CHAPTER **1**

What Is Business Strategy?

LEARNING OBJECTIVES

Studying this chapter should provide you with the knowledge to:

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

Strategy at Apple

STANCA SANDA/Alamy Stock Photo

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

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

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

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

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

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

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

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

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

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

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

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

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

What Is Business Strategy?

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

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

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

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

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

Competitive Advantage

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

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

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

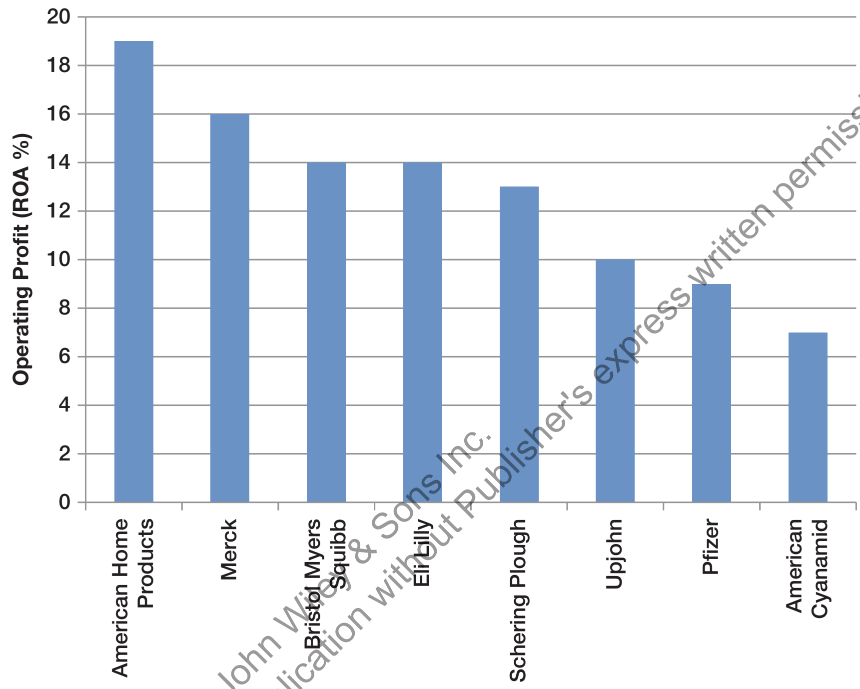
Many organizations work to achieve objectives other than profit. For example, universities, many hospitals, government agencies, not-for-profit organizations, and social entrepreneurs play important roles in making our economy work and our society a better place to live. These organizations do not measure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

