# STRATEGIC MANAGEMENT

## COMPETITIVENESS AND GLOBALISATION

7TH ASIA-PACIFIC EDITION

HANSON | BACKHOUSE | LEANEY
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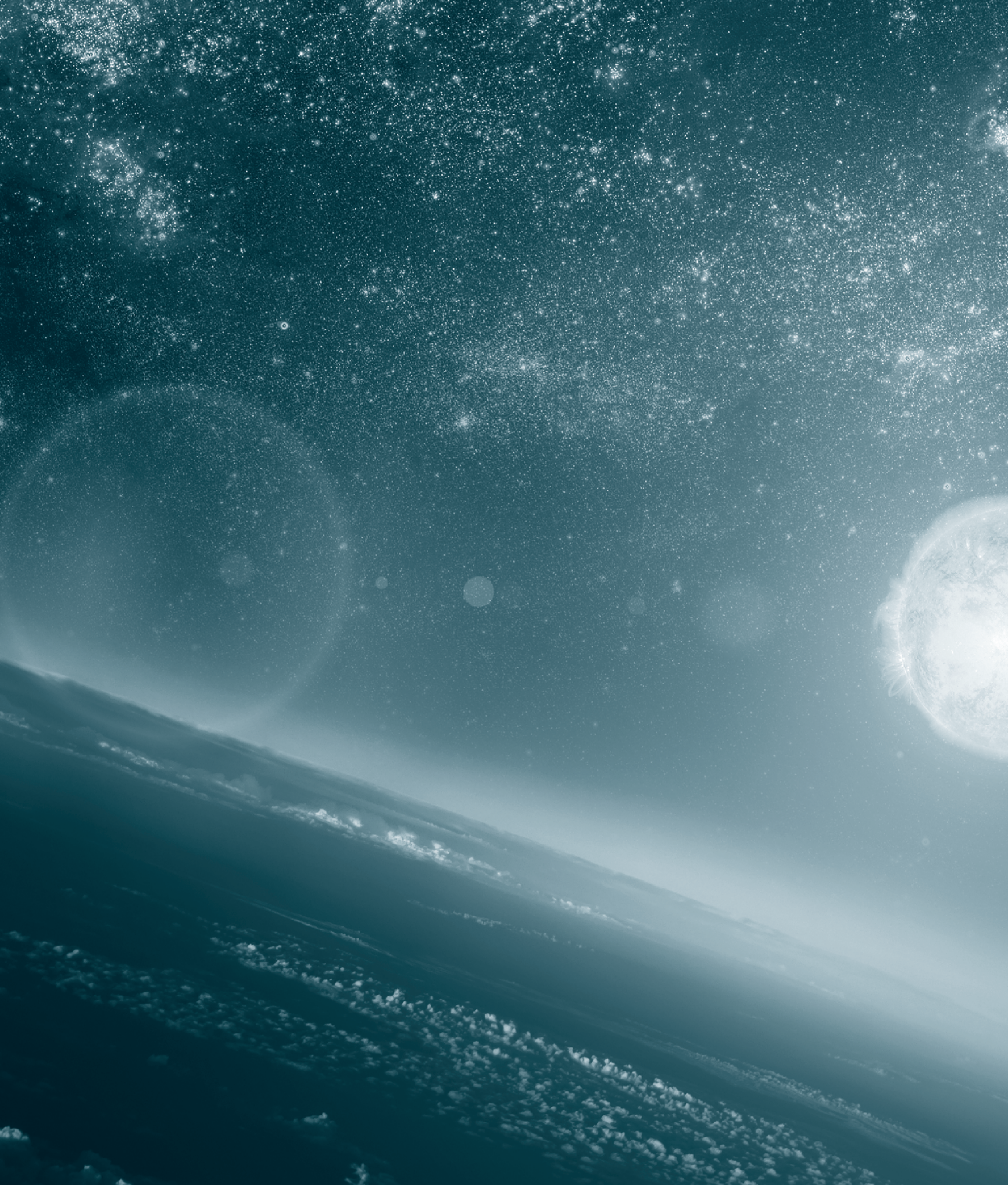

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CENGAGE

**Strategic Management: Competitiveness and Globalisation**
**7th Edition**
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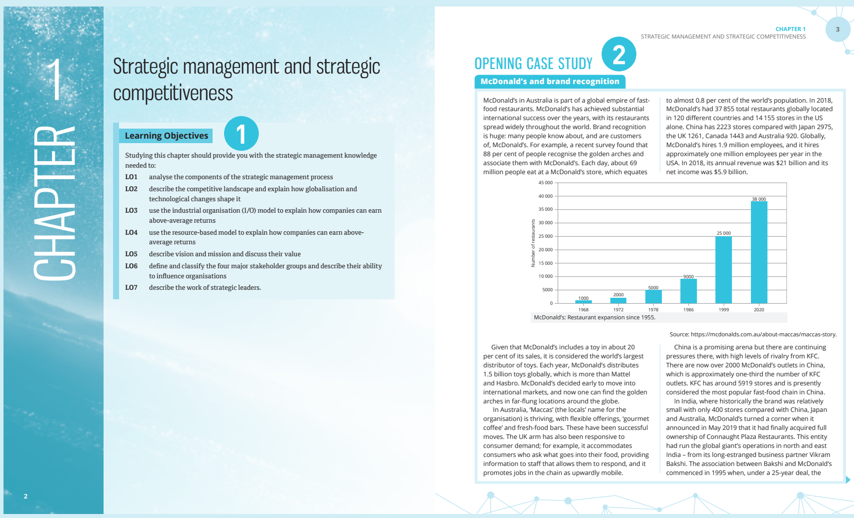
# BRIEF CONTENTS

# CONTENTS

# Guide to the text

As you read this text you will find a number of features in every chapter to enhance your study of strategic management and help you understand how the theory is applied in the real world.

## CHAPTER-OPENING FEATURES



CHAPTER 1

Strategic management and strategic competitiveness

**Learning Objectives** 1

Studying this chapter should provide you with the strategic management knowledge needed to:

- **LO1** analyse the components of the strategic management process
- **LO2** describe the competitive landscape and explain how globalisation and technological changes shape it
- **LO3** use the industrial organisation (I/O) model to explain how companies can earn above-average returns
- **LO4** use the resource-based model to explain how companies can earn above-average returns
- **LO5** describe vision and mission and discuss their value
- **LO6** define and classify the four major stakeholder groups and describe their ability to influence organisations
- **LO7** describe the work of strategic leaders.

2

CHAPTER 1
STRATEGIC MANAGEMENT AND STRATEGIC COMPETITIVENESS 3

OPENING CASE STUDY 2

**McDonald's and brand recognition**

McDonald's in Australia is part of a global empire of fast-food restaurants. McDonald's has achieved substantial international success over the years, with its restaurants spread widely throughout the world. Brand recognition is huge: many people know about, and are customers of, McDonald's. For example, a recent survey found that 88 per cent of people recognise the golden arches and associate them with McDonald's. Each day, about 69 million people eat at a McDonald's store, which equates to almost 0.8 per cent of the world's population. In 2018, McDonald's had 37 855 total restaurants globally located in 120 different countries and 14 155 stores in the US alone. China has 2223 stores compared with Japan 2975, the UK 1261, Canada 1443 and Australia 920. Globally, McDonald's hires 1.9 million employees, and it hires approximately one million employees per year in the USA. In 2018, its annual revenue was $21 billion and its net income was $5.9 billion.



McDonald's: Restaurant expansion since 1955.

Source: https://mcdonalds.com.au/about-maccas/maccas-story.

Given that McDonald's includes a toy in about 20 per cent of its sales, it is considered the world's largest distributor of toys. Each year, McDonald's distributes 1.5 billion toys globally, which is more than Mattel and Hasbro. McDonald's decided early to move into international markets, and now one can find the golden arches in far-flung locations around the globe.

In Australia, 'Maccas' (the locals' name for the organisation) is thriving, with flexible offerings, 'gourmet coffee' and fresh-food bars. These have been successful moves. The UK arm has also been responsive to consumer demand; for example, it accommodates consumers who ask what goes into their food, providing information to staff that allows them to respond, and it promotes jobs in the chain as upwardly mobile.

China is a promising arena but there are continuing pressures there, with high levels of rivalry from KFC. There are now over 2000 McDonald's outlets in China, which is approximately one-third the number of KFC outlets. KFC has around 5919 stores and is presently considered the most popular fast-food chain in China.

In India, where historically the brand was relatively small with only 400 stores compared with China, Japan and Australia, McDonald's turned a corner when it announced in May 2019 that it had finally acquired full ownership of Connaught Plaza Restaurants. This entity had run the global giant's operations in north and east India – from its long-estranged business partner Vikram Bakshi. The association between Bakshi and McDonald's commenced in 1995 when, under a 25-year deal, the

1 **Knowledge objectives**
Identify the key concepts that the chapter will cover with the learning objectives that start each chapter.

2 **Opening Case study**
Gain an insight into how strategic management theories relate to the real world through the case study at the beginning of each chapter.

## FEATURES WITHIN CHAPTERS

### KEY TERMS WITH MARGIN DEFINITIONS

Definitions or explanations of important key terms are located in the margin for quick reference.

**strategic management process**
the full set of commitments, decisions and actions required for an organisation to achieve strategic competitiveness and earn above-average returns

### STRATEGIC FOCUS BOXES

Examine the ways in which key concepts are applied in a business context, using real situations and familiar local and international companies. The Strategic Focus boxes are categorised to emphasise the focus: general, ethics, technology, sustainability and globalisation.

### STRATEGY NOW

**Strategy Now** margin icons highlight companies that have effectively put a strategic management tool, concept or technique into practice.

STRATEGY NOW
Apple's drive to innovate

**Increasing knowledge intensity**

Knowledge (information, intelligence and expertise) is the basis of technology and its application. In the competitive landscape of the 21st century, knowledge is a critical organisational resource and an increasingly valuable source of competitive advantage.[75]

Indeed, starting in the 1980s, the basis of competition shifted from hard assets to intangible resources; for example, 'Walmart transformed retailing through its proprietary

## END-OF-CHAPTER FEATURES

At the end of each chapter you'll find several tools to help you to review, practise and extend your knowledge of the key learning objectives.

### SUMMARY

**LO1** The organisation's external environment is challenging and complex. The external environment has three major parts: the general environment (elements in the broader society that affect industries and their organisations), the industry environment (factors that influence an organisation, its competitive actions and responses, and the industry's profit potential) and the competitor environment (in which the organisation analyses each major competitor's future objectives, current strategies, assumptions and capabilities).

**LO2** The external environmental analysis process has four steps: scanning, monitoring, forecasting and assessing. Through environmental analyses, the organisation identifies opportunities and threats.

model of competition comprises the threat of entry, the power of suppliers, the power of buyers, product substitutes and the intensity of rivalry among competitors. By studying these forces, the organisation can find a position in an industry where it can influence the forces in its favour or where it can buffer itself against the power of the forces in order to achieve strategic competitiveness and earn above-average returns.

**LO5** Industries are populated with different strategic groups. A strategic group is a collection of organisations following similar strategies along similar dimensions. Competitive rivalry is greater within a strategic group than between strategic groups.

**Summary**
The end-of-chapter summary lists key points from the chapter, providing a snapshot of the important concepts covered.

### KEY TERMS

| | | | |
|---|---|---|---|
| competitor intelligence | general environment | opportunity | sociocultural segment |
| complementors | global segment | physical environment segment | strategic group |
| demographic segment | industry | political/legal segment | technological segment |
| economic environment | industry environment | | threat |

**Key terms**
Review the important terminology from the chapter margin with the **Key terms** list.

### REVIEW QUESTIONS

1. Why is it important for an organisation to study and understand the external environment?
2. What are the differences between the general environment and the industry environment? Why are these differences important?
3. What are the four steps in the external environmental analysis process? What does the organisation want to learn when using this process?
4. What are the seven segments of the general environment? Explain the differences among them. Is any segment more important than another?
5. How do the five forces of competition in an industry affect its profit potential? Explain.
6. What is the importance of collecting and interpreting data and information about competitors? What practices should an organisation use to gather competitor intelligence, and why?

**Review questions**
These questions promote the application and critical analysis of theories and practices as well as encourage group discussion.

### EXPERIENTIAL EXERCISES

**Exercise 1: Strategic group mapping**

If a given set of organisations emphasise similar strategic dimensions and use a similar strategy, these organisations can be said to reside in the same strategic group. Other common definitions of strategic groups typically argue that the organisations in a given industry follow similar strategies, such as pricing, degree of specialisation, research and development commitment and the like. It is also likely that organisations operating in a given industry may have very different profitability profiles, which raises the question: if one organisation is the most profitable, why don't all the others in that industry attempt to move into the same

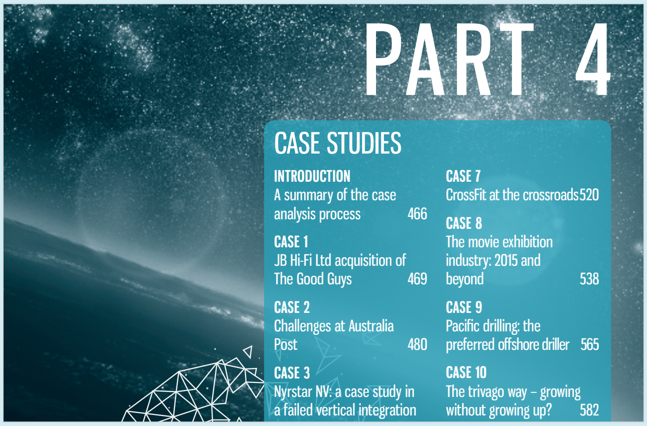
5. What conclusions can you reach about why some organisations end up where they do among various strategic groups?

**Exercise 2: What does the future look like?**

A critical ingredient in studying the general environment is identifying opportunities and threats. An opportunity is a condition in the environment that, if exploited, helps a company to achieve strategic competitiveness. In order to identify opportunities, you must be aware of trends that affect the world around us now or that are projected to do so in the future.

**Experiential exercises**
These exercises emphasise applied learning, giving students the opportunity to put knowledge into practice.

## END-OF-BOOK FEATURES




**Case Studies**
Apply the case analyses process to in-depth case studies. Thirteen case studies are provided to demonstrate theory in practice.

Each case includes a Case Link identifying the relevant chapters where key concepts explored in the case are introduced in the book.

# Guide to the online resources

## FOR THE INSTRUCTOR

Cengage is pleased to provide you with a selection of resources that will help you prepare your lectures. These teaching tools are accessible via **cengage.com.au/instructors** for Australia or **cengage.co.nz/instructors** for New Zealand.

### MINDTAP

Premium online teaching and learning tools are available on the *MindTap* platform – the personalised eLearning solution.

*MindTap* is a flexible and easy-to-use platform that helps build student confidence and gives you a clear picture of their progress. We partner with you to ease the transition to digital – we're with you every step of the way.

The *Cengage Mobile App* puts your course directly into students' hands with course materials available on their smartphone or tablet. Students can read on the go, complete practice quizzes or participate in interactive real-time activities.

*MindTap* for Hanson's *Strategic Management* is full of innovative resources to support critical thinking, and help your students move from memorisation to mastery! Includes:

- Hanson's *Strategic Management* eBook
- 'What would you do?' polling questions
- Video Cases
- 'You make the decision' simulation activities.

*MindTap* is a premium purchasable eLearning tool. Contact your Cengage learning consultant to find out how MindTap can transform your course.

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### INSTRUCTOR'S MANUAL

The **Instructor's Manual** includes:

- knowledge objectives
- chapter outlines
- lecture notes
- answers to review questions
- instructor's notes for experiential exercises
- instructor's notes for MindTap including What Would You Do?, You Make the Decision and Video Cases.
- additional questions and exercises.

### CASE STUDY RESOURCES

Case notes for each of the end-of-book case studies, a case analysis rubric and case matrix allow instructors to assign case studies for analysis. Cases and case notes from the previous editions are also available.

### TEST BANK

A bank of questions has been developed in conjunction with the text for creating quizzes, tests and exams for your students. Create multiple test versions in an instant and deliver tests from your LMS, your classroom, or wherever you want using Cognero. Cognero test generator is a flexible online system that allows you to import, edit and manipulate content from the text's test bank or elsewhere, including your own favourite test questions.

## POWERPOINT™ PRESENTATIONS

Use the chapter-by-chapter PowerPoint presentations to enhance your lecture presentations and handouts to reinforce the key principles of your subject.

## ARTWORK FROM THE TEXT

Add the digital files of graphs, pictures and flowcharts into your course management system, use them in student handouts, or copy them into your lecture presentations.

# FOR THE STUDENT

## MINDTAP

*MindTap* is the next-level online learning tool that helps you get better grades!

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# PREFACE

This new seventh Asia–Pacific edition of *Strategic Management: Competitiveness and Globalisation* has been updated to include new material and cases from Australia, New Zealand and the Asia–Pacific region. It continues to integrate ‘cutting edge’ research and content from the US authors Hitt, Ireland and Hoskisson.

## Features

- Australian and Asia–Pacific material in all chapters
- chapter opening cases and ‘Strategic focus’ segments
- organisation-specific examples that are integrated with each chapter’s topic
- inclusion of public sector and community organisation examples
- substantial emphasis on use of the internet and e-commerce
- substantial emphasis on corporate governance
- coverage of strategic issues in the 21st-century competitive landscape, including a strong emphasis on the competition created through e-commerce ventures *and* start-ups
- global coverage with an emphasis on the international context
- new and current research integrated throughout the chapters’ conceptual presentations
- review questions, including application discussion questions and ethics questions at the end of each chapter
- experiential exercises
- a summary of the case analysis process.

The book emphasises a global outlook with comprehensive coverage of Australian and international concepts and issues. The book contains a wealth of references. Drawn from the business literature and academic research, these materials are used to present current and accurate descriptions of how organisations use the strategic management process. Our goal while preparing this book has been to present you, our readers, with a complete, accurate and up-to-date explanation of the strategic management process as it is used in the global economy. We have sought to include enough local content to stimulate interest, and enough international content to reflect the nature of current strategic management.

## The book’s focus

This book is intended for use primarily in strategic management and business policy courses. The materials presented in the 13 chapters have been researched thoroughly. Both the academic, scholarly literature and the business, practitioner literature were studied and then integrated to prepare this edition. The academic literature provides the foundation to develop an accurate yet meaningful description of the strategic management process. The business practitioner literature yields a rich base of current domestic and global examples to show how the strategic management process’s concepts, tools and techniques are applied in different organisations.

Our discussion of the strategic management process is both traditional and contemporary. In maintaining tradition, we examine important materials that have historically been a part of understanding strategic management. For example, we thoroughly examine how to analyse an organisation’s external environment and internal environment.

# The strategic advantage

The strategic management process is critical to organisational success. As described in Chapter 1, strategic competitiveness is achieved when an organisation develops and exploits a sustained competitive advantage. Attaining such an advantage results in the earning of above-average returns; that is, returns that exceed those an investor could expect from other investments with similar amounts of risk.

## The competitive advantage

Success in the 21st-century competitive landscape requires specific capabilities, including the abilities to:

1 use scarce resources wisely to maintain the lowest possible costs
2 constantly anticipate frequent changes in customers' preferences
3 adapt to rapid technological changes
4 identify, emphasise and effectively manage what an organisation does better than its competitors
5 continuously structure an organisation's operations so objectives can be achieved more efficiently
6 successfully manage and gain commitments from a culturally diverse workforce.

## The global advantage

Critical to the approach used in this text is the fact that all organisations face increasing global competition. Organisations no longer operate in relatively safe domestic markets, as Australian supermarkets have discovered. In the past, many companies produced large quantities of standardised products. Today, organisations typically compete in a global economy that is complex, highly uncertain and unpredictable. To a greater degree than in a primarily domestic economy, the global economy rewards effective performers, whereas poor performers are forced to restructure significantly to enhance their strategic competitiveness. As noted earlier, increasing globalisation and the technological revolution have produced a new competitive landscape in the 21st century. This landscape presents a challenging and complex environment for organisations, but one that also has opportunities. The importance of developing and using these capabilities should not be underestimated.

## Final comment

Organisations face exciting and dynamic competitive challenges in the 21st century. These challenges, and effective responses to them, are explored in *Strategic Management: Competitiveness and Globalisation*. The strategic management process conceptualised in this text offers valuable insights and knowledge to those committed to meeting successfully the challenge of dynamic competition. Thinking strategically – as this book challenges you to do – increases the likelihood that you will assist your organisation to achieve strategic success. In addition, continuous practice with strategic thinking and the use of the strategic management process gives you skills and knowledge that will contribute to career advancement and success. Finally, we want to wish you all the best and nothing other than complete success in all of your endeavours.

**Dallas Hanson**
**Hobart**

# ABOUT THE AUTHORS

## Dallas Hanson

Dallas Hanson lectured in strategic management at the University of Tasmania for many years. He has wide-ranging intellectual (and scholastic) interests, including brand management, tourism, green strategy and governance. He has won teaching awards for his work in strategy and enjoys the challenge of making strategy interesting and engaging. He now advises as a strategy consultant, which continually reminds him that organisation politics matter in the world of strategy, while logic does not always win in the process of strategy implementation.

## Kim Backhouse

Kim Backhouse has lectured in strategic management, law and other business units for the past two decades in the Faculty of Business and Faculty of Law at the University of Tasmania. Kim has also facilitated units in legal and risk for the Australian Institute of Company Directors and runs short courses on governance through the Law School at the University of Tasmania. Kim is passionate about research and teaching in strategic management and governance and enjoyed being part of Dr Hanson's teaching team in strategy for many years. Dr Backhouse has published in a variety of journals on governance and corporate social responsibility. She has won teaching awards for many years for her work in strategy and organisational behaviour. Dr Backhouse also works in part-time executive roles outside of the academic landscape and consults regularly to boards on complex governance issues. Kim has a current practising certificate from the Law Society of Tasmania, Fellow of the Governance Institute of Australia and is a current board member of the Governance Institute of Australia (Tas). Kim currently sits on several not-for-profit boards such as ACHAT and has been sitting on various boards for the past two decades.

## David Leaney

David Leaney lectures in strategic management at post-graduate level at the Australian National University (ANU) and the Australian Graduate School of Management (AGSM) at the University of NSW. He also lectures in marketing and global supply chain management at post-graduate and under-graduate levels. David brings a practitioner's perspective, fuelled by his work as a management consultant and his role as the Managing Director of Strategium – an IT and business strategy consultancy. David is the chair of several private company boards in professional services and technology, and advises clients in the public sector, defence, utilities, banking and the retail sector. He is sought as a facilitator for executive workshops and the development of corporate strategy and organisational change management. David is a Fellow of the Institute of Managers and Leaders (FIML) and a Certified Management Consultant (CMC).

## Michael A. Hitt

### Texas A&M University

Michael A. Hitt is a Distinguished Professor and holds the Joe B. Foster Chair in Business Leadership at Texas A&M University. He received his PhD from the University of Colorado and has more than 260 publications, including 26 co-authored or co-edited books. He has been recognised as one of the 10 most cited scholars in management over a 25-year period in an article published in the 2008 volume of the *Journal of Management*. He is co-editor of numerous management, organisation, strategy and development books and has served on the editorial review boards of multiple journals, including the *Academy of Management Journal*, *Academy of Management Executive*, *Journal of Applied Psychology*, *Journal of Management*, *Journal of World Business and Journal of Applied Behavioral Sciences*.

In addition, Professor Hitt has served as Consulting Editor and Editor of the *Academy of Management Journal* and is currently a co-editor of the *Strategic Entrepreneurship Journal*. He is the current past president of the Strategic Management Society, is a past president of the Academy of Management and is a Fellow in the Academy of Management and in the Strategic Management Society. He received an honorary doctorate from the Universidad Carlos III de Madrid and is an Honorary Professor and Honorary Dean at Xi'an Jiao Tong University. He has received the Irwin Outstanding Educator Award and the Distinguished Service Award from the Academy of Management and has received best paper awards for articles published in the *Academy of Management Journal*, *Academy of Management Executive* and *Journal of Management*.

# R. Duane Ireland

## University of Richmond

R. Duane Ireland is a Distinguished Professor and holds the Conn Chair in New Ventures Leadership at the Mays Business School, Texas A&M University, where he previously served as head of the management department. He teaches strategic management courses to undergraduate, masters, doctoral and executive students and has more than 175 publications, including more than a dozen books. His research on diversification, corporate entrepreneurship and strategic entrepreneurship has been published in *Academy of Management Journal*, *Academy of Management Executive*, *Strategic Management Journal*, *Journal of Management*, *Strategic Entrepreneurship Journal*, *Entrepreneurship Theory and Practice* and *Journal of Management Studies*, among others. He has served on editorial review boards for the *Academy of Management Journal*, *Journal of Management*, *Journal of Business Venturing*, *Journal of Business Strategy* and *European Management Journal.* He is current editor of the *Academy of Management Journal* and has completed editorial terms for *Academy of Management Journal*, *Academy of Management Executive* and *Entrepreneurship Theory and Practice.* He has co-edited special issues of *Academy of Management Review*, *Academy of Management Executive*, *Journal of Business Venturing* and *Organizational Research Methods.*

Professor Ireland has received awards for the best article published in *Academy of Management Executive* and *Academy of Management Journal*. He is a Fellow of the Academy of Management and 21st Century Entrepreneurship Research Scholar, and served a three-year term as Representative-at-Large for the Academy of Management's Board of Governors. He received the Award for Outstanding Intellectual Contributions to Competitiveness Research from the American Society for Competitiveness and the USASBE Scholar in Corporate Entrepreneurship Award.

# Robert E. Hoskisson

## The University of Oklahoma

Robert E. Hoskisson is the George R. Brown Chair of Strategic Management at the Jesse H. Jones Graduate School of Business, Rice University. He received his PhD from the University of California-Irvine. Dr Hoskisson's research topics focus on corporate governance, acquisitions and divestitures, corporate and international diversification and cooperative strategy. He teaches courses in corporate and international strategic management, cooperative strategy and strategy consulting. Dr Hoskisson's research has appeared in more than 120 publications, including the *Academy of Management Journal*, *Strategic Management Journal*, *Journal of Management*, *Journal of International Business Studies*, *Journal of Management Studies* and the *Academy of Management Executive*. He has co-authored 26 books, including recent books on business strategic and competitive advantage, and is currently Associate Editor of the *Strategic Management Journal* and Consulting Editor for the *Journal of International Business Studies*. He also serves on the Editorial Review board for the *Academy of Management Journal*. Professor Hoskisson has served on editorial boards for the *Academy of Management Journal*, *Journal of Management*, *Journal of Management Studies* and *Entrepreneurship Theory and Practice*, among others. He is Special Professor at the University of Nottingham and Honorary Professor at Xi'an Jiao Tong University.

Professor Hoskisson is also a Fellow of the Strategic Management Society and has received awards from the American Society for Competitiveness and the Marriott School of Management, Brigham Young University. He completed three years of service as Representative-at-Large for the Board of Governors of the Academy of Management and currently serves on the Board of Directors of the Strategic Management Society.

# ACKNOWLEDGEMENTS

To my wonderful wife Meg for supporting me in consulting full-time, running three companies, teaching at two universities, and adding a textbook to my list of additional interests.

**David Leaney**

This has been a long journey and a heartfelt thanks to my children who have patiently waited on the sidelines for me to complete my part and who forfeited many weekends with their mother, in pursuit of academic excellence. I would like to thank Dallas Hanson for his continued support of my academic career and to my dear friends who have supported me from afar: Dr Kevin Radecki (USA) and Fran Scherrer (Spain). I hope you enjoy this edition.

**Kim Backhouse**

Cengage would also like to thank Greg Zooeff and Francis Hartnett for contributing new case studies to this edition, and would also like to thank the following reviewers for their incisive and helpful feedback:

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- Austin Norman – Victoria University
- Ralitza Bell – Australian Catholic University, North Sydney
- Lisa Daniel – University of the Sunshine Coast
- Stuart Middleton – University of Queensland
- Georges Baume – University of Adelaide.

# PART 1

## STRATEGIC MANAGEMENT INPUTS



CHAPTER 1

# Strategic management and strategic competitiveness

## Learning Objectives

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# OPENING CASE STUDY

## McDonald's and brand recognition

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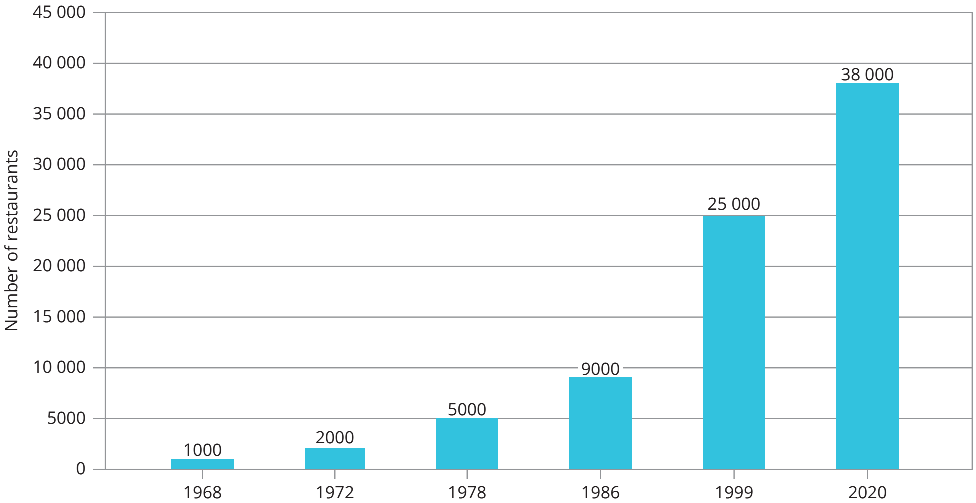


McDonald's: Restaurant expansion since 1955.

Source: https://mcdonalds.com.au/about-maccas/maccas-story.

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In India, where historically the brand was relatively small with only 400 stores compared with China, Japan and Australia, McDonald's turned a corner when it announced in May 2019 that it had finally acquired full ownership of Connaught Plaza Restaurants. This entity had run the global giant's operations in north and east India – from its long-estranged business partner Vikram Bakshi. The association between Bakshi and McDonald's commenced in 1995 when, under a 25-year deal, the two partners formed a 50:50 joint venture company – Connaught Plaza Restaurant – to set up outlets in the north and the east under the franchisee model. To date, McDonald's has two business entities in India. Amit Jatia's Hardcastle Restaurants runs the McDonald's business in southern and western India. McDonald's India is committed to sourcing almost all of its products from within the country. For this purpose, it has developed local Indian businesses, which can supply the highest-quality products required for its Indian operations.

The McDonald's empire is obviously difficult to control and constantly presents country-specific challenges. Clever strategy is important for its continued survival and, for the company, hopefully, its growth post the Covid-19 pandemic.

Sources: C. Smith, 2020, 50 interesting McDonald's statistics and facts 2020, DMR Business Statistics, https://expandedramblings.com/index.php/mcdonalds-statistics, 28 May; R. Darling, 2019, Thanks to the Happy Meal, McDonald's is the largest toy manufacturer, http://www.considerable.com, 6 November; 2019, KFC is most popular food chain in China, http://www.businessinsider.com, 8 March; *The Economic Times*, 2019, Vikram Bakshi is finally out, and McDonald's India is lovin' it, ET Online, https://economictimes.indiatimes.com/industry/services/hotels-/-restaurants/vikram-bakshi-is-finally-out-and-mcdonalds-india-is-lovin-it/articleshow/69309704.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst, 14 May; T. DiChristopher, 2015, McDonald's new CEO faces many problems, CNBC, http://www.cnbc.com/2015/01/29/how-mcdonalds-new-ceo-can-turn-around-the-company.html, 29 January; FT Reporters, 2015, McDonald's and its challenges worldwide: A market-by-market look, *Financial Times*, http://www.ft.com/intl/cms/s/0/f8ac22fc-a7c1-11e4-8e78-00144feab7de.html#slide0, 29 January.

As we can see from the opening case, McDonald's organisations in Australia, the UK, China, India, Japan and the USA are all in different competitive positions. Therefore, we can conclude that they are not equally competitive (i.e. they are unable to achieve similar strategic competitiveness). In the USA, the organisation is now using the strategic management process (see Figure 1.1) as the foundation for changes to the commitments, decisions and actions it undertook to pursue strategic competitiveness and above-average terms. It may well succeed, given time.[1]

# The strategic management process

As explained in the opening case, McDonald's is trying to enrich its traditional approach globally with more marketing and by making its stores more responsive to local consumers' needs. A study conducted to identify the factors that contribute to the success of top corporate performers shows why the organisation is doing this. This study found that the top performers were entrepreneurial, were market oriented (possessing effective knowledge of the customers' needs), used valuable competencies and offered innovative products and services.[2]

**strategic management process**
the full set of commitments, decisions and actions required for an organisation to achieve strategic competitiveness and earn above-average returns

**strategic competitiveness**
achieved when an organisation successfully formulates and implements a value-creating strategy

**strategy**
an integrated and coordinated set of commitments and actions designed to exploit core competencies and gain a competitive advantage

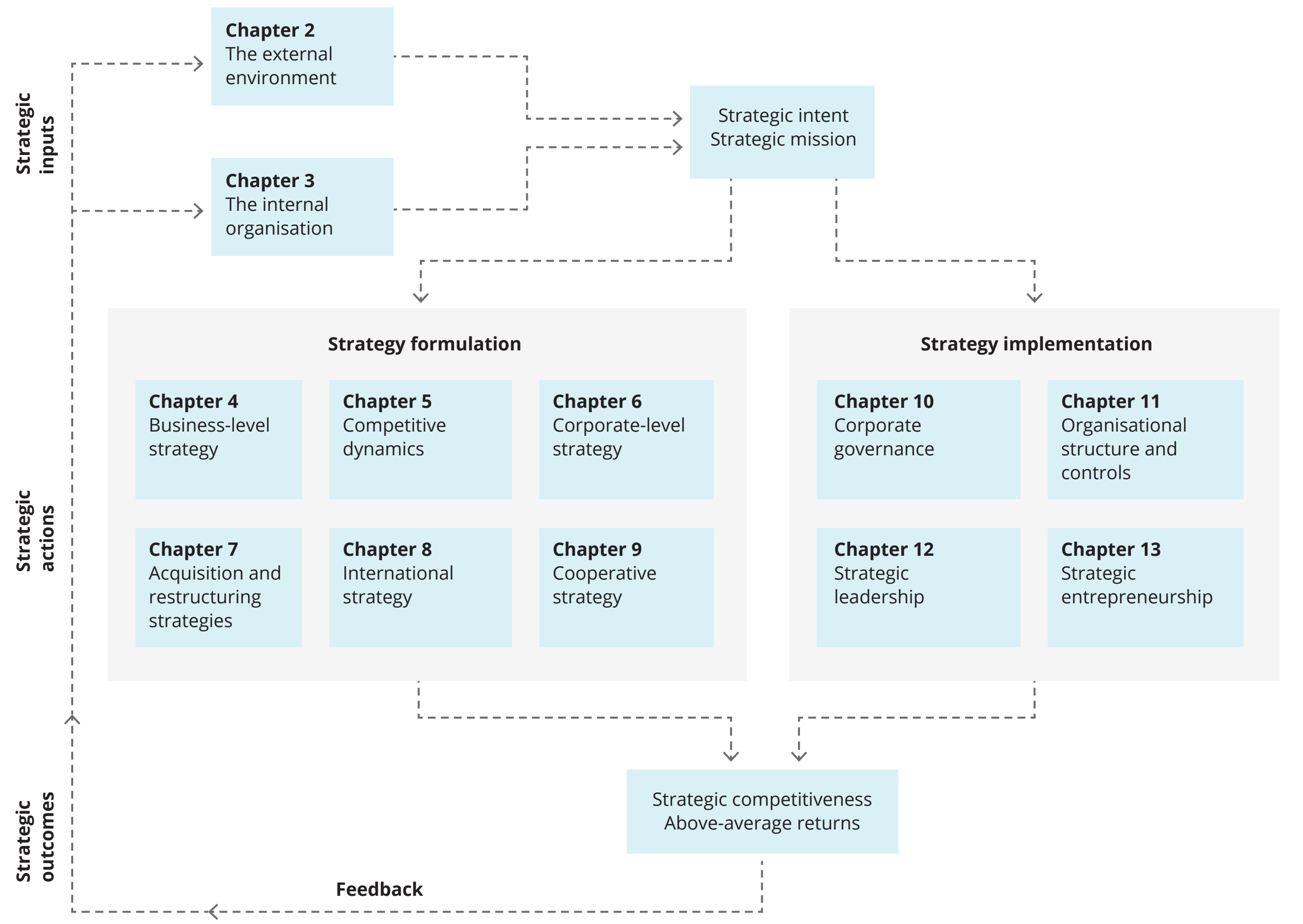
The types of behaviours exhibited by top performers like McDonald's represent a **strategic management process** (see Figure 1.1), which is a full set of commitments, decisions and actions required for an organisation to achieve strategic competitiveness and earn above-average returns. The organisation's first step in the process is to analyse its external environment and internal organisation to determine its resources, capabilities and core competencies – the sources of its 'strategic inputs'. We will now analyse each of the different components of the strategic management process.

**Strategic competitiveness** is achieved when an organisation successfully formulates and implements a value-creating strategy. A **strategy** is an integrated and coordinated set of commitments and actions designed to exploit core competencies and gain a competitive advantage. When choosing a strategy, organisations make choices among competing alternatives as the pathway for deciding how they will pursue strategic competitiveness.[3]

In this sense, the chosen strategy indicates what the organisation will do as well as what the organisation will not do. An organisation's strategy also demonstrates how it differs from its competitors.

An organisation has a competitive advantage when it implements a strategy that creates superior value for customers and that its competitors are unable to duplicate or find too costly to imitate.[4] An organisation can be confident that its strategy has resulted in one or more useful competitive advantages only after competitors' efforts to duplicate its strategy have ceased or failed. In addition, an organisation must understand that no competitive advantage is permanent, and this was witnessed in 2020 during the Covid-19 pandemic.[5] The speed with which competitors are able to acquire the skills needed to duplicate

**Figure 1.1 The strategic management process**




the benefits of an organisation's value-creating strategy determines how long the competitive advantage will last.[6]

**Above-average returns** are returns in excess of what an investor expects to earn from other investments with a similar amount of risk. **Risk** is an investor's uncertainty about the economic gains or losses that will result from a particular investment.[7] The most successful organisations learn how to effectively manage risk. Effectively managing risks reduces investors' uncertainty about the results of their investment.[8] Returns are often measured in terms of accounting figures, such as return on assets, return on equity or return on sales. Alternatively, returns can be measured on the basis of stock market returns, such as monthly returns (the end-of-the-period stock price minus the beginning stock price, divided by the beginning stock price, yielding a percentage return). In smaller, new venture organisations, returns are sometimes measured in terms of the amount and speed of growth (e.g. in annual sales) rather than more traditional profitability measures[9] because new ventures require time to earn acceptable returns (in the form of return on assets and so forth) on investors' investments.[10]

**above-average returns**
returns in excess of what an investor expects to earn from other investments with a similar amount of risk

**risk**
an investor's uncertainty about the economic gains or losses that will result from a particular investment

Understanding how to exploit a competitive advantage is important for organisations seeking to earn above-average returns.[11] Organisations without a competitive advantage or that are not competing in an

**average returns**
returns equal to those an investor expects to earn from other investments with a similar amount of risk

attractive industry earn, at best, **average returns**. Average returns are returns equal to those an investor expects to earn from other investments with a similar amount of risk. In the long run, an inability to earn at least average returns results first in decline and, eventually, failure. Failure occurs because investors withdraw their investments from those organisations earning less-than-average returns. As we noted above, there are no guarantees of permanent success. Even considering its excellent current performance, McDonald's still must be careful not to become overconfident, and continue its quest to be the leader in its markets.

With the information gained from external and internal analyses, the organisation develops its vision and mission and formulates one or more strategies. To implement its strategies, the organisation takes actions towards achieving strategic competitiveness and above-average returns. Effective strategic actions that take place in the context of carefully integrated strategy formulation and implementation efforts result in positive outcomes. This dynamic strategic management process must be maintained as ever-changing markets and competitive structures are coordinated with an organisation's continuously evolving strategic inputs.[12]

In the remaining chapters of this book, we use the strategic management process to explain what organisations do to achieve strategic competitiveness and earn above-average returns. These explanations demonstrate why some organisations consistently achieve competitive success while others fail to do so.[13] As you will see, the reality of global competition is a critical part of the strategic management process and significantly influences organisations' performances.[14] Indeed, learning how to successfully compete in the globalised world is one of the most significant challenges for organisations competing in the 21st century.[15]

**global economy**
one in which goods, services, people, skills and ideas move freely across geographic borders

Several topics are discussed in this chapter. First, we describe the current competitive landscape. This challenging landscape has been created primarily by the emergence of a **global economy**, globalisation resulting from that economy, rapid technological changes and the Covid-19 pandemic. Next, we examine two models that organisations use to gather the information and knowledge required to choose and then effectively implement their strategies. The insights gained from these models also serve as the foundation for forming the organisation's vision and mission. The first model (the industrial organisation or I/O model) suggests that the external environment is the primary determinant of an organisation's strategic actions. Identifying and then competing successfully in an attractive (i.e. profitable) industry or segment of an industry are the keys to competitive success when using this model.[16] The second model (resource based) suggests that an organisation's unique resources and capabilities are the critical link to strategic competitiveness.[17] Thus, the first model is concerned primarily with the organisation's external environment, while the second model is concerned primarily with the organisation's internal environment. After discussing vision and mission, direction-setting statements that influence the choice and use of strategies, we describe the stakeholders that organisations serve. The degree to which stakeholders' needs can be met increases when organisations achieve strategic competitiveness and earn above-average returns. Closing the chapter are introductions to strategic leaders and the elements of the strategic management process.

For ease, this book is divided into three parts. In Part 1, we describe what organisations do to analyse their external environment (Chapter 2) and internal organisation (Chapter 3). These analyses are completed to identify marketplace opportunities and threats in the external environment (Chapter 2), and to decide how to use the resources, capabilities, core competencies and competitive advantages in the organisation's internal organisation to pursue opportunities and overcome threats (Chapter 3). The analyses explained in Chapters 2 and 3 comprise the well-known SWOT analyses (strengths, weaknesses, opportunities and threats).[18] (In our analysis, the important 'strengths' concept is made more sophisticated by using the ideas of capabilities and core competencies.) With knowledge about its external environment and internal organisation, the organisation forms its strategy considering the organisation's vision and mission.

The organisation's strategic inputs (see Figure 1.1) provide the foundation for choosing one or more strategies and deciding how to implement them. As suggested in Figure 1.1 by the horizontal arrow linking the two types of strategic actions, formulation and implementation must be simultaneously integrated to successfully use the strategic management process. Integration happens as decision makers think about implementation issues when choosing strategies and as they think about possible changes to the organisation's strategies while implementing a currently chosen strategy.

In Part 2 of this book, we discuss the different strategies organisations may choose to use. First, we examine business-level strategies (Chapter 4). A business-level strategy describes the actions an organisation takes to exploit its competitive advantage over rivals. A company competing in a single product market (e.g. a locally owned grocery store operating in only one location) has one business-level strategy, while a diversified organisation competing in multiple product markets forms a business-level strategy for each of its businesses. In Chapter 5, we describe the actions and reactions that occur among organisations in marketplace competition. Competitors typically respond to and try to anticipate each other's actions. The dynamics of competition affect the strategies organisations choose, as well as how they try to implement the chosen strategies.[19]

For the diversified organisation, corporate-level strategy (Chapter 6) is concerned with determining the businesses in which the company intends to compete as well as how to manage its different businesses. Other topics vital to strategy formulation, particularly in the diversified company, include acquiring other businesses and, as appropriate, restructuring the organisation's portfolio of businesses (Chapter 7) and selecting an international strategy (Chapter 8). With cooperative strategies (Chapter 9), organisations form a partnership to share their resources and capabilities in order to develop a competitive advantage. Cooperative strategies are becoming increasingly important as organisations seek ways to compete in the global economy's array of different markets.[20]

To examine actions taken to implement strategies, we consider several topics in Part 3. First, we examine the different mechanisms used to govern organisations (Chapter 10). With demands for improved corporate governance being voiced by many stakeholders in the current business environment, organisations are challenged to learn how to simultaneously satisfy their stakeholders' different interests.[21] Finally, the organisational structure and actions needed to control an organisation's operations (Chapter 11), the patterns of strategic leadership appropriate for today's organisations and competitive environments (Chapter 12), and strategic entrepreneurship (Chapter 13) as a path to continuous innovation are addressed.

# The competitive landscape

The fundamental nature of competition in many of the world's industries is changing. The reality is that financial capital continues to be scarce and markets are increasingly volatile.[22] Because of this, the pace of change is relentless and ever-increasing. Even determining the boundaries of an industry has become challenging.

Managers must adopt a new mindset that values flexibility, speed, innovation, integration and the challenges that evolve from constantly changing conditions.[23] The conditions of the competitive landscape result in a perilous business world, one in which the investments that are required to compete on a global scale are enormous and the consequences of failure are severe.[24] Effective use of the strategic management process reduces the likelihood of failure for organisations as they encounter the conditions of today's competitive landscape.

**Hypercompetition** is a term often used to capture the realities of the competitive landscape. Under conditions of hypercompetition, assumptions of market stability are replaced by notions of inherent instability and change.[25] Hypercompetition results from the dynamics of strategic manoeuvring among global and innovative combatants. In a hypercompetitive market, organisations often aggressively challenge their competitors in the hopes of improving their competitive position and, ultimately, their performance.[26] In recent years, internet giant Tencent Holdings Ltd of China has become one of the world's largest technology investors. Between 2013 and mid-2018, the organisation took stakes in 277 start-ups. Analysts believe this is a calculated strategy to crowd out rivals and to increase profits.[27]

**hypercompetition**
a condition where competitors engage in intense rivalry, markets change quickly and often, and entry barriers are low

Several factors create hypercompetitive environments and influence the nature of the competitive landscape. The emergence of a global economy and technology – specifically rapid technological change – have been the two primary drivers of hypercompetitive environments and the nature of today's competitive landscape.

## The global economy

A global economy is one in which goods, services, people, skills and ideas move freely across geographic borders. Relatively unfettered by artificial constraints, such as tariffs, the global economy significantly expands and complicates an organisation's competitive environment.[28] The global economy is under pressure, weighed down by trade tensions, inequality and geopolitical uncertainty. The world is at an economic 'tipping point' according to the 2019 *Global Competiveness Report* 'amid a backlash against capitalism and globalization'.[29]

Interesting opportunities and challenges are associated with the emergence of the global economy.[30] For example, the European Union (EU; composed of 27 countries after the UK exited the EU in 2020) has become one of the world's largest markets, with 700 million potential customers, while China has rapidly become a huge market that was pursued by many organisations prior to the Covid-19 pandemic. Notwithstanding, China remains an extremely competitive market in which local market-seeking multinational corporations (MNCs) must fiercely compete against other MNCs, as well as against those local companies that are more cost-effective and faster in product development. While China has been viewed as a country from which to source low-cost goods, many MNCs, such as Procter & Gamble (P&G), are actually net exporters of local management talent; they have been dispatching more Chinese abroad than bringing foreign expatriates to China.[31]

The size of parts of the global economy is an important aspect of studying this competitive landscape. In 2019, for example, the USA was the world's largest economy at a value of US$21 trillion. It accounts for approximately 20 per cent of global output; the economy is still larger than that of China;[32] and the services sectors in the USA are technologically sophisticated. China is the world's second-largest economy, with a nominal gross domestic product (GDP) value of US$9.2 trillion, while Japan in 2019 was ranked the third-largest global economy at US$5.2 trillion. Following Japan were Germany at US$4.2 trillion and the UK at US$3.2 trillion. These were closely followed by India, which overtook the French economy in 2018, and looks set to move into fifth position in 2021–22. In observing economies' values in 2018, the World Economic Forum noted that the size of the USA's economy was 'larger than the combined economies of numbers four to 10 on the list. Overall, the global economy (was) worth an estimated $79.98 trillion, meaning the United States in 2018 accounted for more than one-quarter of the world total'.[33] Thus, organisations scanning the global economy for opportunities in 2021 might conclude that markets in the USA, China and Japan yield potentially significant opportunities for them.

Of course, such an analysis also must consider entry barriers to various economies in the form of tariffs. This type of analysis must also be forward-looking in that the World Economic Forum has estimated that the economies of China and India would exceed the size of the US economy by 2050 and that the economies of Germany, the UK and France would decline in size by this time as well. Organisations should study carefully future forecasts when determining the parts of the world in which growth opportunities, as well as threats to their competitive global positions, may exist in the next decade. US-based Netflix, for example, studies the global economy to identify opportunities in countries and regions in which it may grow. In mid-2018, Netflix continued adding subscribers, reaching 125 million globally. Analysts predicted the organisation would have 360 million subscribers by 2030, and that international markets would be the source of much of the growth in subscribers.[34] Informing this prediction was the expectation that Netflix would achieve reasonable levels of market penetration internationally, including reaching penetration in 35 per cent of all broadband households worldwide, excluding China.[35] In 2018 alone, the organisation allocated $8 billion to develop original programming, with some of those programs targeted to international customers.[36] Netflix was one of the rare organisations that continued to grow during the Covid-19 pandemic, adding

15.8 million subscribers between March and April 2020, more than double the amount that was predicted and representing a huge growth of over 22 per cent during the 12-month period to 2020. Netflix also saw a quarterly revenue of US$5.76 billion in 2020.[37] According to market research organisation HarrisX, Netflix is a long way ahead of its competitors; however, the organisation is mindful that there are challenges ahead, as noted in a recent article: ‘when you’re number one, it’s always difficult to grow as fast as your competitors or whoever’s trailing you’.[38]

India, one of the world’s largest democracies, has an economy that also is growing rapidly and now ranks as the fifth largest in the world, and it has a very fast-growing population.[39] Simultaneously, many organisations in emerging economies are moving into international markets and are now regarded as multinational organisations. Barriers to entering foreign markets still exist. The statistics detailing the nature of the global economy reflect the realities of a hypercompetitive business environment and challenge individual organisations to think seriously about the markets in which they will compete; the case of Netflix is a good example.

## Starbucks is a new economy multinational yet has had failures in key markets

**Strategic focus** | Globalisation

Starbucks is not an ordinary supplier of a cup of coffee. It is a large and innovative multinational organisation that engages in major strategic actions to enter new international and product markets (e.g. acquisitions). It is a multibillion-dollar organisation with many stores operating in multiple countries. Starbucks surpassed its goal set to have at least 12 500 stores in the USA by 2015 to 15 149 US locations in 2020. Starbucks was the largest global coffeehouse company in 2019 with 31 256 stores across the globe. Starbucks has become a major player in Asian markets, which is interesting because it took on a largely ingrained tea-drinking culture. Starbucks had 1026 stores operating in China in 2015, 1540 in 2017 (which was the expected store numbers for 2015), and in 2019 there were 4123 Starbuck stores in China, with 629 newly opened stores and 27 closures – a major increase over its 3000 stores since 2015. Starbucks adapted to local market tastes by developing larger stores where, for example, people can lounge and meet with friends. It has products that cater to tea drinkers as well. China ranked second in front of Japan, which had a total of 1286 locations in 2019, and Starbucks generated more than US$16 billion in the region.

Starbucks has also entered Vietnam and India with high expectations. In 2013 it opened its first store in Vietnam, although in 2019 it had only 46 stores there. Interestingly, Vietnam is the second-largest producer of coffee beans in the world, behind Brazil. Starbucks works with local Vietnamese farmers to grow a high-quality Arabica coffee bean. In partnership with the Tata Group, Starbucks also opened its first stores in India, with plans to expand rapidly there, and in 2019 it had 132 stores in India, three times that of Vietnam.

In contrast, in Australia the scorecard has been extremely poor. CNBC reported that while the Australian café industry was expected to reach more than A$6 billion in revenue in 2018, in its first seven years in Australia, Starbucks accumulated A$105 million in losses and 61 locations were forced to close. Starbucks referred to its efforts in the country as a ‘huge flop’. Starbucks entered the market hard in 2000 and had 84 stores at its peak. The problems were obvious from the start. The organisation charged more than competitors, had stores in low-traffic locations and, basically, the well-established coffee culture of Australia was better than the Starbucks offerings. Melbourne-style coffee is arguably the world’s best and Starbucks could not compete on taste in an already thriving coffee culture, which proved to be a huge challenge for the US brand. Starbucks has not given up just yet, and in 2021 there were 55 locations (more than Vietnam) in Australia. With slow growth forecasts into the future, its Australian goal is to focus more on international tourists that recognise this global brand.

