the general environment. People in b****oundary spanning*** *positions are in charge for these analyses.*

Segments of the general environment

- ***Demographic segment***
  - *Population size: expected to still increase at a slower pace*
  - *Age structure: aging population is an increased problem; influences economy (need to social workers, baby boom generation is approaching retirement)*
  - *Geographic distribution: many emerging countries have stagnant populations; population density in huge cities such as Mexico, Tokyo; changes in the distribution pattern affects firm's strategy in the future*
  - *Ethnic mix: immigrants bring cultural changes; changes workforce composition and cooperation*
  - *Income distribution: dual-couple income increased whereas normal distribution generally decreased*
- ***Economic segment****: refers to the nature and direction of the economy in which a firm competes or may compete; generally, firms want to compete in stable economies*
- ***Political/legal segment****: arena in which organizations and interest groups compete for attention, resources and a voice in overseeing the body of laws and regulations guiding interactions among nations as well as between firms and governmental agencies*
  - *Antitrust laws, labor training laws, degree of commitment to educational institutions*

- ***Socio-cultural segment**: about society's attitudes and cultural values*
    - *Participation of women in the workforce*
    - *Attitudes about health care*
    - *Continuing growth of contingency workers (part-time, temporary)*
- ***Technological segment**: includes institutions and activities involved with creating new knowledge and translating that knowledge into new outputs, products, processes and materials*
    - *Internet has far reaching implications*
- ***Global segment:** relevant new global markets, existing markets that are changing, important international political events, critical cultural and institutional characteristics of global markets*
    - *Globalization of markets create opportunities for firms but also threats*
    - *Global focusing: focusing on a global niche market*
    - *Global markets have different institutional and socio-cultural attributes*
- ***Physical environmental segment**: refers to potential and actual changes in the physical environment and business practices that are intended to positively respond to and deal with those changes*
    - *Global warming*
    - *Energy consumption*

Industry environment analysis

The **industry** is a group of firms producing products that are close substitutes. The industry environment has a more direct effect on the firm's strategic competitiveness and ability to earn above-average returns.
Five forces influence the firm's position:

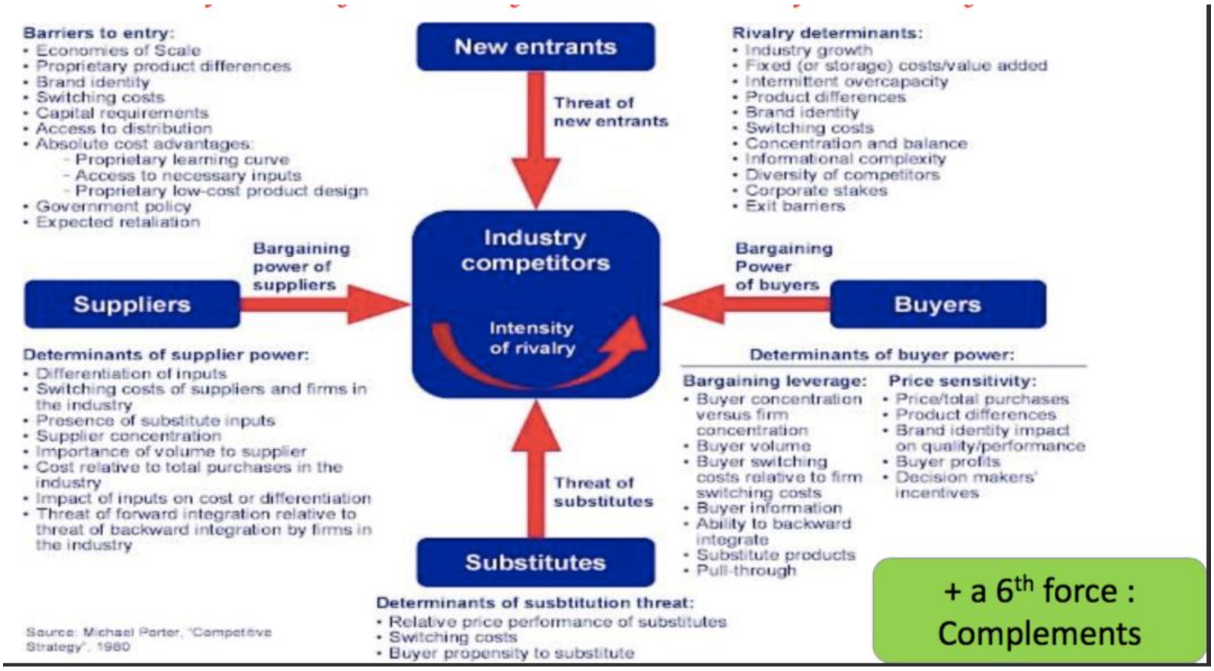
1. **Threat of new entrants:** entrants bring additional production capacity which holds consumers' cost down, resulting in less revenue and lower returns for competing firms;
   Entry depends on:
    a. Barriers to entry
        i. *Economies of scale*: incremental efficiency improvements through experience as firm grows lager, reducing the <u>unit cost</u>; increases flexibility of firms
           → new firms have no economies of scale making it difficult to enter industry
        ii. *Product differentiation:* The higher the products are differentiated, the more difficult to enter the industry; product distinctiveness = customer value
        iii. *Capital requirements:* The higher the capital requirements for the industry, the more difficult it is to enter
        iv. *Switching cost:* Switching cost = one-time costs that customers incur when they buy from a different supplier; the higher the switching costs of one company the more difficult it is for other companies to enter since customers won't switch often
        v. *Access to distribution channels:* having easier the access to distribution channels (= closer relationship with distributors) means more advantages for the competing firm (and more difficult to enter industry for other firms)
        vi. *Cost disadvantages independent from scale:* established competitors might have cost advantages that new competitors don't have
        vii. *Government policy:* With licensing and permit requirements, the government can control the barriers to entry (the higher the regulations, the more difficult it is for competitors to entry)
        viii. High entry barriers usually mean higher profits for firm in an industry but variability of profits **<u>does not</u>** depend on entry barriers
    b. Expected retaliation from current industry participants (about the responses from existing competitors in the industry)
        i. Strong retaliation occurs when existing firm has a major stake in the industry, when it has substantial resources and when industry growth is slow or constrained

2. **Bargaining power of suppliers:** Suppliers can increase prices, reduce quality of products; they are powerful when:
    a. Supplier group is dominated by a few large companies and is more concentrated
    b. No satisfactory substitute products are available
    c. Industry companies are not a significant customer for the supplier group
    d. Effectiveness of supplier's products has created high switching costs for industry firms
    e. Forward integration: suppliers integrating forward become firm's competitors

3. **Bargaining power of buyers:** buyers bargain for lower prices and higher quality; they are powerful when:
    a. They purchase a large portion of industry's total output
    b. Sales of the product being purchased accounts for a significant portion of seller's revenue
    c. Low switching costs
    d. Industry's products are undifferentiated or standardized
    e. Backward integration (buyers become suppliers)

4. **Threat of substitute products**: Products that perform similar or same functions as the industry product

5. **Rivalry among competing firms:** actions of one firm triggers competitive actions of other firms in the industry; rivalry intensifies when there is an opportunity to improve market position or when firm is challenged by competitor's actions
Factors that affect the rivalry:
    a. *Numerous or equally balanced competitors:* Either many competitors or few competitors of equal size have high rivalry
    b. *Slow industry growth*
    c. *High fixed costs or high storage costs:* when fixed costs are large portion of total costs, firms try to maximize production capacity increasing the entire supply in the industry and thus decreasing the prices → lower prices intensify rivalry
    d. *Lack of differentiation or low switching costs:* customers can switch more easily
    e. *High strategic stakes:* rivalry is high when it is important for competitors to perform well in the market (due to brand name, e.g. Samsung, geographic locations)
    f. *High exist barriers:* economic, strategic and emotional factors causing firms to stay in the industry
        i. Specialized assets (assets linked to business or location)
        ii. Fixed cost of exit (e.g. labor agreements)
        iii. Strategic interrelationships (relationships of mutual dependence)
        iv. Emotional barriers
        v. Government and social restrictions



Analyzing these five forces allows the firm to determine the industry's attractiveness. The stronger the forces are, the lower the opportunity to earn above-average returns.

Strategic groups

A **strategic group** is a set/cluster of firms having **similar strategic dimensions** to use a similar product-market strategy (e.g. technology, pricing, distribution, customer segments).

- Can have different profitability rates
- Mobility barriers between strategic groups explain intra-industry variation in performance
- The closer the strategic groups in terms of strategy, the lower the average industry profits

Competition among strategic groups is *fiercer* than competition between outside members. *Intra-strategic group competition is higher than inter-strategic group competition*. The membership of a strategic group defines characteristics of the firm, e.g. technological leadership, product quality, pricing policies, distribution channels and customer service.

→ the closer the strategic groups in terms of strategy, the lower the average industry profits

- High mobility barriers, high rivalry and low resources among firms within an industry hinder the formation of strategic groups

Implications of strategic groups:
- High competitive rivalry inside the group
- Strengths of the five forces differ across groups

Positioning literature suggests (1980s)
- Use five forces to see where to compete (which industry)
- Use business-level strategies to see how to compete (cost leader vs differentiation)
- Possible strategic groups drive down industry profits

In general, the positioning literature provides:
- Valuable template (systematic analysis of external environment to inform strategy making)
- Makes for a **static framework** (not dynamic) that can cast light on firm performance & inform competitor analysis at a point in time
    - However the present cannot be taken into the future → strategy based on positioning literature might not lead to SCA in the future
    - Too much focusing on present might neglect entrepreneurial and creative envisioning
    - Shortcomings led to the **resource-based view** of strategy making

Competitor analysis
It focuses on each company against which a firm directly competes. In a competitor analysis, the firm seeks to understand the following:
- What drives the competitor (**future objectives**)?
- What is the competitor doing and can do (**current strategy**)?
- What does the competitor believe about the industry (**assumptions**)?
    - Is the future volatile, assumptions about competitors?
- What are the competitors' capabilities (**strengths/weaknesses**)?

→ these factors influence the **response** profile for each competitor

Executives often fail to analyse competitors' possible reactions to competitive actions their firm takes. Critical to a successful competitor analysis is gathering data and information that can help the firm understand its competitors' intentions and the strategic implications resulting from them. Useful data combine to form ***competitive intelligence***, which is the set of data and information the firm gathers to better understand and better anticipate competitor's objectives, strategies, assumptions and capabilities. It also includes public policies.

When gathering competitive intelligence, firms must pay attention to **complementors** of products and strategy (= companies that sell complementary goods/services that are compatible with the firm's focal good/service).

Ethical considerations
When firms conduct competitor analyses, they have to follow laws, regulations and ethical guidelines.

Chapter 3 – The internal organization: Resources, capabilities, core competencies and competitive advantages

Firms have to exploit their resources and capture the value. To achieve above-average returns, firms need to identify and successfully use resources over time and acquire their core competencies effectively.

The sustainability of competitive advantage is a function of three factors:

1. The **rate of core competence** obsolescence because of environmental changes
2. The **availability of substitutes** for the core competence
3. The **imitability** of the core competence

The **resource-based view literature** suggests that developing a strategy is about 1) identifying those resources & capabilities that can provide competitive advantage and 2) leveraging them.

Analyzing the internal organization

The context of internal analysis

Within the global economy, traditional factors such as labor costs, access to financial resources and raw materials, and protected or regulated markets remain sources of competitive advantages but to a lesser degree. Nowadays, those who analyze the firm's internal organization should use a **global mindset** which is the ability to analyze, understand and manage an internal organization in ways that are not dependent on the assumptions of a single country, culture or context.
Moreover, it requires to examine the firm's portfolio of resources and bundles of heterogeneous resources and capabilities that managers have created.

<u>Components of internal analysis leading to competitive advantage</u>

1) Resources (tangible/intangible)
2) Capabilities
3) Core competencies
4) Discovering core values
   a. Sustainable advantages:
      i. **Valuable**
      ii. **Rare**
      iii. **Costly to imitate**
      iv. **Nonsubstituable**
         → ***VRIM*** → proposed by the **resource-based view!**
   b. **Value chain analysis**
      i. Outsource
5) Competitive advantage
6) Strategic competitiveness

Creating value

Firms create value for their customers by exploiting core competencies to meet / exceed the standards of global competition. **Value** is measured by a product's performance characteristics and by its attributes for which customers are willing to pay. Firms create value by innovatively bundling and leveraging their resources and capabilities. Creating value is the source of above-average returns. It affects the choice of *business-level strategy (CH5)* and its *organizational structure (CH11)*

The challenge of analyzing the internal organization

The strategic decisions managers make about the components of the internal environment have ethical implications and influence the ability to earn above-average returns.

Correctly identifying, developing, deploying and protecting resources, capabilities and core competencies is important and not always easy. Mistakes have to be admitted and corrected.
Several conditions affect managerial decisions:

- **Uncertainty** regarding characteristics of the general and industry environments, competitors' actions and customers' preferences

    - Uncertainty due to new proprietary technologies, rapidly changing economic and political trends, transformation in societal values and shifts in consumer demand;
    - Uncertainty increases the complexity
- **Complexity** regarding the interrelated causes shaping a firm's environments and perceptions of the environments
- **Intra-organizational conflicts** among people making managerial decisions and those affected by them.

When making decisions affected by these three conditions, **judgment** is required (= the capability of making successful decisions when no obviously correct model or rule is available or when relevant data are unreliable or incomplete). Overconfidence can lower value.

Developing anything is a challenge when the external context is changing constantly. There has been no let-up in fluidity of context of companies for years.

Resources, capabilities and core competences

They are the foundation of competitive advantage. Resources are bundled to create organizational capabilities. Capabilities are the source of firm's core competencies, which are the basis for competitive advantage.

- **Resources**
    - Individual, social and organizational phenomena
    - Have to be bundled to create advantage
    - **Tangible resources** (observable, quantifiable; value is constrained because they are difficult to leverage)
        - Financial resources
            - Borrowing capacity
            - Ability to generate internal funds
        - Organizational resources
            - Formal reporting structure
            - Formal planning, controlling, coordinating systems
        - Physical resources
            - Sophistication and location of plant and equipment
            - Access to raw materials
        - Technological resources
            - Patents, trademarks, copyrights, trade secrets
    - **Intangible resources** (superior source of core competencies since they are harder to imitate or substitute for)
        - Human resources
            - Knowledge
            - Trust
            - Managerial capabilities
            - Organizational routines
        - Innovation resources
            - Ideas
            - Scientific capabilities
            - Capacity to innovate
        - Reputational resources
            - Reputation with customers
            - Brand name
            - Perceptions about quality, durability, reliability
            - Reputation with suppliers
            - Interactions and relationships

- **Capabilities**
    - Exist when resources have been purposely integrated to achieve a specific task / set of tasks, e.g. HR selection, marketing, R&D activities
    - Often based on developing, carrying and exchanging information and knowledge through the firm's human capital
    - Often developed in functional areas

- Distribution: effective use of logistics management techniques
- HR: motivating, empowering, retaining employees
- Management information systems: effective and efficient control of inventories through point-of-purchase data collection methods
- Marketing: Effective promotion of products, customer service
- Management: effective structure, adaptation to change
- Manufacturing: product quality, exploitation of platform
- R&D: innovative technology, rapid transformation of technology into new products
- Design: digital technology, usage innovation, emotional differentiation

- **Core competencies**
  - = capabilities that serve as a source of competitive advantage for the firm
  - Emerge over time

Building core competencies

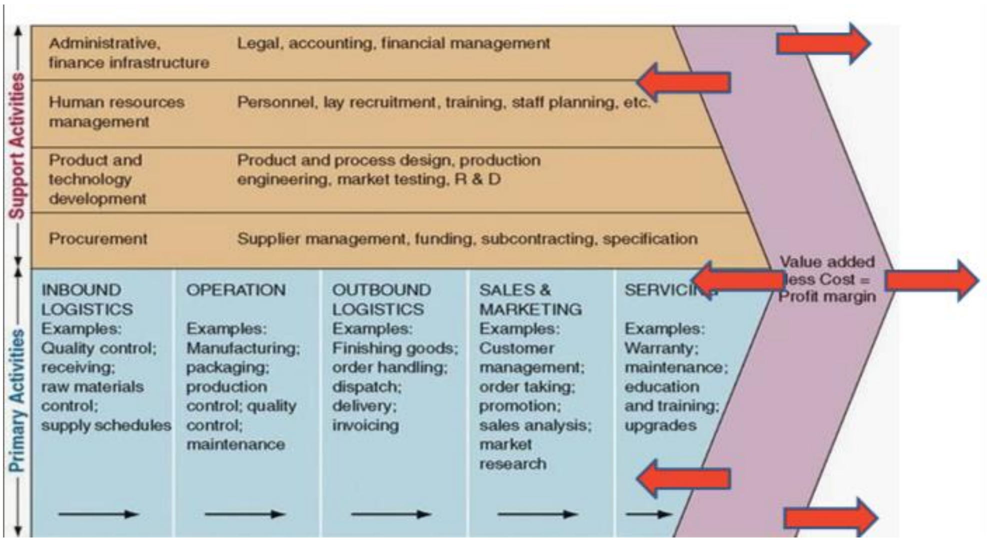
The resource-based view proposes using the following resources:
Two tools to identify and build core competencies:

1) **Four specific criteria of sustainable competitive advantage** (**VRIN**)
   a. ***Valuable*** *capabilities*: help firm neutralize threats or exploit opportunities
   b. ***Rare*** *capabilities*: not possessed by many others
   c. ***Costly-to-imitate*** *capabilities:*
      i. Historical: unique/valuable culture of brand name
      ii. Ambiguous cause: causes and uses of competence is unclear
      iii. Social complexity: interpersonal relationships, trust, friendship among managers
   d. ***Non-substitutable capabilities****:* no strategic equivalent
   → capabilities that meet these criteria are core competencies (Every core competence is a capability but not every capability is a core competence)

Outcomes from combinations of the criteria

Resource/ capability valuable?	Resource/ capability rare?	Resource/capability costly to imitate?	Resource/capability non-substitutable?	Competitive consequence	Performance implications
No	No	No	No	Competitive disadvantage	Below-average returns
Yes	No	No	No	Competitive parity	Average returns
Yes	Yes	No	No	Temporary competitive advantage	Average – above-average returns
Yes	Yes	Yes	Yes	Sustainable competitive advantage	Above-average returns

2) **Value chain analysis**
   a. Allows the firm to understand the parts of the organization that create value and those that do not

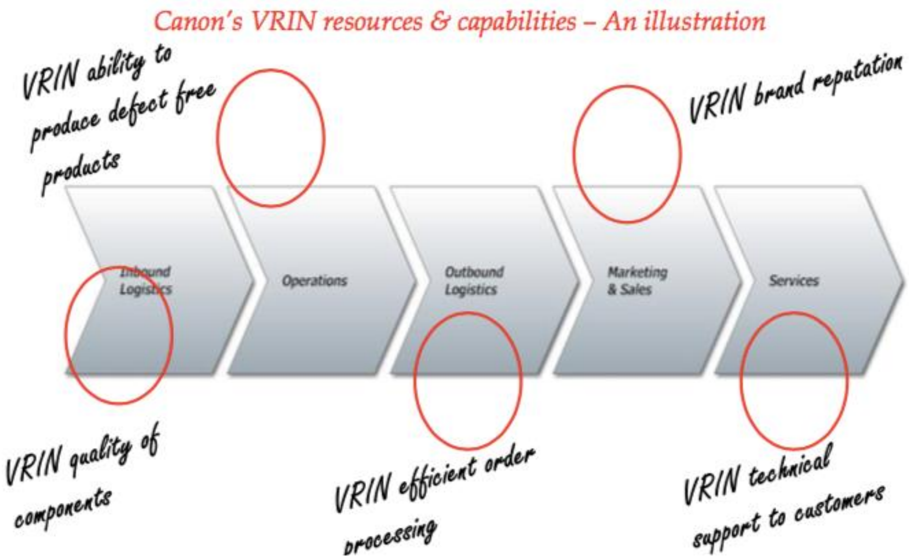


b. To provide competitive advantage, resources/capabilities must allow the firm to:
   i. Perform an activity in a manner that it provides value superior to that provided by competitors
   ii. Perform a value-creating activity that competitors cannot perform
c. Value added by having strong relationships with suppliers and with customers
d. **Primary activities:** involved with a product's physical creation, its sale and distribution to buyers and its service after the sale
   i. *Inbound logistics***:** materials handling, warehousing, inventory control
   ii. *Operations:* activities that convert inputs into outputs (packaging, assembly, equipment maintenance)
   iii. *Outbound logistics:* collecting, storing, physically distributing products
   iv. *Marketing and sales:* activities through which customers can purchase products and induce them to do so (advertising, promotion)
   v. *Service:* enhance and maintain product's value (installation, repair, training)
   each activity should be benchmarked against competitors (superior, equivalent, inferior activities)
e. **Support activities:** provide assistance necessary for the primary activities
   i. *Procurement:* activities completed to purchase the inputs needed to produce firm's product
   ii. *Technological development:* activities to improve product and processes
   iii. *HR management:* recruiting, training, developing personnel
   iv. *Firm infrastructure:* general management, planning, finance, accounting, legal support, governmental relations
f. Firm should create additional value without incurring significant costs
g. Most valuable links are people who have knowledge about customers (very important in today's global world)
h. **Profit margin** = Value added – costs (right line = price; left line = costs)

→ Idea is to identify the resources and refine them to become better in order to be able to differentiate yourself in eyes of customers
Identify resources to reduce cost of the resources
IN ORDER TO **increase** profit margin which is ultimate goal

The internet has changed many aspects in the value chain

Illustration of Canon's VRIN resources and capabilities
Resource = things that are tangible, physical (capital, HR capital, plants)
Capabilities = not necessarily tangible but can have a tangible component (e.g. very good at design, creativity, vision; this is then brought into real life through tangible things)



Canon's **dynamic capability** (ability to integrate resources and capabilities in new ways)

Tech. Cap. 1 Precision Mechanics	Tech. Cap. 2 Fine Optics	Tech. Cap. 3 Micro Electronics	Products
√	√		Basic Camera
√	√	√	Video Camera
√		√	Laser Fax
√	√	√	Laser Beam Printer
√	√	√	Copiers
√	√	√	Cell Analyzers

Canon has a competitive advantage (ex post view) because it came out with new products all these years that *fit its dynamic capabilities*.

Another example: *Apple*
Strong position in Macintosh domain but nowadays many other companies are more successful in this domain. However, Apple launched so many new products and is has a sustainable competitive advantage because it is innovative. Creates new products over the long term. The most admired company for many years.

Outsourcing

Outsourcing is the purchase of a value-creating activity from an outside supplier.
Effective outsourcing can improve the firm's flexibility, mitigates risks and reduce capital investments. By outsourcing, firms increase their chance of competitive advantage since they do not over-extend their capabilities.

Innovation and technological uncertainty are two important factors when considering outsourcing.
Offshoring = obtaining services / products from another country

Competencies, strengths, weaknesses and strategic decisions

Strengths and weaknesses are **internal** to the organization. Tools such as outsourcing help the firm to focus on a couple of resources and capabilities and build the foundation for competitive advantage. Even when a core competence is found, firms should not overly rely on it since inertia can become a weakness. Firms have to remain flexible.

After studying the external environment and its internal environment, firms have to form a **link between its internal and external resources** (CH4) and select a business-level strategy that will help reach its vision and mission.

- **Discontinuous change** – change that makes the competencies of a company redundant
- **Continuous change** – change that amplifies/strengthens a company's competencies

Two factors for change: **IT** and **globalization** made (dis)continuous change lasting

- IT allowed companies to disaggregate its operations
- Gloablization made countries more open to exchange of capital and labor
- Strategies must be developed in an age of temporary rules

Multinationals have operations in different countries

Globalization = idea that different countries in the world are more open to linking their economies to other economies (setting up operations in other countries)

Change has challenges and gives opportunities.
Strategies must be developed in an age of temporary rules (things may change very suddenly.

Chapter 4 – Integrating internal and external resources: Open innovation, absorptive capacity and integration approaches

When firms are able to use **external resources** to support their strategy they are able to create strategic advantages. External resources are assets, knowledge and skills that lie outside the boundary of corporations and are often owned by other market players.

Similarly, competitive advantages are often strongly related to **internal resources** (such as patents, routines, practices).

Lead users are intrinsically motivated individuals or communities who experiment to invent, improve and adapt existing products.

Sensing is the awareness of weak signals, opportunities or new knowledge. **Consumer ethnography** is the approach that seeks to understand consumers and their behavior by employing fieldwork and other ethnographic tools. **Fieldwork** is the methodological approach to generate data and insight in (consumer) ethnography.

Firms have to recognize that the external environment is resource rich and that change is not always threatening.

By integration, the firm can link external threats with its internal resources.

1) Identify critical external resources
2) Internalize them and develop synergies with internal resources
3) Increase performance by exploiting these complementary assets
4) Institutionalize the integration of external and internal resources and analysis of risks pertaining to external and internal factors

Core rigidities are the consequence of core competencies when firms fail learn and get trapped with what mattered in the past.

The context of resource integration

Resource integration is the mutually beneficial combination of external and internal resources.
External resources traditionally include raw materials, labor at low costs, access to financial resources or barriers to success for other firms. Intellectual property is also important.
Technological development (rapid improvements and diffusion of IT and the Internet) have lowered barriers to integrating external resources. Lower communication costs and speed of information processing allow companies to interact online and to exchange explicit knowledge (and also tacit knowledge).

One of the most important factor is **internationalization**, increasing the world trade, GDP. An explanation for internationalization is the skill with which companies integrate home country resources with host country resources (CH8). Many automobile manufacturers achieved growth by tapping into the design, engineering, manufacturing and sales. **Turnaround** is the rare managerial accomplishment of organizational change that may follow dramatic performance decline.
Internationalization increases the firm's profitability since it increases the external resources to be exploited.

Benefits of integration and its costs

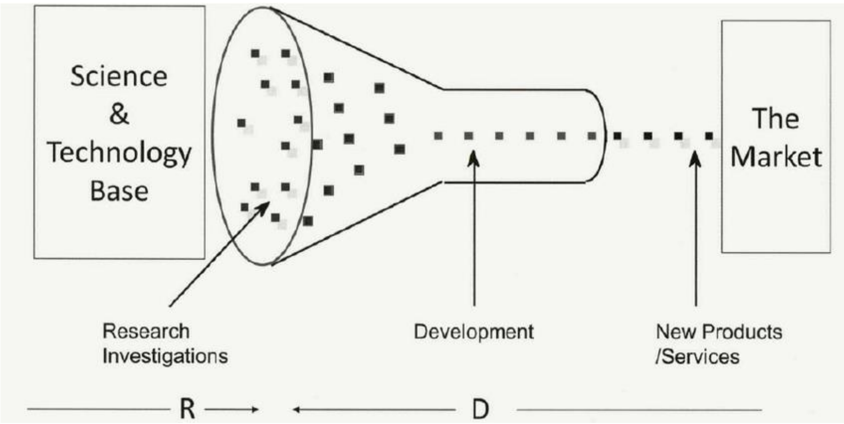
Sometimes, parties cooperate and have highly complementary goods. This is called **coopetition** (the value creating constellation in which market players cooperate or develop complementary products and simultaneously compete, e.g. when it comes to value caption).

Costs of integrating external resources are about positioning the firm which often underestimates the role of the firm's resources and capabilities.

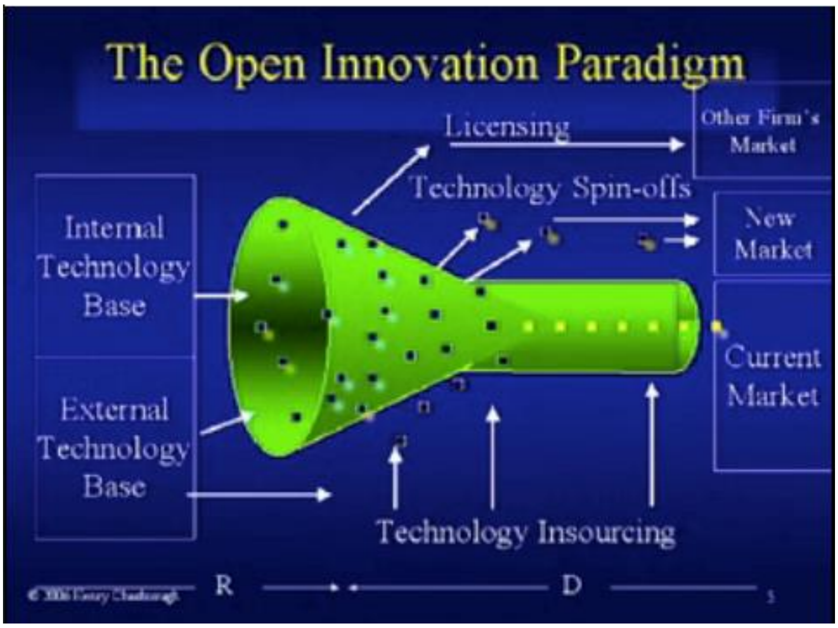
- Competence trap: When firms overemphasize the core competencies after position was found and competing primarily on the basis of firm-specific factors

- Core rigidities: lock-in effects that prevent firms from seeing and using highly complementary assets

Resource integration: open innovation, absorptive capacity and organizational change



Current paradigm: **Closed innovation system**
- Returns of R&D are limited due to rising technology, shorter product life cycles
- → internally focused innovation



Open innovation:
- relies on internal resources
- involves commercializing external ideas by deploying **outside** (and in-house) **pathways** to the market
- suggests that companies must enhance their value creating potential to survive new competition by using their **absorptive capacity** and **tapping external resources**

→ Open innovation seeks to integrate concepts such as lead users, network model of innovation, the importance of information and **knowledge processes** (the ways organizations create, absorb, transfer and transform knowledge)

Seizing leads firms to act upon promising weak signals, opportunities or new knowledge.
Openness relates mainly to technology, R&D, management and renewal of companies.