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

Strategy in Practice

Measuring American Home Products' Competitive Advantage

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



Profitability of Different Firms in the Pharmaceutical Industry

Source: Annual reports, 1973–1992

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

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

The Strategic Management Process

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

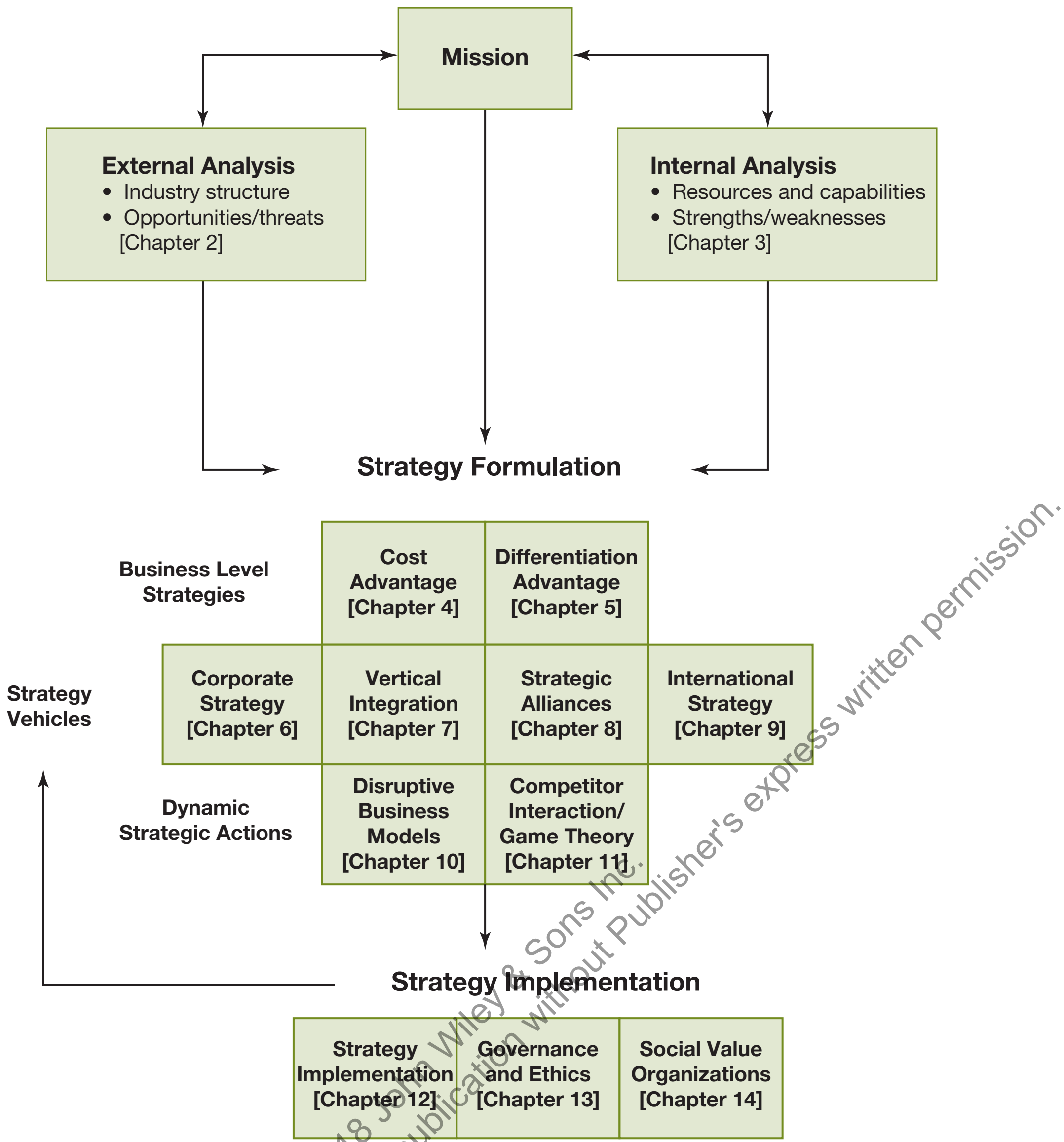


FIGURE 1.1 **The Strategic Management Process**

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

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

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

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

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

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

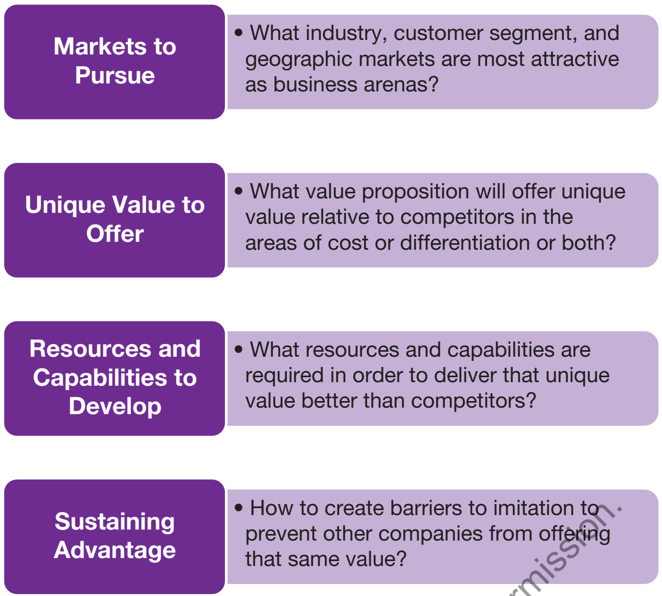


FIGURE 1.2 **Four Key Strategic Choices in Strategic Management**

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

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

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

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

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

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

The traditional answer to offering unique value is to be either a low-cost (low-price) provider or a differentiator. In fact, strategy professor Michael Porter, whose five forces analysis will be introduced later in this chapter, has cautioned that trying to do both simultaneously can result in being "stuck in the middle"—meaning that by trying to do both, companies don't effectively do the job of either low price, or differentiation. Increasingly, however, companies are finding ways to deliver on both low cost *and* differentiation.[13] Does Amazon beat brick-and-mortar stores because of price or differentiation (e.g., convenience)? Does Uber beat taxis because of price or differentiation (e.g., convenience)? The answer, of course, is both. Some companies have discovered ways to offer both low price and a differentiated product—which turns out to be a powerful source of competitive advantage (See "New Thinking: Achieving both Cost and Differentiation Advantages" at the end of Chapter 5).

Resources and Capabilities Delivering unique value requires developing resources and capabilities (the focus of Chapter 3) that will allow the company to perform activities better than competitors. Indeed, *perhaps the most critical role of the strategist is to figure out how to build or acquire the resources and capabilities necessary to deliver unique value*.

Resources refer to assets that the firm accumulates over time, such as plants, equipment, land, brands, patents, cash, and people. Elon Musk is a key resource for Tesla because his reputation as an innovator allows him to raise the large sums of money Tesla needs for product development at a low price.