The experience of Starbucks in Europe has been more mixed. It has had some success, but has also encountered another different set of coffee cultures. At first, it tried to encourage Europeans to adapt to the Starbucks approach, but this strategy failed. Now, because of the importance Starbucks places on its future in Europe, the company is adapting to the European café culture. This means that Starbucks is building larger stores with additional seating to allow people to meet and spend time in its stores, as it has done in Asia. It has implemented other practices and products that adapt even more to local (country) cultures and tastes (e.g. in France and England).

In addition to Starbucks' international thrust, it also engages in significant innovation and strategic actions to add to its product line. In recent years, it has introduced Via, an instant coffee, and a single-cup coffee maker (named the Verismo) that allows customers to make their own lattes at home. Another attempt to add to its product line was evidenced by its acquisition of the tea chain Teavana. In fact, it paid US$620 million to acquire the Atlanta-based company. In recent times, it also acquired a juice maker, Evolution Fresh, and Bay Bread, the operator of La Boulange bakeries. Starbucks' variety of beverage and food companies now includes: Seattle's Best Coffee, Teavana, Tazo, Evolution Fresh, Torrefazione Italia Coffee and Ethos Water.

Sources: S. Lock, 2019, Starbucks stores: US and international 2005 to 2019, http://www.statista.com; http://www.financesonline.com, Number of Starbucks worldwide 2020: facts, statistics, and trends; L. L. Thomala, 2020, Number of Starbucks stores in China from 2005 to 2019, Statista.com, 27 May; L. MacLellan, 2019, The countries with the most Starbucks locations, Quartz, http://www.qz.com, 30 January; A. Turner, 2018, Why there are almost no Starbucks in Australia, CNBC, http://www.cnbc.com, 25 July; J. Gertner, 2013, For infusing a steady stream of new ideas to revive its business, *Fast Company*, http://www.fastcompany.com; A. Gasparro, 2013, Starbucks enjoys sales jolt from its US, China stores, *Wall Street Journal*, http://www.wsj.com, 24 January; J. Noble, 2013, Starbucks takes on Vietnam coffee culture, *Financial Times*, http://www.ft.com, 3 January; A. Gasparro, 2012, Starbucks: China to become no. 2 market, *Wall Street Journal*, http://www.wsj.com, 6 December; 2012, A look at Starbucks' U.S. presence over the years, *Bloomberg Businessweek*, http://www.businessweek.com, 5 December; L. Burkitt, 2012, Starbucks plays to local Chinese tastes, *Wall Street Journal*, http://www.wsj.com, 26 November; J. Jargon, 2012, Starbucks CEO: 'We will do for tea what we did for coffee', *Wall Street Journal*, http://www.wsj.com, 14 November; V. Bajaj, 2012, Starbucks opens in India with pomp and tempered ambition, *New York Times*, http://www.nytimes.com, 19 October; S. Strom, 2012, Starbucks to introduce single-serve coffee maker, *New York Times*, http://www.nytimes.com, 20 September; L. Alderman, 2012, In Europe, Starbucks adjusts to a café culture, *New York Times*, http://www.nytimes.com, 30 March.

## The march of globalisation

Globalisation is the increasing economic interdependence among countries and their organisations as reflected in the flow of goods and services, financial capital and knowledge across country borders.[40] Globalisation is a product of a large number of organisations competing against one another in an increasing number of global economies.

In globalised markets and industries, financial capital might be obtained in one national market and used to buy raw materials in another. Manufacturing equipment bought from a third national market can then be used to produce products that are sold in yet a fourth market. Thus, globalisation increases the range of opportunities for companies competing in the current competitive landscape.[41] Organisations operating globally must make culturally sensitive decisions when using the strategic management process,[42] as evidenced in Starbucks' operations in European and Asian countries. Additionally, highly globalised organisations should anticipate ever-increasing complexity in their operations as goods, services and people move freely across geographic borders and throughout different economies.

Overall, it is important to note that globalisation has led to higher performance standards in many competitive dimensions, including those of quality, cost, productivity, product introduction time and operational efficiency. In addition to organisations competing in the global economy, these standards affect organisations competing on a domestic-only basis. The reason is that customers will purchase from a global competitor rather than a domestic organisation when the global company's good or service is superior. Because workers now flow rather freely among global economies, and because employees are a key source of competitive advantage, organisations must understand that, increasingly, 'the best people will come from … anywhere'.[43] Thus, managers have to learn how to operate effectively in a 'multi-polar' world, with many important countries having unique interests and environments.[44] Organisations must learn how to deal with the reality that, in the competitive landscape of the 21st century, only companies capable of meeting, if not exceeding, global standards typically have the capability to earn above-average returns.

Although globalisation offers potential benefits to organisations, it is not without risks. Collectively, the risks of participating outside of an organisation's domestic country in the global economy are labelled a 'liability of foreignness'.[45]

The increasing opportunities available in emerging economies is a major driver of growth in the size of the global economy. Important emerging economies include the BRIC countries (Brazil, Russia, India and China),[46] the VISTA countries (Vietnam, Indonesia, South Africa, Turkey and Argentina),[47] as well as Mexico and Thailand. Demonstrating the growth in size of some of these economies was the 2018 prediction that, by 2050, Indonesia, Brazil, Russia and Mexico would be the fourth-, fifth-, sixth- and seventh-largest economies in the world by size, respectively. If this were to happen, by 2050 the size of these emerging economies would exceed those of Japan, Germany, the UK and France.[48] Emerging economy organisations now compete in global markets, some with increasing success.[49] Indeed, the emergence of MNCs in international markets forces large MNCs based in developed markets to enrich their own capabilities to compete effectively in global markets.[50]

One risk of entering the global market is the amount of time typically required for organisations to learn how to compete in markets that are new to them. An organisation's performance can suffer until this knowledge is either developed locally or transferred from the home market to the newly established global location.[51] Additionally, an organisation's performance may suffer with substantial amounts of globalisation. In this instance, an organisation may over-diversify internationally and this may have strong negative effects on overall performance.

Thus, entry into international markets, even for organisations with substantial experience in the global economy, requires effective use of the strategic management process. It is also important to note that even though global markets are an attractive strategic option for some companies, they are not the only source of strategic competitiveness. In fact, for most organisations – even those capable of competing successfully in global markets – it is critical to remain committed to and strategically competitive in both domestic and international markets by staying attuned to technological opportunities and potential competitive disruptions that innovations create.[52] The challenge is also to be responsive to local needs, something Starbucks failed to do in Australia. Starbucks is now emphasising both product innovation and international expansion as means of growing profitably.

## Technology and technological changes

Boston Consulting Group analysts describe the impact of technology as follows: 'No company can afford to ignore the impact of technology on everything from supply chains to customer engagement, and the advent of even more advanced technologies, such as artificial intelligence (AI) and the Internet of Things, portends more far-reaching change.'[53] There are three categories of technology-related trends and conditions affecting today's organisations: technology diffusion and disruptive technologies; the information age; and increasing knowledge intensity. These categories have a significant effect on the nature of competition in many industries.

### Technology diffusion and disruptive technologies

The rate of technology diffusion, which is the speed at which new technologies become available and are used, has increased substantially over the past 15 to 20 years. Consider the following rates of technology diffusion:

> It took the telephone 35 years to get into 25 per cent of all homes in the United States. It took TV 26 years. It took radio 22 years. It took PCs 16 years. It took the internet 7 years.[54]

The impact of technological changes on organisations and industries is broad and significant. For example, in the not-too-distant past, people rented movies on videotapes from global retail stores such as Blockbuster. Blockbuster has just one store that remains open globally, located in Oregon, USA. Fifteen years earlier there were 9000 stores. Today, customers on a global basis use electronic means almost exclusively to rent movies (such as via Foxtel) and games (e.g. Fortnite). The publishing industry (books, journals, magazines and newspapers) is moving rapidly from hard copy to electronic formats. Many organisations in these industries, operating with a more traditional business model, are suffering. These changes are also affecting other industries, from trucking to mail services.

Perpetual innovation is a term used to describe how rapidly and consistently new, information-intensive technologies replace older ones. The shorter product life cycles resulting from the rapid diffusion of new technologies place a competitive premium on being able to quickly introduce new, innovative goods and services into the marketplace.[55]

In fact, when products become somewhat indistinguishable because of the widespread and rapid diffusion of technologies, speed to market with innovative products may be the primary source of competitive advantage (see Chapter 5).[56] Indeed, some argue that the global economy is increasingly driven by, or revolves around, constant innovations. Not surprisingly, such innovations must be derived from an understanding of global standards and expectations of product functionality.[57] Although some argue that large established organisations may have trouble innovating, evidence suggests that today these organisations are developing radically new technologies that transform old industries or create new ones.[58] Apple is an excellent example of a large established organisation capable of radical innovation. Also, in order to diffuse the technology and enhance the value of an innovation, additional organisations need to be innovative in their use of the new technology, building it into their products.[59] Although mature organisations may have trouble innovating, evidence suggests that today these organisations are developing radically new technologies that transform old industries or create new ones.[60] In 2018, for example, Boston Consulting Group identified the 50 most innovative companies in the world. The first five organisations on this list are large companies: Apple, Google, Microsoft, Amazon and Samsung.[61] Wireless AirPods, ARKit (the organisation's augmented-reality framework) and HomePod (an intelligent speaker) are some of the innovative products Apple has introduced and for which some recognise it as the most innovative company in the world.[62]

Another indicator of rapid technology diffusion is that it now may take only 12 to 18 months for organisations to gather information about their competitors' research and development and product decisions.[63] In the global economy, competitors can sometimes imitate an organisation's successful competitive actions within a few days. In this sense, the rate of technological diffusion has reduced the competitive benefits of patents. Today, patents may be an effective way of protecting proprietary technology in a small number of industries such as pharmaceuticals. Indeed, many organisations competing in the electronics industry often do not apply for patents, in order to prevent competitors from gaining access to the technological knowledge included in the patent application.

Disruptive technologies – technologies that destroy the value of an existing technology and create new markets[64] – surface frequently in today's competitive markets. Think of the new markets created by the technologies underlying the development of products such as the iPad and AirPods. These types of products are thought by some to represent radical or breakthrough innovations.[65] (We talk more about radical innovations in Chapter 13.) A disruptive or radical technology can create what is essentially a new industry or it can harm industry incumbents. However, some incumbents are able to adapt due to their superior resources, experience and ability to gain access to the new technology through multiple sources (e.g. alliances, acquisitions and ongoing internal research).[66] Clearly, Apple has developed and introduced 'disruptive technologies' such as the iPad and AirPods, and in so doing changed several industries. For example, the iPod and its complementary iTunes have revolutionised how music is sold to, and used by, consumers. In conjunction with other complementary and competitive products (e.g. Amazon's Kindle), the iPad has contributed to and sped up major changes in the publishing industry, which, as noted earlier, is moving more and more from hard copies to electronic books. Apple's new technologies and products are also contributing to the new 'information age'. Thus, Apple provides an example of entrepreneurship through technology emergence across multiple industries.[67]

## The information age

Dramatic changes in information technology have occurred in recent years. Personal computers, mobile phones, artificial intelligence, virtual reality, massive databases and multiple social networking sites are only a few examples of how information is used differently as a result of technological developments. An important outcome of these changes is that the ability to effectively and efficiently access and use information has become an important source of competitive advantage in virtually all industries. Information technology advances have given small organisations more flexibility in competing with large organisations, if that technology can be efficiently used.[68]

Data and information are vital to organisations' efforts to understand customers and their needs and to implement strategies that satisfy those needs as well as the interests of all other stakeholders. For today's organisations in virtually all industries, information technology is an important capability that contributes positively to product innovation efforts and may be a source of competitive advantage as well. Organisations failing to harness the power of data and information are disadvantaged compared to their competitors.[69] Both the pace of change in information technology and its diffusion continue to increase on a global scale. In 2018, 36 per cent of the world's population owned a smartphone. While expectations are that the number of personal computers (PCs) sold annually will decline, from 258.8 million in 2017 to 215.8 million in 2023, conversely, technology innovations, such as touch-enabled PCs, ultra-slim and convertible laptops, and hybrid machines, will stimulate revenue growth among technology companies.[70] Technology-based innovations also stimulate additional markets. For example, predictions are that the global video streaming market will reach US$70 billion by 2021. Contributing to this market's growth is the fact that in 2018, the percentage of internet and mobile audiences watching live video continued to expand.[71] Trends such as these inform the work that organisations complete to select and implement their strategies in the global economy. The most successful organisations envision information technology-derived innovations as opportunities to identify and serve new markets rather than as threats to the markets they serve currently.[72]

Both the pace of change in information technology and its diffusion will continue to increase. For instance, the number of personal computers in use globally was recently expected to surpass 2.3 billion.[73] The declining costs of information technologies and the increased access to them are also evident in the current competitive landscape. The global proliferation of relatively inexpensive computing power and its linkage on a global scale via computer networks combine to increase the speed and diffusion of information technologies. Thus, the competitive potential of information technologies is now available to companies of all sizes throughout the world, including those in emerging economies.[74]

The internet is another technological innovation contributing to hypercompetition. Available to an increasing number of people throughout the world, the internet provides an infrastructure that allows the delivery of information to computers in any location. Access to the internet on smaller devices such as smartphones is having an ever-growing impact on competition in a number of industries. However, possible changes to the pricing structures of internet service providers (ISPs) could affect the rate of growth of internet-based applications. Users downloading or streaming high-definition films, playing video games online and so forth would be affected the most if ISPs were to base pricing structures around total usage.

**Strategic focus | Technology**

### The core of Apple: technology and innovation

Apple has transformed industries with the introduction of new products such as the iPod, iPad, iPhone, Apple Watch and AirPods. The extent of its dominance of the smartphone industry is hard to comprehend: around 1000 companies make smartphones but just one makes most of the profits in this industry. In 2019, Apple announced that its revenue totalled US$260 billion for the 2019 financial year. How? It commands higher prices, does not sell products cheap and never appears to discount its products, ever. Samsung is the other profit maker in this highly competitive industry and it sells many more units than Apple. Going back to 2012, industry profits were 50–50 between Apple and Samsung, but no longer.

This dominance and good performances from other arms of the Apple empire have yielded huge profits.

Apple has achieved phenomenal success with the introduction of innovative products and brand maintenance. The late Steve Jobs was selected by *Fortune* magazine as the CEO of the first decade of the 21st century, based on the fact that Apple under his leadership had transformed four industries, three of them in a decade. In addition, in 2020 Fast Company named Apple in the World's Most Innovative Companies list. Apple is one of the top companies in the world based on almost any criterion or set of criteria used. Because of this, Apple is perceived exceptionally well by customers. Apple's growth rate has been extraordinary and its financial performance even more impressive. And the appeal of Apple's products is global. For example, Apple's iPhones now exceed 925 million units globally. Apple also disclosed that there were 1.4 billion active devices as of January 2019.

Apple retail stores enjoy a steady flow of traffic each day. More remarkable is that Apple's stores in China handled in excess of 40 000 people daily prior to the Covid-19 pandemic. Apple has opened 510 retail stores across 25 countries, with 271 located in the United States alone. Apple's newest locations include: Kawasaki and Tokyo, Japan; Mexico City; Singapore Airport; and Taipei, Taiwan.

Source: Newspix/Alan Pryke

Although there are many reasons for its success, the primary reasons rest with Apple's new technology development and innovative new products.

Sources: MacRumors Staff, 2020, Keep track of Apple's retail stores worldwide, http://www.macrumors.com, 12 May; Above Avalon, 2019, http://www.aboveavalon.com, 30 May; *Fortune*, 2011, World's most admired companies, http://www.fortune.com, 3 March; B. Worthen, 2011, With new iPad, Apple tries to stay ahead of wave of tablet rivals, *Wall Street Journal*, http://www.online.wsj.com, 3 March; G. A. Fowler & N. Wingfield, 2011, Apple's showman takes the stage, *Wall Street Journal*, http://www.online.wsj.com, 3 March; *Financial Times*, 2011, Apple and the tablets, http://www.ft.com, 1 March; N. Louth, 2011, Finding value in Apple's core, *Financial Times*, http://www.ft.com, 25 February; M. Helft, 2011, After iPad's head start, rival tablets are poised to flood offices, *New York Times*, http://www.nytimes.com, 20 February; L. Chao, 2011, New Shanghai Apple store will be biggest in China, *Wall Street Journal*, http://www.online.wsj.com, 18 February.

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Apple's drive to innovate

## Increasing knowledge intensity

Knowledge (information, intelligence and expertise) is the basis of technology and its application. In the competitive landscape of the 21st century, knowledge is a critical organisational resource and an increasingly valuable source of competitive advantage.[75]

Indeed, starting in the 1980s, the basis of competition shifted from hard assets to intangible resources; for example, 'Walmart transformed retailing through its proprietary approach to supply chain management and its information rich relationships with customers and suppliers'.[76] Relationships with customers and suppliers are an example of an intangible resource.

Knowledge is gained through experience, observation and inference, and is an intangible resource. The value of intangible resources, including knowledge, is growing as a proportion of total shareholder value in today's competitive landscape.[77] In fact, the Brookings Institution estimates that intangible resources contribute approximately 85 per cent of that value.[78] The probability of achieving strategic competitiveness is enhanced for the organisation that develops the ability to capture intelligence, transform it into useable knowledge and diffuse it rapidly throughout the company.[79] Therefore, organisations must develop (e.g. through training programs) and acquire (e.g. by hiring educated and experienced employees) knowledge, integrate it into the organisation to create capabilities, and then apply it to gain a competitive advantage.[80]

A strong knowledge base is necessary to create innovations. Organisations lacking the appropriate internal knowledge resources are less likely to invest money in research and development.[81] Organisations must continue to learn (building their knowledge stock) because knowledge spillovers to competitors are common. There are several ways in which knowledge spillovers occur, including the hiring of professional staff and managers by competitors.[82] Because of the potential for spillovers, organisations must move quickly to use their knowledge in productive ways. In addition, organisations must build routines that facilitate the diffusion of local knowledge throughout the organisation for use everywhere that it has value.[83] Organisations are better able to do these things when they have **strategic flexibility**.

**strategic flexibility**
a set of capabilities used to respond to various demands and opportunities existing in a dynamic and uncertain competitive environment

Strategic flexibility is a set of capabilities used to respond to various demands and opportunities existing in a dynamic and uncertain competitive environment. Thus, strategic flexibility involves coping with uncertainty and its accompanying risks.[84] Organisations should try to develop strategic flexibility in all areas of their operations. However, those working within organisations to develop strategic flexibility should understand that the task is not easy, largely because of inertia that can build up over time. An organisation's focus and past core competencies may actually slow the rate of change and its aptitude for strategic flexibility.[85]


The pricing landscape of ISPs evolves based upon the advent of streaming video and the increased use of iPads and other tablet and mobile devices.

Source: iStockphoto/hocus-focus

To be strategically flexible on a continuing basis, and to gain the competitive benefits of such flexibility, an organisation has to develop the capacity to learn. Continuous learning provides the organisation with new and up-to-date skill sets that allow it to adapt to its environment as it encounters changes.[86] Organisations capable of rapidly and broadly applying what they have learned exhibit the strategic flexibility and the capacity to change in ways that will increase the probability of successfully dealing with uncertain, hypercompetitive environments.

# The I/O model of above-average returns

The external environment has been viewed historically as the primary determinant of strategies that organisations selected to be successful.[87] In addition, leading organisations believe that the external environment rather than the internal organisation is the strongest influence on the choice of strategy. The industrial organisation model of above-average returns explains the external environment's dominant influence on an organisation's strategic actions. The model specifies that the industry, or segment of an industry, in which a company chooses to compete has a stronger influence on performance than do the choices managers make inside their organisations.[88] The organisation's performance is believed to be determined primarily by a range of industry properties, including economies of scale, barriers to market entry, diversification, product differentiation and the degree of concentration of organisations in the industry.[89] We examine these industry characteristics in Chapter 2.

Grounded in economics, the I/O model has four underlying assumptions. First, the external environment is assumed to impose pressures and constraints that determine the strategies that would result in above-average returns. Second, most organisations competing within an industry or within a segment of that industry are assumed to control similar strategically relevant resources and to pursue similar strategies in light of those resources. Third, resources used to implement strategies are assumed to be highly mobile across organisations, so any resource differences that might develop between organisations will be short-lived. Fourth, organisational decision makers are assumed to be rational and committed to acting in the organisation's best interests, as shown by their profit-maximising behaviours.[90] The I/O model challenges organisations to find the most attractive industry in which to compete. Because most organisations are assumed to have similar valuable resources that are mobile across companies, their performance generally can be increased only when they operate in the industry with the highest profit potential and learn how to use their resources to implement the strategy required by the industry's structural characteristics.[91]

The five forces model of competition is an analytical tool used to assist organisations find the industry that is the most attractive for them. The model (explained in Chapter 2) encompasses several variables and tries to capture the complexity of competition. The five forces model suggests that an industry's profitability (i.e. its rate of return on invested capital relative to its cost of capital) is a function of interactions among five forces: suppliers, buyers, competitive rivalry among organisations currently in the industry, product substitutes, and potential entrants to the industry.[92]

Organisations use the five forces model to identify the attractiveness of an industry (as measured by its profitability potential) as well as the most advantageous position for the organisation to take in that industry, given the industry's structural characteristics.[93] Typically, the model suggests that organisations may earn above-average returns by producing either standardised goods or services at costs below those of competitors (a cost leadership strategy) or by producing differentiated goods or services for which customers are willing to pay a price premium (a differentiation strategy). (Cost leadership and product differentiation strategies are discussed in Chapter 4.) Operating in an unattractive industry does not mean profits cannot be made. The fact that 'the fast food industry is becoming a "zero-sum industry" as companies battle for the same pool of customers'[94] suggests that fast-food giant McDonald's is competing in a relatively unattractive industry. However, by focusing on product innovations and enhancing existing facilities while buying properties in different global markets at attractive prices to selectively build new stores, McDonald's is positioned in the fast-food (or quick-service) restaurant industry to earn above-average returns. There may be bumps in the road of profit, but McDonald's has demonstrated that it can change and succeed.

As shown in Figure 1.2, the I/O model suggests that above-average returns are earned when organisations are able to effectively study the external environment as the foundation for identifying an attractive industry and implementing the appropriate strategy. For example, in some industries, organisations can reduce competitive rivalry and erect barriers to entry by forming joint ventures. Because of these outcomes, the joint ventures increase profitability in the industry.[95] Companies that develop or acquire the internal skills needed to implement strategies required by the external environment are likely to succeed, while those that do not are likely to fail.[96] Hence, this model suggests that returns are determined primarily by external characteristics rather than by the organisation's unique internal resources and capabilities.

Research findings support the I/O model in that approximately 20 per cent of an organisation's profitability is explained by the industry in which it chooses to compete. However, this research also shows that 36 per cent of the variance in profitability can be attributed to the organisation's characteristics and actions.[97] These findings suggest that the external environment and an organisation's resources, capabilities, core competencies and competitive advantages (see Chapter 3) influence its ability to achieve strategic competitiveness and earn above-average returns.

As shown in Figure 1.2, the I/O model assumes that an organisation's strategy is a set of commitments and actions flowing from the characteristics of the industry in which it has decided to compete.

The resource-based model, discussed next, takes a different view of the major influences on an organisation's choice of strategy.

**Figure 1.2** **The I/O model of above-average returns**

| | |
|---|---|
| 1 Study the external environment, especially the industry environment. | **The external environment**<br>• The general environment<br>• The industry environment<br>• The competitor environment |
| 2 Locate an industry with high potential for above-average returns. | **An attractive industry**<br>An industry whose structural characteristics suggest above-average returns |
| 3 Identify the strategy called for by the attractive industry to earn above-average returns. | **Strategy formulation**<br>Selection of a strategy linked with above-average returns in a particular industry |
| 4 Develop or acquire assets and skills needed to implement the strategy. | **Assets and skills**<br>Assets and skills required to implement a chosen strategy |
| 5 Use the organisation's strength (its developed or acquired assets and skills) to implement the strategy. | **Strategy implementation**<br>Selection of strategic actions linked with effective implementation of the chosen strategy |
| | **Superior returns**<br>Earning of above-average returns |

# The resource-based model of above-average returns

The resource-based model assumes that each organisation is a collection of unique resources and capabilities. The uniqueness of its resources and capabilities is the basis of an organisation's strategy and its ability to earn above-average returns.[98]

**Resources** are inputs into an organisation's production process, such as capital equipment, the skills of individual employees, patents, finances and talented managers. In general, an organisation's resources are classified into three categories: physical, human and organisational capital. Described fully in Chapter 3, resources are either tangible or intangible in nature.

Individual resources alone may not yield a competitive advantage.[99] In fact, resources have a greater likelihood of being a source of competitive advantage when they are formed into a **capability**. A capability is the capacity for a set of resources to perform a task or an activity in an integrative manner. Capabilities evolve over time and must be managed dynamically in pursuit of above-average returns.[100] **Core competencies** are resources and capabilities that serve as a source of competitive advantage for an organisation over its rivals. Core competencies are often visible in the form of organisational functions.

**resources**
inputs into an organisation's production process, such as capital equipment, the skills of individual employees, patents, finances and talented managers

**capability**
the capacity for a set of resources to perform a task or an activity in an integrative manner

**core competencies**
capabilities that serve as a source of competitive advantage for an organisation over its rivals

For example, Apple's R&D function is one of its core competencies. Amazon's distribution function is also considered a core competency. There is little doubt that the ability to produce innovative new products that are perceived as valuable in the marketplace is a core competence for Apple, as suggested in the earlier 'Strategic focus' feature.

According to the resource-based model, differences in an organisation's performances across time are due primarily to its unique resources and capabilities rather than the industry's structural characteristics. This model also assumes that an organisation acquires different resources and develops unique capabilities based on how it combines and uses the resources; that resources and certain capabilities are not highly mobile across organisations; and that the differences in resources and capabilities are the basis of competitive advantage.[101] Through continued use, capabilities become stronger and more difficult for competitors to understand and imitate. As a source of competitive advantage, a capability 'should be neither so simple that it is highly imitable, nor so complex that it defies internal steering and control'.[102]

The resource-based model of superior returns is shown in Figure 1.3. This model suggests that the strategy the organisation chooses should allow it to use its competitive advantages in an attractive industry (the I/O model is used to identify an attractive industry).

**Figure 1.3** **The resource-based model of above average returns**

| | |
|---|---|
| 1 Identify the organisation's resources. Study its strengths and weaknesses compared with those of competitors. | **Resources**<br>Inputs into an organisation's production process |
| 2 Determine the organisation's capabilities. What do the capabilities allow the organisation to do better than its competitors? | **Capability**<br>Capacity of an integrated set of resources to integratively perform a task or activity |
| 3 Determine the potential of the organisation's resources and capabilities in terms of a competitive advantage. | **Competitive advantage**<br>Ability of an organisation to outperform its rivals |
| 4 Locate an attractive industry. | **An attractive industry**<br>An industry with opportunities that can be exploited by the organisation's resources and capabilities |
| 5 Select a strategy that best allows the organisation to utilise its resources and capabilities relative to opportunities in the external environment. | **Strategy formulation and implementation**<br>Strategic actions taken to earn above-average returns |
| | **Superior returns**<br>Earning of above-average returns |

Not all of an organisation's resources and capabilities have the potential to be the foundation for a competitive advantage. This potential is realised when resources and capabilities are valuable, rare, costly to imitate and non-substitutable.[103] Resources are valuable when they allow an organisation to take advantage of opportunities or neutralise threats in its external environment. They are rare when possessed by few (if any) current and potential competitors. Resources are costly to imitate when other organisations either cannot obtain them or are at a cost disadvantage in obtaining them compared with the organisation that already possesses them. And they are non-substitutable when they have no structural equivalents. Many resources can either be imitated or substituted over time. Therefore, it is difficult to achieve and sustain a competitive advantage based on resources alone.[104] Individual resources are often integrated to produce integrated configurations in order to build capabilities. These capabilities are more likely to have these four attributes.[105] When these four criteria are met, however, resources and capabilities become core competencies.

As noted previously, research shows that both the industry environment and an organisation's internal assets affect that organisation's performance over time.[106] Thus, to form a vision and mission, and subsequently to select one or more strategies and determine how to implement them, organisations use both the I/O and resource-based models.[107] In fact, these models complement each other in that one (I/O) focuses outside the organisation while the other (resource-based) focuses inside the organisation. Next, we discuss the forming of the organisation's vision and mission: the actions taken after the organisation understands the realities of its external environment (Chapter 2) and internal organisation (Chapter 3).

# Vision and mission

After studying the external environment and the internal environment, the organisation has the information it needs to form its vision and mission (see Figure 1.1). Stakeholders (those who affect or are affected by an organisation's performance, as explained later in the chapter) learn a great deal about an organisation by studying its vision and mission. Indeed, a key purpose of vision and mission statements is to inform stakeholders of what the organisation is, and what it seeks to accomplish in line with its strategic direction.

## Vision

**Vision** is a picture of what the organisation wants to be and, in broad terms, what it wants to ultimately achieve.[108] A vision statement articulates the ideal description of an organisation and gives shape to its intended future. In other words, a vision statement points the organisation in the direction of where it would like to be in the years to come.[109] An effective vision stretches and challenges people as well. Carmine Gallo, in her book about Steve Jobs, Apple's phenomenally successful CEO, argues that one of the reasons Apple is so innovative was Jobs' vision for the company. She suggests that he thought bigger than, and differently from, most people – she describes it as 'putting a dent in the universe'. To be innovative, she explains that one has to think differently about their products and customers – 'sell dreams not products' – and differently about the story to 'create great expectations'.[110] Interestingly, many new entrepreneurs are highly optimistic when they develop their ventures.[111]

**vision**
a picture of what the organisation wants to be and, in broad terms, what it wants to ultimately achieve

It is also important to note that vision statements reflect an organisation's values and aspirations and are intended to capture the heart and mind of each employee and, hopefully, many of its other stakeholders. An organisation's vision tends to be enduring, while its mission can change with new environmental conditions. A vision statement tends to be relatively short and concise, making it easily remembered. Examples of vision statements include the following:

> Our vision is to be the world's best quick service restaurant.[112]
>
> McDonald's

> The Red Cross, born of a desire to bring assistance without discrimination to the wounded on the battlefield, endeavors – in its international and national capacity – to prevent and alleviate human suffering wherever it may be found. Its purpose is to protect life and health and to ensure respect for the human being.[113]
>
> The Red Cross

> We aim to be the airline of choice for customers with specific needs, by providing a travel experience that is comfortable and hassle free, whilst ensuring the safety of passengers and our staff.[114]
>
> Qantas

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Red Cross's sustainability vision

As an organisation's most important and prominent strategic leader, the CEO is responsible for working with others to form the organisation's vision. Experience shows that the most effective vision statement results when the CEO involves a host of stakeholders (e.g. other top-level managers, employees working in different parts of the organisation, suppliers and customers) to develop it. In addition, to help the organisation reach its desired future state, a vision statement should be clearly tied to the conditions in the organisation's external environment and internal organisation. Moreover, the decisions and actions of those involved with developing the vision, especially the CEO and the other top-level managers, must be consistent with that vision.

## Mission

**mission**
specifies the business or businesses in which the organisation intends to compete and the customers it intends to serve

The vision is the foundation for the organisation's mission. A **mission** specifies the business or businesses in which the organisation intends to compete and the customers it intends to serve.[115] The organisation's mission is more concrete than its vision. However, similar to the vision, a mission should establish an organisation's individuality and should be inspiring and relevant to all stakeholders.[116] Together, the vision and mission provide the foundation that the organisation needs to choose and implement one or more strategies. The probability of forming an effective mission increases when employees have a strong sense of the ethical standards that guide their behaviours as they work to help the organisation reach its vision.[117] Thus, business ethics are a vital part of the organisation's discussions to decide what it wants to become (its vision) as well as who it intends to serve and how it desires to serve those individuals and groups (its mission).[118]

Even though the final responsibility for forming the organisation's mission rests with the CEO, they and other top-level managers often involve more people in developing the mission. The main reason is that the mission deals more directly with product markets and customers, and middle- and first-level managers and other employees have more direct contact with customers and the markets in which they are served. McDonald's mission statement, for example, flows from its vision of being the world's best quick-service restaurant:

> Be the best employer for our people in each community around the world; deliver operational excellence to our customers in each of our restaurants.[119]
>
> McDonald's

Some say that vision and mission statements provide little value. One expert believes: 'Most vision statements are either too vague, too broad in scope, or riddled with superlatives'.[120] Clearly, vision and mission statements that are poorly developed do not provide the direction an organisation needs to take appropriate strategic actions. Still, as shown in Figure 1.1, an organisation's vision and mission are critical aspects of the strategic inputs required to engage in strategic actions that help to achieve strategic competitiveness and earn above-average returns. Therefore, organisations must accept the challenge of forming effective vision and mission statements.

# Stakeholders

Every organisation involves a system of primary stakeholder groups with whom it establishes and manages relationships.[121] **Stakeholders** are the individuals, groups and organisations who may affect the organisation's vision and mission, who are affected by the strategic outcomes achieved, and who have enforceable claims on the organisation's performance.[122] Claims on an organisation's performance are enforced through the stakeholders' ability to withhold participation essential to the organisation's survival, competitiveness and profitability.[123] Stakeholders continue to support an organisation when its performance meets or exceeds their expectations.[124] Also, research suggests that organisations that effectively manage stakeholder relationships outperform those that do not. Stakeholder relationships therefore can be managed to be a source of competitive advantage.[125]

**stakeholders**
the individuals and groups who can affect and are affected by the strategic outcomes achieved and who have enforceable claims on an organisation's performance

Although organisations have dependency relationships with their stakeholders, they are not equally dependent on all stakeholders at all times.[126] As a consequence, not every stakeholder has the same level of influence.[127] The more critical and valued a stakeholder's participation, the greater an organisation's dependence on it. Greater dependence, in turn, gives the stakeholder more potential influence over an organisation's commitments, decisions and actions. Managers must find ways to either accommodate or insulate the organisation from the demands of stakeholders controlling critical resources.[128]

## Classifications of stakeholders

The parties involved with an organisation's operations can be separated into at least four groups.[129] As shown in Figure 1.4, there are the capital market stakeholders (shareholders and the major suppliers of an organisation's capital), the product market stakeholders (the organisation's primary customers, suppliers, host communities and unions representing the workforce), the organisational stakeholders (all of an organisation's employees, including both non-managerial and managerial personnel) and the natural environment (as represented by activist groups).

**Figure 1.4** **The four stakeholder groups**

**Stakeholders** → People who are affected by an organisation's performance and who have claims on its performance

**Capital market stakeholders**
- Shareholders
- Major suppliers of capital (e.g. banks)

**Product market stakeholders**
- Primary customers
- Suppliers
- Host communities
- Unions

**Organisational stakeholders**
- Employees
- Managers
- Non-managers

**The natural world**
- Natural resources
- Climate
- Governments and environmental groups

Each stakeholder group expects those making strategic decisions in an organisation to provide the leadership through which its valued objectives will be reached.[130] The objectives of the various stakeholder groups often differ from one another, sometimes placing those involved with an organisation's strategic management process in situations where trade-offs have to be made. The most obvious stakeholders are shareholders: individuals and groups who have invested capital in an organisation in the expectation of earning a positive return on their investments. These stakeholders' rights are grounded in laws governing private property and private enterprise.

In contrast to shareholders, another group of stakeholders – the organisation's customers – prefer that investors receive a minimum return on their investments. Customers could have their interests maximised when the quality and reliability of an organisation's products are improved, but without high prices. High returns to customers, therefore, might come at the expense of lower returns for capital market stakeholders.

Because of potential conflicts, each organisation must carefully manage its stakeholders. First, an organisation must thoroughly identify and understand all important stakeholders. Second, it must prioritise them in case it cannot satisfy all of them. Power is the most critical criterion in prioritising stakeholders. Other criteria might include the urgency of satisfying each particular stakeholder group and the degree of importance of each to the organisation.[131]

When the organisation earns above-average returns, the challenge of effectively managing stakeholder relationships is lessened substantially. With the capability and flexibility provided by above-average returns, an organisation can more easily satisfy multiple stakeholders simultaneously. When the organisation earns only average returns, it is unable to maximise the interests of all stakeholders. The objective then becomes one of at least minimally satisfying each stakeholder.

Trade-off decisions are made in light of how important the support of each stakeholder group is to the organisation. For example, environmental groups may be very important to organisations in the energy industry but less important to professional service organisations.[132] An organisation earning below-average returns does not have the capacity to minimally satisfy all stakeholders. The managerial challenge in this case is to make trade-offs that minimise the amount of support lost from stakeholders. Societal values also influence the general weightings allocated among the four stakeholder groups shown in Figure 1.4. Although all the groups are served by organisations in the major industrialised nations, the priorities in their service vary because of cultural differences. Next, we present additional details about each of the major stakeholder groups.

## Capital market stakeholders

Shareholders and lenders both expect an organisation to preserve and enhance the wealth they have entrusted to it. The returns they expect are commensurate with the degree of risk accepted with those investments (i.e. lower returns are expected with low-risk investments while higher returns are expected with high-risk investments). Institutional investors (e.g. superannuation funds) often are willing to sell their share in the fund if the returns are not what they desire, or to take actions to improve the organisation's performance, such as pressuring top managers to improve the governance oversight by the board of directors. Some institutions owning major shares of an organisation's shareholding may have conflicting views about the actions needed, which can be challenging for managers. This is because some may want an increase in returns in the short term, while others may desire a focus on building long-term competitiveness.[133] Managers may have to balance their desires with other shareholders or prioritise the importance of the institutional owners with different goals. Clearly, shareholders who hold a large share parcel (sometimes referred to as large-block shareholders – see Chapter 10 for more explanation) are influential, especially in the determination of the organisation's capital structure (i.e. the amount of equity versus the amount of debt used). Often, large shareholders prefer that the organisation minimise its use of debt because of the risk, its cost and the possibility that debt holders have first call on the organisation's assets in case of default over the shareholders.[134]

## Product market stakeholders

Some might think that product market stakeholders (customers, suppliers and unions) share few common interests. However, all these groups can benefit as organisations engage in competitive battles. For example, depending on product and industry characteristics, marketplace competition may result in lower product prices being charged to an organisation's customers and higher prices being paid to its suppliers (the organisation might be willing to pay higher supplier prices to ensure delivery of the types of goods and services that are linked with its competitive success).[135]

Customers (also known as 'clients' in many not-for-profit organisations), as stakeholders, demand reliable products (or services) at the lowest possible prices. Suppliers seek loyal customers who are willing to pay the highest sustainable prices for the goods and services they receive. Although all product market stakeholders are important, without customers the other product market stakeholders are of little value. Therefore, the organisation must try to learn about and understand current and potential customers.[136]

### Organisational stakeholders

Employees – the organisational stakeholders – expect their place of employment to provide a dynamic, stimulating and rewarding work environment. Employees are usually satisfied working for an organisation that is growing and actively developing their skills, especially those skills required to be effective team members and to meet or exceed global work standards. Employees who learn how to use new knowledge productively are critical to organisational success. In a collective sense, the education and skills of an organisation's workforce are competitive weapons affecting strategy implementation and organisational performance.[137] Strategic leaders are ultimately responsible for serving the needs of organisational stakeholders on a day-to-day basis. In fact, to be successful, strategic leaders must effectively use the organisation's human capital.[138] The importance of human capital to their success is possibly why outside directors are more likely than inside strategic leaders to propose downsizing, with insiders more likely to use preventative cost-cutting measures and seek to protect incumbent employees.[139] A highly important means of building employee skills for the global competitive landscape is through international assignments. The process of managing expatriate employees and helping them build knowledge can have significant effects over time on the organisation's ability to compete in global markets.[140]

### The natural world and corporate social responsibility (CSR)

The natural world is increasingly important as a stakeholder because of the vital issue of the depletion of nature resulting from human actions. In addition, the presence of well-organised, well-funded environmental groups representing the interests of nature means that organisations should be very careful about their impact on the environment if they do not want legal challenges and brand damage to occur. This is clearly evident in resource extraction industries such as coal and iron ore, where great care has to be taken to respect nature if projects are to proceed; but it is also evident in retailing industries where major companies such as IKEA are now concerned about ensuring the sustainable sourcing of timber because of pressure from consumers.

Accenture (a Fortune Global 500 company) in 2020 noted that 65 per cent of global CEOs interviewed on the topic of seeking responsible leadership agreed that they need to decouple economic growth from the use of natural resources and that: 'Organisations have the opportunity and the obligation to drive growth in tandem with positive social and environmental outcomes. This starts with redefining what it means to lead responsibly…'[141] In a similar vein, corporate social responsibility (CSR) has become a major interest and very topical as an issue for many global organisations, and a major factor in corporate governance, which we will explore further later in the chapter. The growing interest in working towards a sustainable society requires a new type of leadership that promotes CSR's ideals.[142] This point provides a natural segue into the topic of strategic leadership.

## Strategic leaders

**Strategic leaders** are people located in different areas and levels of the organisation using the strategic management process to select strategic actions that assist the organisation achieve its vision and fulfil

**strategic leaders**
people located in different sections of the organisation using the strategic management process to assist the organisation reach its vision and mission

its mission. Regardless of their location in the organisation, successful strategic leaders are decisive, committed to nurturing those around them[143] and committed to assisting the organisation create value for all stakeholder groups.[144] In this vein, research evidence suggests that employees who perceive that their CEO is a visionary leader also believe that the CEO leads the organisation to operate in ways that are consistent with the values of all stakeholder groups, rather than emphasising only the maximising of profits for shareholders. In turn, visionary leadership helps to obtain extra effort by employees, thereby achieving enhanced organisational performance.

When identifying strategic leaders, most of us tend to think of CEOs and other executives. Clearly, these individuals are strategic leaders. In the final analysis, CEOs are responsible for making certain their organisation effectively uses the strategic management process. Indeed, the pressure on CEOs to manage strategically is stronger than ever.[145] However, many other people assist in choosing an organisation's strategy and then determining the actions for successfully implementing it.[146] The main reason is that the realities of 21st-century competition, discussed earlier in this chapter (e.g. the global economy, globalisation, rapid technological change, and the increasing importance of knowledge and people as sources of competitive advantage), are creating a need for those 'closest to the action' to make decisions and determine the actions to be taken.[147] The most effective CEOs and executives understand how to delegate strategic responsibilities to people throughout the organisation who influence the use of organisational resources. Delegation also helps to avoid too much managerial hubris at the top and the problems this causes, especially in situations allowing significant managerial discretion.[148]

**organisational culture** refers to the complex set of ideologies, symbols and core values that are shared throughout the organisation and that influence how the organisation conducts business

**Organisational culture** also affects strategic leaders and their work. In turn, strategic leaders' decisions and actions shape an organisation's culture. Organisational culture refers to the complex set of ideologies, symbols and core values that are shared throughout the organisation and that influence how the organisation conducts business. It is the social energy that drives – or fails to drive – the organisation.[149] For example, US airline Southwest Airlines is known for having a unique and valuable culture that encourages employees to work hard but also to have fun while doing so. Moreover, its culture entails respect for others – employees and customers alike.

Some organisational cultures are a source of disadvantage or dysfunction. For example, the Australian Prudential Regulation Authority (APRA) released the *Prudential Inquiry into the Commonwealth Bank of Australia (CBA) Final Report* in May 2018, noting that it '... found a number of prominent cultural themes such as a widespread sense of complacency, a reactive stance in dealing with risks, being insular and not learning from experiences and mistakes, and an overly collegial and collaborative working environment which lessened the opportunity for constructive criticism, timely decision-making and a focus on outcomes...'. The Panel recommended that 'cultural change that moves the dial from reactive and complacent to empowered, challenging and striving for best practice in risk identification and remediation'.[150]

It is important for strategic leaders to understand, however, that whether the organisation's culture is functional or dysfunctional, their effectiveness is influenced by that culture. The relationship between organisational culture and strategic leaders' work is reciprocal in that the culture shapes the outcomes of their leadership, while their leadership helps shape an ever-evolving organisational culture.

## The work of effective strategic leaders

Perhaps not surprisingly, hard work, thorough analyses, a willingness to be candid, a penchant for wanting the organisation and its people to accomplish more, and tenacity are prerequisites for an individual's success as a strategic leader.[151] In addition, strategic leaders must have a strong strategic orientation while simultaneously embracing change in the dynamic competitive landscape we have discussed.[152] In order to deal with this change effectively, strategic leaders must be innovative thinkers and promote innovation in their organisation.[153] Promoting innovation is facilitated by a diverse executive management team representing different types of expertise and leveraging relationships with external parties.[154] Strategic leaders may best leverage partnerships with external parties and organisations when their organisations are 'ambidextrous' – that is, the organisations simultaneously promote exploratory learning of new and unique forms of knowledge and exploitative learning that adds incremental knowledge to existing knowledge bases, allowing them to better understand and use their existing products.[155] In addition, strategic leaders need to have a global mindset, or what some refer to as an ambicultural approach to management.[156]

In summary, effective strategic leaders provide a vision as the foundation for the organisation's mission and subsequent choice and use of one or more strategies.

## Predicting outcomes of strategic decisions

Strategic leaders attempt to predict the outcomes of their decisions before taking efforts to implement them, which is difficult to do. Many decisions that are a part of the strategic management process are concerned with an uncertain future and the organisation's place in that future. As such, managers try to predict the effects on the organisation's profits of strategic decisions that they are considering.[157]

Mapping an industry's profit pool is something strategic leaders can do to anticipate the possible outcomes of different decisions and to focus on growth in profits rather than strictly growth in revenues. A **profit pool** entails the total profits earned in an industry at all points along the value chain.[158] (We explain the value chain in Chapter 3 and discuss it further in Chapter 4.) Analysing the profit pool in the industry may assist an organisation to see something others are unable to see and to understand the primary sources of profits in an industry. There are four steps to identifying profit pools:

**profit pool**
entails the total profits earned in an industry at all points along the value chain

1. define the pool's boundaries
2. estimate the pool's overall size
3. estimate the size of the value chain activity in the pool
4. reconcile the calculations.

For example, McDonald's might desire to map the quick-service restaurant industry's profit pools. First, McDonald's would need to define the industry's boundaries and, second, estimate its size (which is large, because McDonald's operates in markets across the globe). The net result of this is that McDonald's tries to take market share away from competitors such as Hungry Jack's or KFC, and growth is more likely to be in international markets. Armed with information about its industry, McDonald's could then estimate the amount of profit potential in each part of the value chain (step 3). In the quick-service restaurant industry, marketing campaigns and customer service are likely to be more important sources of potential profits than are inbound logistics activities (see Chapter 3). With an understanding of where the greatest profits are likely to be earned, McDonald's would then be ready to select the strategy to use to be successful where the largest profit pools are located in the value chain.[159] As this brief discussion shows, profit pools are a potentially useful tool to help strategic leaders recognise the actions to take to increase the likelihood of increasing profits. Of course, profits made by an organisation and in an industry can be partially interdependent with the profits earned in adjacent industries.[160] For example, profits earned in the energy industry can affect profits in other industries (e.g. airlines). When oil prices are high, this can reduce the profits earned in industries that must use a lot of energy to provide their goods or services.

## Ethical dimensions

It is important to emphasise that, primarily because they are related to how an organisation interacts with its stakeholders, almost all strategic management process decisions have ethical dimensions.[161] Organisational ethics are revealed by an organisation's culture; that is, an organisation's decisions are a product of the core values that are shared by most or all of a company's managers and employees. Especially in the turbulent and often ambiguous competitive landscape of the 21st century, those making decisions as a part of the strategic management process are challenged to recognise that their decisions affect capital markets, product markets and organisational stakeholders differently, and to regularly evaluate the ethical implications of their decisions.[162] Decision makers failing to recognise these realities accept the risk of placing their organisation at a competitive disadvantage with regard to ethical business practices.[163]

As you will discover, the strategic management process examined in this book calls for disciplined approaches to serve as the foundation for developing a sustainable competitive advantage. These approaches provide the pathway through which organisations will be able to achieve strategic competitiveness and earn above-average returns. Mastery of this strategic management process will effectively assist and guide you and the organisations for which you will choose to work.

# STUDY TOOLS

## SUMMARY

**LO1** Organisations use the strategic management process to achieve strategic competitiveness and earn above-average returns. Strategic competitiveness is achieved when an organisation develops and implements a value-creating strategy. Above-average returns (in excess of what investors expect to earn from other investments with similar levels of risk) provide the foundation needed to simultaneously satisfy all of an organisation's stakeholders.

**LO2** The fundamental nature of competition is different in the current competitive landscape. As a result, those making strategic decisions must adopt a different mindset, one that allows them to learn how to compete in highly turbulent and chaotic environments that produce a great deal of uncertainty. The globalisation of industries and their markets, and rapid and significant technological changes, are the two primary factors contributing to the turbulence of the competitive landscape.

**LO3** Organisations use two major models to help develop their vision and mission and then choose one or more strategies in pursuit of strategic competitiveness and above-average returns. The I/O model is used to understand the effects an industry's characteristics can have on an organisation when deciding on what strategies to use to compete against rivals. The logic supporting the I/O model suggests that above-average returns are earned when the organisation locates an attractive industry, or part of an industry, and successfully implements the strategy dictated by that industry's characteristics.

**LO4** The resource-based model is based on the assumption that the organisation's unique resources, capabilities and core competencies have a major influence on selecting and using strategies more than does the organisation's external environment. Above-average returns are earned when the organisation uses its valuable, rare, costly-to-imitate and non-substitutable resources and capabilities to compete against its rivals in one or more industries.

**LO5** Vision and mission are formed to guide the selection of strategies based on the information from the analyses of the organisation's internal and external environments. Vision is a picture of what the organisation wants to be and, in broad terms, what it wants to ultimately achieve. Flowing from the vision, the mission specifies the business or businesses in which the organisation intends to compete and the customers it intends to serve. Vision and mission provide direction to the organisation and signal important descriptive information to stakeholders.

**LO6** Stakeholders are those who can affect, and are affected by, an organisation's strategic outcomes. Because an organisation is dependent on the continuing support of stakeholders (e.g. shareholders, customers, suppliers, employees, host communities, the natural world), they have enforceable claims on the organisation's performance.

**LO7** Strategic leaders are people located in different areas and levels of an organisation using the strategic management process to help the organisation achieve its vision and fulfil its mission. In general, the CEO is responsible for making certain that their organisation properly uses the strategic management process. The effectiveness of the process is increased when it is grounded in ethical intentions and behaviours. It is important for all strategic leaders – and especially the CEO and other members of the executive team – to conduct thorough analyses of conditions facing the organisation, be candid and consistently honest, and work jointly to select and implement the correct strategies.

## KEY TERMS

| | | | |
|---|---|---|---|
| average returns | global economy | organisational culture | risk |
| capability | hypercompetition | profit pool | stakeholders |
| core competencies | mission | resources | strategic competitiveness |

strategic flexibility
strategic leaders
strategic management process
strategy
vision

## REVIEW QUESTIONS

1. What are the main components of the strategic management process?
2. Is there any one component of the strategic management process that is more important than others?
3. What are the characteristics of the current competitive landscape? What two factors are the primary drivers of this landscape?
4. According to the I/O model, what should an organisation do to earn above-average returns?
5. What does the resource-based model suggest an organisation should do to earn above-average returns?
6. What are vision and mission? Should all organisations have a vision and mission statement? What is their value for the strategic management process?
7. What are stakeholders? How many primary stakeholder groups could influence an organisation's decision-making process?
8. What are the three main drivers for strategic leaders?

## EXPERIENTIAL EXERCISES

### Exercise 1: Stakeholder analysis, strategic planning and strategic leadership

Every organisation relies on its own unique bundle of organisational stakeholders. Each one of the relationships between the organisation and its stakeholders is influential in its ability to serve its mission and achieve above-average profits in the for-profit sector, or to create value in the not-for-profit sector. However, there are many ways in which stakeholder management differs between the for-profit and not-for-profit worlds. It is easy to think of a for-profit organisation that has product market stakeholders, such as customers, who can add or subtract their support by their decision about whether or not to purchase the organisation's products or services. But who is the customer for a not-for-profit, and are the categories of product, market, organisation and capital market stakeholders very different from the for-profit arena? This exercise challenges you to uncover some of the more influential ways in which this is so.

