FIFTH EDITION

# Strategic Management: Theory and Practice

John A. Parnell

*University of North Carolina at Pembroke*

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# Dedication

***To my students***

**—John Parnell**

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*Strategic Management: Theory and Practice,* 5e, John A. Parnell

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# Brief Contents

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# Preface

## Description of Text

The challenge to lead an organization has never been more demanding. Executives and managers at all levels must think strategically and leverage firm resources effectively. This fifth edition of *Strategic Management: Theory and Practice* draws from all functional areas of business and presents a cohesive strategic management approach. It is most useful for students with backgrounds in related fields, such as management, marketing, finance, accounting, and economics.

*Strategic Management: Theory and Practice,* 5e, has three distinguishing characteristics. First, it is organized sequentially around the strategic management process:

- Foundation (Chapter 1)—*Overview*
- External environment (Chapters 2–4)—*Step 1*
- Internal environment (Chapter 5)—*Step 2*
- Fundamentals of strategy (Chapters 6–8)—*Foundational content for Step 3*
- Strategy formulation (Chapter 9)—*Step 3*
- Strategy execution (Chapters 10–11)—*Step 4*
- Strategic control (Chapter 12)—*Step 5*

Global issues are addressed in the various chapters, not as separate concerns. Numerous examples—many from the *Wall Street Journal*—are integrated as well. This process orientation is augmented with a strong chapter on ethics and social responsibility *before* strategy content is discussed.

A second distinguishing characteristic of *Strategic Management: Theory and Practice* is that the strategic analysis of a firm is viewed as inseparable from the concepts presented in the chapters. *Case Analysis* boxes throughout the text address the twenty-five key questions that should be answered as part of a strategic analysis (i.e., case project). For students participating in *Capstone* or another competitive strategy simulation, each chapter includes a *Simulation 101* section that examines the key concepts affecting the types of decisions students will be making.

Finally, the third distinguishing characteristic of *Strategic Management: Theory and Practice* is that it presents modern strategic management concepts and ideas in a clear and succinct manner. The entire book can be covered in a typical capstone business course, while retaining valuable course time for case projects, a computer simulation, discussion of real-time strategic issues, and other activities.

## What's New in This Edition

The strategic management model presented in the fifth edition of *Strategic Management: Theory and Practice* remains relatively unchanged from that in the previous edition with minor enhancements. New concepts have been integrated and existing ones updated throughout the chapters, including a large number of global strategy references and numerous examples from the *Wall Street Journal* and other sources.

A brief, real-time case has been added at the end of each chapter. These cases can be used for daily discussion or as springboards for term projects, creating a broad range of assignment options.

## Online and in Print

### Student Options: Print and Online Versions

This fifth edition of *Strategic Management: Theory and Practice* is available in multiple versions: online, in PDF, and in print as either a paperback or loose-leaf text. The content of each version is identical.

The most affordable version is the online book, with upgrade options including the online version bundled with a print version. What's nice about the print version is that it offers you the freedom of being unplugged—away from your computer. The people at Academic Media Solutions recognize that it's difficult to read from a screen at length and that most of us read much faster from a piece of paper. The print options are particularly useful when you have extended print passages to read.

The online edition allows you to take full advantage of embedded digital features, including search and notes. Use the search feature to locate and jump to discussions anywhere in the book. Use the notes feature to add personal comments or annotations. You can move out of the book to follow web links. You can navigate within and between chapters using a clickable table of contents. These features allow you to work at your own pace and in your own style, as you read and surf your way through the material. (See "Harnessing the Online Version" for more tips on working with the online version.)

### Harnessing the Online Version

The online version of *Strategic Management: Theory and Practice,* 5e, offers the following features to facilitate learning and to make using the book an easy, enjoyable experience:

- ***Easy-to-navigate/clickable table of contents***—You can surf through the book quickly by clicking on chapter headings, or first- or second-level section headings. And the Table of Contents can be accessed from anywhere in the book.
- ***Key terms search***—Type in a term, and a search engine will return every instance of that term in the book; then jump directly to the selection of your choice with one click.
- ***Notes and highlighting***—The online version includes study apps such as notes and highlighting. Each of these apps can be found in the tools icon embedded in the Academic Media Solutions/Textbook Media's online e-book reading platform (http://www.academicmediasolutions.com).
- ***Upgrades***—The online version includes the ability to purchase additional study apps and functionality that enhance the learning experience.

## Instructor Supplements

In addition to its student-friendly features and pedagogy, the variety of student formats available, and the uniquely affordable pricing options that are designed to provide students with a flexibility that fits any budget and/or learning style, *Strategic Management: Theory and Practice,* 5e, comes with the following teaching and learning aids:

- ***Test Item File***—An extensive set of multiple-choice, short-answer, and essay questions for every chapter for creating original quizzes and exams.
- ***Instructor's Manual***—An enhanced version of the book offering assistance in preparing lectures, identifying learning objectives, developing essay exams and assignments, and constructing course syllabi.
- ***PowerPoint Presentations***—Key points in each chapter that are illustrated in a set of PowerPoint files designed to assist with instruction.

## Student Supplements and Upgrades (Additional Purchase Required)

- ***Lecture Guide***—This printable lecture guide is designed for student use and is available as an in-class resource or study tool. Note: Instructors can request the PowerPoint version of these slides to use as developed or to customize.
- ***StudyUpGrade (Interactive Online Study Guide)***—Students can turbo-charge their online version of *Strategic Management: Theory and Practice,* 5e, with a unique study tool designed to "up your grade." StudyUpGrade is a software package that layers self-scoring quizzes and flash cards into the online version. This inexpensive upgrade helps you improve your grades through the use of interactive content that's built into each chapter. Features include self-scoring multiple-choice quizzes, key concept reviews with fill-in-the-blank prompts, and e-flash cards comprised of key term definitions. For more on this helpful study tool, check out the flash demo at the Academic Media Solutions or Textbook Media websites.
- ***Study Guide***—A printable version of the online study guide is available via downloadable PDF chapters for easy self-printing and review.

## Acknowledgments

I would like to express my sincere appreciation to Dan Luciano, Victoria Putman, and the entire team at Academic Media Solutions for their commitment to this project. I also wish to thank numerous colleagues who have reviewed earlier editions of the text, offered invaluable suggestions, and adopted it for their classes.

# About the Author

John A. Parnell currently serves as the Belk Chair of Management at the University of North Carolina at Pembroke (UNCP). He completed the BSBA, MBA, and MAEd degrees from East Carolina University, the EdD from Campbell University, and the PhD from the University of Memphis. During his academic career, Dr. Parnell has served as professor and head of the Department of Marketing and Management at Texas A&M University–Commerce. He has received numerous awards for teaching, scholarship, and service, including the H. M. Lafferty Distinguished Faculty Award at Texas A&M–Commerce in 2002, the Adolph Dial Award for Scholarly and Creative Activity at UNCP in 2005, and the Spirit of Inquiry Award from the John William Pope Center for Higher Education Policy in 2011. In 2014–2015, Dr. Parnell served as interim dean of the UNCP School of Business.

Dr. Parnell is a recognized authority in the strategic management field, having published more than 200 articles, cases, proceedings, books, and book chapters on strategic management and related fields. His work has appeared in a number of leading journals, including *Academy of Management Learning and Education*, *British Journal of Management*, *Journal of Contingencies and Crisis Management, Journal of Business Ethics, Journal of Small Business Management,* and *Management Decision*. Dr. Parnell is a coauthor of *Crisis Management: Leading in the New Management Landscape,* 2e (SAGE Publications, 2014). He also serves on a number of academic journal editorial boards and consults with select firms in the area of strategic planning. He frequently has been invited to discuss issues related to business and competitiveness on SiriusXM's *The Wilkow Majority*.

Dr. Parnell has lectured at a number of institutions abroad, including the EGADE Business School in Mexico, Chung Yuan Christian University in Taiwan, Yangtze Normal University, and China University of Geosciences in Beijing. He also served as a Fulbright Scholar in Cairo, Egypt, in 1995.

# Fundamentals of Strategic Management

CHAPTER 1

## Chapter Outline




*Source:* iQoncept/Shutterstock.com.

What do Circuit City, Washington Mutual, Saab, Blockbuster, General Motors, Radio Shack, and Borders have in common? All of these recognized companies filed for bankruptcy within the past decade. While the situation surrounding each firm is different—and some of them have since recovered—each one made important strategic mistakes.Perhaps luck plays a role in company downturns, but those with strong, competent strategic leadership usually fare the best.

This text is about developing a systematic, strategic perspective for managing an organization. It is applicable for leaders of manufacturing and service firms, and the concepts presented herein are useful in nonprofit and government organizations as well. These ideas vary in complexity, but understanding and applying them can enhance the odds of success.

Strategic management is more important than ever. Today's business world is global, Internet-driven, and obsessed with speed, and the challenges it creates for top managers are often complex, ambiguous, and unstructured. Add to this the incessant allegations of top management wrongdoings, economic stagnation, and increasing executive compensation, and it is easy to see why leaders are under great pressure to respond to strategic problems quickly, decisively, and responsibly. Indeed, the need for effective strategic management has never been more pronounced.

> Mission statements vary widely. Compare and contrast many of the mission statements of *Fortune 500* firms at *www.missionstatements.com/fortune_500_mission_statements.html.*

This chapter introduces the notion of strategic management, highlights its importance, and presents a five-step process for strategically analyzing an organization. The remaining chapters expand on the five steps in the process, with special emphasis on their application to ongoing enterprises.

## What Is Strategic Management?

**mission** The reason for an organization's existence. The mission statement is a broadly defined but enduring statement of purpose that identifies the scope of an organization's operations and its offerings to affected groups (i.e., stakeholders, as defined later in the book).

**strategy** Top management's plans to attain outcomes consistent with the organization's mission and goals.

**competitive advantage** A situation whereby a business unit's successful strategies cannot be easily duplicated by its competitors.

**strategic management** The continuous process of determining the mission and goals of an organization within the context of its external environment and its internal strengths and weaknesses, formulating and implementing strategies, and exerting strategic control to ensure that the organization's strategies are successful in attaining its goals.

Each organization exists for a purpose. Its **mission** is articulated in a broadly defined but enduring statement of purpose that identifies the scope of an organization's operations and its offerings to affected groups and entities. Most established organizations have developed a formal mission statement, a concept discussed in greater detail in Chapter 5.

**Strategy** refers to top management's plans to develop and sustain **competitive advantage**—a situation whereby a firm's successful strategies cannot be easily duplicated by its competitors[1]—so that the organization's mission is fulfilled.[2] Following this definition, it is assumed that an organization has a plan, its source of competitive advantage is understood, and that its members understand the reason for its existence. These assumptions may appear self-evident, but many strategic problems can be traced to fundamental misunderstandings associated with defining the strategy. Debates over the nature of the organization's competitive advantage, its mission, and whether or not a strategic plan is really needed can be widespread.[3] As such, comments such as "We're too busy to focus on developing a strategy" or "I'm not exactly sure what my company is really trying to accomplish" can be overheard in many organizations.

***Strategic management*** is a broader term than strategy and is a process that includes top management's analysis of the organization's environment prior to formulating a strategy, as well as the plan for implementation and control of the strategy. Put another way, the difference between a strategy and the strategic management process is that the latter includes considering what must be done before a strategy is formulated through assessing whether or not the success of an implemented strategy was successful. The strategic management process can be summarized in five steps, each of which is discussed in greater detail in subsequent chapters of the book (see Figure 1-1):[4]

1. **External analysis:** Analyze the opportunities and threats or constraints that exist in the organization's external environment, including industry and forces in the external environment.
2. **Internal analysis:** Analyze the organization's strengths and weaknesses in its internal environment. Consider the context of managerial ethics and corporate social responsibility.
3. **Strategy formulation:** Formulate strategies that build and sustain competitive advantage by matching the organization's strengths and weaknesses with the environment's opportunities and threats.
4. **Strategy execution:** Implement the strategies that have been developed.
5. **Strategic control:** Measure success and make corrections when the strategies are not producing the desired outcomes.

The sequential order of the steps is logical. A thorough understanding of the organization and its environment is essential if the appropriate strategy is to be developed, put into action, and controlled. One could transpose the first two steps and analyze the internal environment before the external environment, the logic being that comprehending the organization informs the strategic assessment of factors outside of the firm. The external environment is analyzed before the internal environment in Figure 1-1, however, because internal goals, resources, and competencies are viewed vis-à-vis rivals and are understood

**FIGURE 1-1**
Organization of the Book

**Foundation**
Chapter 1: Fundamentals of Strategic Management

**Step 1: External Analysis**
Chapter 2: Industry Competition
Chapter 3: The External Environment: Political-Legal and Economic Forces
Chapter 4: The External Environment: Social and Technological Forces

**Step 2: Internal Analysis**
Chapter 5: The Organization: Ethics and Corporate Social Responsibility

**Step 3: Strategy Formulation**
Chapter 6: Corporate-Level Strategies (also called *Firm Strategies*)
Chapter 7: Business Unit Strategies (also called *Competitive Strategies*)
Chapter 8: Functional Strategies (also called *Tactics*)
Chapter 9: Strategy Formulation

**Step 4: Strategy Implementation**
Chapter 10: Strategy Execution: Structure
Chapter 11: Strategy Execution: Strategic Change, Culture, and Leadership

**Step 5: Strategic Control**
Chapter 12: Strategic Control and Crisis Management

within the context of the industry and the factors that drive it. This dilemma resembles the "chicken and egg" argument; in reality, analysis of the external and internal environments occurs simultaneously.

The notion of strategic management can be linked to two key economic concepts. The first is what economists and investors call the **efficient market hypothesis**, or the idea that all individuals or firms in a market earn the same returns in the long run. For investors, this means that everyone has access to the same information, so it is impossible to *consistently* "buy low and sell high." For firms, this means that special benefits or high profits result from either randomness or strategic resources that can be copied by other rivals as well. While there is some rationale to the efficient market hypothesis—and a thorough review of extant research is beyond the scope of this book—completely accepting it minimizes the value of strategic planning. If the hypothesis is not entirely accurate, then firms whose managers plan effectively can enjoy higher-than-average profits over a period of time.

**efficient market hypothesis** The idea that all individuals or firms in a market earn the same returns in the long run.

The second concept is that of **subjective value**, or the idea that a resource's value is determined by the individual or organization possessing it, not an objective measure that would be the same for all firms. For example, having a highly trained workforce with strong

**subjective value** The idea that a resource's value is determined by the individual or organization possessing it; not an objective measure that would be the same for all firms.

technical skills is of greater value to an organization that emphasizes technology in production than to one whose approach is labor intensive. The notion of subjective value explains why one firm is willing to pay a premium (i.e., more than the value based on the current stock price) to acquire another firm; its managers believe that the firm offers greater value if it is possessed by the acquiring firm. The efficient market hypothesis explains why companies with similar resources tend to perform at similar levels, but the notion of subjective value explains why substantial performance variation can exist among similar firms.