<u>Challenges of open and closed innovation</u>
- **Identifying critical external resources**
  - Companies that are not open enough have difficulties in finding external resources (they don't analyze the external environment sufficiently)
  - Focus on internal search
  - Decisions concerning external resources, capabilities and core competencies are influenced by:
    - Uncertainty (due to rapidly changing political and economic trends, transformation in societal values, shifts in customer demands, likelihood of success of technology seeds, intellectual property rights etc.)
    - Complexity
    - Inter-organizational dynamics

  - Openness is essential for competitiveness; for assessing how far openness should go, **peripheral attention** can help (**peripheral vision** allows people to become aware of e.g. movement without visually focusing on what moves)
  - Important to pay attention to what seems insignificant
  - Identifying resources often involves making trade-offs
  - **Clusters** of firms in specific locations indicate presence of complementary resources (e.g. Silicon Valley)

- **The challenge of selecting and absorbing knowledge: Internalizing critical external resources**
  - Once being open, companies need to develop ways to internalize or utilize the external resources
  - Success depends on the **ability to learn** (depends on the ability to value new external knowledge)
  - Selection of resources depends on size of opportunities in terms of market potential and technological positioning
  - **Assimilation** = placing new knowledge within the existing frame of reference (for assimilation, you need flexibility and energy)
  - With disruptive technologies, firms **transform** the frame of reference (i.e. fundamental organizational change is necessary); **organizational change** = adapting structures, processes, methods and cognition
  - Methods to grow organizational research pools include;
    - **Alliances** (agreements between two or more parties to undertake activities to pursue shares goals or protect common interests)
    - **Acquisitions** (takeover, buyouts)

New ways of integrating external resources include summer camps, regular and online submissions.

- **The challenge of developing routines for open innovation: Why doing what is good is difficult**
  - Setbacks such as external crises (changes in currency rates, volatility in energy prices)
  - **Not invented here syndrome** (closedness of organizations to external ides)
  - Reluctance motivated by behavioral responses or (lack of) incentives can lead to **adaptive resistance** (humor, anticipation) and maladaptation (e.g. denial)
  - Examples of resistance to change:
    - Broadening tasks /functions can lead to resistance
    - Exploiting external resources internally
    - Focusing on exploitation of new resource combinations is only possible if other resources are released through e.g. spin-offs, licensing or selling
    - Find balance between incremental and revolutionary change

Basic models of integration

- **Stable integration**
  - Companies select and internalize resources without trying to change the new combination (e.g. restructuring headcounts following acquisitions)
- **Modular integration**
  - Purposeful selection of resources that are better sourced externally to substitute specific elements of the original value chain
- **Dynamic integration**
  - More a process
  - Continued knowledge exchange with the environment

Lecture 3

Competitive advantage in Global Markets
(Chapter 5 – business-level strategy)

Business-level strategies is an integrated and coordinated set of commitments and actions the firm uses to gain a competitive advantage by exploiting core competencies in specific product markets.
A properly defined strategy:

- Integrates and allocates the firm's resources, capabilities and competencies so that it will be properly aligned with the external environment
- Rationalizes the firm's vision and mission
- Reduce uncertainty regarding outcomes

Every firm must use a business-level strategy but not necessarily a corporate-level strategy (CH 7-10). The business-level strategy is the **core strategy** (how the firm intends to compete in the market).

Generic strategies are strategies that can be used by any organization competing in any industry.

Customers: Their relationship with business-level strategies

Firms need to attract customers with their business-level strategy since the relationships are the foundation for the returns.

These relationships are strengthened when firms deliver *superior value* to the customers. Strong interactive relationships with customers often provide the foundation for the firm's efforts to profitably serve customers' unique needs.
Effectively managing the relationships with customers is the essence for returns. Firms relationships with customers are characterized by three dimensions:

1) **Reach dimensions** of relationships with customers is concerned with the firm's access and connection to customers. It is especially critical in social network sites (e.g. Facebook)
2) **Richness dimension** is concerned with the depth and detail of the two-way flow of information between the firm and the customer
    a. More and in-depth information allows firms to better understand their customers and their needs (e.g. Amazon)
3) **Affiliation dimensions** is concerned with facilitating useful interactions with customers
    a. Viewing the world though customers' eyes and seeking ways to create more value for customers (e.g. Microsoft, Internet firms)

When determining the business-level strategy, the firm determines:

1) Who will be served?
2) What do those target customers need to have that it will satisfy?
3) How those needs will be satisfied?

Who: Determining the customers to serve

Companies divide customers into groups based on differences in customers' needs (= **Market segmentation**: clustering people with similar needs into individual and identifiable groups).

<u>Basics for customer segmentation</u>

- Consumer markets
    - Demographic factors (e.g. age, sex, income)
    - Socioeconomic factors (e.g. social class, stage in family life cycle)
    - Geographic factors (cultural, regional, national differences)
    - Psychological factors (lifestyle, personality)
    - Consumption patterns (heavy, moderate, light users)
    - Perceptual factors (benefit segmentation, perceptual mapping)
- Industrial Markets

- End-use segments
- Product segments (based on technological differences or production economics)
- Geographic segments (country boundaries, regional differences within them)
- Common buying factor segments
- Customer size segments

What: determining which customer needs to satisfy

Needs are related to product's benefits and features. To identify those needs, frequent and close interactions help the firm to identify current and future needs. Generally, the products are either provided at **low cost** with **acceptable features** or **highly differentiated** features with **acceptable cost**.

How: determining core competencies necessary to satisfy customer needs

Firms use its core competencies (resources and capabilities that serve as a source of competitive advantage) to implement value-creating strategies and thereby satisfy customers' needs. Firms are only able to meet customer demand if they are able to continuously improve, innovate and upgrade their competencies.

The purpose of a business-level strategy

The purpose is to create differences between the firm's position in an industry and those of its competitors. To position itself the firm must decide whether it intends to *perform activities differently* or to *perform different activities*.

→ Business level is about how the firm will perform the value chain's primary and support activities to create unique value.

Types of business-level strategy

There are five different business-level strategies. Each strategy helps the firm establish and exploit a particular *competitive advantage* within a particular *competitive scope.*

- Competitive advantage
  - Lower cost than rivals
  - Ability to differentiate and command a premium price
- Competitive scope
  - Broad target
  - Narrow target (select segment / group of segments in the industry)

The effectiveness of each strategy is contingent to the threats of the external environment and on the strengths and weaknesses derived from the internal portfolio.

1. **Cost leadership strategy**

Produce goods or services with features that are acceptable to customers at the lowest cost, relative to that of competitors.

- *Broad* customer group
- Often *standardized* products to industry's most typical customers
- *Process innovation* (production and distribution methods)
- *Economies of scale* help reducing costs

Constantly rethinking how to complete primary and support activities to reduce costs:

- Primary activities:
  - Inbound and outbound logistics are main cost factor: cost leaders try to reduce the cost by **outsourcing** to low-cost firms with low-wages
  - Small workforce
- Support activities:
  - Procurement support can facilitate cost leadership strategy
  - Easy-to-use manufacturing technologies
  - Simplified planning practices

How to implement a cost leadership strategy:

- Rivalry with existing competitors
    - Cost leaders have advantageous position since competitors hesitate to compete based on price before evaluating the outcomes
- Bargaining power of buyers
    - Powerful customers can force the cost leader to reduce prices but not lower than the cost leader's next-most-efficient industry competitor
- Bargaining power of suppliers
    - Cost leader have margins greater than the ones of competitors
- Potential entrants
    - Cost leaders are highly efficient making it more difficult for other company to enter the market (e.g. economies of scale)
- Product substitutes
    - Cost leader is more flexible than competitors

Competitive risks of the cost leadership strategy:

- Processes used could become obsolete due to competitor's innovations
- Too much focus by cost leader on cost reductions and not on features/value-adding activities (e.g. Aldi too few salespersons)
- Imitation of cost leadership strategy

2. **Differentiation strategy**

Produce goods of services at an acceptable cost that customers perceive as being different in ways that are important to them.

- *Product innovation* (products differ from those produced and marketed by competitors)
- Have understanding of what its target customers value, relative importance that they attach to the products and what they are willing to pay
- *Non-standardized goods* (superior product reliability, durability, high-performance)
- *Upgrade differentiated product features* without cost increase
- Concentrate on *investing in* and *developing features* that differentiate a product in ways that create value for customers

Differentiation includes:

- Unusual features
- Rapid product innovations
- Technological leadership
- Perceived prestige, status

Value chain:

- Primary activities:
    - Outbound logistics: superior handling of raw materials
    - Operations: Consistent manufacturing of attractive products
    - Outbound logistics: accurate and responsive order-processing procedures
    - Marketing: extensive granting of credit buying arrangements for customers
- Support activities:
    - Infrastructure: highly developed information systems
    - Superior personnel training
    - Purchase of highest quality replacement parts

How to implement a differentiation strategy:

- Rivalry with existing competitors
    - Loyalty of customers decreases their sensitivity to prices
    - Reputation of companies
- Bargaining power of customers
    - Uniqueness of products decreases sensitivity to prices which decreases the power of customers
- Bargaining power of suppliers
    - Suppliers must provide high-quality components (driving up firm's costs)
- Potential entrants

    - Customer loyalty and uniqueness of product are barriers to entry for new entrants
- Product substitutes
    - Differentiators are well-positioned against substitutes

<u>Competitive risks of differentiation strategy</u>

- Customers perceive differences between differentiator price and cost leader price too large; thus, differentiators become vulnerable to competitors that offer similar features at lower costs
- Experience can narrow customers' perceptions of the value of a product's differentiated features
- Counterfeiting (Fälschen)

3. **Focus strategies**

Produce goods or services that serve the needs of a particular competitive segment.

- Utilize *core competencies* to serve *industry niche*:
    - Particular buyer group (e.g. youths/seniors)
    - Different segment of a product line (e.g. do-it-yourself group/professional painters)
    - Different geographic market (e.g. Northern Italy/Southern Italy)
- Exploitation of a narrow target's differences from the balance of the industry
- Successful when effectively serving industry more than industry-wide competitors can do

- **Focused cost leadership strategy**
    - E.g. IKEA: targeting younger buyers desiring style at a low cost
        - Firm's engineers design low-cost modular furniture ready to assembly (instead of third-party manufacturers)
- **Focused differentiation strategy**
    - E.g. New Look Laser Tattoo Removal

<u>Competitive risks of focused strategy</u>

- Same risks as cost leadership/differentiation strategy
- Additional risks:
    - Competitor focusing on a more narrowly defined segment and offering lower costs / more differentiated products
    - Needs of customers of the narrow segment might become the same as the one of the broad segment, reducing the advantages of a focused strategy

4. **Integrated cost leadership/differentiation strategy**

Engaging in primary and support activities that allow the firm to simultaneously pursue low cost and differentiation.

- Efficiently produce products (source of cost leader) with some differentiated features (source of differentiation)
- Adapt quickly to new technologies and rapid changes in external environments
- This increases the number of primary and support activities to become competent; requires *flexibility*
    - Flexible manufacturing systems (FMS)
        - Increases flexibilities of human, physical and information resources
        - Computer-controlled process used to produce products in moderate, flexible quantities with minimum of manual intervention
        - Modularization of manufacturing process
        - Allows firms to respond more effectively to changes in customers' needs while retaining low-cost advantages and consistent product quality
    - Information networks
        - Linking firms with suppliers, distributors and customers
        - Customer relationship management (CRM): determine trade-offs that customers are willing to make between differentiated features and low cost
    - Total quality management systems (TQM)
        - Managerial innovation that emphasizes an organization's total commitment to the customer and to *continuous improvement* of every process through the use of *data-driven* problem-solving approaches based on empowerment of employee groups and teams

        - Use TQM to 1) increase customer satisfaction, 2) cut costs, 3) reduce amount of time required to introduce innovative products to the marketplace
        - TQM helps firm to develop flexibility needed to spot opportunities to simultaneously increase differentiation and reduce costs
- Often strong networks with external partners that perform some of the primary/support activities
- E.g. Zara

<u>Competitive risks of integrated cost leadership/differentiation strategy:</u>
- Firms become *stuck in the middle*: costs are not low enough and differentiation is not enough (industry-wide competitors can also get stuck-in-the-middle)
- Need to form alliances with other firms (which also costs more)

Generally, firms pursuing a pure strategy mostly outperform firms using a hybrid strategy. Still, the hybrid form is becoming more common and maybe necessary due to technological advances and global competition.

Chapter 6 – Competitive rivalry and competitive dynamics

Key questions in the global market
- How to identify competitors for the purpose of competitor analysis
- How to decide where to internationalize
- How to analyze and enter foreign markets
- How to protect proprietary knowledge in foreign countries
- Which organization design strategy to follow

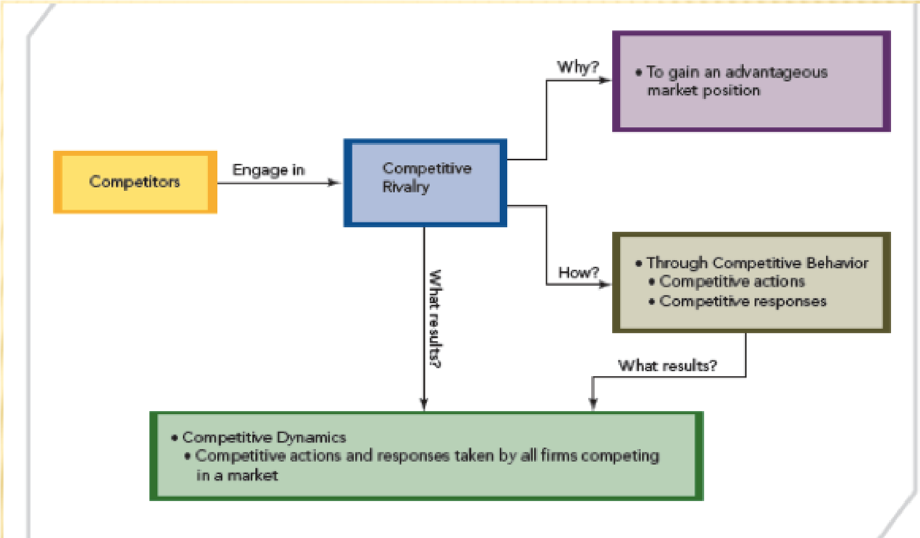
Opportunity exploitation requires a mastery of <u>competitor analysis</u>.
- Local vs global competition is, in essence, the same (you compete for market share etc.)
- As global competition: you encounter a *greater* number of competitors and competitors that have *more resources* → global competition more challenging than local
- You will be successful
    - What are competitors?
        - firms operating in the *same market*, offering *similar* products and targeting *similar* customers.
    - What are strategy and actions (and competitors' strategies and actions)
    - **Multimarket competition** – where the same firms compete in multiple markets

Firms such as Vodafone interact with their competitors as part of the broad context within which they operate while attempting to earn above-average returns.
Learning how to select the markets in which to compete and how to best compete within them is highly important (80-90% of firms fail in general).

Competitive rivalry is the ongoing set of *competitive actions* and *competitive responses* that occur among firms as they maneuver for an advantageous market position. It influences an individual's firm ability to gain and sustain competitive advantage.

Rivalry results from firms initiating their own competitive actions and then responding to actions taken by its competitors. **Competitive behavior** is the set of competitive actions and competitive responses the firm takes to *build or defend its competitive advantages and to improve its market position*.
Through competitive behavior, the firm tries to successfully position itself relative to the <u>five forces of competition</u> and to defend current competitive advantages while building advantages for the future.
Multimarket competition occurs when firms compete against others in several product or geographic markets.

Competitive dynamics is all competitive behavior (total set of actions and responses taken by all firms competing within a market).



Source: Adapted from M. J. Chen, 1996, Competitor analysis and interfirm rivalry: Toward a theoretical integration, Academy of Management Review, 21: 100–134.

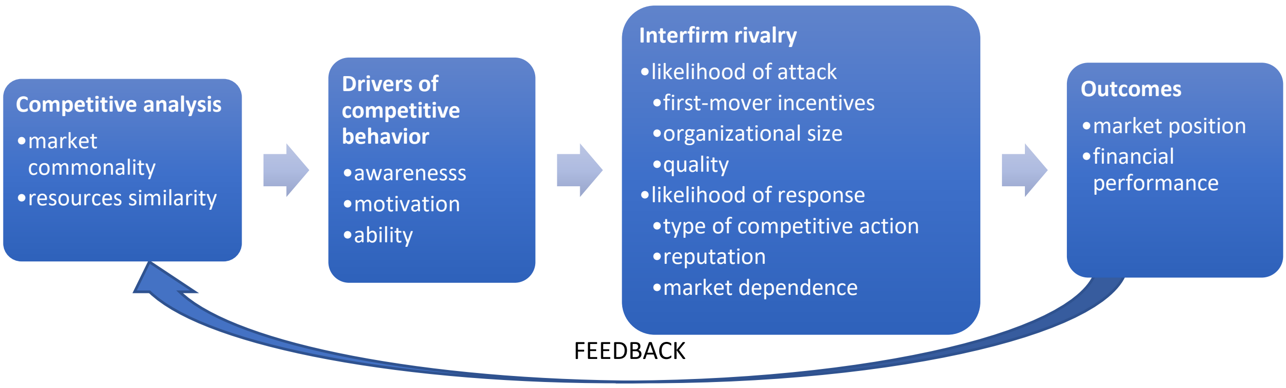
A firm's strategies are **dynamic** because actions taken by one firm elicit responses from competitors, that, in turn, typically result in responses from the firm that took the initial action.

The strategy's success is determined by not only the firm's *initial* competitive actions but also by how well the firm *anticipates* and *responds* to its competitors' initial actions (also called **attacks**).

Competitive rivalry influences all strategies (corporate, acquisition, international) but *dominantly* affects the firm's **business-level strategy**. This strategy is concerned with what the firm does to successfully use its competitive advantages in specific product markets. Generally, competitive rivalry is intensifying.

A model of competitive rivalry

Competitive rivalry evolves from the pattern of actions and responses between two firms. Therefore, the firms are **mutually interdependent**. Increasing rivalry decreases both firm's profitability.



Being able to predict competitors' actions and responses has a positive effect on the firm's market position and its subsequent financial performance.

Competitor analysis

The number of markets in which firms compete against each other (**market commonality**) and the similarity in their resources (**resource similarity**) determine extent to which firms are competitors.
→ high market commonality and high resource similarity are *direct and mutually acknowledged competitors*.

The drivers of competitive behavior – as well as factors influencing the likelihood that a competitor will initiate competitive actions and will respond to its competitor's actions – influence the <u>intensity of rivalry</u>.

Chapter 2: *Understand* competitors
Chapter 6: *Predict* actions

Market commonality

Generally, an industry (e.g. financial service industry) is divided into different markets (insurance, brokerage, services etc.). The different markets can then be subdivided (insurance market: market segments, such as commercial, consumer; product segments, such as health insurance, life insurance etc.).

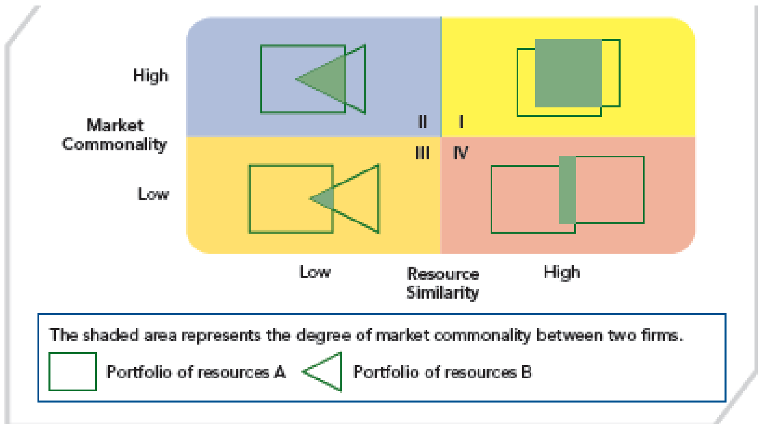
Market commonality = the number of markets with which a firm and a competitor are jointly *involved* and the degree of importance of the individual markets to each.
When firms produce similar products and compete for the same customers, the competitive rivalry is likely to be high.

Multimarket competition occurs when firms are *competing* against each other in several or many markets (product and geographic markets).

Firms can respond to a competitor's actions not only within the market in which actions are taken but also in other markets in which they compete with the rival. This potential complicates the rivalry. Firms with greater multimarket contact are **less likely** to **initiate** attack, but **more likely** to move (**respond) aggressively** when attacked.
→ ***Multimarket competition reduces competitive rivalry***.

Resource similarity

Resource similarity is the extent to which the firm's tangible and intangible resources are comparable to a competitor's in terms of both type and amount.
Firms with similar types and amounts of resources are likely to have similar strengths and weaknesses and use similar strategies.



Source: Adapted from M. J. Chen, 1996, Competitor analysis and interfirm rivalry: Toward a theoretical integration, *Academy of Management Review*, 21: 100–134.

Intersections indicate extent to which the firm and those with which it is compared are competitors.

I: direct and mutually acknowledged competitors

III: not direct competitors

Key question:
Who are my rivals?
E.g. for **Toyota**

- Ford, GM, Honda (based on multimarket contact and sales data)
- Nissan, Renault, Volkswagen (based on strategic group)
- Tata motors? (based on deep pockets & ambition)
- Google? (steer less car and ambition)

→ You need to consider all competitors of the company when building a strategy

For strategy: **Time factor** & **substitution potential** are important to consider!

E.g. Mobile phone industry
<u>Retrospective look</u> at competitive dynamics and outcomes in mobile phone industry

- **Ericsson Motorola** was world's leading competitor by phone sales 1998-2012
- **Apple** wasn't seen as a competitor, but still completely disrupted the smartphone market from 2007 onwards

    - They miscast the substitution potential from their phone and the smartphones from 2007
- **Samsung** was also not a competitor for Nokia; it was a IT company; still, today it is with Apple the leading smartphone competitors

→ If you do competitor analysis and you leave out potential competitors, you might destroy the business

Fast-cycle markets are markets that cannot be shielded from imitation.
Nokia, e.g. thought that it was a slow-cycle market but the smartphone market is def. fast-cycle market

Drivers of competitive actions and responses

Market commonality and resource similarity influence the **drivers of competitive actions and reponses**, which in turn, influence the firm's competitive behaviour (shown by actions and responses).

➢ **Awareness**

= Prerequisite to any competitive action or response taken by a firm

- Extent to which competitors recognize the *degree of their mutual interdependence* that results from *market commonality* and *competitive rivalry*
- Affects extent to which the firm understands the consequences of its competitive actions and responses
- Lack of awareness can lead to excessive competition, resulting in a negative effect on all competitor's performance.

➢ **Motivation**

Firm's incentive to take action or to respond to a competitor's attack; relates to perceived gains and losses.

- Firms might not respond if it perceives that its position will not improve
- Market commonality affects firm's perceptions and resulting motivation (more likely to attack competitor with low market commonality)

➢ **Ability**

Firm's *resources* and the *flexibility* they provide in choosing to attack a competitor or to respond to an attack.

- Without available resources (e.g. financial capital, people), firm lacks the ability to attack a competitor or to respond to its actions (e.g. smaller firm often lack ability to attack and respond)

Resource dissimilarity also influences competitive actions and responses between firms. The greater the resource imbalance between the acting firm and competitors, the greater will be the <u>delay</u> in response by the firm with <u>resource disadvantage</u>.

Competitive rivalry

Understanding competitor's awareness, motivation and ability helps firm to predict likelihood of an attack by competitor. These predictions are grounded in market commonality and resource similarity.

Strategic and tactical actions

Competitive action is a strategic or tactical action the firm takes to build or defend its competitive advantages or improve its market position.
A **competitive response** is a strategic or tactical action the firm takes to *counter* the effects of a competitor's competitive action.

- *Strategic* actions and responses are market-based moves that involve <u>significant commitment</u> of resources; <u>difficult</u> to implement / reverse
    - *E.g. Airbus decision to build the A380, the world's largest passenger aircraft*
- *Tactical* actions and responses are market-based moves that are more like a <u>fine-tuning</u> strategy; involve fewer resources; relatively <u>easy</u> to implement / reverse

Likelihood of attack

Other factors will also influence the decision whether a competitor will use strategic and tactical actions to attack its competitor.

First-mover incentives

First movers are firms that take an *initial* competitive action in order to build / defend their competitive advantages or to improve their market positions.

- Allocate funds for product innovation and development, aggressive advertising, and advanced R&D
- Especially valuable in today's fast-cycle markets with rapid changes
- Often critical to firm's success in industries experiencing rapid technological developments and relatively short product life cycles
- First mover can gain 1) above average returns, 2) loyalty of customers who may become committed to the goods/services, 3) lasting market share that might be difficult to take from in later periods

Organizational slack makes it possible for firms to become a first mover. **Slack** is the buffer provided by actual or obtainable resources that are not currently in use and are in excess.

Risks of first movers include:

- Difficulty to estimate returns that will generated from introducing product innovations into the marketplace
- Cost to develop product can be substantial

Second movers are firms that respond to the first mover's competitive action, typically through **imitation**. Second movers can analyse customers' responses to the first mover and alter the way a little bit. They also have the time to develop processes and technologies that are more efficient than those used by the first mover.

Late movers are firms that respond to a competitive action a significant amount of time after the first mover's action and the second mover's response. It is generally better than no response at all, however, success is not as high as if being the first- or second mover. Real success only if they find a way to uniquely enter the market.

Organizational size

Small firms are more likely

- To launch competitive actions
- Quicker in launching competitive actions
- Nimble and flexible competitors
- To rely on speed and surprise to defend their competitive advantage
- To have flexibility needed to launch a greater *variety* of competitive actions

Large firms are more likely

- To initiate competitive as well as strategic actions over time
- To have slack resources (thus, able to launch greater *number* of competitive actions)

Organization should have enough slack resources held by a large firm to launch greater *number* of competitive actions, and a small firm's flexibility to launch a greater *variety* of competitive action

"Think and act big and we'll get smaller, think and act small and we'll get bigger" (relying on a limited number or types of competitive actions can lead to reduced competitive success because competitors learn how to efficiently respond to the predictable.

Quality

Quality is the outcome of how a firm completes primary and support activities. Quality exists when the firm's goods or services meet or exceed customers' expectations.

<u>Product quality dimensions</u>

- Performance
- Features
- Flexibility
- Durability
- Conformance
- Serviceability
- Aesthetics

- Perceived quality

<u>Service quality dimensions</u>
- Timeliness
- Courtesy
- Consistency
- Convenience
- Completeness
- Accuracy

Quality is possible only when top-level managers support it and when its importance is institutionalized throughout the entire organization. Quality is a necessary but insufficient condition for competitive success. Competitors will probably not initiate aggressive competitive actions as long as quality issues are not resolved.

Likelihood of response
A competitive response is a strategic or tactical action the firm takes. A firm is likely to respond to a competitor's action when 1) the action leads to *better use* of competitor's capabilities to gain or produce stronger competitive advantages or an improvement in market position; 2) the action *damages* the firm's ability to use its capabilities to create or maintain an advantage; 3) the firm's market position *becomes less defensibl*e.
Three conditions on how likely a competitor is to respond to competitive actions:

Type of competitive action
Strategic actions receive strategic responses
- Strategic actions elicit *fewer* total competitive responses due to the <u>significant resources</u> required and their <u>irreversibility</u>
- The time needed to implement and assess a strategic action delays competitor's responses

Tactical actions receive tactical responses
- Competitor likely will respond *quickly* to a tactical action (e.g. airline industry: price drops)

Actor's reputation
An **actor** is the firm taking an action or a response, while **reputation** is the positive or negative attribute ascribed by one rival to another based on past competitive behaviour.
- Competitors are more likely to respond to strategic or tactical actions when they are taken by a <u>market leader</u> (study shows that especially strategic actions will quickly be imitated)
- Competitors are less likely to take responses against a company with a reputation for competitive behaviour that is <u>risky, complex and unpredictable</u>

Dependence on the market
Market dependence is the extent to which a firm's revenues or profits are derived from a particular market.
- Firms with *high* market dependence are likely to respond strongly to attacks threatening their market position;

Competitive dynamics
Competitive dynamics concerns the ongoing actions and responses among *all* firms competing within a market for advantageous positions.
Varying rates of competitive speeds have effects on the competitive dynamics:

Slow-cycle markets
Slow-cycle markets are those in which the firm's competitive advantages are shielded from imitation commonly for long periods of time and where imitation is costly.
- Building unique and proprietary capabilities for competitive advantage
- Difficult for competitors to understand
- Costly-to-imitate
- Usually results from historical conditions, ambiguity, social complexity (CH1)

- Protected by patents, copyrights

Firms usually launch the product that has been developed through proprietary change (e.g. R&D) and then exploit it for as long as possible until competitors counteract.

Fast-cycle markets

These are markets in which firm's capabilities that contribute to competitive advantage aren't shielded from imitation and where imitation is rapid and inexpensive.