Capabilities refer to processes (or recipes) the firm develops to coordinate human activity to achieve specific goals. To illustrate, Starbucks has key resources that allow it to succeed through differentiation, including its Starbucks brand, its retail store locations, its recipes to produce different coffee blends, and even some patents to protect those recipes. Its capabilities include its processes to roast coffee beans for the best flavor, create new coffee blends, design stores with great atmosphere, and find optimal store locations. These resources and capabilities have allowed Starbucks to deliver unique value to customers, thereby helping the company outperform other coffee shops within the coffee retailing industry.

The development of key resources and capabilities needed to deliver unique value should be part of the company's strategy implementation plan. The strategy implementation plan involves the company developing a set of processes (capabilities) within each function (e.g., R&D, operations, sales, service, HR, etc.) that align with the unique value the company hopes to offer. For example, because Walmart's unique value is "low prices," every function of the company is focused on how it can perform its activities at the lowest possible cost. Strategists also have learned that it is helpful to align the firm's structure (organization design), staffing (people), skills (capabilities/processes), systems (e.g., information and reward systems), and shared values and style (its culture) with its strategy for offering unique value (implementation is discussed in detail in Chapter 12).

Sustaining Advantage By being the first to offer music downloads through its easy-to-use iTunes software, Apple encouraged its customers to store their entire music libraries on iTunes. Designing iTunes so that it wouldn't download songs to other music players helped Apple to prevent competing MP3 players from taking market share from iPod. Of course, Apple's brand image and its Apple Stores also prevent competitors from easily imitating its products and services. These actions helped Apple capture and sustain the value it created.

What Information and Analysis Guides Strategy Formulation?

As Figure 1.1 shows, the earliest steps in the strategic management process involve analyses and choices that later result in the formulation and implementation of a company's strategy. These choices are made within the context of the company's *mission* and only after an analysis of the *external environment* and *internal organization*.

Mission

mission A company's primary purpose that often specifies the business or businesses in which the firm intends to compete—or the customers it intends to serve.

A company's **mission** outlines the company's primary purpose and often specifies the business or businesses in which the firm intends to compete—or the customers it intends to serve. People in business often use the terms *mission, vision*, or *purpose* somewhat interchangeably. For our purposes in this book, we will use the term *mission* to refer to the primary purpose of the organization.

Most business firms start with a mission, even if it isn't formally stated. For example, Starbucks founder Howard Schultz got the idea to introduce coffee bars to America when he visited Italy and experienced the great coffee and convenience of Italian espresso bars. His external analysis of the coffee shop industry in the United States led him to believe that there was an opportunity to bring an exceptional coffee experience to America. Schultz once said American coffee was so bad it tasted like "swill." He discovered *café latte* when visiting an espresso bar in Verona, Italy, and thought, "I have to take this to America."[14] So he launched Starbucks, a company that offered higher-quality coffee than traditional coffee shops, and included many varieties at a premium price. In essence, Starbucks started with a mission to bring high-quality coffee to the masses in the United States.

As companies grow and develop formal mission statements, these statements often define the core values that a firm espouses, and are often written to inspire employees to behave in particular ways. Starbucks formalized its mission as follows:

> *Our mission: to nurture and inspire the human spirit—one person, one cup, and one neighborhood at a time.*[15]

It then proceeds with the statement: *Here are the principles of how we live that every day*—which is followed by a set of principles or values designed to guide employee behaviors. Even after it has been formalized, however, a company's mission is still open to interpretation, as *Strategy in Practice: Apple's Evolving Mission* shows.

External Analysis

SWOT analysis Strategic planning method used to evaluate the strengths, weaknesses, opportunities, and threats involved in a business.

External analysis is critical for addressing the first strategic choice: Where should we compete? External analysis involves: (1) an examination of the competition and the forces that shape industry competition and profitability; and (2) customer analysis to understand what customers really want. The combined results of external analysis with internal analysis of the firm are often summarized as a **SWOT analysis**. SWOT is an acronym for **S**trengths, **W**eaknesses, **O**pportunities, and **T**hreats.[16] External analysis is particularly useful for shedding light on the latter two: opportunities and threats.

Industry Analysis One of the central questions for the strategist is to determine which markets or industries to compete in. The fact of the matter is, all industries are not created equal. To illustrate, between 1992 and 2006, the average return on invested capital in US industries ranged from as low as zero to more than 50 percent.[17] The most profitable industries include prepackaged software, soft drinks, and pharmaceuticals. These industries are more than five times as profitable as the least profitable industries, which include airlines, hotels, and steel. This does not mean that a steel or airline company cannot be successful or profitable (Southwest Airlines has been quite profitable[18]), but it does mean that the average profitability of all firms in these industries is low compared to other industries. This makes the challenge of making money in these low-profit industries even greater.