In this exercise, you will be working in teams of approximately four to five students.

1. Conduct a web search for a not-for-profit organisation. Decide which not-for-profit organisation you would like to analyse. Otherwise consider the Red Cross, Amnesty International, World Wide Fund for Nature (WWF) or Greenpeace.
2. Determine two or three key strategic initiatives of this not-for profit organisation. Most not-for-profits, particularly well-known ones, post their strategic plans on their websites.
3. Now perform an analysis, such as a macro-environmental analysis, and list all known or expected stakeholders for the organisation. You should place them in the context of product, market and organisational stakeholders.

## NOTES

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CHAPTER 2

# The external environment: opportunities, threats, industry competition and competitor analysis

## Learning Objectives

Studying this chapter should provide you with the strategic management knowledge needed to:

**LO1** define and describe the general environment, the industry environment and the competitor environment

**LO2** explain the importance of analysing and understanding the organisation's external environment, and discuss the four activities of the external environmental analysis process

**LO3** outline and describe the seven segments of the general environment

**LO4** identify the five competitive forces and interpret industry analyses to determine an industry's profit or surplus potential

**LO5** define strategic groups and describe their influence on the organisation

**LO6** describe what organisations need to know about their competitors, competitor analysis and ethical considerations.

# OPENING CASE STUDY

## Drilling for oil: risks and rewards

British Petroleum (BP) has had experience of disasters in drilling; however, because of the demand for oil and issues with supply from the Middle East, there is continuing investigation and exploitation of oil reserves that are difficult to access. The Deepwater Horizon spill by BP in the Gulf of Mexico in April 2010 was the largest accidental offshore spill in history, at 206 million gallons. One of the main challenges for the organisation's strategic leadership was to understand what the external environment's effects were on the organisation and to predict how its future strategic actions might lead to success.

The Gulf disaster has not deterred BP. It still explores in difficult situations. In 2016, BP was planning to go ahead with a controversial US$1 billion-plus frontier exploration campaign in the Great Australian Bight, off the coast of South Australia, in the face of mounting concern from environmental groups, and despite a tumbling oil price that has deterred other explorers around the country from drilling. US giant Chevron also has a permit to drill in the region, as does Santos, a local oil company. Following the Deepwater Horizon accident, BP recovered to grow as a better-disciplined organisation, one that delivered consistently for 12 consecutive quarters. BP made a profit of US$10 billion in 2019 and operating cash flow was strong at US$26 billion for the year.

BP's head of exploration for Asia-Pacific, Bryan Ritchie, said that while the oil company has cut back on exploration in some regions, it wants to go forward in Australia because of the large potential oil price on offer. However, the company is spreading costs, and risk, by selling a further stake in the venture, intending to cut its 70 per cent holding to 40 or 50 per cent.

The project is aiming to drill 2.5 km underwater. It will cost US$600 million for four wells, and in addition BP is having a US$755 million drilling rig built in South Korea. The financial risks are huge. Peter Owen, the South Australian director of the Wilderness Society, pointed to huge community concern about the drilling plans: 'We don't need a Gulf of Mexico disaster in the Great Australian Bight'. The Gulf catastrophe will clearly be easy to use as part of a media campaign by environmentalists.

In 2020, the Chair of BP, Helge Lund, noted to shareholders that 'We enter a new decade with a new company purpose: to reimagine energy for people and our planet.' In 2019, the BP board of directors recommended that shareholders support a special resolution requisitioned by Climate Action 100+ on climate change disclosures.

The economic segment of the general environment will continue to produce demand for energy, especially with the rise of emerging markets such as China and India; thus, exploration for hydrocarbon products will continue, at least while social forces stay favourable to this. The Global Energy Review 2020 by the International Energy Association (IEA) noted that the global energy demand decreased by 3.8 per cent in the first quarter of 2020. Globally, the demand for coal fell by approximately 8 per cent due to three reasons: first, China – a coal-based economy – was hit the hardest by the Covid-19 pandemic in the first quarter; second, cheap gas and continued growth in renewable energy elsewhere challenged coal; and, third, mild weather also capped coal use. Oil demand also dropped by 5 per cent and the impact of the pandemic on gas demand was more moderate, at a 2 per cent decrease. Despite these factors, demand for energy will continue and the pressure to use alternative sources of energy will rise, driven by the sociocultural segment of the environment because of the carbon emissions produced by such hydrocarbons. The value to society of hydrocarbons is that it accelerates development and deployment of clean technologies for transport, industry and power according to the IEA. Government policies could include hydrogen use in national decarbonisation plans, public research and development funding and adopt transmission tariff exemptions for electrolysers.

Technology changes have also affected many companies in this industry. Gas drilling and fracturing (fracking) have dramatically increased gas reserves and may provide a substitute for other $CO_2$ emission-producing resources such as coal. Problems with fracking include the potential effects on water tables, and thus farming, so there is widespread opposition to this technique. The Lock the Gate Alliance in Australia is one example of such farmer-driven activism.

The Arctic is another frontier for exploration, despite the enormous environmental risks of drilling in this fragile ecosystem. BP has worked there in cooperation with the

Russian Government–owned company Rosneft. In 2019, BP reported that it had a 19.75 per cent shareholding in Rosneft, one of Russia's largest oil and gas companies, which has both upstream and downstream operations.

Exxon-Mobil also had a US$700 million deal with Russia, which was eager to proceed because the country needs oil. The prospects are enticing – the Kara Sea has reserves estimated at US$900 billion, exceeding Saudi Arabia's reserves. But the Exxon-Mobil deal came unstuck in mid-2015 because of events in the political sphere, when Western financial sanctions were enacted in response to Russia's takeover of the Crimean Peninsula.

As these examples demonstrate, assessing the influence of various segments of the external environment is critical in ensuring future success for any organisation. This is especially true for energy organisations, which are part of a global integrated process of extracting energy, refining various products and distributing them around the world. The economic rise of China and India, coupled with the rise of Brazil as an energy power, and Russia's energy reserves, is a significant influence in world markets. Balancing this are increasingly high-profile environmental groups aided by the power and reach of social media. Understanding how these complex processes work and how to deal with these segments of the external environment is critical in formulating successful strategies to manage global environmental forces.

The external world for oil exploration is especially complex and very uncertain. Many forces are at play: there is new technology allowing deep well exploration; there are ever-better-organised environmental groups; governments are sensitive to environmental issues; unpredictable international events impact on permissions; competition is fierce for new areas to exploit; fracking is now common, and productive; alternative energy sources are developing quickly; and there still is a demand for oil albeit at a low price (how low can it go?). The situation with low prices threatens the stability of the industry that will remain central to the functioning of the global economy. Oil companies still face the challenges of investing to offset natural production declines and to meet future growth. Global capital expenditure by exploration and production companies in 2020 is forecast to drop by 32 per cent, the lowest level for 13 years. The reduction of financial resources will undermine the ability of the oil industry to develop several of the technologies needed for clean energy transitions around the globe. The strategists in oil companies must remain very alert indeed.

Sources: BP, 2019, *Energy with Purpose: BP Annual Report and Form 20-F 2019*, https://www.bp.com/content/dam/bp/business-sites/en/global/corporate/pdfs/investors/bp-annual-report-and-form-20f-2019.pdf; IEA, 2020, *Oil Market Report – April 2020*, http://www.iea.org; IEA, 2020, Carbon-free hydrogen from low cost wind power, stored for use on demand, IEA Paris, https://www.iea.org/articles/Carbon-free hydrogen from low cost wind power, stored for use on demand, 3 July; IEA, 2020, *Global Energy Review 2020. The Impact of the Covid-19 Crisis on Global Energy Demand and $CO_2$ Emissions. Flagship Report – April 2020*; M. Galluchi, 2015, Russian oil giant Rosneft is delaying Arctic drilling plans amid Western sanctions against Moscow, *International Business Times*, 30 January; C. Winter, 2015, Oil and gas companies converge on the Great Australian Bight to explore reserves, ABC, http://www.abc.net.au/news/2015-01-19/bight-oil-gas-exploration/6025402, 19 January; A. Macdonald-Smith, 2015, BP forges ahead with $1b Great Australian Bight exploration, *Sydney Morning Herald*, 20 May; *The Economist*, 2011, Dancing with bears: BP in Russia, 5 February, 73; J. Ball, 2011, Environment (special report) – lessons from the Gulf: William Reilly on why the oil spill happened, and where the industry goes from here, *Wall Street Journal*, http://www.wsj.com, 7 March, R5; P. Elkind, D. Whitford & D. Burke, 2011, An accident waiting to happen, *Fortune*, 7 February, 105–32; P. Hunter & P. Russell, 2011, Capitol Hill views divided on oil spill report, *Engineering News-Record*, 7 February, 7; A. Peaple, 2011, Reshaped BP finds east is no Eden, *Wall Street Journal*, http://www.wsj.com, 23 February, C14; R. Gold, 2010, Halliburton faulted over cement job, *Wall Street Journal*, http://www.wsj.com, 9 September; J. Weisman, 2010, BP softens political hit, *Wall Street Journal*, http://www.wsj.com, 21 June.

As described in the opening case, the external environment affects an organisation's strategic actions.[1] For example, BP also sought to expand its oil reserves by forming joint ventures in Russia with Rosneft Corporation and in India with Reliance Industries.[2] In addition, it is clear that BP's strategic actions are affected by conditions in other segments of its general environment, such as the political/legal, sociocultural and physical environment segments. As we explain in this chapter, an organisation's external environment creates both opportunities (e.g. the opportunity for BP to enter other global markets) and threats (e.g. the possibility that additional regulation in its markets will reduce opportunities to extract oil and gas). Collectively, opportunities and threats affect an organisation's strategic actions.[3]

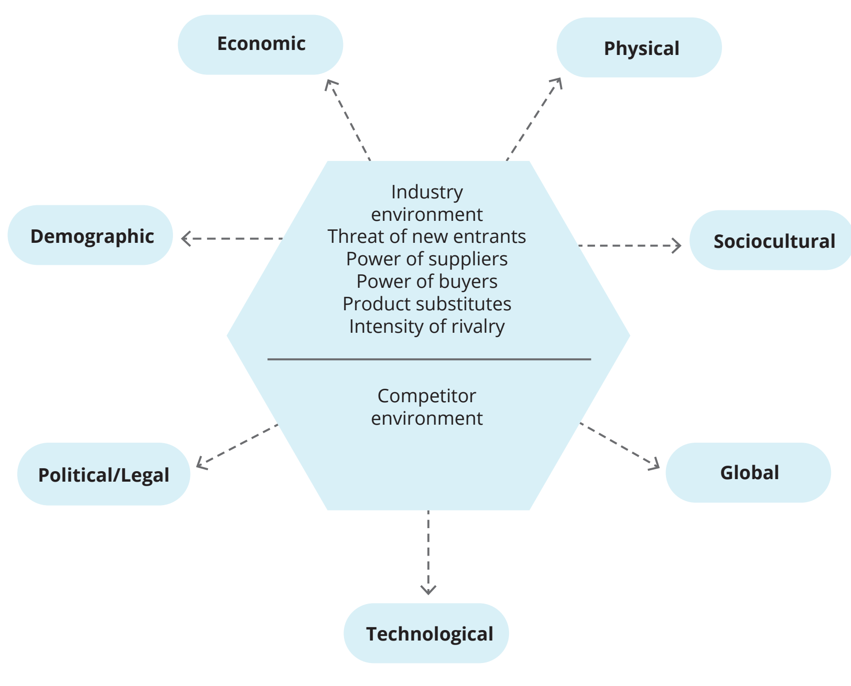
Regardless of the industry in which organisations compete, the external environment influences organisations as they seek strategic competitiveness and above-average returns. This chapter focuses on how organisations analyse their external environment. The understanding of conditions in its external environment that the organisation gains by analysing that environment is matched with knowledge about its internal organisation (discussed in the next chapter) as the foundation for forming the organisation's vision, developing its mission, and identifying and implementing strategic actions (see Figure 1.1).

As noted in Chapter 1, the environmental conditions in the current global economy differ from historical conditions. For example, technological changes and the continuing growth of information gathering and processing capabilities increase the need for organisations to develop effective competitive actions on a timely basis;[4] in other words, organisations have little time to correct errors when implementing their competitive actions. The rapid sociological changes occurring in many countries affect labour practices and the nature of products demanded by increasingly diverse consumers. Governmental policies and laws also affect where and how organisations choose to compete.[5] In addition, changes to nations' financial regulatory systems that were enacted in 2010 and beyond are expected to increase the complexity of organisations' financial transactions.[6]

Viewed in their totality, the conditions that affect organisations today indicate that, for most organisations, their external environment is filled with uncertainty. To successfully deal with this uncertainty, and to achieve strategic competitiveness and thrive, organisations must be aware of and fully understand the different segments of the external environment.[7]

Organisations understand the external environment by acquiring information about competitors, customers and other stakeholders to build their own base of knowledge and capabilities.[8] On the basis of the new information, organisations take action, such as building new capabilities and core competencies, in the hope of buffering themselves against any negative environmental effects and to pursue opportunities as the basis for better serving their stakeholders' needs.[9] An organisation's strategic actions are influenced by the conditions in the three parts of its external environment: the general, industry and competitor (see Figure 2.1).

**Figure 2.1** **The external environment**



# The general, industry and competitor environments

**general environment**
composed of dimensions in the broader society that influence an industry and the organisations within it

**industry environment**
the set of factors that directly influences an organisation and its competitive actions and competitive response: the threat of new entrants, the power of suppliers, the power of buyers, the threat of product substitutes and the intensity of rivalry among competitors

The **general environment** is composed of dimensions in the broader society that influence an industry and the organisations within it.[10] We group these dimensions into seven environmental segments: demographic, economic, political/legal, sociocultural, technological, global and physical. Examples of elements analysed in each of these segments are shown in Table 2.1.

Organisations cannot directly control the general environment's segments, as business failure and bankruptcies indicate. Because organisations cannot directly control the segments of their external environment, successful organisations learn how to gather the information needed to understand all segments and their implications for selecting and implementing the organisation's strategies.

The **industry environment** is the set of factors that directly influences an organisation and its competitive actions and responses: the threat of new entrants, the power of suppliers, the power of buyers, the threat of product substitutes and the intensity of rivalry among competitors.[11] In total, the interactions among these five factors determine an industry's profit potential; in turn, the industry's profit potential influences the choices each organisation makes about its strategic actions. The challenge for an organisation

**Table 2.1 The general environment: segments and elements**

| Segments | Elements | |
|---|---|---|
| Demographic | • Population size<br>• Age structure<br>• Geographic distribution | • Ethnic mix<br>• Income distribution |
| Economic | • Inflation rates<br>• Interest rates<br>• Trade deficits or surpluses<br>• Budget deficits or surpluses | • Personal savings rate<br>• Business savings rates<br>• Gross domestic product |
| Political/legal | • Taxation laws<br>• Superannuation laws<br>• Deregulation philosophies | • Labour training laws<br>• Educational philosophies and policies |
| Sociocultural | • Women in the workforce<br>• Workforce diversity<br>• Attitudes about the quality of work life | • Shifts in work and career preferences<br>• Shifts in preferences regarding product and service characteristics<br>• Vegan activists |
| Technological | • Product innovations<br>• Applications of knowledge | • Focus of private and government-supported R&D expenditures<br>• New communication technologies |
| Global | • Important political events<br>• Critical global markets<br>• Pandemic (Covid-19) | • Newly industrialised countries<br>• Different cultural and institutional attributes |
| Physical environment | • Energy consumption<br>• Practices used to develop energy sources<br>• Renewable energy efforts<br>• Minimising an organisation's environmental footprint | • Availability of water as a resource<br>• Producing environmentally friendly products<br>• Reacting to natural or human-made disasters |

is to locate a position within an industry where it can favourably influence the five factors or where it can successfully defend against their influence. The greater an organisation's capacity to favourably influence its industry environment, the greater the likelihood that the organisation will earn above-average returns.

How companies gather and interpret information about their competitors is called competitor analysis. Understanding the organisation's competitor environment complements the insights provided by studying the general and industry environments.[12] This means, for example, that BP wants to learn as much as it can about its major competitors – such as Exxon-Mobil and Royal Dutch Shell plc – while also learning about its general and industry environments.

Analysis of the general environment is focused on environmental trends; an analysis of the industry environment is focused on the factors and conditions influencing an industry's profitability potential; and an analysis of competitors is focused on predicting competitors' actions, responses and intentions. In combination, the results of these three analyses influence the organisation's vision, mission and strategic actions. Although we discuss each analysis separately, performance improves when the organisation integrates the insights provided by analyses of the general environment, the industry environment and the competitor environment.

# External environmental analysis

Most organisations face external environments that are highly turbulent, complex and global: conditions that make interpreting those environments difficult.[13] To cope with often ambiguous and incomplete environmental data, and to increase understanding of the general environment, organisations engage in external environmental analysis. This analysis has four parts: scanning, monitoring, forecasting and assessing (see Table 2.2). Analysing the external environment is a difficult, yet significant, activity.[14]

Identifying opportunities and threats is an important objective of studying the general environment. An **opportunity** is a condition in the general environment that, if exploited effectively, helps a company to achieve strategic competitiveness. For example, market research results suggested to Procter & Gamble (P&G) after its acquisition of Gillette, a shaving products company, that an increasing number of men globally are interested in fragrances and skin-care products. To take advantage of this opportunity, P&G reoriented towards beauty products to better serve both men and women generally. The change constituted an organisation change focused on combining product categories rather than its typical organisation around a specific branded product.[15]

**opportunity**
a condition in the general environment that, if exploited, helps a company achieve strategic competitiveness

A **threat** is a condition in the general environment that may hinder an organisation's efforts to achieve strategic competitiveness.[16] Microsoft is currently experiencing a severe external threat as smartphones surpassed personal computer (PC) sales. In the second quarter of 2020, worldwide PC shipments totalled 64.8 million units, according to results by Gartner. Lenovo and HP shared the number one position in the worldwide PC market. They accounted for half of PC shipments in the second quarter of 2020, up from 46.6 per cent in the second quarter of 2019. Although PC growth will continue to expand, it is not growing at the rate that smartphones are. Yet, although the top five smartphone vendors reported a decline in the first

**threat**
a condition in the general environment that may hinder a company's efforts to achieve strategic competitiveness

**Table 2.2 Components of the external environmental analysis**

| | |
|---|---|
| Scanning | Identifying early signals of environmental changes and trends |
| Monitoring | Detecting meaning through ongoing observations of environmental changes and trends |
| Forecasting | Developing projections of anticipated outcomes based on monitored changes and trends |
| Assessing | Determining the timing and importance of environmental changes and trends for organisations' strategies and their management |

quarter of 2020, sales among them totalled near 300 million smartphones, which was over four times the global sales of PCs during the same period. Samsung recorded sales of 51 million smartphones, Huawei 42 million and, closely following in third spot, Apple sold nearly 41 million smartphones. While Apple is not as dependent on the China market as Huawei is, it still faced challenges with supply constraints and store closures due to the Covid-19 pandemic, which negatively impacted global sales. However, the impact of the pandemic was less significant for Apple compared to its impact on other top vendors. Apple had a strong start to 2020 due to its new product lineup.[17]

STRATEGY NOW

Smartphones – Apple

Organisations use several sources to analyse the general environment, including a wide variety of printed materials (such as trade publications, newspapers, business publications and the results of academic research and public polls), trade shows and suppliers, customers, and employees of public-sector organisations. People in boundary-spanning positions may obtain a great deal of this type of information. Customer service staff, sales personnel, purchasing managers, public relations directors and customer service representatives – each of whom interacts with external constituents – are examples of boundary-spanning positions.

## Scanning

*Scanning* entails the study of all segments in the general environment. Through scanning, organisations identify early signals of potential changes in the general environment and detect changes that are already underway.[18] Scanning often reveals ambiguous, incomplete or unconnected data and information. Thus, environmental scanning is challenging but critically important for organisations, especially those competing in highly volatile environments.[19] In addition, scanning activities must be aligned with the organisational context.

Many organisations use special software to assist them in identifying events that are taking place in the environment and that are announced in public sources. For example, news event detection uses information-based systems to categorise text and reduce the trade-off between an important missed event and false alarm rates.[20] The internet provides significant opportunities for scanning. Amazon, for example, records significant information about individuals visiting its website, particularly if a purchase is made. Amazon then welcomes these customers by name when they revisit the website. The organisation sends messages to customers about specials and new products similar to those they purchased on previous visits. Other organisations, such as Netflix, also collect demographic data about their customers in an attempt to identify their unique preferences (demographics is one of the segments in the general environment).

Philip Morris International (PMI), a manufacturer and retailer of tobacco products, continuously scans segments of its external environment to detect current conditions and to anticipate changes that might take place in different segments. For example, PMI studies various nations' tax policies on cigarettes (these policies are part of the political/legal segment), because raising cigarette taxes reduces sales (as it has in Australia), while lowering these taxes might increase sales.

## Monitoring

When *monitoring*, analysts observe environmental changes to see if an important trend is emerging from among those spotted through scanning.[21] Critical to successful monitoring is the organisation's ability to detect meaning in environmental events and trends. For example, Tesco, the UK's largest retailer, added Turkish, Sri Lankan, Latin, Filipino and African and South African cuisine to its food offerings. One analyst noted: 'Britain has become one of the most ethnically diverse nations on Earth, and there is a very strong, growing demand by those who have settled here to buy food from their homelands'.[22] Tesco already sells Asian, oriental, Afro-Caribbean, kosher, Polish and halal foods. Continual monitoring of these trends is necessary for a large retailer such as Tesco to maintain the right balance among its products.

Effective monitoring requires the organisation to identify important stakeholders and understand its reputation among these stakeholders as the foundation for serving their unique needs.[23] (Stakeholders' unique needs are described in Chapter 1.) Scanning and monitoring are particularly important when an organisation competes in an industry with high technological uncertainty.[24] Scanning and monitoring can provide the organisation with information; they also serve as a means of importing knowledge about markets and about how to successfully commercialise new technologies the organisation has developed.[25]

## Forecasting

Scanning and monitoring are concerned with events and trends in the general environment at a point in time. When *forecasting*, analysts develop feasible projections of what might happen, and how quickly, as a result of the changes and trends detected through scanning and monitoring.[26] For example, analysts might forecast the time that will be required for a new technology to reach the marketplace, the length of time before different corporate training procedures are required to deal with anticipated changes in the composition of the workforce, or how much time will elapse before changes in governmental taxation policies affect consumers' purchasing patterns.

Forecasting events and outcomes accurately is challenging. Forecasting demand for new technological products is difficult because technology trends are continually driving shorter product life cycles. This is particularly difficult for an organisation like Intel, for example, whose products go into many customers' technological merchandise that are consistently updated. Increasing the difficulty, each new wafer fabrication or silicon chip technology production plant that Intel invests in becomes significantly more expensive for each generation of chip products. Having tools that allow better forecasting of electronic product demand is increasingly important.[27]

During an economic downturn, forecasting becomes more difficult and more important. For example, P&G, Unilever and Colgate-Palmolive, which primarily sell branded products, have been pushed by retailers to lower their prices, while at the same time these retailers (including Coles and Woolworths) are selling lower-priced, private-label goods. Hence, these consumer product companies are forecasting the effects of the two trends noted as they seek to project demand. Fortunately for these consumer product companies, they are seeing demand increase for branded products as the economy improves.[28]

## Assessing

The objective of *assessing* is to determine the timing and significance of the effects of environmental changes and trends that have been identified.[29] The timing of a product release is imperative as it could result in either positive or negative sales or returns. For instance, in March 2020, executive producers in the Hollywood film industry strategically delayed scheduled blockbuster movies due to the impact of the Covid-19 pandemic. It was determined that releasing these movies when originally scheduled would have been financially disastrous at the box office, due to the restrictions placed on access to cinemas globally.[30] The James Bond movie, *Quiet Place 2*, and the most recent Marvel movie were among those due to be released in April 2020, but were rescheduled to be released from November 2020. Through scanning, monitoring and forecasting, analysts are able to understand the general environment. Going a step further, the intent of assessment is to specify the implications of that understanding. Without assessment, the organisation is left with data that may be interesting but of unknown competitive relevance. Even if formal assessment is inadequate, the appropriate interpretation of that information is important.

How accurate senior executives are in assessing their competitive environments may be less important for strategy and corresponding organisational changes than correctly interpreting environmental trends. Thus, although gathering and organising information is important, it is paramount to appropriately interpret that intelligence to determine if an identified trend in the external environment is an opportunity or a threat.[31]

# Segments of the general environment

As noted, the general environment is composed of segments that are external to the organisation (see Table 2.1). Although the degree of impact varies, these environmental segments affect all industries and the organisations competing in them. The challenge to each organisation is to scan, monitor, forecast and assess the elements in each segment to determine their effects on the organisation. Effective scanning, monitoring, forecasting and assessing are vital to the organisation's efforts to recognise and evaluate opportunities and threats.

## The demographic segment

**demographic segment**
concerned with a population's size, age structure, geographic distribution, ethnic mix and income distribution

The **demographic segment** is concerned with a population's size, age structure, geographic distribution, ethnic mix and income distribution.[32] Demographic segments are commonly analysed on a global basis because of their potential effects across countries' borders and because many organisations compete in global markets.

### Population size

The world's population doubled (from three billion to six billion) between 1959 and 1999. In November 2020, the global population was recorded as 7.8 billion people, according to the World Population Clock.[33] Current projections suggest that population growth will continue in the 21st century, albeit at a slower pace, and it is projected to be nine billion by 2040.[34] By 2050, India is expected to be the most populous nation in the world (with over 1.8 billion people). China, the USA, Indonesia and Pakistan are predicted to be the next four most-populous nations in 2050. Organisations seeking to find growing markets in which to sell their goods and services will want to recognise the market potential that may exist for them in these five nations.

Many Asian countries have ageing populations of citizens aged 65 or older. Ageing populations are a significant issue because of the need to maintain the workforce and the burden on the government and taxes required to fund retirement programs.

Source: age-fotostock/imagenavi

While observing the population of different nations and regions of the world, organisations also study changes occurring within different populations to assess their strategic implications. For example, Japan is experiencing what is known as a 'super-ageing' society.[35] In 2019, the World Bank reported that 28 per cent of Japan's citizens were aged 65 or older, compared with China at 9 per cent and India at 6 per cent, and it has been forecast that China will not reach this level until 2036 (Australia will reach 25 per cent in 2042).[36] Ageing populations are a significant problem for countries because of the need for workers and the burden of funding retirement programs. In Japan, and other countries, employees are being encouraged to work longer to overcome these problems. Interestingly, the USA has a higher birth rate and significant immigration, placing it in a better position than Japan and European nations.

### Age structure

As noted earlier, the world's population is rapidly ageing. In North America and Europe, millions of baby boomers have approached retirement. However, even in developing countries with large numbers of people under the age of 35, birth rates have declined sharply. In China, for example, by 2040 there will be more than 400 million people over the age of 60. China is a particularly interesting case of the power of demography. With around 1.43 billion people, it has a huge market and labour force. The problem China will face in the future is that the number of women of childbearing age will fall quickly.[37] The problems in Europe are more immediate. Low fertility rates in Italy, Spain and Germany mean that the native-born populations of these countries may be reduced by more than 80 per cent in coming years, although this may be replaced to some extent by immigration.

The possibility of future declines in wealth based on housing is creating uncertainty for European Union (EU) baby boomers about how to invest and when they might be able to retire.[38] On the other hand, delayed retirements by baby boomers in Australia, the EU and the USA with value-creating skills may facilitate organisations' efforts to successfully implement their strategies. Moreover, delayed retirements may allow organisations to think of creative ways for skilled, long-time employees to impart their accumulated knowledge to younger employees as they work longer than originally anticipated.

## Geographic distribution

For decades, the Australian population has been shifting to the coast, while in China there is a move to urban areas, and in the USA the population has been shifting from the north and east to the south and west. Organisations should consider the effects of this shift in demographics.[39] For example, in Australia, the areas with the highest proportion of people aged over 65 are in mid-North Coast New South Wales (around Port Macquarie, with around 20 per cent over 60 years of age), the Wimmera in Victoria and Yorke Peninsula in South Australia.[40] Organisations providing goods and services that are targeted to senior citizens might pay close attention to these areas.

Geographic distribution patterns are not identical throughout the world. For example, in China, 60 per cent of the population lives in rural areas; however, the growth is in urban communities such as Shanghai (with a current population in excess of 27 million) and Beijing (over 20 million). These data suggest that organisations seeking to sell their products in China should recognise the growth in metropolitan areas rather than in rural areas. Larger cities are expected to generate more growth in gross domestic product (GDP) per person than smaller cities and also attract more human capital – people with talent to produce economic growth.[41]

## Ethnic mix

The ethnic mix of most countries' populations continues to change. For example, Hispanics are now the largest ethnic minority (18.5%) in the USA, representing more than 50 million of the total US population in 2019 of 328 million.[42] In fact, the US Hispanic market is the third-largest 'Latin American' economy behind Brazil and Mexico. Spanish is now the dominant language in parts of US states such as Texas, California, Florida and New Mexico. In Australia, Melbourne is perhaps the country's leading region for ethnic diversity, with 34 per cent of the population born overseas. Melbourne has now the 10th-largest immigrant population among world metropolitan areas. Given these facts, some organisations might want to assess the degree to which their goods or services could be adapted to serve the unique needs of these consumers. This is particularly appropriate for companies competing in consumer sectors such as restaurants, groceries, financial services and clothing.

## Income distribution

Understanding how income is distributed within and across populations informs organisations of different groups' purchasing power and discretionary income. Studies of income distributions suggest that although living standards have improved over time, variations exist within and between nations.[43] In Australia, for example, the median household income in the Australian Capital Territory, home to many public service workers, represents the highest-paying jurisdiction (A$1825.80 per week), followed by Western Australia and the Northern Territory, whose median earnings were A$1200 per week. The lowest earnings were Tasmania (A$1000 per week) and South Australia (A$1010 per week). The minimum average wage in Australia, as of 1 July 2020, was A$753.80 per week. In 2019, the median weekly earnings for an employee in Australia was A$1100.00, and there was still a marked difference between male employee median weekly earnings at A$1275.00 compared with female employee earnings at A$950.00. Managers had the highest incomes, and income in mining was the highest, while retailing and accommodation and food services were the lowest industry categories.[44]

These earnings statistics are interesting to organisations because the average incomes of households and individuals are related to expenditure: not only how much they spend, but what they spend their money on. Another income-based factor is the increase in numbers of dual-career couples, which has a notable effect on average household incomes.

The growth of the economy in China has attracted many organisations, not only for the relatively low-cost production there, but also because of the large potential demand for products, given its huge population base. However, it has been reported that income inequality in China could expand in 2020 as the negative effects of the Covid-19 pandemic flow through the economy. It has been reported that approximately one-third of Chinese households earning annual incomes of US$1426 expect their earnings to decrease, while only 13 per cent of wealthier households earning over US$185 000 believed that the pandemic would affect their income severely.[45] The relationship between China and the world is changing. The 2019 McKinsey Global Institute China-World Exposure Index notes that China's exposure to the world in trade, technology and capital has fallen in relative terms. Conversely, the world's exposure to China has increased. This reflects the rebalancing of the Chinese economy towards domestic consumption. In 11 of the 16 quarters since 2015, consumption contributed more than 60 per cent of total GDP growth. Exposure to China varies significantly among sectors and geographies, according to an analysis of 20 sectors and 73 economies.[46]

India also is viewed by global corporations as one of the key markets from where future growth is likely to emerge. India now comprises a huge middle class, a relatively large affluent class and a small economically disadvantaged class. Despite Covid-19, growth in India's consumer market is likely still to be driven primarily by a favourable population composition and increasing disposable income. Per capita GDP of India is expected to reach US$3273.85 in 2023, up from US$1983.00 in 2012. The maximum consumer spending is likely to occur in the food, housing, consumer durables, and transport and communication sectors.[47] Figures 2.2 and 2.3 offer some insight into the Indian consumer market.

**Figure 2.2** **Indian consumer market size**

- Indian appliance and consumer electronics (ACE) market reached US$10.93 billion in 2019.
- Appliances and consumer electronics industry is expected to double to US$21.18 billion by 2025.
- Electronics hardware production in the country increased from US$31.13 billion in FY14 to US$65.53 billion in FY19.
- Television industry in India reached an estimated US$11.26 billion in 2019 and is projected to reach US$13.66 billion) by 2021.
- Smartphone shipments in India increased 8 per cent year-on-year to reach 152.5 million units in 2019, the fastest growing among the top 20 smartphone markets in the world.
- The S&P BSE Consumer Durables Index was up 6.8 per cent in Jan 2020 and gained 32.1 per cent in one year.

Source: India Brand Equity Foundation, 2020, *India Consumer Durables Industry Report*, Snapshot, https://www.ibef.org/industry/indian-consumer-market.aspx.

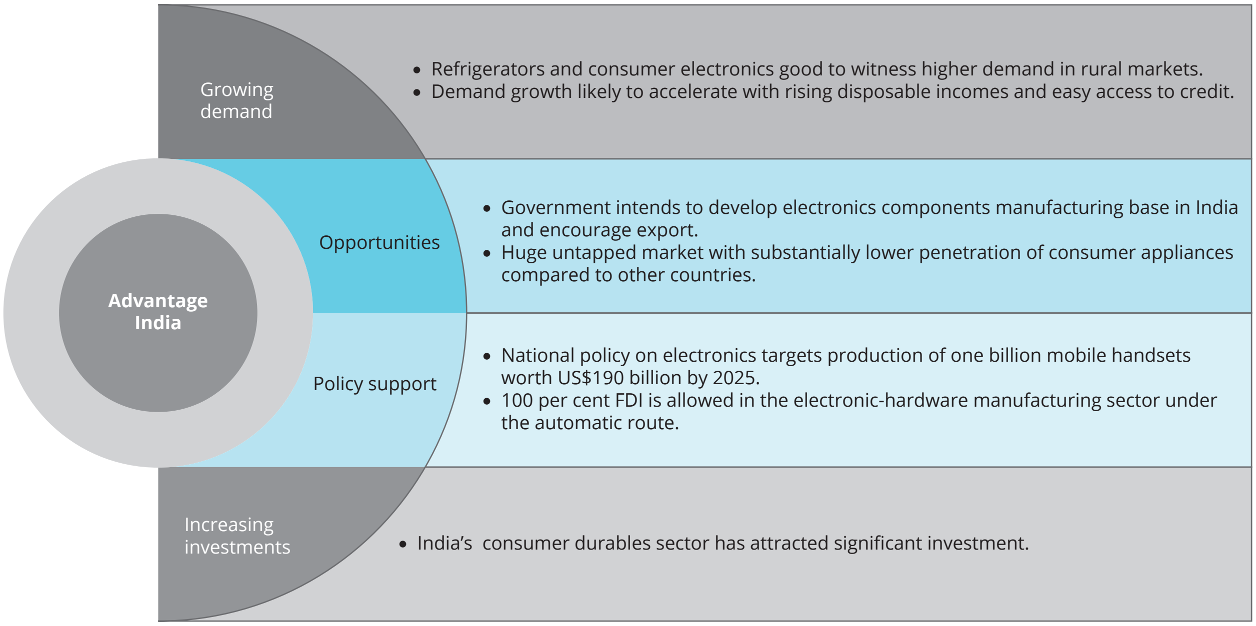
As such, many Western multinationals are considering entering India as a consumption market as its middle class grows. Although India has poor infrastructure, its middle-class consumers are in a good position to spend. Furthermore, the urban–rural income difference has been declining in India more rapidly than in China. Because of situations like these in China and India, paying attention to the differences between markets based on income distribution can be very important for organisations.[48]

## The economic segment

**economic environment** refers to the nature and direction of the economy in which an organisation competes or may compete

The **economic environment** refers to the nature and direction of the economy in which an organisation competes or may compete.[49] In general, organisations seek to compete in relatively stable economies with strong growth potential. Australia, for example, was more stable during the global financial crisis (GFC; 2008–09) than either the EU or USA, and therefore attracted strong foreign interest.[50] This also appears to have been the case during the Covid-19 pandemic. In June 2020, the International Monetary Fund (IMF)

**Figure 2.3** **A snapshot of the Indian consumer market**




Source: India Brand Equity Foundation, 2020, *India Consumer Durables Industry Report*, 4 September, https://www.ibef.org/industry/indian-consumer-market.aspx.

noted that the economic outlook growth projections for the US for 2020 were negative (-8.0%), but 2021 was forecast to have positive 4.5 per cent growth to the economy. The IMF also recorded that Germany growth projections were negative (-7.8%), as were those of other European countries such as France (-12.5%), and Italy and Spain (both -12.8%). Economic growth outlook was projected for the UK at -10.2 per cent, for China at 1.0 per cent and for India at -4.5 per cent. The IMF forecast for 2021 is positive for all countries (see Table 2.3).[51] Because nations are interconnected as a result of the global economy, organisations must scan, monitor, forecast and assess the health of their host nation and the health of the economies outside their host nation.

As organisations prepare to compete during the third decade of the 21st century, the world's economic environment is uncertain, with challenging times ahead due to the impact of Covid-19 on the world economy.

In terms of specific economic environments, organisations competing in Japan or desiring to do so might continue to carefully evaluate the ongoing economic impact of the radiation leaks at the nuclear power generation plants in Sendai and Fukushima that occurred in 2011.[52] Although the crisis in Japan was country specific, its ripple effects were felt at the time around the globe. Because of its acknowledged economic growth, a number of companies are evaluating the possibility of entering Russia to compete or, for those already competing in that nation, to expand the scope of their operations.[53] This unique and sometimes difficult-to-understand business environment presents significant risks. This challenging environment can also be an advantage because it serves as an entry barrier to limit the number of companies willing to enter, learn how to operate effectively and then reap the returns. Another country with growth opportunities is Vietnam, as organisations across the globe take note of how its government reforms and economic decentralisation are creating opportunities for investment for sourcing, as well as its developing consumer market.[54]

**Table 2.3** IMF world economic outlook growth projections, June 2020

| (Real GDP, annual per cent change) | 2019 | Projections 2020 | Projections 2021 |
|---|---|---|---|
| World output | 2.9 | –4.9 | 5.4 |
| Advanced economies | 1.7 | –8.0 | 4.8 |
| **United States** | 2.3 | –8.0 | 4.5 |
| **Euro Area** | 1.3 | –10.2 | 6.0 |
| Germany | 0.6 | –7.8 | 5.4 |
| France | 1.5 | –12.5 | 7.3 |
| Italy | 0.3 | –12.8 | 6.3 |
| Spain | 2.0 | –12.8 | 6.3 |
| **Japan** | 0.7 | –5.8 | 2.4 |
| **United Kingdom** | 1.4 | –10.2 | 6.3 |
| **Canada** | 1.7 | –8.4 | 4.9 |
| **Other advanced economies** | 1.7 | –4.8 | 4.2 |
| **Emerging markets and developing economies** | 3.7 | –3.0 | 5.9 |
| **Emerging and developing Asia** | 5.5 | –0.8 | 7.4 |
| China | 6.1 | 1.0 | 8.2 |
| India | 4.2 | –4.5 | 6.0 |
| ASEAN-5 | 4.9 | –2.0 | 6.2 |
| **Emerging and developing Europe** | 2.1 | –5.8 | 4.3 |
| Russia | 1.3 | –6.6 | 4.1 |
| **Latin America and the Caribbean** | 0.1 | –9.4 | 3.7 |
| Brazil | 1.1 | –9.1 | 3.6 |
| Mexico | –0.3 | –10.5 | 3.3 |
| Middle East and Central Asia | 1.0 | –4.7 | 3.3 |
| Saudi Arabia | 0.3 | –6.8 | 3.1 |
| Sub-Saharan Africa | 3.1 | –3.2 | 3.4 |
| Nigeria | 2.2 | –5.4 | 2.6 |
| South Africa | 0.2 | –8.0 | 3.5 |
| Low-income developing countries | 5.2 | –1.0 | 5.2 |

Source: International Monetary Fund, 2020, *World Economic Outlook Update*, June 2020, https://www.imf.org/en/Publications/WEO/Issues/2020/06/24/WEOUpdateJune2020.

**political/legal segment**
the arena in which organisations and interest groups compete for attention, resources and a voice in overseeing the body of laws and regulations guiding the interactions among nations

## The political/legal segment

The **political/legal segment** is the arena in which organisations and interest groups compete for attention, resources and a voice in overseeing the body of laws and regulations guiding interactions among nations as well as between organisations and various local governmental agencies.[55] Essentially, this segment represents how organisations try to influence governments and how they try to understand the influences (current and projected) of those governments on their strategic actions.

When regulations are formed in response to new legislation, they often influence an organisation's strategic actions. For example, less-restrictive regulations on organisations' actions are a product of the global trend towards privatisation of government-owned or government-regulated organisations. Much privatisation in recent years has been driven by government budget concerns and the desire to raise funds by selling government-owned organisations to reduce deficits.[56] Some believe that the transformation from state-owned to private organisations that has occurred in multiple nations has substantial implications for the competitive landscapes in a number of countries and across multiple industries.[57]

Organisations must carefully analyse a new political administration's business-related policies and philosophies. Competition laws, taxation laws, industries chosen for deregulation, labour training laws and the degree of commitment to educational institutions are areas in which an administration's policies can affect the operations and profitability of industries and individual organisations across the globe. To deal with issues such as those we are describing, organisations often develop a political strategy to influence governmental policies that might affect them. Some argue that developing an effective political strategy was essential to the restructured General Motors' efforts to achieve strategic competitiveness during the GFC-related economic downturn. In addition, the effects of global governmental policies (e.g. those related to organisations in India that are engaging in information technology outsourcing work) on an organisation's competitive position increase the need for organisations to form an effective political strategy.[58]

Organisations competing in the global economy encounter an interesting array of political/legal questions and issues. Key recent developments affecting doing business in Australia include changes to foreign investment regulations, currency regulations and incentives, laws regulating employment relationships, competition law, data protection, product liability and safety, taxation and residency, intellectual property rights over patents, trademarks, registered and unregistered designs.

To restore business confidence in Australia in 2019, regulatory change followed from the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, which concluded in February 2019.[59] For example, Treasury laws that came into effect in March 2019 introduced new maximum penalties for corporate and financial sector misconduct and expanded the civil penalty regime for financial services licensees in Australia and corporates for certain contraventions.

Regulatory bodies have increased enforcement matters in Australia, as a result of the Australian Transaction Reports and Analysis Centre (AUSTRAC) alleging in late 2019 that one of the four Australian major banks had turned a blind eye to approximately 23 million transactions and had allegedly breached counterterrorism finance laws and anti-money laundering laws.[60]

Australia and other countries also follow United Nations Security Council sanctions with regard to imposing trade restrictions on certain countries. They are selected by the Foreign Affairs Minister at any given time and implemented in Australia under the *Autonomous Sanctions Act 2011* (Cth) and the Autonomous Sanctions Regulations 2011 (Cth).

## The sociocultural segment

The **sociocultural segment** is concerned with a society's attitudes and cultural values. Because attitudes and values form the cornerstone of a society, they often drive demographic, economic, political/legal and technological conditions and changes.

**sociocultural segment**
concerned with a society's attitudes and cultural values

Societies' attitudes and cultural values appear to have undergone changes in the second decade of the 21st century. In the USA, attitudes and values about health care are one area in which sociocultural changes are occurring. Specifically, while the USA has the highest overall health care expenditure as well as the highest expenditure per capita of any country in the world, millions of the nation's citizens lack health insurance. National health care spending in the United States is forecast to grow at an average annual rate of 5.4 per cent from the period 2019 to 2028, which is greater than the average growth rate of GDP of 4.3 per cent.[61] The USA spends 19.7 per cent of GDP on health care while similarly prosperous countries such as Germany and the Netherlands spend 11.7 and 13 per cent, respectively; yet Australia spends only 10.3 per cent, and Singapore and Malaysia spend only 4 per cent.[62] Most of these countries have quite varied health insurance systems compared with the USA. Continuing changes to the nature of health care policies can have a significant effect on business organisations,[63] so they must carefully examine trends regarding health care in order to anticipate the effects on their operations.

Any national workforce is diverse in its makeup and work patterns. From a population of 25 million, the Australian workforce in September 2020 was 12.6 million.[64] Within it, a range of complex differences between groups make planning difficult. For example, the labour force participation rate in 2019 was 64.8 per cent, which was an all-time high.[65] The 2018–19 figures revealed some other patterns buried in a broad statistic, such as: for women aged 20–74, participation was 67.4 per cent, but for males in that age group it was 78.5 per cent. Furthermore, the labour force participation rate for the 60–64-year-old group increased for women (51%), compared to men (65.4%).[66] For the age bracket 30 to 34 year olds, 76.1 per cent were females compared to 92.7 per cent males. In Australia in 2018–19, the industries with the highest proportion of women were health care and social assistance (78.2%) and education and training (72%), whereas men dominated mining (84%) and construction (88%). Women were more likely to be employed part-time, with 43.4 per cent of women working part-time.

Growing gender, ethnic and cultural diversity in the workforce creates challenges and opportunities, including combining the best of both men's and women's traditional leadership styles. Although diversity in the workforce has the potential to improve performance, research indicates that management of diversity initiatives is required in order to reap these organisational benefits. Human resource practitioners are trained to successfully manage diversity issues to enhance positive outcomes.[67]

Women in the Workplace will create further leadership opportunities for women in 2021.

Source: iStock.com/gremlin

Other marked differences in relation to gender have been highlighted during the Covid-19 pandemic, with the Workplace Gender Equality Agency (WGEA) in Australia noting that the pandemic has affected women and men differently. The effects on women include their predominant employment in the health care sector and responsibility for care work, the gendered division of domestic duties, as well as issues related to financial security and domestic violence. Federal government data has shown, however, that men are more likely to die from Covid-19. To date, generally equal numbers of women and men are confirmed to have contracted Covid-19.[68]

A manifestation of changing attitudes towards work is the continuing growth of contingency workers (part-time, temporary and contract employees) throughout the global economy. This trend is significant in several parts of the world, including Canada, Australia, Japan, Latin America, Western Europe and the USA.

National cultural values affect behaviour in organisations and thus also influence organisational outcomes, such as differences in CEO compensation.[69] The average pay for a Chinese CEO is CNY 2 301 327 a year (equivalent to AU$500 000) and CNY 1106 an hour in Beijing. The average salary range for a CEO is between CNY 1 412 752 and CNY 3 914 057. On average, a Master's Degree is the highest level of education for a CEO.[70] In Australia, median cash pay for ASX100 CEOs in 2018 fell 1 per cent from $2.87 million to $2.84 million, while the average salary fell 4.1 per cent to $2.92 million. Median cash pay for ASX100 CEOs has been flat for a decade, ranging between $2.79 million (FY20) and $2.95 million (FY11). The five highest-paid CEOs in the ASX100 on a cash pay basis all received more than $5 million, and three (CSL's Perreault, Sonic's Goldschmidt and Amcor's Delia) all received more than $5 million in cash pay; while Treasury's Clarke and Macquarie's Moore both received more than $4.7 million in FY17.[71] See Table 2.4.

Likewise, national culture influences to a large extent the internationalisation strategy that organisations pursue relative to their home country.[72] Knowledge sharing is important for dispersing

**Table 2.4** **Chief executive remuneration September 2019**

| | FY18 | FY17 | FY13 | FY08 | One-year increase | Five-year p.a. increase | 10-year p.a. increase |
|---|---|---|---|---|---|---|---|
| Median | $2 841 711 | $2 871 409 | $2 529 885 | $2 903 752 | −1 per cent | 2.4 per cent | −0.2 per cent |
| Average | $2 919 156 | $3 044 666 | $3 005 935 | $3 814 687 | −4.1 per cent | −0.6 per cent | −2.6 per cent |
| Highest | $6 236 722 | $12 944 540 | $11 107 787 | $27 894 726 | | | |
| Lowest | $750 000 | $646 396 | $616 972 | $198 648 | | | |
| Median (incumbent) | $2 939 000 | $2 920 000 | | | | | |
| Average (incumbent) | $2 983 746 | $2 952 839 | | | | | |

Source: Australian Council of Superannuation Investors, 2019, CEO pay in ASX200 companies: September 2019, Melbourne: ACSI, https://acsi.org.au/wp-content/uploads/2020/02/CEO-Pay-in-ASX200-Companies-September-2019.pdf, p. 27.

new knowledge within organisations and increasing the speed of implementing innovations. Personal relationships are especially important in China, where *guanxi* (personal connections) is a way of doing business within the country and for individuals to advance their careers in what is becoming a more open-market society. Understanding the importance of *guanxi* is critical for foreign organisations doing business in China.[73]

## The technological segment

Pervasive and diversified in scope, technological changes affect many parts of societies. These effects occur primarily through new products, processes and materials, notwithstanding the significant technological innovations that have been an outcome of the Covid-19 pandemic. The **technological segment** includes the organisations and activities involved in creating new knowledge and translating that knowledge into new outputs, products, processes and materials. Given the rapid pace of technological change and risk of disruption, it is vital for organisations to thoroughly study the technological segment.[74] The importance of these efforts is suggested by the finding that early adopters of new technology often achieve higher market shares and earn higher returns. Thus, both large and small organisations should continuously scan the external environment to identify potential substitutes for technologies that are in current use, as well as to identify newly emerging technologies from which their organisation could derive competitive advantage.[75]

**technological segment**
the organisations and activities involved with creating new knowledge and translating that knowledge into new outputs, products, processes and materials

As a significant technological development, the internet has remarkable capability to provide information easily, quickly and effectively to an ever-increasing percentage of the world's population. Organisations continue to study the internet's capabilities to anticipate how it may allow them to create more value for customers and staff in the future and to anticipate future trends.

In spite of the internet's far-reaching effects, wireless communication technology is becoming the next significant technological opportunity for companies to apply when pursuing strategic competitiveness. Handheld devices and other wireless communications equipment are used to access a variety of network-based services. The use of handheld computers with wireless network connectivity, web-enabled mobile phone handsets and other emerging platforms (e.g. consumer internet-access devices such as the iPhone and iPad) has increased substantially and should soon become the dominant form of communication and commerce.[76] For example, in the first quarter of 2020, global sales totalled nearly 300 million for smartphones alone. With each new version of mobile devices such as the iPhone, iPad and Kindle, amazing additional functionalities and software applications are added.

# The global segment

**global segment** includes relevant new global markets, existing markets that are changing, important international political events and critical cultural and institutional characteristics of global markets

The **global segment** includes relevant new global markets, existing markets that are changing, important international political events, and critical cultural and institutional characteristics of global markets.[77] There is little doubt that markets are more global and that consumers, as well as companies throughout the world, accept this fact. Consider the automobile industry. The global automobile industry is one in which an increasing number of people believe that because 'we live in a global community', consumers in multiple nations are willing to buy cars and trucks 'from whatever area of the world'.[78]

When studying the global segment, organisations (including automobile manufacturers) should recognise that globalisation of business markets may create opportunities to enter new markets as well as threats that new competitors from other economies may also enter their market. This is both an opportunity and a threat for the world's automobile manufacturers: worldwide production capacity is now a potential threat to all global companies where entering another market to sell a company's products appears to be an opportunity. In China, the world's biggest auto market has experienced slower car sales since 2015, although the industry remains sustainable.


Elon Musk delivers made-in-China Teslas – just one of many consumer options within the Chinese automotive market.

Source: Getty Images/AFP

Over the past decade, China's automotive industry has been in overdrive, growing approximately 15 per cent each year, and accounting for 70 per cent of global growth over this period. By 2012, China had surpassed the USA as the world's largest auto market, but by 2018 China's cooling economy put the brakes on the auto market, pushing sales growth into negative territory, a trend that persisted through 2019. Over the two years up to 2019, China sales fell from 8.2 per cent to 6 per cent. According to the China Association of Automobile Manufacturers, 25.8 million vehicles were sold in 2019.[79]

Further challenges have occurred in the auto industry since 2020 due to the global economic slowdown resulting from the Covid-19 pandemic. Other issues are that, in order to increase sales, many car companies want to enter foreign markets and this has led to overcapacity worldwide. In China, labour unions often organise strikes to demand higher wages, further increasing pressures in this industry.