A distinction between outside and inside perspectives on strategy is also relevant. *Outsiders* analyzing a firm should apply a systematic approach that progresses through these steps in order. Doing so develops to a holistic understanding of the firm, its industry, and its strategic challenges.

Inside organizations, strategies are being formulated, implemented, and controlled simultaneously while external and internal factors are continually reassessed. In addition, changes in one stage of the strategic management process will inevitably affect other stages as well. After a planned strategy is implemented it often requires modification as conditions change. Hence, because these steps are so tightly intertwined, *insiders* tend to treat all of the steps as a single integrated, ongoing process.[5]

Consider the strategic management process at a fast-food restaurant chain. At any given time, top managers are likely assessing changes in consumer taste preferences and food preparation, analyzing the activities of competitors, working to overcome firm weaknesses, controlling remnants of a strategy implemented several years ago, implementing a strategy crafted months earlier, and formulating strategic plans for the future. Although each of these activities can be linked to a distinct stage in the strategic management process, they occur simultaneously.

**business model** The economic mechanism by which a business hopes to sell its goods or services and generate a profit.

An effective strategy is built on the foundation of the organization's **business model**, the mechanism whereby the organization seeks to earn a profit by selling its goods or services. While all firms seek to produce a product or service and sell it at a price higher than its production and overhead costs, a business model is stated in greater detail. For example, a magazine publisher might adopt a "subscription model," an "advertising model," or perhaps some combination of the two. Profits would be generated primarily from readers under the subscription model but from advertisers under the advertising model. As we can see, identifying a firm's business model can become more complex when intricate details are considered. Progressive firms often devise innovative business models that extract revenue—and ultimately profits—from sources not identified by competitors.

Consider the *razor and blades* business model invented by Gillette. A company gives away or deeply discounts a product—the razor—while planning to profit from future sales of required replacement or complementary products—the blades. Customers willing to sign a two-year service contract might receive a deeply discounted cell phone. Computer printers are typically sold below production cost, but customers must periodically replace the ink cartridges—high margin items. This model is not foolproof, however. In a competitive marketplace, customers may be able to purchase the required complementary products at lower prices from rivals not under pressure to recoup initial losses. Interestingly, online companies like Harry's and Dollar Shave Club are challenging the razor and blades business model with a new way to purchase shaving supplies.

Successful business models can change over time, and many of the changes are Internet driven. For example, since early 2000, a number of authors have strayed from the traditional business model whereby book publishers offer contracts and pay royalties of 10–15 percent. Leveraging advances in publishing software, social media, and a strong online retail book market, they have opted for a "self-publishing" model. Enterprising authors who publish their own work also shoulder the initial risk, but can net as much as a 70 percent return on e-book sales from companies like Amazon.com. The total print book and e-book output of self-publishers in the UNITED STATES rose from about 50,000 titles in 2006 to over 125,000 in 2010 and over 450,000 in 2013.[6] Smashwords' Mark Coker contends that self-published e-books will capture 50 percent of the market by 2020.[7]

Consider the auto industry. Tesla sells its electric vehicles to consumers in the United States directly through the Internet. Tesla is pursuing this approach both out of necessity—the small carmaker lacks a nationwide dealer network—and a desire to improve efficiency. Industry groups have attempted to block the move, arguing that carmakers should not be allowed to "bypass" franchised auto retailers. In some states, laws restricting direct sales have been in place for years to protect the territorial rights of local franchises. Tesla has no franchisees and its leadership has argued that such laws violate the company's right to sell products in the way it deems appropriate.[8]

South Africa's SMD (*www.smd.co.za*) sells vehicles on behalf of insurance companies direct to the public. These vehicles are often damaged—some substantially—and require repair. SMD's customers may be willing to do some of the work themselves or to tolerate a few dents. Hence, SMD is making vehicle ownership affordable to an underserved lower-income category of South Africans.

The emergence of new Internet-based business models has created a number of serious challenges, however. Many websites do not receive revenue directly from patrons but instead from advertisers, based on traffic generated through the site. "Paying for clicks" has its merits because advertisers are only required to compensate sites when prospective customers actually respond to an ad. However, tens of thousands of dubious websites have emerged in the last few years, each supported by "botnets," armies of hijacked computers from unknown locations across the globe. The botnets create phony web traffic to advertisers, enabling the proprietors of these illegitimate sites to collect payments. The most sophisticated botnets appear to be real online consumers, pausing to view advertisements, clicking from site to site, watching videos, and even putting items in shopping carts. Hence, advertisers are paying for faux web traffic. Given the technological complexity and global nature of the problem, prosecuting perpetrators of this crime has been elusive.[9]

Business models can also include the concept of social entrepreneurship. Superior performance can be defined in a number of ways beyond profitability. Indeed, a number of entrepreneurs define success in part by examining the effects that their products and services have on individuals or specific groups, such as the poor—the "bottom of the pyramid." TOMS donates a pair of shoes to the poor for each one purchased, a pair of glasses for each pair of TOMS eyewear purchased, and a week of clean water for each bag of coffee purchased. From a social perspective, this business model can be judged on both profitability and alleviation of poverty. From a marketing standpoint, this business model targets consumers who wish to purchase from firms that embody a social orientation.

While a successful strategy is built on the firm's business model, crafting one can be a challenge. Realistically, a number of factors are typically associated with successful strategies. Some of these factors including the following:

1. The organization's competitive environment is well understood, in detail.
2. Strengths and weaknesses are assessed in a thorough and realistic manner.
3. The strategy is consistent with the mission and goals of the organization.
4. Plans for putting the strategy into action are designed with specificity before it is implemented.
5. Possible future changes in the proposed strategy—a process called strategic control—are evaluated before the strategy is adopted.

Careful consideration of these factors reinforces the interrelatedness of the steps in the strategic management process. Each factor is most closely associated with one of the five steps, yet they fit together like pieces of a puzzle. The details associated with the success factors—and others—will be discussed in greater detail in subsequent chapters.

While some of these success factors are associated with the competitive enviroment in profit-seeking firms, strategic management is not limited to for-profit organizations. Top managers of any organization, regardless of profit or nonprofit status, must understand the organization's environment and its capabilities and develop strategies to assist the enterprise in attaining its goals. Former Drexel University President Constantine Papadakis, for example, was widely considered to be leading strategic thinker among university top executives. The innovative Greek immigrant promoted Drexel through aggressive marketing, while campaigning for an all-digital library without books. In many respects, he managed the university in the same way that other executives manage profit-seeking enterprises. His annual salary was close to $1,000,000 in the years preceding his death in 2009, making him one of the highest paid university presidents in the country.[10]

## Intended and Realized Strategies

A critical challenge facing organizations is the reality that strategies are not always implemented as originally planned. Sometimes, strategic decisions seem to evolve incrementally. In this respect, strategy formulation can be seen as an iterative process where decision makers take actions, make sense of those actions afterwards, and then decide how to proceed.

**intended strategy** The original strategy top management plans and intends to implement.

**realized strategy** The strategy that top management actually implements.

Henry Mintzberg introduced two terms to help clarify the shift that often occurs between the time a strategy is formulated and the time it is implemented. An **intended strategy** (i.e., what management originally planned) may be realized just as it was planned, in a modified form, or even in an entirely different form. Occasionally, the strategy that management intends is actually realized, but the intended strategy and the **realized strategy**—what management actually implements—usually differ.[11] Hence, the original strategy may be realized with desirable or undesirable results, or it may be modified as changes in the firm or the environment become known.

The gap between the intended and realized strategies usually results from unforeseen environmental or organizational events, better information that was not available when the strategy was formulated, or an improvement in top management's ability to assess its environment. Although it is important for managers to formulate responsible strategies based on a realistic and thorough assessment of the firm and its environment, things invariably change along the way. Hence, it is common for such a gap to exist, creating the need for constant strategic action if a firm is to stay on course. Instead of resisting modest strategic changes when new information is discovered, managers should search for new information and be willing to make such changes when necessary. This activity is part of strategic control, the final step in the strategic management process.

> Henry Mintzberg has contributed greatly to our current understanding of strategic thinking. His views often challenge the conventional wisdom. Consider his five Ps for strategy at *www.mindtools.com/pages/article/mintzberg-5ps.htm.*

## Scientific and Artistic Perspectives on Strategic Management

There are two different perspectives on the approach that top executives should take to strategic management. Most strategy scholars have endorsed a *scientific perspective*, whereby strategic managers systematically assess the firm's external environment and evaluate the pros and cons of myriad alternatives before formulating strategy. The business environment is seen as largely objective, analyzable, and predictable. As such, strategic managers should follow an orderly process of environmental, competitive, and internal analysis, and build the organization's strategy accordingly.

According to the scientific perspective, strategic managers should be trained, highly skilled analytical thinkers capable of digesting data from a multitude of sources and rendering it into a desired direction for the firm. "Strategy scientists" tend to minimize the role of imagination and creativity in the strategy process, and are not generally receptive to alternatives that emerge from any process other than a comprehensive, analytical approach.

Others have a different view. According to the *artistic perspective* on strategy, the lack of environmental predictability and the fast pace of change render elaborate strategy planning as suspect at best. Instead, strategists should incorporate large doses of creativity and intuition in order to design a comprehensive strategy for the firm.[12] Henry Mintzberg's notion of a craftsman—encompassing individual skill, dedication, and perfection through mastery of detail—embodies the artistic model. The strategy artist senses the state of the organization, interprets its subtleties, and seeks to mold its strategy like a potter molds clay. The artist visualizes the outcomes associated with various alternatives and ultimately charts a course based on holistic thinking, intuition, and imagination.[13] "Strategy artists" may even view strategic planning exercises as time poorly spent and may not be as likely as those in the science school to make the effort necessary to maximize the value of a formal planning process.[14]

This text acknowledges the artistic perspective but emphasizes the science view. Creativity and innovation are important and encouraged, but are most likely to translate into organizational success when they occur as part of a comprehensive, systematic approach to strategic management. Nonetheless, the type of formal strategic planning proposed in this text is not without its critics. Some charge that such models are too complex, or that they apply only to businesses in highly certain environments.[15] Others emphasize that the stages in the process are so closely interrelated and that considering them as independent steps may be counterproductive. Still others, such as Mintzberg, argue that planning models stifle the creativity and imagination that is central to formulating an effective strategy.[16] Although these views have merit, the comprehensive, systematic model proposed herein is presented as a proper foundation for understanding the strategic management process. It does not, however, preclude the application of other approaches.

## Theoretical Perspectives on Strategic Management

Strategic managers must understand the technical dimensions of their own organizations as well as the functional areas of business, such as marketing, production, finance, and human resources. Because strategic management is an interdisciplinary field, however, managers must also be familiar with contributions from related areas, such as economics, psychology, and sociology. The required breadth of knowledge contributes to the complexity of the field. Answers to strategic problems are often unclear and depend on one's perspective, but not every alternative is equally viable. A closer look at the strategic management discipline sheds light on this dilemma.

The roots of the strategic management field can be traced to the 1950s when the discipline was originally called "business policy." Today, strategic management is an eclectic field, drawing upon a variety of theoretical frameworks. Three prominent perspectives are summarized in Table 1-1. There are a number of other influences as well, but these three illustrate how competing viewpoints have coalesced into an overarching discipline.

**Industrial organization (IO)**, a branch of microeconomics, emphasizes the *influence of the industry environment* upon the firm. The central tenet of industrial organization theory is the notion that a firm must adapt to influences in its industry to survive and prosper; thus, its financial performance is primarily determined by the success of the industry in which it competes. Industries with favorable structures offer the greatest opportunity for firm profitability.[17] Following this perspective, it is more important for a firm to choose the correct industry within which to compete than to determine *how* to compete within a given industry. Recent research has supported the notion that industry factors tend to play a dominant role in the performance of most firms, except for those that are the notable industry leaders or losers.[18]

**industrial organization (IO)** A view based in microeconomic theory that states that firm profitability is most closely associated with industry structure.

IO assumes that an organization's performance and ultimate survival depend on its ability to *adapt* to industry forces over which it has little or no control. According to IO, strategic managers should seek to understand the nature of the industry and formulate

**TABLE 1-1** Theoretical Perspectives on Firm Performance

| Theoretical Perspective | Primary Influence on Firm Performance | How Perspective Is Applied to the Case Analysis |
|---|---|---|
| Industrial organization (IO) theory | Structure of the industry | Industry analysis portion of the external environment |
| Resource-based theory | Firm's unique combination of strategic resources | Analysis of internal strengths and weaknesses |
| Contingency theory | Fit between the firm and its external environment | SWOT (strengths, weaknesses, opportunities, and threats) analysis and SW/OT matrix |

strategies that feed off the industry's characteristics.[19] Because IO focuses on industry forces, strategies, resources, and competencies are assumed to be fairly similar among competitors within a given industry. If one firm deviates from the industry norm and implements a new, successful strategy, other firms will rapidly mimic the higher-performing firm by purchasing the resources, competencies, or management talent that have made the leading firm so profitable. Hence, although the IO perspective emphasizes the industry's influence on individual firms, it is also possible for firms to influence the strategy of rivals, and in some cases even modify the structure of the industry.[20]

**resource-based theory** The perspective that views performance primarily as a function of a firm's ability to utilize its resources.

**distinctive competence** Unique resources, skills, and capabilities that enable a firm to distinguish itself from its competitors and create competitive advantage.

**sustained competitive advantage** A firm's ability to enjoy strategic benefits over an extended period of time.

Perhaps the opposite of the IO perspective, **resource-based theory** views performance primarily as a function of a firm's ability to utilize its resources.[21] Although environmental opportunities and threats are important, a firm's unique resources comprise the key variables that allow it to develop a **distinctive competence**, enabling the firm to distinguish itself from its rivals and create competitive advantage. "Resources" include all of a firm's tangible and intangible assets, such as capital, equipment, employees, knowledge, and information.[22] An organization's resources are directly linked to its capabilities, which can create value and ultimately lead to profitability for the firm.[23] Resource-based theory focuses primarily on individual firms rather than on the competitive environment.

If resources are to be used for **sustained competitive advantage**—a firm's ability to enjoy strategic benefits over an extended period of time—those resources must be valuable, rare, not subject to perfect imitation, and without strategically relevant substitutes.[24] Valuable resources are those that contribute significantly to the firm's effectiveness and efficiency. Rare resources are possessed by only a few competitors, and imperfectly imitable resources cannot be fully duplicated by rivals. Resources that have no strategically relevant substitutes enable the firm to operate in a manner that cannot be effectively imitated by others, and thereby sustain high performance.

**contingency theory** The view that the most profitable firms are likely to be the ones that develop the best fit with their environment.