Why are some industries more profitable than others? Strategy professor Michael Porter developed a model for conducting industry analysis called the *Five Forces that Shape Industry Competition*.[19] Understanding the five forces that shape industry competition is one of the starting points for developing strategy, and will be discussed in detail in Chapter 2. This framework helps managers think about what the company can do to increase its power over suppliers and buyers, create barriers to other firms looking to enter the market, reduce the threat of substitute products or services, and reduce rivalry with competitors.

Strategy in Practice

Apple's Evolving Mission

When Steve Jobs and Steve Wozniak launched Apple in 1976, their primary purpose was to make great computers that people loved to use. Twenty-four years later, Apple was still essentially a computer company when it launched the iPod, a device that took the company into the music industry.

But did you know that Apple was not the first computer company to make a small, handheld MP3 player with a mini-hard drive that could store your entire music library? That honor goes to Compaq (later acquired by HP). Compaq developed an MP3 player before Apple, but the company decided this was not an industry and product market that it wanted to enter. Compaq decided not to pursue the MP3 business because it saw its mission as being a computer maker, and music players fell outside of that mission. Instead of refining the design and launching its MP3 player on the market, Compaq sold the technology to a Korean company. In contrast, Apple decided that this product market was not outside its mission.

Apple's decision was influenced by its external analysis. Apple looked at the multibillion-dollar music business and quickly realized that no company was offering legal digital downloads—so the market was wide open because of the challenges of protecting the files from easily being copied. Apple's leaders also considered its internal capabilities. Unlike Compaq—which only made computer hardware but not software—Apple had vast experience at writing software for Apple computers. It also had far greater design expertise than Compaq. In fact, the company had long been hailed for the cutting-edge designs of the iMac and some of its other computers. Apple decided to channel its internal capabilities at writing software to navigate an MP3 player. Apple's software engineers came up with the innovative "flywheel" design for navigating the iPod. Likewise, it channeled its design capabilities toward designing a product that was elegant and small enough to fit in your pocket.

As a result of formulating a strategy to enter the MP3 player market—and subsequently the iPhone and iPad markets—Apple's mission has broadened. The company no longer focuses on just being a computer maker. In fact, in 2007 it changed its name from Apple Computer Inc. to Apple Inc. to reflect this change in its mission.

Customer Analysis External analysis also involves an analysis of customers or potential customers, notably an analysis of their needs and **price sensitivity**. In particular, the strategist can make better decisions about how to offer unique value by considering groups of customers who all have similar needs. This is called customer **segmentation analysis**.[20] For example, in the automobile industry, some customers want cars that are very stylish, powerful, luxurious, and packed with technology and gadgets. These customers are the focus of companies such as Porsche, Mercedes-Benz, BMW, and Lexus. Others want trucks with the capacity to haul heavy items and move easily over rough terrain. These customers are the focus of the truck divisions of Chevy and Ford. Still others want economy cars for basic transportation—the focus of Hyundai and Kia.

price sensitivity The degree to which the price of a product or service affects consumers' willingness to purchase the product or service.

segmentation analysis Dividing up customers into groups or segments based on similar needs or wants.

External analysis should enlighten managers about the competitive forces that influence the profitability of particular markets and industries, as well as *opportunities* and *threats*. In addition, it should shed light on what customers want and what they are willing to pay to have their needs met.

Internal Analysis

Whereas external analysis focuses on a company's industry, customers, and competitors, internal analysis focuses on the company itself. Internal analysis completes the SWOT by focusing on *strengths* and *weaknesses*. More formally, internal analysis involves an analysis of the company's set of resources and capabilities that can be deployed—or should be developed—to deliver unique value to customers. We discuss internal analysis in greater detail in Chapter 3.

In the 1980s, the **resource-based view of the firm**, also known as the resource-based model, was developed to explain why some firms outperform other firms *within the same industry*.[21] Why does Nucor make money in the steel business when most of its US competitors do not? Why does Southwest fly high in the air travel business while most of its competitors are (financially) grounded? The resource-based model assumes that each company is a collection of resources and capabilities (also referred to as *competencies*) that are deployed to deliver unique value.[22]

resource-based review of firm Determining the strategic resources available to a company.

Firms that don't have the resources and capabilities that are necessary to implement the strategies they are contemplating may need to improve, change, or possibly create them in order to offer unique value to their customers. This is where *resource allocation* becomes an important dimension of strategy. After a company decides *how* it hopes to offer unique value, it must allocate the resources necessary to build those resources or capabilities. For example, after Target realized that it could not compete directly on prices with Walmart, it allocated additional resources to move "upmarket." This involved investing heavily in a *trends* department, a new mix of higher-quality products, relationships with designers, more expensive suburban retail locations, and significant TV advertising to get the message out to customers.