McKinsey research highlights that Chinese consumers' automobile brand loyalty, measured by their willingness to purchase their existing brand of car again, increased from 12 per cent in 2017 to 31 per cent in 2019. Companies selling cars in the mid-price range (100 000–200 000 RMB) will face particular challenges, with pressure coming from opposite ends of the price spectrum. At the top, premium brands are making their cars more affordable to appeal to consumers seeking to trade up. In China, consumers' acceptance level for autonomous vehicles in 2019 is 80 per cent, double that of Germany and the USA. With the Chinese Government expected to double down on support for autonomous vehicles, China is likely to be at the forefront of autonomous vehicle development. 'The considerable costs of keeping pace with these trends is forcing consolidation and collaboration among rivals. BMW and Mercedes-Benz, for instance, have forged a partnership focused on the next generation of mobility. Volkswagen and Ford have also teamed up to develop autonomous and electric vehicles, in a further example of a trend we expect to see more of in future'.[80] Another change in purchasing vehicles is likely to occur with the consideration that the days of purchasing cars exclusively through dealers are numbered. For instance, China's dealership industry is highly fragmented, with profit margins having been squeezed in recent years. Electric car sellers Tesla and NIO have attempted to overcome this, for example, by focusing on selling cars online directly to the consumer, while Daimler launched Mercedes me, a system that allows drivers to track and control their vehicle remotely.[81]

The markets from which organisations generate sales and income are one indication of the degree to which they are participating in the global economy. For example, H. J. Heinz Company, a large global food producer, acquired a stake in Coniexpress S.A. Industrias Alimenticias, a leading Brazilian manufacturer of tomato-based products, condiments and vegetables, in order to target the South American market. Heinz's sales in emerging economies grew 16.8 per cent while its main North American group grew 14.5 per cent. Thus, much of Heinz's sales growth and its profit margins were coming from emerging markets.[82] For this company, and so many others, understanding the conditions of today's global segment and being able to predict future conditions is critical to success.

The global segment presents organisations with both opportunities and threats or risks. Because of the threats and risks, some organisations choose to take a more cautious approach to competing in international markets. These organisations participate in what some refer to as 'global focusing'. Global focusing often is used by organisations with moderate levels of international operations that increase their internationalisation by focusing on global niche markets.[83] In this way, they build on and use their special competencies and resources while limiting their risks within the niche market. Another way in which organisations limit their risks in international markets is to focus their operations and sales in one region of the world.[84] In this way, they can build stronger relationships in, and knowledge of, their markets. As they build these strengths, rivals find it more difficult to enter their markets and compete successfully.

In all instances, organisations competing in global markets should recognise their sociocultural and institutional attributes. For example, Korean ideology emphasises communitarianism, a characteristic of many Asian countries. Korea's approach differs from those of Japan and China, however, in that it focuses on *inhwa*, or harmony. *Inhwa* is based on a respect for hierarchical relationships and obedience to authority. Alternatively, as noted earlier, the approach in China stresses *guanxi* – personal relationships or good connections – while, in Japan, the focus is on *wa*, or group harmony and social cohesion.[85] The institutional context of China suggests a major emphasis on centralised planning by the government. The Chinese Government provides incentives to organisations to develop alliances with foreign organisations that have sophisticated technology, in the hope of building knowledge and introducing new technologies to the Chinese markets over time.[86] As such, it is important to analyse the strategic intent of foreign organisations when pursuing alliances and joint ventures abroad, especially where the local partners are receiving technology that in the long run may reduce the foreign organisations' advantages.[87]

## The physical environment segment

The **physical environment segment** refers to potential and actual changes in the physical (natural) environment and business practices that are intended to positively respond to and deal with those changes.[88] Concerned with trends oriented to sustaining the world's physical environment, organisations recognise that ecological, social and economic systems interactively influence what happens in this particular segment.[89]

**physical environment segment**
refers to potential and actual changes in the physical environment and business practices that are intended to positively respond to and deal with those changes

There are many parts or attributes of the physical environment that organisations should consider as they try to identify trends in this segment.[90] Many now argue that climate change is a trend that organisations and nations should carefully examine in efforts to predict any potential effects on societies globally, as well as on their business operations. Investors are seeking to take advantage of this trend – calling it 'green alpha' – by looking to profit by increasing environmental sustainability.[91] Energy consumption is another part of the physical environment that concerns both organisations and nations.

Because of increasing concern about sustaining the quality of the physical environment, a number of companies are developing environmentally friendly policies. BP has established a new ambition to become a net zero emissions company by 2050 and to assist the world to achieve net zero emissions. Its ambition is supported by 10 aims, released in February 2020, and these include: net zero across BP's operations on an absolute basis by 2050 or sooner; net zero on carbon in BP's oil and gas production on an absolute basis by 2050 or sooner; a 50 per cent cut in the carbon intensity of products BP sells by 2050 or sooner; to install methane measurement at all BP's major oil and gas processing sites by 2023 and reduce methane intensity of operations by 50 per cent; and to increase the proportion of investment into non-oil and gas businesses over time. It includes five aims to assist the global community achieve net zero emissions, and these are: more active advocacy for policies that support net zero, including carbon pricing; to further incentivise BP's workforce to deliver aims and mobilise them to advocate for net zero; to set new expectations for relationships with trade associations; to aim to be recognised as a leader for transparency of reporting, including supporting the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD); and launch a new team to help countries, cities and large companies decarbonise. To deliver these ambitions, BP plans to reorganise to become a more focused and more integrated company.[92]

As our discussion of the general environment shows, identifying anticipated changes and trends among external elements is a key objective of analysing the organisation's general environment. With a focus on the future, the analysis of the general environment allows organisations to identify opportunities and threats. It is necessary to have a senior management team with the experience, knowledge and sensitivity required to effectively analyse this segment of the environment.[93] Also critical to an organisation's choices of strategic action is an understanding of its industry environment and its competitors; we consider these issues next.

**Strategic focus** | Technology

## Target (Tar-zhey) is trying to navigate in a new and rapidly changing competitive landscape

Target became known by consumers as Tar-zhey, the retailer of cheaper but 'chic' products. The firm offered a step up in quality goods at a slightly higher price than discount retailers such as Walmart, but was targeted below major, first-line retailers such as Macy's and Nordstrom. Additionally, it promoted its stores to offer one-stop shopping with clothing, toys, health products and food goods, among other products. For many years, Tar-zhey 'hit the bullseye' and performed well serving this large niche in the market. But the company took its eye off the target and began losing market share (along with other poor strategic actions).

The first major crack appeared with the announcement of a massive cyber attack on Target's computer system that netted customers' personal information. Not only was this a public relations disaster, it drew a focus on Target that identified other problems. For example, careful analysis showed that Target was losing customers to established competitors and new rivals, especially internet retailers (e.g. Amazon.com).

Target's marketing chief stated that 'it's not that we became insular. We were insular'. This suggests that the organisation was not analysing its environment. By allowing rivals, and especially internet competitors, to woo the company's customers, it lost sales, market share and profits. It obviously did not predict and prepare for the significant competition from internet rivals that is now reshaping most retail industries. Competitors were offering better value to customers (perhaps more variety and convenience through online sales). Thus, Target's reputation and market share were simultaneously harmed.

Because of all the problems experienced, Target hired a new CEO, Brian Cornell, in 2014. Cornell made a number of changes, but the continued revolution in the industry, largely driven by Amazon, continued to gnaw away at Target's annual sales. Target's annual sales declined by approximately 5 per cent in 2017 and its stock price suffered as a result. Target was forced to develop a new strategy, which involved a major rebranding. It launched four new brands late in 2017, including A New Day, a fashionable line of women's clothes, and Goodfellow & Co, a modern line of menswear, with the intent to make an emotional connection with customers. It also plans to remodel 100 of its stores and change in-store displays to improve customer experiences. It will add 30 small stores that offer innovative designs and, to compete with Amazon, is emphasising its digital sales and delivery of products. Up to now, its digital strategy has not been highly successful, so it is narrowing its focus to increase its effectiveness.

Target planned to discontinue several major brands by 2019 and will continue to introduce new brands


Goodfellow & Co menswear, a new line introduced by Target in late 2017.

Source: ZUMA Wire/TNS/Glen Stubbe

(12 in total are planned). The intent is to increase the appeal of Target and its products to millennials. These actions alone suggest the importance of gathering and analysing data on the market and competitors' actions. The next few years will show the fruits of all of Target's changes. If they are successful, Target will still face substantial competition from Amazon and Walmart; if they are not successful, Target may suffer the same fate of many other large and formerly successful retailers that no longer exist.

Sources: A. Pasquarelli, 2017, Our strategy is working: Target plows into the holidays, *AdAge*, http://adage.com, 19 October; S. Heller, 2017, Target's biggest brands are about to disappear from stores, *The Insider*, http://www.theinsider.com, 6 July; 2017, Rebranding its wheel: Target's new strategy, *Seeking Alpha*, http://seekingalpha.com, 4 July; K. Safdar, 2017, Target's new online strategy: Less is more, *Wall Street Journal*, http://www.wsj.com, 15 May; 2015, What your new CEO is reading: Smell ya later; Target's new CEO, *CIO Journal/Wall Street Journal*, http://www.wsj.com/cio, 6 March; J. Reingold, 2014, Can Target's new CEO get the struggling retailer back on target? *Fortune*, http://www.fortune.com, 31 July; G. Smith, 2014, Target turns to PepsiCo's Brian Cornell to restore its fortunes, *Fortune*, http://www.fortune.com, 31 July; P. Ziobro, M. Langley & J. S. Lublin, 2014, Target's problem: Tar-zhey isn't working. *Wall Street Journal*, http://www.wsj.com, 5 May.

As described in the 'Strategic focus' feature, Target failed to maintain a good understanding of its industry and lost market share to internet company rivals and other more established competitors. We conclude that critical to an organisation's choices of strategies and their associated competitive actions and responses is an understanding of its industry environment, its competitors and the general environment of the countries in which it operates. Next, we discuss the analyses organisations complete to gain such an understanding.[94]

# Industry environment analysis

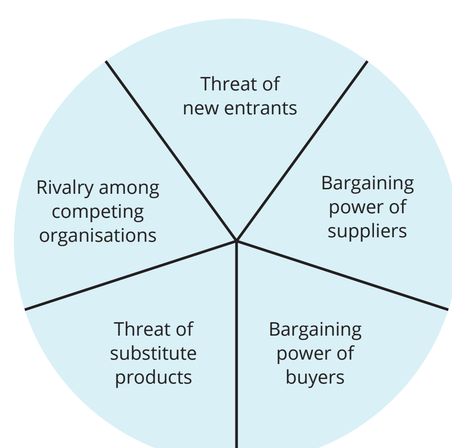
**industry**
a group of organisations producing products that are close substitutes

An **industry** is a group of organisations producing products that are close substitutes. In the course of competition, these organisations influence one another. Typically, industries include a rich mixture of competitive strategies that organisations use in pursuing above-average returns. In part, these strategies are chosen because of the influence of an industry's characteristics.[95]

Compared with the general environment, the industry environment has a more direct effect on the organisation's strategic competitiveness and ability to earn above-average returns.[96] An industry's profit potential is a function of five forces of competition: the threats posed by new entrants, the power of suppliers, the power of buyers, product substitutes and the intensity of rivalry among competitors (see Figure 2.4).

The five forces model of competition expands the arena for competitive analysis. Historically, when studying the competitive environment, organisations concentrated on companies with which they competed directly. However, organisations must now search more broadly to recognise current and potential competitors by identifying potential customers as well as the organisations serving them. For example, the communications industry is now broadly defined as encompassing media companies, telecoms, entertainment

**Figure 2.4** **The five forces of competition model**



companies and companies producing devices such as smartphones.[97] In such an environment, organisations must study many other industries to identify organisations with capabilities (especially technology-based capabilities) that might be the foundation for producing a good or a service that can compete against what they are producing. Using this perspective finds organisations focusing on customers and their needs rather than on specific industry boundaries to define markets.

When studying the industry environment, organisations must also recognise that suppliers can become an organisation's competitors (by integrating forward) as can buyers (by integrating backward). For example, several organisations have integrated forward in the pharmaceutical industry by acquiring distributors or wholesalers. In addition, organisations choosing to enter a new market and those producing products that are adequate substitutes for existing products can become a company's competitors. Next, we examine the five forces the organisation analyses to understand the profitability potential within the industry (or a segment of an industry) in which it competes or may choose to compete.

## Threat of new entrants

Identifying new entrants is important because they may threaten the market share of existing competitors.[98] One reason new entrants pose such a threat is that they bring additional production capacity. Unless the demand for a good or service is increasing, additional capacity holds consumers' costs down, resulting in less revenue and lower returns for competing organisations. Often, new entrants have a keen interest in gaining a large market share. As a result, new competitors may force existing organisations to be more efficient and to learn how to compete on new dimensions (e.g. using an internet-based distribution channel).

The likelihood that organisations will enter an industry is a function of two factors: barriers to entry and the retaliation expected from current industry participants. Entry barriers make it difficult for new organisations to enter an industry and often place them at a competitive disadvantage even when they are able to enter. As such, high entry barriers tend to increase the returns for existing organisations in the industry and may allow some organisations to dominate the industry.[99] Thus, organisations competing successfully in an industry want to maintain high entry barriers in order to discourage potential competitors from deciding to enter the industry.

### Barriers to entry

Organisations competing in an industry (and especially those earning above-average returns) try to develop entry barriers to thwart potential competitors. For example, the server market is hypercompetitive and dominated by IBM, Hewlett-Packard and Dell. Historically, the scale economies these organisations have developed by operating efficiently and effectively have created significant entry barriers, causing potential competitors to think very carefully about entering the server market to compete against them. Oracle, primarily a software-oriented company, acquired Sun Microsystems, which is primarily a server hardware company, to overcome the barriers to entry that exist in this industry. Oracle intended to preload Oracle software into its new server line: 'Hardware makers such as Dell and HP are getting into software, and software companies like Oracle are getting into hardware' because these 'companies want to create the integrated hardware and software systems that can satisfy a corporate customer's every IT need'.[100] The degree of success Oracle might achieve as a result of its decision to enter the server market via an acquisition remained uncertain. By mid-2015, Oracle's server operation was part of a 'floundering division' that competed in a crowded marketplace. However, things turned around in 2020 with Oracle's Gen2 Cloud Infrastructure, which added more customers and growing revenue at a rate of over 100 per cent per year once the barriers to entry into the marketplace were overcome.[101]

Several kinds of potentially significant entry barriers may discourage competitors from entering a market.

## Economies of scale

Economies of scale are derived from incremental efficiency improvements through experience as an organisation grows larger. Therefore, the cost of producing each unit declines as the quantity of a product produced during a given period increases. This is the case for IBM, Hewlett-Packard and Dell in the server market, as previously described.

Economies of scale may be developed in most business functions, such as marketing, manufacturing, research and development, and purchasing.[102] Increasing economies of scale enhances an organisation's flexibility. For example, an organisation may choose to reduce its price and capture a greater share of the market. Alternatively, it may keep its price constant to increase profits. In so doing, it likely will increase its free cash flow, which is very helpful during financially challenging times.

New entrants face a dilemma when confronting current competitors' scale economies. Small-scale entry places them at a cost disadvantage. Given the size of Sun Microsystems relative to the three major competitors in the server market, Oracle has found it easier to compete against its scale-advantaged competitors in 2020.[103] Additionally, large-scale entry through such an acquisition, in which the new entrant manufactures large volumes of a product to gain economies of scale, risks strong competitive retaliation.

Some competitive conditions reduce the ability of economies of scale to create an entry barrier. Many companies now customise their products for large numbers of small customer groups. Customised products are not manufactured in the volumes necessary to achieve economies of scale. Customisation is made possible by flexible manufacturing systems (this point is discussed further in Chapter 4). In fact, the new manufacturing technology facilitated by advanced information systems has allowed the development of mass customisation in an increasing number of industries. Although it is not appropriate for all products, and implementing it can be challenging, mass customisation has become increasingly common in manufacturing products.[104] Online ordering has enhanced the ability of customers to obtain customised products. Companies manufacturing customised products learn how to respond quickly to customers' needs in lieu of developing scale economies.

Many organisations like Woolworths produce private label products like tissues in an effort to capture market share.

Source: Dreamstime.com/Richard Van Der Spuy

## Product differentiation

Over time, customers may come to believe that an organisation's product is unique. This belief can result from the organisation's service to the customer, effective advertising campaigns or being the first to market a good or service. The Coca-Cola Company and PepsiCo have established strong brands in the soft drink market and now control the carbonated soft drink industry (CSD) globally. Since 2004, Coca-Cola Company has been the market leader, according to Statista. However, in 2020 PepsiCo had a market cap of US$188.6 billion compared with Coca-Cola of US$185.8 billion. These brands compete with each other worldwide, with Coca-Cola owning 500 brands. Because each has used a great deal of resources building their brands, customer loyalty is strong. These companies battle each other for market leadership, which has changed back and forth over the years. When considering entry into the soft drink market, an organisation needs to pause to examine how one can overcome the brand image and consumer loyalty to these two giants in this global industry. One needs significant resources to capture market share, although many organisations that have the resources to produce private label products, such as Woolworths and Coles, are doing so.

Companies such as P&G and Colgate-Palmolive spend a great deal of money on advertising and product development to convince potential customers of their products' distinctiveness and the value their brands provide. Customers valuing a product's uniqueness tend to become loyal to both the product and the company producing it. In turn, customer loyalty is an entry barrier for organisations thinking of entering an industry and competing against the likes of P&G and Colgate-Palmolive. To compete against organisations offering differentiated products to individuals who have become loyal customers, new entrants often allocate many resources. To combat the perception of uniqueness, new entrants frequently offer products at lower prices. This decision, however, may result in lower profits or even losses.

## Capital requirements

Competing in a new industry requires an organisation to have resources to invest. In addition to physical facilities, capital is needed for inventories, marketing activities and other critical business functions. Even when a new industry is attractive, the capital required for successful market entry may not be available to pursue the market opportunity.[105] For example, defence industries are difficult to enter because of the substantial resource investments required to be competitive. In addition, because of the high knowledge requirements of the defence industry, an organisation might acquire an existing company as a means of entering this industry, but it must have access to the capital necessary to do this.

## Switching costs

Switching costs are the one-time costs customers incur when they buy from a different supplier. The costs of buying new ancillary equipment and of retraining employees, and even the psychological costs of ending a relationship, may be incurred in switching to a new supplier. In some cases, switching costs are low, such as when the consumer switches to a different brand of soft drink. Switching costs can vary as a function of time. For example, in terms of credit hours towards graduation, the cost to a student to transfer from one university to another in their first year is much lower than it is when the student is entering their final year.

Occasionally, a decision made by manufacturers to produce a new, innovative product creates high switching costs for the final consumer. Customer loyalty programs, such as airlines' frequent flyer points, are intended to increase the customer's switching costs. If switching costs are high, a new entrant must offer either a substantially lower price or a much better product to attract buyers. Usually, the more established the relationships between parties, the greater the switching costs.

## Access to distribution channels

Over time, industry participants typically develop effective means of distributing products. Once a relationship with its distributors has been built, an organisation will nurture it, thus creating switching costs for the distributors. Access to distribution channels can be a strong entry barrier for new entrants, particularly in consumer non-durable goods industries (e.g. in grocery stores where shelf space is limited) and in international markets. New entrants have to persuade distributors to carry their products, either in addition to or in place of those currently distributed. Price breaks and cooperative advertising allowances may be used for this purpose; however, those practices reduce the new entrant's profit potential. Interestingly, access to distribution is less of a barrier for products that can be sold on the internet.

## Cost disadvantages independent of scale

Sometimes, established competitors have cost advantages that new entrants cannot duplicate. Proprietary product technology, favourable access to raw materials, desirable locations and government subsidies are examples. Successful competition requires new entrants to reduce the strategic relevance of these factors. Delivering purchases directly to the buyer can counter the advantage of a desirable location; new food establishments in an undesirable location often follow this practice.

## Government policy

Through licensing and permit requirements, governments can also control entry into an industry. Liquor retailing, radio and television broadcasting, banking and trucking are examples of industries in which government decisions and actions affect entry possibilities. Also, governments often restrict entry into some industries because of the need to provide quality service or the need to protect jobs. Alternatively, deregulation of industries, exemplified by the airline industries in Australia and the USA, allows more organisations to enter.[106]

### Expected retaliation

Companies seeking to enter an industry also anticipate the reactions of organisations in the industry. An expectation of swift and vigorous competitive responses reduces the likelihood of entry. Vigorous retaliation can be expected when the existing organisation has a major stake in the industry (e.g. it has fixed assets with few, if any, alternative uses), when it has substantial resources and when industry growth is slow or constrained. For example, any organisation attempting to enter the airline industry can expect significant retaliation from existing competitors due to overcapacity.

Locating market niches not being served by incumbents allows the new entrant to avoid entry barriers. Small entrepreneurial organisations are generally best suited for identifying and serving neglected market segments. When Honda first entered the US motorcycle market, it concentrated on small-engine motorcycles, a market that organisations such as Harley-Davidson had ignored. By targeting this neglected niche, Honda avoided competition. After consolidating its position, Honda used its strength to attack rivals by introducing larger motorcycles and competing in the broader market. Competitive actions and competitive responses between organisations such as Honda and Harley-Davidson are discussed more fully in Chapter 5.

## Bargaining power of suppliers

Increasing prices and reducing the quality of their products are potential means suppliers use to exert power over organisations competing within an industry. If an organisation is unable to recover cost increases by its suppliers through its own pricing structure, its profitability is reduced by its suppliers' actions. A supplier group is powerful when:

- it is dominated by a few large companies and is more concentrated than the industry to which it sells
- satisfactory substitute products are not available to industry organisations
- industry organisations are not a significant customer for the supplier group
- suppliers' goods are critical to buyers' marketplace success
- the effectiveness of suppliers' products has created high switching costs for industry organisations
- it poses a credible threat to integrate forward into the buyers' industry. Credibility is enhanced when suppliers have substantial resources and provide a highly differentiated product.

The airline industry is one in which suppliers' bargaining power is changing. Though the number of suppliers is low, the demand for major aircraft is also relatively low. Boeing and Airbus aggressively compete for orders of major aircraft, creating more power for buyers in the process. When a large airline signals that it might place a 'significant' order for wide-body airliners that either Airbus or Boeing might produce, both companies are likely to battle for the business and include a financing arrangement, highlighting the buyer's power in the potential transaction.

## Bargaining power of buyers

Organisations seek to maximise the return on their invested capital. Conversely, buyers (customers of an industry or an organisation) want to buy products at the lowest possible price – the point at which the industry earns the lowest acceptable rate of return on its invested capital. To reduce their costs, buyers bargain for higher quality, greater levels of service and lower prices.[107] These outcomes are achieved by encouraging competitive battles among the industry's organisations. Customers (buyer groups) are powerful when:

- they purchase a large portion of an industry's total output
- the sales of the product being purchased account for a significant portion of the seller's annual revenues
- they could switch to another product at little, if any, cost

- the industry's products are undifferentiated or standardised, and the buyers pose a credible threat if they were to integrate backward into the sellers' industry.

Consumers armed with greater amounts of information about the manufacturer's costs and the power of the internet as a shopping and distribution alternative have increased bargaining power in many industries. One reason for this shift is that individual buyers incur virtually no switching costs when they decide to purchase from one manufacturer rather than another, or from one dealer as opposed to any other.

## Threat of substitute products

Substitute products are goods or services from outside a given industry that perform similar or the same functions as a product that the industry produces. For example, as a sugar substitute, NutraSweet and other sugar substitutes place an upper limit on sugar manufacturers' prices; NutraSweet and sugar perform the same function, though with different characteristics. Other product substitutes include email instead of overnight mail delivery, plastic containers rather than glass jars, and tea instead of coffee. Newspaper organisations have experienced significant circulation declines over the past decade or more. The declines are due to substitute outlets for news, including internet sources, cable television news channels, and email and mobile phone alerts. Likewise, satellite television and cable and telecommunication companies provide substitute services for basic media services such as television, the internet and the telephone. However, the possible switching is becoming more complicated as consumer demand for content is changing through increasing use of mobile devices, such as tablets and smartphones.[108]

In general, product substitutes present a strong threat to an organisation when customers face few, if any, switching costs and when the substitute product's price is lower or its quality and performance capabilities are equal to or greater than those of the competing product. Differentiating a product along dimensions that customers value (such as quality, service after the sale and location) reduces a substitute's attractiveness.

### Strategic focus | Globalisation

### German performance/luxury cars: if you've seen one, have you seen them all?

Audi, BMW and Mercedes-Benz (Mercedes) have long competed against each other in the performance/luxury segment of the car industry. Given that they implement similar strategies in many of the same markets throughout the world and emphasise similar dimensions to do so, these organisations form a strategic group. This means that the rivalry within the group is more intense than is the rivalry between members of this group and companies offering products that are intended to functionally serve and satisfy a mass-market appeal among large customer groups. One could even argue that three sub-strategic groups exist for these organisations in that each offers products in the large, mid-size and small parts of the performance/luxury segment. (Think of the Audi S8 versus the BMW 7 series versus the S Mercedes series as products through which these organisations compete against each other in terms of large performance/luxury cars.)

The similarities among these organisations as they compete are extensive. The Chinese and US markets are critical to their success. With respect to China, an analyst noted that 'BMW, Audi and Daimler's Mercedes-Benz units have benefited as China's fast-growing wealthy population has flocked to high-end cars in recent years'. A new generation of younger, more eco-minded and female consumers is driving innovation in the luxury car industry. In response to this shift in demand for their products, all three organisations are investing billions of dollars to expand production and their sales operations in China.

These organisations are emphasising similar dimensions or product features to produce new models as well as some existing ones. For example, diesel engines are important to the companies and their efforts to sell more cars in China and the USA. To better serve the needs of younger consumers, all three companies are 're-thinking everything from dashboard entertainment systems to the relative importance of mileage over horsepower to fundamental marketing strategies'. An initial outcome from these evaluation processes was a decision to include smartly presented, smartphone-driven multimedia systems in models.

As is often the case with strategic groups, the rivalry and strategic moves among Audi, BMW and Mercedes have remained stable over the years. As such, we can anticipate that the rivalry among them will remain intense as they rely on similar strategic dimensions to implement similar strategies. Yet there is more rivalry to commence with other players in the market, such as Jaguar with its E and F Pace, and Tesla, to name a few. This industry also faces fresh competition from manufacturers specialising in all-electric cars that are encroaching in the sector; with lower barriers to entry, electric cars appear easier to design and build than traditional cars. As demographics shift, car manufacturers are becoming nimbler and taking greater risks to remain competitive. Chris Craft, Bentley's Head of Sales and Marketing, noted that new luxury car buyers won't associate with brands they don't feel have their values. For example, in 2016 Rolls-Royce launched its Black Badge range designed to appeal to a hip-hop and clubbing culture, rather than to its cars' traditional owners.

Globally, the age of luxury car buyers varies dramatically. For example, in the EU, Japan and the UK, typical luxury car purchasers will be in their 50s. In California, the typical age is 35 and in China it as young as 20. These fresh-faced customers bring with them different demands, including the latest technological innovations. In addition, regardless of the gender of buyers, sales of high-end SUVs are increasing. For example, 60 per cent of Lamborghini sales in the first half of 2019 were the Urus SUV, and the company reported that buyers were trading in Range Rovers to purchase the Urus. Aston Martin has strategically forecast its upcoming DBX (an SUV) will be a success.

Sources: P. Campbell, 2019, Luxury car makers are battling to cater to the changing needs of the super-rich, *Financial Times*, http://www.ft.com, 31 August; B. Laban, 2003, *The Mini: Making of a Modern Icon*, Singapore: Collins; C. Carroll, 2013, Audi plans to attract more U.S. buyers with diesels, *Wall Street Journal*, http://www.wsj.com, 8 February; V. Fuhrmans, 2013, Europe bets U.S. auto demand to stay high, *Wall Street Journal*, http://www.wsj.com, 16 January; V. Fuhrmans, 2013, German auto makers to shake up l uxury market, *Wall Street Journal*, http://www.wsj.com, 14 January; V. Fuhrmans & F. Geiger, 2013, VW to bolster its output in China, *Wall Street Journal*, http://www.wsj.com, 14 March; F. Geiger, 2013, Daimler boosts investment in China, *Wall Street Journal*, http://www.wsj.com, 1 February; J. W. White, 2013, Beyond boomer buyers: Car makers seek younger crop of customers, *Wall Street Journal*, http://www.wsj.com, 16 January.

## Intensity of rivalry among competitors

Because an industry's organisations are mutually dependent, actions taken by one organisation usually invite competitive responses. In many industries, organisations actively compete against one another. Competitive rivalry intensifies when an organisation is challenged by a competitor's actions or when a company recognises an opportunity to improve its market position.

Organisations within industries are rarely homogeneous: they differ in resources and capabilities and seek to differentiate themselves from competitors.[109] Typically, organisations seek to differentiate their products from competitors' offerings in ways that customers value and in which the organisations have a competitive advantage. Common dimensions on which rivalry is based include price, service after the sale and innovation.

Next, we discuss the most prominent factors that experience shows to affect the intensity of organisations' rivalries.

### Numerous or equally balanced competitors

Intense rivalries are common in industries with many companies. With multiple competitors, it is common for a few organisations to believe they can act without eliciting a response. However, the evidence suggests that other organisations generally are aware of competitors' actions and often choose to respond to them. At the other extreme, industries with only a few organisations of equivalent size and power also tend to have strong rivalries. The large and often similar-sized resource bases of these organisations permit vigorous actions and responses. The competitive battles between Airbus and Boeing mentioned earlier exemplify intense rivalry between relatively equal competitors. Coca-Cola and PepsiCo have a strong rivalry in drink products as consumers demand not only great taste but real health benefits.[110]

## Slow industry growth

When a market is growing, organisations try to effectively use resources to serve an expanding customer base. Growing markets reduce the pressure to take customers from competitors. However, rivalry in no-growth or slow-growth markets (slow change) becomes more intense as organisations battle to increase their market shares by attracting competitors' customers. For example, there is a growing trend globally of competition in the health care of baby boomers, who are now aged 65 or older. Competition is also increasing in in-home health care; however, as regulation becomes more prominent in this industry (e.g. resulting from recommendations released in February 2021 by Australia's Royal Commission into Aged Care Quality and Safety), growth is likely to slow and rivalry will increase.[111]

Typically, battles to protect market share are fierce. As indicated, this has been the case in the airline industry, as well as in the fast-food industry as McDonald's, Hungry Jack's and KFC try to win each other's customers, and in the highly competitive sports footwear segment between Nike, Adidas and Reebok. The instability in markets that results from these competitive engagements may reduce the profitability for all organisations engaging in such battles.

## High fixed costs or high storage costs

When fixed costs account for a large part of total costs, organisations try to maximise the use of their productive capacity. Doing so allows an organisation to spread costs across a larger volume of output. However, when many organisations attempt to maximise their productive capacity, excess capacity is created on an industry-wide basis. To then reduce inventories, individual organisations typically cut the price of their products and offer rebates and other special discounts to customers. However, these practices, such as have been common in the car manufacturing industry, often intensify competition. The pattern of excess capacity at the industry level, followed by intense rivalry at the organisation level, is observed frequently in industries with high storage costs. Perishable products, for example, rapidly lose their value with the passage of time. As their inventories grow, producers of perishable goods often use pricing strategies to sell products quickly.

## Lack of differentiation or low switching costs

When buyers find a differentiated product that satisfies their needs, they frequently purchase the product loyally over time. Industries with many companies that have successfully differentiated their products have less rivalry, resulting in lower competition for individual organisations. Organisations that develop and sustain a differentiated product that cannot be easily imitated by competitors often earn higher returns. However, when buyers view products as commodities (i.e. as products with few differentiated features or capabilities), rivalry intensifies. In these instances, buyers' purchasing decisions are based primarily on price and, to a lesser degree, service. Personal computers are a commodity product. Thus, the rivalry between Dell, Hewlett-Packard, Lenovo and other computer manufacturers is strong and these companies are always trying to find ways to differentiate their offerings (Hewlett-Packard now pursues product design as a means of differentiation). Apple has been able to maintain a differentiation strategy through ease of use of its superb brand, products, software applications and integration capabilities with other software platforms.

## High strategic stakes

Competitive rivalry is likely to be high when it is important for several of the competitors to perform well in the market. For example, although it is diversified and is a market leader in other businesses, Samsung has targeted market leadership in the consumer electronics market and is doing quite well. This market is also important to Sony and other major competitors, such as Hitachi, Matsushita, NEC and Mitsubishi, suggesting that rivalry among these competitors will remain strong.

High strategic stakes can also exist in terms of geographic locations. For example, Japanese automobile manufacturers are committed to a significant presence in the US marketplace because it is the world's largest single market for cars and trucks. Due to the high stakes involved in the USA for both Japanese and US manufacturers, rivalry among the global organisations from these two countries is intense. With the excess capacity in this industry we mentioned earlier in this chapter, there is every reason to believe that the rivalry among global car manufacturers will remain intense in the foreseeable future.

### High exit barriers

Sometimes companies continue competing in an industry even though the returns on their invested capital are low or negative. Organisations making this choice likely face high exit barriers, which include economic, strategic and emotional factors that cause them to remain in an industry when the profitability of doing so is questionable. Exit barriers are especially high in the airline industry. Although earning even average returns is difficult for these organisations, they face substantial exit barriers, such as their ownership of specialised assets (e.g. large aircraft).[112] Common exit barriers include the following:

- specialised assets (assets with values linked to a particular business or location)
- fixed costs of exit (such as labour agreements)
- strategic interrelationships (relationships of mutual dependence, such as those between one business and other parts of a company's operations, including shared facilities and access to financial markets)
- emotional barriers (aversion to economically justified business decisions because of fear for one's own career, loyalty to employees and so forth)
- government and social restrictions (often based on government concerns for job losses and regional economic effects).

## Interpreting industry analyses

Effective industry analyses are products of careful study and interpretation of data and information from multiple sources. A wealth of industry-specific data is available to be analysed by individual companies and, because of globalisation, international markets and rivalries must be included in the organisation's analyses. Research shows that in some industries, international variables are more important than domestic ones as determinants of strategic competitiveness. Furthermore, because of the development of global markets, a country's borders no longer restrict industry structures. In fact, movement into international markets enhances the chances of success for new ventures as well as more established organisations.[113]

Analysis of the five forces in the industry allows the organisation to determine the industry's attractiveness in terms of the potential to earn adequate or superior returns. In general, the stronger competitive forces are, the lower the profit potential is for an industry's organisations. An unattractive industry has low entry barriers, suppliers and buyers with strong bargaining positions, strong competitive threats from product substitutes and intense rivalry among competitors. These industry characteristics make it difficult for organisations to achieve strategic competitiveness and earn above-average returns. Conversely, an attractive industry has high entry barriers, suppliers and buyers with little bargaining power, few competitive threats from product substitutes and relatively moderate rivalry.[114] Next, we explain strategic groups as an aspect of industry competition.

# Strategic groups

A set of organisations that emphasise similar strategic dimensions and use a similar strategy is called a **strategic group**.[115] For example, the budget airline group in the Australian domestic airline industry includes

**strategic group**
a set of organisations that emphasise similar strategic dimensions and use a similar strategy

Virgin Australia and Jetstar. It does not include Qantas. The competition between organisations within a strategic group is greater than the competition between a member of a strategic group and companies outside that strategic group. Therefore, intra-strategic group competition is more intense than is inter-strategic group competition. In fact, more heterogeneity is evident in the performance of organisations within strategic groups than across the groups. The performance leaders within groups are able to follow strategies similar to those of other organisations in the group and yet maintain strategic distinctiveness to gain and sustain a competitive advantage.[116]

The extent of technological leadership, product quality, pricing policies, distribution channels and customer service are examples of strategic dimensions that organisations in a strategic group may treat similarly. Thus, membership in a particular strategic group defines the essential characteristics of the organisation's strategy.[117]

The notion of strategic groups can be useful for analysing an industry's competitive structure. Such analyses can be helpful in diagnosing competition, positioning and the profitability of organisations within an industry.[118] High mobility barriers, high rivalry and low resources among the organisations within an industry limit the formation of strategic groups.[119] Research suggests that after strategic groups are formed, their membership remains relatively stable over time, although some research has also examined how change occurs.[120] Using strategic groups to understand an industry's competitive structure requires the organisation to plot companies' competitive actions and competitive responses along strategic dimensions such as pricing decisions, product quality, distribution channels and so forth. This type of analysis shows the organisation how certain companies are competing similarly in terms of how they use similar strategic dimensions.

Strategic groups have several implications. First, because organisations within a group offer similar products to the same customers, the competitive rivalry among them can be intense. The more intense the rivalry, the greater the threat is to each organisation's profitability. Second, the strengths of the five industry forces differ across strategic groups. Third, the closer the strategic groups are in terms of their strategies, the greater is the likelihood of rivalry between the groups.

# Competitor analysis

The competitor environment is the final part of the external environment requiring study. Competitor analysis focuses on each company against which an organisation directly competes. For example, Coca-Cola and PepsiCo, Woolworths and Coles, and Boeing and Airbus are keenly interested in understanding each other's objectives, strategies, assumptions and capabilities. Indeed, intense rivalry creates a strong need to understand competitors.[121] In a competitor analysis, the organisation seeks to understand the following:

- what drives the competitor, as shown by its future objectives
- what the competitor is doing and can do, as revealed by its current strategy
- what the competitor believes about the industry, as shown by its assumptions
- what the competitor's capabilities are, as shown by its strengths and weaknesses.[122]

Information about these four dimensions assists the organisation to prepare an anticipated response profile for each competitor (see Figure 2.5). The results of an effective competitor analysis help an organisation to understand, interpret and predict its competitors' actions and responses. Understanding the actions of competitors clearly contributes to the organisation's ability to compete successfully within the industry.[123] Interestingly, research suggests that executives often fail to analyse competitors' possible reactions to competitive actions their organisation takes,[124] placing their organisation at a potential competitive disadvantage as a result.

Critical to an effective competitor analysis is gathering data and information that can help the organisation understand its competitors' intentions and the strategic implications resulting from them.[125]

**Figure 2.5** Competitor analysis components

**Future objectives**
- How do our goals compare with our competitors' goals?
- Where will emphasis be placed in the future?
- What is the attitude towards risk?

**Current strategy**
- How are we currently competing?
- Does this strategy support changes in the competitive structure?

**Assumptions**
- Do we assume the future will be volatile?
- Are we operating under a status quo?
- What assumptions do our competitors hold about the industry and themselves?

**Capabilities**
- What are our strengths and weaknesses?
- How do we rate compared to our competitors?

**Response**
- What will our competitors do in the future?
- Where do we hold an advantage over our competitors?
- How will this change our relationship with our competitors?

Useful data and information combine to form **competitor intelligence**, the set of data and information the organisation gathers to better understand and anticipate competitors' objectives, strategies, assumptions and capabilities. In competitor analysis, the organisation gathers intelligence not only about its competitors but also regarding public policies in countries around the world. Such intelligence facilitates an understanding of the strategic posture of foreign competitors. Through effective competitive and public policy intelligence, the organisation gains the insights needed to make effective strategic decisions on how to compete against its rivals.

**competitor intelligence**
the set of data and information the organisation gathers to better understand and better anticipate competitors' objectives, strategies, assumptions and capabilities

When asked to describe competitive intelligence, it seems that a number of people respond with phrases such as 'competitive spying' and 'corporate espionage'. These phrases denote the fact that competitive intelligence is an activity that appears to involve trade-offs.[126] According to some, the reason for this is that 'what is ethical in one country is different from what is ethical in other countries'. This position implies that the rules of engagement to follow when gathering competitive intelligence change in different contexts.[127] However, organisations avoid the possibility of legal entanglements and ethical quandaries only when their competitive intelligence gathering methods are governed by a strict set of legal and ethical guidelines.[128] This means that ethical behaviour and actions, as well as the mandates of relevant laws and regulations, should be the foundation on which an organisation's competitive intelligence-gathering process is formed. We address this matter in greater detail in the next section.

When gathering competitive intelligence, organisations must also pay attention to the complementors of its products and strategy.[129] **Complementors** are companies or networks of companies that sell complementary goods or services that are compatible with the focal organisation's good or service. When a complementor's good or service adds value to the sale of the focal organisation's good or service, it is likely to create value for the focal organisation.

**complementors**
companies or networks of companies that sell complementary goods or services that are compatible with the focal organisation's good or service

There are many examples of organisations whose good or service complements other companies' offerings. For example, organisations manufacturing affordable home photo printers complement other companies' efforts to sell digital cameras. Intel and Microsoft are perhaps the most widely recognised complementors. The Microsoft slogan 'Intel Inside' demonstrates the relationship between two organisations that do not directly buy from or sell to each other but whose products have a strong complementary relationship. Alliances among airline operations (e.g. the Star Alliance and the SkyTeam Alliance) find these companies sharing their route structures and customer loyalty programs as a means of complementing each other's operations – each alliance is a network of complementors.

As our discussion shows, complementors expand the set of competitors organisations must evaluate when completing a competitor analysis. For example, sometimes complementors change, as in the purchase of Sun Microsystems by Oracle. After the acquisition, Oracle was no longer a complementor of Dell and HP but a competitor. Similarly, Intel and Microsoft analyse each other's actions in that those actions might either help each organisation gain a competitive advantage or damage each organisation's ability to exploit a competitive advantage.

## Ethical considerations

Organisations must follow relevant laws and regulations as well as carefully articulated ethical guidelines when gathering competitor intelligence. Industry associations often develop lists of these practices that organisations can adopt. Practices considered both legal and ethical include: obtaining publicly available information (e.g. court records, competitors' help-wanted advertisements, annual reports and financial reports of publicly held corporations); and attending trade fairs and shows to obtain competitors' brochures, view their exhibits and listen to discussions about their products. By contrast, certain practices (including blackmail, trespassing, hawking, eavesdropping, and stealing drawings, samples or documents) are widely viewed as unethical and often are illegal.

Some competitor intelligence practices may be legal, although an organisation must decide whether they are also ethical, given the image it desires as a corporate citizen (which is generally achieved through its own corporate social responsibility policies and procedures). Especially with electronic transmissions, the line between legal and ethical practices can be difficult to determine. For example, an organisation may develop website addresses that are similar to those of its competitors and thus occasionally receive email transmissions that were intended for those competitors. This shows the challenges companies face in deciding how to gather intelligence about competitors, while simultaneously determining how to prevent competitors from learning too much about them. To deal with these challenges, organisations should establish principles and take actions that are consistent with them.

Open discussions of intelligence-gathering techniques may assist an organisation to ensure that employees, customers, suppliers and even potential competitors understand its conviction to follow ethical practices for gathering competitor intelligence. An appropriate guideline for competitor intelligence practices is to respect the principles of common morality and the right of competitors not to reveal certain information about their products, operations and strategic intentions.[130]

# STUDY TOOLS

## SUMMARY

**LO1** The organisation's external environment is challenging and complex. The external environment has three major parts: the general environment (elements in the broader society that affect industries and their organisations), the industry environment (factors that influence an organisation, its competitive actions and responses, and the industry's profit potential) and the competitor environment (in which the organisation analyses each major competitor's future objectives, current strategies, assumptions and capabilities).

**LO2** The external environmental analysis process has four steps: scanning, monitoring, forecasting and assessing. Through environmental analyses, the organisation identifies opportunities and threats.

**LO3** The general environment has seven segments: demographic, economic, political/legal, sociocultural, technological, global and physical. For each segment, the organisation has to determine the strategic relevance of environmental changes and trends.

**LO4** Compared with the general environment, the industry environment has a more direct effect on the organisation's strategic actions. The five forces model of competition comprises the threat of entry, the power of suppliers, the power of buyers, product substitutes and the intensity of rivalry among competitors. By studying these forces, the organisation can find a position in an industry where it can influence the forces in its favour or where it can buffer itself against the power of the forces in order to achieve strategic competitiveness and earn above-average returns.

**LO5** Industries are populated with different strategic groups. A strategic group is a collection of organisations following similar strategies along similar dimensions. Competitive rivalry is greater within a strategic group than between strategic groups.

**LO6** Competitor analysis focuses on each company against which an organisation directly competes. Critical to an effective competitor analysis is gathering data and information that can help the organisation understand its competitors' intentions and the strategic implications resulting from them. Organisations must follow mandatory laws and regulations as well as ethical guidelines when gathering competitor intelligence.

## KEY TERMS

competitor intelligence
complementors
demographic segment
economic environment
general environment
global segment
industry
industry environment
opportunity
physical environment segment
political/legal segment
sociocultural segment
strategic group
technological segment
threat

## REVIEW QUESTIONS

1. Why is it important for an organisation to study and understand the external environment?
2. What are the differences between the general environment and the industry environment? Why are these differences important?
3. What are the four steps in the external environmental analysis process? What does the organisation want to learn when using this process?
4. What are the seven segments of the general environment? Explain the differences among them. Is any segment more important than another?
5. How do the five forces of competition in an industry affect its profit potential? Explain.
6. What is the importance of collecting and interpreting data and information about competitors? What practices should an organisation use to gather competitor intelligence, and why?

# EXPERIENTIAL EXERCISES

### Exercise 1: Strategic group mapping

If a given set of organisations emphasise similar strategic dimensions and use a similar strategy, these organisations can be said to reside in the same strategic group. Other common definitions of strategic groups typically argue that the organisations in a given industry follow similar strategies, such as pricing, degree of specialisation, research and development commitment and the like. It is also likely that organisations operating in a given industry may have very different profitability profiles, which raises the question: if one organisation is the most profitable, why don't all the others in that industry attempt to move into the same strategic group as the industry leader?

## Part 1

1. Form teams and pick an industry the team finds interesting. A list of industries and industry leaders may be found at Yahoo! Finance (http://biz.yahoo.com/ic/ind_index.html).
2. Investigate this industry in order to create a strategic group map. You must pick the two dimensions for your map that best represent the key success factors in this industry (e.g. R&D investments, pricing, geographic reach).
3. For each organisation listed on your map, investigate its overall financial performance, not only historically, but also its five-year growth forecast. (This information is also available at Yahoo! Finance and other locations.)

## Part 2

Prepare a presentation to the class that discusses your findings and answers the following key issues or questions:

1. Who are the most direct competitors and on what basis do they mostly compete? That is, why did you choose the competitive dimensions that you did?
2. How does profitability stack up between strategic groups? Which groups are most profitable, and why?
3. What would it take for an organisation to move from an underperforming (in terms of profitability) strategic group to a more profitable strategic group? How likely is it that this could happen?
4. Think about one of the organisations in a particular strategic group. Are there any opportunities for this organisation that you see because of your strategic group mapping?
5. What conclusions can you reach about why some organisations end up where they do among various strategic groups?

### Exercise 2: What does the future look like?

A critical ingredient in studying the general environment is identifying opportunities and threats. An opportunity is a condition in the environment that, if exploited, helps a company to achieve strategic competitiveness. In order to identify opportunities, you must be aware of trends that affect the world around us now or that are projected to do so in the future.

Thomas Fry, senior futurist at the DaVinci Institute, believes that the chaotic nature of interconnecting trends and the vast array of possibilities that arise from them are somewhat akin to watching a spinning compass needle. From the way we use phones and email and recruit new workers to organisations, the climate for business is changing and shifting dramatically, and at rapidly increasing rates. Sorting out these trends and making sense of them provides the basis for opportunity decision making. Which ones will dominate and which ones will fade? Understanding this is crucial for business success.

Your challenge (either individually or as a group) is to identify a trend, technology, entertainment or design that is likely to alter the way in which business is conducted in the future. Once you have identified this, be prepared to discuss which of the six dimensions of the general environment this will affect. (There may be more than one.)

- Describe the impact.
- List some business opportunities that will come from this.
- Identify some existing organisations that stand to benefit.
- What, if any, are the ethical implications?

You should consult a wide variety of sources. For example, the Gartner Group and McKinsey & Co. both produce market research and forecasts for business. There is also a host of web forecasting tools and addresses. These include TED (see http://www.ted.com for videos of its discussions), which hosts an annual conference for path-breaking new ideas. Similarly, the DaVinci Institute, Institute for Global Futures and a wide range of others have their own unique visions of tomorrow's environment.

## NOTES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CHAPTER 3

# The internal organisation: resources, capabilities, core competencies and competitive advantages

## Learning Objectives

Studying this chapter should provide you with the strategic management knowledge needed to:

**LO1** explain why organisations need to study and understand their internal organisation

**LO2** define value and discuss its importance

**LO3** describe the differences between tangible and intangible resources

**LO4** define capabilities and discuss their development

**LO5** describe four criteria of sustainable competitive advantage used to determine whether resources and capabilities are core competencies

**LO6** explain how organisations analyse the support functions and activities of the value chain for determining where they can create value for customers.

# OPENING CASE STUDY

## Large pharmaceutical companies, big data analytics, artificial intelligence and core competencies: a brave new world

To date, and perhaps surprisingly, the idea of using data strategically remains somewhat novel in some organisations. However, the reality of 'big data' and 'big data analytics' (which is 'the process of examining big data to uncover hidden patterns, unknown correlations, and other useful information that can be used to make better decisions') is becoming increasingly popular in business. Indeed, in the current competitive landscape, most businesses must use big data analytics (BDA) across all customer channels (mobile, web, email and physical stores) throughout their supply chain to help them become more innovative.

This is the situation for large pharmaceutical companies (the organisations often called 'big pharma') in that many have been working to develop a core competence in BDA. (We define and discuss core competencies in this chapter.) There are several reasons they are doing this. In addition to the vast increases in the amounts of data that must be studied and interpreted for competitive purposes, 'health care reform and the changing landscape of health care delivery' systems throughout the world are influencing these organisations to think about developing BDA as a core competence. Many benefits can accrue to big pharma organisations that develop BDA as a core competence. For example, having BDA as a core competence can help an organisation quickly identify trial candidates and accelerate its recruitment, develop improved inclusion and exclusion criteria to use in clinical trials, and uncover unintended uses and indications for products. In terms of customer functionality, superior products can be provided at a faster pace as a foundation for helping patients live better and healthier lives. In developing their BDA capabilities, many of the big pharma companies are investing in artificial intelligence (AI). AI provides the capability to analyse many different sets of information. For example, AI can help analyse data on clinical trials, health records, genetic profiles and preclinical studies. AI can analyse and integrate these data to identify patterns in the data and suggest hypotheses about relationships. A new drug generally requires a decade of research and $2.6 billion of investment. And only about 5 per cent of the drugs that enter experimental research make it to the market and are successful. Eventually, it is expected that the use of AI could reduce the early research development time from four to six years to one year, not only greatly reducing the time of development but also the costs.

AI can help analyse data on clinical trials, health records, genetic profiles and preclinical studies. China has a goal to become the world leader in AI.

Source: Shutterstock.com/Creativa Images

As we discuss in this chapter, capabilities are the foundation for developing core competencies. There are several capabilities big pharma companies need for BDA to be a core competence. Supportive architecture, the proper mix of data scientists, and 'technology that integrates and manages new types and sources of data flexibility and scalability while maintaining the highest standards of data governance, data quality, and data security' are examples of capabilities that big pharma need if they wish to develop BDA as a core competence. Of course, using artificial intelligence provides strong support for the application of BDA.

Having a strong BDA competence could be critical for pharmaceutical organisations in the future. Most Chinese pharmaceutical companies are medium-sized and sell generic drugs and therapeutic medicines, investing in R&D at only about 25 per cent of the amount invested by big pharma in developed countries. However, China has a plan to develop large, competitive pharmaceutical organisations by 2025. In 2017, for example, China's second-largest class of investments was biopharma. Interestingly, the largest Chinese investment that year was in information systems, including AI. China has a goal to become the world leader in AI.

In recent years, big pharma has been earning mediocre returns of about 3 per cent ROI, down from 10 per cent a decade earlier. Thus, big pharma executives feel pressure, especially with the initial costs of developing BDA and AI. They hope soon to be able to reduce their costs and experience higher rates of success in the development of new drugs. Until then, however, analysts are predicting record numbers of mergers and acquisitions in the pharmaceutical industry, with big pharma acquiring successful medium-sized pharmaceuticals and biotechnology businesses.

Sources: S. Mukherjee, 2018, How big pharma is using AI to make better drugs, *Fortune*, http://fortune.com, 19 March; Z. Torrey, 2018, China prepares for big pharma, http://thediplomat.com, 14 March; E. Corbett, 2018, European mid-sized pharma companies-biotechs and big pharma? *The Pharmaletter*, http://www.thepharmaletter.com, 9 March; M. Jewel, 2018, Signs that 2018 will be a record year for pharma M&A, *The Pharmaletter*, http://www.thepharmaletter.com, 1 March; B. Nelson, 2018, Why big pharma and biotech are betting big on AI, *NBC News*, http://www.nbc.news, 1 March; Big data analytics: What it is & why it matters, 2015, *SAS*, http://www.sas.com, 2 April; Big data for the pharmaceutical industry, Informatica, http://www.informatica.com, 17 March; B. Atkins, 2015, Big data and the board, *Wall Street Journal Online*, http://www.wsj.com, 16 April; S. F. DeAngelis, 2014, Pharmaceutical big data analytics promises a healthier future, Enterrasolutions, http://www.enterrasolutions.com, 5 June; T. Wolfram, 2014, Data analytics has big pharma rethinking its core competencies, *Forbes Online*, http://www.forbes.com, 22 December.