According to the third perspective, **contingency theory**, the most profitable firms develop *beneficial fits* with their environments. In other words, a strategy is most likely to be successful when it is consistent with the organization's mission, its competitive environment, and its resources. Contingency theory represents a *middle ground* perspective that views organizational performance as the joint outcome of environmental forces and the firm's strategic actions. Firms can become proactive by choosing to operate in environments where opportunities and threats match the firms' strengths and weaknesses.[25] Should the industry environment change in a way that is unfavorable to the firm, its top managers should consider leaving that industry and reallocating its resources to other, more favorable industries.

Which perspective is most accurate? Each has its own intuitive appeal. Several prominent studies have attempted to unravel this quandary. Overall, organization-specific effects account for about half of a firm's performance variation relative to its rivals, with the remainder split between industry effects and other factors. Hence, while the numbers vary across industries, individual firm performance is best understood from multiple perspectives. Luck can even play a role.[26]

Differences aside, each perspective has merit and has been incorporated into the strategic management process laid out in this text. The industrial organization view is seen in the industry analysis phase, most directly in Michael Porter's "five forces" model. Resource-based theory is applied directly to the internal analysis phase and the effort to identify an organization's resources that could lead to sustained competitive advantage. Contingency theory is seen in the strategic alternative generation phase, where alternatives are developed to improve the organization's fit with its environment. Hence, multiple perspectives are critical to a holistic understanding of strategic management.[27]

## Corporate Governance and Boards of Directors

Small businesses are often governed by one or several individuals well known to everyone in the organization. Ownership is often *privately held* and may rest with a single person, a family, or a few business partners. Because more resources are needed, many mid-size and large organizations are *publicly held*, with shares of stock available for purchase on exchanges such as the New York Stock Exchange. Shareholders in public organizations—the owners of the firm—are represented by an elected board of directors legally authorized to monitor firm activities, as well as the selection, evaluation, and compensation of top managers. Strategic decision-making in these firms is more complex because the ownership is widely dispersed and often changes frequently.

**Corporate governance** refers to the board of directors, institutional investors (e.g., pension and retirement funds, mutual funds, banks, insurance companies, among other money managers), and large shareholders known as **blockholders** who monitor firm strategies to ensure effective management. Boards of directors and institutional investors—representatives of pension and retirement funds, mutual funds, and financial institutions—are generally the most influential in the governance systems. Because institutional investors own more than half of all shares of publicly traded firms, they tend to wield substantial influence. Blockholders tend to hold less than 20 percent of the shares, so their influence is proportionally less than that of institutional investors.[28]

**corporate governance** The board of directors, institutional investors, and blockholders who monitor firm strategies to ensure managerial responsiveness.

**blockholders** Large shareholders who monitor firm strategies to ensure effective management.

Boards of directors often include both inside (i.e., firm executives) and outside directors. Insiders bring company-specific knowledge to the board, whereas outsiders bring independence and an external perspective. Over the past several decades, the composition of the typical board has shifted from one controlled by insiders to one controlled by outsiders. This increase in outside influence often allows board members to oversee managerial decisions more effectively.[29] Moreover, when additional outsiders are added to insider-dominated boards, dismissal of the chief executive officer (CEO) is more likely when corporate performance declines[30] and outsiders are more likely to pressure for corporate restructuring.[31]

Many companies became concerned about both potential conflicts of interest and the amount of time a board member who sits on multiple boards can spend with the affairs of each company. As a result, many companies have begun to limit the number of board memberships their own board members may hold. Approximately two-thirds of corporate board members at the largest 1,500 U.S. companies do not hold seats on other boards. The average director's direct compensation ranged from $90,775 at firms with revenues between $50 and $500 million to $228,058 at the 200 largest firms in the Standard & Poors 500 based on revenue.[32]

The **Sarbanes-Oxley Act** passed in 2002 requires firms to include more independent directors on their boards and to make disclosures on internal controls, ethics codes, and the composition of their audit committees on annual reports. The act requires that both the CEO and the chief financial officer (CFO) certify every report that contains company financial statements. It restricts membership of the firm's audit committee—the formal group charged with reporting oversight—to outsiders (i.e., board members who are not managers). Sarbanes-Oxley also prohibits firms from extending personal loans to board members or executives.

**Sarbanes-Oxley Act** Legislation passed in 2002 that created more-detailed reporting requirements for boards and executives in public U.S. companies and accounting firms.

Even with new disclosure regulations, however, it can be difficult to determine precisely what top executives earn at public companies. A number of analysts have noted positive changes among boards as a result of this legislation in terms of both independence and expertise, while others contend that government regulations like Sarbanes-Oxley have merely added more costly paperwork.[33] A record number of public firms went private in the mid-2000s, primarily due to investor and management frustration with the legislation. Evidence also suggests that many CEOs have become more reluctant to sit on boards of publicly held companies. Increased liability on the part of board members and recent policy changes that often restrict the number of outside boards on which a CEO may serve have also contributed to this change.[34]

> Sarbanes-Oxley has been both hailed and criticized since its passage in 2002. Its costs and benefits are explained in *Forbes* at *www.forbes.com/sites/hbsworkingknowledge/2014/03/10/the-costs-and-benefits-of-sarbanes-oxley/.*

Boards of directors are responsible for monitoring activities in the organization, evaluating top management's strategic proposals, and establishing the broad strategic direction for the firm. As such, boards select and terminate the CEO, establishing his or her compensation package, advising top management on strategic issues, and monitoring managerial and company performance as representatives of the shareholders. Critics charge that board members do not always fulfill their legal roles.[35] One reason is that they are nominated by a CEO who expects support in return. The generous compensation they often receive can create a conflict of interest as well.[36]

**CEO duality** A situation in which the CEO also serves as the chair of the board.

**hedge fund** An investment fund open to only a small number of investors but permitted by regulators to undertake riskier and more speculative investments.

When insiders control a board, a "rubber stamp" mentality can develop, whereby directors do not aggressively challenge executive decisions as they should. This is particularly true when the CEO also serves as chair of the board, a phenomenon known as **CEO duality**.[37] Insider board members may be less willing to exert control when the CEO is also the chair of the board because present rewards and future career prospects within the firm are largely determined by the CEO. In the absence of CEO duality, however, insiders may be more likely to contribute to board control, often in subtle and indirect ways so as not to document any opposition to the decisions of the CEO. For example, the insiders may ostensibly present both sides of various issues, while carefully framing the alternatives in favor of one that may be in opposition to the wishes of the CEO.

Activist shareholders can significantly influence a firm's operations. Target, for example, suffered the effects of the recession and experienced sluggish sales in the late 2000s and early 2010s. Investor activist William Ackman challenged Target to address the recession more aggressively. Ackman's Pershing Square Capital Management **hedge fund**—an investment fund open to only a small number of investors but permitted by regulators to undertake riskier and more speculative investments—is Target's sixth largest shareholder and has actively supported dissident nominees for board slots. In response to Ackman, Target expanded its fresh foods and other "recession-proof" offerings in many of its stores.[38]

Pressure on directors to acknowledge shareholder concerns has continued well into the 2010s. The major source of pressure in recent years has come from institutional investors, owners of large chunks of most publicly traded companies via retirement or mutual funds. By virtue of the size of their investments, they wield considerable power and are more willing to use it than ever before (see Strategy at Work 1-1). Some challenge companies they believe are underperforming, while others seek to institute social change by influencing product and human resource policies in companies like Walmart and McDonald's.

Criticism notwithstanding, some board members have played effective stewardship roles. Many directors vigorously promote the best interests of the firm's shareholders and other stakeholders. Board members are often invaluable sources of environmental and competitive information.[39] By conscientiously carrying out their duties, directors can ensure that management remains focused on company performance.[40]

A number of recommendations have been made on how to promote an effective governance system. For example, it has been suggested that outside directors be the only ones to evaluate the performance of top managers against established mission and goals, that all outside board members should meet alone at least once annually, and that boards of directors should establish appropriate qualifications for board membership and communicate these qualifications to shareholders. For institutional shareholders, it is recommended that institutions and other shareholders act as owners and not just investors,[41] that they not interfere with day-to-day managerial decisions, that they evaluate the performance of the board of directors regularly,[42] and that they should recognize that the prosperity of the firm benefits all shareholders.

## Strategic Decisions

How does one think and act strategically, and who makes the strategic decisions? The answers to these questions vary across firms and may also be influenced by ownership and other issues related to corporate governance. It is also important to distinguish between strategic decisions and common management decisions. In general, strategic decisions are marked by five key distinctions:

1. Strategic decisions have a wide impact on the organization. They involve input from and affect multiple functional areas. As a result, they require a multi-perspective, integrated approach. Decisions that address only part of the organization—perhaps a single functional area—are usually not considered to be strategic decisions.
2. Strategic decisions are long term and future oriented, but are built on knowledge about the past and present. Scholars and managers do not always agree on what constitutes the "long term," but most agree that it can range anywhere from several years in duration to more than a decade.

### Strategy at Work 1-1

#### The Growing Responsiveness of Corporate Boards[43]

There is an adage on Wall Street: "If you don't like the stock, sell it." Over the past decade, however, a number of dismayed investors have decided to challenge the board instead. Many corporate boards have historically functioned as rubber stamps for top executives. Nonetheless, the directors of many prominent corporations have become increasingly responsible to shareholder interests, thanks in part to the increased influence of institutional shareholders. These large investment firms control substantial numbers of shares in widely held firms and have the clout necessary to pressure board members for change when needed.

Consider the case of Nell Minow. A principal at activist money-management firm Lens Inc., Minow searches for companies with strong products and underlying values that appear to be underperforming. After identifying a target, Minow purchases a substantial number of shares in the company and then advises the CEO of her ownership position. She requests a meeting with the CEO and/or the board to discuss changes that could improve the performance of the firm. Activist owners like Minow have sent a message to both top executives and boards that poor performance is not unlikely to go unchallenged.

However, a number of analysts and executives believe that further change to the system is needed. According to David Leighton, former chairman of the board at Nabisco Brands, Ltd., companies should seek out more independent and qualified board members who will consider the strategic direction of the firm more aggressively.

3. Strategic decisions seek to capitalize on favorable situations outside the organization. In general, this means taking advantage of opportunities that exist for the firm, but it also includes taking measures to minimize the effects of external threats as well.
4. Strategic decisions are nonrepetitive and may not remotely resemble situations addressed in the past. Because organizations and their environments are constantly changing, such decisions often lack precedence and require a fresh look at all of the options. When made, however, their influence cascades throughout the organization as department managers seek to make functional decisions in ways that reflect the broader direction of the firm.
5. Strategic decisions involve choices. Although making "win-win" strategic decisions may be possible, most involve some degree of trade-off between alternatives, at least in the short run. For example, raising salaries to retain a skilled workforce can increase wages, and adding product features or enhancing quality can increase the cost of production. However, such trade-offs may diminish in the long run, as a more skilled, higher paid workforce may be more productive than a typical workforce, and sales of a higher quality product may increase, thereby raising sales and potentially profits. Decision-makers must understand these complex relationships across the business spectrum. Hence, strategic decisions should be based on a systematic, comprehensive analysis of internal attributes and factors external to the organization.

The ongoing Walmart-Amazon.com battle illustrates the strategic choice imperative. As the world's largest retailer, Walmart is heavily invested in brick-and-mortar stores. Online behemoth Amazon.com has no stores, but has invested in over 135 warehouses stocked with inventory. Walmart *chose* a traditional retail model, whereas Amazon.com *chose* an online model. Both companies have been successful, but both struggle to compete *directly* with each other. Lacking the sophisticated online distribution center, Walmart promotes shipment of merchandise to local stores for customer pick-up. Walmart attempts to utilize its own inventory system to fulfill online orders, but doing this has been a challenge. Amazon.com has avoided the brick-and-mortar option altogether.[44]

Because of these distinctions, strategic decision-making is generally reserved for the top executive and members of his or her **top management team**. The chief executive is the individual ultimately responsible (and generally *held responsible*) for the organization's strategic management, but he or she rarely acts alone. Except in the smallest

**top management team**
A team of top-level executives—headed by the CEO—all of whom play instrumental roles in the strategic management process.

companies, he or she relies on a *team* of top-level executives—including members of the board of directors, vice presidents, and even various line and staff managers in some instances—all of whom play instrumental roles in strategically managing the firm. Generally speaking, the quality of strategic decisions improves dramatically when more than one capable executive participates in the process.[45]

The size of the team on which the top executive relies for strategic input and support can vary across firms. Companies organized around functions such as marketing and production generally involve the heads of the functional departments in strategic decisions. Very large organizations often employ corporate-level strategic-planning staffs and outside consultants to assist top executives in the process. The degree of involvement of top and middle managers in the strategic management process also depends on the personal philosophy of the CEO.[46] Some chief executives are known for making quick decisions, whereas others have a reputation for involving a large number of top managers and others in the process.

Input to strategic decisions, however, need not be limited to members of the top management team. To the contrary, obtaining input from others throughout the organization, either directly or indirectly, can be quite beneficial. In fact, most strategic decisions result from the streams of inputs, decisions, and actions of many people. The top management team might create the context for strategic decisions by establishing rules and procedures, and by influencing the informal means through which things are accomplished in the organization. Strategic decisions do not necessary start with top management action, however, but instead can "bubble up" from a series of lower level decisions throughout the firm. For example, an employee in a company's research and development department may attend a trade show where a new product or production process idea that seems relevant to the company is discussed. The employee may relate the idea to his or her manager, who, in turn, may modify and pass it along to his or her manager. Eventually, a version of the idea may be discussed with the organization's marketing and production managers, and later presented to top management. Ultimately, the CEO will decide whether or not to incorporate the idea into the ongoing strategic planning process. This example illustrates the indirect involvement of individuals throughout the organization in the strategic management process. Top management is ultimately responsible for the final decision, but its

**Top Management Team**

The CEO leads the top management team, but others in the organization play important roles.
*Source:* OPOLJA/Shutterstock.com.

decision is based on a culmination of the ideas, creativity, information, and analyses of others[47] (See Strategy at Work 1-1).

While participation can be healthy, most firms place significant limits of the say that their managers have in strategic decisions. There are a few exceptions, however. At Ternary Software, for example, all of its thirteen employees must agree before a strategic decision can be implemented. Such democracy is easier to implement in larger organizations, but even large companies like Google have taken steps to create an egalitarian culture for decision-making.[48]

The corporate boardroom is often a place where decisions that have already been made in a less formal setting are confirmed. A formal, systematic decision-making process is often applied as a means of confirming what top executives already see as the appropriate course of action. A danger associated with this type of approach is that it tends to jump straight to a proposed solution without considering how a decision should be made. Although there are no guarantees, top management teams that circumvent a logical decision-making approach are more susceptible to mistakes. For example, when a systematic cost-benefit analysis is not employed, leaders may confuse actual costs of a decision with sunk costs—those already expended—a common error that distorts decision-making and can lead to an escalation of commitment to a failed strategy.[49]

## The Global Imperative

Most business organizations buy, sell, or trade across borders, whether they have a physical presence in other countries or sell a significant amount of imported merchandise. Although firms typically concentrate on serving local or domestic markets before expanding internationally, many must interact with entities in other nations as a means of survival. For example, virtually all of Japan's industries would grind to a halt if imports of raw materials from other nations ceased because Japan is small and isolated, and its natural resources are quite limited. In larger nations like the United States, manufacturers typically utilize components from abroad in their production processes, while most retailers sell products that were produced abroad. Hence, strategic management is—by definition—a global undertaking. For this reason, examples related to concepts, industries, and firms throughout the world are integrated into each of the chapters.