- Competitive advantages are not sustainable (ever-changing competitive advantages)
- Importance of speed: rapid product innovations and upgrades
- Technology-based strategy focused
- Strategic decision gets complex, increasing need for comprehensive approach integrated with decision speed
- Reverse engineering and rapid technology diffusion facilitate imitation
- Continuous reduction in costs
- Companies focus on how to rapidly and continuously develop new competitive advantages that are superior to those they replace
- Strategic alliances are common
- Offshoring

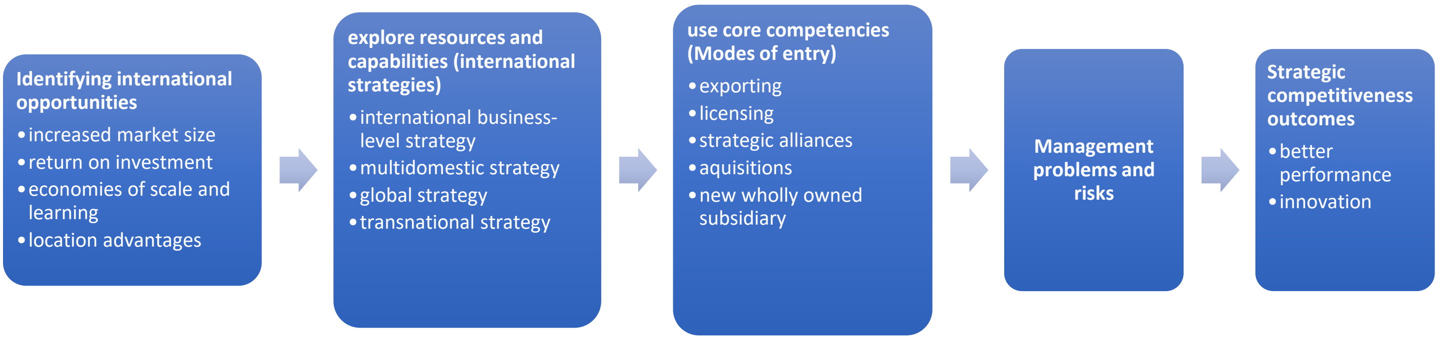
Standard-cycle markets

Markets in which the firm's competitive advantages are moderately shielded from imitation and where imitation is moderately costly.

- Competitive advantage is only sustainable when firms continuously upgrade the quality of its capabilities
- Competitive actions and responses designed to seek large market shares, gain customer loyalty through brand names and to carefully control firm's operations
- Less specialized core competencies: faster and less costly imitation
- Often large volume/mass markets
- Innovations can be radical or incremental

In general, innovations have substantial influence on actions/responses in all three markets.

Chapter 9 – International strategy



Key Question
*Internationalizing – **where to go**?*

Reasons to internalize:

- Access to new markets
- Access to new factor markets

Developing international strategy is essential deciding about:

- ***Where to go*** – **diamond model** (Porter) – consider culture differences, exchange rate risk, attractiveness reports
- ***How to do*** – international entry strategies
- ***How to proceed***

Identifying international opportunities: incentives to use an international strategy

An **international strategy** is a strategy through which the firm sells its goods or services outside its domestic market. International markets have many new opportunities.

- Demand develops in other countries for the product innovated in the home country
- Secure needed resources
- Pressure for global integration of operations
- Pressure for cost reduction

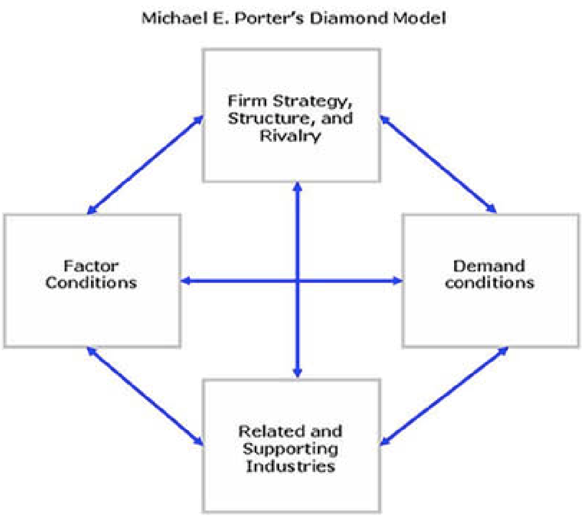
Benefits of international strategies:

- **Increased market size**
  - Particularly interesting for firms that have limited growth opportunities in their home markets
  - Larger markets offer higher returns and less risk
- **Return on investment**
  - Most R&D intensive industries are international (e.g. electronics)
  - Opportunity to recoup significant capital investments and large-scale R&D expenditures
  - Primary motive: generate above-average returns on investments
- **Economies of scale and learning**
  - By standardizing its products across country borders, firm are more likely to achieve economies of scale (e.g. critical to the automobile industry)
  - Exploit core competencies in international markets through resource- and knowledge-sharing between units and network partners across country borders
- **Location advantages**
  - Facilities that have lower costs (labor, energy, other natural resources, access to suppliers/customers)

International strategies

Firms choose one or both basic types of international strategies: business-level international strategy and corporate-level international strategy:

International business-level strategy – where to go



Home country is the most important source of competitive advantage.
= **Diamond model**

- Emphasize environmental and structural attributes of a national economy that contribute to national advantage
- Government policy also contributes

<u>Factors contributing to the advantage of firms in a global industry:</u>

1. Factors of production / Factor conditions
    a. Inputs necessary to compete in any industry:
        i. ***Basic factors*** (labor, land, natural resources, capital)
        ii. ***Advanced factors*** (digital communication systems, educated workforce)
        iii. ***Generalized factors*** (highway systems, supply of debt capital)
        iv. ***Specialized factors*** (skilled personnel in a specific industry)
        → Advanced and specialized factors contribute the most to competitive advantage
    b. Often countries lack basic and generalized factors and therefore have advanced & specialized factors
2. Related and supporting industries
    a. Related industries that provide e.g. skilled employees and which are located in certain location helps new companies settle there
    b. E.g. Italy became leading shoe manufacturing country since it is a well-established leather-processing industry
3. Demand conditions
    a. Nature and size of buyers' needs in home market for the industry's goods or service
    b. Large market segment can produce the demand necessary to create economies of scale
4. Firm strategy, structure and rivalry
    a. Strategy can only be implemented with certain structures
    b. Region is attractive when structure fits strategy and due to rivalry, the companies are triggering each other to be innovative

Independent reports also help figuring out where to go:

- A.T. Kearney
    - Global services location index
    - FDI confidence index
- Financial times
    - fDi reports
- Ernst&Yound
    - Country attractiveness report (renewable energy investment)
- The Economist IU
    - Country, industry, risk analysis

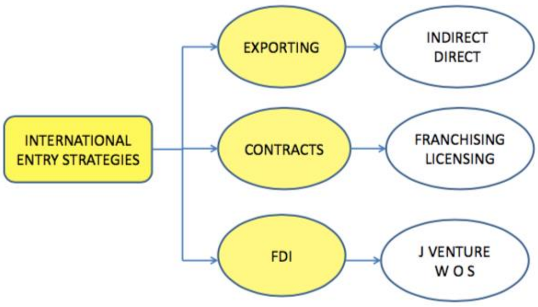
These factors only contribute to competitive advantage only when the firm develops and implements an appropriate strategy that takes advantage of distinct country factors. Thus, when making a decision about which business-level to choose (cost leadership, differentiation, focused), one has to consider all country-related factors.

Choice of international entry mode – how to go?

Entry Mode	Characteristics
Exporting	High cost, low control
Licensing	Low cost, low risk, little control, low returns
Strategic alliances	Shared costs, shared resources, shared risks, problems of integration (e.g. two corporate cultures)
Acquisition	Quick access to new market, high cost, complex negotiations problems of merging with domestic operations
New wholly owned subsidiary	Complex, often costly, time consuming, high risk, maximum control, potential above-average returns

Exporting

International trade of goods or services shipped from an exporting company in one country to an importing company in another country/countries.



- Does not require expense of establishing operations in the host countries
- Establish some means of marketing and distributing products
- Contractual forms with host-country firms
- High cost of transportation and tariffs placed on some incoming goods
- Exporter has less control over marketing and distribution of its products in host country
- Especially cost leadership strategies enhance performance of exports in developed countries, whereas larger differentiation strategies are most successful in emerging countries
- Occurs mostly between countries that are close in their facilities (lower transportation cost)
- Especially used by small businesses (limited risk and high potential)

- ***Indirect exporting*** – selling to an intermediary who in turn sells the products to the customer
- ***Direct exporting*** – export directly to customer (no intermediary)

Licensing

Allows a foreign company to purchase the right to manufacture and sell the firm's products within a host country or set of countries.

- Licensor is paid a royalty fee on each product sold
- Licensee takes risk and makes monetary investments in facilities to manufacture products
- Least costly form of international strategies
- Firm can rarely control the manufacture and marketing of its products in foreign countries
- Least potential returns
- No transfer of ownership
- Licensor does not have control over licensee
- E.g. buying a software which you embed in own business

Franchising

- Franchiser keeps full control buy gives franchisee permission to use intellectual property and operating system
- Franchiser plays more active supporting role; exercises control over franchisee
- Franchisee pays royalty fee
- E.g. McDonalds, Subway

Strategic alliances

Allow firms to share risks and resources required to enter international markets and can facilitate development of new core competencies that contribute to future competitive advantage.

- Gaining access to new technologies and markets
- Failure due to incompatibility between partners and conflict; especially difficult to manage
- Trust is critical; relies on:
    - Initial condition of relationship
    - Negotiation process to arrive at an agreement
    - Partner interactions
    - External events
- Equity-based alliances have most control and thus highest returns

Acquisitions

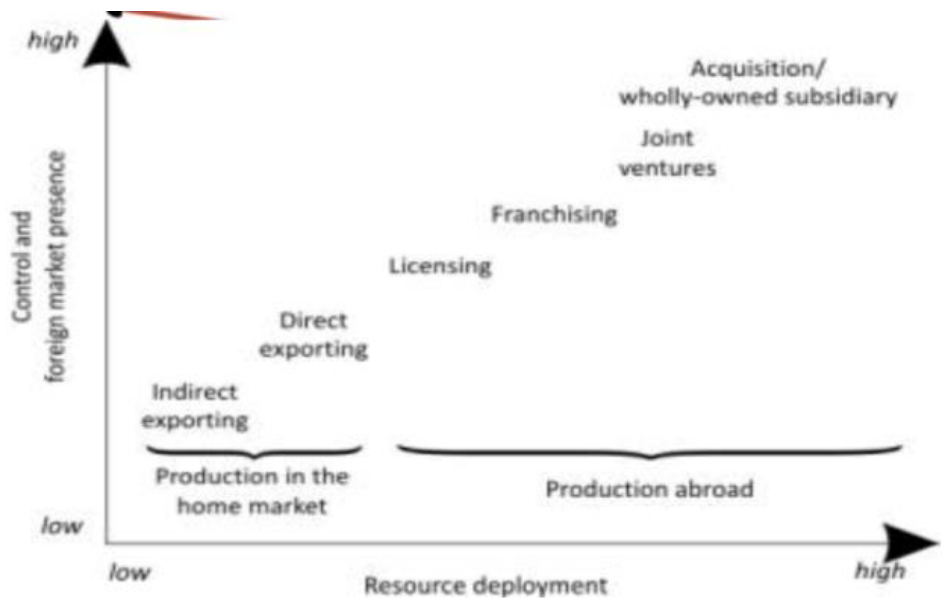
- Provide quick access to new markets
- Fastest and largest initial international expansion
- Expensive; often require debt financing
- Legal and regulatory requirements
- Differences in culture and practices
- Preferred when firm is human capital intensive

Foreign direct investments

Investment in the form of a controlling ownership in a business in one country by an entity based in another country

- **Joint ventures**
    - Two firms get together to create a completely *new* venture; shared ownership between these companies
    - Company A and company B from focal country company A wants to expand to (new venture is in country of company B then)

- **Wholly owned subsidiaries**
    - **Greenfield venture** = establishment of a new wholly-owned subsidiary
    - Owned by a single company (therefore also riskier) → maximum control
    - Highest returns possible
    - Business establishes smaller, separate entities (separate from parent company but parent company maintains full control and ownership over it)
    - Preferred when capital-intensive plants are planned; when markets are known
    - Firms have to acquire knowledge
    - E.g. greenfield project, acquisition of another company



Dynamics of mode of entry

- Initial market entry often through **exporting**
- Licensing can facilitate product improvements necessary to enter foreign markets
- **Strategic alliances** allow firm to connect with experienced partner; reduced cost and shared risk (often used in uncertain market conditions, e.g. emerging markets)

→ all well suited for early entry

- **Joint venture / wholly-owned subsidiary** (controlled by one company) preferred if intellectual property rights are not well protected
- When securing stronger presence in international market, **acquisitions** or **greenfield ventures** required → come at later stages

Firms can use one entry mode and then choose a different one or choose some simultaneously, each applying in different markets.

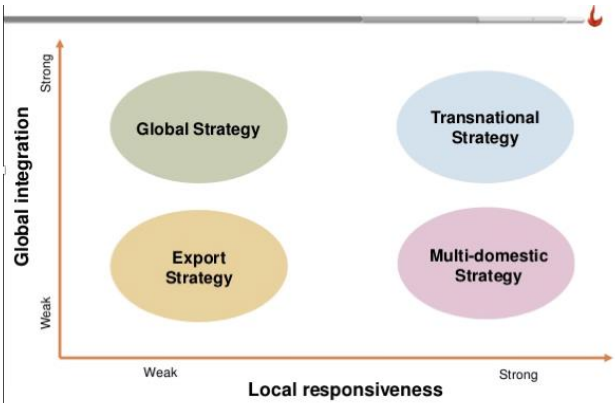
International corporate-level strategy – how to proceed

Focuses on the scope of a firm's operations through both product and geographic diversification. It is required when the firm operates in multiple industries and multiple countries or regions.

Volkswagen story: Volkswagen wanted to expand to China

- Goal:
  - New market; PLC extension
  - Factor advantages
- Entry mode
  - From export of assembly kits to joint venture

Many different competitors, such as FAW, SAIC Motor, Wuling Motors, GM



1. **Multi-domestic strategy**
   a. Decentralized strategic and operating decisions; allows each unit to tailor products to the local market
   b. Markets segmented by region/country → Focuses on competition within each country; low integration
   c. Expands **local** market share
   d. Results in less knowledge sharing for the corporation as a whole due to differences across markets, decentralization and different strategies by local country units
   e. Not conducive for economies of scale
      i. E.g. Unilever; Nestlé
2. **Global strategy**
   a. Centralized decisions from head office
   b. More standardization of products across the country markets
   c. Greater integration across business units among themselves and head office (leads to efficiencies etc.); SBUs are interdependent
   d. More knowledge exchange possible
   e. Greater opportunities to take innovations developed at corporate level
   f. Less risk
   g. Forgo growth opportunities since markets are less likely to be identified as growth opportunity
   h. Requires sharing resources and facilitating coordination and cooperation
   i. Conducive to economies of scale
      i. E.g. Coca-Cola; Ikea
3. **Transnational strategy** (integrate the former two strategies; most difficult to implement)
   a. Global coordination
   b. Local flexibility
   c. Requires management of paradox

d. Shared identity very important (broad sense of what are the company's values etc)
    i. E.g. McDonalds (demand for same kind of menu etc., process can be replicated, food is still cheap etc. but still, local adaptations such as buying beer in Germany or different burgers across different burgers);
    ii. General electrics

Environmental trends

Increasing competition puts pressure on firms. Moreover, there is an increased emphasis on local requirements and governmental regulations. Some products and industries may be more suited than others for standardization across borders.
As a result, some large multinational firms with diverse products employ a multi-domestic strategy with certain product lines and a global strategy with others.

Liability of foreignness

International strategies are still difficult to implement due the liability of foreignness relative to domestic competitors in a host country. A regional focus might be better since the company can use their resources more effectively.

Regionalization

Where international markets differ greatly (in which firms must pursue a multi-domestic strategy), a regional focus might be better since it can focus more on understanding the cultures, norms and other factors that are important.
Companies that develop trade agreements to increase the economic power of their regions may promote regional strategies (e.g. EU, OAS, NAFTA).

After a firm selects its international strategy and decides whether to employ them in regional or world markets, it must choose a market entry mode.

Strategic competitive outcomes

The goals of internationalization strategies are **returns** and **innovation**.

International diversification and returns

International diversification is a strategy through which a firm expands the sales of its goods or services across borders of global regions and countries into different geographic locations or markets.
As diversification increases, returns initially *decrease* but then *increase* quickly as they learn to manage international expansion.

- Private versus government ownership
- Potential economies of scale
- Experience
- Location advantages
- Increased market size
- Opportunity to stabilize returns (reduces overall risk)
- *Offshore outsourcing* has created significant value-creation opportunities for firms

International diversification and innovation

The development of new technology is at the heart of strategic competitiveness. This depends on the ability to innovate. International diversification provides the opportunity to achieve greater returns on their innovations (through larger markets) and reduces risk of R&D investments.

- Maybe necessary to generate resources to sustain large R&D operation
- Improves ability to appropriate additional returns from innovation

Complexity of managing multinational firms

Increased complexity increases uncertainty due to multiple risks involved in international strategies.
Constraints include complexity, culture, institutional systems, highly competitive nature of global markets, shifts in currency values and instability of national governments.

Risks in an international environment

- **Political risks**
  - Instability of national governments:
    - Government regulations can create economic risk and uncertainty
    - Conflicting legal authorities
    - Corruption
    - Nationalization of private assets
  - War

- **Economic risks**
  - Interdependent with political risks
  - Perceived security risk
  - Terrorism decreases investments
  - Fluctuations in currency rates

- **Management problems**
  - Limits to diversification after certain point
  - Greater geographic dispersion increases costs of coordination between units and distribution of products
  - Trade barriers, logistical costs, cultural diversity, other differences by countries
  - Institutional and cultural factors
  - Relationship between host government and company

Lecture 4

Corporate Strategy & Diversification (Chapter 7)

Corporate-level strategy specifies actions a firm takes to gain a competitive advantage by selecting and managing a group of different businesses competing in different product markets. These strategies help firms to select new strategic positions that are expected to increase firm's value.

Basic corporate strategy: **Diversification**
The diversified company operates in several different and unique product markets: Corporate level (**company-wide**) and business-level (**competitive**). Corporate-level strategies are concerned with two key issues:
1. In what product markets and businesses should the firm compete
2. How should corporate headquarters manage those businesses

The business-level strategy then must be selected for each of the businesses the firm is competing.

A corporate-level strategy's value is ultimately determined by the degree to which the 'businesses in the portfolio are worth more under the management of the company than they would be under any other ownership'.

Product diversification (primary focus of corporate-level strategies) concerns the scope of the markets and industries in which the firm competes.

Business Strategy vs. Corporate Strategy

- **Business strategy**
  - Set of commitments and strategies to gain *competitive advantage* based on core competencies
- **Corporate strategy**
  - Actions to gain competitive advantage based on managing groups of businesses across **product markets**

Single market strategy – one product
Multi product strategy – multiple products in multiple markets

Levels of diversification

Low levels of diversification

- **Single-business diversification strategy:** 95% or more of its revenue stems from its main business area
  - e.g. Wim Wrigley Jr Company historically was active in a few product markets

- **Dominant business diversification strategy** is pursued by a company which has 70% - 90% of its revenues generated by its core business
  - e.g. UPS generated 56% of its core business (package delivery) and 28% from its non US package delivery

Moderate to high levels of diversification

A **related** diversification strategy occurs when a firm generates more than 30% of its revenue outside a dominant business and whose businesses are related to each other in some manner.

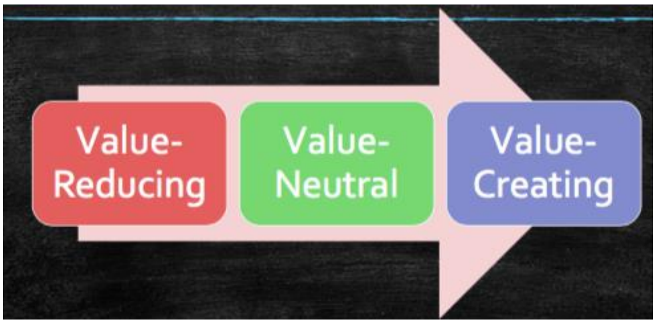
- **Related constrained**: links are rather direct
  - **E**.g. Procter&Gamble, Merck&Company, Campbell Soup
- **Related linked**: only few links between businesses
  - **E**.g. General electric
  - Share fewer resources and assets
  - Concentrate on transferring knowledge and core competencies

High levels of diversification

- **Unrelated diversification strategy**
  - No relationship between businesses
  - E.g. Samsung, United Technologies, Textron,
    = **conglomerates** (combination of two or more corporations engaged in entirely different businesses that fall under one corporate group, usually involving a parent company and many subsidiaries (e.g. Samsung)
    - Requires inherent demand of market and internal capabilities
    - Main characteristic: being engaged in entirely different businesses
    - Motivation: risk diversification

Reasons for diversification

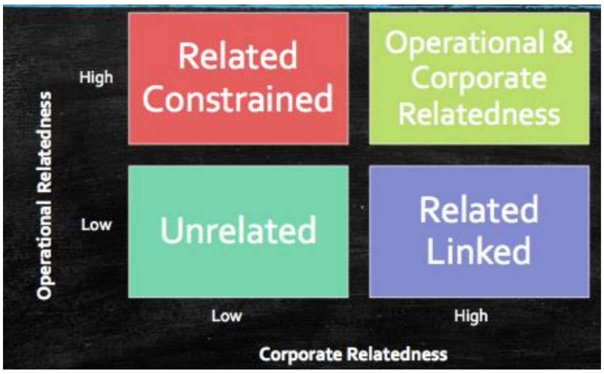
- **Value-creating diversification** (either created by related or unrelated diversification)
  - ***Economies of scope*** (*related diversification*): cost savings by successfully
    - Sharing activities (operational relatedness)
    - Transferring core competencies from one business into the other (corporate relatedness)
  - ***Market power*** (*related diversification*)
    - Blocking competitors through multipoint competition
    - Vertical integration
  - ***Financial economies*** (*unrelated diversification*)
    - Efficient internal capital allocation
    - Business recruiting
  - Highly efficient systems to link suppliers' product with firm's production process
  - Highly trained sales force
  - Product prices so as generate significant sales volume



- **Value-neutral diversification**
  - Antitrust regulation
  - Tax laws
  - Low performance
  - Limited growth opportunities in existing sectors
  - Find new use of core competencies and activities
  - Uncertain future cash flows
  - Risk reduction
  - Tangible / intangible resources
  - ***Strategic fit***

- **Value-reducing diversification**
  - Diversifying managerial employment risk
  - Increasing managerial compensation
    → Diversification is not always adding value (decisions to expand businesses might have negative effects)

Value-creating diversification: Related diversification



Related constrained diversification - Operational relatedness: Sharing activities between businesses

- Share primary activities (e.g. inventory delivery systems)
- Share support activities (e.g. purchasing practices)
- Product markets in which we operate are very closely connected and offer opportunities for synergies

Firms using the **related constrained diversification** strategy share activities in order to create value.
Example: Proctor and Gamble

- Can be risky because ties between firm's businesses create links between outcomes
- Economies of scope possible which can be important to lower risk and create value

Related linked diversification - Corporate relatedness: Transferring core competencies

- Corporate-level core competencies are sets of resources and capabilities that link different businesses, primarily through managerial and technological knowledge, experience, and expertise
- Firms often **transfer core competencies** by moving key people in new management positions
- Too much dependence on outsourcing can lower usefulness of core competencies and reduce transferability
- Engage in product markets that offer opportunities for synergies (but are still to a large extent separate from core market)

Firms use the **related linked diversification strategy** to transfer core competencies. Two ways to create value:

- Second business does not need to develop core competencies since they are simply transferred (save costs)
- Intangible resources are difficult for competitors to understand and imitate (thus, competitive advantage for firms)

Market power

Firms using a related diversification strategy may gain **market power** which exists when a firm is able to sell its products above the existing competitive level or to reduce the costs of its primary and support activities below the competitive level (or both).

Firms can also create market power through

- **Multipoint competition** (when two or more diversified firms simultaneously compete in the same product areas or geographical markets)
  - Geographic competition increases
  - If one firm successfully gains positions in several markets, market power is increased
- **Vertical integration** (when a company produces its own inputs – ***backward integration*** – or owns its own sources of output distribution – **forward integration**)
  - Sometimes firms partially integrate their operations and produce and sell their products by using company businesses as well as outside sources
  - Avoid market costs, improve product quality, protect technology

    - Limitations: Suppliers producing at lower costs; substantial investments in specific technologies reduces firm's flexibility; coordination problems; capacity balance problems;
    - **Deintegration** is also source of market power: companies helping to foster value
    - **Virtual integration** due to Internet: closer relationships are possible

Simultaneous operational and corporate relatedness

Firms can create economies of scope by simultaneously sharing activities and transferring core competencies. This makes it difficult for competitors to imitate. Firms that fail to achieve it have **diseconomies of scope**.

Example: Walt Disney, Amazon

For investors it can be difficult to see the value created by sharing the activities and transferring core competencies.

Strategic fit

Strategic fit exists when the value chains of different businesses present opportunities for **cross-business resource transfer, lower costs** though combining the performance of related value chain activities or resource-sharing, **cross-business use of a potent brand name** and cross-business **collaboration** to build stronger competitive capabilities.

Unrelated diversification

Unrelated diversification can also create value through two types of **financial economies** which are cost savings realized through improved allocations of financial resources based on investments inside or outside the firm.

- No strategic fit
- No meaningful value chain relationships
- No unifying strategic theme

Efficient internal capital market allocation

- Efficiently allocate capital internally (headquarter offices distribute capital to the businesses to create value for overall corporation)
- Efficiency results when investors take <u>equity</u> positions (ownership) with high expected future cash-flow values
- "Conglomerate discount": Analysts not knowing how to value a vast array of large businesses with complex financial reports

Restructuring of assets

Financial economies can be created when firms learn how to create value by buying, restructuring and then selling the restructured companies' assets in the external markets.
For high-technology and service-based companies, only few tangible assets can be restructured to create value and sell profitably.

Value-neutral diversification: Incentives and resources

Sometimes, diversification strategies are used with value-neutral objectives on mind.

Incentives to diversify that permit diversification that is value-neutral

- **Anti-competition regulation and tax laws** (external incentives)
    - When diversifying, companies have higher tax advantages than when merging (many laws/regulations prohibiting mergers)
- **Low performance**
    - Low returns are related to higher level of diversification
    - Curvilinear relationship between diversification and performance: Dominant business and unrelated business have lower performance than related constrained diversification
      → High diversification has lower returns and too little diversification has low returns
- **Uncertain future cash flows**
    - Diversification as defensive strategy
- **Synergy and firm risk reduction**

  - **Synergy** exists when the value created by business units working together exceeds the value that hose same units create working independently
  - However, increasing relatedness also increases risk of corporate failure since synergy products joint interdependence between businesses which constrains flexibility → two decisions might be forced:
    - Reduce technological change by operating in environments that are more certain making the firm more risk averse and thus foregoing new product lines
    - Firm might constrain its level of activity sharing and forgo synergy's potential benefit

Resources and diversification
When incentives for diversification exist, firms must have the types and levels of resources and capabilities needed to successfully use a corporate-level diversification strategy. Resources have to have the VRIN characteristics, otherwise they are not creating value.

Excess capacity can be used to diversify more easily. Might be more useful for related diversification because it may be utilized to sell similar products.

Value-reducing diversification: Managerial motives to diversify
Managerial motives may exist independently of value-neutral reasons and value-creating reasons. Managers desire increased compensation (increased firm size increases compensation) and reduced managerial risk (risk of getting fired decreases).

Example: **Walt Disney**
- Different product markets, such as movie, who wants to be a millionaire, cruise ship etc.
- Disney is very diverse: They compete in different product markets
- Diversifying **conglomerate** (various different product markets, scattered across these product markets; product markets not really related → the businesses the company operates in are unrelated)

Walt Disney has different business lines
- Media Networks (broadcasting, cable networks)
- Studio Entertainment (theatrical films, Buena Vista Home entertainment, Buena Vista Music Group, TV production)
- Theme Parks and Resorts (Walt Disney attractions, Walt Disney Imagineering, Anaheim Sports, Disney Regional Entertainment)
- Consumer Products (merchandising, licensing, Disney Store, Disney Publishing, Walt Disney Art Classics, Disney Interactive)
- Internet and Direct Marketing (Disney online, ESPN Internet group, ABC Internet group, GO Network)

Diversification
The Quest for **synergy**
- By 2000: Synergy needed geographically, horizontally, vertically

Horizontal diversification: Adding parallel products or services to the existing product/service line
Disney Quest multistory facilities (with elaborate video games), cruise chips, educational retreats (adventures in learning),
Vertical diversification: Vertical Integration: Expand business by forward or backward integration
Internet and TV, merger with Touchstone Television
http://www.businessmanagementideas.com/management/growth-strategies/diversification-of-firms-horizontal-and-vertical/4799

Why and when to diversify
- **WHY?**
  - To create shareholder value, based on:

        - Industry attractiveness test
        - Cost-of entry test
        - Synergy test
    - Limited growth opportunities in existing sectors
    - Spread the risk
    - Save costs
    - Find new use of core competencies and capabilities
    - Strategic fit

- **WHEN?**
    - **You have**
        - Leverage on a powerful brand name
        - Leverage on resources and capabilities that are competitive in the new business
    - **You can achieve**
        - Cost-reduction of competitive resources and capabilities
        - Complementarities between technologies and product of current and new businesses

At **Disney**, what is at its core?