As discussed in the first two chapters, several factors in the global economy, including the rapid development of the internet's capabilities[1] and globalisation in general, have made it increasingly difficult for organisations to find ways to develop sustainable competitive advantages.[2] Increasingly, innovation appears to be a vital path to efforts to develop competitive advantages, particularly sustainable ones. Innovative actions are required by big pharma companies, and they need to develop new drugs more quickly and at lower costs while improving the success of the drugs that they develop. As the opening case shows, they are trying to use AI to help develop capabilities in big data analytics that hopefully can become *core competencies*.

As is the case for big pharma companies, innovation is critical to most organisations' success. This means that many organisations seek to develop innovation as a core competence. We define and discuss core competencies in this chapter and explain how organisations use their resources and capabilities to form them. As a core competence, innovation has long been critical to Boeing's success, for example. Today, however, the organisation is focusing on incremental innovations as well as developing new technologies that are linked to major innovations and the projects they spawn, such as the 787 Dreamliner. The first delivery of the 787-10 Dreamliner was made to Singapore Airlines on 26 March 2018. Boeing believes its incremental innovations enable the organisation to deliver reliable products to customers more quickly and at a lower cost.[3]

**value**
measured by a product's performance characteristics and by its attributes for which customers are willing to pay

To identify and successfully use resources over time, leading organisations need to think constantly about how to manage resources for the purpose of increasing the **value** their goods or services create for customers, as compared with the value rivals' products create. As this chapter shows, organisations achieve strategic competitiveness and earn above-average returns by acquiring, bundling and leveraging their resources for the purpose of taking advantage of opportunities in the external environment in ways that create value for customers.[4]

Even if the organisation develops and manages resources in ways that create core competencies and competitive advantages, competitors will eventually learn how to duplicate the benefits of any organisation's value-creating strategy; thus, all competitive advantages have a limited life.[5] Because of this, the question of duplication of a competitive advantage is not if it will happen, but when. In general, a competitive advantage's sustainability is a function of three factors: the rate of core competence obsolescence because of environmental changes; the availability of substitutes for the core competence; and the imitability of the core competence.[6] For all organisations, the challenge is to effectively manage current core competencies while simultaneously developing new ones.[7] Only when organisations are able to do this can they expect to achieve strategic competitiveness, earn above-average returns and remain ahead of competitors (see Chapter 5).

We studied the general, industry and competitor environments in Chapter 2. Armed with knowledge about the realities and conditions of their external environment, organisations have a better understanding of marketplace opportunities and the characteristics of the competitive environment in which those opportunities exist. In this chapter, we focus on the organisation itself. By analysing its internal organisation, an organisation determines what it can do. Matching what an organisation can do (a function of its resources, capabilities and core competencies in the internal organisation) with what it might do (a function of opportunities and threats in the external environment) is a process that yields insights the organisation requires to select its strategies.

We begin this chapter by briefly describing conditions associated with analysing the organisation's internal organisation. We then discuss the roles of resources and capabilities in developing core competencies, which are the sources of the organisation's competitive advantages. Included in this discussion are the techniques organisations use to identify and evaluate resources and capabilities, and the criteria for identifying core competencies from among them. Resources by themselves typically are not competitive advantages; in fact, resources create value when the organisation uses them to form capabilities, some of which become core competencies, and hopefully competitive advantages. Because of the relationship among resources, capabilities and core competencies, we also discuss the value chain and examine four criteria that organisations use to determine if their capabilities are core competencies and, as such, sources of competitive advantage.[8] The chapter closes with cautionary comments about **outsourcing** and the need for organisations to prevent their core competencies from becoming core rigidities. The existence of core rigidities indicates that the organisation is too anchored to its past, which prevents it from continuously developing new capabilities and core competencies.

**outsourcing**
the purchase of a value-creating activity from an external supplier

# Analysing the internal organisation

## The context of internal analysis

One of the conditions associated with analysing the internal organisation is the reality that, in today's global economy, some of the resources that were traditionally critical to organisations' efforts to produce, sell and distribute their goods or services – such as labour costs, access to financial resources and raw materials, and protected or regulated markets – are still important; however, it is now less likely that these resources will become core competencies and possibly competitive advantages.[9] An important reason for this is that an increasing number of organisations are using their resources to form core competencies through which they successfully implement an international strategy (discussed in Chapter 8) as a means of overcoming the advantages created by these more traditional resources.

The Volkswagen Group has established a 'Together 2025 + Group Strategy', replacing its 'Strategy 2018' as its international strategy. This organisation sells its products in over 150 countries, employs (including its Chinese joint venture) around 667 748 people worldwide to operate over 60 production plants located in 15 countries. In 2019, the Volkswagen Group delivered close to 11 million vehicles to customers, which exceeded the previous year's figures by 1.3 per cent and set a new organisational record.[10]

Increasingly, those analysing their organisation's internal organisation use a **global mindset** to do so. A global mindset is the ability to analyse, understand and manage an internal organisation in ways that are not dependent on the assumptions of a single country, culture or context.[11] Because they are able to span artificial boundaries, those with a global mindset recognise that their organisations must possess resources and capabilities that allow understanding of, and appropriate responses to, competitive situations that are influenced by country-specific factors and unique cultures. Using a global mindset to analyse the internal organisation has the potential to significantly help the organisation in its efforts to outperform rivals.[12]

**global mindset**
the ability to study an internal environment in ways that are not dependent on the assumptions of a single country, culture or context

This Volkswagen technician is one of nearly 700 000 people Volkswagen employs to operate its 62 production plants located in 15 European countries and China by way of a joint venture.

Source: Alamy Stock Photo/dpa picture alliance

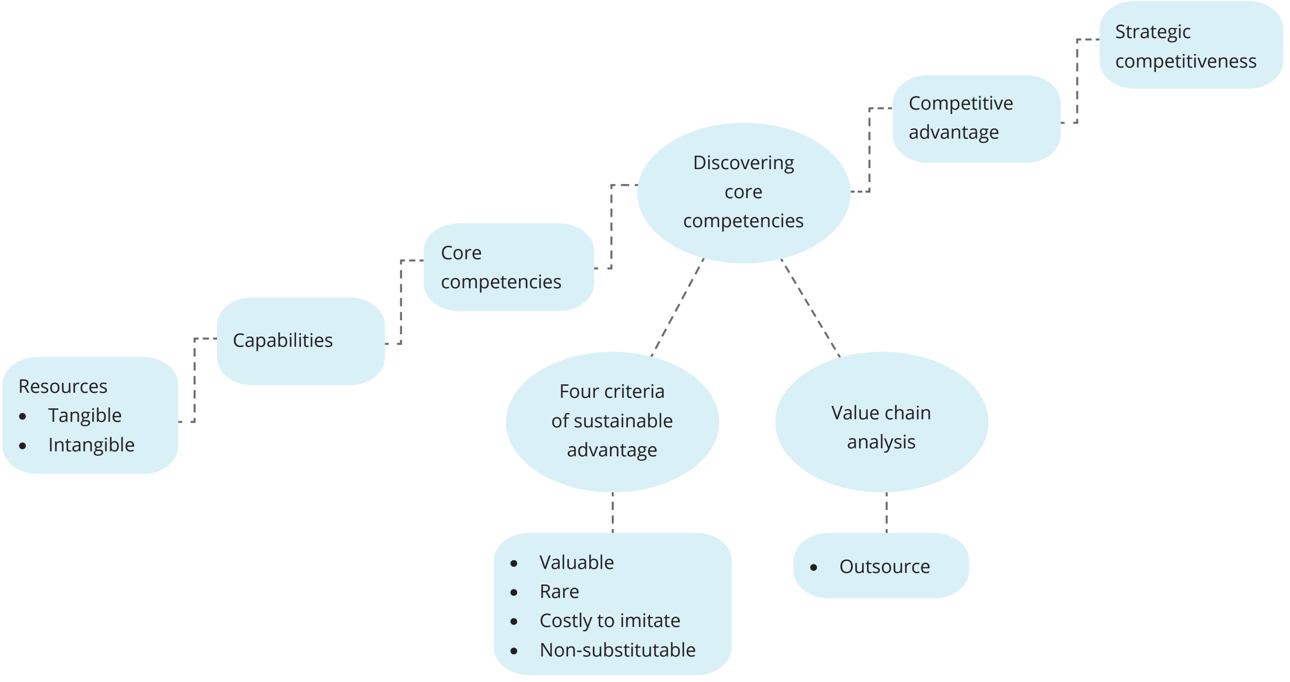
Finally, analysing internal organisation requires that evaluators examine the organisation's entire portfolio of resources and capabilities. This perspective suggests that individual organisations possess at least some resources and capabilities that other companies do not – at least not in the same combination. Resources are the source of capabilities, some of which lead to the development of core competencies; in turn, some core competencies may lead to a competitive advantage for the organisation.[13] Understanding how to leverage the organisation's unique bundle of resources and capabilities is a key outcome decision makers seek when analysing the internal organisation.[14] Figure 3.1 illustrates the relationships among resources, capabilities, core competencies and competitive advantages, and shows how their integrated use can lead to strategic competitiveness. As we discuss next, organisations use the assets in their internal organisation to create value for customers.

## Creating value

Organisations use their resources as the foundation for producing goods or services that will create value for customers.[15] Organisations create value by innovatively bundling and leveraging their resources to form capabilities and core competencies.[16]

Organisations with a competitive advantage create more value for customers than do their competitors.[17] Big W, Kmart and Target have used their 'everyday low price' approach to doing business (an approach that is grounded in the organisations' core competencies, such as lower priced products and distribution channels) to create value for those seeking to buy products at a low price compared with competitors' prices for those products.[18] Australian mattress manufacturer Koala creates value for customers

**Figure 3.1** **Components of an internal analysis**



interested in buying what the organisation promotes as 'a better sleep starts with Koala' and is now rated as Australia's highest-rated mattress brand. The organisation has diversified its single product range of selling mattresses to making furniture for the digital age. Koala states that it has replaced negative and unattractive industry practices, such as overpricing and showrooms, with a complete experience from high-tech design through to instant delivery. Combining furniture with the internet is likely to prove a source of competitive advantage for Koala into the future.[19] The stronger such organisations' core competencies, the greater the amount of value they are able to create for their customers.[20]

Ultimately, creating value for customers is the source of above-average returns for an organisation. What the organisation intends regarding value creation affects its choice of business-level strategy (see Chapter 4) and its organisational structure (see Chapter 11).[21] In the discussion of business-level strategies in Chapter 4, we note that value is created by a product's low cost, by its highly differentiated features or by a combination of low cost and high differentiation, compared with competitors' offerings. A business-level strategy is effective only when it is grounded in exploiting the organisation's capabilities and core competencies. Thus, the successful organisation continuously examines the effectiveness of current capabilities and core competencies while thinking about the capabilities and competencies it will require for future success.[22]

At one time, the organisation's efforts to create value were largely oriented to understanding the characteristics of the industry in which it competed and, in light of those characteristics, determining how it should be positioned relative to competitors. This emphasis on industry characteristics and competitive strategy underestimated the role of the organisation's resources and capabilities in developing core competencies as the source of competitive advantages. In fact, core competencies, in combination with product-market positions, are the organisation's most important sources of competitive advantage.[23] An organisation's core competencies, integrated with an understanding of the results of studying the conditions in the external environment, should drive the selection of strategies.[24] As Clayton Christensen noted, 'Successful strategists need to cultivate a deep understanding of the processes of competition and progress and of the factors that undergird each advantage. Only thus will they be able to see when old advantages are poised to disappear and how new advantages can be built in their stead'.[25] By emphasising core competencies when selecting and implementing strategies, companies learn to compete primarily on the basis of organisation-specific differences. However, while doing so, they must be simultaneously aware of how things are changing in the external environment.[26]

## The challenge of analysing the internal organisation

The strategic decisions managers make about their organisation's internal organisation are non-routine,[27] have ethical implications[28] and significantly influence the organisation's ability to earn above-average returns.[29] These decisions involve choices about the resources the organisation needs to collect and how to best manage them.

Making decisions involving the organisation's assets – identifying, developing, deploying and protecting resources, capabilities and core competencies – may appear to be relatively easy. However, this task is as challenging and difficult as any other with which managers are involved; moreover, it is a task that is being increasingly internationalised.[30] Some believe that the pressure on managers to pursue only decisions that assist the organisation meet the quarterly earnings expected by market analysts makes it difficult to accurately examine the organisation's internal organisation.[31]

The challenge and difficulty of making effective decisions is implied by preliminary evidence suggesting that one-half of organisational decisions fail.[32] Sometimes, mistakes are made as the organisation analyses conditions in its internal organisation.[33] Managers might, for example, think a capability is a core competence when it is not. This may have been the case at Polaroid Corporation when decision makers continued to believe that the capabilities it used to build its instant film cameras were highly relevant at the time its competitors were developing and using the capabilities required to introduce digital cameras. In this instance, Polaroid's decision makers may have concluded that superior manufacturing was a core competence, as was the organisation's


At one time, Polaroid's cameras created a significant amount of value for customers. Poor decisions may have contributed to the organisation's subsequent inability to create value and its initial filing for bankruptcy in 2001.

Source: Getty Images/claudio.arnese

ability to innovate in terms of creating value-adding features for its instant cameras. If a mistake is made when analysing and managing an organisation's resources, such as appears to have been the case at Polaroid, decision makers must have the confidence to admit it and take corrective actions.[34]

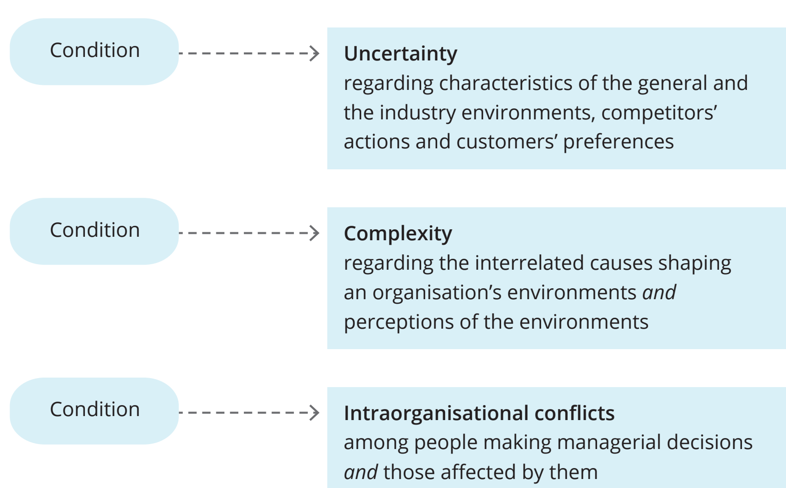
An organisation may improve by studying its mistakes; in fact, the learning generated by making and correcting mistakes can be important to efforts to create new capabilities and core competencies.[35] A study by the Australian Centre for Business Growth, which examined the failure of Australian business leaders, linked lack of leadership and management, lack of planning and execution as the key reasons.[36]

As we discuss next, three conditions – uncertainty, complexity and intra-organisational conflict – affect managers as they analyse the internal organisation and make decisions about resources (see Figure 3.2).[37]

Managers face uncertainty because of a number of issues, including those of new proprietary technologies, rapidly changing economic environments such as those experienced during the Covid-19 pandemic, and political trends, transformations in societal values and shifts in customers' demands.[38] Environmental uncertainty increases the complexity and range of issues to examine when studying the internal environment.[39] For example, consider the way uncertainty affects how to use resources at Peabody.

Peabody is the world's largest private-sector coal company listed on the New York Stock Exchange. The organisation's coal products fuel approximately 11 per cent of all US electricity generation and 2 per cent of worldwide electricity. It conducts its operations in both the USA and Australia and has over 6600 employees across its global operations. Its mission is to create superior value for shareholders as the leading global supplier of coal to enable economic prosperity and a better quality of life. However, in 2011, the organisation faced a loss in market share to companies operating cost-efficient surface mining operations. Today it still continues to face a great deal of uncertainty with respect to how it might best use its resources to prepare for the future. One reason for

**Figure 3.2** **Conditions affecting managerial decisions about resources, capabilities and core competencies**




Source: Adapted from R. Amit & P. J. H. Schoemaker, 1993, Strategic assets and organizational rent, *Strategic Management Journal*, 14: 33.

this is that, for many, coal is thought of as a 'dirty fuel'. Partly to reduce the uncertainty the organisation faces because of this, Peabody is using some of its resources to build a 'clean' coal-fired plant and has signed two agreements to develop clean coal in China (where air purity is a hot topic). As a proponent of strong emissions standards, Peabody's leaders argue for more use of 'clean coal'. One of these agreements calls for Peabody and its partners to develop a green coal energy campus, including a 1200-megawatt power plant that will capture carbon dioxide and convert it into green building materials.[40] The complexity of the decisions Peabody is making to reduce uncertainty (such as working with partners in China) is quite significant. In 2016, Peabody experienced greater uncertainty when it filed for Chapter 11 bankruptcy protection. A year later, the organisation had recovered from bankruptcy and started to trade on the New York Stock Exchange in 2017. Peabody was ranked number 582 on the Fortune 500 list released in 2020.[41]

Biases about how to cope with uncertainty affect decisions made about how to manage the organisation's resources and capabilities to form core competencies.[42] For example, Peabody's CEO strongly believes in coal's future, suggesting that automobiles capable of burning coal could be built. Finally, intra-organisational conflict may surface when decisions are made about the core competencies an organisation should develop and nurture. Conflict might surface in Peabody about the degree to which resources and capabilities should be used to form core competencies to support current coal technologies relative to the building of core competencies to support newer 'clean technologies'.

Environmental uncertainty (including the Covid-19 pandemic) increases the complexity and range of issues to examine when studying the internal environment. The pandemic current forecast for the last quarter of 2020 includes a 13–32 per cent decline in merchandise trade, a 30–40 per cent decrease in foreign direct investment and an 80 per cent drop in international airline passengers in 2020. It is forecast also that trade flows will undo globalisation future considerations, including researching global growth patterns, supply chain examinations and technological shifts.[43] In making decisions affected by these three conditions, judgement is required. Judgement is the capability of making successful decisions when no obviously correct model or rule is available or when relevant data are unreliable or incomplete. In such situations, decision makers must be aware of possible cognitive biases, such as overconfidence. Individuals who are too confident in the decisions they make about how to use the organisation's resources may fail to fully evaluate contingencies that could affect those decisions.[44]

When exercising judgement, decision makers often take intelligent risks. In the current competitive landscape, executive judgement can become a valuable capability. One reason is that, over time, effective judgement allows an organisation to build a strong reputation and retain the loyalty of stakeholders whose support is linked to above-average returns.[45]

Finding individuals who can make the most successful decisions about using the organisation's resources is challenging. Being able to do this is important because the quality of leaders' decisions regarding resources and their management affect an organisation's ability to achieve strategic competitiveness. Individuals holding these key decision-making positions are called strategic leaders. This is discussed fully in Chapter 12, but for our purposes in this chapter we can think of strategic leaders as individuals with an ability to make effective decisions when examining the organisation's resources, capabilities and core competencies for the purpose of making choices about their use.

Next, we consider the relationships among an organisation's resources, capabilities and core competencies. While reading these sections, keep in mind that organisations have more resources than capabilities, and more capabilities than core competencies.

# Resources, capabilities and core competencies

Resources, capabilities and core competencies are the foundation of competitive advantage. Resources are bundled to create organisational capabilities. In turn, capabilities are the source of an organisation's core

**Strategic focus | General**

### Tangible and intangible resources as the base for core competencies

While tangible resources are important, intangible resources are perhaps even more important in the development of an organisation's core competencies. Understandably, most professional service organisations have few tangible resources, but they can have high market value primarily because of their intangible resources. For example, Herbert Smith Freehills is a premier commercial law firm located in Melbourne, Australia, and is one of the world's leading professional service businesses. Its aim is to provide superior legal services to its clients. Within this broad framework, however, there is a core competence. The organisation provides legal advice and support for commercial business, and corporate transactions for large institutions, high-net-worth individuals and privately owned businesses. For example, in 2019 it provided the legal services to represent AustralianSuper on its US$1 billion investment in India's national investment and infrastructure fund. This complex transaction required lengthy negotiations with a multi-level corporate legal team.

It is important to note that organisations' reputations are often significant intangible assets; for example, professional service organisations must be considered not only highly knowledgeable in the areas in which they compete, but also must be considered honest and highly trustworthy. Organisations can also enhance intangible assets, such as their reputation, through use of their core competencies. For example, in the aftermath of the Australian bushfires in 2019–20, Andrew 'Twiggy' Forrest pledged A$70 million to bushfire recovery efforts and stated that leading by example is more important than preaching to people. Other significant contributors to the bushfire recovery included NewsCorp, Crown, National Australia Bank, Earth Alliance, the Australian Football League and BHP. Such contributions assist organisations in strengthening their local brand and demonstrate that they are practising corporate social responsibility within their community.

Generous corporate philanthropy benefits Australian bushfire victims.

Source: AAP Image/Richard Wainwright

Sources: Herbert Smith Freehills, 2020, Herbert Smith Freehills named as one of the top international law firms for India for India-related work for the 12th consecutive year, http://www.Herbertsmithfreehills.com, 27 August; D. Taylor & L. Mottram, 2020, Australian bushfire donations from big business worth millions but charities warn long term assistance needed, *ABC News online*, PM, 10 January, updated 11 January.

competencies, which are the basis of establishing competitive advantages.[46] We show these relationships in Figure 3.1. Here, we define and provide examples of these building blocks of competitive advantage.

## Resources

Broad in scope, resources cover a spectrum of individual, social and organisational phenomena.[47] By themselves, resources do not allow organisations to create value for customers as the foundation for earning above-average returns. Indeed, resources are combined to form capabilities.[48] The fast-food company Subway links its fresh ingredients with several other resources, including the continuous training it provides to those running the organisation's units, as the foundation for customer service as a capability. As its sole distribution channel, the internet is a resource for Amazon. The organisation uses the internet to sell goods at prices that typically are lower than those offered by competitors selling the same goods through what are more costly bricks-and-mortar shopfronts. By combining other resources (such as access to a wide product inventory), Amazon has developed a reputation for excellent customer service. Amazon's capability in terms of customer service is a core competence as well, in that the organisation creates unique value for customers through the services it provides to them. Amazon was ranked in 2020 as being in the top five recognisable brands globally. The brand itself has become a core competency. Amazon also uses its technological core competence to offer AWS (Amazon Web Services), through which businesses can rent computing power from Amazon at a cost of cents per hour. In the words of the leader of this effort, 'AWS makes it possible for anyone with an internet connection and a credit card to access the same kind of world-class computing systems that Amazon uses to run its multi-billion-a-year operation'.[49] In January 2020, Amazon reported a profit of US$87.4 billion in the fourth quarter 2019, and a net income of US$3 billion. AWS was up 34 per cent, and subscriptions had increased 32 per cent.[50]

Some of an organisation's resources (defined in Chapter 1 as inputs to the organisation's production process) are tangible, while others are intangible. **Tangible resources** are assets that can be observed and quantified. Production equipment, manufacturing facilities, distribution centres and formal reporting structures are examples of tangible resources; for example, Peabody's factories, location and coal are tangible resources. **Intangible resources** are assets that are rooted deeply in the organisation's history and have accumulated over time. Because they are embedded in unique patterns of routines, intangible resources are difficult for competitors to analyse and imitate. Knowledge, trust between managers and employees, managerial capabilities, organisational routines (the unique ways people work together), scientific capabilities, the capacity for innovation, brand name, the organisation's reputation for its goods or services, how it interacts with people (such as employees, customers and suppliers) and organisational culture are intangible resources.[51] The reputation for reliability of Amazon or Apple is an example of an intangible resource. The four primary categories of tangible resources are financial, organisational, physical and technological (see Table 3.1). The three primary categories of intangible resources are human, innovation and reputational (see Table 3.2).

**tangible resources**
assets that can be seen and quantified

**intangible resources**
assets that generally are rooted deeply in the organisation's history and have accumulated over time

**Table 3.1 Tangible resources**

| | |
|---|---|
| Financial resources | • The organisation's capacity to borrow<br>• The organisation's ability to generate funds through internal operations |
| Organisational resources | • Formal reporting structures |
| Physical resources | • The sophistication of an organisation's plant and equipment and the attractiveness of its location<br>• Distribution facilities<br>• Product inventory |
| Technological resources | • Availability of technology-related resources such as trade secrets |

Sources: Adapted from J. B. Barney, 1991, Firm resources and sustained competitive advantage, *Journal of Management*, 17: 101; R. M. Grant, 1991, *Contemporary Strategy Analysis*, Cambridge, UK: Blackwell Business, 100–2.

**Table 3.2 Intangible resources**

| | |
|---|---|
| Human resources | • Knowledge<br>• Trust<br>• Skills<br>• Abilities to collaborate with others |
| Innovation resources | • Ideas<br>• Scientific capabilities<br>• Capacity to innovate |
| Reputational resources | • Brand name<br>• Perceptions of product quality, durability and reliability<br>• Positive reputation with stakeholders such as suppliers and customers |

Sources: Adapted from R. Hall, 1992, The strategic analysis of intangible resources, *Strategic Management Journal*, 13: 136–9; R. M. Grant, 1991,*Contemporary Strategy Analysis*, Cambridge, UK: Blackwell Business, 101–4.

## Tangible resources

As tangible resources, an organisation's borrowing capacity and the status of its physical facilities are visible. The value of many tangible resources can be established through financial statements; however, these statements do not account for the value of all the organisation's assets because they disregard some intangible resources.[52] The value of tangible resources is also constrained because they are hard to leverage; that is, it is difficult to derive additional business or value from a tangible resource.

Although production assets are tangible, many of the processes necessary to use these assets, such as human capital, are intangible. Thus, the learning and potential proprietary processes associated with a tangible resource, such as manufacturing facilities, can have unique intangible attributes, such as quality control processes, manufacturing processes and technologies that develop over time.[53]

## Intangible resources

Compared to tangible resources, intangible resources are a superior source of capabilities and, subsequently, core competencies.[54] In fact, in the global economy, 'the success of a corporation lies more in its intellectual and systems capabilities than in its physical assets. [Moreover], the capacity to manage human intellect – and to convert it into useful products and services – is fast becoming the critical executive skill of the age'.[55]

Because intangible resources are less visible and more difficult for competitors to understand, purchase, imitate or substitute for, organisations prefer to rely on them rather than on tangible resources as the foundation for their capabilities. In fact, the more unobservable (i.e. intangible) a resource is, the more valuable that resource is to create capabilities.[56] Another benefit of intangible resources is that, unlike most tangible resources, their use can be leveraged. For instance, sharing knowledge among employees does not diminish its value for any one person. To the contrary, two people sharing their individualised knowledge sets often can be leveraged to create additional knowledge that, although new to each individual, contributes to performance improvements for the organisation.

Reputational resources (see Table 3.2) are important sources of an organisation's capabilities and core competencies. Indeed, some argue that a positive reputation can even be a source of competitive advantage, as it is for Apple.[57] Earned through the organisation's actions as well as its words, a value-creating reputation is a product of years of superior marketplace competence as perceived by stakeholders.[58] A reputation indicates the level of awareness an organisation has been able to develop among stakeholders and the degree to which they hold the organisation in high esteem.[59]

A well-known and highly valued brand name is a specific reputational resource.[60] A continuing commitment to innovation and aggressive advertising facilitates organisations' efforts to take advantage of the reputation associated with their brands.[61] Harley-Davidson has a reputation for producing and servicing high-quality motorcycles with unique designs. The company also produces a wide range of accessory items that it sells on the basis of its reputation for offering unique products with high quality. Sunglasses, jewellery, belts, wallets, shirts, slacks and hats are just a few of the accessories customers can purchase from a Harley-Davidson dealer or from its online store.[62]

## Capabilities

The organisation combines individual tangible and intangible resources to create capabilities. In turn, capabilities are used to complete the organisational tasks required to produce, distribute and service the goods or services the organisation provides to customers for the purpose of creating value for them.[63] As a foundation for building core competencies and hopefully competitive advantages, capabilities are often based on developing, carrying and exchanging information and knowledge through the organisation's human capital.[64] Hence, the value of human capital in developing and using capabilities and, ultimately, core competencies cannot be overstated.[65] In fact, it seems to be 'well known that human capital makes or breaks companies'.[66] At pizza-maker Domino's, human capital is critical to the organisation's efforts to change how it competes. Describing this, CEO Patrick Doyle says that, in many ways, Domino's is becoming 'a tech company … that sell pizzas'.[67]

As illustrated in Table 3.3, capabilities are often developed in specific functional areas (such as manufacturing, R&D and marketing) or in a part of a functional area (such as advertising). Table 3.3 shows a grouping of organisational functions and the capabilities that some companies are thought to possess in terms of all or parts of those functions.

## Core competencies

Defined in Chapter 1, core competencies are capabilities that serve as a source of competitive advantage for an organisation over its rivals. Core competencies distinguish a company competitively and reflect its personality. Core competencies emerge over time through an organisational process of accumulating and learning how to deploy different resources and capabilities.[68] As the capacity to take action, core competencies are the 'crown jewels of a company', the activities the organisation performs especially well compared with competitors and through which the organisation adds unique value to the goods or services it sells to customers.[69] Thus, if a big pharma company (such as Pfizer) developed big data analytics as a core competence, one could conclude that the organisation had formed capabilities through which it was able to analyse and effectively use huge amounts of data in a competitively superior manner.

Innovation is thought to be a core competence at Apple, Google, Facebook, Amazon, Alphabet and Netflix. As a capability, research and development (R&D) activities are the source of this core competence. More specifically, the way Apple has combined some of its tangible (e.g. financial resources and research laboratories) and intangible (e.g. scientists and engineers and organisational routines) resources to complete R&D tasks creates a capability in R&D. By emphasising its R&D capability, Apple is able to innovate in ways that create unique value for customers in the form of the products it sells, suggesting that innovation is a core competence for Apple.

Excellent customer service in its retail stores is another of Apple's core competencies. In this instance, unique and contemporary store designs (a tangible resource) are combined with knowledgeable and skilled employees (an intangible resource) to provide superior service to customers. A number of carefully developed training and development procedures are capabilities on which Apple's core competence of excellent customer service is based. The procedures that are capabilities include 'intensive control of how employees interact with customers, scripted training for on-site tech support and consideration of every store detail down to the pre-loaded photos and music on demo devices'.[70]

**Table 3.3 Examples of organisations' capabilities**

| Functional areas | Capabilities | Examples of organisations |
|---|---|---|
| Distribution | • Effective use of logistics management techniques | • Woolworths<br>• IKEA |
| Human resources | • Motivating, empowering and retaining employees | • Microsoft<br>• Southwest Airlines |
| Management information systems | • Effective and efficient control of inventories through point-of-purchase data-collection methods | • Coles |
| Marketing | • Effective promotion of brand-name products<br>• Effective customer service<br>• Innovative merchandising | • Procter & Gamble (P&G)<br>• Ralph Lauren Corp.<br>• McKinsey & Co.<br>• RM Williams |
| Management | • Ability to envision the future of clothing | • Zara |
| Manufacturing | • Design and production skills yielding reliable products<br>• Product and design quality<br>• Miniaturisation of components and products | • Komatsu<br>• Sony |
| Research and development | • Innovative technology<br>• Development of sophisticated lift-control solutions<br>• Rapid transformation of technology into new products and processes<br>• Digital technology | • Caterpillar<br>• Otis Elevator Co.<br>• Cochlear<br>• Apple<br>• Amazon<br>• Netflix<br>• Google<br>• Alphabet<br>• Facebook |

Consumer products giant P&G sells branded products that it values as superior quality and value to customers located in more than 180 countries and generating billions of dollars in annual sales revenue. Net sales in the third quarter of the 2020 fiscal year were US$17.2 billion, up 5 per cent compared with the previous year. While its Beauty and Grooming segments only increased nominally, its Skin and Personal Health Care, Fabric Care and Home Care segments increased by 10 per cent for the quarter.[71] P&G has numerous tangible and intangible resources that are used to form capabilities, some of which are core competencies. Interestingly, even in light of its size and scale (in terms of the number of products sold and the organisation's encompassing geographic reach), P&G has perhaps five core competencies (labelled core strengths by the organisation).

# Building core competencies

Two tools assist organisations to identify their core competencies. The first consists of four specific criteria of sustainable competitive advantage that can be used to determine which capabilities are core competencies. Because the capabilities shown in Table 3.3 have satisfied these four criteria, they are

**Strategic focus** | General

## Procter & Gamble: using capabilities and core competencies to create value for customers

Guided by its slogan of 'Touching lives, improving life', P&G is known throughout the world for its stable of consumer brands. Organised within 10 global business categories (Skin and Personal Health Care), Fabric Care and Home Care, Grooming, Beauty, Hair Care, Baby and Feminine Care, Oral Care and Family Care are just a few of the categories. Eight of the 10 global categories held or experienced growth in 2019.

The organisation has 97 000 employees (compared with 135 000 in 2007); a whopping 3500 products produced in 25 manufacturing plants predominantly located in the US and 14 customer business centres; and it has grown its customer base to five billion, with its largest brand reportedly being Pantene hair care products.

How have these achievements been realised? According to company officials and analysts, in part it was done through plans to move quickly and broadly into developing countries such as China and India, and to produce products that would appeal to new but lower-income customers. Of course, efforts simultaneously continued to satisfy the needs of P&G's huge stable of current customers. These actions appear to support the view that P&G is an effective competitor that continuously seeks growth through its competitive actions.

P&G relies on its capabilities and core competencies to satisfy current customers and to develop products to serve the needs of new customers. Typically, P&G likes to use its capabilities and competencies to grow organically rather than through mergers and acquisitions or through cooperative relationships. In the words of a previous P&G CEO: 'Organic growth is more valuable because it comes from your core competencies. Organic growth exercises your innovation muscle. If you use it, it gets stronger'. The company does spend a lot on the bases for competencies. For example, it claims 'consumer understanding', based not only on its history but also on 20 000 studies of consumers each year. Cutting-edge technology, supply chain management skills, marketing and advertising expertise, a broad product portfolio, and R&D skills with respect to fats, oils, skin chemistry, surfactants and emulsifiers, are a few of P&G's highly regarded capabilities. All of these capabilities, which result from combinations of the organisation's tangible and intangible resources, allow P&G to perform tasks that must be completed to produce, sell, distribute and service its branded products.

Taking this a step further, we discover that these capabilities contribute to the organisation's five core competencies (called core strengths by P&G). For example, R&D capabilities are foundational to P&G's innovation and are a core competence. Similarly, the organisation's marketing and advertising skills contribute to its consumer understanding and brand-building core competencies. The supply chain management capability is critical to the go-to-market core competence (a competence through which P&G 'reaches retailers and consumers at the right place and time') and to the scale competence (a competence allowing P&G to be efficient and to create value for customers as a result). Thus, we see how some of P&G's capabilities are linked to one or more of the organisation's five core competencies. From an operational perspective, these core competencies are activities P&G performs especially well relative to competitors and through which the organisation is able to create unique value for customers.

Sources: Procter & Gamble, 2019, *P&G 2019 Annual Report*, http://pg.com; M. Shahbandeh, 2019, Procter & Gamble – Statistics & Facts, Statista, 23 October; P&G, 2018, http://www.Pglocations.com; Statista, 2015, Total number of employees of Procter & Gamble worldwide from 2007 to 2015 (in thousands), http://www.statista.com/statistics/244037/total-number-of-employees-of-procter-und-gamble-worldwide; P&G, 2015, Core strengths, https://www.pg.com/en_ANZ/company/core-strengths.shtml; E. Byron, 2011, P&G turns Febreze into a $1 billion brand, *Wall Street Journal*, http://www.wsj.com, 8 March; A. K. Reese, 2011, Planning to succeed at Procter & Gamble, *Supply & Demand Chain Executive*, http://www.sdcexe.com, 12 January; Reuters, 2011, Energizer to shut two international battery plants, http://www.fidelity.com, 9 March; Procter & Gamble, 2011, P&G core strengths, http://www.p&g.com, 6 June; *Standard & Poor's Stock Report*, 2011, Procter & Gamble Co., http://www.standardandpoors.com, 11 June; Treflis, 2011, P&G's strategy to win market share to pay off, http://www.treflis.com, 12 January; B. Horovitz, 2010, Procter & Gamble looks beyond US borders, *USA Today*, http://www.usatoday.com, 19 March.

core competencies. The second tool is the value chain analysis. Organisations use this tool to select the value-creating competencies that should be maintained, upgraded or developed, and those that should be outsourced.

## The four criteria of sustainable competitive advantage

Capabilities that are valuable, rare, costly to imitate and non-substitutable are core competencies (see Table 3.4). In turn, core competencies can lead to competitive advantages for the organisation over its rivals. Capabilities failing to satisfy the four criteria are not core competencies, meaning that although every core competence is a capability, not every capability is a core competence. In other words, for a capability to be a core competence, it must be valuable and unique from a customer's point of view. For a core competence to be a potential source of competitive advantage, it must be inimitable and non-substitutable by competitors.[72]

**Table 3.4 The four criteria of sustainable competitive advantage**

| | |
|---|---|
| Valuable capabilities | • Assist an organisation to neutralise threats or exploit opportunities |
| Rare capabilities | • Are not possessed by many others |
| Costly-to-imitate capabilities | • Historical: a unique and valuable organisational culture or brand name<br>• Ambiguous cause: the causes and uses of a competence are unclear<br>• Social complexity: interpersonal relationships, trust and friendship among managers, suppliers and customers |
| Non-substitutable capabilities | • No strategic equivalent |

A sustainable competitive advantage exists only when competitors cannot duplicate the benefits of an organisation's strategy or when they lack the resources to attempt imitation. For some period of time, the organisation may have a core competence by using capabilities that are valuable and rare but imitable. For example, some organisations are trying to develop a core competence and potentially a competitive advantage by out-greening their competitors.

Interestingly, developing a 'green' core competence can contribute to the organisation's efforts to earn above-average returns while benefiting the broader society. For example, Qantas Group is committed to minimising its impact on the environment by sustainable aviation through emissions and waste reduction initiatives. A strong initiative includes removing 100 million single-use plastics from Qantas operations by the end of 2020.[73]

### Valuable

**valuable capabilities** allow the organisation to exploit opportunities or neutralise threats in its external environment

**Valuable capabilities** allow an organisation to exploit opportunities or neutralise threats in its external environment. By effectively using capabilities to exploit opportunities or neutralise threats, an organisation creates value for customers. For publishers, e-books are both an opportunity (to sell books through different distribution channels) and a major threat (a reduction in publishers' ability to sell books through traditional channels, such as physical shopfronts). To neutralise the possibility or threat of lower sales revenue from traditional channels, publishers such as Penguin Group are trying to determine how to take advantage of the opportunities digital technologies create to transform their businesses. In partnership with other companies, Penguin sees using the internet to sell directly to customers as an opportunity to create value for customers. Revenue in its e-books segment was projected to amount to US$15 635 million in 2021 with 1019 million users.[74] Forbes, BBC and Fortune have all noted a massive boom in e-books and reading apps readers as a result of the Covid-19 lockdowns.[75] Amazon is considered a major threat to other booksellers by some in both the digital and print worlds, and in December 2019 it was reported that Amazon had 42 per cent of the US print book market and at least 80 per cent of the publishers' e-book sales.[76] It also owns Book Depository, the UK online bookseller that operates a system with free postage for all books.[77]

## Rare

**Rare capabilities** are capabilities that few, if any, competitors possess. A key question to be answered when evaluating this criterion is: 'How many rival organisation possess these valuable capabilities?' Capabilities possessed by many rivals are unlikely to become core competencies for any of the involved organisations. Instead, valuable albeit common (i.e. not rare) capabilities are sources of competitive parity.[78] Competitive advantage results only when organisations develop and exploit valuable capabilities that become core competencies and that differ from those shared with competitors. For example, Qantas' safety record is considered a core competency that can be differentiated from competitors such as Malaysian Airlines.

**rare capabilities**
capabilities that few, if any, competitors possess

## Costly to imitate

**Costly-to-imitate capabilities** are capabilities that other organisations cannot easily develop. Capabilities that are costly to imitate are created because of one reason or a combination of three reasons (see Table 3.4). First, an organisation sometimes is able to develop capabilities because of unique historical conditions. As organisations evolve, they often acquire or develop capabilities that are unique to them.[79]

**costly-to-imitate capabilities**
capabilities that another organisation cannot easily develop

An organisation with a unique and valuable organisational culture that emerged in the early stages of the company's history 'may have an imperfectly imitable advantage over firms founded in another historical period'[80] – one in which less valuable or less competitively useful values and beliefs strongly influenced the development of the organisation's culture. Briefly discussed in Chapter 1, organisational culture is a set of values that is shared by members in the organisation. We explain this in greater detail in Chapter 12. An organisational culture is a source of advantage when employees are held together tightly by their belief in it.[81] With its emphasis on cleanliness, consistency and service, and the training that reinforces the value of these characteristics, the McDonald's culture is thought by some to be a core competence and a competitive advantage. Equally, Southwest Airlines' culture in the US is considered a core competency.[82] The same seems to be the case for Natio, the Australian cosmetics company. It uses 'pure and natural, plant-based' ingredients, and the founders base the growing range of products on insight developed through yoga and meditation. It is one of the fastest-growing brands in the industry and sells in top-end department stores and chemists.[83]

A second condition of being costly to imitate occurs when the link between the organisation's core competencies and its competitive advantage is causally ambiguous.[84] In these instances, competitors cannot clearly understand how an organisation uses its capabilities that are core competencies as the foundation for competitive advantage. As a result, organisations are uncertain about the capabilities they should develop to duplicate the benefits of a competitor's value-creating strategy. For years, organisations tried to imitate Southwest Airlines' low-cost strategy, but most have been unable to do so, primarily because they cannot duplicate this organisation's unique culture. In the same way, the apparent simple success of The Body Shop with environmentally sensitive cosmetics has not been fully imitated, despite several attempts by global organisations.

Social complexity is the third reason that capabilities can be costly to imitate. Social complexity means that at least some, and frequently many, of the organisation's capabilities are the product of complex social phenomena. Interpersonal relationships, trust, friendships among managers and between managers and employees, and an organisation's reputation with suppliers and customers are examples of socially complex capabilities. Southwest Airlines is careful to hire people who fit or align with its culture. This complex interrelationship between the culture and human capital adds value in ways that other airlines cannot match, such as jokes on flights by the flight attendants or the cooperation between gate personnel and pilots.

## Non-substitutable

**non-substitutable capabilities**
capabilities that do not have strategic equivalents

**Non-substitutable capabilities** are capabilities that do not have strategic equivalents. This final criterion 'is that there must be no strategically equivalent valuable resources that are themselves either not rare or imitable. Two valuable firm resources (or two bundles of firm resources) are strategically equivalent when they each can be separately exploited to implement the same strategies'.[85] In general, the strategic value of capabilities increases as they become more difficult to substitute. The more intangible and hence invisible capabilities are, the more difficult it is for organisations to find substitutes and the greater the challenge there is for competitors trying to imitate an organisation's value-creating strategy. Organisation-specific knowledge and trust-based working relationships between managers and non-managerial personnel are examples of capabilities that are difficult to identify and for which finding a substitute is challenging. However, causal ambiguity may make it difficult for the organisation to learn as well and may stifle progress, because the organisation may not know how to improve processes that are not easily codified and thus are ambiguous.[86]

In summary, only using valuable, rare, costly-to-imitate and non-substitutable capabilities has the potential for the organisation to create sustainable competitive advantages. Table 3.5 shows the competitive consequences and performance implications resulting from combinations of the four criteria of sustainability. The analysis suggested by the table helps managers to determine the strategic value of an organisation's capabilities. The organisation should not emphasise capabilities that fit the criteria described in the first row in the table (i.e. resources and capabilities that are neither valuable nor rare and that are imitable and for which strategic substitutes exist). Capabilities yielding competitive parity and either temporary or sustainable competitive advantage, however, will be supported. Some competitors, such as Coca-Cola and PepsiCo, and Boeing and Airbus, may have capabilities that result in competitive parity. In such cases, the organisations will nurture these capabilities while simultaneously trying to develop capabilities that can yield either a temporary or sustainable competitive advantage.

**Table 3.5** **Outcomes from combinations of the criteria for sustainable competitive advantage**

| Is the capability valuable? | Is the capability rare? | Is the capability costly to imitate? | Is the capability non-substitutable? | Competitive consequences | Performance implications |
|---|---|---|---|---|---|
| No | No | No | No | Competitive disadvantage | Below-average returns |
| Yes | No | No | Yes/no | Competitive parity | Average returns |
| Yes | Yes | No | Yes/no | Temporary competitive advantage | Average returns to above-average returns |
| Yes | Yes | Yes | Yes/no | Sustainable competitive advantage | Above-average returns |

## Value chain analysis

Value chain analysis allows the organisation to understand the parts of its operations that create value and those that do not.[87] Understanding these issues is important because the organisation earns above-average returns only when the value it creates is greater than the costs incurred to create that value.[88]

The value chain is a template that organisations use to analyse their cost position and to identify the multiple means that can be used to facilitate implementation of a chosen strategy.[89] Today's competitive landscape demands that organisations examine their value chains in a global rather than a domestic-only context. In particular, activities associated with supply chains should be studied within a global context.[90]

We show a model of the value chain in Figure 3.3. As depicted in the model, an organisation's value chain is segmented into **value chain activities** and **support functions**. Value chain activities are activities or tasks the organisation completes in order to produce products and then sell, distribute and service those products in ways that create value for customers. Support functions include the activities or tasks the organisation completes in order to support the work being done to produce, sell, distribute and service the products the organisation is producing. An organisation may develop a capability and/or a core competence in any of the value chain activities and in any of the support functions. When it does so, it has established an ability to create value for customers. In fact, as shown in Figure 3.3, customers are the ones organisations seek to serve when using value chain analysis to identify their capabilities and core competencies. When using their unique core competencies to create unique value for customers that competitors cannot duplicate, organisations have established one or more competitive advantages. This appears to be the case for P&G as it relies on the five core competencies described earlier in the 'Strategic focus' feature to produce unique, high-quality branded products that are sold to customers throughout the world.

**value chain activities** activities or tasks the organisation completes in order to produce products and then sell, distribute and service those products in ways that create value for customers

**support functions** include the activities or tasks the organisation completes in order to support the work being done to produce, sell, distribute and service the products the organisation is producing

The activities associated with each part of the value chain are shown in Figure 3.4, while the activities that are part of the tasks organisations complete when dealing with support functions appear in Figure 3.5. All items in both figures should be evaluated relative to competitors' capabilities and core competencies. To become a core competence and a source of competitive advantage, a capability must allow the organisation to either perform an activity in a manner that provides value superior to that provided by competitors, or

**Figure 3.3** A model of the value chain

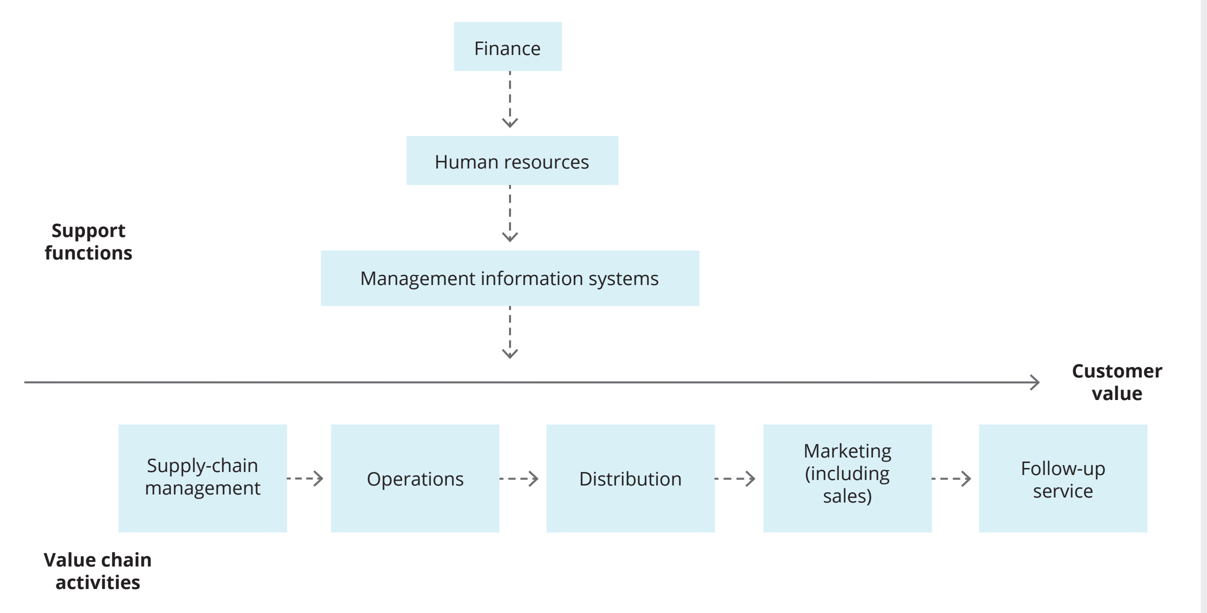
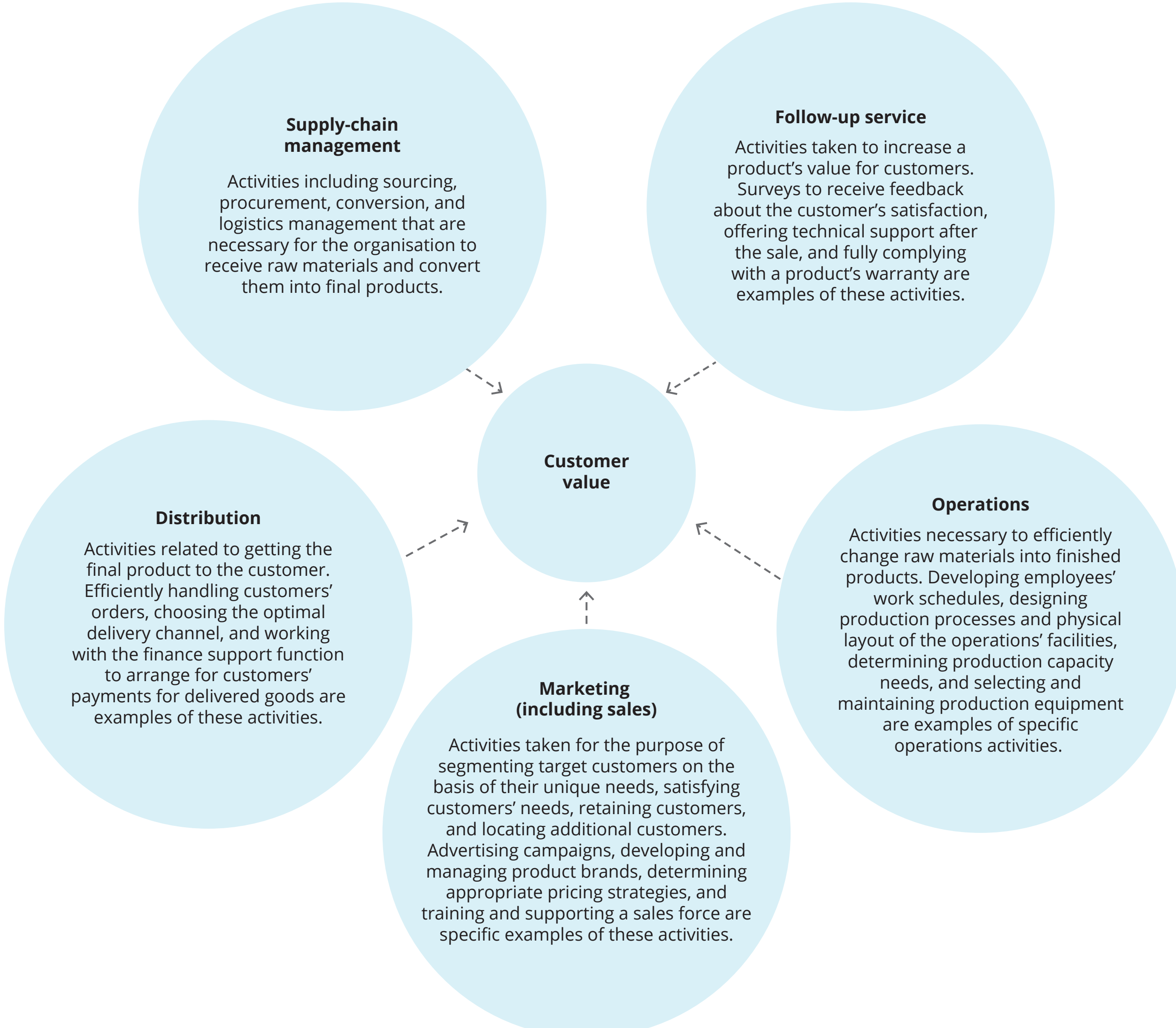


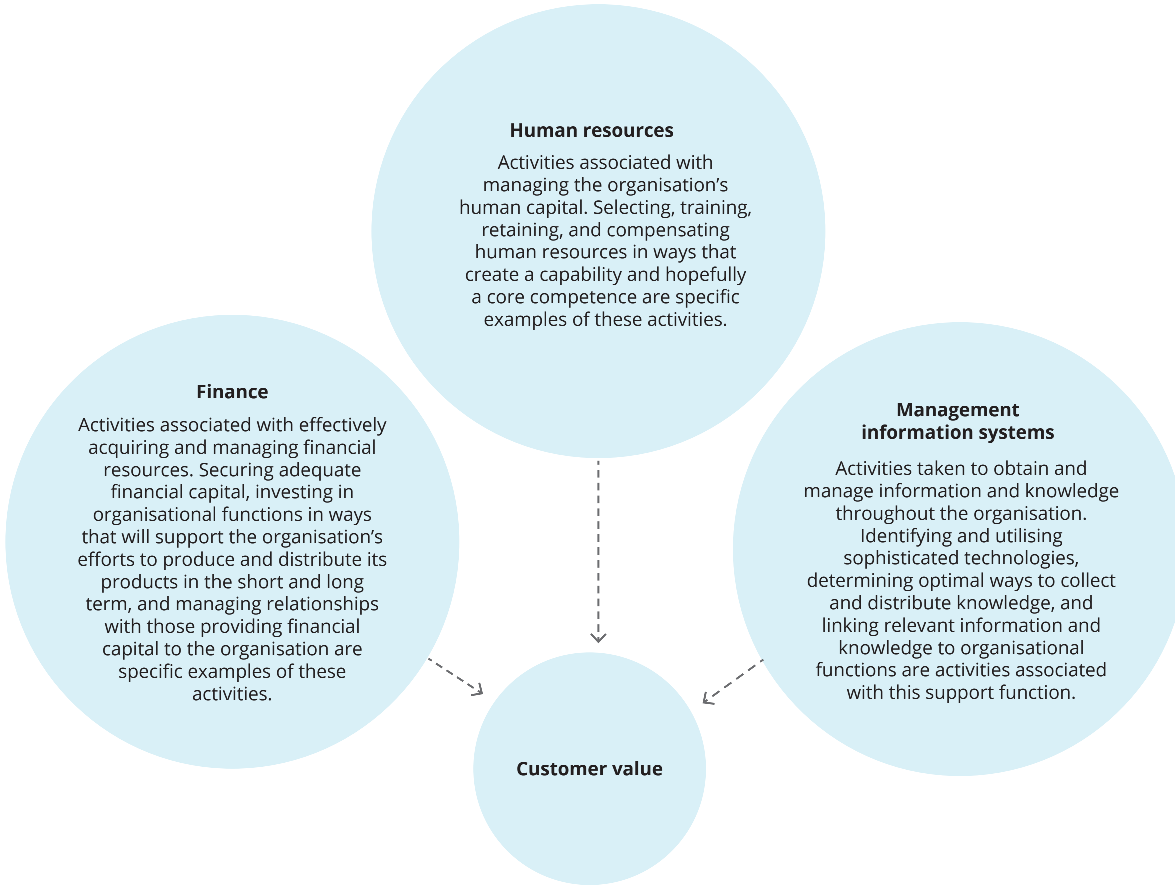
**Figure 3.4** Creating value through value chain activities




to perform a value-creating activity that competitors cannot perform. Only under these conditions does an organisation create value for customers and have opportunities to capture that value.