How are Strategies Formulated?

Formulating a strategy involves selecting which actions the company will take to gain and sustain competitive advantage. Remember, competitive advantage requires that the company do all of the following:

- Provide unique value to a set of customers in the appropriate markets.
- Develop a set of resources and capabilities that allow the company to deliver that unique value to customers better than competitors.
- Sustain the competitive advantage by figuring out how to prevent imitation of the chosen strategy.

A company will also need to formulate, and then implement, strategy at three different levels of the organization: corporate, business unit (product), and functional.

corporate strategy Decisions about what markets to compete in, made by executives at the corporate level of an organization.

business unit strategy Decisions about how to gain and sustain advantage, made at the manager level for each standalone business unit within a company.

functional strategy Decisions about how to effectively implement the business unit strategy within functional areas like finance, product development, operations, information technology, sales and marketing, and customer service.

Corporate strategy refers to decisions that are made by senior corporate executives about *where* to compete in terms of industries and markets. For example, Amazon's corporate executives made the decision to use its Kindle to enter the electronic reader/tablet business where it would face new competitors such as Apple. Similarly, Amazon's launch of Amazon Web Services—a business that provides web hosting, cloud storage, and marketplace software—was made at corporate headquarters by the corporate management team. **Business unit strategy** is made at the level of the strategic business unit—standalone business units in a company that typically have their own profit and loss responsibility. Amazon's online discount business would be considered one business unit, whereas Kindle and Amazon Web Services would be different business units. The general manager of each business unit addresses the questions we've identified regarding *how* to gain and sustain advantage in that particular market. Finally, within each business unit are different functions such as product development, operations, information technology, sales and marketing, and customer service. A **functional strategy** should align with the overall business unit strategies to effectively implement the business unit strategy (see Figure 1.3).

Strategy Vehicles for Achieving Strategic Objectives

strategy vehicles Activities and strategic choices—such as make versus buy, acquisitions, and strategic alliances—that influence a firm's ability to enter particular markets, deliver unique value to customers, or create barriers to imitating its product.

In many instances, firms rely on a few key **strategy vehicles** to help them enter attractive markets and build the resources and capabilities necessary to deliver unique value. These strategy vehicles include such things as diversification, acquisitions, alliances, vertical integration, and international expansion. In some cases, a firm may choose to grow by *diversifying*, adding to its products or opening a new line of business. *Acquisition* is a strategy vehicle used for growth and diversification or to acquire key resources.

For example, when Apple acquired NeXT Computing, the late Steve Jobs's start-up, Apple acquired the operating system that became OSX—and the acquisition brought Steve Jobs back to Apple.[23] More recently, Apple acquired SIRI, a company that made voice recognition and search software that was the technology behind SIRI (pronounced sir'-ee), Apple's personal assistant on the iPhone.

Sometimes companies decide to access new resources and capabilities through a *strategic alliance*—an exclusive relationship with another firm—rather than through acquisition. For example, Apple teamed up with AT&T in an alliance to launch the iPhone in the United

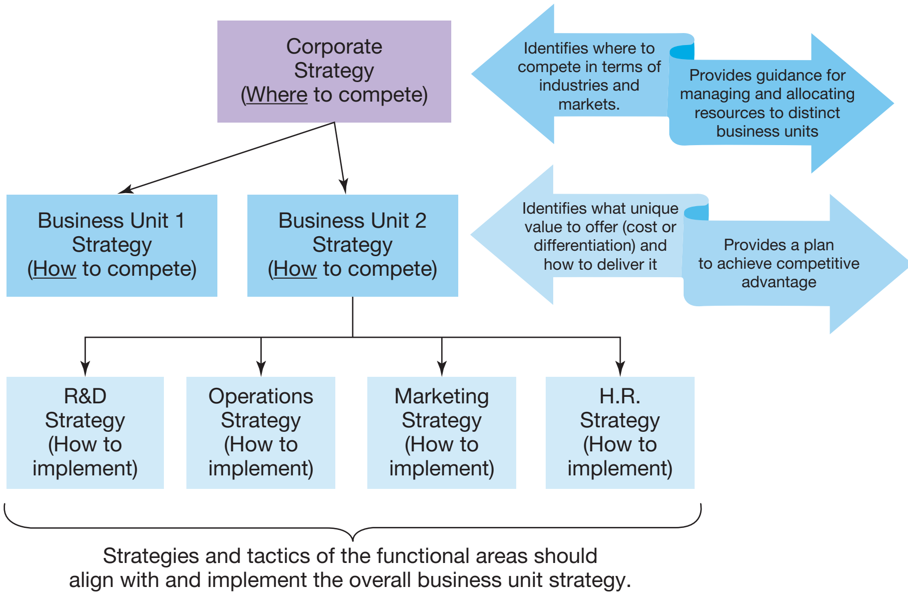


FIGURE 1.3 **Multiple Levels of Strategic Analysis**

States. AT&T put huge promotional dollars behind the iPhone—and paid Apple 10 percent of its revenues from each iPhone subscriber—in order to be the exclusive distributor of iPhones for the first five years.