- Mickey does not age
- Characters are fully controlled
- There is no 'agent' for Mickey
- Competitively superior, family-oriented brand of cartoons (compared to Warner Bros)
- Customer base renews for every few years
- Complexity and scope of operations is hard to imitate

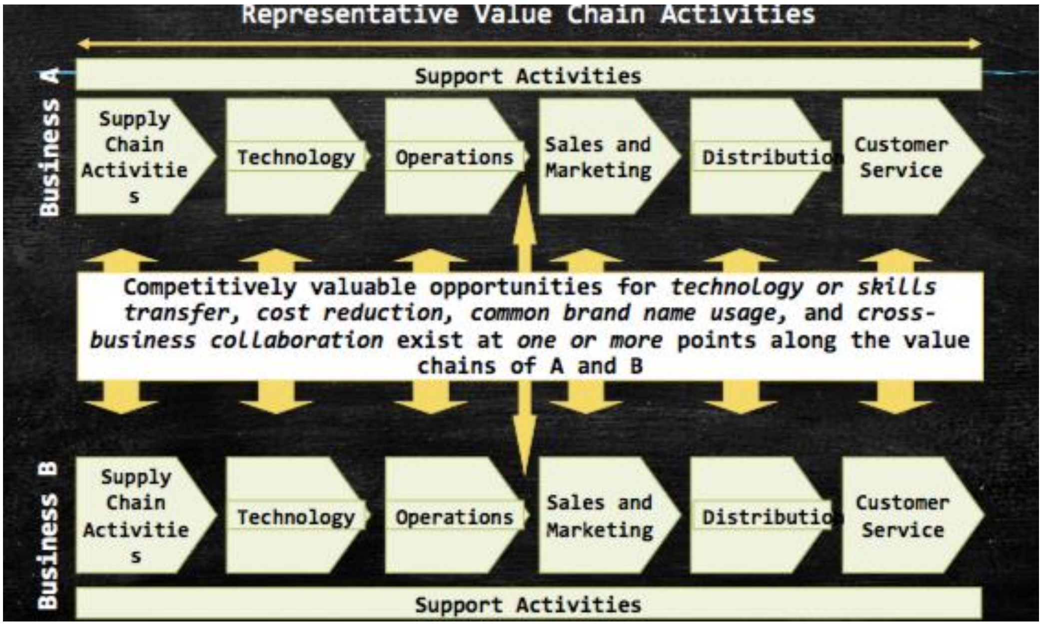
At **Disney**

- What is Disney's diversification? How does its vision affect the businesses it goes into?
- How do we assess its corporate strategy?
    - Does it create value to its separate businesses?
- What are the characteristics of a valuable resource for an organization? How does it apply to Disney?
- What are the limits to diversification? How would you position Disney?
    - Consider geographical expansion, vertical integration and product differentiation

Where is the barrier?

- Brand name
- Share the assets in some way? Creating a synergy by creating products and sharing it across

Related businesses



Two things

1. Business A and Business B; Can I share any activities across the supply chain, technology, customer service etc.? Is there any synergy that I can create?
    a. **Operational relatedness** (it's about operations of the company)
2. Nature of the relatedness: look horizontally (is there anything of my company that I can share across the different functions, such as brand knowledge, understanding the customer etc. (share horizontally to other businesses? E.g. brand)
    a. Richard Branson;

Determining the type of diversification

- Are there opportunities to share value chain activities and achieve strategic fits?
- Are there similarities in the business units' products?
- Are there similarities in the business units' customers'?
- Are there similarities in the business units' distribution channels?

Lecture 5

Mergers & Acquisition
(Chapter 8 – Strategic acquisition and restructuring)

Mergers and acquisition strategies help firms become more diversified.

The popularity of merger and acquisition strategies

Firms use M&A strategies to improve their ability to create more value for all stakeholders. However, not always value is created.

- **Merger**
        - E.g. *Daimler and Chrysler*
    - Companies integrate their operations in a newly created company by agreement of the shareholder of the original companies
    - Two firms agree to integrate their operations on a relatively **coequal** basis
    - Exchange shares for shares in the new company
        - Generally, horizontal mergers should be more successful than diversifying ones
        - Generally, related diversification mergers should outperform unrelated ones
- **Acquisition**
        - E.g. *Bank of America acquired Marrill Lynch*
    - One firm buys a controlling (100%) interest in another firm with the intention of making the acquired firm a subsidiary business within its portfolio
    - Acquiring firm makes an offer for the common stock of the other company at a fixed price per share
- **Takeover**
    - Special type of acquisition
    - Target firm does not solicit the acquiring firm's bid (= unfriendly acquisition)

Reasons for acquisitions (and associated problems)

Increased market power

Market power is usually derived from size of the firm and its resources and capabilities to compete in the marketplace. Goal is to become market leader.

- Geographical expansion

<u>Problems:</u> Integration difficulties

- Company culture
- Financial and control systems
- Effective working relationships

<u>Forms to increase market power</u>

- **Horizontal acquisitions**
    - Acquisition of a company competing in the same industry as the acquiring firm
    - Exploit cost-based and revenue-based synergies
    - Result in **higher performance** when the firms have similar characteristics such as strategy, managerial styles and resource allocation patterns
    - Most effective when acquiring firm integrates the acquired firm's assets with its own assets
- **Vertical acquisitions**
    - Acquisition of a supplier or distributor of one or more of the acquiring firm's goods or services
- **Related acquisitions**
    - Acquisition of a firm in a highly related industry
    - Firms seek to create value through synergies that can be created by integrated some of their resources and capabilities

All these acquisitions are subject to regulations and close supervision by financial analysts.

Overcoming entry barriers

Acquiring an established company might be easier than entering the market as a competitor and offering a product that is unfamiliar to current buyers. The greater the entry barriers, the greater the probability that a firm will acquire an existing firm to overcome them. This can be particularly interesting when entering international markets.

Cross-border acquisitions are acquisitions between companies with headquarters in different countries. Research shows that in the future, the largest part of these acquisitions will be held in Asia. However, managers have to see the risks of regulations, currency, due diligence, etc.

<u>Problem</u>: inadequate evaluation of target

- Due diligence = process through which a potential acquirer evaluates a target firm or acquisition
- In a proper due diligence process, hundreds of items are evaluated but when firms fail to adequately evaluate other firms are likely to pay an excessive premium for the other firm

Cost of new product development and increased speed to market

Developing products internally and bringing them on the market is time-consuming. Acquisitions are another means to gain access to new products. Not only quicker market entry but also higher returns can be achieved.

<u>Problem:</u> large or extraordinary debt

- Especially in the 80s/90s, **junk bonds** made risky acquisitions possible (unsecured financing options)
- High debt increases likelihood of bankruptcy, downgrade of firm’s credit ranking

Lower risk compared to developing new products

Acquisitions may be perceived as well risky than when producing own products and entering new markets. However, acquisitions may become a substitute for innovation and thus acquisitions should be strategic rather than defensive in nature.

<u>Problem:</u> Inability to achieve synergy

- Competitive advantage is only achieved when transaction of acquisition generates private synergy (combining both firms’ assets and capabilities which could not be achieved when integrating any two firms’ assets and capabilities)
- Possible when firms’ assets are complementary in unique ways (unique type of asset)
- Bring along *transaction costs* (direct: legal fees, charges; indirect: managerial time, loss of employees)

Increased diversification

To diversify its products lines, firms frequently make use of acquisitions.
Acquisition strategies can be used for both unrelated and related diversification. In general, the more related the acquired firm is to the acquiring firm, the greater the probability the acquisition will be successful.

Example: Disney bought CapCities ABC Channel

<u>Problem:</u> Too much diversification

- Requires more information processing
- Leads to decline in performance which often results in divestments
- Managers need to rely on financial rather than strategic performance evaluations which might have a negative effect on the business (too much short-term focus)
- Tendency for acquisitions to become substitutes for innovation

Reshaping the firm’s competitive scope

Firms use acquisition strategies to lessen their dependence on one or more products or markets and thereby decreasing the negative effects of high intensity of competitive rivalry. Reducing a company’s dependence on specific markets shapes the firm’s competitive scope.

<u>Problem: </u>Managers overly focused on acquisitions

- Times consuming processes such as 1) searching for viable acquisitions candidates, 2) completing effective due-diligence processes, 3) preparing negotiations, 4) managing the integration process
- Managers get overly involved and do not focus on the actual business anymore

Learning and developing new capabilities

Firms complete acquisitions to gain access to capabilities they **lack** (e.g. technological capability). Firms increase their potential to gain new capabilities with *cross-border acquisitions*. Firms are better able to learn those capabilities if they share some similar properties with the firm's current capabilities.

- Acquire resources or capabilities that are
  - Non transferable
  - Not easily replicated
  - Based on tacit knowledge
  - Difficult or less efficient to develop internally

Example: Disney & Pixar – tacit resources

- Personal and professional respect between employees of Disney and Pixar
- Rapid communication to Pixar employees about the merger
- Clear organizational structure map of roles and activities within Pixar that will remain unchanged or that integrated into Disney's practices
- Pixar's president in chard of Disney's Animation Studios
- Protection of Pixar's Creative Culture

<u>Problem:</u> Too large

- Companies becoming too large exceed the benefits of economies of scale and increased market power
- Complexity can lead to *bureaucratic controls* (can lead to rigid and formalized behavior)

Generally, <u>horizontal mergers</u> should be more successful than <u>diversifying</u> ones & <u>related diversification</u> mergers should outperform <u>unrelated</u>.
BUT: no universal rule of thumb

<u>Post-merger integration problems</u>

- Acquisitions are expensive
- **Lemons problem** - the quality of goods traded in a market can degrade in the presence of information asymmetry between buyers and sellers, leaving only "lemons" behind
- (over)diversification
  - inability to value stock
- culture clashes
  - increasingly if there are differences in **both national and corporate culture**
- personality clashes
- management system incompatibilities

Example: Daimler and Chrysler "Merger of Equals"

- Daimler-Benz:
  - Luxury, highly-engineered cars
  - Sold in over 200 countries
  - Yet:
    - Difficulties with (over)diversification strategy
    - Truck division: heavy losses
    - Increase in competitors offering luxury cars
    - Mercedes still not a global player
- Chrysler
  - Bold, risk-taking
  - Offers affordable, well-engineered car
  - Managed escaping bankruptcy a few times since WWII
  - Big Three (with GM and Ford)
  - Highly profitable in the 80s and 90s

- Increased competiton

After the merger ("Merger of equals, not an acquisition"):

- Brands largely kept separate (no synergies)
- No overlapping products (DB: high-end cars; Chrysler: affordable cars) → no synergies
- Entering a slower market growth period
- Very difficult cultural context → strong turmoil between the two companies

Effective acquisitions

Attributes	Results
Acquired firm has assets or resources that are complementary to the acquiring firm's core business	High probability of synergy and competitive advantage by maintaining strengths
Acquisition is friendly	Faster and more effective integration and possibly lower premiums
Acquiring firm conducts effective due diligence	Firms with strongest complementarities are acquired and overpayment is avoided
Acquiring firm has financial slack	Financing (debt/equity) is easier and less costly
Merged firm maintains low to moderate debt position	Lower financing cost, lower risk and avoidance of trade-offs that are associated with high debt
Acquiring firm has sustained and consistent emphasis on R&D	Maintain long-term competitive advantage in markets
Acquiring firm manages change well and is flexible and adaptable	Faster and more effective integration facilitates achievement of synergy

Restructuring

Restructuring is a strategy through which a firm changes its set of businesses or its financial structure. Divesting and downsizing are common restructuring strategy.

- **Downsizing**
  - Reduction in the number of a firm's employees and sometimes the number of operating units
  - Failing to downsize appropriately may prevent the new firm from realizing cost synergies
  - *Short-term outcome*: reduced labor costs
  - *Long-term outcome*: loss of human capital, lower performance

- **Downscoping**
  - Divestiture, spin-off, or some other means of eliminating businesses that are unrelated to a firm's core business
  - More positive than downsizing
  - Refocus core businesses
  - Often used simultaneously to downsizing
  - More increasingly with globalization, enhanced competition and more open markets
  - *Short-term outcome*: reduced debt costs, emphasis on strategic controls
  - *Long-term outcome*: higher performance

- **Leveraged buyouts (LBO)**
  - One party (e.g. private equity firm) buys all of the firm's assets in order to take the firm private; huge amounts of debt included (therefore *leveraged*)
  - Afterwards, stock is no longer traded publicly
  - **Management buyouts (MBO)**→ lead to downscoping, increased strategic focus and improved performance
  - **Employee buyouts (EBO)**
  - **Whole-firm buyouts**
  - *Short-term outcome*: emphasis on strategic controls, high debt costs
  - *Long-term outcome*: higher performance, higher risk

Chapter 10 – cooperative strategy

Firms use three means to grow and improve their performance:
1) Internal development
2) M&As
3) Cooperation

Cooperative strategy is a strategy in which firms work together to achieve a shared objective. Firms use cooperative strategies to serve customers better than competitors and gain advantageous positions relative to competitors.

Strategic alliances as primary type of cooperative strategy

In a **strategic alliance,** firms combine (exchange and share) some of their resources and capabilities to create competitive advantage. It allows firms to leverage their existing resources and capabilities while working with partners to develop additional resources and capabilities as the foundation for competitive advantage.

Competitive advantage developed through a cooperative strategy is called a *collaborative* or *relational* advantage.

Strategic alliance – formal agreement between two or more separate companies in which they agree to work co-operatively toward some common objective

What makes alliances "strategic"?
- Build, sustain or enhance a core competence or competitive advantage
- Block competitive threat
- Increase bargaining power of alliance members over suppliers or buyers
- Opens new market opportunities
- Mitigate risk to a company's business

Why do firms form alliances?
- **Access**, rather than acquire capabilities (Intel and DreamWorks)
- Exploit **complementarities** between resources and capabilities owned by different companies
- Share risk
- Lower costs (resource pooling)
- More flexible organizational structures (more adaptive to change)
- Rapidly deployed (crucial in fast changing markets)

Types of strategic alliances

1. **Joint venture**
    a. Two or more firms create a legally independent company
    b. Shared ownership, shared revenues, shared expenses
    c. Often formed to compete in uncertain environments
    d. Effective in establishing long-term relationships and transferring tacit knowledge
    e. Shared risks and costs → shared ownership
    f. Optimal when firms need to combine their resources and capabilities to create competitive advantage that is different than the one they possess independently

e.g.: JV signed between Tata Motors and Fiat Group
To consider:
- The Indian Market, Consumer, Value chain
- Technology (Fiat owns it)
- Fiat India is not profitable
- Country and industry-level cultural differences

2. **Equity strategic alliance**
    a. Two or more firms own different percentages of the company they have formed by combining some of their resources and capabilities

    b. Many foreign direct investments
3. **Nonequity strategic alliance**
    a. Two or more firms develop a contractual relationship to share some of their unique resources and capabilities to create competitive advantages
    b. No separate independent company is formed, thus no equity positions taken
    c. Less formal and demand fewer partner commitments
    d. Unsuitable for complex projects
    e. Licensing agreements, distribution agreements, supply contracts, outsourcing

Reasons firms develop strategic alliances

They allow partners to create value that they couldn't develop independently and to enter markets more quickly and with greater market penetration possibilities. It also reduces competition, enhances competitive capabilities, makes it possible to gain access to resources, take advantages of opportunities, build strategic flexibility and innovate.

The **market type** influences different objectives.

Market	Reason
Slow-cycle (competitive advantages are shielded from imitation for a long time; imitation is costly; close to monopolistic conditions)	• Gain access to a *restricted* market • Establish a franchise in a *new* market • Maintain market stability (e.g. establishing standards)
Fast-cycle (no long-term sustainability, quick and costless imitation)	• Speed up development of new goods or services • Speed up market entry • Maintain market leadership • Form an industry technology standard • Share risky R&D expenses • Overcome uncertainty
Standard-cycle (competitive advantages moderately shielded)	• Gain market power (reduce industry overcapacity) • Gain access to complementary resources • Establish better economies of scale • Overcome trade barriers • Meet competitive challenges from other competitors • Pool resources for very large capital projects • Learn new business techniques

International alliances

- Gain local knowledge
- Political connections
- Access to distribution channels
- If the financial commitment for an acquisition strategy is not attractive to the company
- Share resources and capabilities

Pitfalls of strategic alliances

- Culture clash
- Integration issues
- Expected gains may not materialize
- Becoming too dependent on the new partner
- **Loss of control over access to proprietary knowledge based**, technologies or trade secrets (especially in collaborate R&D)

Cooperative strategies

Business-level cooperative strategy

Business-level cooperative strategy is used to grow and improve its performance on individual product markets. It details what the firm intends to do to gain a competitive advantage in specific product markets.

Types of business-level cooperative strategies

➢ **Complementary strategic alliances**

Business-level alliance in which firms share some of their resources and capabilities in complementary ways to develop competitive advantage. There are two types:

1. ***Vertical complementary strategic alliance***
   a. Firms share their resources and capabilities from different stages of the value chain to create a competitive advantage
   b. Often formed to adapt to environmental changes
   c. Greatest possibility of creating sustainable competitive advantage
2. ***Horizontal complementary strategic alliance***
   a. Firms share some of their resources and capabilities from the same stage/stages of the value chain to create competitive advantage
   b. Focus on long-term product development and distribution opportunities
   c. Can be difficult to maintain (often between rival competitors)

➢ **Competition response strategy**

Competitors initiate competitive actions to attack rivals and launch competitive responses to their competitors' actions. Strategic alliances can be used to respond to competitors' attacks.

- Rather strategic than tactical actions
- Many complementary strategic alliances are formed in response to competition
- More temporary

➢ **Uncertainty-reducing strategy**

Use business-level strategic alliances to hedge against risk and uncertainty (especially in fast-cycle markets or when entering new markets).
More temporary competitive advantage.

➢ **Competition-reducing strategy**

Collusive strategies are often illegal. There are two types of collusive strategies:

1. ***Explicit collusion***
   a. Two or more firms negotiate directly with the intention to jointly agreeing about the amount to produce and the price of the products that are produced
   b. Illegal in Europe and most developed countries (except in regulated industries)
2. ***Tacit collusion***
   a. Several firms in an industry indirectly coordinate their production and pricing decisions by observing each other's competitive actions and responses

b. Results in production output that is below fully competitive levels and above fully competitive prices
c. Tends to be used in highly concentrated industries (e.g. airline or breakfast cereals)
d. *Mutual forbearance*: firms do not take competitive actions against rivalry they meet in multiple markets

Competition-reducing strategy has lowest probability of creating sustainable competitive advantage.

Corporate-level cooperative strategy

Firms use **corporate-level cooperative strategy** to help diversify in terms of products offered or markets served, or both. Cooperative corporate-level strategies are in general broader and more costly than business-level strategies.

Types of corporate-level cooperative strategy

- ***Diversifying strategic alliance***

Cooperative strategy in which firms share some of their resources and capabilities to diversify into new product or market areas. Highly diverse networks of alliances can lead to poorer performance by partner firms. Cooperative ventures are also used to reduce diversification in firms that are too overdiversified.

- ***Synergistic alliance***

Cooperative corporate-level strategy in which firms share some of their resources and capabilities to create economies of scope. It creates synergies across multiple functions or multiple businesses between partner firms.

e.g. Disney and YouTube: YouTube is advertising its movies and products by showing short clips

- ***Franchising***

A firm (franchisor) uses a franchise as a contractual relationship to describe and control the sharing of its resources and capabilities with partners (franchisees).
The franchisor grants the franchisee the right to sell the franchisor's products or do business under its trademarks in a given location for a specified period of time.

- ***Cross-border strategic alliance***

Firms with headquarters in different countries share resources and capabilities.

International cooperative strategy

A ***cross-border strategic alliance*** is an international cooperative strategy in which firms with headquarters in different nations decide to combine some of their resources and capabilities to create a competitive advantage. They increased in recent years and can be formed as M&As.

- Multinational corporations often outperform domestic-only firms
- Firm leverages core competencies that are foundation of its domestic success (e.g. Nike)
- Limited domestic growth opportunities
- Partnering up with firms in host country provides access to resources, knowledge and experience
- More complex and risky than domestic strategic alliances

Network cooperative strategy

A **network cooperative strategy** is a cooperative strategy wherein several firms agree to form multiple partnerships to achieve shared objectives.

- Offering multiple goods and services in multiple geographic (domestic and international) locations
- Particularly effective when formed by geographically clustered firms (e.g. Silicon Valley)
- Effective social relationships and interactions among partner to make it more successful
- *Strategic center firm* (CH13)

Alliances network types

Primary advantage of network strategy is that firms gain access to partner firm's partners. The set of strategic alliance partnerships resulting from use of a network cooperative strategy is often called an **alliance network**.
A **stable alliance network** is formed in mature industries where demand is relatively constant and predictable.

Dynamic alliance networks are used in industries characterized by frequent product innovations and short product life cycles.

Competitive risks with cooperative strategies

- Opportunistic behavior of partner
- Firm has misrepresented the competencies it can bring to the partnership
- Failing to make resources available to the partner
- Make investments while the other partner does not

Managing cooperative strategies

Firms must learn how to manage both tangible and intangible assets. There are two approaches to manage cooperative strategies:

1) Cost minimization
    a. Firm develops formal contracts with its partners
    b. Specify how cooperative strategy is to be monitored and how partner behavior is controlled
    c. Minimize strategy's cost and prevent opportunistic behavior by partner
2) Opportunity maximization
    a. Maximize partner value-creation opportunities
    b. Less formal contracts with fewer constraint on behavior
    c. Costs are less than with the other approach

Guest lecture

The scientific method

Scientific method

- Descriptive
- Focused on understanding
- Focus on insight
- 100% certain

Problem solving

- Prescriptive
- Focused on decision making under time and information constraints
- 80% better than 100%

Seven steps of the scientific method

1. Define the problem
    a. Problem definition = One specific question about what to do (one sentence)
        i. Understand and reformulate the context you've been given
    b. Questions fall within three categories:
        i. Binary question (Yes vs No) → Closed question
        ii. Which options should we choose (option 1, option 2, option 3) → Closed question

        iii. How can we achieve objectives (we know end results but don't know the way) → Open question
    c. E.g. HelpDesk: profitability declined
        i. Good problem formulation: *How can HelpDesk increase its profits? (still a bit vague)*
        ii. *How can HelpDesk increase profits through cost reduction (more specific but in context, there was nothing about cost reduction)*
        iii. *How can HelpDesk increase profits by 10 million in 2 years? (good formulation; take context of clients and then reformulate it)*
2. Structure the approach
    a. Break it down into smaller questions
    b. What doesn't work:
        i. Jumping to 1^{st} ideas that come to mind
        ii. Researching or analyzing data in the hope to find something
    c. For HelpDesk, break question into:
        i. How can HelpDesk increase revenue?
            1. Increase numbers of contracts? → Company already growing
            2. Increase revenue/contract? → Contract prices sticky, competitive industry
        ii. How can HelpDesk reduce costs?
            1. Reduce call center costs? → Efficiency: reduce time per call
            2. Reduce dispatch costs? → Reduce volume of dispatch, improve efficiency of dispatch
            3. Reduce overhead costs? → consolidate suppliers
    d. Step 1: Unpack key assumptions
        i. What would have to be true
        ii. What would make it NOT true
    e. Step 2-3: Find a way to "prove" assumptions
        i. Assumption: Referral rates differ across CC technicians
3. Prioritize and hypothesize
4. Design analyses and work plan
5. Collect data and conduct analyses
6. Synthesize and recommend
7. Structure the final presentation
    a. 1. The problem
    b. 2. Give the answer
    c. 3. Why is that the answer
    d. 4. Make comments on the answers

Tips for SM slides:

1. Each slide should have one message (include verb in the title of the slide)

Check that analyses are robust

- Defendable?
    - Logical
    - Based on verifiable facts or expert opinions

Lecture 6

Entrepreneurial Strategies
(Chapter 14 – Strategic entrepreneurship)

Strategic entrepreneurship is the process of taking entrepreneurial actions using a strategic management perspective.
Organizational actors attempt to identify opportunities in the external environment that can be readily exploited through internal adaptation and innovation.

- *Entrepreneurship dimension:* **search** dimension (intensified scanning of activities)
- *Strategy dimension:* **internal selection** that determines the best way to manage the firm's adaptation to external environment
    - Helps the established firm to renew their product and service base and venture into markets previously unexplored
    - Limited to financial risk assessment regarding future benefits

Corporate entrepreneurship is the use or application of entrepreneurship within an established firm.

Entrepreneurship and entrepreneurial opportunities

Entrepreneurship is the process by which individuals, teams or organizations (either on their own or inside organizations) *identify and pursue entrepreneurial opportunities* without being immediately constrained by the resources they currently control.

- Results in the "creative destruction" of existing products

Entrepreneurial opportunities are conditions in which new goods or services can satisfy a need in the market.

- Exist because of competitive imperfections
- Timing as essential aspect

Difficult with continuous innovation within established firm is threefold:

- **Internal retention processes** – organizational actors are focused on existing activities and refrain from new ones because of <u>uncertainty</u> and possible <u>future penalties</u> in case of failure
- **Path-dependent portfolios:** If organizational actors do decide to develop an outward looking notion, they are <u>constrained</u> by <u>vested interests</u> and <u>current portfolio</u> of activities
- **High failure rate:** Only 5-10% of efforts turn out to be successful
    - Embrace entrepreneurship

Innovation

Innovation is the specific function of entrepreneurship, whether in an existing business, service institution or new venture. It is the means by which the entrepreneur either creates new wealth-producing resources or endows existing resources with enhanced potential for creating wealth.

- Key outcome firms seek through entrepreneurship
- Source of competitive success
- Increases capacity for action should entrepreneurial activities arise

Invention – the act of creating or developing a new product or process.
Innovation – the process of creating a commercial product from an invention

- Most critical

Imitation – the adoption of a similar innovation by different firms

- Leads to product or process standardization

Incremental and radical innovation

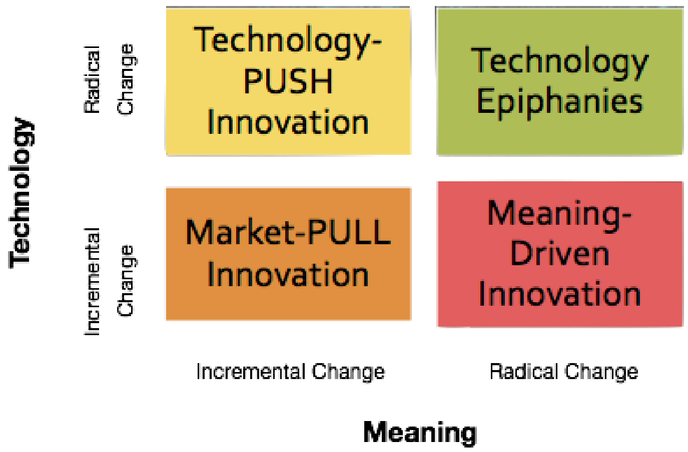
- **Incremental innovation:** build on existing knowledge bases and provide small improvements in the current product lines
    - Evolutionary, linear

  - Markets are well-defined, product characteristics are well-understood
  - Profit margins are lower
  - Efficient production technologies
  - Competition based on price

- **Radical innovation**: provide significant technological breakthroughs and create new knowledge
  - Nonlinear, revolutionary
  - Strong profit potential
  - Often developed in separate business units
  - Rare
  - Require creativity
  - More powerful in adding to above-average returns

Internally developed incremental and radical innovations result from deliberate efforts = **internal corporate venturing** (set of activities firms use to develop internal inventions and innovations).

- Larger set of <u>radical innovations</u> stem from **autonomous strategic behavior**
- Larger number of <u>incremental innovations</u> stem from **induced strategic behavior**



- **Technology PUSH Innovation**
    - E.g. Amazon Prime Air, Segway
  - Various new technologies that you try to convince people that they really want it

- **Market PULL innovation**
  - <u>Human- or user-centered design</u> assumes that innovation should start by <u>getting close</u> to users and observing their activities
  - Emerges in response to an **already developed and observed** market need
    - E.g. sustainable solutions: recycling bins, reusable carrier bags, hybrid cars, low energy light bulbs → People do want certain solutions; use company to provide solutions that people are willing to pay for

- **Meaning-driven change**
  - You **redesign** business model
    - E.g. *Swatch*: used to pass watches on to generations; Swatch became a fashion item
  - Change **the meaning and the sentimental connection** to the product
    - E.g. *Kodak:* developed Kodak camera; used marketing campaign to convince people that this camera is now a lifestyle thing → completely changed perception of product
    - E.g. *Kitchenware:* changing the company from being functional to being "symbolic objects of irony and affection"

- **Technology Epiphany**
  - Change the **meaning** *<u>and</u>* you use advanced **technology** that wasn't available before

    - Technology and meaning change
        - E.g. *Microsoft Kinect*: specialized for video gamer → game for everyone (like a Wii kind of) (changes entirely the concept)
    - **Push and pull at the <u>same</u> time**
    - New technology; change way at which product is being used; change meaning of product to customer

Autonomous strategic behavior

- Bottom-up process
- Product champion (organizational member with an entrepreneurial vision of a new good/service) pursue new ideas (often through political process) by means of which they develop and coordinate the commercialization of the new product until it achieves success at the marketplace
- Champions are vital to sell ideas to others in the organizations so that the ideas become commercialized
    - Use their social capital to develop informal networks; as process is made these become more formal
- Firm's technological capabilities and competencies are basis for new products and processes
- Requires that knowledge is continuously diffused throughout the firm (diffusion of **tacit knowledge** is vital)

Induced strategic behavior

- Top-down process
- Firm's current strategy and structure foster innovations that are closely associated with strategy and structure
- Results in internal innovations that are highly consistent with current strategy
    - Especially important in industries that draw heavily upon the status quo where firms have high vested interests that have to be protected from new developments

Implementing internal innovations

An **entrepreneurial mindset** values uncertainty in the marketplace and seeks to continuously identify opportunities with the potential to lead to important innovations.