Creating value for customers by completing activities that are part of the value chain often requires building effective alliances with suppliers (and sometimes others to which the organisation outsources activities, as discussed in the next section) and developing strong, positive relationships with customers. When organisations have such strong, positive relationships with suppliers and customers, they are said to have 'social capital'.[91] The relationships themselves have value because they produce knowledge transfer and access to resources that an organisation may not hold internally.[92] To build social capital whereby resources such as knowledge are transferred across organisations requires trust between the parties. The partners must trust each other in order to allow their resources to be used in such a way that both parties will benefit over time and neither party will take advantage of the other.[93] Trust and social capital usually

**Figure 3.5** **Creating value through support functions**




evolve over time with repeated interactions, but organisations may also establish special means to jointly manage alliances that promote greater trust with the outcome of enhanced benefits for both partners.[94]

Evaluating an organisation's capability to execute its value chain activities and support functions is challenging. Earlier in the chapter, we noted that identifying and assessing the value of an organisation's resources and capabilities requires judgement. Judgement is equally necessary when using value chain analysis, because no obviously correct model or rule is universally available to help in the process. What should an organisation do about value chain activities and support functions in which its resources and capabilities are not a source of core competence? Outsourcing is one solution to consider.

## Outsourcing

Concerned with how components, finished goods or services will be obtained, outsourcing is the purchase of a value-creating activity or a support function activity from an external supplier.[95] Not-for-profit agencies as well as for-profit organisations actively engage in outsourcing.[96] Organisations engaging in effective outsourcing increase their flexibility, mitigate risks and reduce their capital investments.[97] In multiple global industries, the trend towards outsourcing continues at a rapid pace.[98] Moreover, in some industries, virtually all organisations seek the value that can be captured through effective outsourcing. As with other strategic management process decisions, careful analysis is required before the organisation decides to outsource.[99] And if outsourcing is to be used, organisations must recognise that only activities where they cannot create value or where they are at a substantial disadvantage compared with competitors should be outsourced.[100]

Outsourcing can be effective because few, if any, organisations possess the resources and capabilities required to achieve competitive superiority in all value chain activities and support functions. For example, research suggests that few companies can afford to develop internally all the technologies that might lead to competitive advantage.[101] By nurturing a smaller number of capabilities, an organisation increases the probability of developing core competencies and achieving a competitive advantage because it does not become overextended. In addition, by outsourcing activities in which it lacks competence, the organisation may fully concentrate on those areas in which it can create value. The consequences of outsourcing cause additional concerns.[102] For the most part, these concerns revolve around the potential loss in organisations' innovative ability and the loss of jobs within companies that decide to outsource some of their work activities to others. Thus, innovation and technological uncertainty are two important issues to consider when making outsourcing decisions. However, organisations can also learn from outsource suppliers how to increase their own innovation capabilities.[103] Companies must be aware of these issues and be prepared to fully consider the concerns about opportunities from outsourcing suggested by different stakeholders (e.g. employees). The opportunities and concerns may be especially significant when organisations outsource activities or functions to a foreign supply source (often referred to as offshoring).[104] Bangalore, Bangladesh and Belfast are hot spots for technology outsourcing, competing with major operations in other nations such as China.[105] The global pharmaceutical giant GlaxoSmithKline made a similar decision in expanding its manufacturing base in Australia, despite the high wage levels there. It reasons that the manufacturing plants are more efficient and quality control is easier in Australia.

# Competencies, strengths, weaknesses and strategic decisions

By analysing the internal organisation, organisations are able to identify their strengths and weaknesses in resources, capabilities and core competencies. For example, if an organisation has weak capabilities or does not have core competencies in areas required to achieve a competitive advantage, it must acquire those resources and build the capabilities and competencies needed. Alternatively, the organisation could decide to outsource a function or activity where it is weak in order to improve its ability to use its remaining resources to create value.[106]

In considering the results of examining the organisation's internal organisation, managers should understand that having a significant quantity of resources is not the same as having the 'right' resources. The 'right' resources are those with the potential to be formed into core competencies as the foundation for creating value for customers and developing competitive advantages as a result of so doing. Interestingly, decision makers sometimes become more focused and productive when seeking to find the right resources when the organisation's total set of resources is constrained.[107]

Tools such as outsourcing assist the organisation to focus on its core competencies as the source of its competitive advantage. However, evidence shows that the value-creating ability of core competencies should never be taken for granted. Moreover, the ability of a core competence to be a permanent competitive advantage cannot be assumed. The reason for these cautions is that all core competencies have the potential to become core rigidities.[108] Typically, events occurring in the organisation's external environment create conditions through which core competencies can become core rigidities, generating inertia and stifling innovation: 'Often the flip side, the dark side, of core capabilities is revealed due to external events when new competitors figure out a better way to serve the firm's customers, when new technologies emerge, or when political or social events shift the ground underneath'.[109]

As discussed previously, over the past decade, digital technologies (part of the organisation's external environment) have rapidly changed customers' shopping patterns for reading materials. For example, Amazon's use of the internet significantly changed the competitive landscape for bricks-and-mortar sellers such as Angus and Robertson. Managers studying the organisation's internal organisation are responsible for making certain that core competencies do not become core rigidities.

After studying its external environment to determine what it might choose to do (as explained in Chapter 2) and its internal organisation to understand what it can do (as explained in this chapter), the organisation has the information required to select a business-level strategy that it will use to compete against rivals. We describe different business-level strategies in the next chapter.

# STUDY TOOLS

## SUMMARY

**LO1** In the current competitive landscape, the most effective organisations recognise that an internal analysis is identified by studying the organisation's internal organisation and it is imperative to determine the organisational level of strength, capabilities and competencies are matched with opportunities (determined by studying the organisation's external environment).

**LO2** Value is measured by a product's performance characteristics and by its attributes for which customers are willing to pay. Even if the organisation develops and manages resources in ways that create core competencies and competitive advantages, competitors will eventually learn how to duplicate the benefits of any organisation's value-creating strategy; thus, all competitive advantages have a limited life. Because competitive advantages are not always permanently sustainable, as witnessed during the Covid-19 pandemic, organisations must exploit their current advantages while simultaneously using their resources and capabilities to form new advantages that may lead to future competitive success.

**LO3** Tangible resources are assets that may be observed and quantified. Production equipment, manufacturing facilities, distribution centres and formal reporting structures are examples of tangible resources. Intangible resources are assets that are rooted deeply in the organisation's history and have accumulated over time. The knowledge the organisation's human capital possesses is among the most significant of an organisation's capabilities and ultimately provides the base for most competitive advantages. The organisation must create an organisational culture that allows people to integrate their individual knowledge with that held by others so that, collectively, the organisation has a significant amount of value-creating organisational knowledge.

**LO4** Capabilities are a more likely source of core competence, and subsequently of competitive advantages, than are individual resources. How an organisation nurtures and supports its capabilities so they can become core competencies is less visible to rivals, making efforts to understand and imitate the focal organisation's capabilities difficult.

**LO5** Only when a capability is valuable, rare, costly to imitate and non-substitutable is it a core competence and a source of competitive advantage. Core competencies are a source of competitive advantage only when they allow the organisation to create value by exploiting opportunities in its external environment. When this is no longer possible, the organisation shifts its attention to forming other capabilities that satisfy the four criteria of a sustainable competitive advantage. Effectively managing core competencies requires careful analysis of the organisation's resources (inputs to the production process) and capabilities (resources that have been purposely integrated to achieve a specific task or set of tasks).

**LO6** Value chain analysis is used to identify and evaluate the competitive potential of resources and capabilities. By studying their skills relative to those associated with value chain activities and support functions, organisations can understand their cost structure and identify the activities through which they can create value.

## KEY TERMS

competitive advantage
core competence
costly-to-imitate capabilities
global mindset
intangible resources
non-substitutable capabilities
outsourcing
rare capabilities
strategic competitiveness
strategy
support functions
tangible resources
valuable capabilities
value
value chain activities

## REVIEW QUESTIONS

1. Why is it important for an organisation to study and understand the strengths of its internal organisation?
2. What is value? Why is it critical for the organisation to create value? How would an organisation examine its value propositions?
3. What is meant by a value chain analysis? Why is this analysis so important for managers to conduct?
4. What are the differences between tangible and intangible resources? Are tangible resources more valuable than intangible resources, or is the reverse true? Why?
5. What are capabilities? How do organisations create capabilities?
6. What four criteria must capabilities satisfy for them to become core competencies? Why is it important for organisations to use these criteria to evaluate their capabilities' value-creating potential?
7. Why do organisations need to create core competencies to be sustainable?
8. What is outsourcing? Why do organisations outsource? Will outsourcing's importance grow in the future? If so, why?
9. How do organisations identify internal strengths and weaknesses? Why is it necessary that managers have a clear understanding of their organisation's strengths and weaknesses?
10. What are core rigidities? What does it mean to say that each core competence could become a core rigidity?

## EXPERIENTIAL EXERCISES

### Exercise 1: VRIO analysis – is the organisation's advantage sustainable?

In this chapter, the concepts of sustainable competitive advantage and how organisations can use their unique bundle of resources to achieve such an advantage were introduced. Remember that a sustainable competitive advantage can only be present if competitors are unsuccessful in duplicating the organisation's benefit or the competitor is unable to acquire the resources necessary to imitate.

However, discovering if a competitive advantage is sustainable or merely temporary can be difficult for managers. According to *Business Insider's War Room* online magazine (http://www.businessinsider.com/warroom), there are six critical ingredients to achieve a sustainable competitive advantage:

1. real intellectual property
2. a dynamic rather than a single product line
3. dramatic cost-improvement capabilities
4. a proven team with inside relationships
5. a lock on the customer or market
6. strong focus and differentiation.

In your teams, prepare for class discussion an analysis of a *Fortune 500* company that your team finds interesting (the 2020 list may be viewed at http://fortune.com/fortune500). Your team should be prepared, at a minimum, to address the following issues:

1. How does the organisation describe its value proposition?
2. What are the organisation's capabilities?
3. What do you consider to be the organisation's core competencies?
4. Do you consider this organisation to possess a sustainable competitive advantage? If so, do you believe this to be sustainable in the future?
5. Categorise the organisation's performance over the past few years.

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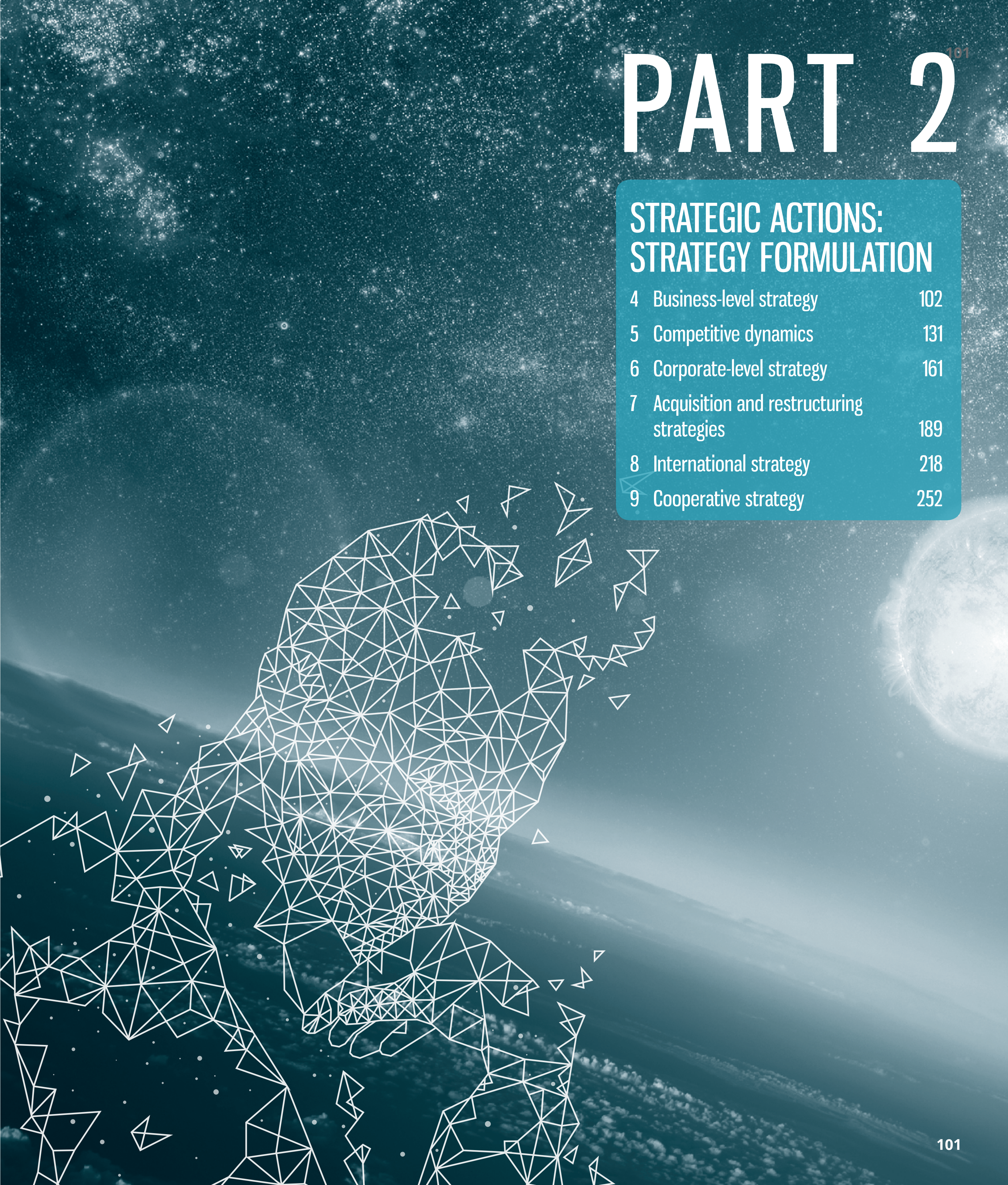


# PART 2

## STRATEGIC ACTIONS: STRATEGY FORMULATION

CHAPTER 4

# Business-level strategy

## Learning Objectives

Studying this chapter should provide you with the strategic management knowledge needed to:

**LO1** discuss the relationship between customers and business-level strategies in terms of who, what and how

**LO2** explain the purpose of forming and implementing a business-level strategy

**LO3** describe business models and explain their relationship with business-level strategies

**LO4** explain the differences among business-level strategies

**LO5** use the five forces of competition model to explain how above-average returns can be earned through each business-level strategy

**LO6** discuss the risks of using each of the business-level strategies.

# OPENING CASE STUDY

## Clonakilla Wines in a quality niche position

Clonakilla Wines is a Canberra region winery well-known for its high-quality wines, particularly its Shiraz Viognier, which was named as Australia's wine of the year in 2006 and 2011 and retails for over A$100 a bottle. The Australian wine industry is highly competitive – it is worth A$40 billion, encompassing 65 wine regions, 2500 wineries and 6000 grape growers and, as such, a vast range of quality, volume produced and regional prominence. The Canberra region alone has more than 30 wineries and 150 grape growers competing for local, national and international customers.

Clonakilla's iconic Shiraz Viognier

Clonakilla (the name means 'meadow of the church' in Irish) is a family business based in Murrumbateman, New South Wales, north of Canberra. The winery produces between 18 000 and 20 000 cases (216 000 to 240 000 bottles) of wine annually, from grape varieties such as Shiraz, Viognier and Riesling. According to Clonakilla, when CSIRO Plant Industry researcher Dr John Kirk planted the first vines in 1971, he had 'no idea that his vineyard would one day be celebrated as one of the best in the country' and that over the decades, there would be 'trials and tribulations as well as moments of unprecedented success'.

After John's son Tim Kirk visited the Rhone Valley in France in 1991, his decision to blend a small amount of Viognier white wine with the 1992 Shiraz paid off. The major awards started in 1999, winning the NSW wine of the year, followed by many others, and culminating in the 2006 and 2011 Australian wine of the year, and 2010 and 2011 international airlines best first class red wine. *The Wall Street Journal* stated 'some argue this is Australia's greatest red wine, it is certainly one of the greatest Shirazs'. Wine critic and writer James Halliday described Clonakilla's Shiraz Viognier as 'an icon wine, one of the best in Australia'. Langton's Andrew Callard describes it as 'one of the most important advances in the development of Australian Shiraz since the release of 1952 Penfolds Grange Hermitage'. Langton, an Australian wine auction house and publisher of the Langton classification of the leading wines in Australia, went further and has included the Shiraz Viognier in the highest category, 'Exceptional', since 2010, a category it shares with other Australian icons such as Penfolds Grange and Henschke Hill of Grace. Tim Kirk himself was awarded Gourmet Traveller's Australian Winemaker of the Year in 2013, one of the highest accolades in the Australian wine industry.

Similar to other winemakers, recurring trials or challenges faced by Clonakilla included droughts and water shortages, high evaporation rates, frosts and grasshopper plagues, and all of these have been exacerbated by the effects of climate change. Recent challenges include how to deal with demand and growth, maintain quality and differentiate the winery (and its flagship wine) in an increasingly crowded market.

One of the important things for any organisation, but particularly for a small business, is to define its competitive strategy. Will the organisation compete on the basis of cost or quality, and will it serve the whole market or focus on a niche? Clonakilla employs a focused differentiation strategy, with an integrated set of actions taken to produce goods that serve the needs of a particular competitive segment (at an acceptable cost) that customers perceive as being different in ways that are important to them. For Clonakilla, the differentiation is via quality.

This strategy has consequences for the competitive forces that impact the organisation and also has wide-ranging consequences for the organisation itself. To successfully implement a focused differentiation strategy, it needs to be consistent, persistent and aligned across all aspects of the business. The product, price, place, promotion, people, processes and physical evidence (the '7Ps' of marketing) associated with the brand all need to align with the chosen strategy – in this case, a quality niche strategy.

Time will tell if Clonakilla's focused differentiation business-level strategy will maintain and build on its market success.

Sources: Clonakilla website, 2020, A philosophy of wine, https://clonakilla.com.au/story; G. Whiteside, 2019, Australia's wine industry recovers from decade-long grape glut, industry marketing group says, *ABC News*, https://www.abc.net.au/news/rural/2019-10-18/australias-wine-glut-is-over/11613680, 18 October; H. Hooke, 2018, Langton's Classification of Australian Wine, *The Real Review*, https://www.therealreview.com/2018/09/03/langtons-classification-of-australian-wine, 3 September; M. Allen, 2017, Odd couple: Meet the winemakers at Clonakilla and Ravensworth, *Australian Financial Review*, https://www.afr.com/life-and-luxury/food-and-wine/strange-bedfellows-the-winemakers-at-clonakilla-and-ravensworth-20170518-gw7mdq, 25 May; H. Hooke, 2012, Rewards for a 'killa instinct, *Sydney Morning Herald*, https://www.smh.com.au/lifestyle/rewards-for-a-killa-instinct-20120922-26d4j.html, 25 September.

**STRATEGY NOW**

Clonakilla's focused differentiation strategy

Vital to an organisation's success,[1] strategy is concerned with making choices among two or more alternatives.[2] As we noted in Chapter 1, when choosing a strategy, the organisation decides to pursue one course of action instead of others. The choices are influenced by opportunities and threats in the organisation's external environment[3] (see Chapter 2), as well as by the nature and quality of the resources, capabilities and core competencies in its internal organisation[4] (see Chapter 3). As we see in the opening case, Clonakilla has chosen a differentiation strategy that focuses on a specific niche in the market.

The fundamental objective of using any type of strategy (see Figure 1.1) is to gain strategic competitiveness and earn above-average returns.[5] Strategies are purposeful, precede the taking of actions to which they apply, and demonstrate a shared understanding of the organisation's vision and mission.[6] An effectively formulated strategy marshals, integrates and allocates the organisation's resources, capabilities and competencies so that it will be properly aligned with its external environment.[7] A properly developed strategy also rationalises the organisation's vision and mission along with the actions taken to achieve them.[8] Information about a host of variables, including markets, customers, technology, worldwide finance and the changing world economy, must be collected and analysed to properly form and use strategies. In the final analysis, sound strategic choices that reduce uncertainty regarding outcomes are the foundation for building successful strategies.[9]

**business-level strategy**
an integrated and coordinated set of commitments and actions the organisation uses to gain a competitive advantage by exploiting core competencies in specific product markets

**Business-level strategy**, this chapter's focus, is an integrated and coordinated set of commitments and actions the organisation uses to gain a competitive advantage by exploiting core competencies in specific product markets.[10] Business-level strategy indicates the choices the organisation has made about how it intends to compete in individual product markets. The choices are important because long-term performance is linked to an organisation's strategies.[11] Given the complexity of successfully competing in the global economy, the choices about how the organisation will compete can be difficult.[12] For example, many traditional bricks-and-mortar retail organisations have found themselves disrupted by the so-called FAANG group of technology companies trading publicly in the market – Facebook (FB), Amazon (AMZN), Apple (AAPL), Netflix (NFLX) and Google (GOOG) – as customers change purchasing preferences to online and subscription-based services.[13] This chapter will examine some of the aspects of information, reach, richness and affiliation that help a business-level strategy to be successful.

Every organisation must form and use a business-level strategy. This extends beyond commercial organisations to include government departments, health care, sporting and community not-for-profit organisations. Every organisation competes for staff, resources and market share. However, every organisation may not use all the strategies – corporate-level, merger and acquisition, international and cooperative – that we examine in Chapters 6 to 9. An organisation competing in a single product market area in a single geographic location does not need a corporate-level strategy to deal with product diversity or an international strategy to deal with geographic diversity. By contrast, a diversified organisation will use one of the corporate-level strategies as well as a separate business-level strategy for each product market area in which it competes. Every organisation – from the local dry cleaner to a community not-for-profit to the multinational corporation – must develop and use at least one business-level strategy. Thus business-level strategy is the *core* strategy: the strategy that the organisation forms to describe how it intends to compete in a product market.[14]

We discuss several topics to examine business-level strategies. Because customers are the foundation of successful business-level strategies and should never be taken for granted,[15] we present information about customers that is relevant to business-level strategies. In terms of customers, when selecting a business-level strategy the organisation determines *who* will be served, *what* needs those target customers have that it will satisfy and *how* those needs will be satisfied. Selecting customers and deciding which of their needs the organisation will try to satisfy – as well as how it will do so – are challenging tasks. Global competition has created many attractive options for customers, making it difficult for an organisation to determine the strategy to best serve them.[16] Effective global competitors have become adept at identifying the needs of customers in different cultures and geographic regions, as well as learning how to quickly and successfully adapt the functionality of an organisation's good or service to meet those needs.

Descriptions of the purpose of business-level strategies, and of the five business-level strategies, follow the discussion of customers. The five strategies we examine are called *generic* because they can be used in any organisation competing in any industry.[17] Our analysis describes how the effective use of each strategy allows the organisation to favourably position itself relative to the five competitive forces in the industry (see Chapter 2).In addition, we use the value chain (see Chapter 3) to show examples of the primary and support activities necessary to implement specific business-level strategies. Because no strategy is risk-free,[18] we also describe the different risks the organisation may encounter when using these strategies. In Chapter 11, we explain the organisational structures and controls linked with the successful use of each business-level strategy.

# Customers: their relationship with business-level strategies

Strategic competitiveness results only when the organisation satisfies a group of customers by using its competitive advantages as the basis for competing in individual product markets.[19] A key reason organisations must satisfy customers with their business-level strategy is that returns earned from relationships with customers are the lifeblood of all organisations.[20] Even government agencies or community organisations exist to provide a return on investment to their owners, although the words 'return', 'investment' and 'owner' might mean different things to each of them. Every organisation has customers and every organisation has competitors. For example, one of the major competitors of the Australian Taxation Office (ATO) is non-compliance with taxation laws, and the ATO invests significant resources to convince and assist its customers to maintain voluntary compliance. Effective relationships with customers are vital to success.

The most successful organisations try to find new ways to satisfy current customers and/or to meet the needs of new customers. Being able to do this can be even more difficult when organisations and consumers face challenging economic conditions. During such times, organisations may decide to reduce their workforce to control costs. This can lead to problems, however, when having fewer employees makes it more difficult for organisations to meet individual customers' needs and expectations. In these instances, some suggest that organisations should follow several courses of action, including paying extra attention to their best customers and developing a flexible workforce by cross-training employees so they can undertake a variety of responsibilities on their jobs. Amazon and Lexus have been identified as 'customer service champions' because they devote extra care and attention to customer service, especially during challenging economic times.[21]

## Effectively managing relationships with customers

The organisation's relationships with its customers are strengthened when it delivers superior value to them. Strong interactive relationships with customers often provide the foundation for the organisation's efforts to profitably serve customers' unique needs.

As the following statement shows, Caesar's Entertainment (the world's largest provider of branded casino entertainment) is committed to providing superior value to customers: 'Caesar's Entertainment is focused on building loyalty and value with its customers through a unique combination of great service, excellent products, unsurpassed distribution, operational excellence and technology leadership'.[22] Importantly, as Caesar's appears to anticipate, delivering superior value often results in increased customer loyalty. In turn, customer loyalty has a positive relationship with profitability. However, more choices and easily accessible information about the functionality of organisations' products are creating increasingly sophisticated and knowledgeable customers, making it difficult to earn their loyalty.[23]

A number of organisations have become skilled at the art of *managing* all aspects of their relationship with their customers.[24] For example, Amazon is widely recognised for the quality of information it maintains about its customers, the services it renders and its ability to anticipate customers' needs. Using the information it has, Amazon tries to serve what it believes are the unique needs of each customer, and it has a strong reputation for being able to successfully do this. Amazon uses big data gathered from customers while they browse to build and fine-tune its recommendation engine. The more Amazon knows about them, the better it can predict what they want to buy.[25]

As we discuss next, organisations' relationships with customers are characterised by three dimensions. Companies such as Acer and Amazon understand these dimensions and manage their relationships with customers in light of them.

## Reach, richness and affiliation

The *reach* dimension of relationships with customers is concerned with the organisation's access and connection to customers. In general, organisations seek to extend their reach, adding customers in the process of doing so.

Reach is an especially critical dimension for social networking sites such as Facebook and Instagram in that the value these organisations create for users is to connect them with others. The number of Facebook users has been dramatically increasing globally.[26] Reach is also important to Netflix, which began life as a provider of postal DVDs in the USA and now streams movies and series to 190 countries. Fortunately for this organisation, its reach continues to expand. In a letter sent to shareholders in July 2019, Netflix reported it had 151 million subscribers and estimated it would grow that number by seven million in one quarter to 158 million total subscribers.[27] Nine years earlier, the company had just over 20 million subscribers, and it added 25 million subscribers in 2018–19.

*Richness*, the second dimension of organisations' relationships with customers, is concerned with the depth and detail of the two-way flow of information between the organisation and the customer. The potential of the richness dimension to help the organisation establish a competitive advantage in its relationship with customers leads many organisations to offer online services in order to better manage information exchanges with their customers. Broader and deeper information-based exchanges allow organisations to better understand their customers and their needs. Such exchanges also enable customers to become more knowledgeable about how the organisation can satisfy them. Internet technology and e-commerce transactions have substantially reduced the costs of meaningful information exchanges with current and potential customers. As we have noted, Amazon is a leader in using the internet to build relationships with customers. In fact, it bills itself as the most 'customer-centric company' on Earth. Amazon and other organisations use rich information from customers to help them develop innovative new products that better satisfy customers' needs.[28]

*Affiliation*, the third dimension, is concerned with facilitating useful interactions with customers. Viewing the world through the customer's eyes and constantly seeking ways to create more value for the customer have positive effects in terms of affiliation. This approach enhances customer satisfaction and produces fewer customer complaints. In fact, for services, customers often do not complain when dissatisfied; instead they simply go to competitors for their service needs.[29] Internet navigators such as

Microsoft's MSN Autos help online clients find and sort information. MSN Autos provides data and software to prospective car buyers that enables them to compare car models along multiple objective specifications. A prospective buyer who has selected a specific car based on comparisons of different models can then be linked to dealers that meet the customer's needs and purchasing requirements. Information about other relevant issues such as financing and insurance, and even local traffic patterns, is also available at the site. Because its revenues come not from the final customer or end user but from other sources (such as advertisements on its website, hyperlinks, and associated products and services), MSN Autos represents the customer's interests, a service that fosters affiliation.[30] In Australia, Seek promotes a similar affiliation for customers through the number of services it provides to job seekers via its portal, including career advice and templates for résumés.[31]


Reach is important for Netflix

Source: Shutterstock.com/DenPhotos

As we discuss next, effectively managing customer relationships (along the dimensions of reach, richness and affiliation) helps the organisation answer questions related to the issues of *who*, *what* and *how*.

## Who: determining the customers to serve

Deciding *who* the target customer is that the organisation intends to serve with its business-level strategy is an important decision.[32] Organisations divide customers into groups based on differences in the customers' needs (needs are discussed further in the next section) to make this decision. Dividing customers into groups based on their needs is called **market segmentation**, which is a process that clusters people with similar needs into individual and identifiable groups.[33] In the animal food products business, for example, the food product needs of owners of companion pets (e.g. dogs and cats) differ from the needs for food and health-related products of those owning production animals (e.g. livestock). A subsidiary of Colgate-Palmolive, Hill's Pet Nutrition, sells food products for pets. In fact, the company's mission is 'to help enrich and lengthen the special relationship between people and their pets'.[34] Thus, Hill's Pet Nutrition targets the needs of different segments of customers with the food products it sells for animals.

**market segmentation**
a process used to cluster people with similar needs into individual and identifiable groups

Almost any identifiable human or organisational characteristic can be used to subdivide a market into segments that differ from one another on a given characteristic. Common characteristics on which customers' needs vary are illustrated in Table 4.1.

## What: determining which customer needs to satisfy

After the organisation decides *who* it will serve, it must identify the targeted customer group's needs that its goods or services can satisfy. In a general sense, needs (*what*) are related to a product's benefits and features.[35] Successful organisations learn how to deliver to customers what they want, when they want it.[36] Having close and frequent interactions with both current and potential customers helps the organisation identify those individuals' and groups' current and future needs.[37]

From a strategic perspective, a basic need of all customers is to buy products that create value for them. The generalised forms of value that goods or services provide are either low cost with acceptable features or highly differentiated features with acceptable cost. During the global financial crisis (GFC) of 2008–09, organisations across industries recognised their customers' needs to feel as secure as possible when making purchases. The most effective organisations continuously strive to anticipate changes in customers' needs. The organisation that fails to anticipate and certainly to recognise changes in its customers' needs may lose its customers to competitors whose products can provide more value to the focal organisation's customers. It is also recognised that consumer needs and desires have been changing in recent years. For example, more consumers desire to have an experience rather than to simply purchase a good or service. As a result,

**Table 4.1 Basis for customer segmentation**

| | |
|---|---|
| **Consumer markets** | 1 Demographic factors (age, income, sex, etc.)<br>2 Socioeconomic factors (social class and stage in the family life cycle)<br>3 Geographic factors (cultural, regional and national differences)<br>4 Psychological factors (lifestyle and personality traits)<br>5 Consumption patterns (heavy, moderate and light users)<br>6 Perceptual factors (benefit segmentation and perceptual mapping) |
| **Industrial markets** | 1 End-use segments<br>2 Product segments (based on technological differences or production economics)<br>3 Geographic segments (defined by boundaries between countries or by regional differences within them)<br>4 Common buying factor segments (cut across product market and geographic segments)<br>5 Customer size segments |

Source: Based on information in S. C. Jain, 2009, *Marketing Planning and Strategy*, Mason, OH: South-Western-Cengage Custom Publishing.

one of Starbucks' goals has been to provide an experience, not just a cup of coffee. Customers also prefer to receive customised goods and services. Starbucks in the USA has been doing this for some time, by allowing customers to design their own drinks, within its menus (which have become rather extensive over time). Customers also demand fast service. Consumers of coffee are known for their impatience, and rapid service is now expected by most consumers.[38] Unhappy consumers lead to lost sales, from both those consumers and others who learn of their dissatisfaction. Therefore, it is important to maintain customer satisfaction by meeting and satisfying consumers' needs.[39]

## How: determining core competencies necessary to satisfy customer needs

After deciding *who* the organisation will serve and the specific *needs* of those customers, the organisation is prepared to determine how to use its capabilities and competencies to develop products that can satisfy the needs of its target customers. As explained in Chapters 1 and 3, core competencies are resources and capabilities that serve as a source of competitive advantage for the organisation over its rivals. Organisations use core competencies (*how*) to implement value-creating strategies and thereby satisfy customers' needs. Only those organisations with the capacity to continuously improve, innovate and upgrade their competencies can expect to meet and hopefully exceed customers' expectations across time.[40] Organisations must continuously upgrade their capabilities to ensure that they maintain an advantage over their rivals by providing customers with a superior product.[41] Often these capabilities are difficult for competitors to imitate, partly because they are constantly being upgraded, but also because they are integrated and used as configurations of capabilities to perform an important activity (e.g. R&D).[42]

Organisations draw from a wide range of core competencies to produce goods or services that can satisfy customers' needs. For example, Merck is a large pharmaceutical organisation well known for its R&D capabilities. In recent times, Merck has been building on these capabilities by investing heavily in R&D. In 2015, Merck invested US$6.7 billion to conduct research and identify major new drugs; in 2018, it invested US$9.7 billion. These new drugs are intended to meet the needs of consumers and to sustain Merck's competitive advantage in the industry.[43]

SAS Institute is the world's largest privately owned software company and is the leader in business intelligence and analytics. Customers use SAS programs for data warehousing, data mining and decision support purposes. SAS serves 83 000 sites in 147 countries and 92 per cent of the top Fortune 100 firms. Allocating approximately 24 per cent of revenues to R&D, a percentage that exceeds its competitors, SAS relies on its core competence in R&D to satisfy the data-related needs of such customers, including a host of consumer goods organisations (e.g. hotels, banks and catalogue companies).[44]

This crowded shop could benefit from more attention to service or alternative service options such as self-service or online shopping. Too few salespeople to process transactions can have a negative impact on a customer's experience.

Source: Shutterstock.com/Sorbis

Sometimes organisations may find it necessary to use their core competencies as the foundation for producing new goods or services for new customers. This may be the case for some small car parts suppliers. Given that car production in recent years has declined about one-third from more typical levels in major markets, a number of these organisations are seeking to diversify their operations, perhaps exiting the car parts supplier industry as a result. Some analysts believe that the first rule for these small manufacturers is to determine how their current capabilities and competencies might be used to produce value-creating products for different customers. One analyst gave the following example of how this might work: 'There may be no reason that a company making automobile door handles couldn't make ball-and-socket joints for artificial shoulders'.[45]

Our discussion about customers shows that all organisations must use their capabilities and core competencies (the *how*) to satisfy the needs (the *what*) of the target group of customers (the *who*) that the organisation has chosen to serve. Next, we describe the different business-level strategies that are available to organisations to use to satisfy customers as the foundation for earning above-average returns.

# The purpose of a business-level strategy

The purpose of a business-level strategy is to create differences between the organisation's position and those of its competitors.[46] To position itself differently from competitors, an organisation must decide whether it intends to *perform activities differently* or to *perform different activities*. Strategy defines the path that provides the direction of actions to be taken by leaders of the organisation.[47] In fact, 'choosing to perform activities differently or to perform different activities than rivals' is the essence of business-level strategy.[48] Thus, the organisation's business-level strategy is a deliberate choice about how it will perform the value chain's primary and support activities to create unique value. Indeed, in the current complex competitive landscape, successful use of a business-level strategy results from the organisation learning how to integrate the activities it performs in ways that create superior value for customers.

# Business models and their relationship with business-level strategies

As is the case with strategy, there are multiple definitions of a **business model**.[49] The consensus across these definitions is that a business model describes what an organisation does to create, deliver and capture value for its stakeholders.[50] As explained in Chapter 1, stakeholders value related yet different outcomes. For example, for shareholders, the organisation captures and distributes value to them in the form of a return on their investment. For customers, the organisation creates and delivers value in the form of a product featuring the combination of price and features for which they are willing to pay. For employees, the organisation creates and delivers value in the form of a job about which they are passionate and through

**business model** describes what an organisation does to create, deliver and capture value for its stakeholders which they have opportunities to develop their skills by participating in continuous learning experiences. In a sense then, a business model is a *framework* for how the organisation will create, deliver and capture value while a business-level strategy is the set of commitments and actions that yields the *path* an organisation intends to follow to gain a competitive advantage by exploiting its core competencies in a specific product market. Understanding customers in terms of *who*, *what* and *how* is foundational to developing and using successfully both a business model and a business-level strategy.[51]

Regardless of the business model chosen, those leading an organisation should view that selection as one that will require adjustment in response to conditions that change from time to time in the organisation's external environment (e.g. an opportunity to enter a new region surfaces) and its internal environment (e.g. the development of new capabilities).[52] Particularly because it is involved primarily with implementing a business-level strategy, the operational mechanics of a business model should change given the realities an organisation encounters while engaging rivals in marketplace competitions.

There is an array of different business models, from which organisations select one to use.[53] A franchise business model, for example, finds an organisation licensing its trademark and the processes it follows to create and deliver a product to franchisees. In this instance, the organisation franchising its trademark and processes captures value by receiving fees and royalty payments from its franchisees.

McDonald's and Jim's Group (Jim's Mowing, Jim's Cleaning, Jim's Dog Wash, etc.) both use the franchise business model. McDonald's uses the model as part of its cost leadership strategy, while Jim's Group uses it to implement a differentiation strategy (we discuss both strategies in detail in the next major section). The McDonald's cost leadership strategy finds it using processes detailed in its franchise business model to deliver food items to its customers that are offered at a low price but with acceptable levels of differentiation. Customers receive acceptable levels of differentiation in terms of taste quality, service quality, the cleanliness of the organisation's units and the value customers believe they receive when buying McDonald's food.[54] Jim's Group also uses a franchise business model, but its model differs from the McDonald's model. Rather than having the same product at each franchise, Jim's has over 50 divisions covering household services such as mowing, cleaning, dog washing and fencing.[55] Also, Jim's employs a regional and national franchisor model where owning a region or a division allows the franchisor the right to sell franchises in a specific area.[56] Thus, while McDonald's and Jim's Group use the same business model, the franchising business models these organisations use differ in the actions they take to implement different business-level strategies.

As mentioned, there are multiple kinds of business models, including the subscription model. In this instance, the business model finds an organisation offering a product to customers on a regular basis, such as once-per-month, once-per-year or upon demand. Netflix uses a subscription business model, as does Xero, an organisation providing accounting software that extends to business functions such as payroll, timesheets and expense management. In this way, Xero combines the differentiation strategy with a subscription model to create, deliver and capture value for the stakeholders (e.g. customers, suppliers and employees) with whom the organisation interacts while implementing its business-level strategy.[57] Other business models that also support the use of any of the five generic business-level strategies we discuss next include the following: (1) a freemium model (here the organisation provides a basic product to customers for free and earns revenues and profits by selling a premium version of the service – examples include Dropbox and Mailchimp); (2) an advertising model (where, for a fee, organisations provide advertisers with high-quality access to their target customers – Google and Pinterest are examples of organisations using this business model); and (3) a peer-to-peer model (where a business matches those wanting a particular service with those providing that service – an example is Airbnb).

# Types of business-level strategies

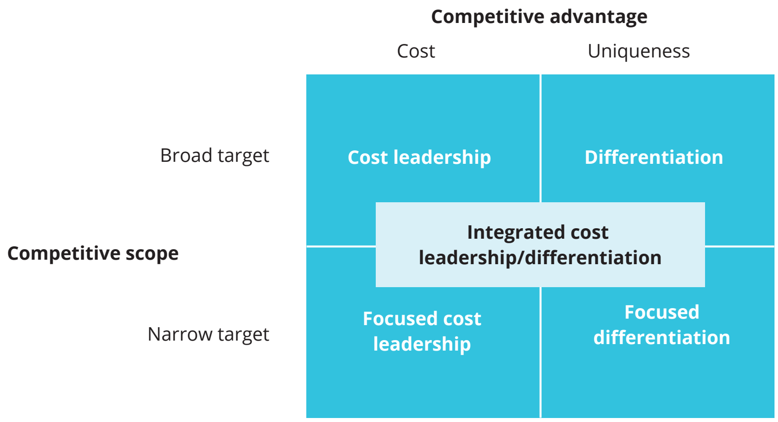
Organisations choose from among five business-level strategies to establish and defend their desired strategic position against competitors: *cost leadership*, *differentiation*, *focused cost leadership*, *focused* *differentiation* and *integrated cost leadership/differentiation* (see Figure 4.1). Each business-level strategy helps the organisation to establish and exploit a particular *competitive advantage* within a particular *competitive scope*. How organisations integrate the activities they perform within each different business-level strategy demonstrates how they differ from one another.[58] For example, organisations have different activity maps, and thus Virgin Australia's activity map differs from those of competitor airlines Jetstar and Regional Express. Superior integration of activities increases the likelihood of an organisation being able to gain an advantage over competitors and earn above-average returns.

When selecting a business-level strategy, organisations evaluate two types of potential competitive advantages: 'lower cost than rivals, or the ability to differentiate and command a premium price that exceeds the extra cost of doing so'.[59] Having lower cost derives from the organisation's ability to perform activities differently from rivals; being able to differentiate indicates the organisation's capacity to perform different (and valuable) activities. Thus, based on the nature and quality of its internal resources, capabilities and core competencies, an organisation seeks to form either a cost competitive advantage or a distinctiveness competitive advantage as the basis for implementing its business-level strategy.[60]

Two types of target markets are a broad market and narrow market segment(s) (see Figure 4.1). Organisations serving a broad market seek to use their capabilities to create value for customers on an industry-wide basis. A narrow market segment means that the organisation intends to serve the needs of a narrow customer group. With focus strategies, the organisation 'selects a segment or group of segments in the industry and tailors its strategy to serving them to the exclusion of others'.[61] Buyers with special needs and buyers located in specific geographic regions are examples of narrow customer groups.[62] As shown in Figure 4.1, an organisation could also strive to develop a combined low-cost/distinctiveness value-creation approach as the foundation for serving a target customer group that is larger than a narrow market segment but not as comprehensive as a broad (or industry-wide) customer group. In this instance, the organisation uses the integrated cost leadership/differentiation strategy.

None of the five business-level strategies shown in Figure 4.1 is inherently or universally superior to the others.[63] The effectiveness of each strategy is contingent both on the opportunities and threats in an organisation's external environment and on the strengths and weaknesses derived from the organisation's resource portfolio. It is critical, therefore, for the organisation to select a business-level strategy that is based on a match between the opportunities and threats in its external environment and the strengths of its internal organisation as shown by its core competencies.[64] After the organisation chooses its strategy, it should consistently emphasise actions that are required to successfully use it. For example, Big W's

**Figure 4.1** **Five business-level strategies**



continuous emphasis on driving its costs lower is thought to be a key to the organisation's effective cost leadership strategy.[65]

## Cost leadership strategy

**cost leadership strategy**
an integrated set of actions taken to produce goods or services with features that are acceptable to customers at the lowest cost, relative to that of competitors

The **cost leadership strategy** is an integrated set of actions taken to produce goods or services with features that are acceptable to customers at the lowest cost, relative to those of competitors.[66] Organisations using the cost leadership strategy commonly sell standardised goods or services (but with competitive levels of differentiation) to the industry's most typical customers. Process innovations – which are newly designed production and distribution methods and techniques that allow the organisation to operate more efficiently – are critical to successful use of the cost leadership strategy.[67]

As noted, cost leaders' goods and services must have competitive levels of differentiation that create value for customers. For example, in recent years Hyundai Motors has emphasised the design of its cars in the market as a source of differentiation while implementing a cost leadership strategy. Called 'cheap chic', this is used by Kia Motors, and some analysts have a positive view of this decision, saying: 'When they're done, Kia's cars will still be low-end [in price], but they won't necessarily look like it'.[68] It is important for organisations using the cost leadership strategy to not simply concentrate on reducing costs, because it could result in the organisation efficiently producing products that no customer wants to purchase. In fact, such extremes could limit the potential for important process innovations and lead to employment of lower-skilled workers, poor conditions on the production line, accidents and a poor quality of work life for employees.[69]

As shown in Figure 4.1, the organisation using the cost leadership strategy targets a broad customer segment or group. Cost leaders concentrate on finding ways to lower their costs relative to competitors by constantly rethinking how to complete their primary and support activities to reduce costs still further, while maintaining competitive levels of differentiation.[70]

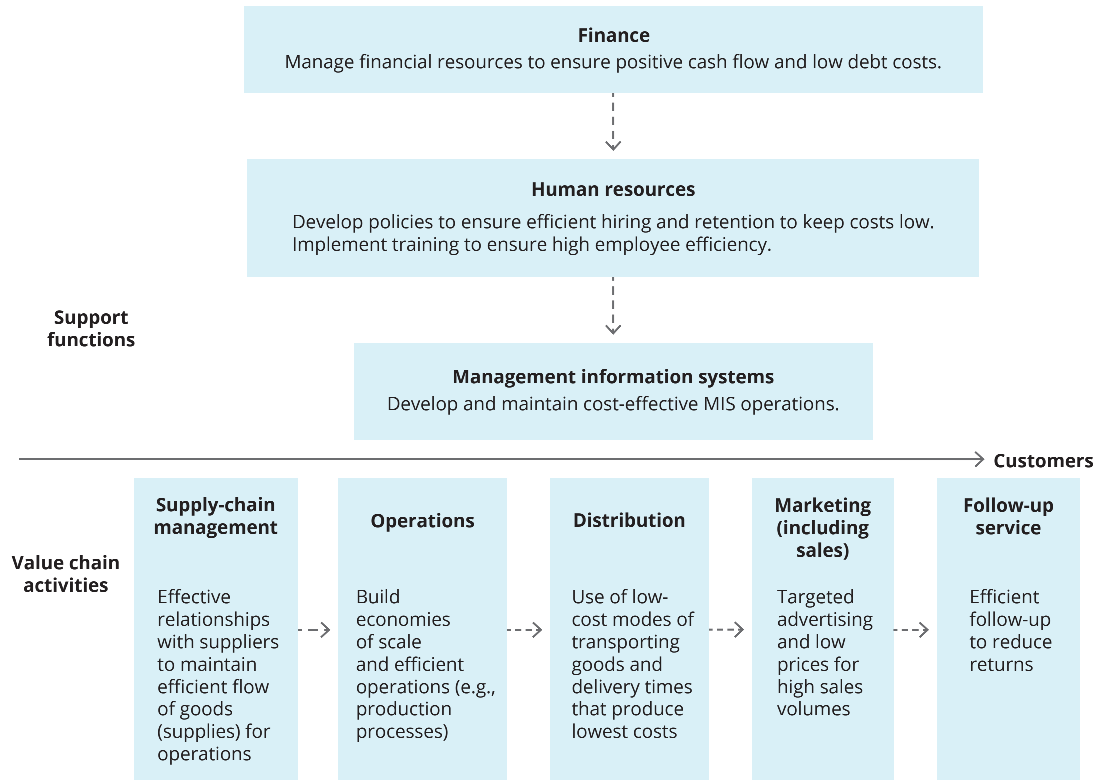
As primary activities, inbound logistics (e.g. materials handling, warehousing and inventory control) and outbound logistics (e.g. collecting, storing and distributing products to customers) often account for significant portions of the total cost to produce some goods and services. Research suggests that having a competitive advantage in logistics creates more value with a cost leadership strategy than with a differentiation strategy.[71] Thus, cost leaders seeking competitively valuable ways to reduce costs may want to concentrate on the primary activities of inbound logistics and outbound logistics. In so doing, many organisations choose to outsource their manufacturing operations to low-cost organisations with low-wage employees (e.g. China).[72] However, care must be taken because outsourcing also makes the organisation more dependent on organisations over which they have little control. At best, it creates interdependencies between the outsourcing organisation and the suppliers. If dependencies become too great, it gives the supplier more power, with which it may increase the prices of the goods and services provided. Such actions could harm the organisation's ability to maintain a low-cost competitive advantage.[73]

Cost leaders also carefully examine all support activities to find additional potential cost reductions. Developing new systems for finding the optimal combination of low-cost and acceptable levels of differentiation in the raw materials required to produce the organisation's goods or services is an example of how the procurement support activity can facilitate successful use of the cost leadership strategy.