**Global Business**

International considerations are an integral part of business today.
*Source:* Ferbies/Shutterstock.com.

## Case Analysis 1-1

### Step 1: Introduction of the Organization

The first step in analyzing a firm is to develop familiarity with the organization. Analyzing an ongoing enterprise begins with a general introduction and understanding of the firm. When was the organization founded, why, and by whom? Is any unusual history associated with the organization? Is it privately or publicly held? What is the company's mission? Has the mission changed since its inception?

It is also important at this point to identify the business model currently employed. In other words, what does the company do, specifically, to generate profit? Identifying the business model is simple for some companies (Ford, for example, hopes to sell cars and offer consumer financing at a profit) but may be complicated for others where revenue streams and competitive advantage are more difficult to identify.

**comparative advantage**
The idea that certain products may be produced more cheaply or at a higher quality in particular countries, due to advantages in labor costs or technology.

The high degree of global interconnectedness common in many enterprises today emanates from the economic concept of **comparative advantage**, the idea that certain products may be produced more cheaply or at a higher quality in particular countries due to advantages in labor costs or technology. For this reason, many manufacturers in the United States and other developed nations have shifted their production to Asia and other parts of the world. Firms do not always engage in production only in areas where they are most efficient for several reasons, however. The cost of transporting raw materials or goods from one nation to another can exceed the potential cost savings. Political turmoil or trade restrictions can also create a barrier. Moreover, even if one nation enjoys an absolute advantage over another in most areas, the weaker nation must participate in some forms of business to maintain economic viability and employ its citizens. Firms in these nations tend to produce in areas where the absolute advantage is lowest. Put another way, even when firms in less-developed nations lack a comparative advantage, they tend to produce in areas where their inefficiencies are less pronounced, while their counterparts in developed nations concentrate on industries that are more vital. All nations benefit economically from such an arrangement.

The notion of comparative advantage is fluent, as nations enjoying a form of comparative advantage at one period may not enjoy it in future period. Chinese manufacturers enjoyed some of the lowest global labor rates for unskilled or semi-skilled production in the 2000s. Worker skills and production quality has increased in the rapidly developing nation, making Chinese labor the third most expensive in Asia in 2011, well ahead of nations like India, Pakistan, Indonesia, Cambodia, and Viet Nam.[50]

Of course, comparative advantage is a national concept. The fact that a given nation possesses certain forms of comparative advantage can influence the strategic actions of companies within that nation, but it is only one consideration. Moreover, while comparative advantage is a key consideration for international operations, it is not the only one. Global involvement may also provide advantages to a firm not directly related to costs. For political reasons, a firm often needs to establish operations in other countries, especially if a substantial proportion of sales is derived abroad. Doing so can also provide managers with a critical understanding of local markets. For example, Ford operates a number of plants in Western Europe, where manufacturing has helped Ford's engineers design windshield wipers for cars engaged in high-speed driving on the German autobahns.[51]

## Summary

Top managers face more complex strategic challenges today than ever before. Strategic management involves analysis of an organization's external and internal environments, formulation and implementation of its strategic plan, and strategic control. These steps in the process are interrelated and typically done simultaneously in many firms.

A firm's intended strategy often requires modification before it has been fully implemented due to changes in environmental and/or organizational conditions. Because these changes are often difficult to predict, substantial changes in the environment may transform an organization's realized strategy into one that is quite different from its intended strategy.

The strategic management field has been influenced by such perspectives as industrial organization theory, resource-based theory, and contingency theory. Although they are based on widely varied assumptions about what leads to high performance, each of these perspectives has merit and contributes to an overall understanding of the field.

Strategy formulation is typically a global undertaking and is the direct responsibility of the CEO, but he or she relies on a team of other individuals as well, including the board of directors, vice presidents, and other various managers. In its final form, a strategic decision is crafted from the streams of inputs, decisions, and actions of the entire top management team.

## Key Terms

blockholders
business model
CEO duality
comparative advantage
competitive advantage
contingency theory
corporate governance
distinctive competence
efficient market hypothesis
hedge fund
industrial organization (IO)
intended strategy
mission
realized strategy
resource-based theory
Sarbanes-Oxley Act
strategic management
strategy
subjective value
sustained competitive advantage
top management team

## Review Questions and Exercises

1. Is it necessary that the five steps in the strategic management process be performed sequentially? Why or why not?
2. What is the difference between an intended strategy and a realized strategy? Why is this distinction important?
3. How have outside perspectives influenced the development of the strategic management field?
4. Does the CEO *alone* make the strategic decisions for an organization? Explain.

## Chapter 1 Practice Quiz

### True or False

1. A strategy seeks to develop and sustain competitive advantage.
2. Strategic management refers to formulating successful strategies for an organization.
3. Each step in the strategic management process is independent so that changes in one step will not substantially affect other steps.
4. The intended strategy and the realized strategy can never be the same.
5. Whereas industrial organization theory emphasizes the influence of industry factors of firm performance, resource-based theory emphasizes the role of firm factors.
6. Strategic decisions are made solely by and are ultimately the responsibility of the chief executive alone.

### Multiple Choice

7. Strategies are formulated in the strategic management stage that occurs immediately after
   - **A.** the assessment of internal strengths and weaknesses.
   - **B.** implementation of the strategy.
   - **C.** control of the strategy.
   - **D.** none of the above
8. The strategy originally planned by top management is called the
   - **A.** grand strategy.
   - **B.** realized strategy.
   - **C.** emergent strategy.
   - **D.** none of the above

9. The notion that successful firms tend to be the ones that adapt to influences in their industries is based on
   **A.** industrial organization theory.
   **B.** resource-based theory.
   **C.** contingency theory.
   **D.** none of the above

10. The notion of distinctive competence is consistent with
   **A.** industrial organization theory.
   **B.** resource-based theory.
   **C.** contingency theory.
   **D.** none of the above

11. In order to contribute to sustained competitive advantage, firm resources should be
   **A.** valuable and rare.
   **B.** not subject to perfect imitation.
   **C.** without strategically relevant resources.
   **D.** all of the above

12. Which of the following is not a characteristic of strategic decisions?
   **A.** They are long-term in nature.
   **B.** They involve choices.
   **C.** They do not involve trade-offs.
   **D.** All of the above are characteristics of strategic decisions.

## Case 1: Costco

The first Price Club Warehouse was opened in San Diego in 1975 by Sol Price, Robert Price (Sol's son), Rick Libenson, and Giles Bateman. The firm originally sought to sell merchandise in volume at deep discounts only to small businesses, but later expanded the concept to include government, utility, and hospital employees. By 1980, the company had four stores in Arizona and California and went public.

During the 1980s, the company expanded to the eastern United States and Canada. In 1988, Price Club acquired grocery distributor A. M. Lewis and launched Price Club Furnishings. In the early 1990s, however, competition intensified from Sam's Club and Pace. In 1992 and 1993, Price Club's joint venture with retailer Controladora Comercial Mexicana led to the opening of two Price Clubs in Mexico City.

Later in 1993, Price Club merged with Costco Wholesale. During the 1990s, the firm expanded its international interests, launching outlets in Great Britain, Japan, and South Korea. Price Club changed its corporate name to Costco Companies in 1997 and again to Costco Wholesale in 1999.

Today, Costco is the largest wholesale club operator in the United States, operating 672 membership warehouses—each amassing about $150 million in sales—and serving about 65 million members. Most of its outlets are located in the United States and Canada, but additional stores can be found in Mexico, Japan, Australia, South Korea, Taiwan, Puerto Rico, and the United Kingdom. Membership costs about $50 per year and is available to businesses and individuals.

Costco's business model emphasizes rock-bottom prices on a limited selection of mostly name-brand products in a wide range of merchandise categories. A typical outlet carries about 4,000 products, ranging from alcoholic beverages and appliances to fresh food, pharmaceuticals, and tires. Costco also offers its members insurance, financial, and travel services. Its subsidiary, Costco Wholesale Industries, is an operating manufacturing business in food packaging, meat processing, and jewelry to support the retail efforts.

Much of Costco's success can be attributed to its ability to minimize costs by negotiating fiercely with suppliers. The company never requires its members to pay more than 14 percent above the firm's cost for goods.

Jim Sinegal stepped down as CEO in 2012 and was succeeded by COO Craig Jelinek.

### Case Challenges

1. How does Costco differ from other warehouse clubs like Sam's Club?

2. Does Costco compete with nonmembership retailers, such as Walmart and Target? Why or why not?

3. Can Costco compete successfully on a large scale outside of the United States and Canada? Why or why not?

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## Simulation 101: Overview

Many strategic management courses include *Capstone* or another competitive business simulation as part of the required activities. Each simulation is different, but they share certain commonalities.

While participation in a simulation can be an individual assignment, students are usually divided into teams to make marketing, production, finance, and other decisions for a virtual company. Student companies often compete in a single industry, although multiple industries or computer-run companies might be added to balance the number of firms. A typical game might include eight rounds, each round representing a quarter or a year in the life of the company. Students are provided with results on their companies and industry after each round so they can make decisions for the next round accordingly.

There are a few obvious limitations of strategy simulations. They include only a representative set of decisions that a business would make, and these must cover a fixed period of time and cannot be changed until a round is completed. Simulations make assumptions about interest rates, changes in demand from one round to the next, and other factors that affect company performance. Moreover, they cannot consider the softer side of various decisions. For example, an increase in an advertising budget will affect demand for products without regard to the content of a particular ad. Some students will seek help on the simulation from other students who took the same course in a past term, from blogs posted by students at other colleges, or from online videos posted by individuals who claim to know how to master the game. Good advice is always helpful, but *it is not possible to "game the system" and master a sophisticated simulation with a few tricks*. Take shortcuts, and you will likely learn this the hard way.

While it is important to recognize these limitations, a simulation can reinforce key strategic management concepts. It allows students to operate virtual companies over an extended period of time without the risk of losing real money. Well-designed simulations also do an excellent job of reinforcing the interrelationships among functional areas of business. Overlooking these links can be a formula for disaster. For example, it is important to offer attractive products, but this does not guarantee success. Buyers will not know your products exist without marketing campaigns. They might not purchase them if prices are too high, and your company might not cover its expenses if prices are too low. Your company must produce enough products to meet demand, but producing too many can raise inventory costs. You must also obtain sufficient capital through borrowing, issuing stock, or some other means, or the simulation will punish your firm by providing an emergency loan at an exorbitant interest rate or restricting your firm's activities. Hence, an otherwise effective strategy can easily go awry if you ignore one of the functional areas. A chain is only as strong as its weakest link, and this is certainly true in this instance.

Each chapter in this book contains a *Simulation 101* section that connects content in the chapter with some of the issues you will encounter in a typical strategy simulation. It is critical that you understand exactly how the game works at the outset. Invest the necessary time to understand the specifics associated with all of the competitive decisions you will make, the support provided to assist you in making these decisions, and how the performance of your virtual company will be evaluated. Profitability and market share are important, but most simulations provide a balanced scorecard that also evaluates your team's management with regard to other factors, such as inventory management, cash flow, and human resources. Identifying a strategy for your company before you start is also a must. *Figuring out the details as you go is a recipe for disaster because recovering from losses in the first few rounds can be very difficult*.

Keep in mind that the results of each round are not guaranteed; having a reasonable strategy and making "good decisions" could still result in a financial loss or market share decline. This is a reality of the business world, and it can raise anxiety during the simulation experience. Nonetheless, competing in a simulation can be a lot of fun and a great learning experience if you do your homework.

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# Industry Competition

CHAPTER 2


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## Chapter Outline

**Industry Life-Cycle Stages**
**Industry Structure**
**Intensity of Rivalry among Incumbent Firms**
**Threat of Entry**
**Pressure from Substitute Products**
**Bargaining Power of Buyers**
**Bargaining Power of Suppliers**
**Limitations of Porter's Five Forces Model**

This chapter marks the beginning of the strategic management process and is the first of three that consider the external environment. At this point, we focus on factors *external* to the organization, viewing firm performance from an industrial organization perspective. *Internal* factors (e.g., firm resources, capabilities, and strategies) are considered in later chapters.

Each business operates among a group of rivals that produce competing products or services known as an **industry**. The concept of an industry is a simple one, but it is often confused in everyday conversations. The term *industry* does not refer to a single company or specific firms in general. For example, in the statement, "A new industry is moving to the community," *industry* should be replaced by *company* or *firm*.

**industry** A group of competitors that produce similar products or services.

Each industry tends to have its own "rules of engagement" governing such issues as product quality, pricing, and distribution; these evolve over time. This is especially true for industries with a large number of businesses offering standardized products and services. Most competitors—but not all—follow the rules. For example, service stations in the United States generally offer regular unleaded, mid-grade, and premium unleaded gasoline at prices that do not differ substantially from those at nearby stations. They typically offer an array of soft drinks, snacks, and other convenience items as well. These rules or norms developed because they tend to serve the market effectively. "Breaking the rules" and charting a different strategic course (i.e., modifying the business model) might be possible, but rivals that deviate too much from the norm often fail. As such, it is important for strategic managers to understand the structure of the industry(s) in which their firms operate before deciding how to compete successfully. Sometimes, a new approach makes sense, but strategic managers should understand the landscape before considering a change.

**critical success factors (CSFs)** Elements of the strategy that are essential for success among most or all competitors within a given industry.

While industry norms suggest business practices common to most firms in an industry, **critical success factors (CSFs)** represent elements of the strategy that are essential for success for most rivals. CSFs can be gleaned by examining current and recent examples of success and failure in an industry; they include factors such as competitive capabilities, product or service attributes, service speed, and even locations. For example, CSFs in the automobile industry include factors such as vehicle reliability, safety, and modern styling. A manufacturer that possesses these factors is more likely than others to succeed. CSFs are only predictors of success and failure, however. They represent a starting point for understanding a strategy that *might* be best for a company in a given industry, but they do not guarantee any level of performance.

> Identifying CSFs is an integral part of understanding the prospects for success in an industry. A number of sophisticated tools have been developed to identify them. Learn more at *http://rapidbi.com/criticalsuccessfactors/*.