- Required to be innovative and successful internal corporate ventures
- Firms often provide incentives for managers to be innovative and commercialize innovations

Successful introduction of innovations into the marketplace reflects implementation effectiveness.

- Required to effectively integrate various functions involved in the innovation processes to implement incremental and radical innovations resulting from internal corporate ventures

Cross-functional product development team

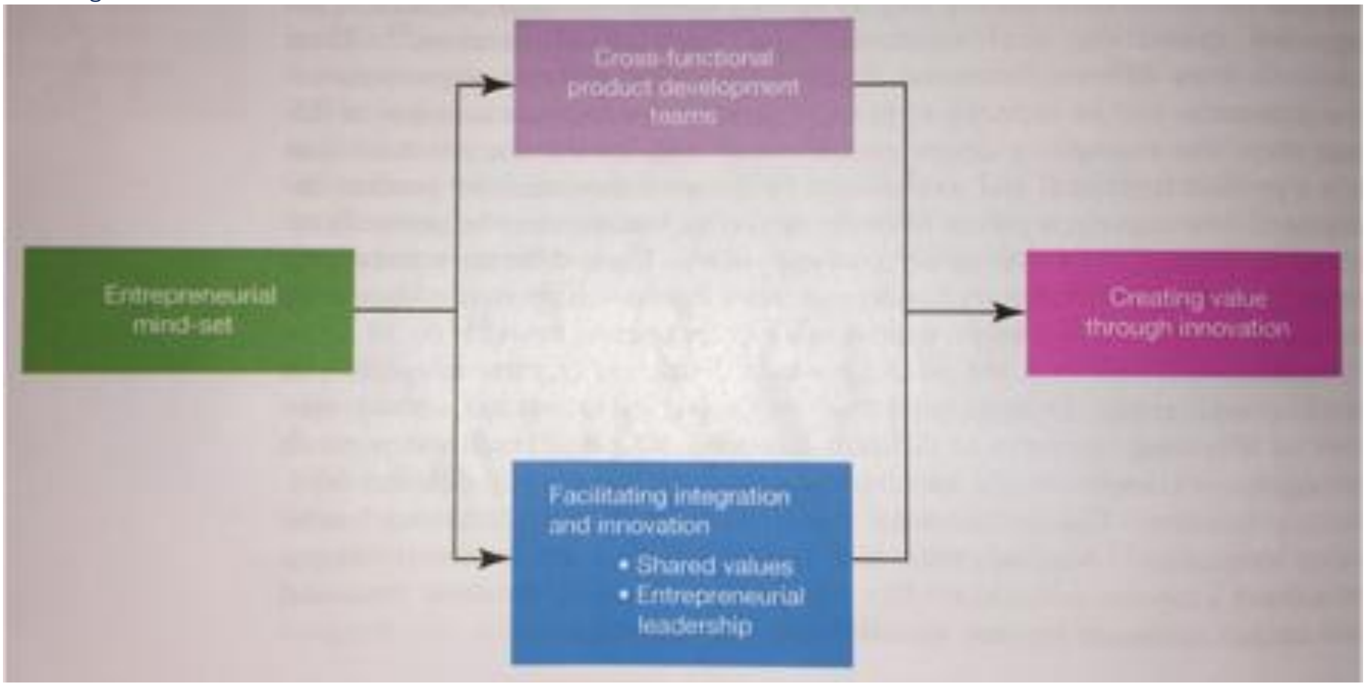
They facilitate efforts to **integrate activities** associated with different organizational functions (design, manufacturing, marketing etc.).

- May include representatives from major suppliers and/or customers
- New product development can be completed more quickly
- Supported by **horizontal organizational structures** to integrate innovation-based activities across organizational functions → organization is built around horizontal hierarchical functions (informal and formal innovation efforts)
    - Allows firm to tailor production to unique core competencies and market needs
- **Shared values** and **effective leadership** needed to implement cross-functional teams

- Barriers that prevent successful use of cross-functional teams:
    - Independent frame of reference of team members
        - Sub-groups are likely to use the same decision criteria due to similar backgrounds, thus perceive product development in different ways
        - Vary along four dimensions:
            - Time orientation
            - Interpersonal orientation

        - Goal orientation
        - Formality of structure
    - Organizational politics
        - E.g. inter unit conflict may result from aggressive competition for resources among those representing different functions

Creating value from internal innovation



Firms can create value from internal corporate venturing processes they use to develop and commercialize new goods and services.

- Entrepreneurial mindset is necessary so that managers and employees will consistently try to identify entrepreneurial opportunities
- Cross-functional teams can promote integrated new product design ideas
- Effective leadership and shared values promote integration and vision for innovation and commitment

- ***Newer entrepreneurial firms*** are often more effective than larger, established firms in the identification of entrepreneurial opportunities
    - Often produce more radical innovations, more risk taking
    - Must learn how to gain competitive advantage
    - Exceed in **opportunity-seeking dimension**
- ***Larger, well established*** firms have more resources and capabilities to exploit entrepreneurial opportunities
    - Must learn how to identify entrepreneurial opportunities
    - Exceed in **advantage-seeking dimension**

Firms operating in different markets tend to be more innovative. **Entrepreneurs are individuals who perceive** entrepreneurial opportunity and then take risks to develop an innovation to exploit it.

Types of strategic entrepreneurship

- **Start-up entrepreneurship**
    - One of the most important drivers of economic growth
    - The start of an entirely **new firm** (without support of parent firm)
    - Adds to level of competitiveness and innovativeness of countries
    - Higher uncertainty due to absence of prior knowledge, experience, customer bases and steady cash flow
    - Not constrained by existing activities and don't have to take into account huge sunk costs
    - Act as guiding light for incumbent firms

  - May be acquired by them in case of breakthrough innovations

- **Venture capital**
  - Not bound to activities or sunk costs
  - More free than incumbent firms who are bound by major investments
  - Venture capitalist have experienced risk evaluation and can offer financial support
  - Provide skilled management
  - Tend to invest in areas where they have created expertise
  - Reduce time-to-market of newly developed products by speeding up the development cycle
    - Higher amount of capital in the expansion phase – shortly after initial investments prove successful

Entrepreneurial Opportunity

Two different approaches:

1. ***Opportunity creation***
   a. Radical, put in the market
   b. *Example*
      i. Internet: created so many opportunities
      ii. Smartphones
   c. ***Schumpeterian approach***
      i. The entrepreneur is an **innovator** who initiates changes through a process of '<u>creative destruction'</u> and recombination of resources
      ii. Entrepreneur <u>disrupts</u> the market equilibrium
      iii. Opportunities are a result of **innovation and creative recombination** of resources, resulting in new-to-the market offerings
      iv. Changes in the economic, political or social context or technological breakthroughs can create space for such market disequilibrium
      v. Require new information, very innovative and rare

2. ***Opportunity discovery***
   a. You are uniquely exposed to information; because of personal experience and perception, you notice things differently → when presented with the same information you interpret it differently
   b. ***Kirznerian approach***
      i. The entrepreneur is **alert** and creates entrepreneurial profits by discovering information and knowledge gaps among people in the market
      ii. Exploit opportunities by acting as an <u>arbitrageur</u> (price adjuster), based on ***information asymmetries***
      iii. *Examples*
         1. AirBnB
      iv. Opportunities can be seized (discovered) by anyone, so long as they observe them first
      v. **Opportunities seen simply as result of differential access to information** > capitalize opportunities (do not require new information or technological advances)

Video entrepreneurs: Richard Branson, Jeff Bezos, Elon Musk, Hoffman (PayPal)

- *Early in entrepreneurial activities*
- *Loners*
- *Geeks*
- *Branson:*

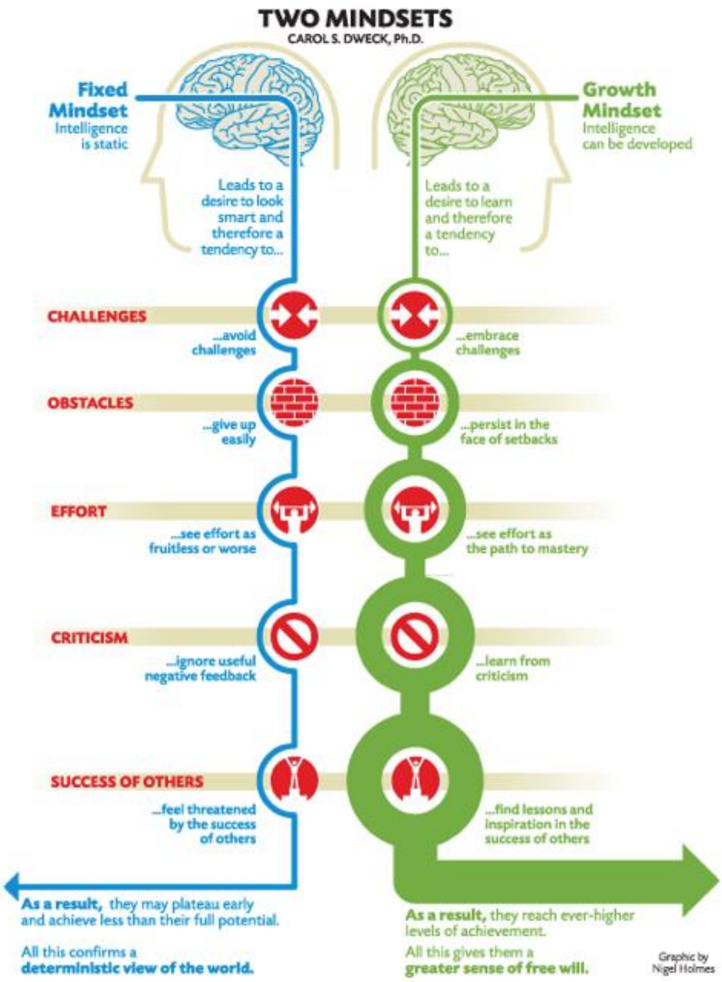
In all entrepreneurs have personal differences
Only differentiator: ***Growth mindset***

Characteristics important for being an entrepreneur
Check "penny stocks" sales pitch

- *Risk taking*

- *Creativity*
- *Locus of control* (degree to which people believe that they have control over the outcome of events in their lives, as opposed to external forces beyond their control)
    - *Internal locus of control: add failures and successes to yourself*
    - *External locus of control: add failures and successes to others (don't feel accountable)*
- *Counterfactual thinking* (human tendency to create possible alternatives to life events that have already occurred; something that is contrary to what actually happened)
    - *Ability to see these 'what-of' scenarios*
- *Need for achievement*
- *Personality traits*
- *Regulatory focus*
    - *Focus on opportunities (to learn)*
    - *Focus on threats*

<u>*Growth vs. fixed mindset*</u>



- ➢ **Growth mindset:**
    - Push to embrace challenges
    - Persistence
    - Effort as path to mastery
    - Learning from criticism
    - Asking for negative feedback

      → they reach ever-higher levels of achievement; greater sense of free will
- ➢ **Fixed mindset**
    - Avoid challenges

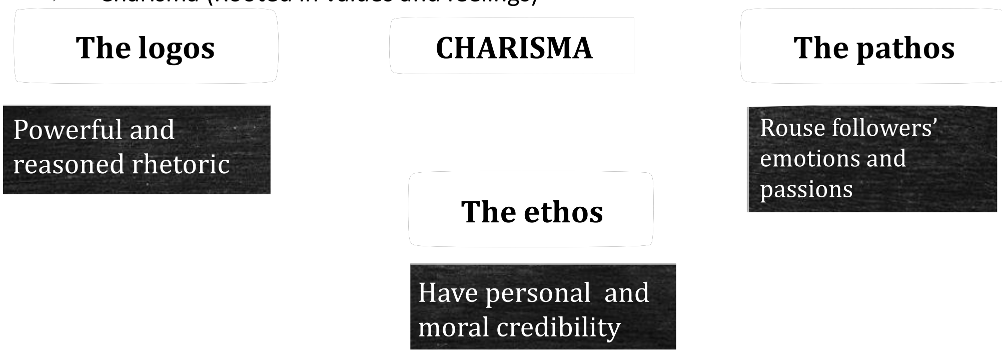
- Give up easily
- See effort as worse/fruitless
- Ignore useful negative feedback
- Feel threatened by success of others
  → plateau early and achieve less than full potential; confirms deterministic view of the world

Silicon Valley company: **E-Leadership**
Characteristics about successful companies:

- Determination: intelligent and not easily demoralized
- Flexibility: “Don’t give up on your dreams” vs. “modify your dreams to do”
- Imagination: Level of intelligence that produces ideas with just the right level of craziness
- Naughtiness (delight in breaking the rules, but not rules that matter)
- Friendship: “strong, genuine relationship between founders”

Other characteristics:

- Charisma (Rooted in values and feelings)



- The **logos** (powerful and reasoned rhetoric)
- The **ethos** (have personal and moral credibility)
- The **pathos** (rouse followers’ emotions and passions)

Charismatic leaders tend to:

- ***Connect, compare and contrast***: metaphors, similes, analogies; stories, anecdotes, contrasts
- ***Engage***: rhetorical questions; three-part lists
- ***Show integrity, authority and passion***: expressions of moral conviction, reflections of group’s sentiments; setting of high goals; conveying confidence that they can be achieved
- ***Rely on nonverbal behavior***: animated voice, facial expressions, and gestures

Entrepreneurial reasoning

= Taking examples from one context and figuring out how to apply them to another context;

Analogies:

- A **novel** problem that has to be solved or a new opportunity that begs to be tapped
- A specific prior setting that individuals seem to be similar in its essentials; a solution that they can ***transfer from its original setting to the unfamiliar context***
- Individuals are especially likely to rely on analogical reasoning in **unfamiliar**, **ambiguous** environments where other forms of thinking, like **deduction**, **break down**

- **Surface Analogs:** Working concepts that you can ‘plug in’ in a different setting

Example: Starbucks: copying coffee concept of Italy to the US

- **Structural analogs:**
  - E.g. Idea of printing press by copying idea of how to make wine (stamping with the foot)

- **Analogs**:
  - Successful predecessors worth mimicking in some way
  - e.g. Sony Walkman and Napster (distribute music over the Internet)

- Pay for a song
- People do enjoy listening to music on the go

- → *Apple* profited from these insights (with the IPod)

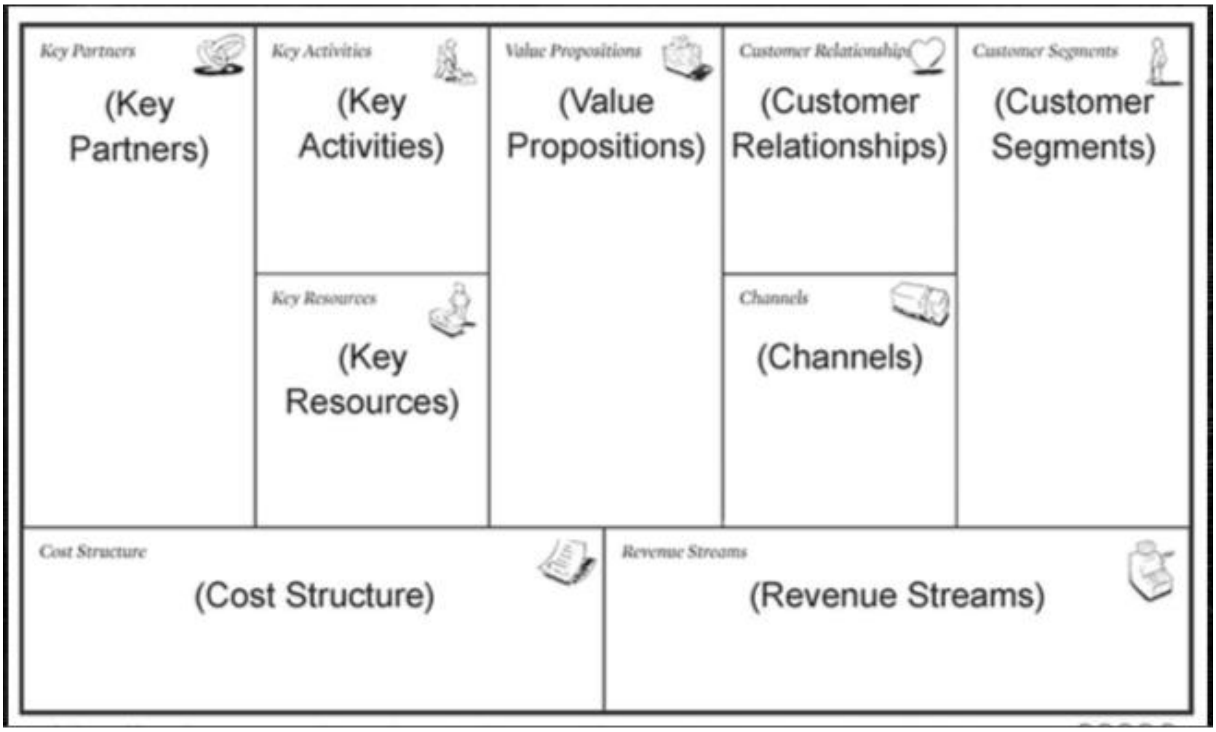
- **Unicorn companies**
  - How was this opportunity being recognized?

Business model innovation

Rather than improving service or product, companies are more changing the entire **business model**.
Over 50% of executives believe business model innovation will become even more important for success than product or service innovation.

How to analyze company's business model?

Business Model Canvas



Example: Airbnb

Corporate venturing

Corporate venturing – an approach to new business development in which companies establish a separate organizational unit (corporate venture unit) that **invests** and **provides** support to **start-up business ventures**

E.g. Samsung Venture Investment Corporation (the corporate venture capital arm of Samsung Group)

Intrapreneurship – Foster **discovery** and **creation** of new business ideas ***within*** established corporation

- 3M, the maker of Post-it notes: workers spend 15% of their time on their own projects
- Google expects them to spend 20% on own projects
- Disney's Gong Show:

Lecture 7

Organizational structure and strategic design
(Chapter 13 – Organizational structure and controls)

Organizational structure specified the firm's formal reporting relationships, procedures, controls and authority and decision-making processes. It determines its capacity

- Properly alignment of elements facilitates implementation of strategy

- **Structural stability** - provides the capacity the firm requires to consistently and predictably manage daily work routines
- **Structural flexibility** - provides opportunity to explore competitive possibilities and then allocate resources to activities that will shape the competitive advantage the firm will need to be successful in the future
  - Allows firm to exploit current competitive advantages, while developing new ones that can be used in the future

Modification of the current strategy requires changes in the structure which can result in inertia from employees. Often, firms change their structures when inefficiencies force them to do so.

Alfred Chandler: Top-level management often refuses to change as it means that they admit that they did something wrong. Thus, structural change is often initiated by **shareholders**.

Organizational controls

Organizational controls guide the use of strategy, indicate how to compare actual results with expected results and suggest corrective actions to take when the difference is unacceptable.

- More effective when fewer differences separate actual from expected outcomes

Strategic controls are largely subjective criteria intended to verify that the firm is using appropriate strategic for the conditions in the external environment and the company's competitive advantages.

- Examine the fit between that the firm *might do* (opportunities in external environment) and what it *can do* (competitive advantages)
- Demand rich communication between managers and those implementing the strategy
- Business-level strategy: used to study primary and support activities
- Corporate-level strategy: used to verify the sharing of appropriate strategic factors such as knowledge, markets, technologies across businesses
- Often used by **differentiation strategy**

Financial controls are largely objective criteria used to measure the firm's performance against previously established quantitative standards (e.g. ROI, ROA, EVA).

- Used for unrelated diversification strategy (difficult for strategic controls)
- Often firms that are largely diversified and **cost leaders**

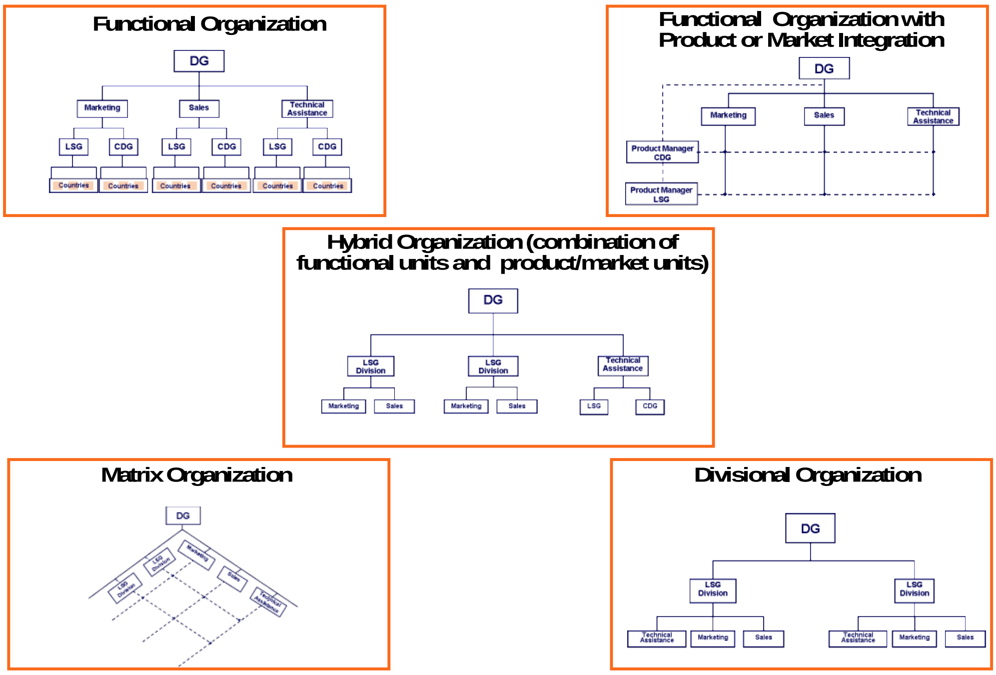
→ Goal: Balance strategic and financial controls

The **Sarbanes-Oxley Act** requires firm's principal executive and financial officers to certify corporate financial and related information in quarterly/annual reports submitted to the SEC

Strategy and structure

- Reciprocal relationship
- Interconnectedness between strategy formulation (CH5-10) and strategy implementation (CH11-15).
- Can influence current strategic actions and choices about future strategies
- More important: *Strategy influences structure more than reverse*

Evolutionary patterns of strategy and organizational culture



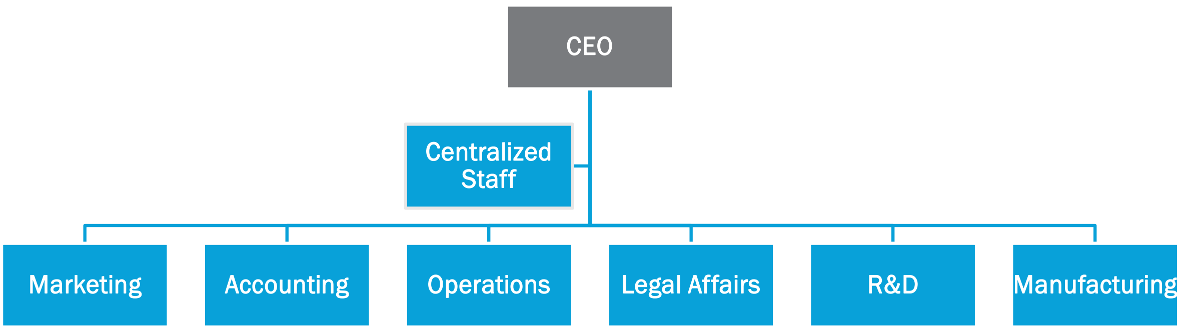
Alfred Chandler: Firms tend to grow first by **volume,** then by **geography**, then **integration** (horizontal, vertical), and finally through **product/business diversification**.

Simple structure

Structure in which the owner-manager makes all major decisions and monitors all activities while the staff serve as an extension of the managers' supervisory authority.

- Informal relationships
- Few rules
- Limited task specialization
- Unsophisticated information systems
- Frequent and informal communication
- Relatively easy to coordinate

Functional structure



Consists of a chief executive and a limited corporate stand, with functional line managers in dominant organizational areas such as production, HR, etc.

- *Functional specialization* that facilitates knowledge sharing within each functional area
- Knowledge exchange
- Little cross-function communication or knowledge sharing
- Can negatively affect communication among different functions
- CEO must ensure that decisions and individual actions of functions help the firm as a whole
- Supports implementing *business-level strategies* and some corporate-level strategies with ***low levels of diversification*** (single/dominant corporate strategy)

When changing from simple to functional structure, firms want to avoid introducing value-destroying bureaucratic procedures that fail to promote innovation and creativity.

Firms use different forms of the functional structure to support implementing the different **business-level strategies**. There are three important structural characteristics:

1) **Specialization** (type and number of jobs required to complete work)
2) **Centralization** (degree to which decision-making is retained at **higher** managerial levels)
3) **Formalization** (degree to which formal rules and procedures govern work)

Using the functional structure to implement cost leadership strategy

- Simple reporting relationships
- Few layers in decision-making and authority structure
- Centralized **corporate staff**; functional areas directly reporting to them and in turn, centralized staff reports of **office of the president**
- Strong focus on <u>process improvement</u> through <u>manufacturing</u> and not R&D

- **Specialization**: highly specialized; work is divided in homogenous subgroups (mostly functions)
- **Centralization**: highly centralized in a staff function
- **Formalization**: highly formalized with many rules/procedures

Using the functional structure to implement the differentiation strategy

- Complex and flexible reporting relationships
- Frequent use of cross-functional product development teams
- Strong focus on marketing and product R&D
- Development-oriented culture (trying ways to further differentiate)
- Strong focus on external environment to identify new opportunities
- Frequent interaction

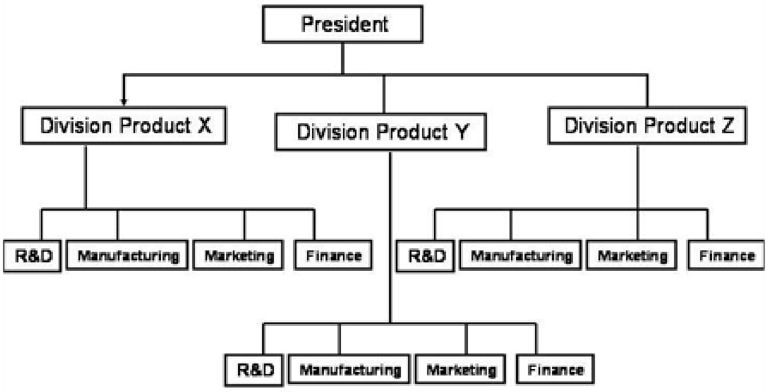
- **Specialization**: not highly specialized in order to promote creativity work
- **Centralization**: decentralized (need for rapid responses to the environment)
- **Formalization**: few rules and procedures

Using the functional structure to implement an integration strategy

- Challenging due to large primary and supporting activities
- Strategy depends on firm's successful combination of activities intended to reduce costs while having activities that differentiate the products

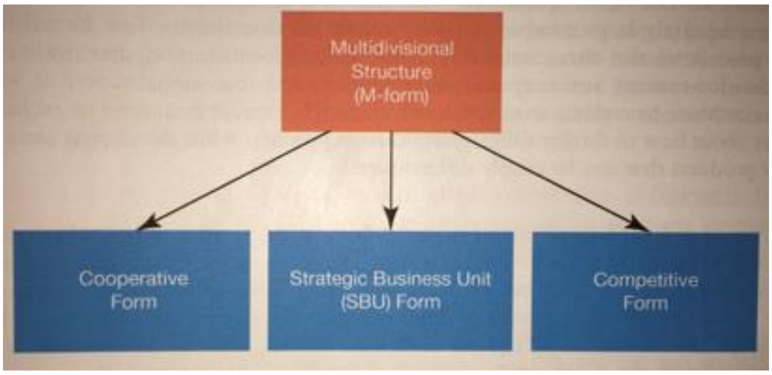
- **Specialization**: semi specialized;
- **Centralization**: partially centralized, partially decentralized
- **Formalization**: some formal and some informal rules

Multidivisional (M-form) structure

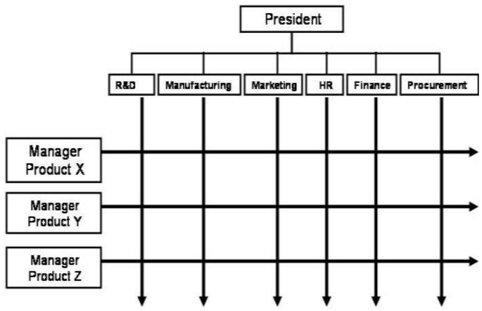


Consists of operating divisions, each representing a separate business or profit center in which the top corporate officer delegates day-to-day operations and business unit strategy to division managers.

- Each division represents a distinct, *self-contained* (independent) business with own functional hierarchy
- Divisions can be organized along **market**, **customer**, **product** or **geographic** lines
- Thought to have 3 benefits:
    - Enabled corporate officers to more accurately monitor the performance of each SBU
    - Facilitated comparisons between SBUs, which improved resource allocation process
    - Stimulated managers of poorly performing SBUs to look for ways to improve performance
- Can inhibit cross-business synergies
- Adopted in diversification strategies
- Appropriate when firm grows through **diversification** (increasing diversification challenges information processing, communication etc. that cannot be handled by the functional structure)

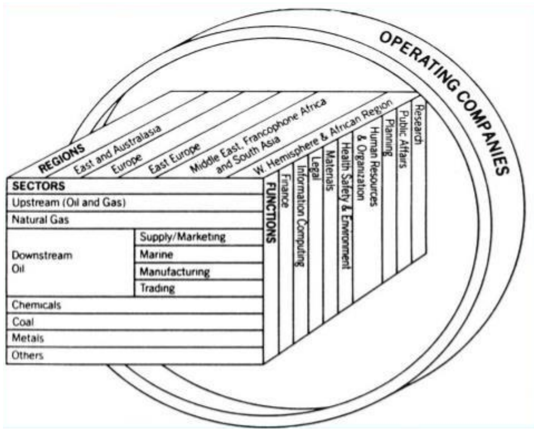


Using the cooperative form to implement the related constrained strategy



The **cooperative form** is a structure in which horizontal integration is used to bring about interdivisional cooperation.