As described in Chapter 3, organisations use value chain analysis to identify the parts of the organisation's operations that create value and those that do not. Figure 4.2 demonstrates the primary and support activities that allow an organisation to create value through the cost leadership strategy. Organisations unable to link the activities shown in this figure through the activity map they form typically lack the core competencies needed to successfully use the cost leadership strategy.

Effective use of the cost leadership strategy allows an organisation to earn above-average returns in spite of the presence of strong competitive forces (see Chapter 2). The five forces model (rivalry with existing competitors, bargaining power of customers, bargaining power of suppliers, threat of new entrants, and

**Figure 4.2** **Examples of value-creating activities associated with the cost leadership strategy**




Sources: Based on M. E. Porter, 1998, *Competitive Advantage: Creating and Sustaining Superior Performance*, New York: The Free Press; D. G. Sirmon, M. A. Hitt & R. D. Ireland, 2007, Managing firm resources in dynamic environments to create value: Looking inside the black box, *Academy of Management Review*, 32: 273–92; J. B. Barney, D. J. Ketchen, Jr, M. Wright, D. G. Sirmon, M. A. Hitt, R. D. Ireland & B. A. Gilbert, 2011, Resource orchestration to create competitive advantage: Breadth, depth and life cycle effects, *Journal of Management*, 37(5): 1390–412.

threat of substitute products) can be applied for any of the five business-level strategies. The next sections (one covering each of the five forces) explain how organisations implement a cost leadership strategy from the perspective of the industry forces that impact on them when using that business-level strategy.

## Rivalry with existing competitors

Having the low-cost position is valuable to deal with rivals. Because of the cost leader's advantageous position, rivals hesitate to compete on the basis of price, especially before evaluating the potential outcomes of such competition.[74] The US giant Walmart is a good case study of how hard this can be: it has been known for its ability to maintain very low costs, thereby creating value for customers in competition with, among others, Target and Dollar Stores. However, changes it made to attract upmarket customers made its low-cost position vulnerable to rivals. Ultra-low-cost players such as Amazon took advantage of this opportunity. Amazon is a low-cost leader and has begun to siphon off Walmart customers. Because of Walmart's unprecedented loss of sales and market position, it has started to fight back by returning to its former strategy, and is implementing new competitive actions as well.

The degree of rivalry present is based on a number of different factors such as size and resources of rivals, their dependence on the particular market, and location and prior competitive interactions, among others.[75] Organisations may also take actions to reduce the amount of rivalry that they face. For example, organisations sometimes form joint ventures to reduce rivalry and increase the amount of profitability enjoyed by organisations in the industry.[76]

In the past, rivals hesitated to compete directly with Walmart strictly on the basis of costs and, subsequently, prices to consumers. Yet, given Walmart's changes, its prices on some products are only slightly below the prices of similar goods at Target. Walmart's changes then also provided an opportunity for Target and Costco. Walmart saw the error in its new direction and vowed to return to its cost leadership strategy of providing the lowest prices on all goods sold.

## Bargaining power of buyers (customers)

Powerful customers can force a cost leader to reduce its prices, but not below the level at which the cost leader's next-most-efficient industry competitor can earn average returns. Although powerful customers might be able to force the cost leader to reduce prices even below this level, they probably would choose not to do so. Prices that are low enough to prevent the next-most-efficient competitor from earning average returns would force that organisation to exit the market, leaving the cost leader with less competition and in an even stronger position. Customers would thus lose their power and pay higher prices if they were forced to purchase from a single organisation operating in an industry without rivals.

Buyers can also develop a counterbalancing power to the customers' power by carefully analysing and understanding each of their customers. To help in obtaining information and understanding the customers, buyers can participate in customers' networks. In so doing, they share information, build trust and participate in joint problem solving with their customers.[77] In turn, they use the information obtained to supply a product that provides superior value to customers by most effectively satisfying their needs.

## Bargaining power of suppliers

The cost leader operates with margins greater than those of competitors and strives to constantly increase its margins by driving its costs lower. Among other benefits, higher gross margins relative to those of competitors make it possible for the cost leader to absorb its suppliers' price increases. When an industry faces substantial increases in the cost of its supplies, only the cost leader may be able to pay the higher prices and continue to earn either average or above-average returns. Alternatively, a powerful cost leader may be able to force its suppliers to hold down their prices, which would reduce the suppliers' margins in the process. This has become the fate of farming globally: large organisations are forcing farmers to sell at low prices.

Some organisations create dependencies on suppliers by outsourcing whole functions. They do so to reduce their overall costs.[78] They may outsource these activities to reduce their costs because of earnings pressures from stakeholders (e.g. institutional investors who own a major stock holding in the company) in the industry.[79] Often when there is such earnings pressure, the organisation may see foreign suppliers whose costs are also lower, providing them the capability to offer the goods at lower prices.[80] Yet when organisations outsource, particularly to a foreign supplier, they also need to invest time and effort into building a good relationship, hopefully developing trust between the organisations.[81]

## Potential entrants

Through continuous efforts to reduce costs to levels that are lower than those of competitors, a cost leader becomes highly efficient. Because increasing levels of efficiency (e.g. economies of scale) enhance profit margins, they serve as a significant entry barrier to potential competitors.[82] New entrants must be willing to accept no-better-than-average returns until they gain the experience required to approach the cost leader's efficiency. To earn even average returns, new entrants must have the competencies required to match the cost levels of competitors other than the cost leader. The low profit margins (relative to margins earned by organisations implementing the differentiation strategy) make it necessary for the cost leader to sell large volumes of its product to earn above-average returns. However, organisations striving to be the cost leader must avoid pricing their products so low that their ability to operate profitably is reduced, even though volume increases.

### Product substitutes

Compared with its industry rivals, the cost leader also holds an attractive position in terms of product substitutes. A product substitute becomes an issue for the cost leader when its features and characteristics, in terms of cost and differentiated features, are potentially attractive to the organisation's customers. When faced with possible substitutes, the cost leader has more flexibility than its competitors. To retain customers, it can reduce the price of its good or service. With still lower prices and competitive levels of differentiation, the cost leader increases the probability that customers prefer its product rather than a substitute.

### Competitive risks of the cost leadership strategy

The cost leadership strategy is not risk free. One risk is that the processes used by the cost leader to produce and distribute its good or service could become obsolete because of competitors' innovations.[83] These innovations may allow rivals to produce at costs lower than those of the original cost leader, or to provide additional differentiated features without increasing the product's price to customers.

A second risk is that too much focus by the cost leader on cost reductions may occur at the expense of trying to understand customers' perceptions of 'competitive levels of differentiation'. Low-cost stores are sometimes criticised for having too few salespeople available to help customers and too few individuals at checkout registers. These complaints suggest that there might be a discrepancy between how organisations and customers define 'minimal levels of service' and organisations' attempts to drive their costs increasingly lower.

Imitation is a final risk of the cost leadership strategy. Using their own core competencies, competitors sometimes learn how to successfully imitate the cost leader's strategy. When this happens, the cost leader must increase the value its good or service provides to customers. Commonly, value is increased by selling the current product at an even lower price or by adding differentiated features that create value for customers while maintaining price.

## Differentiation strategy

The **differentiation strategy** is an integrated set of actions taken to produce goods or services (at an acceptable cost) that customers perceive as being different in ways that are important to them.[84] While cost leaders serve a typical customer in an industry, differentiators target customers for whom value is created by the manner in which the organisation's products differ from those produced and marketed by competitors. Product innovation, which is 'the result of bringing to life a new way to solve the customer's problem – through a new product or service development – that benefits both the customer and the sponsoring company',[85] is critical to successful use of the differentiation strategy.[86]

**differentiation strategy**
an integrated set of actions taken to produce goods or services (at an acceptable cost) that customers perceive as being different in ways that are important to them

Organisations must be able to produce differentiated products at competitive costs to reduce upward pressure on the price that customers pay. When a product's differentiated features are produced at non-competitive costs, the price for the product may exceed what the organisation's target customers are willing to pay. If the organisation has a thorough understanding of what its target customers value, the relative importance they attach to the satisfaction of different needs, and for what they are willing to pay a premium, the differentiation strategy can be effective in helping it earn above-average returns. Of course, to achieve these returns, the organisation must apply its knowledge capital (knowledge held by its employees and managers) to provide customers with a differentiated product that gives them superior value.[87]

Through the differentiation strategy, the organisation produces non-standardised (i.e. distinctive) products for customers who value differentiated features more than they value low cost. For example, superior product reliability and durability and high-performance sound systems are among the differentiated features of Toyota Motor Corporation's Lexus products. However, Lexus offers its vehicles to customers at a competitive purchase price relative to other luxury automobiles. As with Lexus products, a product's unique attributes, rather than its purchase price, provide the value for which customers are willing to pay.

To maintain success with the differentiation strategy results, the organisation must consistently upgrade differentiated features that customers value and/or create new valuable features (innovate) without significant cost increases.[88] This approach requires organisations to constantly change their product lines.[89] These organisations may also offer a portfolio of products that complement each other, thereby enriching the differentiation for the customer and perhaps satisfying a portfolio of consumer needs.[90] For example, Billabong, the Australian surf wear company that started in 1973, has a wide range of surf wear and snowboarding products differentiated by its brand as a well-established surf-oriented and board-sports company. It strives to keep this fresh with a continual stream of new products and with sponsorship of surfing (e.g. the Billabong Pipeline Masters) and snowboarding events. That said, despite the brand's prominence, management at Billabong got the company into trouble in 2012 and 2013, to the extent that the brand's value did not equal the debt level – a good brand is extremely valuable, but is not the complete answer. After disappointing sales and losses, the company was acquired by the owner of rival brand Quiksilver in a A$198 million deal in 2018.[91]

Because a differentiated product satisfies customers' unique needs, organisations following the differentiation strategy are able to charge premium prices. The ability to sell a good or service at a price that substantially exceeds the cost of creating its differentiated features allows the organisation to outperform rivals and earn above-average returns. Rather than costs, an organisation using the differentiation strategy primarily concentrates on investing in and developing features that differentiate a product in ways that create value for customers.[92] Overall, an organisation using the differentiation strategy seeks to be different from its competitors on as many dimensions as possible. The less similarity between an organisation's goods or services and those of competitors, the more buffered it is from rivals' actions. Commonly recognised differentiated goods include Toyota's Lexus, Rolex watches, Caterpillar's heavy-duty earth-moving equipment and McKinsey & Co.'s consulting services.

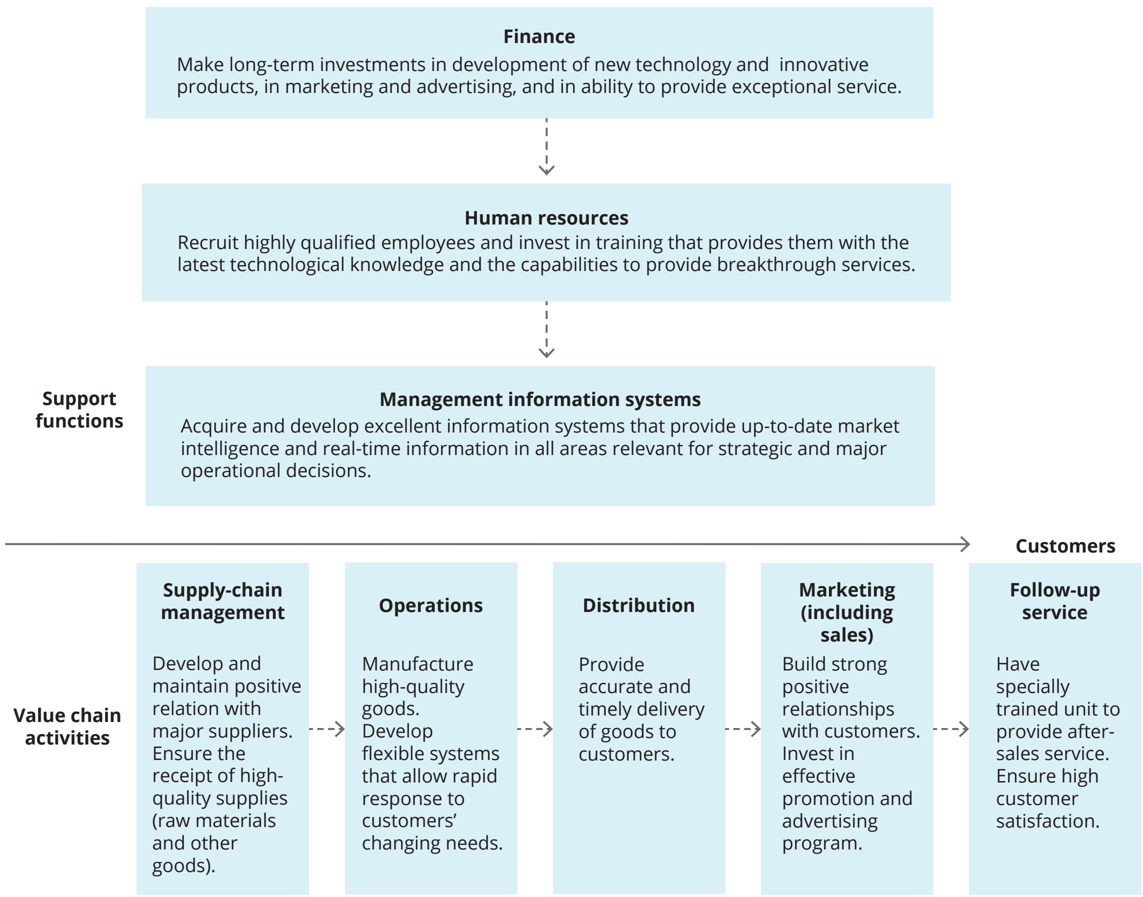
A good or service can be differentiated in many ways. Unusual features, responsive customer service, rapid product innovations and technological leadership, perceived prestige and status, different tastes, and engineering design and performance are examples of approaches to differentiation.[93] While the number of ways to reduce costs may be finite, virtually anything an organisation can do to create real or perceived value is a basis for differentiation. Consider product design as a case in point. Because it can create a positive experience for customers, design is an important source of differentiation (even for cost leaders seeking to find ways to add functionalities to their low-cost products as a way of differentiating their products from competitors) and, hopefully, of competitive advantage.[94] Apple is often cited as the organisation that sets the standard in design, with the iPhone and the iPad demonstrating Apple's product design capabilities.[95]

The value chain can be analysed to determine if an organisation is able to link the activities required to create value by using the differentiation strategy. Examples of primary value chain activities and support functions that are commonly used to differentiate a good or service are shown in Figure 4.3. Organisations without the skills needed to link these activities cannot expect to successfully use the differentiation strategy. Next, we explain how organisations using the differentiation strategy can successfully position themselves in terms of the five forces of competition (see Chapter 2) to earn above-average returns.

## Rivalry with existing competitors

Customers tend to be loyal purchasers of products differentiated in ways that are meaningful to them. As their loyalty to a brand increases, customers' sensitivity to price increases is reduced. The relationship between brand loyalty and price sensitivity insulates an organisation from competitive rivalry. Thus, Bose is insulated from intense rivalry as long as customers continue to perceive that its stereo equipment

**Figure 4.3** **Examples of value-creating activities associated with the differentiation strategy**




Source: Based on M. E. Porter, 1998, *Competitive Advantage: Creating and Sustaining Superior Performance*, New York: The Free Press; D. G. Sirmon, M. A. Hitt & R. D. Ireland, 2007, Managing firm resources in dynamic environments to create value: Looking inside the black box, *Academy of Management Review*, 32: 273–92; J. B. Barney, D. J. Ketchen, Jr, M. Wright, D. G. Sirmon, M. A. Hitt, R. D. Ireland & B. A. Gilbert, 2011, Resource orchestration to create competitive advantage: Breadth, depth and life cycle effects, *Journal of Management*, 37(5): 1390–412.

offers superior sound quality at a competitive purchase price. Bose has a strong positive reputation for high quality and unique products. Thus, reputations can sustain the competitive advantage of organisations following a differentiation strategy.[96]

## Bargaining power of buyers (customers)

The distinctiveness of differentiated goods or services reduces customers' sensitivity to price increases. Customers are willing to accept a price increase when a product still satisfies their perceived unique needs better than does a competitor's offering. Thus, the golfer whose needs are specifically satisfied by Callaway golf clubs will be likely to continue buying those products even if their cost increases. Similarly, the customer who has been highly satisfied with a Louis Vuitton wallet will probably replace that wallet with another one made by the same company, even though the purchase price is higher than the original one. Purchasers of brand-name food and household items (e.g. Vegemite and Kleenex tissues) accept price increases in those products as long as they continue to perceive that the product satisfies their distinctive needs at an acceptable cost. In all of these instances, the customers are relatively insensitive to price increases because they do not think that an acceptable product alternative exists.

## Bargaining power of suppliers

Because the organisation using the differentiation strategy charges a premium price for its products, suppliers must provide high-quality components, driving up the organisation's costs. However, the high margins the organisation earns in these cases partially insulate it from the influence of suppliers in that higher supplier costs can be paid through these margins.[97] Alternatively, because of buyers' relative insensitivity to price increases, the differentiated organisation might choose to pass the additional cost of supplies on to the customer by increasing the price of its unique product.

## Potential entrants

Customer loyalty and the need to overcome the uniqueness of a differentiated product present substantial barriers to potential entrants. Entering an industry under these conditions typically demands significant investments of resources and patience while seeking customers' loyalty.

## Product substitutes

Organisations selling brand-name goods and services to loyal customers are positioned effectively against product substitutes. By contrast, organisations without brand loyalty face a higher probability of their customers switching either to products that offer differentiated features that serve the same function (particularly if the substitute has a lower price) or to products that offer more features and perform more attractive functions.

## Competitive risks of the differentiation strategy

One risk of the differentiation strategy is that customers might decide that the price differential between the differentiator's product and the cost leader's product is too large. In this instance, an organisation may be offering differentiated features that exceed target customers' needs. The organisation then becomes vulnerable to competitors that are able to offer customers a combination of features and price that is more consistent with their needs.

This risk is generalised across a number of organisations producing different types of products during an economic recession, which is a time when sales of luxury goods (e.g. jewellery and leather goods) often suffer. The decline during the GFC was more severe in the USA compared with Australia, but it certainly affected Australian companies. Billabong, already struggling with the fact that its core target had become older and its brand less 'surf', was badly hit by an ill-timed expansion into having its own stores (because that is where the biggest profits were in the value chain). This took shape as the GFC crisis hit, and profits shrank as debt increased, which contributed to the company's sale in 2018.[98]

As the Billabong example demonstrates, another risk of the differentiation strategy is that an organisation's means of differentiation may cease to provide value for which customers are willing to pay (i.e. it stopped being a really credible youth surf brand). A differentiated product becomes less valuable if imitation by rivals causes customers to perceive that competitors offer essentially the same good or service, but at a lower price.[99] A third risk of the differentiation strategy is that experience can narrow customers' perceptions of the value of a product's differentiated features. For example, customers having positive experiences with generic tissues may decide that the differentiated features of the Kleenex product are not worth the extra cost. To counter this risk, organisations must continue to meaningfully differentiate their product (e.g. through innovation) for customers at a price they are willing to pay.[100]

Counterfeiting is the differentiation strategy's fourth risk. 'Counterfeits are those products bearing a trademark that is identical to or indistinguishable from a trademark registered to another party, thus infringing the rights of the holder of the trademark.'[101] Companies such as Hewlett-Packard must take actions to deal with the problems counterfeit goods create for organisations whose rights are infringed upon.

## Focus strategies

The **focus strategy** is an integrated set of actions taken to produce goods or services that serve the needs of a particular competitive segment. Thus, organisations use a focus strategy when they utilise their core competencies to serve the needs of a particular industry segment or niche to the exclusion of others. Examples of specific market segments that can be targeted by a focus strategy include a particular buyer group (e.g. youths or senior citizens), a different segment of a product line (e.g. products for professional painters or the do-it-yourself group) and a different geographic market (e.g. northern or southern Italy by using a foreign subsidiary).[102]

**focus strategy**
an integrated set of actions taken to produce goods or services that serve the needs of a particular competitive segment

There are many specific customer needs that organisations can serve by using a focus strategy. For example, Melbourne-based fast-food organisation Lord of the Fries positions itself as 'hip' and ethical, appealing to students and anti-establishment people with its vegan burgers and high-end fries (hot chips).[103] By successfully using a focus strategy, organisations such as these gain a competitive advantage in specific market niches or segments, even though they do not possess an industry-wide competitive advantage.

Although the breadth of a target is clearly a matter of degree, the essence of the focus strategy 'is the exploitation of a narrow target's differences from the balance of the industry'.[104] Organisations using the focus strategy intend to serve a particular segment of an industry more effectively than can industry-wide competitors. They succeed when they effectively serve a segment whose unique needs are so specialised that broad-based competitors choose not to serve that segment or when they satisfy the needs of a segment being served poorly by industry-wide competitors.[105]

Organisations can create value for customers in specific and unique market segments by using the focused cost leadership strategy or the focused differentiation strategy.

### Focused cost leadership strategy

Based in Sweden (but with a financial base in the Netherlands), IKEA, a global furniture retailer with 433 stores in 27 countries, 211 000 staff, suppliers in 51 countries and sales revenue of €41 billion in 2019, uses the focused cost leadership strategy. Young buyers desiring style at a low cost are IKEA's target customers.[106] For these customers, the organisation offers home furnishings that combine good design, function and acceptable quality with low prices. According to the organisation, 'Low cost is always in focus. This applies to every phase of our activities'.[107]


IKEA, the Swedish branded furniture organisation, is a well-known model for running a low-cost value chain.

Source: iStock.com/cloudytronics

IKEA emphasises several activities to keep its costs low. For example, instead of relying primarily on third-party manufacturers, the organisation's engineers design low-cost, modular furniture ready for assembly by customers. To eliminate the need for sales associates or decorators, IKEA positions the products in its stores so that customers can view different living combinations (complete with sofas, chairs, tables, etc.) in a single room-like setting, which helps the customer imagine how furniture will look in their home. A third practice that helps keep IKEA's costs low is requiring customers to transport their own purchases rather than providing a delivery service.

Although it is a cost leader, IKEA also offers some differentiated features that appeal to its target customers, including its unique furniture designs, in-store playrooms for children, wheelchairs for customer use and extended hours. IKEA believes that these services and products 'are uniquely aligned with the needs of [its] customers, who are young, are not wealthy, are likely to have children (but no nanny), and, because they work, have a need to shop at odd hours'.[108] Thus, IKEA's focused cost leadership strategy also includes some differentiated features with its low-cost products.

## Focused differentiation strategy

Other organisations implement the focused differentiation strategy. As noted earlier, there are many dimensions on which organisations can differentiate their good or service. Lord of the Fries differentiates by the quality of its food and by demonstrating in its newsletter, internet and Facebook presences how highly aware it is of youth music culture. It also sells exclusively vegan products, distinguishing itself from the competition on ethical grounds.

The activities required to use the focused cost leadership strategy are virtually identical to those of the industry-wide cost leadership strategy (see Figure 4.2), and activities required to use the focused differentiation strategy are largely identical to those of the industry-wide differentiation strategy (see Figure 4.3). Similarly, the manner in which each of the two focus strategies allows an organisation to deal successfully with the five competitive forces parallels those of the two broad strategies. The only difference is in the organisation's competitive scope; the organisation focuses on a narrow industry segment. Thus, Figures 4.2 and 4.3 and the text describing the five competitive forces also explain the relationship between each of the two focus strategies and competitive advantage.

## Competitive risks of focus strategies

With either focus strategy, the organisation faces the same general risks as the organisation using the cost leadership or the differentiation strategy, respectively, on an industry-wide basis. However, focus strategies have two additional risks.

First, a competitor may be able to focus on a more narrowly defined competitive segment and thereby 'out-focus' the focuser. This would happen to IKEA if another organisation found a way to offer IKEA's customers (young buyers interested in stylish furniture at a low cost) additional sources of differentiation while charging the same price, or to provide the same service with the same sources of differentiation at a lower price. Second, a company competing on an industry-wide basis may decide that the market segment served by the organisation using a focus strategy is attractive and worthy of competitive pursuit. For example, leading up to Christmas 2019, Billabong's broad youth target was under attack from 'core surf' brands, and the company's operations were disrupted by an international cyber attack.[109]

# Integrated cost leadership/differentiation strategy

Most consumers have high expectations when purchasing a good or service. In general, it seems that most consumers want to pay a low price for products with somewhat highly differentiated features. Because of these customer expectations, a number of organisations engage in primary value chain activities and support functions that allow them to simultaneously pursue low cost and differentiation. Organisations seeking to do this use the **integrated cost leadership/differentiation strategy**. The objective of using this strategy is to efficiently produce products with some differentiated features. Efficient production is the source of maintaining low costs, while differentiation is the source of creating unique value. Organisations that successfully use the integrated cost leadership/differentiation strategy usually adapt quickly to new technologies and rapid changes in their external environments. Simultaneously concentrating on developing two sources of competitive advantage (cost and differentiation) increases the number of primary and support activities in which the organisation must become competent. Such organisations often have strong networks with external parties that perform some of the primary and support activities.[110] In turn, having skills in a larger number of activities makes an organisation more flexible.

**integrated cost leadership/differentiation strategy**
involves engaging in primary value chain activities and support functions that allow an organisation to simultaneously pursue low cost and differentiation

Concentrating on the needs of its core customer group (higher-income, fashion-conscious discount shoppers), Target (Australia) uses an integrated cost leadership/differentiation strategy, as shown by its 'Expect more. Pay less' brand promise. Target's annual report describes this strategy: 'Our enduring "Expect more. Pay less" brand promise helped us to deliver greater convenience, increased savings and a more personalised shopping experience'. However, Australian bricks-and-mortar retail stores are struggling against online shopping and stronger European and US competitors, and Target closed 15 stores in 2018–19 after a 1.5 per cent decline in sales. In 2010, Target had 341 stores in Australia, but this had dropped to 289 stores by 2019.[111] European-based Zara, which pioneered 'cheap chic' in clothing apparel, is another organisation using the integrated cost leadership/differentiation strategy. Zara offers current and desirable fashion goods at relatively low prices. To implement this strategy effectively requires sophisticated designers and means of managing costs, which fits Zara's capabilities. Zara can design and begin manufacturing a new fashion in three weeks, which suggests a highly flexible organisation that can adapt easily to changes in the market or with competitors.[112]

Flexibility is required for organisations to complete primary value chain activities and support functions in ways that allow them to use the integrated cost leadership/differentiation strategy in order to produce somewhat differentiated products at relatively low costs. Chinese car manufacturers have developed a means of product design that provides a flexible architecture that allows low-cost manufacturing but also car designs that are differentiated from competitors.[113] Flexible manufacturing systems, information networks and total quality management systems are three sources of flexibility that are particularly useful for organisations trying to balance the objectives of continuous cost reductions and continuous enhancements to sources of differentiation as called for by the integrated strategy.

The Chinese footwear and apparel company Li Ning has implemented an integrated cost leadership/differentiated strategy. The company entered the market and grew quickly using a cost leadership strategy. It is now entering the upscale markets in China, in which it will compete with Nike and Adidas. It is also entering the US market, in which it will compete against both of these organisations and other brand-name sportswear producers. Thus, it will encounter significant challenges. In fact, it may end up 'stuck in the middle' and not compete effectively in any markets. Perhaps its opportunity is to provide high-quality brand-name goods for a lower price than its 'upmarket' competitors.

## Apple vs Samsung vs Huawei: the battle for smart technology

**Strategic focus** | Technology

Apple traditionally had several advantages that kept it as market leader in its sector of 'smart technology'. It is a product innovator, has a huge installed base of customers, and owns and controls most of its supply chain and value chain. Apple is not only a product innovator; it creates new markets and then dominates them as a first mover. Apple has done this with the iPod, iPhone and iPad. However, as shown in Figure 4.4, both Samsung and Huawei surpassed Apple in smartphone sales in 2018 and 2019, with similar trends for tablets and other devices.

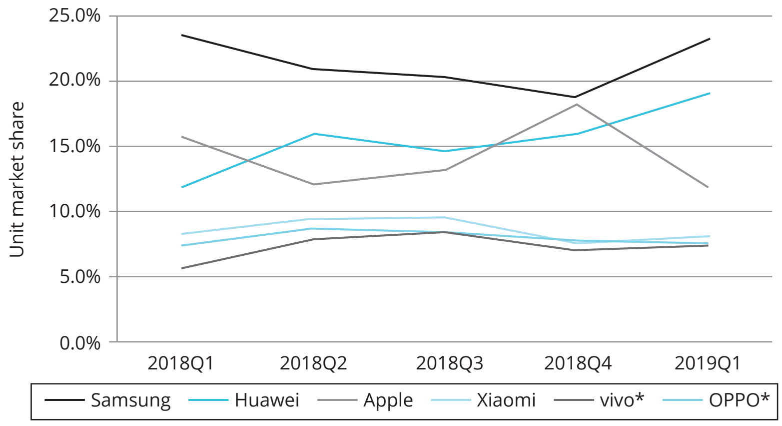
There are significant differences in the overall company market focus between the tech giants. Apple is focused on consumer technology, Huawei is focused more specifically on telecommunications, and Samsung is a highly diversified company with interests in technology, motor vehicles, military hardware, apartments and ships, and even operates a Korean amusement park. Samsung is one of the top four investors in R&D globally, along with Amazon, Alphabet (Google) and Volkswagen. Samsung invested over US$15 billion in R&D in 2018.

In response to its competitors, Apple has stepped up its own R&D spend, with a record US$4.2 billion in a single quarter in 2019. Apple still leads in terms of installed customer base, and perhaps most significantly, in terms of profit. Also, Apple is well-positioned to take advantage of the customer trend towards online and subscription-based services, with Apple's services divisions making up an increasing percentage of its revenues and profits.

Apple's services business brings in more revenue than the iPad or Mac. Apple's future seems to be clearly focused on services and subscriptions, with Apple Music, App Store, iCloud, iTunes, Apple Books, Apple Pay, AppleCare and licensing as the fastest-growing part of the company. Apple may be beaten on physical devices by Samsung and Huawei, but Apple's differentiation strategy based on product innovation, a superb brand, and a focus on services and subscriptions is likely to be a winner.

Sources: E. Schulze, 2019, Huawei smartphone sales surge 50% as Apple and Samsung struggle, CNBC, https://www.cnbc.com/2019/05/01/huawei-ahead-of-apple-in-q1-2019-smartphone-shipments.html, 1 December; J. Riley, 2013, Samsung – the world's biggest diversified company?, https://www.tutor2u.net/business/blog/samsung-the-worlds-biggest-diversified-company, 9 February; *Statista*, 2019, Ranking of the 20 companies with the highest spending on research and development in 2018 (in billion U.S. dollars), https://www.statista.com/statistics/265645/ranking-of-the-20-companies-with-the-highest-spending-on-research-and-development, 1 December; Naresh, 2019, Samsung continues to pour money into R&D, https://www.sammobile.com/news/samsung-spending-on-research-development-grows, 1 September; C. Miller, 2019, Apple R&D spending continues to increase as it invests in core iPhone tech, future products, https://9to5mac.com/2019/08/04/apple-rd-spending-q3, 4 August; C. Gartenberg, 2019, How Apple makes billions of dollars selling services: Breaking down Apple's new focus – from Apple Music to accounting tricks, *The Verge*, https://www.theverge.com/2019/3/20/18273179/apple-icloud-itunes-app-store-music-services-businesses, 20 March; D. Reisinger, 2016, How Apple nabbed 104% of smartphone profits last quarter, *Fortune*, https://fortune.com/2016/11/04/apple-smartphone-profits, 4 November.

**Figure 4.4** **Global smartphone market share**




Source: E. Schulze, 2019, Huawei smartphone sales surge 50% as Apple and Samsung struggle, https://www.cnbc.com/2019/05/01/huawei-ahead-of-apple-in-q1-2019-smartphone-shipments.html, 1 December.

## Flexible manufacturing systems

A flexible manufacturing system (FMS) increases the 'flexibilities of human, physical and information resources'[114] that the organisation integrates to create relatively differentiated products at relatively low costs. A significant technological advance, FMS is a computer-controlled process used to produce a variety of products in moderate, flexible quantities with a minimum of manual intervention.[115] Often the flexibility is derived from modularisation of the manufacturing process (and sometimes other value chain activities as well).[116]

The goal of an FMS is to eliminate the 'low cost versus product variety' trade-off that is inherent in traditional manufacturing technologies. Organisations use an FMS to change quickly and easily from making one product to making another. Used properly, an FMS allows the organisation to respond more effectively to changes in its customers' needs, while retaining low-cost advantages and consistent product quality.[117] Because an FMS also enables the organisation to reduce the lot size needed to manufacture a product efficiently, the organisation's capacity to serve the unique needs of a narrow competitive scope is higher. In industries of all types, effective mixes of the organisation's tangible assets (e.g. machines) and intangible assets (e.g. people's skills) facilitate implementation of complex competitive strategies, especially the integrated cost leadership/differentiation strategy.[118]

## Information networks

By linking organisations with their suppliers, distributors and customers, information networks provide another source of flexibility. These networks, when used effectively, help the organisation to satisfy customer expectations in terms of product quality and delivery speed.[119]

Earlier, we discussed the importance of managing the organisation's relationships with its customers in order to understand their needs. Customer relationship management (CRM) is one form of an information-based network process that organisations use for this purpose.[120] An effective CRM system provides a 360-degree view of the organisation's relationship with customers, encompassing all contact points, business processes and communication media and sales channels.[121] The organisation can then use this information to determine the trade-offs its customers are willing to make between differentiated features and low cost – an assessment that is vital for organisations using the integrated cost leadership/differentiation strategy. Such systems help organisations to monitor their markets and stakeholders and allow them to better predict future scenarios. This capability helps organisations to adjust their strategies to be better prepared for the future.[122] Thus, to make comprehensive strategic decisions with effective knowledge of the organisation's context, good information flow is essential. Better-quality managerial decisions require accurate information on the organisation's environment.[123]

## Total quality management systems

**Total quality management (TQM)** is a managerial process that emphasises an organisation's commitment to the customer and to continuous improvement of all processes through problem-solving approaches based on empowerment of employees.[124] Organisations develop and use TQM systems to increase customer satisfaction, cut costs and reduce the amount of time required to introduce innovative products to the marketplace.[125]

**total quality management (TQM)**
a managerial innovation that emphasises an organisation's total commitment to the customer and to continuous improvement of every process through the use of data-driven, problem-solving approaches based on empowerment of employee groups and teams

Organisations able to simultaneously reduce costs while enhancing their ability to develop innovative products increase their flexibility, an outcome that is particularly helpful to organisations implementing the integrated cost leadership/differentiation strategy. Exceeding customers' expectations regarding quality is a differentiating feature, and eliminating process inefficiencies to cut costs allows the organisation to offer that quality to customers at a relatively low price. Thus, an effective TQM system helps the organisation develop the flexibility needed to identify opportunities to simultaneously increase differentiation and reduce costs. Yet TQM systems are available to all competitors, so they may help organisations maintain competitive parity, but rarely alone will they lead to a competitive advantage.[126]

## Competitive risks of the integrated cost leadership/differentiation strategy

The potential to earn above-average returns by successfully using the integrated cost leadership/differentiation strategy is appealing. However, it is a risky strategy because organisations find it difficult to perform primary value chain activities and support functions in ways that allow them to produce relatively inexpensive products with levels of differentiation that create value for the target customer. Moreover, to properly use this strategy across time, organisations must be able to simultaneously reduce costs incurred to produce products (as required by the cost leadership strategy) while increasing products' differentiation (as required by the differentiation strategy).

Organisations that fail to perform the primary and support activities in an optimum manner become 'stuck in the middle'.[127] Being stuck in the middle means that the organisation's cost structure is not low enough to allow it to attractively price its products and that its products are not sufficiently differentiated to create value for the target customer. These organisations will not earn above-average returns, and they will earn average returns only when the structure of the industry in which they compete is highly favourable.[128] Thus, organisations implementing the integrated cost leadership/differentiation strategy must be able to produce products that offer the target customer some differentiated features at a relatively low cost/price.

Organisations can also become stuck in the middle when they fail to successfully implement *either* the cost leadership *or* the differentiation strategy. In other words, industry-wide competitors too can become stuck in the middle. Trying to use the integrated strategy is costly in that organisations must pursue both low costs and differentiation. This is the challenge for Li Ning Company mentioned earlier. If it can offer high-quality goods desired by consumers at lower prices, however, it may be able to capture market share from the leaders, such as Nike.

Organisations may need to form alliances with other organisations to achieve differentiation, yet alliance partners may extract prices for the use of their resources that make it difficult to meaningfully reduce costs.[129] Organisations may be motivated to make acquisitions to maintain their differentiation through innovation or to add products to their portfolio not offered by competitors.[130] Research suggests that organisations using 'pure strategies', either cost leadership or differentiation, often outperform organisations attempting to use a 'hybrid strategy' (i.e. integrated cost leadership/differentiation strategy). This research suggests the risky nature of using an integrated strategy.[131] However, the integrated strategy is becoming more common and perhaps necessary in many industries because of technological advances and global competition. This strategy often requires a long-term perspective to make it work effectively, and therefore it requires dedicated owners that allow the implementation of a long-term strategy that can require several years to produce positive returns.[132]

# STUDY TOOLS

## SUMMARY

**LO1** Customers are the foundation of successful business-level strategies. When considering customers, an organisation simultaneously examines three issues: who, what and how. These issues refer, respectively, to the customer groups to be served, the needs those customers have that the organisation seeks to satisfy, and the core competencies the organisation will use to satisfy customers' needs. Increasing segmentation of markets throughout the global economy creates opportunities for organisations to identify more distinctive customer needs they can serve with one of the business-level strategies.

**LO2** A business-level strategy is an integrated and coordinated set of commitments and actions the organisation uses to gain a competitive advantage by exploiting core competencies in specific product markets. Five business-level strategies (cost leadership, differentiation, focused cost leadership, focused differentiation and integrated cost leadership/ differentiation) are examined in the chapter.

**LO3** A business model, which describes what an organisation does to create, deliver and capture value for stakeholders, is part of an organisation's business-level strategy. In essence, a business model is a framework for how the organisation will use processes to create, deliver and capture value, while a business-level strategy is the path the organisation will follow to gain a competitive advantage by exploiting its core competencies in a specific product market. There are many types of business models, including the franchise, subscription, freemium, advertising and peer-to-peer models. Organisations may pair each type of business model with any one of the five generic business-level strategies as they seek to compete successfully against rivals.

**LO4** Organisations seeking competitive advantage through the *cost leadership* strategy produce no-frills, standardised products for an industry's typical customer. However, these low-cost products must be offered with competitive levels of differentiation. Above-average returns are earned when organisations continuously emphasise efficiency such that their costs are lower than those of their competitors, while providing customers with products that have acceptable levels of differentiated features.

Through the differentiation strategy, organisations provide customers with products that have different (and valued) features. Differentiated products must be sold at a cost that customers believe is competitive relative to the product's features as compared with the cost–feature combinations available from competitors' goods. Because of their distinctiveness, differentiated goods or services are sold at a premium price. Products can be differentiated on any dimension that a customer group values. Organisations using this strategy seek to differentiate their products from competitors' goods or services on as many dimensions as possible. The less similarity to competitors' products, the more buffered an organisation is against competition with its rivals.

Through the cost leadership and differentiated focus strategies, organisations serve the needs of a narrow competitive segment (e.g. a buyer group, product segment or geographic area). This strategy is successful when organisations have the core competencies required to provide value to a specialised market segment that exceeds the value available from organisations serving customers on an industry-wide basis.

Organisations using the integrated cost leadership/ differentiation strategy strive to provide customers with relatively low-cost products that also have valued differentiated features. Flexibility is required for organisations to learn how to use primary value chain activities and support functions in ways that allow them to produce differentiated products at relatively low costs.

**LO5** Porter's five forces of competition model is a tool for analysing the forces that shape the industry immediately impacting on an organisation. The model helps to define where the major forces are, what shapes competition in that industry and whether the industry is attractive for an organisation. The five forces are: (1) rivalry with existing competitors,

(2) bargaining power of customers, (3) bargaining power of suppliers, (4) threat of new entrants, and (5) threat of substitute products. Effective use of this model can shape business-level strategy to adjust to compensate for or counteract these forces.

**LO6** Competitive risks associated with the cost leadership strategy include: (1) a loss of competitive advantage to newer technologies; (2) a failure to detect changes in customers' needs; and (3) the ability of competitors to imitate the cost leader's competitive advantage through their own distinct strategic actions.

Risks associated with the differentiation strategy include: (1) a customer group's decision that the differences between the differentiated product and the cost leader's goods or services are no longer worth a premium price; (2) the inability of a differentiated product to create the type of value for which customers are willing to pay a premium price; (3) the ability of competitors to provide customers with products that have features similar to those of the differentiated product, but at a lower cost; and (4) the threat of counterfeiting, whereby organisations produce a cheap imitation of a differentiated good or service.

The competitive risks of focus strategies include: (1) a competitor's ability to use its core competencies to 'outfocus' the focuser by serving an even more narrowly defined market segment; (2) decisions by industry-wide competitors to focus on a customer group's specialised needs; and (3) a reduction in differences of the needs between customers in a narrow market segment and the industry-wide market.

The primary risk of the integrated cost leadership/differentiation strategy is that an organisation might produce products that do not offer sufficient value in terms of either low cost or differentiation. In such cases, the organisation becomes 'stuck in the middle'. Organisations stuck in the middle compete at a disadvantage and are unable to earn more than average returns.

## KEY TERMS

business model
business-level strategy
cost leadership strategy
differentiation strategy
focus strategy
integrated cost leadership/differentiation strategy
market segmentation
total quality management

## REVIEW QUESTIONS

1. What is a business-level strategy?
2. What is the relationship between an organisation's customers and its business-level strategy in terms of who, what and how? Why is this relationship important?
3. In what ways do non-commercial organisations (public sector or not-for-profit) compete?
4. What changes in the market (including customer behaviour and preferences) are causing the need to review business-level strategy?
5. What are the differences among the cost leadership, differentiation, focused cost leadership, focused differentiation and integrated cost leadership/differentiation business-level strategies?
6. How can organisations use each of the business-level strategies to position themselves favourably relative to the five forces of competition?
7. What are the specific risks associated with using each business-level strategy?

## EXPERIENTIAL EXERCISES

### Exercise 1: Market segmentation through branding

The 'who' in an organisation's target market is an extremely important decision. As discussed in the chapter, organisations divide customers into groups based upon differences in customer needs, which is the heart of market segmentation. For example, if you owned a restaurant and your target market was university-aged students, your strategy would be very different than if your target market was business professionals.

In this exercise, your team will be identifying market segmentation strategies used by various organisations. Remember that market segmentation 'is a process used to cluster people with similar needs into individual and identifiable groups'.

## Part 1

Your team should select an advertised and prominent brand. You may choose a business or consumer product. However, you should choose a brand widely known and widely advertised. Once you have chosen the brand, find and collect at least four instances of this brand being advertised in print or digital media. Find your four or more instances from different publications, if possible.

## Part 2

Assemble a poster with the images you collected from your research. Be prepared to present your findings to the class.

1. Why did you choose this brand?
2. Review each of the criteria discussed in Table 4.1 for either your consumer market or industrial market.

### Exercise 2: Create a business-level strategy

This assignment brings together elements from the previous chapters. Accordingly, you and your team will create a business-level strategy for an organisation of your own creation. The instructor will assign you an industry. You will create a strategy for entering that industry using one of the five potential business-level strategies.

Each team is assigned one of the business-level strategies described in the chapter:

- cost leadership
- differentiation
- focused cost leadership
- focused differentiation
- integrated cost leadership/differentiation.

## Part 1

Research your industry and describe the general environment and the industry. Using the dimensions of the general environment, identify some factors for each dimension that are influential for your industry. Next, describe the industry environment using the five forces model. Database services like Mint Global, Datamonitor or IBIS World can be helpful in this regard. If those are not available to you, consult your local librarian for assistance. You should be able to clearly articulate the opportunities and the threats that exist.

## Part 2

Create on a poster the business-level strategy assigned to your team. Be prepared to describe the following:

- What is the mission statement?
- What is the description of your target customer?
- Provide a picture of your business. Where is it located (city, suburban, rural etc.)?
- What trends provide opportunities and threats for your intended strategy?
- List the resources, both tangible and intangible, required to compete successfully in this market.
- How will you go about creating a sustainable competitive advantage?

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# Competitive dynamics

CHAPTER 5

## Learning Objectives

Studying this chapter should provide you with the strategic management knowledge needed to:

**LO1** define competitors, competitive rivalry, competitive behaviour and competitive dynamics

**LO2** describe market commonality and resource similarity as the building blocks of a competitor analysis

**LO3** explain awareness, motivation and ability as drivers of competitive behaviours

**LO4** describe how strategic actions and tactical actions drive competitive rivalry between organisations

**LO5** discuss factors affecting the likelihood a competitor will take competitive actions

**LO6** describe factors affecting the likelihood a competitor will respond to actions taken against it

**LO7** explain the competitive dynamics in each of slow-cycle, fast-cycle and standard-cycle markets.

# OPENING CASE STUDY

## Tesco PLC: a case study in competitive behaviour

Major supermarket chains are a global phenomenon. In Australia, Coles and Woolworths control around 80 per cent of the market and are among the 20 biggest retailers in the world, having thrashed the competition for over a century. However, globally they are dwarfed by Tesco. Tesco PLC is the world's third-largest retailer (only Walmart and France's Carrefour are larger), suggesting its ability to compete successfully against companies both in the UK (its home market) and throughout the world. However, the organisation's recent competitive struggles, both domestically and globally, appear to highlight that, as noted in Chapter 1, no company's success at a point in time guarantees its future success.

So what are some descriptors of the situation Tesco encountered? From a financial perspective, the organisation reported a decline in profits in 2012 for the first time in approximately two decades, and profits declined significantly through to 2017 before a partial recovery in 2018 and 2019. In 2013, Tesco closed its Fresh & Easy stores in the USA and also took a write-down of £804 million to reflect the then-current value of its UK properties. In all, Tesco wrote down the value of its global operations by US$3.5 billion in 2013. (This global write-down accounts for the organisation's troubled operations in countries such as Turkey, China and India as well as the closing of its US operations.)

Another issue is that revenue had been declining in Tesco's home market, partially due to competition from discount rivals like Aldi and Lidl, where the company still generates roughly two-thirds of its sales and profits. Part of the reason for the revenue decline is related to customer service, as suggested by the fact that the results from a survey of UK consumers a few years ago 'found that despite £1 billion of investment in the U.K. in FY2012/13, customer perceptions of Tesco's quality, prices, promotions and overall value for money had all deteriorated quarter on quarter and year on year'. In light of these results, the organisation took a number of actions, including adding more and better-trained staff members in its stores, refurbishing those stores, and revamping its product lines and the prices it charged for them.

Revamping product lines and changing the prices charged for items are *tactical actions*. In contrast, entering (and exiting) the US market with the Fresh & Easy concept was a *strategic action* (strategic and tactical actions and responses are defined later in this chapter). On the surface, entering the large US market seems to be a reasonable course of action for a successful global retailer to take. As is often the case, though, execution of that strategic action appears to be where problems were encountered. Fresh & Easy stores were sized to be handy neighbourhood stores such as those found in many European cities. This did not appeal to American consumers, as suggested by an analyst: 'My sense is that what they tried to do was make a European model. Europeans tend to make more frequent trips to grocery stores, maybe every day or every other day, where Americans are used to going for bigger trips less frequently'. Additionally, products carried in stores located in different parts of the USA were not customised to any degree, meaning that the potentially unique needs of any local consumers who might choose to shop daily were not being identified and satisfied. Tesco sold Fresh & Easy in 2013 and exited the American market.

Tesco has taken additional strategic actions as part of its current array of competitive behaviours. For example, it took positions in other companies for the purpose of being able to turn their stores into compelling retail destinations for customers. 'Investments in the Harris & Hoole coffee chain, working with the Euphorium bakery brand in London and acquiring the Giraffe restaurant chain' are examples of the competitive behaviour Tesco displayed as a foundation for improving its performance and trying to outcompete its rivals in the process of doing so. However, after poor results and corporate financial pressures, these investments were divested in 2016. Tesco is hoping that investments in mobile payment technology and other initiatives will help to improve its market position.

Sources: 2016, Tesco starts sell-off ahead of results with Asian disposal, *BBC News*, https://www.bbc.com/news/business-36022305, 12 April; M. Knox, 2015, *Supermarket Monsters*, Melbourne: Redback; J. Davey & K. Holton, 2013, Tesco quits U.S. and takes $3.5 billion global writedown, *Reuters*, http://www.reuters.com, 17 April; J. Dunkley, 2014, Warren Buffett says Tesco investment was a 'huge mistake', *Independent*, https://www.independent.co.uk/news/business/news/warren-buffett-says-tesco-investment-was-a-huge-mistake-9770684.html, 2 October; K. Gordon, 2013, Tesco leans on outside brands, *Wall Street Journal*, http://www.wsj.com, 18 April; R. Head, 2013, Can Tesco outperform Wal-Mart stores?, *Daily Finance*, http://www.dailyfinance.com, 21 March; N. Pratley, 2013, Tesco's era of rolling out its aisles is over, for now, *The Guardian*, http://www.guardian.co.uk, 17 April.

Organisations operating in the same market, offering similar products and targeting similar customers are **competitors**.[1] Qantas, Virgin Australia, Regional Express and Jetstar (part of the Qantas Group) are competitors, as are PepsiCo and Coca-Cola Company, and to some extent, even the Salvation Army and St Vincent de Paul. As described in the opening case study, Tesco in the UK is currently engaging in a competitive battle in the supermarket game with large competitors, with at least one, Aldi, having a slightly different model, one that seems to be successful. Coles and Woolworths also face the Aldi threat in the Australian market.[2]

**competitors**
organisations operating in the same market, offering similar products and targeting similar customers

STRATEGY NOW
Tesco's competitive behaviour

Organisations interact with their competitors as part of the broad context within which they operate while attempting to earn above-average returns.[3] As stated in Chapter 4, competitors and return on investment also applies to non-commercial organisations, including government departments, not-for-profit, sporting, health care and community organisations. The decisions organisations make about their interactions with their competitors significantly affect their ability to earn above-average returns.[4] Because 80–90 per cent of new organisations fail, learning how to select the markets in which to compete and how to best compete within them is highly important.[5]

**Competitive rivalry** is the ongoing set of competitive actions and competitive responses that occur among organisations as they manoeuvre for an advantageous market position.[6] Especially in highly competitive industries, organisations constantly jockey for advantage as they launch strategic actions and respond or react to rivals' moves.[7] It is important for those leading organisations to understand competitive rivalry, in that 'the central, brute empirical fact in strategy is that some firms outperform others',[8] meaning that competitive rivalry influences an individual organisation's ability to gain and sustain competitive advantages.[9]

**competitive rivalry**
the ongoing set of competitive actions and competitive responses occurring between competitors as they compete against each other for an advantageous market position

A sequence of organisation-level moves results, with the rivalry a consequence from organisations initiating their own competitive actions and then responding to actions taken by competitors.[10] **Competitive behaviour** is the set of competitive actions and responses the organisation takes to build or defend its competitive advantages and to improve its market position.[11] Through competitive behaviour, the organisation tries to successfully position itself relative to the five forces of competition (see Chapter 2) and to defend current competitive advantages while building advantages for the future (see Chapter 3). Increasingly, competitors engage in competitive actions and responses in more than one market.[12] Organisations competing against each other in several product or geographic markets are engaged in **multi-market competition**.[13] All competitive behaviour – that is, the total set of actions and responses taken by all organisations competing within a market – is called **competitive dynamics**. The relationships among these key concepts are shown in Figure 5.1.