Industry norms are particularly interesting in the airline industry, where there is a tendency for major competitors to follow very similar approaches to pricing and fees. Penalties for ticket changes typically range from $100 to $150, are commonly applied across the industry, and are usually paid by business travelers. Individual airlines hesitate to deviate from the norm because they would repel customers if they charged more and they would sacrifice profits if they charged less. According to the U.S. Department of Transportation, ticket change and cancellation fees net airlines in the United States about $2 billion per year.[1] Hence, incorporating these fees in a strategic manner might be unpopular among many consumers, but could be considered a CSF because of the fees' substantial contribution to the bottom line.

While the notion of an airline industry is commonly understood, defining a firm's industry is not always an easy task. In a perfect world, each firm would operate in one clearly defined industry. However, many firms compete in multiple industries, and strategic managers in similar firms often differ in their conceptualizations of the industry environment. In addition, some companies have utilized the Internet to redefine industries or even invent new ones, such as eBay's online auction or Uber's transportation service. As a result, defining and analyzing an industry can be especially challenging when Internet competition is considered.[2]

Outside sources can assist in identifying which competitors should be categorized in an industry and why. Government classification systems, such as the popular Standardized Industrial Classification (SIC), as well as distinctions made by trade journals and business analysts can help strategists "draw the industry lines." Although the U.S. Census Bureau replaced the four-digit SIC system in 1997 with the six-digit North American Industry Classification System (NAICS)—an alternative system designed to facilitate comparisons of business activities across North America—SIC codes continue to be referenced. The first two NAICS digits represent one of twenty industry sectors (e.g., agriculture, mining, utilities, etc.), the third digit represents the industry subsector, the fourth represents the industry group, and the fifth represents the industry; the sixth digit is reserved for nation-specific categories in the United States, Canada, or Mexico. The SIC and NAICS categories are worthwhile configurations when defining an industry, but astute managers assess these and other sources, and add their own rigorous and systematic analysis of the competition when defining the industry. Additional information on both classification schemes is readily available on the Internet.

Other useful industry classification schemes are also available. The Global Industrial Classification Standard (GICS) taxonomy was developed by Standard & Poors (S&P) and Morgan Stanley Capital Investments (MSCI) to categorize global firms into 10 sectors, 24 broad industry groups, 68 industries, and 152 subindustries or sectors. The Industry Classification Benchmark (ICB) taxonomy, developed by Dow Jones and Financial Times Stock Exchange (FTSE) International, identifies 10 industries, 19 supersectors, 41 sectors, and 114 subsectors.

Numerous descriptive factors can be employed when drawing the industry lines. In the case of McDonald's, for example, attributes such as speed of service, types of products, prices of products, and level of service may be useful. Hence, one might define McDonald's industry in the United States as consisting of restaurants offering easy-to-consume, moderately priced food products rapidly and in a limited service environment. Broad terms like *fast food* are often used to describe such industries, but doing so does not eliminate the need for a clear, tight definition. Terms like *fast food* can have different interpretations.

Some factors are not helpful when defining an industry, such as those directly associated with strategy and firm size. For example, it is not a good idea to exclude a "fast-food" restaurant in McDonald's industry simply because it is not part of a large chain or because it emphasizes low-priced food. Such a company might represent a very minor competitor because of its small size, but it still belongs in the industry. Factors like firm size explain how such a restaurant might be *positioned* vis-à-vis McDonald's, a concept discussed in greater detail in later chapters.

Industries also change over time. In the mid-2000s, for example, consumer electronics big boxes Best Buy and Circuit City began to face increasing price competition from online retailers. When the economy turned sour in 2008, Circuit City struggled, ultimately filing for bankruptcy in 2009. Circuit City's dissolution redefined the entire industry. Without Circuit City in the picture, Best Buy shifted its competitive efforts to Walmart and online retailers like Amazon. Best Buy benefited from Circuit City's departure for a while, but the entire industry was shifting as online retailers strengthened.[3] Since 2009, Best Buy has faced a new set of challenges.

The concept of primary and secondary industries can be a useful tool in defining an industry. A primary industry may be conceptualized as a group of close competitors, whereas a secondary industry includes less direct competition. When one analyzes a firm's competition, the primary industry is loosely considered to be "the industry," whereas the secondary industry is presented as a means of adding clarity to the analysis. For example, McDonald's primary industry includes such competitors as Burger King and Wendy's, whereas its secondary industry might also include restaurants that do not emphasize hamburgers and offer more traditional restaurant seating, such as Pizza Hut and Denny's. The distinction between primary and secondary industry may be based on objective criteria, such as price, similarity of products, or location, but there is always some degree of subjectivity and informed judgment involved in assigning an industry definition.

Once the industry is defined, it is important to identify the **market share**—a competitor's share of the total industry sales—for the firm and its key rivals. Unless stated otherwise, market share calculations are usually based on total sales revenues of the firms in an industry rather than on units produced or sold by the individual firms. This information is often available from public sources, especially when there is a high level of agreement as to how an industry should be defined. When available market share information is based on a different industry definition, however, the data can be misleading. For example, Southwest Airlines would appear to have a *higher* market share and a *stronger* market position if its industry were defined in terms of North American airlines. Southwest would look like a smaller player in an industry defined in global terms.

**market share** The percentage of total market sales attributed to one competitor (i.e., firm sales divided by total market sales).

When market share is not available or when there are substantial differences in industry definitions, **relative market share**—a firm's share of industry sales when only the firm and its key competitors are considered—can serve as a practical substitute. Consider low-end discount retailer Dollar Tree as an example and assume that the only available market share data consider Dollar Tree to be part of the broadly defined discount department store industry. If a more narrow industry definition is proposed—perhaps one limited to deep discount retailers—new market share calculations will be necessary. In addition, it becomes quite complicated when one attempts to include the multitude of "Mom-n-Pop" nonchain discounters in the calculations. In this situation, computing relative market shares that consider Dollar Tree and its major competitors can be useful.

**relative market share** A firm's share of industry sales when only the firm and its key competitors are considered (i.e., firm sales divided by sales of the key firms in the industry).

Assume for the sake of this example that there are four major competitors identified in this industry—Dollar General, Family Dollar, Dollar Tree, and Fred's—with annual sales of $13, $9, $6, and $2 billion, respectively. Relative market share would be calculated on the basis of a total market size of $30 billion (i.e., 13 + 9 + 6 + 2). In this example, relative market shares for the competitors would be 43, 30, 20, and 7 percent, respectively. From a practical standpoint, calculating relative market share can be appropriate when external data sources are limited.

A firm's market share can also become quite complex as various industry or market restrictions are added. Unfortunately, the precise market share information most useful to a firm may be based on a set of industry factors so complex that computing it becomes an arduous task. In a recent analysis, the Mintel International Group set out to identify the size of the "healthy snack" market in the United States, a task complicated by the fact that many products such as cheese, yogurt, and cereal are eaten as snacks in some, but not all, instances.[4] To overcome this barrier, analysts computed a total for the healthy snack market by adding only the proportion of each food category consumed as a healthy snack. In other words, 100 percent of the total sales of products like popcorn and trail mix—foods consumed as healthy snacks 100 percent of the time—were included in the total. In contrast, only 40 percent of cheese consumption, 61 percent of yogurt consumption, and 21 percent of cereal consumption were included in the total. While this approach is reasonable and can be quite useful, it can only be calculated when one has access to data that may not be readily available. Hence, analysts must use the best data available to describe the relative market positions of the competitors in a given industry (see Case Analysis 2-1).

## Industry Life-Cycle Stages

Once the industry is defined, it is helpful to understand its stage of development. Like firms, industries develop and evolve over time. Not only might the group of competitors within a firm's industry change constantly, but the nature and structure of the industry can also change as it matures and its markets become better defined.

An industry's developmental stage influences the nature of competition and potential profitability among competitors.[5] While identifying the current life-cycle stage in an industry can be challenging, it is important to understand how the industry shifts over time. When top managers understand these changes, they can position their businesses more effectively. In theory, each industry passes through five distinct phases of an **industry life cycle** (see Figure 2-1).

**industry life cycle** The stages (introduction, growth, shakeout, maturity, and decline) through which industries are believed to pass.

A young industry that is beginning to form is in the *introduction stage*. Demand for the industry's outputs is low at this time because product and/or service awareness is still developing. Virtually all purchasers are first-time buyers and tend to be affluent, risk tolerant, and innovative. Technology is a key concern in this stage because businesses often seek ways to improve production and distribution efficiencies as they learn more about their markets. Industries typically progress through the introduction stage very quickly. The existence of new firms with products and services that differ significantly from those currently available in the marketplace is often a sign of a new industry. Although the new firms might not survive buyer scrutiny, the life-cycle model assumes that legitimate industries proceed to the next stage of development.

Normally, after important technological issues are resolved and customer demand begins to rise, the industry enters the *growth stage*. Growth continues but tends to slow as the market demand approaches saturation. Fewer first-time buyers remain, and most purchases tend to be "upgrades" or replacements. Many competitors are profitable, but available funds may be heavily invested into new facilities or technologies. Some of the industry's weaker competitors may go out of business in this stage.

**FIGURE 2-1**
The Industry Life Cycle

Introduction → Growth → Shakeout → Maturity → Decline

**Case Analysis 2-1**

### Step 2: Identification of the Industry, the Life-Cycle Stage, and the Competitors

After the organization has been introduced, its industry must be defined in specific terms. This process can be difficult, depending on the firm. For example, most would agree that Kroger is in the "grocery store industry," and its competition comes primarily from other grocery stores. However, not all industry decisions are this simple. For example, should Walmart be classified in the department store industry (competing with upscale mall-oriented stores) or in the discount retail industry (competing with low-end retailers such as Family Dollar)? Does Pizza Hut compete in the fast-food industry or in the broader restaurant industry? To further complicate matters, many corporations are diversified and compete in a number of different industries. In cases in which multiple business units are competing in different industries, one needs to identify multiple industries. Market shares or relative market shares for the firm and its key competitors—based on the best available data—should also be identified.

*The importance of clarifying the industry definition at the outset cannot be overstated.* External environmental forces that affect the industry cannot be assessed realistically without a clear definition. In addition, a firm's relative strengths and weaknesses can be classified as such only when compared to other companies in the industry.

The industry life-cycle stage should also be identified. As discussed in future chapters, changes in firm- and business-level strategies may be necessary as the industry evolves. It's too early to identify strategic changes at this point, but understanding the stage is an important precursor to developing appropriate strategies.

*Shakeout* occurs when industry growth is no longer rapid enough to support the increasing number of competitors. As a result, a firm's growth is contingent on its resources and competitive positioning instead of on a high growth rate within the industry. Marginal competitors are forced out, and a small number of industry leaders may emerge.

*Maturity* is reached when the market demand for the industry's outputs is becoming saturated. Virtually all purchases are upgrades or replacements, and industry growth may be low, nonexistent, or even negative. Industry standards for quality and service have been established, and customer expectations tend to be more consistent than in previous stages. The U.S. automobile industry is a classic example of a mature industry. Firms in mature industries often seek new uses for their products or services or pursue new markets, often through global expansion. By doing so, they seek to revert to a more prosperous growth stage, as U.S. automakers have done by expanding vigorously into Asia and other parts of the world. In essence, they have redefined their industry in global terms.

Mature industries can become stagnant as competitors become complacent and committed to outmoded ways of doing business. The taxi industry is a good example. With a constant need for individuals to travel around crowded urban centers, taxis have become heavily regulated in most cities, with limited supply and mandated fares. A taxi "medallion" in New York City—a permit required to operate a taxi—must be purchased from the city's Taxi and Limousine Commission at a sealed-bid auction. Fleet owners purchase medallions and "rent" them to drivers. The going price for a medallion in New York City was around $1 million in 2016. Other cities have similar licensing schemes. Upstarts Uber and Lift have challenged this stodgy and heavily regulated industry by allowing patrons to obtain rides from their independent drivers, not taxis. Because their drivers do not need medallions, they can offer lower fares. While the taxi industry remains in the maturity stage, a change like this could shift it back to the growth stage.

The online auction industry is also in (or is rapidly approaching) the maturity stage in the United States and other developed nations. The first online auction can be traced back to the 1980s, but significant industry growth did not commence until the mid-1990s when Onsale, Yahoo, eBay, and others entered the market. Shakeout occurred in the late 1990s and early 2000s as buyers and sellers began to coalesce around eBay, and rivals exited the industry. Today, eBay is the dominant player across product lines, accompanied by a number of specialty auction sites such as StubHub (event tickets) and Auction.com (real estate). Of course, industry characteristics vary in other countries, and additional growth is possible, particularly as more consumers in developing nations gain access to the Internet.

The *decline stage* occurs when demand for an industry's products and services decreases and often begins when consumers begin to turn to more convenient, safer, or higher quality offerings from firms in substitute industries. The once-stellar typewriter industry declined when people began using personal computers instead. Some firms may divest their business units in this stage, whereas others may seek to "reinvent themselves" and pursue a new wave of growth associated with a similar product or service.

Growth is difficult when an industry is in decline. There are exceptions to the rule, however. Lorillard is the third-largest cigarette producer in the United States. Sales at the top two producers—Altria Group and Reynolds American—declined 23 and 25 percent, respectively, from 2006 to 2010. Cigarette consumption declined markedly during the period as well, but Lorillard sales actually grew by 4 percent, increasing its market share from 11 to 14 percent. The company bucked the trend in part by focusing on menthol brands like Newport, and in part because its customers are younger on average than those of its rivals. Maintaining growth in the 2010s will be a challenge, however, as the industry will likely face increased government regulation and declining consumer demand.[6]

A number of external factors can facilitate movement along the industry life cycle. When oil prices spiked in 2005, for example, firms in oil-intensive industries such as airlines and carmakers began to feel the squeeze.[7] When an industry is mature, however, firms are often better able to withstand such pressures and survive.

Although the life-cycle model is useful for analysis, identifying an industry's precise position at a given moment is often difficult, and not all industries follow these exact stages or at predictable intervals.[8] For example, the U.S. railroad industry did not reach maturity for many decades and extended over a hundred years before entering decline, whereas the personal computer industry began to show signs of maturity after only seven years. As the previous examples in the automobile and online auctions demonstrate, the stage of an industry's development can vary across borders. Moreover, changes in the external environment may revitalize new growth when an industry has already progressed through the growth stage. For example, the bicycle industry fell into decline when the automobile gained popularity but has since been rejuvenated by society's interest in health and physical fitness. The cellular telephone industry reached maturity in many developed economies, only to shift back to growth when the smartphone was developed.

**hypercompetition** The notion that industries emerge, develop, and evolve so rapidly that identifying the current life-cycle stage may be neither possible nor worthwhile.

The notion of **hypercompetition** also creates a challenge. According to this perspective, industries emerge, develop, and evolve so rapidly that identifying the current stage may be neither possible nor worthwhile.[9] Because the old rules of industry evolution and competition are no longer valid, executives should be wary of life-cycle models. For these reasons, identifying the industry life-cycle stage can inform the strategic management process, but it is important not to place too much emphasis on the stage when making strategic decisions.

**Industry Life Cycle**

Identifying the appropriate stage of the industry life cycle—and avoiding decline—is challenging.