Vertical integration, or the make-buy decision, is also a vehicle for achieving objectives.[24] For example, when Apple decided to move into retailing by establishing Apple Stores, the company made a decision to "make" stores that sold their own products, rather than simply "buy" the retailing services of stores run by other companies, such as Best Buy or Walmart. Finally, companies may use *international expansion* as a vehicle to achieve economies of scale, access key resources, or learn new skills. Indeed, some companies use international expansion as a primary source of competitive advantage. These strategy vehicles—discussed in detail in Chapters 6 to 9—are important tools that strategists use to achieve key strategic objectives.

Strategy Implementation

The final step in the strategic management process is to implement the strategy that was chosen during the strategy formulation phase. **Strategy implementation** occurs when a company adopts a set of organizational processes that enable it to effectively carry out its strategy. Effective implementation typically requires the following:

strategy implementation The translation of a chosen strategy into organizational action so as to effectively implement the activities required to achieve strategic goals and objectives.

1. The functional strategies within the company—research and development, operations, sales and marketing, human resource management—are well aligned with delivering the unique value identified in the overall strategy. Implementation is generally more successful when a company can measure how effectively functional activities are being performed to support the overall strategy.
2. The organization's structure, systems, staff (people), skills (processor capabilities, style, and shared values (culture) are designed to facilitate the execution of the strategy. This is the McKinsey 7 S framework, which is useful for creating the alignment necessary to ensure effective implementation.

We discuss how companies can effectively create alignment with their strategy—or change the organization to align with a new strategy—in Chapter 12. The *Strategy in Practice: Walmart Functional Strategies Implement the Overall Strategy* feature describes some of the actions that Walmart has taken to ensure that its functional activities align with and implement the overall business unit strategy.

Strategy in Practice

Walmart Functional Strategies Implement the Overall "Low Cost" Strategy

When a company has a clear strategy regarding how it plans to offer unique value, or "win" with customers, this helps guide the implementation of the overall strategy within each of the different business functions. As we've discussed, Walmart's strategy is to win by being a cost leader in its markets. Walmart's functional areas support that strategy in a number of ways:[25]

- *Walmart's human resource management strategy focuses on keeping labor costs as low as possible.* Walmart pays relatively low wages and has few layers of management, which minimizes labor costs. Walmart also has a nonunion stance and once even closed a store in Canada when the workers tried to unionize.[26] Managers have small offices with inexpensive furniture, and when they travel, they stay at inexpensive hotels and frequently share a room.
- *Walmart's information technology and operations areas also focus attention on cost reduction.* Walmart has invested in information technology to lower the costs of communicating with thousands of suppliers and to provide suppliers with real-time data on what products are selling, at what price, in what store.
- *Walmart purchasing department negotiates aggressively with suppliers.* Walmart uses its tremendous buying power to get the lowest prices on products from its suppliers. It also offers a product mix that appeals to price-sensitive customers.
- *Marketing does price checks at competitors.* The goal of the marketing staff is to ensure that Walmart's prices are always as low, if not lower, than competitors.

To ensure successful implementation, the organization should have clear *metrics*, or ways to measure whether or not the plan is being implemented. In Chapter 12, we provide a strategy tool, our version of the balanced scorecard, which suggests some useful metrics that functional area leaders, and the CEO and top management team, can use to determine how effectively strategies are being implemented.[27]

Who is Responsible for Business Strategy?

strategic leaders Organizational leaders charged with formulating and implementing a strategy with the objective of ensuring the survival and success of an organization.

deliberate strategy A plan or pattern of action that is formulated through a deliberate planning process that is then carried out to achieve the mission or goals of an organization.

emergent strategy A plan or pattern of action that develops and emerges over time in an organization despite a mission or goals.