- Based on two (or more) dimensions at once
- Divisions in a firm using related constrained diversification are commonly formed around *products*, *markets* or *both*
- Strong synergies across product lines
- Sharing divisional competencies facilitates corporation's efforts to develop ***economies of scope*** (that are linked with related constrained diversification)
- Direct contact between division managers encourages competencies sharing
- Multiple reporting relationships (***dual reporting***)
- Temporary teams formed around projects
- R&D is likely to be centralized
- Rewards are subjective and emphasize overall corporate performance
- Culture emphasizes cooperative sharing
- Add another additional layer of management



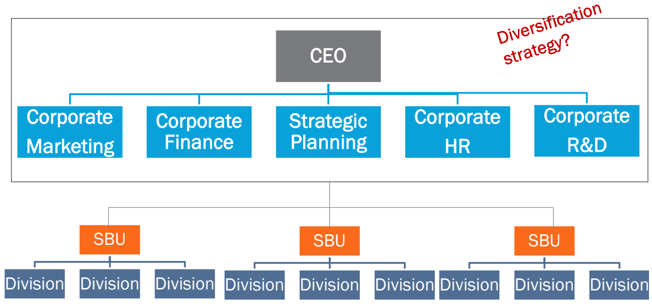
A **matrix organization** is an organizational structure in which there is a dual structure combining both functional specialization and business product or project specialization.

- Can lead to coordination improvement

- **Centralized** at corporate office
- **Extensive** use of **integration** mechanism
- Emphasize **subjective** (strategic) criteria for performance
- Incentive compensation is linked to **overall** corporate performance

Using the strategic business unit form to implement related linked strategy

(Firms with fewer or less constrained links among their divisions).



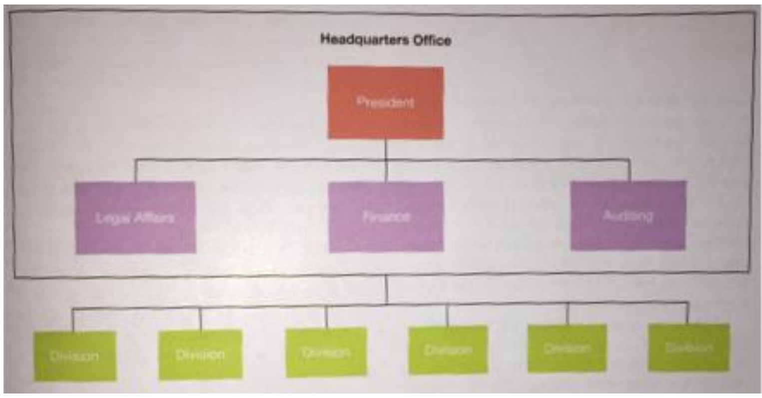
The **SBU form** consists of three levels: Corporate headquarters, strategic business units, SBU divisions.

- Used by large firms, can be complex
- Divisions are related in terms of shared products but have little connection to other SBUs
- Economies of scope within each division (possibly economies of scale)
- Each SBU is a profit center
- Share competencies among SBUs
- Difficult to communicate to stockholders
- Strategic planning as most important functions of headquarters

- **Partially** centralized at corporate office
- **Moderate** use of integration mechanism
- Emphasize **subjective** (strategic) and **financial** criteria for performance
- Incentive compensation is linked to **overall**, **SBU**, and **divisional** corporate performance

Using the competitive form to implement the unrelated diversification strategy

The **competitive form** is a structure characterized by complete independence among the firm's divisions.



- Corporate headquarters has small staff
- Financing and auditing as most prominent functions in the headquarters
- Divisions are independent and separate for financial evaluations
- Divisions retain strategic control, but cash is managed in corporate office
- Divisions compete for resources

- Decentralized to divisions
- Nonexistent use of integration mechanism
- Emphasize objective (financial) criteria for performance
- Incentive compensation is linked to divisional performance

Three benefits from internal competition:

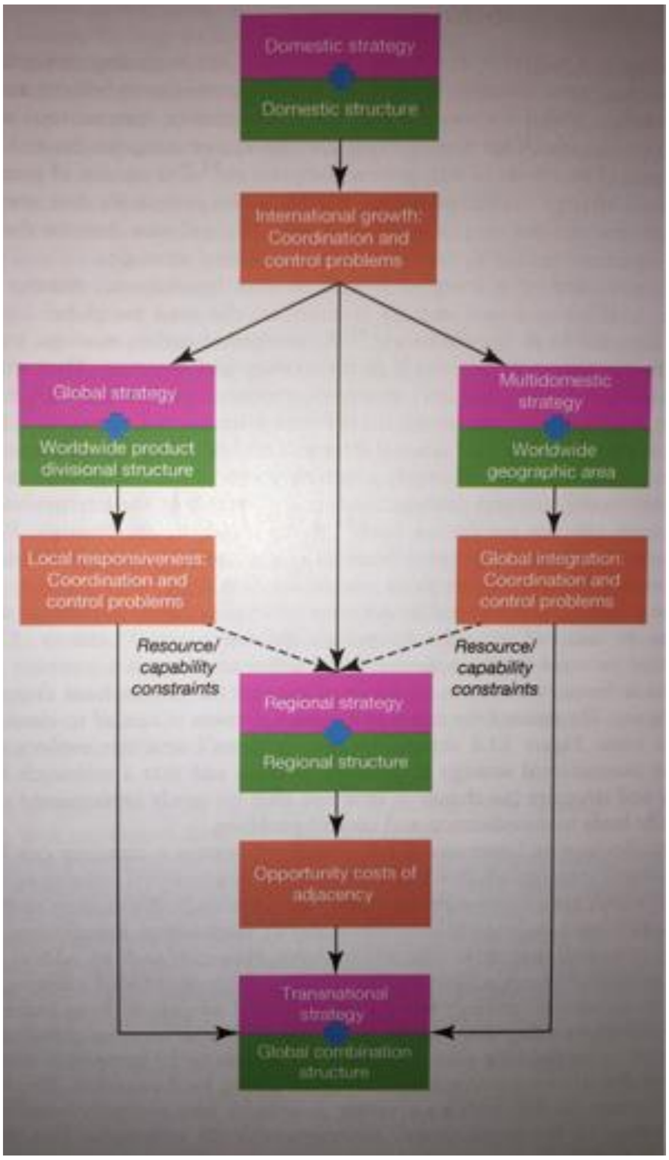
1. ***Creates flexibility*** (resource can be allocated to the division appearing to have the biggest influence on firm's success)
2. ***Challenges the status*** quo and inertia (division heads know that future resource allocations are product of performance)
3. ***Motivates effort*** (challenge of competing against internal peers can be as big as competing against external rivals)

Matches between international strategies and worldwide structure

International strategies are important for long-term success, allow the firm to search for new markets, resources, core competencies and technologies as part of its efforts to outperform competitors.

Combining business-level and corporate-level strategies is based on the need for global integration and local responsiveness. Properly matching international strategies with organizational structure facilitates efforts to coordinate and control global operations.

- Structure needs to adapt as company extends its domestic focus to an international focus



Using the worldwide geographic area structure to implement the multidomestic strategy

The **worldwide geographic area structure** emphasizes national interests and facilitates the firm's efforts to satisfy local differences.

- Mutidomestic strategy focuses on high local adaptation in its international operations
- **Decentralization**
- Emphasis on <u>**differentiation**</u> business-level strategy by local demand to fit an area / country culture
- Corporate headquarters coordinate financial resources among independent subsidiaries
- Requires little coordination among country markets (**low formalization**)
    - Disables firm's ability to create strong global efficiency

Using the worldwide product divisional structure to implement the global strategy

The **worldwide product divisional structure** is where decision-making is centralized in the worldwide division headquarters to coordinate and integrate decisions and actions among divisional business units.

- Global strategy focuses on global integration and thus efficiency based on notion of homogenized global demand
- Fits **cost-leadership** business-level strategy
- Worldwide product divisional structure
    - Difficult in coordinating activities across borders and inability to quickly respond to local needs
- Often used in rapidly growing firms seeking to manage their diversified product lines effectively

- Standardized products across country markets
- Fits cost-leadership strategy
- Centralization of headquarters
- Corporate headquarters use intercoordination devices to facilitate global economies of scale and scope
- Corporate headquarters allocate financial resources

Using the regional structure to implement regional strategy

- Responsive to local customers
- Firms usually located in regions adjacent to domestic regions
- Benefits of applying a "real" global scope
- Similar to structure discussed next

Using the combination structure to implement transnational strategy

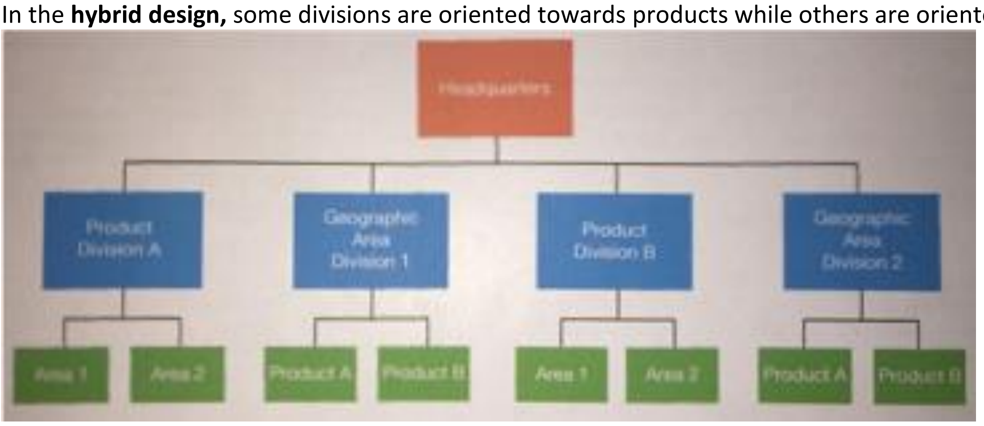
The **transnational strategy** combines multidomestic local responsiveness with global strategy's efficiency.
The **combination structure** is a structure drawing characteristics and mechanisms from both the worldwide geographic area structure and the worldwide product divisional structure.

- Often implemented through two possible structures:
    - **Global matrix form**
    - **Hybrid global design**

The **global matrix form** brings together both local market and product expertise to teams that develop and respond to global marketplace.

- Promotes flexibility and responsiveness
- Employees may be accountable to multiple managers and thus cannot be loyal to all at the same time

In the **hybrid design,** some divisions are oriented towards products while others are oriented towards markets.



The combination structure is

- Simultaneously decentralized and centralized
- Integrated and nonintegrated
- Formalized and non-formalized

Matches between **cooperative strategy** and **network** structure

The **network strategy** exists when partners from several alliances come together in order to improve the performance of the alliance network itself through cooperative endeavors.

A **strategic network** is a group of firms that has been formed to create value by participating in multiple cooperative arrangements. It facilitates discovering opportunities beyond those identified by individuals.
They are used to implement business-level, corporate-level and international-cooperative strategies.

- Strategic center is foundation of structure
- Centralization
- Complex, cooperative interactions between network partners
- Engaged in four primary activities:
    - ***Strategic outsourcing:*** outsources and partners with more firms than do other network members
    - ***Competencies:*** to increase network effectiveness, strategic center seeks to support each member's effort to develop core competencies
    - ***Technology:*** responsible for managing the development and sharing of technology-based ideas among network partners
    - ***Race to learn:*** competition between value chains and networks of value chains → strategic network is only as strong as its weakest value-chain link

Implementing business-level cooperative strategies

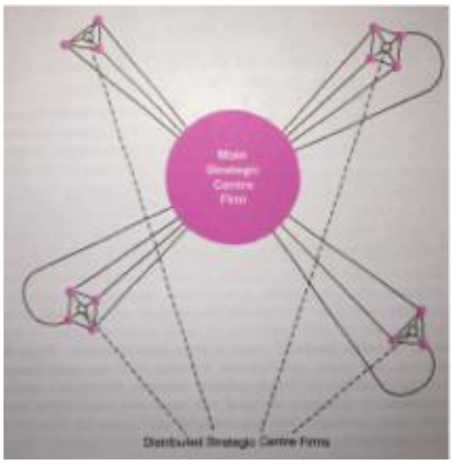
There are two types of business-level complementary alliances (CH10):

- **Vertical** – firms with competencies in different stages of the value chain
    - Implementation issues:
        - *Strategic center encourages subcontractors to modernize their facilities and provides them with technical and financial capital*
        - *Strategic center reduces transaction costs by promoting longer-term contracts with subcontractors* so that suppliers increase long-term productivity
        - *Strategic center enables engineers in upstream companies (suppliers) to have better communication with those companies with whom it has contracts for services*
    - E.g. Toyota: Lean manufacturing

- **Horizontal** – firms with competencies in the same stage of value chain
    - Used less often because governments may suspect illegal collusion
    - E.g. Airlines
    - Difficult to determine strategic center firm

Implementing corporate-level cooperative strategies

Corporate-level cooperative strategies (e.g. franchising) facilitate product and market diversification. E.g. franchising allows firm to use core competencies to extend or diversify its product or market reach



Implementing international cooperative strategies

Strategic networks formed to implement international cooperative strategies result in firms competing in several countries.

Distributed strategic networks are organizational structure used to manage international cooperative strategies.

- Several regional strategic center firms are included

How to decide from the alternatives?

We can organize employees according to:

- ✓ **Common tasks** – cleaners assigned to maintenance tasks
- ✓ **Products** – shelf fillers can go kitchen goods, tableware
- ✓ **Location**
- ✓ **Process** – people are organizing according to quality, assembly, shipping

→ depends on intensity of coordination needs

Factors that have to be analyzed

- ✓ ***Primary***
  - o **Synergies**, economies and similarities within company processes or functions across Products and Markets
  - o **Interdependencies** – across processes of functions within Products or Markets
  - o Product life cycles
  - o Business dimensions factors (market, product, customers, distribution)
- ✓ ***Secondary***
  - o Size
  - o Cultural constraints
  - o Accountability
  - o Interdependencies within processes or functions across products and markets

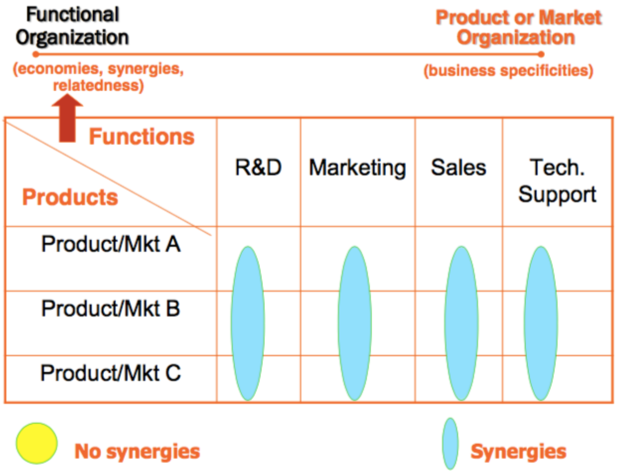
I. Synergies, economies and similarities within company processes or functions across products and markets

Synergies occur

- when two products *share the same customer* (sales & marketing),
- when two products *use same technology* (engineering, manufacturing),
- when two products use the *same raw materials* and components (purchasing)

What is the advantage of functionality integrating the two products?

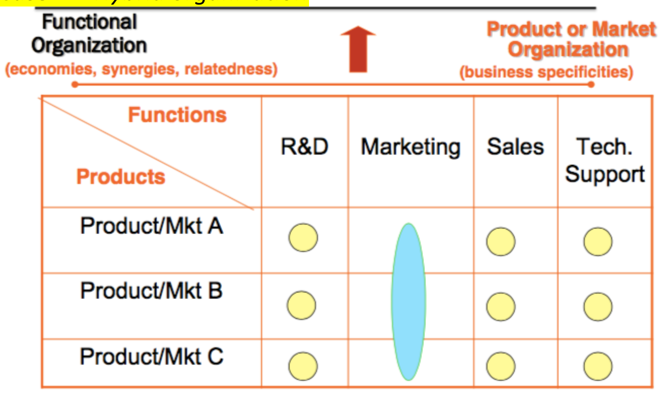
*Case 1 – **Process organization***



Solution: **Process organization**

- Synergies, economies and business **relatedness** among products within the functions
- The best solution is a **functional** organization (**centralized** government)
- High centralization, low delegation to the product/market units

Case 2 – Hybrid organization

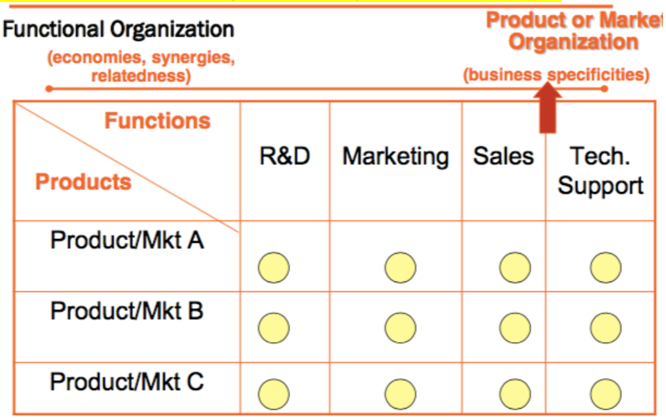


Dots: No synergies; Blue thing: synergies

Solution: **Hybrid organization**

- *Excluding the marketing processes*, no synergies, economies and business relatedness among products within the others
- Low needs of integration among products or market within the processes
- Best solution: Product/market organization with a **centralized unit governing R&D** process for all products/markets
- **High autonomy** (P&L) market and product units

Case 3 – Divisional organization (product or market)



→ Interdependencies across functions within products

Solution: **Divisional organization**

- No synergies, economies and business relatedness among products within the processes
- Low needs of integration among products or market within the processes
- Best solution: ***Product/market organization***
- ***High autonomy*** (P&L) market and product units

The formal hierarchical (bureaucratic) model breaks down, if

- **Markets are turbulent**
- **Innovation is desired**
- **Buyers need customized products**

There is no answer to structure follows strategy vs. strategy follows structure
Select organizational form that is best for problem at hand

Summary of equations

Y Structure and Integration	Xa Synergies across products within functions	Xb Interdependencies across functions within products	Xc Strategy	Xd Product Specificities
FUNCTIONAL	High	Low	Efficiency, Costs, Defender	Low
DIVISIONAL	Low	High	Growth, Innovation, Customer Focus	High
HYBRID (DIVISIONAL WITH CENTRAL FUNCTIONS)	Some	High	Growth, Innovation, Customer Focus, Cost savings	High
MATRIX	High/Med	High	Growth, Innovation, Customer Focus, Cost savings	High

Proctor and Gamble

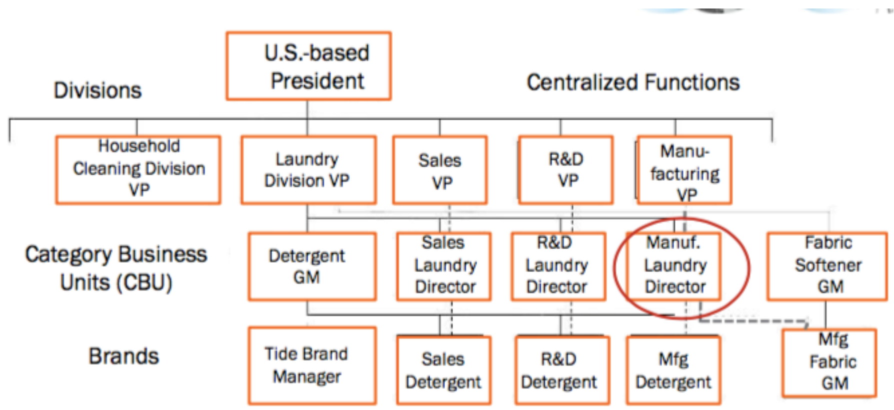
- Established in 1937 by English and Irish immigrant
- Proctor starts as candle maker and Gamble as soap maker
- Strong focus on product differentiation and diversification (one of the first R&D labs)
- 1920-1931: various brands were managed individually
- 1931: focus on product divisions (but still strong centralization for R&D and Marketing)
- 1948-1987: diverging organizational structures
    - US: large, homogenous market
    - Western Europe: decentralized model
- Focus is both on functions and brands: brand managers in the same division compete for market space yet share divisional functions

In the US: **Divisional structure**
Why not a functional structure?

- Not interested in cost minimization but rather on gaining market share and brand recognition
- Invented ‘brand management’ in 1931

P&G in USA:

- 1987: shift away from competitive brand management
- P&G wants to manage categories, not just brands (for instance, not all shampoo brands should go after the same market segment; category manager focus on this!)
- Product categories require more differential functional activities
- 30 US Category Business Units (CBUs) created, ran by general manager (GM)
- Directors report both to functional VPs and to CBUs GMs
- Each CBU: own sales, finance, product development and manufacturing

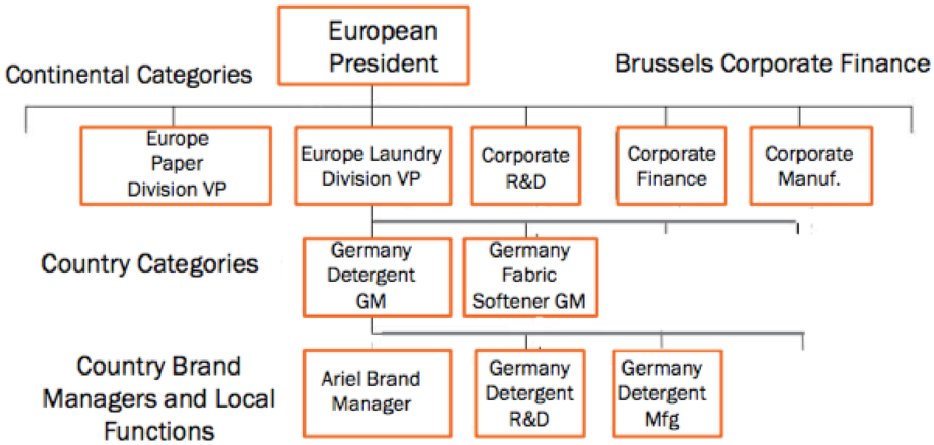


→ Integration between function and product category

P&G in Europe

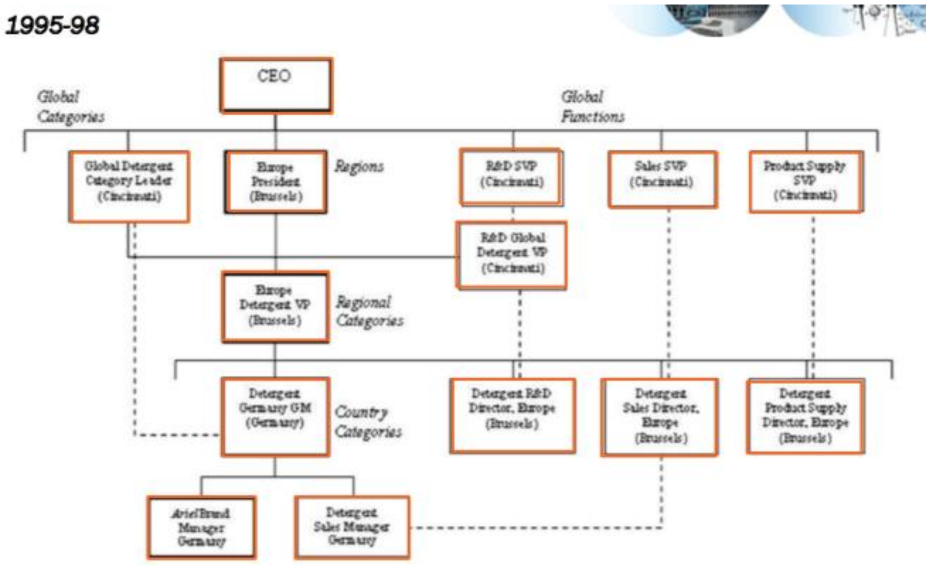
- Initial European design: Mini US
- Self-sufficient subsidiaries led by local GMs
- Country managers (not brand managers) responsible for Profit and Loss
- → innovations could take more than 10 years to globalize (e.g. Pampers)

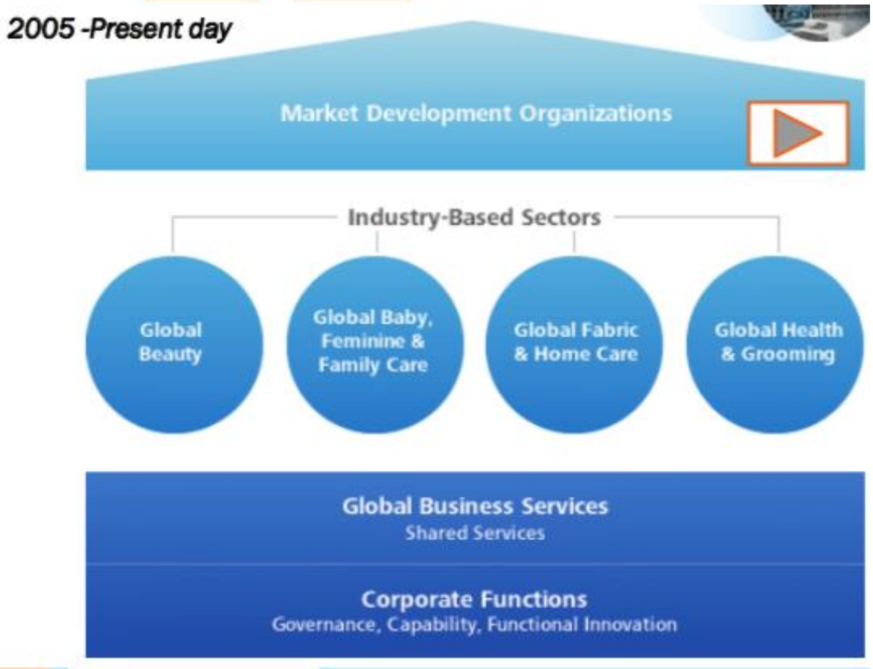
- early 1980s: cross-border cooperation across functions
  → Shift from country to **product-category management**



P&G Global Matrix

- Europe's country functions consolidated into continental ones: dotted line reporting through functional leadership and direct reporting through regional managers
- Global functional senior VPs
- Integration of manufacturing, purchasing, engineering and distribution into global product-supply function
- Powerful and independent global functions ensure knowledge and resource pooling, transfer of best practices

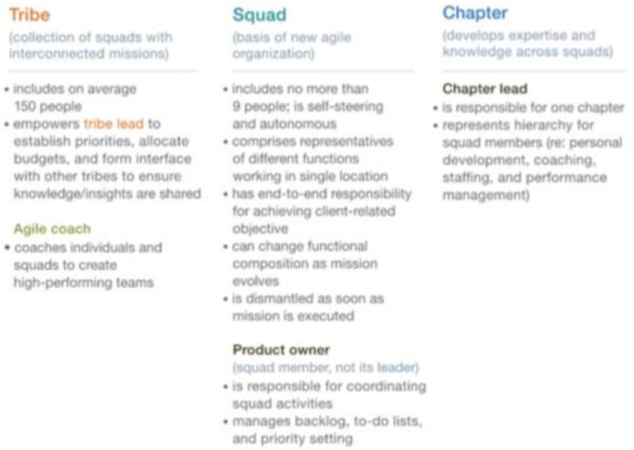




The formal hierarchical (bureaucratic) model breaks down, if:

- Markets are turbulent
- Innovation is desired
- Buyers need customized products

Example
INGs new agile organizational structure has no fixed structure: constantly evolves



Structure follows strategy or strategy follows structure?

There is no one right organizational structure. Rather the task is to select the organizational form that is best for that problem at hand.

Lecture 8

Strategic Renewal
(Chapter 15)

Rapid changes in the environment requires firms to continuously renew by revitalizing and transforming their core activities.

The organization needs to preserve **FIT** between the *external environment* and its *internal organizational* structure, processes, competencies and resources.

The FIT needs to be ***dynamic*** to accommodate to *continuous change* in the environment.
You have to be prepared for <u>discontinuous</u> changes within the environment.
E.g. Start-ups that are flexible can change entirely what is being offered;

Example: George Clooney in Up in the Air, Backpack speech

Path dependence is the (constraining) influence of past stages in organizational development on future decisions and actions.

- Future organizational developments become dependent on past decisions (e.g. structure, systems, routines)
- Problematic when environment changes

Two conflicting forces:

- Need for efficient, stable structure that enables ***exploitation*** (refinement, choice, production, implementation, execution using existing knowledge) of available knowledge and competencies to deal with short term competitive forces
- Firms need to be flexible, transform businesses and explore new sources of wealth through new resource combination: ***exploration*** (search, variation, risk-taking, experimentation, flexibility, discovery, innovation using new learning)

Strategic renewal: definition, theoretical perspectives and dimensions

The fit between firm and its environment should be dynamic and firms have to continuously renew their strategies to maintain fit.
Strategic renewal – adaptive choices and actions that a firm undertakes to alter its path dependence and maintain a **dynamic strategic fit** (firm-specific fit over time between environmental factors and organizational contingencies) with changing environments over time.