*Source:* alexmillos/Shutterstock.com.

## Industry Structure

Factors associated with industry structure have been found to play a dominant role in the performance of many companies, with the exception of those that are the industry's notable leaders or failures.[10] As such, one needs to understand these factors at the outset before delving into the characteristics of a specific firm. Michael Porter, a leading authority on industry analysis, proposed a systematic means of analyzing the potential profitability of firms in an industry known as Porter's "five forces" model. According to Porter, an industry's overall profitability (i.e., the combined profits of all competitors) depends on five basic competitive forces, the relative weights of which vary by industry (see Figure 2-2):

1. The intensity of rivalry among incumbent firms
2. The threat of new competitors entering the industry
3. The threat of substitute products or services
4. The bargaining power of buyers
5. The bargaining power of suppliers

These five factors combine to form the industry structure and suggest (but do not guarantee) profitability prospects for firms that operate in the industry. Each of the factors is discussed in greater detail.

Porter is well known for his five forces model. This site discusses the approach in detail and provides a wealth of examples: *www.quickmba.com/strategy/porter.shtml/.*

## Intensity of Rivalry among Incumbent Firms

Competition intensifies when a firm identifies the opportunity to improve its position or senses competitive pressure from other businesses in its industry, which can result in price wars, advertising battles, new product introductions or modifications, and even increased customer service or warranties.[11] Rivalry can be intense in some industries. For example, a battle is waging in the U.S. real-estate industry, where discount brokers who charge lower fees are challenging traditional brokers who earn a 5–6 percent commission. Agents for the buyer and seller typically split commissions, which are about $7,000 each when a home sells for $250,000. "Discount brokers" argue that the most critical service provided by the seller's agent is listing the home in a multiple listing service (MLS) database, the primary tool used by most buyers and their agents to peruse available properties. Some discount brokers and do-it-yourself firms like FSBO.com provide sellers with an MLS listing in a number of markets for a flat fee, sometimes less than $1,000. Traditional brokers are angry, however, and argue that discount brokers do not provide the full array of services available at a full-service broker. Traditional brokers continue to dominate the industry in most parts of the country, however. They often control the local MLS

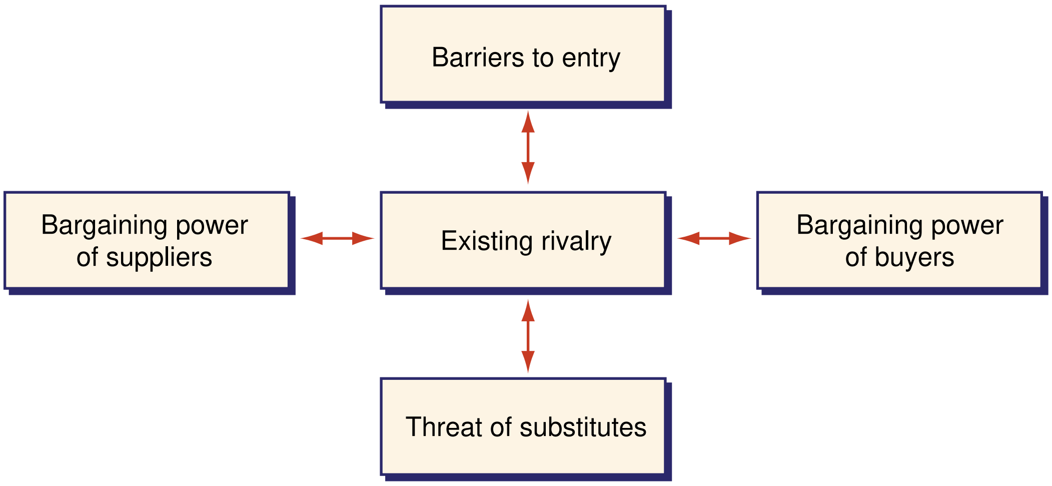


**FIGURE 2-2**
Porter's Five Forces Model

databases, and many discount brokers claim that they are not provided equal access to list their properties.[12] Rivalry in this industry—especially between full-service and discount brokers—remains quite intense.

Many retail sectors—from consumer electronics to department stores—are highly competitive as well. In the United States, the intensity of rivalry is most apparent on the day after Thanksgiving, the official beginning of the Christmas shopping season. Retailers typically slash prices and offer huge incentives to attract customers on this day known as "Black Friday." Some stores open the night before with discounts so deep that some consumers begin forming lines hours in advance.[13]

A similar situation exists in the airline industry, where fares are not based solely on cost and distance travelled, but also on competitive pressures. One study found that passengers flying out of Pittsburgh paid an average of 77 percent less per mile for a domestic airline ticket when compared to passengers flying out of Cincinnati. The reason for the difference has little if anything to do with airport costs, but instead with the presence of discount airlines such as Southwest Airlines and Spirit Airlines.[14] Hence, rivalry in this industry is intense, and price wars can have a keen effect on firm behavior.

The competitive nature of each of the previous examples is predicated on different dynamics. Competitive intensity often evolves over time and depends on a number of interacting factors, as identified by Porter and discussed in Chapter 3. Each of these factors should be assessed independently and then integrated into an overall perspective.

## Concentration of Competitors

Both the number of companies in an industry and the relative sizes or power levels of each one influence an industry's intensity of rivalry. Industries with few firms tend to be less competitive, but those with many firms that are roughly equivalent in size and power tend to be more competitive, as each one fights for dominance. Competition is also likely to be intense in industries with large numbers of firms because some of those companies may believe that they can make competitive moves without being noticed.[15]

A quick means of assessing market concentration is to sum the market shares of the four leading firms in an industry. The larger the four-firm concentration ratio, the more concentrated the industry. A limitation of this measure is that it does not consider the relative sizes of the top four firms, only the sum. An industry with five rivals each holding 20 percent of the market would be more competitive than an industry whose top four firms hold 75, 2, 2, and 1 percent, respectively. In this example, however, both industries would have the same four-firm concentration ratio, 80.

**Herfindahl-Hirschman Index (HHI)** A sophisticated measure of market concentration calculated by summing the squares of the market shares for each firm competing in an industry.

The **Herfindahl-Hirschman Index (HHI)** is a commonly accepted, more sophisticated measure of market concentration. The HHI is calculated by summing the squares of the market shares for each firm competing in an industry. Following the previous example, the HHI in the first industry would be $20^2 + 20^2 + 20^2 + 20^2 + 20^2$, or 2000, whereas the HHI in the second industry would be $75^2 + 2^2 + 2^2 + 1^2$, or 5634. The higher the HHI, the more concentrated the industry.[16]

Regulators often block proposed mergers and acquisitions when industry concentration is high, arguing that the proposed mergers and acquisitions would stifle competition. Historically, the U.S. Department of Justice and the Federal Trade Commission have considered HHI scores above 1800 to be concentrated and scores below 1000 to be "unconcentrated," often rejecting proposed mergers in the former category and approving those in the latter. Proposed mergers resulting in an HHI between 1000 and 1800 require additional scrutiny. The heavy reliance on the HHI in assessing the competitive effects of a proposed merger is changing, however, as other industry- and firm-specific factors have become greater considerations.

Needless to say, the HHI depends on one's definition of industry, and firms involved in proposed mergers tend to argue for broader definitions than do regulators. The same holds true when regulators seek to dismantle a monopoly, such as occurred in 1982 when the U.S. Department of Justice "broke up" the single telephone company AT&T into seven regional holding companies. When Office Depot and Staples announced plans to merge in 1996, the two firms claimed to control only 6 percent of the market for office supplies. Regulators, however, limited the industry to "superstores," claiming a much higher figure and charging that a merger would stifle competition. To prove this claim, they noted that prices at Staples stores were higher in towns where there was no Office Depot, and the merger was rejected. Interestingly, Office Depot and Office Max merged in 2013, and Staples initiated discussions to acquire the merged Office Depot/Office Max in 2015.[17]

When the two satellite radio providers Sirius and XM announced a merger in 2007, critics—including many in the U.S. Justice Department—claimed that the combined company would hold a monopoly and consumers would be forced to pay higher prices. Company executives questioned the industry definition, as satellite radio is not the only means by which consumers can access a wide array of information, music, and other audio programming. When terrestrial radio and the Internet are also considered, satellite radio represents only a small percentage of the overall market. The Justice Department closed its investigation of the proposed merger in 2008, at which time the two entities were combined to form Sirius XM.

Similar arguments continue to be made in the case of Microsoft's Windows operating system. Critics claim that Microsoft controls 80 percent of the operating system industry, whereas Microsoft argues that it is a small player in the broader software industry. Hence, the notion of market concentration is inseparable from one's definition of the industry.

While it is true that a high concentration of competitors reduced industry competitiveness in the short term, the notion that regulators should take steps to limit industry concentrations is debatable. Critics note that calculating concentration ratios is as much of an art as a science. A high concentration ratio suggests that one or a few companies are meeting customer needs more effectively than others, and it is unjust to limit their growth. Moreover, it is not uncommon for dominant firms once believed to be impenetrable to become victims of the creative destruction inherent in market development.

## High Fixed or Storage Costs

When firms have unused productive capacity, they often cut prices in an effort to increase production and move toward full capacity. The degree to which prices (and profits) can fall under such conditions is a function of the firms' cost structures. Those with high fixed costs are most likely to cut prices when excess capacity exists because they must operate near capacity to be able to spread their overhead over more units of production.

The impact of fixed costs on competitiveness depends on the type of goods or services produced in an industry. A *rival* good, such as a soft drink or an oil change, can only be consumed by one person at a given time; in contrast, a *nonrival* good, such as a TV show or a smartphone app, can be consumed simultaneously by multiple individuals. The more nonrival goods are produced in an industry, the greater the influence of fixed costs on industry competitiveness. For example, digital information is nonrival; the fixed costs associated with its development might be high, but it can be reproduced and distributed at virtually zero marginal cost.[18] Once it is created, companies have an incentive to lower the price as much as necessary to sell it.

The U.S. airline industry experiences this problem periodically, as losses generally result from planes that are flying either with lots of empty seats or are not flying at all. This dynamic often results in last-minute fare specials in an effort to fill vacant seats. Consider the difficult times for U.S. airlines immediately following the 9/11 terrorist attacks. Price wars were common and were even initiated by low-cost airlines such as JetBlue and Southwest.[19]

## Slow Industry Growth

Firms in industries that grow slowly are more likely to be highly competitive than companies in fast-growing industries. In slow-growth industries, one firm's increase in market share must come primarily at the expense of other firms' shares. Competitors often pay more attention to the actions of their rivals than to consumer tastes and trends when formulating strategies.

Slow industry growth can be caused by a sluggish economy, as was the case for vehicles during the early 2000s and again in the early 2010s. As a result, manufacturers began to emphasize value by enhancing features and cutting costs. In the early 2000s, Ford, General Motors, Nissan, Toyota, and others began to produce slightly larger trucks with additional features, while trimming prices. Producers also began to develop lower-priced luxury cars in a fierce battle for sales.[20] In the early 2010s, many producers emphasized value and fuel economy to attract buyers.

Slow industry growth—and even a decline in total revenues—is frequently caused by shifts in consumer demand patterns. For example, per capita consumption of carbonated soft drinks in the United States fell from its peak of 54 gallons in 1997 to around 41 gallons by 2015. During this same period, annual world growth declined, and consumption of fruit juices, energy drinks, bottled water, and other noncarbonated beverages continued to rise. Coca-Cola and PepsiCo acquired or developed a number of noncarbonated brands during this time in efforts to counter the sluggish growth prospects in soft drinks. Interestingly, these rivals now appear to have modified their industry definitions from a narrow "soft-drink" focus to a broader perspective that includes noncarbonated beverages.[21]

### Lack of Differentiation or Low Switching Costs

The more similar the offerings among competitors, the more likely customers are to shift from one to another. As a result, such firms tend to engage in price competition. When **switching costs**—one-time costs that buyers incur when they switch from one company's products or services to those of another company—are low, firms are under considerable pressure to satisfy customers who can easily switch competitors at any time. Likewise, when products or services are less differentiated, purchase decisions are based on price and service considerations, resulting in greater competition. While newcomers prefer low switching costs to facilitate entry into an industry, incumbents tend to raise these costs whenever possible to keep them out.

**switching costs** One-time costs that buyers of an industry's outputs incur as they switch from one company's products or services to those of another company.

Switching costs include both financial and nonfinancial costs that must be incurred by customers who switch from one rival to another. For example, the switching costs for PC users who switch to a Mac include *both* financial outlays—the price of a new computer, software, and the like—and the time, energy, and effort required to become accustomed with a new operating system. Hence, where switching costs are high, the original producers tend to retain a strong position and can even thwart newcomers with more attractive offerings and prices.

Interestingly, firms often seek to create switching costs in efforts to encourage customer loyalty. Historically, Internet service provider (ISP) America Online (AOL) encouraged its users to obtain and use an AOL e-mail account, eliminating it if the AOL customer switched to another provider. When free e-mail accounts with Yahoo and other providers proliferated in the mid-2000s, AOL had no choice but to loosen this restriction in 2006, suggesting that most consumers no longer viewed the loss of an e-mail account as a switching cost when considering a change to another ISP. Today, e-mail accounts are widely and freely available, and few people use accounts associated with their ISP. Similarly, frequent-flier programs also reward fliers who fly with partner airlines.

The cellular telephone industry in the United States benefited from key switching costs for a number of years. Until regulations changed in late 2003, consumers who switched providers were not able to keep their telephone numbers. Hence, many consumers were reluctant to change due to the complications associated with alerting friends and business associates of a new number. Today, number portability greatly reduces switching costs, allowing individuals and businesses to retain their original telephone numbers when they switch providers.[22] Many wireless carriers employ one- and two-year contracts as another means of creating high switching costs. Of the 326 million wireless subscribers in the United States in 2013, only 19 million actually left the top two carriers—Verizon and AT&T—during the previous three years. Less than 1 percent of wireless customers change carriers each month. This lack of mobility makes it extremely difficult for upstarts or smaller carriers like Sprint and T-Mobile to gain market share.[23]

### Capacity Augmented in Large Increments

When production can be easily added in single increments, overcapacity is not a major concern. However, if economies of scale or other factors dictate that production be augmented in large blocks, then capacity additions may lead to temporary overcapacity in the industry, and firms may cut prices to clear inventories. Airlines and hotels, for example, must acquire additional capacity in large increments because it is not feasible to add a few airline seats or hotel rooms as demand warrants. When additional blocks of seats or rooms (i.e., additional planes or hotels) become available, firms are under intense pressure to cover the additional costs by filling them.

### Diversity of Competitors

Companies that are diverse in their origins, cultures, and strategies often have different goals and means of competition. Such firms may have a difficult time agreeing on a set of "rules of combat." As such, industries with global competitors or with entrepreneurial owner-operators tend to be diverse and particularly competitive. Internet businesses often "change the rules" for competition by emphasizing alternative sources of revenue, different channels of distribution, or a new business model. This diversity can increase rivalry sharply.