Strategic leaders are typically the leaders of an organization who develop strategy through the strategic management process. These leaders are responsible for not only formulating strategy, but also for explaining the strategy in a way that employees will understand—and in a way that will motivate employees to execute it. Chapter 13 explains the role the board of directors and the top management team play in formulating and implementing strategy. Theorist Henry Mintzberg refers to strategies that are developed by management, using the strategic management process shown in Figure 1.1, as "intended" or "deliberate" strategies.[28] **Deliberate strategies** are implemented as a result of careful analysis of markets, customers, competitors, and a firm's resources and capabilities. Target's move to upscale discount retailing came after it concluded that it could not compete with Walmart on costs and prices. So it created a trends department, created partnerships with high-end fashion designers (e.g., Oscar de la Renta) and stores (Neiman Marcus), offered a higher-end mix of products, and built stores in more affluent suburban areas as opposed to rural towns. Target's strategy to become *Tar-zhay* was the result of a deliberate strategic plan.

Emergent strategy is a strategy that was not expressly intended in the original planning of strategy. Strategies that emerge when leaders recognize and act on unexpected opportunities that occur through serendipity, such as ideas from people within the organization, are called emergent strategies.[29] Apple's transformation from a computer company to a company known mostly for its music players and cell phones was the result of a strategy that emerged after the introduction of the iPod. The iPod opened up opportunities—such as the iPhone and iPad—that the company's senior executives did not necessarily foresee.

Successful companies typically have strategies that are partly deliberate, due to effective strategic planning processes, and partly emergent, due to a willingness to respond to changes in the external environment and to ideas that come from within the organization. That is why a strategy needs to be a plan to gain and sustain advantage. In a successful company, everyone in the organization has some responsibility for understanding the company's strategy and for offering ideas to improve the company's strategic position.

Ethics and Strategy

The Price Companies Pay to Stay Competitive

One of the central ethical challenges facing the strategist is making decisions designed to deliver unique value to customers. A decision could, for example, focus on low cost and how it might result in reduced value for specific stakeholder groups.

Over the past few years, an increasing number of US companies have shut down US facilities and fired American workers as they have shifted their activities overseas to save money. For example, IBM laid off more than 1,200 employees in New York and Vermont because their jobs could be done more cost effectively in "Brazil, India, and now China."[32] In similar fashion, HP announced layoffs of 500 customer service workers in Arkansas due to global restructuring, the term often used to describe a company's plan to fire workers and move activities from one location to another.[33] And Eaton, a 101-year-old Cleveland-based manufacturer of electronic components, moved its corporate address to Ireland, where the top corporate tax rate is 12.5 percent versus 35 percent in the United States. These are only a few of the many examples of organizations making difficult decisions in order to stay competitive. But at what price?

In each of these instances, the company's leaders are responding to customer demands (lower prices) and shareholder demands (higher profit returns). But in doing so, they are neglecting employee demands (job retention) and community demands (taxes provide community benefits). Some may question whether it is ethical to fire employees and avoid US taxes in order to better meet the desires of customers and shareholders. Others will argue that if the company does not keep its customers and shareholders happy, employees will eventually lose their jobs anyway because the company will not be cost competitive, and companies that go bankrupt cannot pay taxes. The challenge of meeting the sometimes-competing needs of various stakeholder groups is one that is constantly faced by a company's leaders. A typical response is to prioritize stakeholders' needs—with customers and shareholders needs coming first—and take strategic actions that best meet their needs. But actions that take unduly from employees and communities to compensate customers and shareholders are viewed by many as unethical.

Who Benefits from a Good Business Strategy?

Every organization has a set of **stakeholders** to whom it is accountable—and who therefore can influence business strategy. Organizations have four primary stakeholder groups:

stakeholders Those who have a share or an interest in the activities and performance of an organization.

1. *Capital market stakeholders* (shareholders, banks, etc.)
2. *Product market stakeholders* (customers, suppliers)
3. *Organizational stakeholders* (employees)
4. *Community stakeholders* (communities, government bodies, community activists)[30]

There is a lively debate that will be discussed in Chapter 13 about which of these four stakeholder groups is the most important and should be the primary beneficiaries of successful business strategies. Some people believe that **shareholders** (owners of the company) are the most important. Others make the case that customers, employees, governments, or communities should be the primary beneficiaries of business activity. In the United States, shareholders typically receive highest priority, but each stakeholder group can influence the strategic decisions that are made by a company.

shareholders Owners of a company.

Sometimes, different stakeholder groups have conflicting views as to the appropriateness of different strategic decisions. Imagine that your company can lower its product costs by closing down your plants in the United States and moving production to China, where labor is cheaper. This will require firing many of your US employees. Both the employee stakeholder group and community stakeholder groups in the cities where your plants are located will perceive this move as negative, and they will try to stop the company from making this decision. However, shareholders and customer stakeholder groups may applaud this decision. It could increase profits for shareholders and lower prices for customers, or both. Because of conflicts like this, companies need to make sure their strategic actions follow accepted ethical standards for business activity. In the ideal situation, a firm has such an effective business strategy that it generates above-average profit returns. Above-average returns allow companies to not only meet the expectations of shareholders, but also satisfy the expectations of other suppliers of capital, product-market, organizational, and community stakeholders. Since stakeholders influence, and are influenced by, strategic decisions made by a company's management team, it is important to understand and consider the needs of different stakeholder groups when making strategic decisions.[31]