- Changing, replacing, refreshing one or more core organizational attributes which might affect firm's long-term performance, and survival

Key challenges for organizations

"The basic problem confronting an organization to engage in sufficient exploitation to ensure its current viability and, at the same time, to devote enough energy to exploration to ensure its future viability"

Exploration activities → search, discovery, autonomy and innovation
Exploitation activities → efficiency control, certainty and variance reduction

If organization can do both activities, it is an **ambidextrous** organization

What makes exploitation appealing?

- ➢ Short-term success

What makes exploration appealing?

How to use exploration and exploitation?

- In a **sequential** fashion – we alternate periods of one or the other activity
  - We focus on large scale organizations
  - Changes take place over long periods of time
  - Easier to switch between formal structures than to change organizational culture or informal norms within organization
    - E.g. Hewlett-Packard
- In a **simultaneous** fashion – we have separate units that are involved strictly in exploitation or in exploration activities
  - Separate structural units
  - Separate competences, processes, incentives and structures
  - What ties these together?
    - Common strategic intent
    - Overarching values
    - Linking mechanisms
- In a **contextual** fashion – integrating systems and processes that allow people to make their own judgment about how to allocate their time between exploration and exploitation activities
  - Ambidexterity means: aligned and efficient in their management of today's business demands
  - Also adaptive enough to change in the environment that they will still be around tomorrow
    - Toyota: workers have both routine tasks (exploitation) but also required to continuously change their jobs (exploration)
    - Importantly,

✓ *All three models are potentially viable*
✓ *Companies may start with structural ambidexterity, switch to contextual and then move back to structural again*
✓ *Pursue simultaneously*
  - *Incremental innovation s*
  - *Architectural innovations (fundamentally*

➢ **Selection perspective**
  - Firms are assumed to be limited in their ability and agility for adaptation
  - Organizations <u>cannot</u> 'catch up' with environmental change
  - Organization forms (or mutations) that survive are chosen by the environment (only if you have certain forms you are able to survive)
  - Look at organization as a ***black box:*** individuals make no difference → only populations of organizations and how do they adapt to environmental changes (you'll die out if you don't have special characteristics)
    - Vs. **white box** – recognizing diversity within populations
    - Darwinian theory

  - Strategic renewal can only be achieved in familiar ways
  - ***Population ecology theory*** – environmental factors "select" organizations that are reliable and specialized (firms that exhibit unique features, resources, competencies and routines that match environmental niche)
    - Based on variation-retention-selection model of biology and verified using quantitative methods
    - After surviving selection, organizations build up **inertia** (persistent resistance to changing organizational features)
    - Opposite of **fitness** (organizational capacity to learn and to change behavioral characteristics or capabilities to fit to new circumstances in organizational environments)

<u>Internal and external sources of inertia</u>

Internal/External	Type of constraint	Locus of constraint	Examples

Internal	**Prior investment**	Intra-firm	Sunk cost; investment in PPP; long-term investments
Internal	**Behavioral predispositions**	Individual & teams	Commitment to status quo; risk averseness
Internal	**Established social structures**	Relation between individuals	Shared identity; culture; strong social ties
External	**Resource dependencies**	Relation between firms and providers of key resources	Long-term contracts; customer bases
External	**Normative expectations**	Firm at interface with society/stakeholders	Collective rationality; industry receipts
External	**Legal and fiscal barriers**	Firm at interface with regulatory agencies	Anti-trust regulations; protectionist policies

- Attempts to adapt to environment might decrease survival likelihood
- Inertia may enable a more effective and economical use of managerial skills in simple environments
- When environments change, inertia lead to "selecting out" the organizations
- **Relative inertia** – responding too slowly to threats and opportunities of environment
- **Hypercompetition –** environmental condition by rapidly escalating competition, high uncertainty, heterogeneity of players and constant disequilibrium and change

- ***Evolutionary theory*** is similar to the population-ecology theory:
  - Limited role for organizational adaptability
  - Population level of analysis
  - Importance of environmental selection
  - Instead of organizational form, focus in evolutionary theories is **routines** (regular and predictable behavior patterns of firms which which day-to-day operations get done)

- ***Resource-based view –*** firms are bundles of tangible and intangible resources and tacit know-how that must be identified, selected, developed and deployed to generate superior performance
  - Competitive advantage due to heterogeneity of resources (VRIM resources)
  - Failing to develop competencies further results in **core rigidities / competence traps**

- ***Institutional theory –*** why firms exhibit **isomorphism** (similarity in strategy and behavioral characteristics between firms)
  - ***Coercive isomorphism*** – political influence and legitimacy constraints that firms face
    - Formal and informal rules
  - ***Normative isomorphism*** – professionalization and conforming to dominant industry values and norms
    - Unwritten
  - ***Mimetic isomorphism*** – standard responses to uncertainty
    - Imitate behavior of firms that are perceived to be successful
    - Reflected in **bandwagon phenomenon** (tendency of firms to follow the behavior and belief of others)

- **Adaptation perspective**
  - Organizations undertake intentional actions to adapt to changing environmental conditions
  - Organizations <u>can</u> 'catch up' with environmental change
  - Organizations can adapt to new changes; respond to changes internally within organization
  - Firms are able to change in *unfamiliar* ways
  - ***Strategic choice theory*** – organizations are not always passive recipients of environmental influences but have the power and opportunity to drive strategic renewal and reshape environment
    - Strategic renewal as dynamic interaction between managerial action and environmental forces

- ***Dynamic capabilities theory*** (extension of resource based theory) – focuses dynamics of resource deployments within firms over time
  - Firms should remain in a **dynamic-capability-building mode** and continuously renew themselves by exploring opportunities arising in their environment
  - Organizational and strategic routines firms use to achieve new resource configurations as markets evolve
  - **Dynamic capabilities** are firm's processes that to integrate, reconfigure, gain and release resources to match and even create market change
    - Organizational and strategic routines by which firms achieve new resource configuration as markets emerge, collide, split, evolve and die
    - Continuous renewal by exploring opportunities in the environment

- ***Organizational learning theory*** – focuses on how organizational members notice, interpret and use information and knowledge to reconsider the fit of firms within their environment
  - Continuous training of personnel
  - Firm's learning and to create **absorptive capacity** – firm's ability to value, assimilate and utilize new *external knowledge* – are principal drivers of strategic renewal

- ***Behavioral theory*** – organizations are coalitions of individuals with their own objectives that need to be satisfied by balancing resource allocation processes
  - Foundation for organizational learning theory and evolutionary theory
  - Decision makers are ***boundedly rational*** and seek to avoid uncertainty by satisficing decision making, maintaining firm performance within industry average and seeking stability
  - Change = result of unsatisfactory firm performance leading to a search for adaptive solutions or *"problemistic search"*

ECOLOGY	STRATEGY
Selection	Adaptation
Inertia	Flexibility
Black box	White box
Population level	Firm level
Indirect competition	Direct competition
Survival	Financial performance
Universal laws	Contingency conditions
Monodisciplinary	Multidisciplinary
Longer run	Shorter run
Managerial irrelevance	Managerial relevance

Dimensions of strategic renewal

Decisions about strategic renewal include ***what*** needs to be changed to alter path dependencies, ***where*** to seek knowledge, and ***how*** to manage the renewal.

There are three dimensions of strategic renewal:

1) **Content dimension** (What)
   a. Which core attributes of the current strategy should be changed, replaced or refreshed → doing more than what is done currently (exploitation) or doing new things (exploration)
   b. E.g. changing product scope, technologies, organizational design, administrative systems
2) **Context dimension** (Where)
   a. Learning **internally** developed through experimental learning
      i. Driven by **experience** and **experimentation** with internal resources, recombination of these, and internal development of capabilities
   b. Learning is **externally** acquired through acquisitive learning

        i. Use external resources and acquiring or cooperating with outside partners
        ii. E.g. M&As, joint ventures
3) **Process dimension** (How and When)
    a. Incorporates temporal sequences of events that unfold as change occurs
    b. Timing, frequency, interaction and volatility of strategic renewal

Incremental and discontinuous strategic renewal

- **Incremental transformation**
    - Adaptation is the outcome of relatively small iterative interactions between patch dependent choices and environmental feedback over time
- **Discontinuous transformation**
    - Renewal is revitalizing company's operations by drastically redefining scope of business, and its competitive approach (or both)

Mostly, it can only be identified by taking a longitudinal perspective towards strategic renewal path. Key distinction is based on *renewal pattern* that emerges over a long period of time.

Organizational learning in strategic renewal

To renew successfully, organizations need to manage their learning trajectories.

"The basic problem confronting an organization is to engage in sufficient exploitation to ensure its current viability and at the same time, to devote enough energy to exploration to ensure its future viability"

Learning have two generic types:

1) **Exploitative learning**
    a. Things you already do – efficiency, control, certainty and variance reduction – **low risk**
    b. Encompasses those actions that lie in line with the organization's current activities and competencies in existing domains
    c. Shorter time orientation; short-term success
    d. Greater certainty
    e. More incremental paths

2) **Explorative learning**
    a. Things you develop newly - Search, discovery, autonomy, innovation – **high risk**
    b. Adds new attributes to the organization's current portfolio of activities and competencies
    c. Turbulent environments
    d. High velocity of change processes
    e. Increased competitiveness
    f. When sufficient resources are available
    g. E.g. launching new products and services, starting up new businesses, entering new markets or new geographic regions
    h. Underlying discontinuous path creations

The flexibility paradox: tension between exploration and exploitation

Distinction between selection and adaptation highlights the tension between stability versus change.

- Firms need to engage in sufficient exploitation while putting enough time and effort into exploration to ensure future viability
- Exploitation associated with more certain returns
    - Only exploiting: trapped in suboptimal stable equilibria
    - Drives inertia and dynamic conservatism; crowds out exploration
    - ***Overexploitation:*** core competencies can become core rigidities and cause a **competence trap** (overexploitation of existing competencies and specialized resources)
- Exploration with more variable and distant in time returns
    - Only exploring: suffer costs of experimentation without gaining many of its benefits
    - Drives out efficiency from exploitation (economies of scale)
    - ***Overexploration:*** creates instability as a consequence of overreactions and excessive information searches; organization exaggerates the importance of local errors and becomes

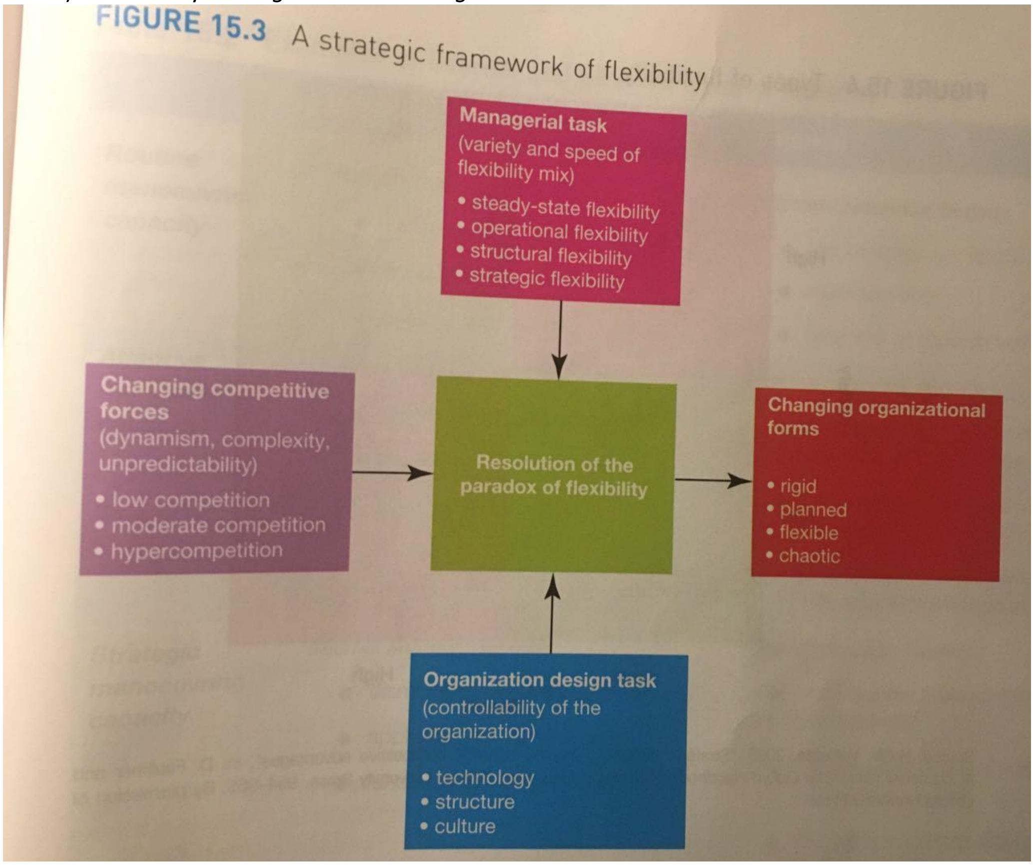
overresponsive to fads and fashion; results in **renewal trap** (overreaction and excessive search resulting in destroyed value)

Strategic framework for flexibility

Firms have to continuously develop and adapt to new sources of advantage and thus become the fastest runner in the Red Queen race (?). This requires new modes of managing and organizing to enable firms to explore new opportunities effectively as well as exploit those opportunities efficiently.

To resolve the paradox of flexibility, the framework suggests two important tasks required:

1) Flexibility is a *managerial task*
2) Flexibility is a *organizational design task*

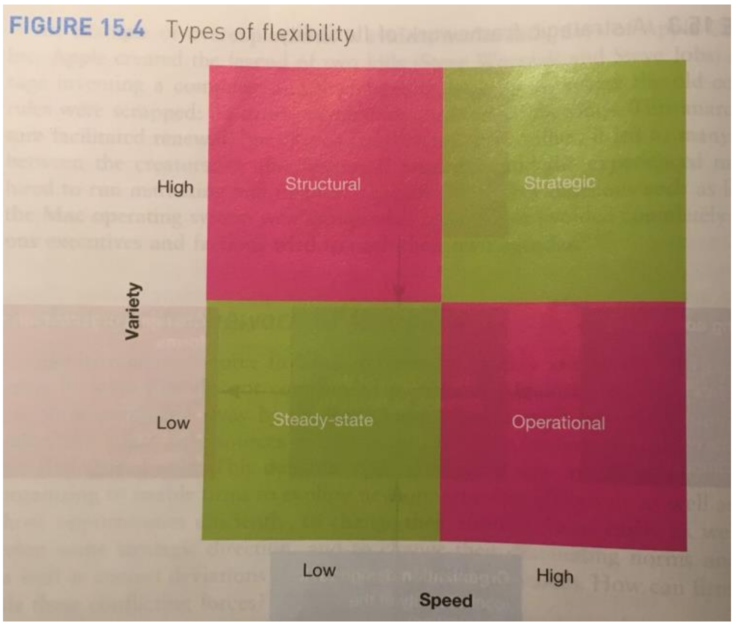


The managerial task: developing dynamic capabilities

Flexibility involves the creation and promotion of capabilities for situations that generate unexpected disturbance. The managerial task consists of two core components:

- **Variety**
  - Managers need a range of capabilities to respond to possible emergences of opportunities or threats
  - In terms of quantity or quality (temporary vs. durable) of capabilities
- **Speed**
  - Flexibility is a dynamic process

The dynamic capabilities that endow the firm with flexibility are manifested in the flexibility mix. Combining different levels of variety and speed results in a flexibility matrix:



1. **Steady-state flexibility** (Low variety, low speed)
    a. Static procedures to optimize firm performance
    b. Only minor change
    c. Relatively low premium on speed of response to external conditions

For the others, there is a distinction between *internal* and *external* flexibility:

- Internal flexibility – management's capability to adapt to demands of environment
- External flexibility – management's capability to influence the environment so that firm becomes less vulnerable to environmental changes

2. **Operational flexibility** (Low variety, high speed)
    a. Consists of routine capabilities that are based on present structures/goals of the organization
    b. Most common type of flexibility
    c. Related to volume and mix of activities (and not kinds of activities)
    d. Provides rapid change to changes that are familiar

	Internal	External
Routine maneuvering capacity	Internal operational flexibility • Variation of production volume • Building up inventories • Use of crash teams	External operational flexibility • Use of temporary labor • Multi-sourcing • Reserving of capacity with suppliers

3. **Structural flexibility** (High variety, low speed)
    a. Consists of managerial capabilities for adapting the organization structure and its decision and communication processes
    b. Provides the firm with capacity to respond to complex change in the environment
    c. Faced with revolutionary changes (unfamiliar changes)

Adaptive maneuvering capacity	Internal structural flexibility • Creating multifunctional teams • Changing managerial roles • Alternations in control systems	External structural flexibility • Purchasing of components from suppliers with JIT • Purchasing of subassemblies from suppliers • Developing of subcomponents together with suppliers

4. **Strategic flexibility** (High variety, high speed)
    a. Consists of dynamic capabilities for adapting the goals of the organization

   b. Provides the firm with capacity to respond to unpredictable changes in the environment
   c. Most radical type of flexibility

Strategic maneuvering capacity	Internal strategic flexibility • Dismantling of current strategy • Applying new technologies • Fundamentally renewing products	External strategic flexibility • Creating new product-market combinations • Using market power to deter entry and control competitors • Engaging in political activities to counteract trade regulations

The organization design task: creating adequate organizational conditions

Ability to initiate managerial capabilities depends on the design adequacy of organizational conditions, such as technology, structure and culture. This determines controllability and responsiveness

- **Organizational technology** – hardware and software used in the transformation of inputs into outputs, as well as configuration of the hardware and software
    - Routine and non-routine
- **Organizational structure** – comprises the actual distribution of responsibilities and authority among the organization's personnel (basic form), the planning and control systems and process regulations of decision-making, coordination and execution
    - Can range from **mechanistic** to **organic**
- **Organizational culture** –to set of beliefs and assumptions held commonly throughout the organization and taken for granted by its members

A typology of organizational forms for coping with competitive environments

Managerial and organization design task have to be matched with various levels of competition to achieve effective flexibility. Four ideal types can be distinguished:

1) **The rigid form strategic programming**
    a. Very restricted flexibility mix dominated by simple procedures (steady-state flexibility)
    b. Choice and variation is limited
    c. No improvisation
    d. Design is characterized by mature, routine technology, mechanistic structure, monotonous culture
    e. Found in static, simple and predictable environments
    f. Little need for flexibility (gets nuisance)

2) **The planned form: strategic planning**
    a. Adequate for firms coping with moderate competition
    b. Dynamic and largely predictable environments
    c. Extensive information-processing capacity
    d. Potential for operational flexibility originating from non-routine technology
    e. Many specific rules, detailed procedures
    f. If non-anticipated changes occur, **strategic drift** (process towards rigidity due to the fact that consciously managed incremental changes in the organization don't keep pace with more radical environmental changes) takes place
    g. Standardization, formalization, specialization
    h. Very detailed planning and control system

3) The flexible form: adaptive strategies
    a. Extensive flexibility mix, dominated by *strategic* and *structural flexibility*
    b. High ability to change organizational conditions
    c. Can adapt to disturbances
    d. Innovative culture
    e. Non-routine technology, organic structure
    f. Effective in non-predictable environments (dynamic, complex)

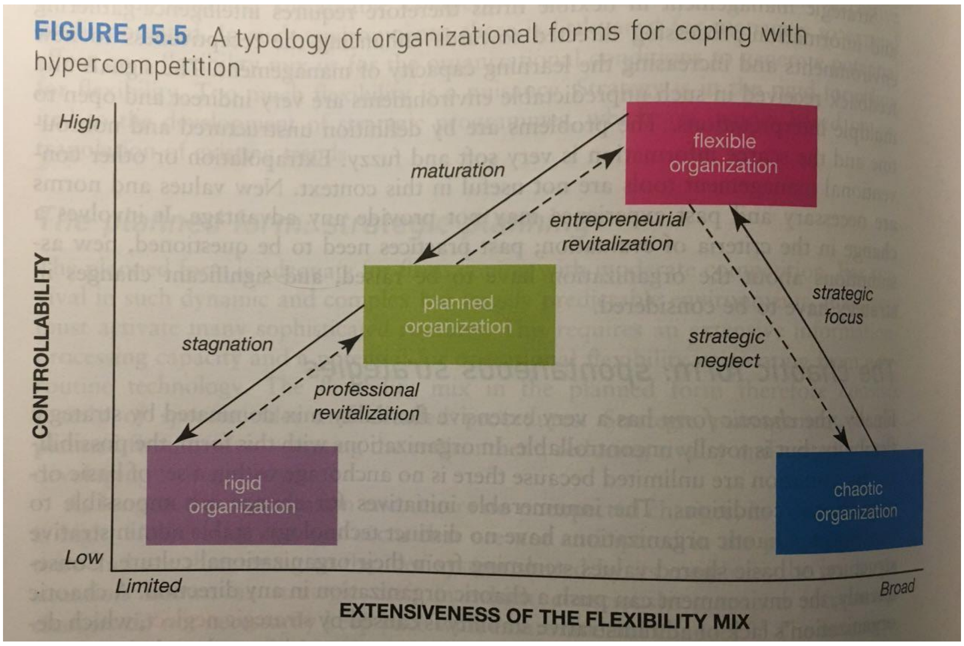
g. Requires intelligence-gathering and information-processing directed towards enhancing receptiveness to new environments and increasing the learning of management

4) The chaotic form: spontaneous strategies

a. Very extensive flexibility mix (dominated *by strategic flexibility*)
b. Uncontrollable
c. No distinct technology, no stable administrative structure or basic shared values
d. Environment can push a chaotic organization in any direction
e. **Strategic neglect** – process towards chaos and reduction of decision-making capacity due to the deliberate tendency of management not to pay attention to a shared strategic orientation or a stable structure
    i. Thus, management decision making is greatly reduced
f. Locked in a Red Queen race, not able to sustain competitive advantage

Single and dual trajectories of renewal

None of the previously mentioned four structures create a permanent solution.



solid line = natural trajectory of routinization
dashed line = reverse trajectory of revitalization

The natural trajectory of routinization: decreasing levels of competition

With decreasing levels of competition, the natural trajectory goes from chaotic state to flexible, planned to rigid forms. Decreasing competition facilitates processing information, and routines.

The **natural trajectory of routinization** is a process of accumulation of specialized routines and fine-tuning of organizational conditions when firms age and competition decreases.

- Suggests that starting entrepreneurial firms and new ventures operate chaotically in order to develop new capabilities
- From the *chaotic organization*, the transition to the *flexible organization* requires a capacity for achieving some degree of **strategic focus**
- With decreasing level of competition, the flexible organization faces a crisis; thus, it must become more efficient to extract greater benefit; it goes through some sort of **maturation** (requires greater need for the firm to professionalize and institutionalize its intelligence-gathering and information-processing functions); ends as *planned organization*
- *Planned organization* runs risk of losing its strategic and structural flexibility as it concentrated increasingly on accumulating and optimizing a large number of operational procedures and routines (operational flexibility); becoming more rigid is a process of **stagnation** which ends as a *rigid organization* (bureaucratic, traditional and resistant to change)

The reversed trajectory of revitalization: escalating levels of competition

Trajectories of revitalization is a process of developing dynamic capabilities and transforming organizational conditions to cope with increasing levels of competition.

- Most likely to be successful in case of hypercompetition
- With increasing levels of competition, firms face the task of shifting back toward the flexibility mix and the organizational conditions of the *planned organization;* this transition is called **professional revitalization** (involved comprehensive and toward adaptiveness, vigilance and diversification)
- As soon as it is inadequate, the *planned organization* must transform itself into a more *flexible form* (**entrepreneurial revitalization**)
    - More organic structure, more heterogeneous, open and externally oriented culture
    - New leadership composed of visionary entrepreneurs, reduction of process regulations
    - Loose organizational forms
    - More open external orientation
    - High tolerance for ambiguity
- Afterwards, the organization faces the danger of overshooting its target and becoming chaotic (= **strategic neglect)**

Dual renewal trajectories in multi-unit organizations

If multiple levels or parts are considered, **dual trajectories** for coping with hypercompetition can be found.

- **Radical transformation** (from rigid to chaos and vice versa): less time consuming, but risk of ending in chaos state is higher; effective when pressing need for organization to respond collectively
- **Sequential revitalization**: more effective when firm is not concerned about a speedy reaction and radical transformation when there is a need for fast collective response

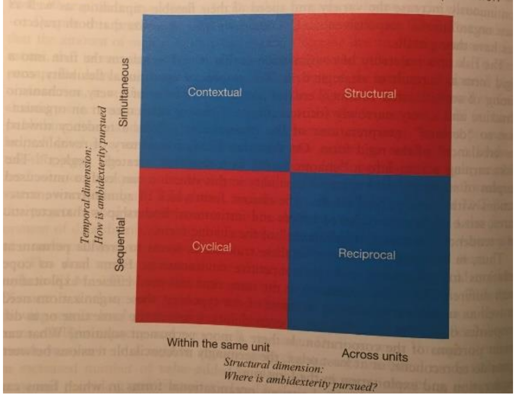
Towards sustained strategic renewal: permanent solutions for multi-unit firm

- Old model of competition: natural trajectory of routinization is most likely
- New mode of rapid, escalating hypercomeptition, trajectory of revitalization is more likely
    - Firms must increase variety and speed of flexible capabilities and organizational responsiveness
    - Risk: transform firm into rigid form as result from strategic drift
- No permanent solution

Ambidexterity = ability to achieve high levels of exploration and exploitation
"The ability to simultaneously pursue both incremental and disruptive innovation, from hosting multiple contradictory structures, processes, and cultures within the same firm"

- **Ambidextrous organization** – an organization that does both things at the same time; leads to:
    - Innovation
    - Market valuation
    - Firm survival
    - Sales growth
    - Subjective ratings of performance

FIGURE 15.7 Generic modes of balancing exploration and exploitation



Organizational ambidexterity: generic modes of balancing exploration and exploitation

- **Contextual ambidexterity** – ***simultaneous*** pursuit of exploitation and exploration ***within*** an organizational unit by creating an organizational context that stimulates individuals to do both
  - At the same time and within same unit
  - Creating organizational context that stimulates people to do both

- **Structural ambidexterity** – ***simultaneous*** pursuit of exploitation and exploration ***across*** organizational units that each specialize in either exploration or exploitation
  - Highly differentiated units, targeted structural integration
  - Compartmentalizing and synchronizing of exploration and exploitation within different structural units or divisions
  - Across units there is **inconsistency** in the activities pursued
  - Cross-functional interfaces, informal connectedness, job rotation, social integration at senior team level, periodic reorganizations

- **Cyclical ambidexterity** – ***sequential*** pursuit of exploitation and exploration within an organization unit over time
  - Alternate in time periods of one or the other activity
  - Small entrepreneurial firms
  - Low sunk costs due to lack of tight connectedness

- **Reciprocal ambidexterity** – sequential pursuit of exploitation and exploration across domains, functions and hierarchical needs
  - Balance across domains of activity
  - E.g. explore upstream but exploit downstream
  - Relationship with ongoing information exchange, collaborative problem solving, joint decision making
  - ***Hierarchical separation*** – top management operates in flexible mode and has high absorptive capacity for exploring new business opportunities
  - ***Functional separation*** – production departments operate in rigid/planned mode, marketing departments in a more flexible and R&D departments in chaotic forms

<u>Overview of balancing modes</u>

Balancing mode	Contextual	Structural	Cyclical	Reciprocal
Locus of balance	Individual, group level	Organizational level	Organizational level	Aggregate across domains
Mechanisms	Mutual adjustment and employee empowerment No buffers between concurrent exploration and exploitation	Separate units dedicated to either exploration or exploitation	Sequential shifts over time from exploration to exploitation	Exploring in one domain while simultaneously exploiting in another domain
Main challenges	Contradictions within units Managing conflict Measuring performance	Coordinating across units Determining levels of differentiation and integration necessary Comparability of performance indicators across different units	Managing transitions between exploration and exploitation	Identifying applicable domains; Deciding whether to explore or exploit
Tension between exploitation and exploration	Orthogonal	Orthogonal	Continuum	Continuum (within domain); orthogonal across domain

- ***Sequential fashion*** – we alternate period of one or the other activity
    - Usually large scale organizations
    - Change takes place over long periods of time
    - Easier to switch between formal structures than to change organizational culture of informal norms within organization
- ***Simultaneous fashion*** – we have **separate** units that are involved strictly in exploitation **or** exploration
    - Separate structural units
    - Separate competences, processes, incentives, structures
        - Common strategic intent
        - Overarching values
        - Linking mechanism
- ***Contextual fashion*** – integrating systems and processes that allow people to make their own judgment about how to allocate their time between exploration and exploitation activities
    - Aligned and efficient in their management of today's business demands
    - Adaptive enough to changes in the environment that they still be tomorrow
    - Culture most promote flexibility and control

All three models viable

- Companies might start with structural ambidexterity, switch to contextual and then move back to structural again
- Always allows you to pursue **simultaneously:**
    - *Incremental innovations* – small improvements which allows them to increase the efficiency of their operations
    - *Architectural innovations* – fundamentally modify components of the business
    - *Discontinuous innovations* – radical advances

Mastering strategic renewal journeys within multi-unit firms: exploring different roles of managers

Strategic renewal trajectories are driven by:

1) External selection forces at industry level
2) Internal forces influenced by managers

Managerial roles of top-, middle-, and front-line management

- Top management

Passive role	Active role
Orchestrators: indirectly influence initiatives for renewal (create right structures and climate)	**Searching role:** identify and define what is needed to ensure alignment between competencies and environment
Retroactive legitimizer: endorse renewal only after they have established them themselves	**Directors**: outline course of action
Judge/arbiters	**Endorsers:** openly advocate change; provide support and legitimacy

- Middle management
    - Function as 'vertical link' within the hierarchy

Passive role	Active role
Implementer: enact mandates for change received from their superiors	**Championing:** devote reputation and skills towards selling issues to top management
	Facilitator: encourage discourse, new perspectives
	Synthesizers: guide sense-making, blend and articulate divergent interpretations of managers in later stages

- Front-line managers
    - Closest to market, current specialized knowledge and expertise

Passive role	Active role
Conforming to prescribed policies	**Experimenting:** improve current approaches, propose new initiatives
Adjusting behaviors to that of subordinates and to new requirements	**Observer**: observe trends, O&T, growth, change

Idealized strategic renewal journeys: interactions between levels of analysis

Four idealized strategies emerge when combining the active and passive approaches of all managers in relation to their environment.