### High Strategic Stakes

Competitive rivalry is likely to be high if firms also have high stakes in achieving success in a particular industry. This often occurs when a firm is losing market share, and its leaders are compelled to make a comeback, whatever the cost. For many strong, traditional companies, failing in their web-based ventures may not be seen as an option. A presence is viewed as necessary, regardless of profitability. Large global firms seeking a permanent presence in a particular country might be willing to operate at a loss for an extended period of time. In industries with high strategic stakes, new entrants are forced to compete with existing firms that are not even profitable.

### High Exit Barriers

**Exit barriers** are economic, strategic, or emotional factors that keep companies from leaving an industry even though they are not profitable or may even be losing money. Examples of exit barriers include fixed assets that have no alternative uses, labor agreements that cannot be renegotiated, strategic partnerships among business units within the same firm, management's unwillingness to leave an industry because of pride, and governmental pressure to continue operations to avoid adverse economic effects in a geographic region.[24] When substantial exit barriers exist, firms choose to compete at a loss as a lesser of two evils, a practice that can drive down the profitability of competitors as well.

**exit barriers** Economic, strategic, or emotional obstacles to leaving an industry.

## Threat of Entry

An industry's productive capacity expands when new competitors enter. Unless the market is growing rapidly, new entrants intensify the fight for market share, lowering prices and, ultimately, industry profitability. When large, established firms control an industry, new entrants are often pelted with retaliation when they establish their operations or begin to promote their products aggressively. For example, Seven-Up launched Like Cola directly against Coke and Pepsi in 1982 in an effort to make inroads into the cola segment of the soft-drink market. Without delay, the two major competitors responded with strong promotional campaigns, Like was withdrawn from the market, and Pepsi and Coke have dominated the cola market in the United States ever since. If prospective entrants anticipate retaliation from existing firms, they are less likely to enter the industry in the first place. As in the Like example, retaliation is most likely to occur when incumbent firms are committed to remaining in the industry or have sufficient cash and productive capacity to meet anticipated customer demand in the future.[25]

**barriers to entry** Obstacles to entering an industry, including economies of scale, brand identity and product differentiation, capital requirements, switching costs, access to distribution channels, cost disadvantages independent of size, and government policy.

The likelihood that new firms will enter an industry also depends on the extent to which **barriers to entry** have been erected—often by existing competitors—to keep prospective newcomers out.[26] From a global perspective, many barriers have declined, as firms in countries like India and China make use of technology—and specifically, a developing global fiber-optic network—to gain access to industries in the West. Over a million U.S. Internal Revenue Service (IRS) tax returns are prepared annually in India each year. Hence, barriers are always changing as technology, political influences, and business practices also change.[27]

Many firms take barriers to entry very seriously. Single-runway Silver Comet Field—located 30 miles northwest of Atlanta—discovered this when Delta Airlines began fighting its effort to introduce four daily commuter flights on the grounds that doing so would threaten "Atlanta's economy." Hartsfield-Jackson Atlanta International Airport is a Delta hub and operates 922,000 commercial flights with 203 gates and 58,000 employees. Georgia's Silver Comet Field is located in Dallas, Georgia, and has one gate and two employees. But as a Delta representative put it, "A second airport can quickly expand, and the impact on Hartsfield-Jackson would be significant." Atlanta is the only U.S. city among the most populous ten that lacks at least one secondary commercial airport, something that Propeller Investments, the private-equity firm managing Silver Comet, is trying to change. Bret Smith, Propeller's managing director, noted that Delta has "controlled and dominated the Atlanta market in a way that no other carrier has been able to in any other large metro area."[28]

The seven major barriers (obstacles) to entry are described in the following sections (see also Strategy at Work 2-1). As with intensity of rivalry, each factor should be assessed independently and then integrated into an overall perspective on entry barriers.

## Economies of Scale

The term *economies of scale* refers to the decline in unit costs of a product or service that occurs as the absolute volume of production increases. Scale economies occur when increased production drives down costs and can result from a variety of factors—namely, high firm specialization and expertise, volume purchase discounts, and a firm's expansion into activities once performed at higher costs by suppliers or buyers. Economies of scale exist in most industries, but to different extents. Substantial economies of scale deter new entrants by forcing them either to enter an industry at a large scale—a costly course of action that risks a strong reaction from existing firms—or to suffer substantial cost disadvantages associated with a small-scale operation. For example, a new automobile manufacturer must accept substantially higher per-unit costs as a result of the massive investment required to establish a production facility unless a large volume of vehicles can be produced at the outset. In contrast, while a new restaurant can enjoy economies of scale by attracting a large number of customers early on, higher per-unit costs associated with a slow start are easier to overcome as long as the firm is able to achieve modest growth.

Automation—the simple substitution of capital for labor—can be worthwhile but often results in limited gains. The greatest benefits from capital-labor substitution require creativity and emanate from a broader organizational restructuring and a complete rethinking of how business is transacted. eBay did not just automate traditional auctions, but pursued and scaled an online model that completely changed the marketplace, taking a big bite out of traditional companies in the process. Prompted by increased labor and benefit costs, major fast-food chains are testing automated systems that allow customers to order and pay for their food without involving cashiers. Nonetheless, decisions to automate and leverage scale economies should be made only after careful consideration.

## Brand Identity and Product Differentiation

Established firms may enjoy strong brand identification and customer loyalties that are based on *actual or perceived* product or service differences. Typically, new entrants must incur substantial marketing and other costs over an extended period of time to overcome this barrier. Differentiation is particularly important among products and services where

## Strategy at Work 2-1

### Creating Barriers to Entry in the Airline Industry[29]

U.S. airline deregulation in 1978 was intended to encourage new start-up ventures and foster competition. For a while, it seemed to be working; new companies such as Southwest Airlines and AirTran (acquired by Southwest in 2011) helped to lower ticket prices significantly. Over time, however, the major airlines have succeeded in erecting enormous barriers to entry, such as:

1. The "global alliances" that exist among major world carriers result in substantial control over hubs and passenger-loading gates at large airports, where such carriers already typically hold 20- to 40-year leases. In addition, most airlines have a large number of U.S. hub airports, a feeder system to those hubs, and international routes that tie into the hubs. Such systems take decades and hundreds of millions of dollars to acquire.
2. Major airlines own the computer reservation systems, negotiate commission arrangements with travel agents for bringing business to them, and charge small carriers hefty fees for tickets sold through those systems. By operating their own websites, U.S. airlines have been able to eliminate the commission fees paid for domestic bookings. Even the surviving online agencies like Travelocity, Orbitz, and Expedia must seek profits by packaging hotels and rental cars with airline tickets, or by purchasing blocks of airline tickets on select flights far in advance to control the price.
3. All major carriers operate frequent-flier programs that encourage passengers to avoid switching airlines. Many of the programs expire when a passenger does not fly on the airline after a specific period of time, often three years.
4. Airline computer-pricing systems enable them to selectively offer low fares on certain seats and to certain destinations (often purchased well in advance or at the last minute), thereby countering a start-up airline's pricing edge.
5. The dominant major carriers are willing to match or beat the ticket prices of smaller, niche airlines, and often respond to price changes within hours. Most are capable of absorbing some degree of losses until weaker competitors are driven out of business.

These barriers are designed to keep control of the airline industry's best routes and markets in the hands of a few carriers, even after two decades of deregulation. As such, newly formed carriers are often limited to less-desirable routes. Although many upstarts fail in their first year or two of operation, however, others such as Southwest and JetBlue have been successful and are filling viable niches in the industry. Interestingly, the airline industry fallout from the events of September 11, 2001, was felt the most by established competitors, such as American, Delta, and United.

the risks associated with switching to a competitive product or service are perceived to be high, such as over-the-counter drugs, insurance, and baby-care products. The producer of a new brand of toothpaste typically spends heavily to counter affinities to established brands like Colgate and Crest.

### Capital Requirements

Generally speaking, higher entry costs tend to restrict new competitors and ultimately increase industry profitability.[30] Large initial financial expenditures may be necessary for production, facility construction, research and development, advertising, customer credit, and inventories. Some years ago, Xerox cleverly created a capital barrier by offering to lease, not just sell, its copiers. As a result, new entrants were faced with the task of generating large sums of cash to finance the leased copiers.[31] Of course, this barrier was short-lived. As the industry grew and technological advances lowered the cost of copiers, this barrier eroded.

### Switching Costs

As previously discussed, switching costs are the upfront outlays—financial and nonfinancial—that buyers of one firm's products may incur if they switch to those of a rival. If these costs are high, buyers may need to test the new product first, make modifications in existing operations to accommodate the change, or even negotiate new purchase contracts. When switching costs

**Low Switching Costs**

When customers can easily switch among rivals, competition is more intense.

*Source:* Prextimize/Shutterstock.com.

are low—typically the case when consumers try a new grocery store—change may not be difficult. Likewise, fast-food restaurants generally have little difficulty persuading consumers to switch from one restaurant to another—at least once—when products are introduced.

### Access to Distribution Channels

In some industries, firms that wish to use entering existing distribution channels must entice distributors through price breaks, cooperative advertising allowances, or sales promotions. Existing competitors may have distribution channel ties based on long-standing or even exclusive relationships, requiring the new entrant to create its own channels of distribution. For example, many manufacturers and retailers have formed partnerships with FedEx or UPS to transport merchandise directly to their customers. As a distribution channel, the Internet may offer an alternative to companies unable to penetrate the existing channels.

### Cost Advantages Independent of Size

Many firms enjoy cost advantages emanating from economies of scale, but some may have also developed cost advantages *not* associated with firm size that cannot be easily duplicated by newcomers. Such factors include patents or proprietary technology, favorable locations, superior human resources, and experience in the industry. For example, eBay's experience, reputation, and technological capability in online auctions have made it very difficult for prospective firms to enter the industry. When such advantages exist for one or more existing competitors, prospective new entrants usually hesitate to enter the industry.

### Government Policy

Governments often control entry to certain industries with licensing requirements or other regulations. For example, establishing a hospital, a nuclear power facility, or an airline cannot be done in most nations without meeting substantial regulatory requirements. Even hairdressers, cosmetologists, and pest control companies require licenses in most locales. Although firms generally oppose government attempts to regulate their activity, this is not always the case. Existing competitors often lobby legislators to enact policies that increase costs because they also create barriers to entry for prospective rivals.

## Pressure from Substitute Products

Firms in one industry often compete indirectly with firms in other industries that produce **substitute products.** By definition, substitute products are produced by firms in other industries; they satisfy similar consumer needs but differ in specific characteristics. It should be emphasized that products and services affected by a firm's competitors (i.e., companies in the same industry) do *not* represent substitutes for that firm. *Substitutes always reside outside of a firm's industry.*

**substitute products** Alternative offerings produced by firms in another industry that satisfy similar consumer needs.

Because substitutes are not part of the industry, they cannot be identified until the industry is defined clearly. For example, suppose McDonald's industry is defined specifically as fast food. Because Applebee's does not meet the criteria for inclusion in the industry—fast service, drive-through service, easy-to-eat food, and the like—it would not be considered a substitute. If McDonald's industry is defined more broadly to include all restaurants, then Applebee's would meet the criteria. In this instance, Applebee's would be a rival, not a substitute.

Although they emanate from outside the industry, substitutes can influence demand patterns within the industry and can even limit the prices that firms can charge. For instance, low fares offered by airlines can place a ceiling on the long-distance bus fares that Greyhound can charge for similar routes. Hence, firms that operate in industries with few or no substitutes are more likely to be profitable.

## Bargaining Power of Buyers

Firms in every industry must negotiate with both suppliers of required resources and buyers of the finished products or services. The buyers of an industry's outputs can lower that industry's profitability by bargaining for higher quality or more services and playing one firm against another. Levi Strauss discovered this when negotiating a sizeable contract with mega-retailer Walmart. Ultimately, the famous American jean-maker decided to create a lower-cost brand by overhauling production and distribution efforts.[32]

A number of circumstances can raise the bargaining power of an industry's buyers, thereby reducing potential profits within the industry:

1. Buyers are concentrated, or each one purchases a significant percentage of total industry sales. If a few buyers purchase a substantial proportion of an industry's sales, then they wield considerable power over prices. This is especially prevalent in markets for components and raw materials.
2. The products that the buyers purchase represent a significant percentage of the buyers' costs. When this occurs, price will become more critical for buyers, who will shop for a favorable price and will purchase more selectively.
3. The products that the buyers purchase are standard or undifferentiated. In such cases, buyers are able to play one seller against another and initiate price wars.
4. Buyers face few switching costs and can freely switch from one rival to another. Fast food is a prime example because consumers can readily switch among restaurants.
5. Buyers earn low profits, creating pressure for them to reduce their purchasing costs and negotiate more aggressively with industry firms. Producers of automobile parts are often squeezed when profits decline among manufacturers.
6. Buyers can engage in backward integration by becoming their own suppliers. Large fast-food restaurants can purchase their own potato farms if they wish. Aware of this possibility, potato producers are under constant pressure to provide high-quality products and favorable terms.


**Buyers and Sellers**

Bargaining with buyers and sellers is a tug-of-war that affects industry profitability.

*Source:* Nickylarson974/ Shutterstock.com.

7. The industry's product is relatively unaffected by the quality of the buyers' products or services, thereby creating an incentive for firms to change suppliers and demand the lowest prices. When companies purchase bottled water for office consumption, price is a key component. In contrast, when the quality of the buyers' products is greatly affected by what they purchase from the industry, buyer power is reduced because quality and special features will be the most important characteristics.
8. Buyers have access to the same product, market, and cost information as producers in the industry. The more information buyers have regarding demand, actual market prices, and supplier costs, the greater their ability to play one against another. The Internet has increased the quantity and quality of information available to buyers in a number of industries.