Strategy in Your Career

Understanding business strategy and the strategic management process is important for at least two reasons:

1. When you start your own company or are the president or general manager of a department or division within a company, your primary job will be to formulate and implement an effective business strategy. Even as a junior person in your company, by understanding basic strategy principles you will be more effective at developing and implementing ideas that are consistent with, and support, your business unit's overall strategy. Being able to understand and contribute to your firm's strategy may lead to earlier promotions as you stand out from your peers.
2. Understanding strategy will help you evaluate the strategy of companies you choose to work for. Effective strategy can give a company competitive advantage over its rivals. Companies with competitive advantage typically provide superior advancement opportunities, higher pay, and greater job security than companies without any competitive advantage.

In summary, understanding the strategic management process—as well as the concepts that are fundamental to the formulation, and implementation, of strategy—will likely be very helpful as you pursue a successful career in business.

Summary

- A company's business strategy is defined as a plan to achieve competitive advantage. Formulating a strategy involves making four key choices: (1) what markets or industries the company will pursue; (2) what unique value to offer the customer in those markets; (3) what resources and capabilities will allow the firm to deliver that unique value better than competitors; and (4) how the company will sustain its advantage and prevent imitation of its strategy by competitors.
- The strategic management process involves the selection of a company mission as well as external and internal analyses that contribute to the formulation of a company's strategy. A company's mission outlines the company's primary purpose and scope of activity. External analysis involves an analysis of the company's current (or potential) markets or industries to understand the environmental factors that influence a firm's profitability. Internal analysis involves an analysis of the company's set of resources and capabilities (or new ones that need to be developed) that can be deployed to create competitive advantages.
- These analyses contribute to the formulation of a company's strategy. After the plan for creating competitive advantage is created, the final step is to develop a plan to effectively implement the firm's strategy.
- Every organization has a set of stakeholders to whom it is accountable—and who therefore can influence business strategy. The four primary stakeholder groups are capital market stakeholders (shareholders, other suppliers of capital like banks), product market stakeholders (customers, suppliers), organizational stakeholders (employees), and community stakeholders (communities, government bodies).
- The chief executive officer and vice presidents of the different business functions are ultimately responsible for a company's strategy. They are often assisted by a VP of strategic planning (chief strategy officer), who may lead a planning staff, or in some cases by a management-consulting firm. Good strategic leaders, however, will seek information and ideas from anyone in the company.
- You need to understand business strategy because: (1) it will give you the tools to more effectively evaluate, and contribute, to the strategy of the company that employs you; and (2) it will give you the knowledge you need to evaluate the strategy of organizations you may want to join.

Key Terms

Review Questions

1. Why is it important for you to understand business strategy?

2. How would you describe/define strategy?

3. What are the four choices that are part of strategy formulation?

4. What are the two generic strategies, or primary ways, in which companies attempt to offer unique value relative to competitors?

5. Who is ultimately responsible for a company's strategy? Who does this individual (or individuals) call on for help in formulating strategy for the firm?

6. According to Michael Porter's "five forces" model, why do some firms earn higher profits than other firms?

7. What are resources and capabilities, what is the difference between them, and why do firms need to assess them?

8. What are three keys to the successful implementation of a company strategy?

9. Who are the four primary stakeholder groups that influence strategic decisions in a company?

Application Exercises

Exercise 1: Examine the Business Strategy of a Company

1. Identify a company you would like to learn more about that seems to have a competitive advantage (earns above-average profit returns).

2. Gather data about the strategy of that company, using public sources such as the company website or its annual reports, public articles, and your own experience.

3. Identify the mission statement of the company, if it has one. How does this mission statement guide the behavior and actions of people in the company?

4. What markets or industries does the company focus on? Does this differ from competitors in any particular way?

5. What unique value does it try to offer to customers? Why do most of its customers pick its products over those of competitors?

6. Try to identify any resources or capabilities this company has that help it offer unique value. This is the most difficult step in the assignment, because companies often try to hide their sources of competitive advantage.

Exercise 2: Amazon is an online discount retailer that has successfully entered other businesses, such as electronic devices with the Kindle, Kindle Fire, and Echo as well Amazon Web Services. Read what you can about Amazon's entry into these new businesses, and try to explain:

1. why you think they chose to compete in those markets,

2. their unique value is in those markets—why do they win with customers;

3. what resources and capabilities did they possess that they were able to utilize to succeed in the new markets; and what new capabilities did they need to develop; and

4. what makes it hard for competitors to imitate their offerings.

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