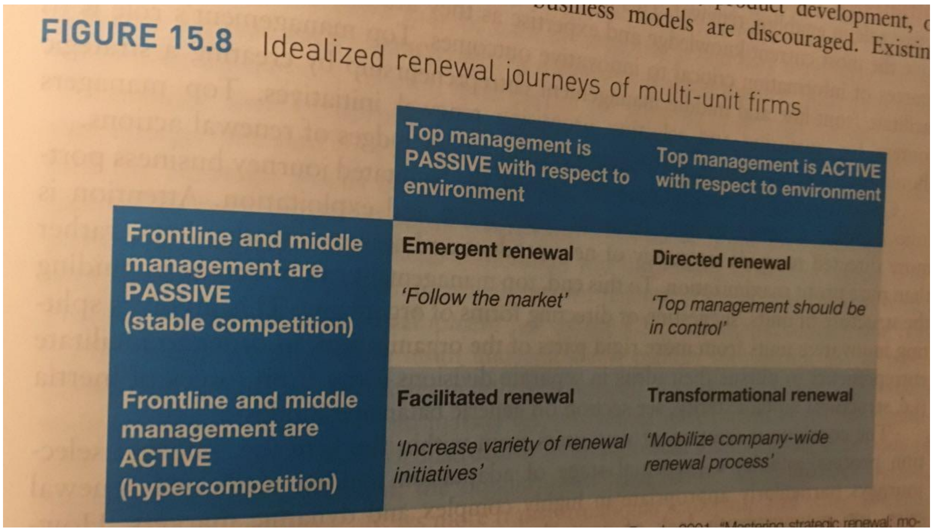


FIGURE 15.8 Idealized renewal journeys of multi-unit firms

	Top management is PASSIVE with respect to environment	Top management is ACTIVE with respect to environment
Frontline and middle management are PASSIVE (stable competition)	Emergent renewal 'Follow the market'	Directed renewal 'Top management should be in control'
Frontline and middle management are ACTIVE (hypercompetition)	Facilitated renewal 'Increase variety of renewal initiatives'	Transformational renewal 'Mobilize company-wide renewal process'

- **Emergent renewal: *Follow the market***
  - Management is passive
  - Internal models (speed, R&D etc.) are discouraged
  - Existing business are evaluated based on **profit-driven**, **market-oriented** approach
  - Often seen in high performing conglomerates

- **Directed renewal: *Top management should be in control***
  - Top management has some power over environment
  - Multi-unit firm is purposeful and adaptive to changes in the environment
  - Strategy making is rational and intentional process
  - Top-down
  - Less suitable for turbulent environment
  - Benefit of formal control and planning
  - Adequate for firms experiencing steady growth or decline

- **Facilitated renewal: *increase variety of renewal initiatives***
  - Lower level of management is active since they have most knowledge
  - Top management should nurture the path and make change possible
  - Better balance between exploration and exploitation
  - Perpetual stage of adaption
  - Highly complex and dynamic markets
  - Lack of control may hamper the multi-unit firm to engage in large-scale developments that require some form of centralization

- **Transformational renewal journey: *mobilize company-wide renewal process***
  - Holistic process
  - Collective sense-making
  - Shared strategic schemas across organizations, social interaction
  - Best in small setting (start-up)

- Possible to enable change quickly
- Systematic rather than piecemeal changes

Renewal journeys of the future

- Market pressures propel **emergent** renewal journeys
  - Represents extreme version
  - Often enforce more rigid standards
- **Transformational:** cooperation between level managers leads to intense learning and difersity
  - **Drawbacks:** poor at dealing with technological discontinuities
- **Facilitated**: very effective in the future business landscape; rather than shaping the pattern constituting renewal (directed renewal), managers shape the context within which it emerges (speeding up the adaptive process)

USA Today: Steps to ambidexterity

I. Change leadership
   a. Appoint new president who is in favor of greater integration between online and newspaper
   b. Hire someone externally to manage TV operations
   c. Replace staff
   d. Let go of senior-level executives
II. Modify incentives
   a. Replace unit-specific goals
   b. Change HR policies
   c. Promotion
III. Modify coordination patterns
   a. Preserve newspaper, online TV units' integrity
   b. Emphasize common mission
   c. Hold meetings
   d. Cross attendance at staff meetings

Alignment of:	EXPLOITATIVE Business	EXPLORATORY Business
Strategic Intent	Cost, profit	Innovation, growth
Critical tasks	Operations, efficiency, incremental innovation	Adaptability, new product, breakthrough innovation
Competencies	Operational	Entrepreneurial
Structure	Formal, mechanistic	Adaptive, loose
Controls, rewards	Efficiency, low risk, quality, customers	Risk taking, speed, flexibility, experimentation
Leadership role	Authoritative, top down	Visionary, involved

(O'Reilly & Tushman, 2004)

Ambidextrous Leadership:

Different alignments are held together through senior-team integration, common vision and values, and common senior-team rewards

Lecture 9

Decision making and top management teams
(Chapter 11 – Strategic leadership)

Strategic leadership is the foundation for successfully using the strategic management process. Strategic leaders guide the firm in ways that result in forming a **vision** and **mission** and they influence **successful strategic actions**, resulting in **formulation of strategies** and **implementation of strategies** which yield in **strategic competitiveness above-average returns.**

Strategic leadership and style

Strategic leadership is the ability to anticipate, envision, maintain flexibility and empower others to create strategic change as necessary. Strategic leadership involves:

- Managing through others
- Managing an entire enterprise rather than a functional subunit
- Coping with change that continues to increase in the global economy

Strategic leaders must learn how to effectively influence human behavior, often in uncertain environments. Most critical leadership skill is to attract and manage human capital since the lack of talented human capital constraints firm growth. They need to <u>identify</u> and <u>respond</u> to changes in the complex global competitive environment.

Strategic leaders are mostly the CEO, then the board of directors, top management team and divisional general managers. Actually, any individual with responsibility for the performance of human capital and/or part of the firm is a strategic leader.

- **Transactional leadership**
    - Engaging followers through exchange between them and their leaders
    - Clarification and specification of what is expected of followers
    - Intervention to monitor and take action when expected standards are not met
    - Can lead to increase in productivity and innovation as it promotes fairness and reward for clearly specified objectives
    - Contributes to learning
    - New exploratory learning is likely to decrease

- **Transformational leadership**
    - Motivating followers to exceed expectations of others
    - Continuously enrich capabilities
    - Place interests of organization above their own
    - Develop and communicate vision for the organization and formulate strategy to achieve vision
    - Make followers aware of what is needed to achieve valued organizational outcomes
    - Encourage followers to strive for higher levels of achievement
    - Have emotional intelligence (understand yourself, strong motivation, empathetic with others, interpersonal skills)
    - Effective in promoting and nurturing innovation in firms

The role of top-level managers

Factors that affect decision-making discretion of top managers:

1) External environment
    a. Industry structure
    b. Rate of market growth
    c. Number and type of competitors
    d. Nature and degree of political/legal constraints
    e. Degree to which products can be differentiated
2) Characteristics of the organization

   a. Size
   b. Age
   c. Culture
   d. Availability of resources
   e. Patterns of interaction among employees
3) Characteristics of the manager
   a. Tolerance for ambiguity
   b. Commitment to the firm and its desired strategic outcomes
   c. Interpersonal skills
   d. Aspiration level
   e. Degree of self-confidence

Top management teams

Managerial hubris: Gesichtsbehaarung: CEOs begin to believe that they are unlikely to make errors; overestimation.
To mitigate that, firms often use top management team to consider strategic opportunities and problems to make strategic decisions. **Top management teams** are composed of the key individuals who are responsible for selecting and implementing the firm's strategies.

The top management team needs to have knowledge about firm's operations and about the three key parts of firm's environment (general, industry, competitor environment), the internal environment, the stakeholders and competitors.

For this, firms normally need a **heterogeneous top management team** (composed of individuals with different functional backgrounds, experience and education). The more heterogeneity, the more debate and the easier the exchange of ideas regarding radical new products or unchartered markets; leads to higher <u>innovation</u> ("think out of the box") and <u>better strategic decisions</u> (leads to strategic change), and thus, higher firm <u>performance</u>.
However, the more heterogeneous, the more difficult effective communication.

The board of directors is an important governance mechanism for monitoring firm's strategic direction and for representing stakeholders' interests (in particular of shareholders). The more the board is involved, the higher performance achieved. Since the CEO influences the board, the CEO's strategic decisions is related to the board and how it chooses to oversee the actions of the CEO and top management team.

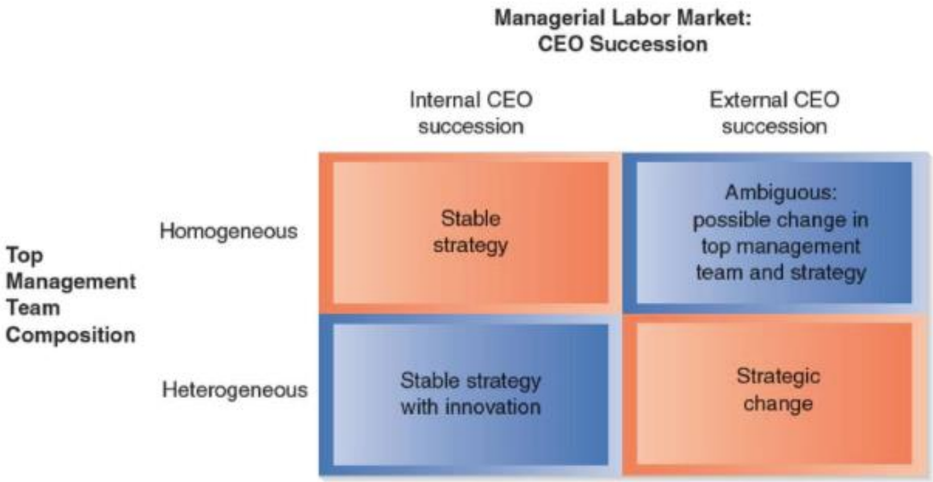
- Independent board structure: enhances board's ability to monitor top-level managers' decisions and actions
- CEO has dual roles: facilitation of effective decisions and actions → increased effectiveness

Long tenured CEOs and management teams have higher influence on board but is thought to constrain the breadth of executive's knowledge base (fewer alternatives but still more strategic control).

- Volatile market needs CEO that can respond quickly (so diverse team may prevent necessary strategic actions)

Managerial succession

Organization select managers from two types of managerial labor markets:
1) **Internal managerial labor market**
   a. Consists of firm's opportunities for managerial positions and the qualified employees within that firm
   b. Insiders are familiar with the products, markets, technologies, operating procedures
   c. Produces lower turnover among existing personnel
   d. When firm is performing well, internal succession is preferred to sustain high performance
   e. Used widely in Europe, Japan and US
2) **External managerial labor market**
   a. Collection of managerial career opportunities and the qualified people who are external to the organization in which the opportunities exist
   b. Preferred when wanting a diversified portfolio of management team
   c. Used when previous long tenure decreased motivation of former CEO



Increasing talent from internal and external parts of the firm increases the likelihood that the firm will be able to form an effective top management team.

Key strategic leadership actions

Effective strategic leadership is about:

- **Determining strategic direction**:
  - Involves specifying the image and character the firm seeks to develop over time
  - The strategic direction is framed by the context of conditions (threats/opportunities) that strategic leaders expect their firm to face in the next 3-5 years
  - The ideal long-term strategic direction has two parts:
    - Core ideology
      - Motivates employees through company's heritage
    - Envisioned future
      - Motivates employees to stretch beyond their expectations of accomplishment
      - Requires significant change and progress
      - Serves as a guide to many aspects of the strategy implementation (motivation, leadership, employee empowerment, organizational design)

- **Establishing balanced organizational control:**
  - Controls help build credibility, demonstrate value of strategies to firm's stakeholders, promote and support strategic change
  - Types of control:
    - *Strategic control*
      - Focuses on content of strategic **actions** (and not outcomes)
    - *Financial control*
      - Focuses on short-term financial **outcomes**
  - **Balanced scorecard** for both strategic and financial control
    - Most appropriate for business-level strategies (but also possible for other)
    - Perspectives:
      - Financial perspective: growth, profitability
      - Customer perspective: amount of customer value
      - Internal business processes:
      - Learning and growth: innovation, growth
- **Effectively managing firm's resource portfolio:**
  - Maybe most important strategic leadership task
  - Firms' resources are divided into:
    - Human capital
    - Financial capital
    - Social capital

        - Organizational capital
          → manage each type of resource *and* manage integration of resources
    - *Exploiting and maintaining core competencies*
        - Strategic leaders must verify that the firm's competencies are emphasized when implementing the strategy
        - Core competencies are often effectively exploited when developed and applied across different organizational units
        - Continuously develop and maybe change core competencies
    - *Developing human and social capital*
        - **Human capital** refers to the knowledge and skills of a firm's entire workforce (people seen as the strongest sustainable source for CA); training and development programs
        - **Social capital** involves relationships inside and outside the firm that help the firm accomplish tasks and create value for customers and shareholders
            - External social capital is increasingly critical; can be developed by strategic alliances

- **Sustaining an effective organizational culture**
    - **Organizational culture** = complex set of ideologies, symbols, core values that are shared throughout the firm and influence the way business is conducted
    - Critical factor of CA
    - *Entrepreneurial mindset*
        - Entrepreneurial opportunities as vital source of growth and innovation
        - Invest in opportunities and real options
        - Five dimensions of mindset:
            - *Autonomy* (employees are allowed to take actions)
            - *Innovativeness* (firms' tendency to engage in, support new ideas, experimentation)
            - *Risk taking*
            - *Proactiveness* (ability to be market leader and not follower)
            - *Competitive aggressiveness* (propensity to take actions that allow to consistently and substantially outperform rivals)
    - *Changing organizational culture and restructuring*
        - Shaping and reinforcing culture is needed for an effective strategy implementation
        - Only successful when supported my middle and top managers

- **Emphasizing ethical practices**
    - Ethical judgment creates 'social capital'
    - Developing ethical culture by:
        - Establishing and communicating specific goals to describe ethical standards
        - Continuously revising and updating code of conduct
        - Disseminating the code of conduct to all stakeholders
        - Developing and implementing methods and procedures to use in achieving ethical standards
        - Creating and using explicit reward systems
        - Creating work environment in which all people are treated with dignity

Lecture

Heuristics as biases

- **Framing effects**
    - Statements with loss and win
    - Framed as **gain** → Risk-averse
    - Framed as **loss** → risk-loving
- **Misconceptions of chance**

    - Probability of tail/head in a sequence
- **Anchoring heuristic** – using a known benchmark ti estimate a probability that is actually completely unrelated to the anchor statement
- **Availability heuristic** – ease with which information is retrievable to you

Other reasoning approaches

Pattern-Recognition & Experience

- Process through which individuals identify ***meaningful patterns*** in complex arrays of events or trends
- The ability to ***recognize opportunities*** for new ventures because of perceived connections (e.g. advances in technology, changes in markets, shifts in government policies)
- Detect meaningful patterns in these connections

Analogical reasoning

- A **novel** problem that has to be solved or a new opportunity that begs to be tapped
- Specific prior setting that individuals deem to be similar in its essentials; solution that they can *transfer* from its original setting to the unfamiliar context
- Deductive reasoning to understand the present (although you cannot assume that every time the future is the same as the past)
- Individuals are especially likely to rely on analogical reasoning in **unfamiliar**, **ambiguous** environments where other forms of thinking like **deduction, break down**

Behavioral strategy

In a perfect world:

- Decision makers are fully rational
- Take into account all

Bounded rationality:

- We are not omniscient: decisions are based on not complete information
- We rely on cognitive shortcuts (heuristics)

Biases

- **Stability biases –** create tendency toward inertia in the presence of uncertainty
    - **Anchoring and insufficient adjustment** – rooting oneself to an initial value, leading to insufficient adjustments of subsequent estimates
    - **Sunk-cost fallacy**
    - **Loss aversion**
    - **Status quo bias** – preference for the status quo in the absence of pressure to change it

→ to minimize all of them, encourage creation of stretch-goals, which are hard to achieve if we simply follow "business-as-usual"

- **Social biases** – arise from preference of harmony over conflict
    - **Groupthink** – striving for consensus at the cost of a realistic appraisal of alternative courses of action
    - **Sunflower management** – tendency for groups to align with the views of their leaders, whether expressed or assumed

→ minimize by creating a climate of trust in which decisions are depersonalized

- **Pattern recognition biases** – lead us to recognize patterns even when there are none
    - **Confirmation bias** – selectively attending to information which is aligned with our personal beliefs and expectations and ignoring or attaching lower importance to evidence against those
    - **Power of storytelling** – tendency to remember and to believe more easily a set of facts when they are presented as part of coherent story
    - **Management by example** – generalizing based on examples that are particularly recent or memorable

    - **False analogies** – relying on comparisons with situations that are not directly comparable
    - **Champion bias** – tendency to evaluate a plan or proposal based on the track record of the person presenting it, more than on the facts supporting it

→ minimize by changing the angle of vision (e.g. several similar case for comparative problem or reframe the problems);

- **Action-oriented bias** – drive us to take action less thoughtfully
    - **Excessive optimism** – tendency for people to be overoptimistic
    - **Overconfidence** – estimating our skill level to others', overestimate ability to affect future outcomes, take credits for past outcomes
    - **Competitor neglect** – tendency to plan without factoring in competitive responses

→ apply a **pre-mortem strategy** – create a clear division between meetings where dissenting voices are encouraged and uncertainty embraces, and meeting where executives are going to take the lead

- **Interest biases** – arise in the presence of conflicting incentives, including non-monetary and even purely emotional ones
    - **Misaligned individual incentives** – incentives for individuals in an organization to adopt views or seek outcomes favorable to their unit or themselves, at the expense of the overall interest of the company
    - **Inappropriate attachments** – emotional attachment of individuals to people or element of the business creating misalignment of interests
    - **Misaligned perception of corporate goals** – disagreements about the hierarchy or relative weight of objectives pursued by the organization and about trade-offs between them

Decision-making strategies in practice

Kodak case

- Decision making culture: avoid risk, maintain status quo

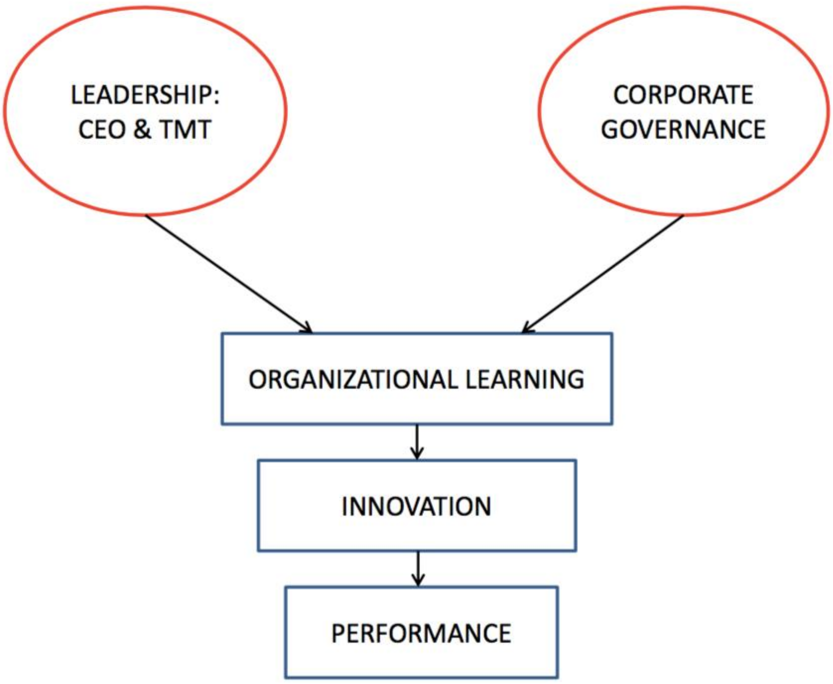
Issues:

- **Cognitive inertia** – when firm gets locked into its traditional ways of thinking about the industry and their positions in the market
    - Hard to adapt their theories, beliefs and assumptions
- **Action inertia** – some strategic options may meet more resistance than others
    - Even if some options are more attractive, strategists should be aware that those may also have action inertia attached to them

Seeing THREATS vs. seeing OPPORTUNITIES

Lecture 10

Corporate governance, organizational learning & performance



Chapter 12 – Corporate governance

Corporate governance is the set of mechanisms used to *manage* the relationship among stakeholders and to determine and control the strategic direction and performance of organizations.

- Concerned with identifying ways to ensure that strategic decisions are made effectively
- Establish harmony between parties (owners and top management), ensure that both interests are aligned
- Oversee areas where owners, managers and board managers have conflicting interests (election of the directors, general supervision of CEO pay, supervision of overall structure and strategic direction)

Separation of ownership and management control

Separation of ownership allows shareholders to purchase stocks in exchange for taking some risk in the company.
On the other hand, family-owned businesses have less separation of ownership but also face two critical issues as they grow bigger:

- Might not have access to all of the skills needed to effectively manage the firm
- Might need to seek outside capital

The **agency relationship** exists when one or more persons (principal(s)) hire another person (agent) as decision-making specialists to perform a service.

Shareholders (Principals) = Firm owners *hire* **Managers (Agents**) = Decision makers *and create* an **agency relationship** (risk-bearing specialist paying compensation to managerial decision-making specialist).

Managerial opportunism is the seeking of self-interest with guile (i.e. cunning/deceit).

- Attitude (inclination)

- Set of behaviors (specific acts of self-interests)

Product diversification as an example of an agency problem
Increased product diversification increases size and complexity of firm and thus often the compensation of managers while reducing the employment risk of managers.
However, shareholders might prefer that the cash used for diversification is used for other investments with positive NPV.

- Shareholders are likely to prefer **point A** (**curve S**)
→ prefer riskier strategies and more focused diversification

- Top management is likely to prefer **point B** (**curve M**)
→ prefer more diversified portfolios

Agency cost and governance mechanism
Agency costs are the sum of incentive costs, monitoring costs, enforcement costs and individual financial losses incurred by principals because governance mechanisms cannot guarantee total compliance by the agent. The more *diversified the firm*, the higher the agency costs.

- Agency costs highest when there is diffused ownership (i.e. large number of shareholders having small holdings)

More intense governance requires changes in strategies.

Ownership concentration (internal mechanism)
Ownership concentration refers to the number of **large-block shareholders** (typically own at least 5% of a corporation's issues shares) and the total percentage of shares they own.

- Diffuse ownership produces weak monitoring of decisions; makes it difficult for owners to effectively coordinate their actions
- Higher monitoring could encourage managers to avoid strategic decisions that harm shareholder value
- Higher ownership concentration is associated with lower product diversification

The growing influence of institutional owners
Ownership of organizations is more and more concentrated in the hands of **institutional investors** (financial institutions such as stock mutual funds and pensions funds that control large-block shareholder positions) rather than individual shareholders. They now own more than 60% of stock in large US corporations. They become more active in their efforts to influence strategic decisions.

Board of directors (internal mechanism)
Typically, shareholders monitor managerial decisions and actions through the board of directors, which is a group of elected individuals whose primary responsibility is to **act in the owners' interest** by formally monitoring and controlling the corporation's top-level managers.
Boards are experiencing increasing pressure by shareholders due to recent criticism.

<u>Classification of board of director members:</u>

- **Insiders**
  - Active top level managers who are elected to the board because they are source of information about the firm's day-to-day operations
  - Firm's CEO and other top-level managers
- **Related outsiders**
  - Some relationship with the firm (contractual or not) but not involved with day-to-day operations
- **Outsiders**
  - Independent counsel to the firm
  - No easy access to firm's internal information

One-tier boards = combination of insiders, related outsiders and outsiders are jointly responsible for ensuring that top level management acts in interest with shareholders.

- Less effective when CEO has more power
- Leans towards shareholder value maximization
- More responsive
- Relatively weak check on CEO

Two-tier boards = formal separation between insiders and outsiders (in charge for supervision and advice)

- Leans towards stakeholder value maximization
- Better monitoring
- Slow decision making

- Monitoring function
  - CEO selection
  - Set executive compensation
  - Review CEO performance
  - Approve annual budget
- Resource-provision function
  - Bring expertise
  - Access to external networks
  - Strategic direction

Effective boards are:

- Varied set of directors
- Independent outsiders
- Minority representation

Enhancing effectiveness of board of directors

Performance is being evaluated more formally and more intensely. Many boards have initiated voluntary changes, such as:

- Strengthening of internal management and accounting control systems
- Establishment and consistent use of formal processes to evaluate board's performance
- Creation of 'lead director' that has strong powers with regard to the board agenda and oversight of non-management board member activities
- Modification of the compensation of directors (e.g. reducing/eliminating stock options included)

Executive compensation (internal mechanism)

This is the governance mechanism that seeks to **align the interests** of managers and owners **through salaries**, **bonuses** and **long-term incentive compensation**, such as stock awards and options.
Challenges in executive compensation include:

- Link compensation to measurable outcomes (financial outcomes)
- Executive's decision often affects firm's financial outcomes over extended period which makes it difficult to assess current decisions
- Other factors (economic, social, legal changes) also influence performance

Incentive compensation plans are subject to managerial manipulation.

- Annual bonuses provide incentives to pursue short-term objectives
- The longer-term the focus of management compensation, the greater the long-term risks borne by top level managers

Market for corporate control (external mechanism)

The market for corporate control is an **external** governance mechanism that becomes active when a firm's internal control fails.

- Composed of individuals and firms that **buy ownership positions** in or **take over potentially under-valued** corporations so they can form new divisions in established diversified companies or merge two previously separate firms
- Only used when governance mechanisms are weak and ineffective
- **Hedge funds** as activist source for investors
    - Portfolio of stocks/bonds, managed by individuals or team on behalf of large number of investors
    - Activism: allows them to influence the market by driving up the stock price
- The more intense governance environment fostered a more active takeover market
- Private equity firms often seek to obtain lower price by friendly deals

Managerial defense tactics

Firms targeted by hostile defense tactics use multiple defense tactics:

- **Poison pill**: preferred stock in the merged firm offered to shareholders at a highly attractive rate of exchange
    - Preventive
    - High popularity
    - High effectiveness
    - Positive stockholder wealth effects
- **Corporate charter attachment:** An amendment to stagger the elections of members to the board of directors of the attacked firm so that all are not elected during the same year, which prevents a bidder from installing a completely new board in the same year
    - Preventive
    - Medium popularity
    - Very low effectiveness
    - Negative stockholder wealth effects
- **Golden parachute:** Lump-sum payments of cash that are distributed to a select group of senior executives when the firm is acquired in a takeover bid
    - Preventive
    - Medium popularity
    - Low effectiveness
    - Negligible stockholder wealth
- **Litigation:** Lawsuits that help a target company stall hostile attacks; areas may include antitrust, fraud, inadequate disclosure
    - Reactive
    - Medium popularity
    - Low effectiveness
    - Positive stockholder wealth
- **Greenmail:** repurchase of shares of stock that have been acquired by the aggressor at a premium in exchange for an agreement that the aggressor will no longer target the company for takeover
    - Reactive
    - Very low popularity
    - Medium effectiveness
    - Negative stockholder wealth
- **Standstill agreement:** contract between the parties in which the pursuer agrees not to acquire any more stock of the target firm for a specified period of time in exchange for the firm paying the pursuer a fee
    - Reactive
    - Low popularity

  - Low effectiveness
  - Negative stockholder wealth
- **Capital structure change:** Dilution of stock, making it more costly for a bidder to acquire; may include employee stock option plans, recapitalization, new debt, stock selling, share buybacks
  - Reactive
  - Medium popularity
  - Medium effectiveness
  - Inconclusive stockholder wealth

However, research shows that in the 1980s, more than 50% of the targeted firms had above-average returns and not weak and ineffective control systems.

International corporate governance

National governance mechanisms are increasingly becoming similar, but still, there are some differences.

- **Corporate governance in Japan and Germany**
  - Owner and manager are same individual, mitigating agency problems
  - With more than 2000 employees, required to have two-tier boards; *aufsichtsrat* and *vorstand*
  - <u>Negative:</u> inefficient and slow decision making process
  - Change towards US system recently
  - **Keiretsu** in Japan (group of people tied together by cross-shareholdings); focus on consensus; system of relationship investments
- **Corporate governance in China**
  - Changed rapidly recently
  - Privatization of business and development of equity market
  - Firms with higher state ownership tend to have lower market value and more volatility in those values over time

Global corporate governance and ethical behavior

Corporate governance increasingly important globally. Effective corporate governance is also required to attract domestic investors.

The firm's agents (corporation's top managers) make strategic decisions that best serve the interests of the owners. Importance of shareholders vary around the globe (US: most important stakeholder).

- Firm's strategic competitiveness is enhanced when governance mechanisms take interests of all stakeholders into consideration
- More important: ethical behavior and corporate governance

→ only when proper corporate governance is exercised, then strategies can be formulated and implemented that will help the firm to achieve strategic competitiveness and earn above-average returns