## Bargaining Power of Suppliers

The "tug of war" between an industry's rivals and their suppliers is similar to that between the rivals and their buyers. When suppliers to an industry wield collective power over the firms in the industry, they can siphon away a portion of excess profits that may be gleaned. Alternatively, when an industry's suppliers are weak, they may be expected frequently to cut prices, increase quality, and add services. This has been the case among U.S. automakers for the last few decades.[33]

A firm or industry's success can be directly linked to the success of suppliers. For example, Tesla Motors cannot sell its electric vehicles without a key supplier—charging stations. Although a number of stations have emerged in the United States so drivers can recharge away from home, Tesla has had a difficult time expanding in China, where private garages are rare and customers must depend on stations installed in their residential complexes.[34]

Firms sometimes challenge the balance of supplier power in an industry. When Apple launched Apple Music in 2015 to compete with Spotify, Pandora, and others, it offered three months free to consumers. Artists—the suppliers of music content—were told that they would not receive royalties during this time either. Apple did not anticipate pushback because it figured that the artists would want to be onboard for the long term, but superstar Taylor Swift announced that she would not allow her latest album to be included. In an open letter to Apple, she argued, "We don't ask you for free iPhones. Please don't ask us to provide you with our music for no compensation." Apple declined to comment at first, but quickly reversed its policy and announced that royalties would be paid during the free period.[35]

The struggle between U.S. service stations and their suppliers—big oil companies—is another interesting example. When the popularity of E85 ethanol—a mixture containing 85 percent ethanol and 15 percent gasoline—began to rise in the mid- to late 2000s, many U.S. service stations were prohibited from carrying the alternative fuel. Oil companies that do not supply E85 lose sales every time drivers fill their tanks with the ethanol mix. As a result, many prohibit their franchisees from carrying fuel from other producers. Service stations that are allowed to carry E85 are often required to dispense it from a pump on a separate island not under the main canopy, a costly endeavor. Because there are only a few major oil companies and thousands of service stations in the United States, the oil companies are able to wield most of the power.[36]

The conditions that make suppliers powerful are similar to those that affect buyers because negotiations are similar in both instances. Specifically, suppliers are powerful under the following circumstances:

1. The supplying industry is dominated by one or a few companies. Concentrated suppliers typically exert considerable control over prices, quality, and terms when selling to fragmented buyers. This is especially true when a monopoly—one dominant producer—exists.
2. There are no substitute products, weakening an industry's rivals in relation to their suppliers. Automobile producers must purchase tires; there are no alternatives. Other factors equal, this reality gives power to the tire manufacturers.

3. The industry as a whole is not a major customer of the suppliers. If a particular industry does not represent a significant percentage of the suppliers' sales, then the suppliers control the balance of power. If competitors in the industry comprise an important customer, however, suppliers tend to understand the interrelationships and are likely to consider the long-term viability of their counterparts—not just price—when making strategic decisions.
4. The suppliers pose a credible threat of forward integration by "becoming their own customers." If suppliers have the ability and resources to distribute their own products and operate their own retail outlets, they will possess considerable control over buyers. Many producers have exerted this control by selling directly to consumers.
5. The suppliers' products are differentiated or have built-in switching costs, thereby reducing the buyers' ability to play one supplier against another. In such instances, firms have little or no choice but to purchase the products, regardless of price or other terms.

## Limitations of Porter's Five Forces Model

Generally speaking, the five forces model is based on the assumptions of the industrial organization (IO) perspective on strategy, as opposed to the resource-based perspective. As such, it assumes that industry structure, not unique firm characteristics, drives firm performance. Although the model serves as a useful analytical tool and an excellent starting point for analysis, it has several key limitations. First, it assumes the existence of a clear, recognizable industry. As complexity associated with industry definition increases, the ability to draw coherent conclusions from the model diminishes. Likewise, the model addresses only the behavior of firms in an industry and does not account for the role of partnerships, a growing phenomenon in many industries. When firms "work together," either overtly or covertly, they create complex relationships that are not easily incorporated into industry models.

Second, the model does not take into account the fact that some firms, most notably large ones, can often take steps to modify the industry structure, thereby increasing their prospects for profits. For example, large airlines have been known to lobby for hefty safety restrictions to create an entry barrier to potential upstarts. Walmart even employs its own team of lobbyists in Washington, D.C., to advance its business interests.

Third, the model assumes that industry factors, not firm resources, comprise the primary determinants of firm profit. This issue continues to be widely debated among both scholars and executives, but as noted in Chapter 1, industry factors typically account for only about a quarter of firm performance.[37] This limitation reflects the ongoing debate between IO theorists who emphasize Porter's model and resource-based theorists who emphasize firm-specific characteristics. The resource-based perspective is addressed later in the strategic management process.

Finally, a firm that competes in many countries must analyze and be concerned with multiple industry structures. The nature of industry competition in the international arena differs among nations, and may present challenges that are not present in a firm's host country.[38] For example, one's definition of McDonald's industry may be limited to fast-food outlets in the United States, but may also include a host of other traditional restaurants when competition in other countries is considered. Different industry definitions for a firm across borders can make the task of assessing industry structure quite complex.

These challenges notwithstanding, a thorough analysis of the industry via the five forces model is a critical first step in developing an understanding of competitive behavior within an industry.[39] In a general sense, Porter's five forces model provides insight into profit-seeking opportunities, as well as potential challenges, within an industry (see Case Analysis 2-2).

## Case Analysis 2-2

### Step 3: Potential Profitability of the Industry

Porter's five forces model should be applied to the industry environment—as identified in the previous step—by examining threat of entry, rivalry among existing competitors, pressure from substitute products, and the bargaining power of buyers and suppliers. Each of the specific factors identified in the rivalry and new entrants sections should be assessed individually; this typically requires a paragraph at minimum to explain each factor. In addition, each of the five forces should be evaluated with regard to its positive, negative, or neutral effect on potential profitability in the industry. In most instances, both positive and negative influences will be identified. An overall assessment that considers the composite effect of all five forces should also be provided. This assessment identifies the industry as either profitable, unprofitable, or somewhere in-between.

### Step 4: What Firms Have Succeeded and Failed in the Industry, and Why? What Are the Critical Success Factors That Emanate from These Examples of Success and Failure?

Every industry has recent winners and losers. The first step in understanding the critical success factors (CSFs) is to identify the companies that are doing well or poorly—or that have done so in the past—and determine whether their performance levels appear to be associated with similar factors. For example, McDonald's, KFC, and Taco Bell are long-term successful players in the fast-food industry, while rival Arby's has struggled. Are there any common factors that may help explain the differences in performance? Consider that many analysts have noted that consistency and speed of service are critical success factors in the fast-food industry. Indeed, McDonald's, KFC, and Taco Bell are all noted for their fast, consistent service.

Several key CSFs can usually be identified by studying an industry's history. Examples of success and failure—not conjecture—should be identified and used as a basis for identifying CSFs. Multiple examples used in developing a list of CFSs may be based on the same company, and it is possible that some examples of the same company might depict success, while others point to failure. Moreover, a business may succeed even if it does not possess a key industry CSF, although this is the exception, not the rule. Chipotle Mexican Grill, for example, has become a highly successful fast-food chain without displaying its products, advertising on television, franchising, or constantly cutting costs, factors one might consider to be CSFs in the fast-food industry.[40] However, the *likelihood* of success is diminished greatly when a business does not possess a CSF.

## Summary

An industry is a group of companies that produce similar products or services. Like organizations, industries evolve over time and tend to pass through several stages. Michael Porter has identified five basic competitive industry forces that can ultimately influence potential profitability within the industry, ultimately affecting performance at the firm level. These include the intensity of rivalry among incumbent firms in the industry, the threat of new entrants in the industry, the threat of substitute products or services, bargaining power of buyers of the industry's outputs, and bargaining power of suppliers to the industry. Firms tend to operate quite profitably in industries with high entry barriers, low intensity of competition among member firms, no substitute products, weak buyers, and weak suppliers. These relationships are tendencies, however, and do not mean that all firms will perform in a similar manner because of industry factors. Although Porter's model has its shortcomings, it represents an excellent starting point for positioning a business among its competitors.

## Key Terms

barriers to entry
critical success factors (CSFs)
exit barriers
Herfindahl-Hirschman Index (HHI)
hypercompetition
industry
industry life cycle
market share
relative market share
substitute products
switching costs

## Review Questions and Exercises

1. Visit the websites of several major restaurant chains. Identify the industry(s) in which each one operates. Would you categorize them in the same industry or in different industries (for example, fast food, family restaurants, etc.)? Why or why not?
2. Identify an industry that has low barriers to entry and one that has high barriers. Explain how the difference in entry barriers influences competitive behavior in these industries.
3. Identify some businesses whose sales have been adversely affected by substitute products. Why has this occurred?
4. Identify an industry in which the suppliers have strong bargaining power and another industry in which the buyers have most of the bargaining power. How does this affect potential profitability in the industries?

## Chapter 2 Practice Quiz

### True or False

1. A firm always operates in a single, distinct industry.
2. All industries follow the stages of the industry life-cycle model.
3. The likelihood that new firms will enter an industry is contingent on the extent to which barriers to entry have been erected.
4. Higher capital requirements for entering an industry ultimately raise average profitability within that industry.
5. Substitute products are produced by competitors in the same industry.
6. A key limitation of Porter's five forces model is its reliance on resource-based theory.

### Multiple Choice

7. Industry growth is no longer rapid enough to support a large number of competitors in which stage of industry growth?
   **A.** growth
   **B.** shakeout
   **C.** maturity
   **D.** decline
8. The intensity of rivalry among firms in an industry is dependent on which of the following?
   **A.** concentration of competitors
   **B.** high fixed or storage costs
   **C.** high exit barriers
   **D.** all of the above
9. The decline in unit costs of a product or service that occurs as the absolute volume of production increases is known as
   **A.** production effectiveness.
   **B.** effective operations management.
   **C.** economies of scale.
   **D.** technological analysis.
10. When switching costs are high,
    **A.** customers are less likely to try a new competitor.
    **B.** companies spend more on technology.
    **C.** companies seek new suppliers to reduce costs.
    **D.** none of the above
11. Which of the following is not a cost advantage independent of scale?
    **A.** proprietary technology
    **B.** favorable locations
    **C.** experience in the industry
    **D.** high volume of production
12. What is occurring when those who purchase an industry's goods and services exercise great control over pricing and other terms?
    **A.** a high bargaining power of suppliers
    **B.** a low bargaining power of suppliers
    **C.** a balance of power among suppliers
    **D.** none of the above

## Case 2: Home Depot

Bernard Marcus and Arthur Blank founded Home Depot after losing their jobs in the home improvement industry in 1978. Their vision was to focus on the needs of the do-it-yourself (DIY) market, specializing in building materials and lawn and garden equipment. Three stores were launched in the Atlanta area in 1979, and four stores in south Florida were added in 1981. The firm posted sales of $50 million that year and went public. By 1983, Home Depot had opened stores in Louisiana and Arizona, with total sales exceeding $250 million.

Home Depot expanded into California in 1985, and by the following year, had amassed a total of sixty stores and sales of $1 billion. Home Depot continued to grow and entered the northeastern United States and Canada in subsequent years, reaching 500 stores by 1997. Home Depot added a direct-mail interest by acquiring mail-order firm National Blind & Wallpaper Factory and direct-marketer Maintenance Warehouse.

Home Deport launched Villager's Hardware stores in New Jersey in 1999, 40,000-square-foot outlets designed to compete with traditional hardware stores. The firm also began to add large appliances to many of its stores. In 2000, Marcus and Blank became co-chairmen, and former General Electric executive Robert Nardelli was named president and CEO.

Aggressive expansion continued in 2001 when Home Depot added another 200 stores and acquired Total Home, a small home-improvement chain in Mexico. Marcus and Blank stepped down as co-chairmen, and Nardelli assumed the role in addition to his CEO responsibilities.

Having abandoned its Villager's Hardware concept the previous year, Home Depot opened its first small store—about 60,000 square feet—in New York City in 2002. The firm continued its expansion into Mexico, acquiring Del Norte, a small chain in Juarez. Home Depot operates over 100 stores in Canada and has opened a business-development office in China.

Competitive pressure from Lowe's has caused Home Depot to aggressively upgrade its old stores, while continuing its growth efforts, and contributed to CEO Robert Nardelli's ouster in 2007, when he was replaced by Frank Blake. Sales peaked in 2008 amidst the housing crisis, stagnated, and then rose again throughout the early 2010s.

Today, Home Depot is the world's largest home improvement chain and the second-largest retailer after Walmart, amassing $79 billion in annual revenues, operating approximately 2,250 stores, and employing 371,000 workers throughout the Americas. Home Depot continues to focus on the DIY customer, with more than 40,000 products stocked in a 130,000-square-foot facility. Home Depot promotes a community focus through the Home Depot Foundation.

### Case Challenges

1. Is it necessary for Home Depot to emphasize both the DIY and contractor segments of the market to build and maintain economies of scale? Is one segment tied more closely to the general state of the economy than the other? Explain.
2. Has competitive pressure from Lowe's caused Home Depot to modify its business strategy? If so, how?
3. Do international opportunities exist for Home Depot beyond North America?

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## Simulation 101: Industry Fundamentals

Industry definition is not required in a simulation. It has already been defined for you, but there are two key concepts in this chapter that you should consider when making strategy decisions. The first is the life-cycle stage of the industry. Most simulations provide narratives and industry revenue growth data to aid in your decision making. If your industry is young and growing, it is worthwhile to consider expansions to capacity, an emphasis on marketing for the long term, and developing new products aimed at meeting future needs. If your industry is mature, issues such as cost containment and product reliability might be more important. Of course, all of these issues should be considered to some extent, regardless of life-cycle stage.

The second key concept from this chapter is the evaluation of existing rivalry. The text identifies a number of factors that increase rivalry, thereby reducing the potential for profit for each firm. If rivalry is high, then it is possible for most or all companies to lose money. This usually occurs in a simulation when virtual companies end up in a price war to secure market share. There is no way to resolve this dilemma until enough team managers decide that cutthroat competition is counterproductive and raise prices. This is easier said than done because each player has an incentive to increase prices until doing so has a strong negative effect on demand. The result is a guessing game because industry prices are not known until after a round has been completed. Be warned that some students might attempt to collude with others and agree to raise prices in unison. This is both unethical and unlawful in the real world, and will invite the deserved wrath of the administrator—your professor—if (and usually when) it is discovered.

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# The External Environment: Political-Legal and Economic Forces

CHAPTER 3

## Chapter Outline




*Source:* dizain/Shutterstock.com.

After the industry has been defined clearly and Porter's five forces model has been applied to assess the industry's potential profitability, attention turns to forces outside of the industry. The effects of external forces on the industry are constantly changing, so it is important to understand their collective influence—first on the industry and then on the firm—before developing a strategic plan. Although a number of individual companies are discussed in this chapter as examples, the chapter continues with an industrial organization (IO) perspective by emphasizing the effects of outside factors on entire industries, not just firms.

## Analysis of the External Environment

Organizations and industries exist within a complex network of external forces. Together, these elements comprise the external environment, or **macroenvironment**. There are four categories of macroenvironmental forces: political-legal, economic, social, and technological (see Figure 3-1). The analysis of external factors may be referenced as **PEST**—political-legal, economic, social, and technological—an acronym derived from the first letter of each of the four categories of forces. The effects of external environmental forces on a firm's industry should be well understood before strategic options are developed and evaluated. Political-legal and economic forces are addressed in this chapter. Social and technological forces are addressed in Chapter 4.

Firms operating in multiple, distinct geographical markets may be affected in different manners by external forces in each market. For example, wide

**macroenvironment** The general environment that affects all business firms in an industry, which includes political-legal, economic, social, and technological forces.

**PEST** An acronym referring to the analysis of the four macroenvironmental forces: **p**olitical, **e**conomic, **s**ocial, and **t**echnological.