**competitive behaviour**
the set of competitive actions and competitive responses the organisation takes to build or defend its competitive advantages and to improve its market position

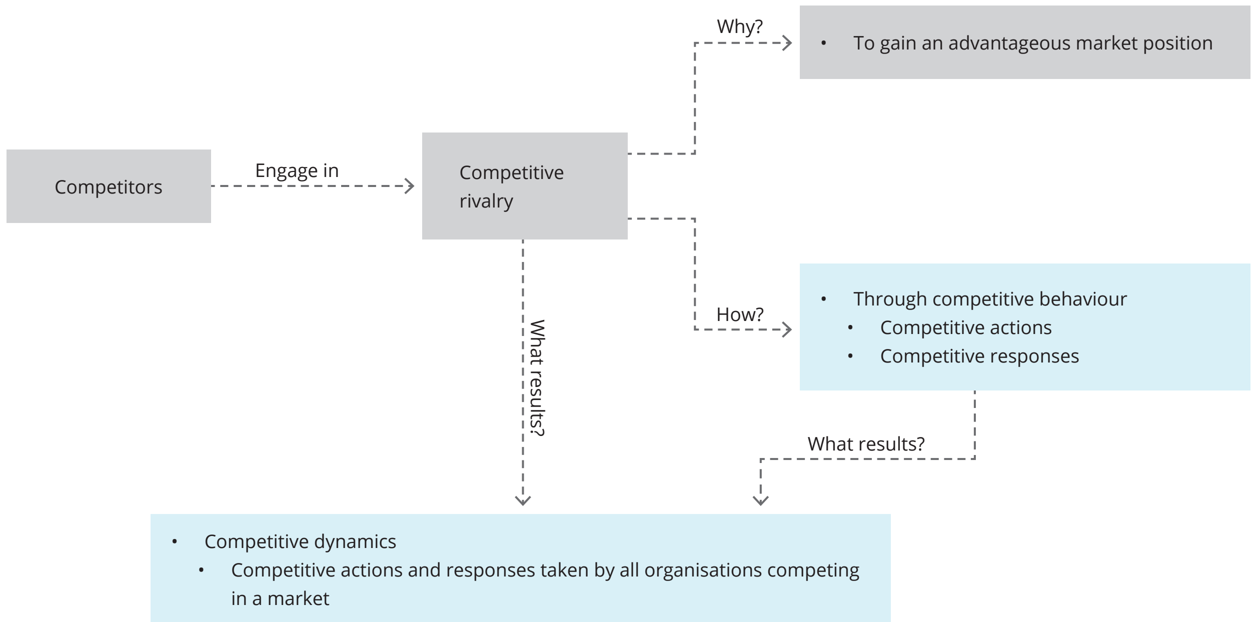
**multi-market competition**
occurs when organisations compete against each other in several product or geographic markets

**competitive dynamics**
refers to all competitive behaviours; that is, the total set of actions and responses taken by all organisations competing within a market

This chapter focuses on competitive rivalry and competitive dynamics. An organisation's strategies are dynamic in nature because actions taken by one organisation elicit responses from competitors that, in turn, typically result in responses from the organisation that took the initial action.[14] Strategy is not a matter of following a recipe. It is more like a game of chess. You cannot have an effective strategy without considering the responses by competitors, and your response to their responses.

Competitive rivalries affect an organisation's strategies, as shown by the fact that a strategy's success is determined not only by the organisation's initial competitive actions but also by how well it anticipates competitors' responses to them *and* by how well the organisation anticipates and responds to its competitors' initial actions (also called attacks).[15] Although competitive rivalry affects all types of strategies (e.g. corporate-level, acquisition and international), its dominant influence is on the organisation's business-level strategy or strategies. Indeed, organisations' actions and responses to those of their rivals are the basic building blocks of business-level strategies.[16] You will recall from Chapter 4 that business-level strategy is concerned with what the organisation does to successfully use its competitive advantages in specific product markets. In the global economy, competitive rivalry is intensifying,[17] meaning that the significance of its effect on organisations' business-level strategies is increasing. However, organisations that develop and use effective business-level strategies tend to outperform competitors in individual product markets, even when experiencing intense competitive rivalry that price cuts bring about.[18]

**Figure 5.1** **From competitors to competitive dynamics**




Source: Based on M.-J. Chen, 1996, Competitor analysis and interfirm rivalry: Toward a theoretical integration, *Academy of Management Review*, 21: 100–34.

# A model of competitive rivalry

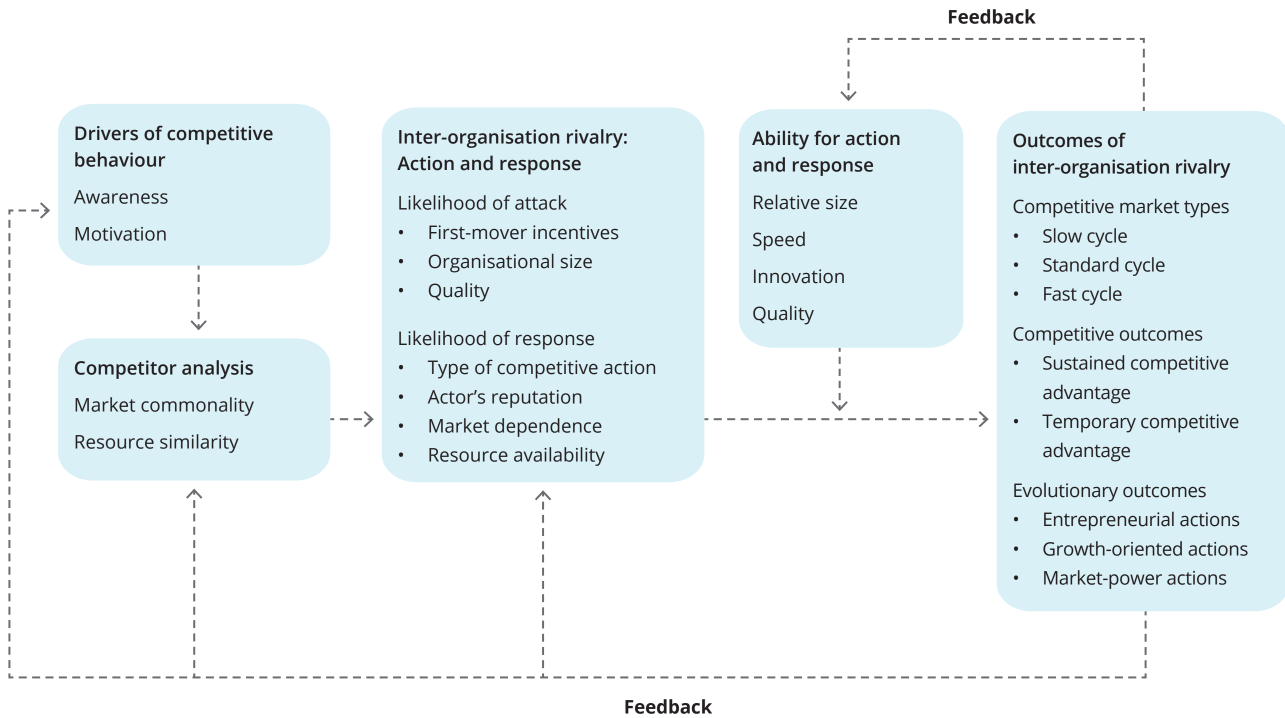
Competitive rivalry evolves from the pattern of actions and responses as one organisation's competitive actions have noticeable effects on competitors, eliciting competitive responses from them.[19] This pattern suggests that organisations are mutually interdependent, that they are affected by each other's actions and responses, and that marketplace success is a function of both individual strategies and the consequences of their use.[20] Increasingly, too, executives recognise that competitive rivalry can have a major effect on the organisation's financial performance.[21] Research shows that intensified rivalry within an industry results in decreased average profitability for the competing organisations.[22] For example, Research In Motion (RIM) dominated the smartphone market with its BlackBerry operating system platform until Apple's iPhone platform emerged. Likewise, the introduction of the Android platform by Google and the growth of Samsung has cut into RIM's market share and thereby further lowered the company's performance expectations. The organisation is now in deep trouble with, in mid-2019, only around 0.04 per cent of the global smartphone market.[23]

**STRATEGY NOW**

Apple's cutting-edge technology strategy

Figure 5.2 presents a straightforward model of competitive rivalry at the organisation level; this type of rivalry is usually dynamic and complex.[24] The competitive actions and responses the organisation takes are the foundation for successfully building and using its capabilities and core competencies to gain an advantageous market position.[25] The model in Figure 5.2 presents the sequence of activities commonly involved in competition between a particular organisation and each of its competitors. Companies can use the model to understand how to be able to predict competitors' behaviour (actions and responses) and reduce the uncertainty associated with competitors' actions.[26] Being able to predict competitors' actions and responses has a positive effect on the organisation's market position and its subsequent financial performance.[27] The sum of all the individual rivalries modelled in Figure 5.2 that occur in a particular market reflect the competitive dynamics in that market.

**Figure 5.2** **A model of competitive rivalry**




Source: Adapted from M.-J. Chen, 1996, Competitor analysis and interfirm rivalry: Toward a theoretical integration, *Academy of Management Review*, 21: 100–34.

The remainder of the chapter explains components of the model shown in Figure 5.2. We first describe market commonality and resource similarity as the building blocks of a competitor analysis. Next, we discuss the effects of three organisational characteristics – awareness, motivation and ability – on the organisation's competitive behaviour. We then examine competitive rivalry between organisations (or inter-organisation rivalry) in detail, by describing the factors that affect the likelihood an organisation will take a competitive action and the factors that affect the likelihood an organisation will respond to a competitor's action. In the chapter's final section, we turn our attention to competitive dynamics to describe how market characteristics affect competitive rivalry in slow-cycle, fast-cycle and standard-cycle markets.

# Competitor analysis

As previously noted, a competitor analysis is the first step the organisation takes to be able to predict the extent and nature of its rivalry with each competitor. The number of markets in which organisations compete against each other (called market commonality, defined in the following section) and the similarity in their resources (called resource similarity, also defined in the following section) determine the extent to which organisations are competitors. Organisations with high market commonality and highly similar resources are 'clearly direct and mutually acknowledged competitors'.[28] The drivers of competitive behaviour – as well as factors influencing the likelihood that a competitor will initiate competitive actions and will respond to its competitors' actions – influence the intensity of rivalry, even for direct competitors.[29]

In Chapter 2, we discussed competitor analysis as a technique organisations use to understand their competitive environment. Together, the general, industry and competitive environments comprise the organisation's external environment. We also described how competitor analysis is used to help the organisation *understand* its competitors. This understanding results from studying competitors' future objectives, current strategies, assumptions and capabilities (see Figure 2.5 in Chapter 2). In this chapter, the discussion of competitor analysis is extended to describe what organisations study to be able to *predict* competitors' behaviour in the form of their competitive actions and responses. The discussions of competitor analysis in Chapter 2 and in this chapter are complementary in that organisations must first *understand* competitors (Chapter 2) before their competitive actions and competitive responses can be *predicted* (this chapter).

Such competitive awareness is illustrated in the competitors in the global automobile market such as Toyota, Ford, General Motors, Honda, Tesla, Tata, Chrysler, Nissan, Volkswagen (VW), Daimler-Benz and others. These analyses are highly important because they help managers to avoid 'competitive blind spots', in which managers are unaware of specific competitors or their capabilities. If managers have competitive blind spots, they may be surprised by a competitor's actions, thereby allowing the competitor to increase its market share at the expense of the manager's organisation.[30] Competitor analyses are especially important when an organisation enters a foreign market. Managers need to understand the local competition and foreign competitors currently operating in the market.[31] Without such analyses, they are less likely to be successful.

## Market commonality

Each industry is composed of various markets. The financial services industry has markets for insurance, brokerage services, banks and so forth. To concentrate on the needs of different, unique customer groups, markets can be further subdivided. The insurance market, for example, could be broken into market segments (such as commercial and consumer), product segments (such as health insurance and life insurance) and geographic markets (such as Western Europe and South-East Asia). In general, the capabilities generated by the internet's technologies help to shape the nature of industries' markets, along with the competition among organisations operating in them. For example, Alex Tosolini, formerly vice president of e-commerce for Procter & Gamble (P&G), noted: 'Facebook is both a marketing and a distribution channel, as P&G has worked to develop "f-commerce" capabilities on its fan pages, fulfilled by Amazon, which has become a top 10 retail account for Pampers', a disposable nappy product.[32]

Competitors tend to agree about the different characteristics of individual markets that form an industry. For example, in the transportation industry, the commercial air travel market differs from the ground transportation market, which is served by such organisations as YRC Worldwide (one of the largest transportation service providers in the world) and major YRC competitor FedEx Freight.[33] Although differences exist, many industries' markets are partially related in terms of the technologies used or the core competencies needed to develop a competitive advantage. For example, although railroads and truck ground transport compete in a different segment and can be substitutes, different types of transportation companies need to provide reliable and timely service. Commercial air carriers such as Jetstar and Virgin Australia must therefore develop service competencies to satisfy their passengers, while YRC, railroads and their major competitors must develop such competencies to serve the needs of those using their services to transport goods.

Organisations sometimes compete against each other in several markets that are in different industries. As such, these competitors interact with each other several times, a condition called market commonality. More formally, **market commonality** is concerned with the number of markets in which the organisation and a competitor are jointly involved and the degree of importance of the individual markets to each.[34] When organisations produce similar products and compete for the same customers, as in the global automobile industry, the competitive rivalry is likely to be high.[35] Organisations competing against one another in several or many markets engage in multi-market competition.[36] Coca-Cola and PepsiCo compete across a number of product (e.g. soft drinks and bottled water) and geographic markets. Airlines, chemicals, pharmaceuticals and consumer foods are examples of other industries in which organisations often simultaneously compete against each other in multiple markets.

**market commonality**
concerned with the number of markets with which the organisation and a competitor are jointly involved and the degree of importance of the individual markets to each

Organisations competing in several markets have the potential to respond to a competitor's actions not only within the market in which the actions are taken, but also in other markets where they compete with the rival. This potential creates a complicated competitive mosaic in which 'the moves an organisation makes in one market are designed to achieve goals in another market in ways that aren't immediately apparent to its rivals'.[37] This potential complicates the rivalry between competitors. In fact, research suggests that an organisation with greater multi-market contact is less likely to initiate an attack but more likely to respond aggressively when attacked. For instance, research in the computer industry found that organisations 'respond to competitive attacks by introducing new products but do not use price as a retaliatory weapon'.[38] Thus, in general, multi-market competition reduces competitive rivalry, but some organisations will still compete when the potential rewards (e.g. potential market share gain) are high.[39]

**Strategic focus | Technology**

## Competitive rivalry in fast fashion: a constant stream of actions and responses

Zara is competing in the 'fast fashion' segment of the retailing clothing industry and 'uses its resources and capabilities as the foundation for its core competencies'. These core competencies allow Zara to 'give customers what they want and get it to them faster than anyone else'. Quick designs and its supply chain are two core competencies that remain critical to Zara's success.

In terms of design, analysts say that Zara gives customers decently made fashion items that are based on the latest looks from runways throughout the world, yet are also sold at affordable prices – hence the reason to ascribe the term 'cheap chic' to the organisation's clothes and to those produced by its major competitors as well. With respect to the supply chain competence, this is framed around the fact that Spanish parent company Industria de Diseño Textil (Inditex) owns a number of brands in addition to Zara, such as Massimo Dutti, Bershka, Pull & Bear, Stradivarius and Oysho. In total, the clothing giant has over 7400 stores located in over 90 countries. In serving the product needs of all of its units, some say that 'Inditex is something of a supply chain marvel: clothes move from concept to design to the Zara stores in a matter of days. And they move out of Zara stores within weeks'.

With over 4500 stores located in over 70 countries, Swedish multinational Hennes & Mauritz (H&M) is another very large global clothing retailer. This organisation also concentrates on the fast fashion market, and Zara and H&M compete on some of the same dimensions, such as supply chain. But as discussed in Chapter 3, organisations' resources are unique or idiosyncratic and as such do not yield identical capabilities and core competencies. This uniqueness is the foundation for how organisations compete against


A window display from a Zara store. Zara's supply chain gives it a competitive advantage and underlies its ability to take competitive actions.

Source: iStock.com/ManuelVelasco

one another. Relative to H&M, Zara's supply chain appears to be an advantage and a means of taking competitive actions. In the words of an analyst: 'Zara has a lightning-fast supply chain with 50 per cent of its clothes made in Western Europe. That allows it to capture catwalk and luxury trends and put product in its stores within weeks – something customers are willing to pay a premium for'. While H&M's supply chain is impressive, it does not allow the organisation to achieve competitive parity with Zara with respect to this competitive dimension. 'H&M with its longer supply chain can't keep pace in terms of fashion, so it tries to compete on price instead: H&M's offerings are on average about 60 per cent cheaper than Zara's. But the Stockholm-based chain is still more expensive than budget competitors such as Primark, owned by Associated British Foods PLC and US chain Forever 21, leaving H&M struggling to position itself'. Thus, in terms of competitive rivalry, Zara uses its supply chain advantage while H&M uses price as a competitive action to try to reduce the value Zara generates by emphasising its supply chain.

There are additional examples of competitive rivalry between Zara and H&M. Recently, H&M, along with other retailers including Gap, American Eagle Outfitters and Forever 21, established units in Mexico. Steadily increasing incomes of Mexican citizens and the country's sizeable and youthful population are reasons for these entries. However, Zara is a first mover in Mexico, having established its first unit there in 1992 and expanding that initial location to around 440 Inditex stores (including more than 90 Zara stores). Thus, entry now by some additional clothing retailers is a competitive response to the competitive action Zara took long ago. On the other hand, H&M is seeking to expand more rapidly in India compared with Zara. In this instance, H&M is taking a competitive action to which Zara may have to respond.

The internet is a growing source of competitive rivalry between Zara and H&M. More specifically, H&M announced that it would establish a significant online shopping presence in the USA. However, this intended action appears to be at least in part a response to Zara's increasing internet-related success. In commenting about its website, a Zara official noted that the number of visitors to the site had doubled and that the site was receiving over two million hits per day. Both chains announced in 2019 that they would be closing some stores to invest more resources in online shopping.

Overall, the never-ending string of competitive actions and responses occurring between Zara and H&M provide an interesting 'picture' of competitive rivalry.

Sources: H&M Group, 2020, https://hmgroup.com/investors/five-year-summary.html, 21 January; G. Smith, 2019, H&M and Zara are closing stores to get ahead, https://fortune.com/2019/08/11/hm-zara-store-closing, 11 August; C. Hudgins, 2019, Zara owner Inditex faces headwinds but still outruns rival H&M, https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/50958006, 8 April; *Inditex Annual Report 2018*, 2018 in data, https://static.inditex.com/annual_report_2018/en/2018-data.html; C. Bjork, 2013, Inditex profit rises as global expansion continues, *Wall Street Journal*, http://www.wsj.com, 13 March; J. Cartner-Morley, 2013, How Zara took over the high street, *The Guardian*, http://www.guardian.co.uk, 15 February; L. Dishman, 2013, H&M's competitive advantage: Expansion in India, *Forbes*, http://www.forbes.com, 29 April; J. Hansegard, 2013, H&M plans U.S. online store in summer, *Wall Street Journal*, http://www.wsj.com, 21 March; M. Moffett, 2013, Soul-searching in Spanish fashion after Bangladesh factory details, *Wall Street Journal*, http://www.wsj.com, 23 May; M. Sanchantra & L. Burkitt, 2013, Asia gravitates to cheap chic, *Wall Street Journal*, http://www.wsj.com, 23 April.

## Resource similarity

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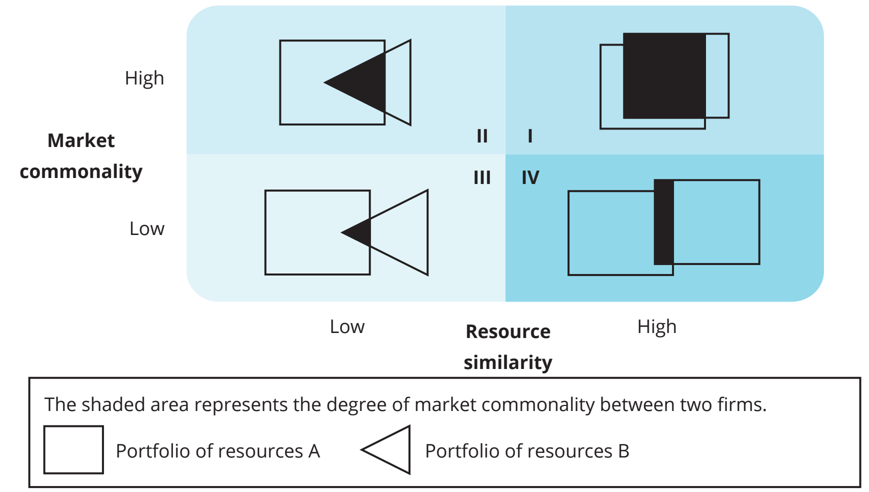
Zara's internet success

**resource similarity**
the extent to which the organisation's tangible and intangible resources are comparable to a competitor's in terms of both type and amount

**Resource similarity** is the extent to which the organisation's tangible and intangible resources are comparable to a competitor's in terms of both type and amount.[40] Organisations with similar types and amounts of resources are likely to have similar strengths and weaknesses and use similar strategies.[41] The competition between FedEx and United Parcel Service (UPS) in using information technology to improve the efficiency of their operations and to reduce costs demonstrates these expectations. Pursuing similar strategies that are supported by similar resource profiles, personnel in these organisations work at pace to receive, sort and ship packages. Rival DHL (owned by Deutsche Post) is trying to compete with the two global giants. DHL has made impressive gains in recent years; it competes strongly in Europe and Asia with resources and capabilities similar to those of FedEx and UPS.[42] To survive, it has negotiated a partnership agreement with UPS and others to make its US deliveries. Such arrangements are often referred to as 'coopetition' (cooperation between competitors). This agreement has helped DHL to focus on its European operations, where it has pioneered the use of street scooters and electric delivery vans to improve its environmental profile.[43]

When performing a competitor analysis, an organisation analyses each of its competitors in terms of market commonality and resource similarity. The results of these analyses can be mapped for visual comparisons. In Figure 5.3, we show different hypothetical intersections between the organisation and individual competitors in terms of market commonality and resource similarity. These intersections indicate the extent to which the organisation and those with which it is compared are competitors.

**Figure 5.3** **A framework of competitor analysis**




Source: M.-J. Chen, 1996, Competitor analysis and interfirm rivalry: Toward a theoretical integration, *Academy of Management Review*, 21: 100–34.

For example, the organisation and its competitor displayed in quadrant I have similar types and amounts of resources (i.e. the two organisations have a similar portfolio of resources). The organisation and its competitor in quadrant I would use their similar resource portfolios to compete against each other in many markets that are important to each. These conditions lead to the conclusion that the organisations modelled in quadrant I are direct and mutually acknowledged competitors (e.g. as in the global car industry). By contrast, the organisation and its competitor shown in quadrant III share few markets and have little similarity in their resources, indicating that they are not direct and mutually acknowledged competitors. Thus, a small, local, family-owned Italian restaurant does not compete directly against Pizza Hut, nor does it have resources that are similar to those of Pizza Hut (which also owns KFC). The organisation's mapping of its competitive relationship with rivals is fluid as organisations enter and exit markets and as companies' resources change in type and amount. Thus, the companies with which the organisation is a direct competitor change across time.

# Drivers of competitive actions and responses

As shown in Figure 5.2, market commonality and resource similarity influence the drivers (awareness, motivation and ability) of competitive behaviour. In turn, the drivers influence the organisation's competitive behaviour, as shown by the actions and responses it takes while engaged in competitive rivalry.[44]

*Awareness*, which is a prerequisite to any competitive action or response taken by an organisation, refers to the extent to which competitors recognise the degree of their mutual interdependence that results from market commonality and resource similarity.[45] Awareness tends to be greatest when organisations have highly similar resources (in terms of types and amounts) to use while competing against each other in multiple markets. Komatsu Ltd, Japan's top construction machinery maker, and Caterpillar Inc. have similar resources and are certainly aware of each other's actions.[46] The same is true for Walmart and France's Carrefour, the two largest supermarket groups in the world. The last two organisations' joint awareness has increased as they use similar resources to compete against each other for dominant positions in multiple European and South American markets. In China, where local competitors Alibaba, JD.com and Suning dominate the market, the success of Walmart and Carrefour has diverged, with Carrefour choosing in 2019 to sell an 80 per cent stake in its 210 retail stores to Suning and basically exit the market, whereas Walmart is remaining with 400 stores.[47] Awareness affects the extent to which the organisation understands the consequences of its competitive actions and responses. A lack of awareness can lead to excessive competition, resulting in a negative effect on all competitors' performance.[48]

*Motivation*, which concerns the organisation's incentive to take action or to respond to a competitor's attack, relates to perceived gains and losses. Thus, an organisation may be aware of competitors but may not be motivated to engage in rivalry with them if it perceives that its position will not improve or that its market position won't be damaged if it doesn't respond.[49] In some cases, organisations may locate near competitors in order to more easily access suppliers and customers.

Market commonality affects the organisation's perceptions and resulting motivation. For example, the organisation is generally more likely to attack the rival with whom it has low market commonality than the one with whom it competes in multiple markets. The primary reason is the high stakes involved in trying to gain a more advantageous position over a rival with whom the organisation shares many markets. As mentioned earlier, multi-market competition can find a competitor responding to the organisation's action in a market different from the one in which the initial action was taken. Actions and responses of this type can cause both organisations to lose focus on core markets and to battle each other with resources that had been allocated for other purposes. Because of the high stakes of competition under the condition of market commonality, the probability is high that the attacked organisation will respond to its competitor's action in an effort to protect its position in one or more markets.[50]

In some instances, the organisation may be aware of the markets it shares with a competitor and be motivated to respond to an attack by that competitor, but lack the ability to do so. *Ability* relates to each organisation's resources and the flexibility they provide. Without available resources (such as financial capital and people), the organisation lacks the ability to attack a competitor or respond to its actions. For example, smaller and newer organisations tend to be more innovative but generally have fewer resources to attack larger and established competitors. Likewise, foreign organisations often are at a disadvantage against local organisations because of the local organisations' social capital (relationships) with consumers, suppliers and government officials.[51] However, similar resources suggest similar abilities to attack and respond. When an organisation faces a competitor with similar resources, careful study of a possible attack before initiating it is essential because the similarly resourced competitor is likely to respond to that action.[52]

Resource *dissimilarity* also influences competitive actions and responses between organisations, in that 'the greater is the resource imbalance between the acting firm and competitors or potential responders, the greater will be the delay in response'[53] by the organisation with a resource disadvantage. For example, Walmart initially used a focused cost leadership strategy to compete only in small communities (those with a population of 25 000 or less). Using sophisticated logistics systems and extremely efficient purchasing practices, among others, to gain competitive advantages, Walmart created a new type of value (primarily in the form of wide selections of products at the lowest competitive prices) for customers in small retail markets. Local competitors lacked the ability to marshal needed resources at the pace required to respond quickly and effectively. However, even when facing competitors with greater resources (greater ability) or more attractive market positions, organisations should eventually respond, no matter how daunting the task seems. Choosing not to respond can ultimately result in failure, as happened with at least some local retailers who didn't respond to Walmart's competitive actions. Of course, the actions taken by Walmart were only the beginning. Walmart has become the largest physical retailer in the world (a title that belongs to Amazon, or perhaps Alibaba, in online retail) and is feared by competitors large and small.

# Competitive rivalry

The ongoing competitive action–response sequence between an organisation and a competitor affects the performance of both organisations;[54] thus, it is important for companies to carefully analyse and understand the competitive rivalry present in the markets they serve to select and implement successful strategies.[55] Understanding a competitor's awareness, motivation and ability helps the organisation to predict the likelihood of an attack by that competitor and the probability that a competitor will respond to actions taken against it.

As we described earlier, the predictions drawn from studying competitors in terms of awareness, motivation and ability are grounded in market commonality and resource similarity. These predictions are fairly general. The value of the final set of predictions the organisation develops about each of its competitors' competitive actions and responses is enhanced by studying the 'Likelihood of attack' factors (such as first-mover incentives and organisational size) and the 'Likelihood of response' factors (such as the actor's reputation) that are shown in Figure 5.2. Evaluating and understanding these factors allows the organisation to refine the predictions it makes about its competitors' actions and responses.

## Strategic and tactical actions

Organisations use both strategic and tactical actions when forming their competitive actions and competitive responses in the course of engaging in competitive rivalry.[56] A **competitive action** is a strategic or tactical action the organisation takes to build or defend its competitive advantages or improve its market position. A **competitive response** is a strategic or tactical action the organisation takes to counter the effects of a competitor's competitive action. A **strategic action or strategic response** is a market-based move that involves a significant commitment of organisational resources and is difficult to implement and reverse. A **tactical action or tactical response** is a market-based move that is taken to fine-tune a strategy; it involves fewer resources and is relatively easy to implement and reverse.

Apple opened a service called 'Game Center' once it found that users were using its iPhone, iPad and iPod platforms for video games. With its update to its iOS (operating system) software, game producers began producing game applications to use the Apple system as its graphics became more advanced. This represented a strategic move by Apple. The now wider category of its 'App store' includes over 1.8 million items, making it easy for Apple users to find handy applications and fun games. Game platform hardware and software producers such as Nintendo and Sony then created strategic responses to the Apple threat. For example, Sony, which produces the PlayStation console, partnered with Sony Ericsson to make the Xperia Play phone, which uses 'PlayStation-certified games' and runs on Google's Android operating system. As of the fourth quarter of 2019, Android users were able to choose between 2.57 million apps, making Google Play the app store with the biggest number of available apps.[57]

Sony, makers of the PlayStation console, partnered with Sony Ericsson to make the Xperia Play phone.

Source: Getty Images/Bloomberg

Coles supermarkets price aggressively as a means of increasing revenues and gaining market share at the expense of competitors. However, pricing is a tactical strategy and is easily matched by Woolworths and IGA in the Australian market. Although pricing aggressively is at the core of what Coles is and how it competes, can the tactical action of aggressive pricing continue to lead to the competitive success the organisation has historically enjoyed? Is Coles achieving the type of balance between strategic and tactical competitive actions and competitive responses that is the foundation for all organisations' success in marketplace competitions? Can it answer the threat of Aldi with still lower prices?

**competitive action**
a strategic or tactical action the organisation takes to build or defend its competitive advantages or improve its market position

**competitive response**
a strategic or tactical action the organisation takes to counter the effects of a competitor's competitive action

**strategic action or strategic response**
a market-based move that involves a significant commitment of organisational resources and is difficult to implement and reverse

**tactical action or tactical response**
a market-based move that is taken to fine-tune a strategy; it involves fewer resources and is relatively easy to implement and reverse

A high rivalry situation can be partly hidden by brands: check the organisations behind water brands and you will find many are owned by Coca-Cola or PepsiCo. There's not as much competition as it seems.

Source: Shutterstock.com/Pressmaster

When engaging rivals in competition, organisations must recognise the differences between strategic and tactical actions and responses and should develop an effective balance between the two types of competitive actions and responses. Several years ago, Airbus, Boeing's major competitor in commercial airliners, became aware that Boeing was strongly committed to taking the actions it believed were necessary to successfully launch the 787 Dreamliner, because deciding to design, build and launch the 787 was a major strategic action. Analysts believed that Boeing's development of the 787 airliner was a strategic response to Airbus' then-new A380 aircraft.[58]

# Likelihood of attack

In addition to market commonality, resource similarity and the drivers of awareness, motivation and ability, other factors affect the likelihood a competitor will use strategic actions and tactical actions to attack its competitors. Three of these factors – first-mover incentives, organisational size and quality – are discussed next.

## First-mover incentives

**first mover**
an organisation that takes an initial competitive action in order to build or defend its competitive advantages or to improve its market position

A **first mover** is an organisation that takes an initial competitive action in order to build or defend its competitive advantages or to improve its market position. The first-mover concept has been influenced by the work of the famous economist Joseph Schumpeter, who argued that organisations achieve competitive advantage by taking innovative actions[59] (innovation is defined and described in detail in Chapter 13). In general, first movers 'allocate funds for product innovation and development, aggressive advertising, and advanced research and development'.[60]

The benefits of being a successful first mover can be substantial.[61] Especially in fast-cycle markets (discussed later in the chapter), where changes occur rapidly and it is virtually impossible to sustain a competitive advantage for any length of time, a first mover can experience many times the valuation and revenue of a second mover.[62] This evidence suggests that although first-mover benefits are never absolute, they are often critical to an organisation's success in industries experiencing rapid technological developments and relatively short product life cycles.[63] In addition to earning above-average returns until its competitors respond to its successful competitive action, the first mover can gain the loyalty of customers who may become committed to the goods or services of the organisation that first made them available, and gain market share that can be difficult for competitors to take during future competitive rivalry.[64] The general evidence that first movers have greater survival rates than later market entrants is perhaps the culmination of first-mover benefits.[65]

The organisation trying to predict its competitors' competitive actions might conclude that they will take aggressive strategic actions to gain first movers' benefits. However, even though an organisation's competitors might be motivated to be first movers, they may lack the ability to do so. First movers tend to be aggressive and willing to experiment with innovation and take higher, yet reasonable, levels of risk.[66] To be a first mover, the organisation must have readily available the resources to significantly invest in R&D, as well as to rapidly and successfully produce and market a stream of innovative products and services.[67] If the organisation does not have the necessary resources or cannot establish the necessary legitimacy, being a first mover can lead to survival risks.[68]

Organisational slack makes it possible for organisations to have the ability (as measured by available resources) to be first movers. *Slack* is the buffer or cushion provided by actual or obtainable resources that are not currently in use and are in excess of the minimum resources needed to produce a given level of organisational output. For example, in January 2020, Apple passed a share price of US$300 (around

A$440) and had a A$245 billion cash hoard.[69] As a liquid resource, slack can quickly be allocated to support competitive actions, such as R&D investment and aggressive marketing campaigns that lead to first-mover advantages. This relationship between slack and the ability to be a first mover allows the organisation to predict that a first-mover competitor likely has available slack and will probably take aggressive competitive actions to continuously introduce innovative products and services. Furthermore, the organisation can predict that, as a first mover, a competitor will try to rapidly gain market share and customer loyalty in order to earn above-average returns until its competitors are able to effectively respond to its first move.

Organisations evaluating their competitors should realise that being a first mover carries risk. For example, it is difficult to accurately estimate the returns that will be earned from introducing product innovations to the marketplace.[70] Additionally, the first mover's cost to develop a product innovation can be substantial, reducing the slack available to support further innovation. Thus, the organisation should carefully study the results a competitor achieves as a first mover. Continuous success by the competitor suggests additional product innovations, while lack of product acceptance over the course of the competitor's innovations may indicate less willingness in the future to accept the risks of being a first mover.[71]

A **second mover** is an organisation that responds to the first mover's competitive action, typically through imitation. More cautious than the first mover, the second mover studies customers' reactions to product innovations. In the course of doing so, the second mover also tries to find any mistakes the first mover made so that it can avoid them and the problems they created. Often, successful imitation of the first mover's innovations allows the second mover to avoid the mistakes and the major investments required of the pioneers (first movers).[72]

**second mover**
an organisation that responds to the first mover's competitive action, typically through imitation

Second movers also have the time to develop processes and technologies that are more efficient than those used by the first mover or that create additional value for consumers.[73] The most successful second movers rarely act too fast (so they can fully analyse the first mover's actions) nor too slow (so they do not give the first mover time to correct its mistakes and 'lock in' customer loyalty).[74] Overall, the outcomes of the first mover's competitive actions may provide an effective blueprint for second and even late movers (discussed below) as they determine the nature and timing of their competitive responses.[75] Determining whether a competitor is an effective second mover (based on its past actions) allows a first-mover organisation to predict that the competitor will respond quickly to successful, innovation-based market entries. The first mover can expect a successful second-mover competitor to study its market entries and to respond with a new entry into the market within a short time period. As a second mover, the competitor will try to respond with a product that provides greater customer value than does the first mover's product. The most successful second movers are able to rapidly and meaningfully interpret market feedback to respond quickly, yet successfully, to the first mover's successful innovations.

For example, Hyundai has traditionally been a second mover in the automobile industry. However, it has decided that 'playing follow the leader on R&D isn't good enough any more'.[76] It is leading the way in a number of new features in its vehicles, such as an 'onslaught of new drive train technologies' and a new hybrid drive that makes the transmission – and therefore the car – efficient at higher speeds than traditional hybrids such as the Toyota Prius. In 2019, Hyundai announced major changes to its R&D structure, with an agile structure aimed at pre-empting changing markets, and an 'architecture-driven system-based organisation' to streamline the vehicle development process.[77]

A **late mover** is an organisation that responds to a competitive action a significant amount of time after the first mover's action and the second mover's response. Typically, a late response is better than no response at all, although any success achieved from the late competitive response tends to be considerably less than that achieved by first and second movers. However, on occasion, late movers can be successful if they develop a unique way to enter the market and compete. For organisations from emerging economies, this often means a niche strategy with lower-cost production and manufacturing.[78]

**late mover**
an organisation that responds to a competitive action, but only after considerable time has elapsed after the first mover's action and the second mover's response

The organisation competing against a late mover can predict that the competitor will likely enter a particular market only after both the first and second movers have achieved success in that market.

Moreover, on a relative basis, the organisation can predict that the late mover's competitive action will allow it to earn average returns only after the considerable time required for it to understand how to create at least as much customer value as that offered by the first and second movers' products.

## Organisational size

An organisation's size affects the likelihood it will take competitive actions, as well as the types and timing of those actions.[79] In general, small organisations are more likely than large companies to launch competitive actions and tend to do it more quickly. Smaller organisations are thus perceived as nimble and flexible competitors who rely on speed and surprise to defend their competitive advantages or develop new ones while engaged in competitive rivalry, especially with large companies, to gain an advantageous market position.[80] Small organisations' flexibility and nimbleness allow them to develop variety in their competitive actions; large organisations tend to limit the types of competitive actions used.[81]

Large organisations, however, are likely to initiate more competitive actions along with more strategic actions during a given period.[82] Thus, when studying its competitors in terms of organisational size, the organisation should use a measurement such as total sales revenue or total number of employees. The competitive actions the organisation likely will encounter from competitors larger than it is will be different from the competitive actions it will encounter from smaller competitors. The organisational size factor adds another layer of complexity. When engaging in competitive rivalry, the organisation often prefers a large number of unique competitive actions. Ideally, the organisation has the amount of slack resources held by a large organisation to launch a greater *number* of competitive actions and a small organisation's flexibility to launch a greater *variety* of competitive actions. Herb Kelleher, cofounder and former CEO of Southwest Airlines (the world's largest low-cost airline), addressed this matter: 'Think and act big and we'll get smaller. Think and act small and we'll get bigger'.[83]

STRATEGY NOW
Southwest Airlines

In the context of competitive rivalry, Kelleher's statement can be interpreted to mean that relying on a limited number or types of competitive actions (which is the large organisation's tendency) can lead to reduced competitive success across time, partly because competitors learn how to effectively respond to the predictable. By contrast, remaining flexible and nimble (which is the small organisation's tendency) in order to develop and use a wide variety of competitive actions contributes to success against rivals.

Coles supermarkets are retailers previously owned by the Wesfarmers corporation, but they demerged from Wesfarmers in 2018. There are around 2200 retail outlets in the Coles group, with supermarkets and liquor stores across Australia. Because of its size, scale and resources, Coles has the flexibility required to take many types of competitive actions that few – if any – of its competitors can undertake, and at reduced cost. Demonstrating this type of flexibility in terms of competitive actions has proven critical to the success of its entry into the petrol retailing and insurance industries.[84]

## Quality

Quality has many definitions, including 'fit for purpose', and well-established definitions relating it to the production of goods or services with zero defects[85] and as a cycle of continuous improvement.[86] From a strategic perspective, we consider quality to be the outcome of how an organisation competes through its primary and support activities (see Chapter 3). Thus, **quality** exists when the organisation's goods or services meet or exceed customers' expectations. Some evidence suggests that quality may be the most critical component in satisfying the organisation's customers.[87]

**quality**
exists when the organisation's goods or services meet or exceed customers' expectations

In the eyes of customers, quality is about doing the right things relative to performance measures that are important to them.[88] Customers may be interested in measuring the quality of an organisation's goods and services against a broad range of dimensions. Sample quality dimensions in which customers commonly express an interest are shown in Table 5.1.

Quality is possible only when top-level managers support it and when its importance is institutionalised throughout the entire organisation and its value chain.[89] When quality is institutionalised and valued by

**Table 5.1 Quality dimensions of goods and services**

| | |
|---|---|
| **Product quality dimensions** | |
| 1 | *Performance* – operating characteristics |
| 2 | *Features* – important special characteristics |
| 3 | *Flexibility* – meeting operating specifications over some period of time |
| 4 | *Durability* – amount of use before performance deteriorates |
| 5 | *Conformance* – match with pre-established standards |
| 6 | *Serviceability* – ease and speed of repair |
| 7 | *Aesthetics* – how a product looks and feels |
| 8 | *Perceived quality* – subjective assessment of characteristics (product image) |
| **Service quality dimensions** | |
| 1 | *Timeliness* – performed in the promised period of time |
| 2 | *Courtesy* – performed cheerfully |
| 3 | *Consistency* – giving all customers similar experiences each time |
| 4 | *Convenience* – accessibility to customers |
| 5 | *Completeness* – fully serviced, as required |
| 6 | *Accuracy* – performed correctly each time |

Source: Adapted from J. Evans, 2008, *Managing for Quality and Performance*, 7th edn, Mason, OH: Thomson Publishing.

all, employees and managers alike become vigilant about continuously finding ways to improve quality.[90] Quality is a universal theme in the global economy and is a necessary but insufficient condition for competitive success.[91] Without quality, an organisation's products lack credibility, meaning that customers don't think of them as viable options. Indeed, customers won't consider buying a product until they believe that it can satisfy at least their base-level expectations in terms of quality dimensions that are important to them.[92] Boeing's 787 aircraft was delayed due to quality concerns. Many of its problems came from its numerous suppliers and supply chain subassemblies, but such media events made large airline customers nervous, and there were some associated postponements in orders.[93]

Quality affects competitive rivalry. The organisation evaluating a competitor whose products suffer from poor quality can predict declines in the competitor's sales revenue until the quality issues are resolved. In addition, the organisation can predict that the competitor likely won't be aggressive in its competitive actions until the quality problems are corrected in order to gain credibility with customers.[94] However, after the problems are corrected, that competitor is likely to take more aggressive competitive actions.

# Likelihood of response

The success of an organisation's competitive action is affected by the likelihood that a competitor will respond to it as well as by the type (strategic or tactical) and effectiveness of that response. As noted earlier, a competitive response is a strategic or tactical action the organisation takes to counter the effects of a competitor's competitive action. In general, an organisation is likely to respond to a competitor's action when:

1 the action leads to better use of the competitor's capabilities to gain or produce stronger competitive advantages or an improvement in its market position

2 the action damages the organisation's ability to use its capabilities to create or maintain an advantage
3 the organisation's market position becomes less defensible.[95]

In addition to market commonality and resource similarity and awareness, motivation and ability, organisations evaluate three other factors – type of competitive action, reputation and market dependence – to predict how a competitor is likely to respond to competitive actions (see Figure 5.2).

## Type of competitive action

Competitive responses to strategic actions differ from responses to tactical actions. These differences allow the organisation to predict a competitor's likely response to a competitive action that has been launched against it. Strategic actions commonly receive strategic responses and tactical actions receive tactical responses. In general, strategic actions elicit fewer total competitive responses because strategic responses, such as market-based moves, involve a significant commitment of resources and are difficult to implement and reverse.[96]

Another reason that strategic actions elicit fewer responses than do tactical actions is that the time needed to implement a strategic action and to assess its effectiveness can delay the competitor's response to that action.[97] By contrast, a competitor likely will respond quickly to a tactical action, such as when an airline company almost immediately matches a competitor's tactical action of reducing prices in certain markets. Either strategic actions or tactical actions that target a large number of a rival's customers are likely to elicit strong responses.[98] In fact, if the effects of a competitor's strategic action on the focal organisation are significant (e.g. loss of market share or loss of major resources such as critical employees), a response is likely to be swift and strong.[99]


Dell's response to actions by competitors such as IBM and HP is influenced by their reputation.

Source: Dreamstime.com/Ken Wolter

## Actor's reputation

In the context of competitive rivalry, an *actor* is the organisation taking an action or a response while *reputation* is 'the positive or negative attribute ascribed by one rival to another based on past competitive behaviour'.[100] A positive reputation may be a source of above-average returns, especially for consumer goods producers.[101] Thus, a positive corporate reputation is of strategic value[102] and affects competitive rivalry. To predict the likelihood of a competitor's response to a current or planned action, organisations evaluate the responses that the competitor has taken previously when attacked – past behaviour is assumed to be a predictor of future behaviour.

Competitors are more likely to respond to strategic or tactical actions when they are taken by a market leader.[103] In particular, evidence suggests that commonly successful actions, especially strategic actions, will be quickly imitated. For example, although a second mover, IBM committed significant resources to enter the information service market. When IBM was immediately successful in this endeavour, competitors such as Hewlett-Packard (HP), Dell and others responded with strategic actions to enter the market.[104] IBM's reputation, as well as its successful strategic action, strongly influenced entry by these competitors.

In contrast to an organisation with a strong reputation such as IBM, competitors are less likely to take responses against a company with a reputation for competitive behaviour that is risky, complex and unpredictable. The organisation with a reputation as a price predator (an actor that frequently reduces prices to gain or maintain market share) generates few responses to its pricing tactical actions because price predators, which typically increase prices once their market share objective is reached, lack credibility with their competitors.[105] Occasionally, an organisation with a minor reputation can sneak up on larger,

STRATEGY NOW
IBM, HP and Dell

more resourceful competitors and take market share from them. In recent years, for example, organisations from emerging markets have taken market share from major competitors based in developed markets.[106]

## Dependence on the market

*Market dependence* denotes the extent to which an organisation's revenues or profits are derived from a particular market.[107] In general, competitors with high market dependence are likely to respond strongly to attacks threatening their market position.[108] Interestingly, the threatened organisation in these instances may not always respond quickly, even though an effective response to an attack on the organisation's position in a critical market is important.

Akamai Technologies is the dominant player in a multi-billion dollar market for content delivery network (CDN) services. If a person clicks on a website to download software or music, or to examine headlines or video clips, Akamai often provides these bigger files to the consumer through its servers rather than through the company computer system from which the download appears to be taking place. Akamai owns and operates the world's largest CDN, which spans more than 216 000 servers in over 120 countries and more than 1500 networks around the world.[109] As such, Akamai has well-equipped servers to facilitate improved and more reliable download performance, as it handles billions of daily web interactions for organisations like NBC, the NASDAQ market and the US Department of Defense. However, because Akamai is dependent on this market (it is not very diversified), rival CDN providers such as Limelight Networks and Level 3 Communications have forced Akamai to lower its basic CDN service prices. The company has responded quickly to both tactical and strategic entry moves and hopes to make up the difference through 'volume'. However, Akamai is facing more competition as major companies such as Amazon (with CloudFront) and Microsoft (with Azure CDN) add content distribution capabilities to their networks.[110]

# Competitive dynamics

Whereas competitive rivalry concerns the ongoing actions and responses between an organisation and its direct competitors for an advantageous market position, *competitive dynamics* concern the ongoing actions and responses among *all* organisations competing within a market for advantageous positions. Building and sustaining competitive advantages are at the core of competitive rivalry, in that advantages are the key to creating value for shareholders.[111]

To explain competitive dynamics, we explore the effects of varying rates of competitive speed in different markets (called slow-cycle, fast-cycle and standard-cycle markets) on the behaviour (actions and responses) of all competitors within a given market. Competitive behaviours as well as the reasons for taking them are similar within each market type but differ across types of markets. Thus, competitive dynamics differ in slow-cycle, fast-cycle and standard-cycle markets. The sustainability of the organisation's competitive advantages differs across the three market types. Research has also shown how organisations go through life-cycle stages as markets within which an organisation is competing evolve over time.[112] However, understanding what happens within each type of market is more pertinent in knowing how to respond to the competition.

As noted in Chapter 1, organisations want to sustain their competitive advantages for as long as possible, although no advantage is permanently sustainable. The degree of sustainability is affected by how quickly competitive advantages can be imitated and how costly it is to do so.

## Slow-cycle markets

**Slow-cycle markets** are those in which the organisation's competitive advantages are shielded from imitation, commonly for long periods of time, and where imitation is costly.[113] Thus, competitive advantages are sustainable over longer periods of time in slow-cycle markets.

**slow-cycle markets**
markets in which the organisation's competitive advantages are shielded from imitation for what are commonly long periods of time and where imitation is costly

Building a unique and proprietary capability produces a competitive advantage and success in a slow-cycle market. This type of advantage is difficult for competitors to understand. As discussed in Chapter 3, a difficult-to-understand and costly-to-imitate resource or capability usually results from unique historical conditions, causal ambiguity and/or social complexity. Copyrights, geography, patents and ownership of an information resource are examples of resources.[114] After a proprietary advantage is developed, the organisation's competitive behaviour in a slow-cycle market is oriented to protecting, maintaining and extending that advantage. Thus, the competitive dynamics in slow-cycle markets usually concentrate on competitive actions and responses that enable organisations to protect, maintain and extend their competitive advantage. Major strategic actions in these markets, such as acquisitions, usually carry less risk than in faster-cycle markets.[115]

Walt Disney Co. continues to extend its proprietary characters, such as Mickey Mouse, Minnie Mouse and Goofy. These characters have a unique historical development as a result of Walt and Roy Disney's creativity and vision for entertaining people. Products based on the characters seen in Disney's animated films are sold through Disney's theme park shops as well as free-standing retail outlets called Disney Stores. Because copyrights shield it, the proprietary nature of Disney's advantage in terms of animated character trademarks protects the organisation from imitation by competitors.

Consistent with another attribute of competition in a slow-cycle market, Disney protects its exclusive rights to its characters and their use. As with all organisations competing in slow-cycle markets, Disney's competitive actions (such as building theme parks in France, Japan and China) and responses (such as lawsuits to protect its right to fully control use of its animated characters) maintain and extend its proprietary competitive advantage while protecting it.

Patent laws and regulatory requirements such as those requiring approval to launch new products shield pharmaceutical companies' positions. Competitors in this market try to extend patents on their drugs to maintain advantageous positions that the patents provide. However, after a patent expires, the organisation is no longer shielded from competition, allowing generic imitations and usually leading to a loss of sales.

The competitive dynamics generated by organisations competing in slow-cycle markets are shown in Figure 5.4. In slow-cycle markets, organisations launch a product (e.g. a new drug) that has been developed through a proprietary advantage (e.g. R&D) and then exploit it for as long as possible while the product is shielded from competition. Eventually, competitors respond to the action with a counterattack. In markets for drugs, this counterattack commonly occurs as patents expire or are broken through legal means, creating the need for another product launch by the organisation seeking a protected market position. It is becoming more difficult for organisations like Merck, Pfizer or GlaxoSmithKline (GSK) to get drugs approved; patent-protected drug approvals are trending down, while risky research spending is rising.[116]

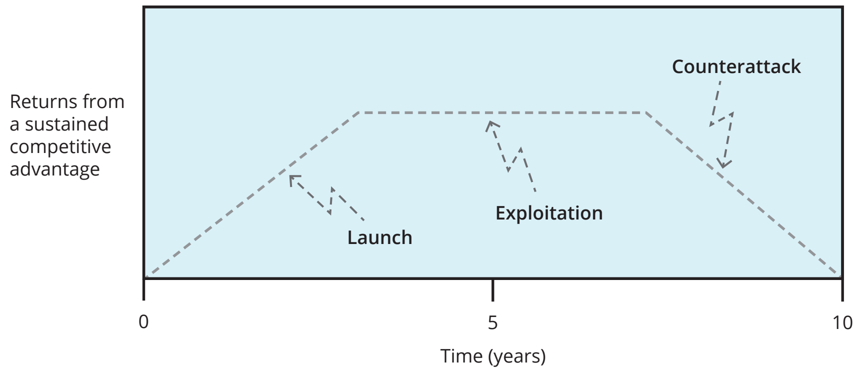
## Fast-cycle markets

**fast-cycle markets**
markets in which the organisation's capabilities are not shielded from imitation and where imitation happens quickly and perhaps somewhat inexpensively

**Fast-cycle markets** are markets in which the organisation's capabilities that contribute to competitive advantages are not shielded from imitation and where imitation is often rapid and inexpensive.[117] Thus, competitive advantages aren't sustainable in fast-cycle markets. Organisations competing in fast-cycle markets recognise the importance of speed; these companies appreciate that 'time is as precious a business resource as money or head count – and that the costs of hesitation and delay are just as steep as going over budget or missing a financial forecast'.[118] Such high-velocity environments place considerable pressures on top managers to quickly make strategic decisions that are also effective.[119] The often substantial competition and technology-based strategic focus make the strategic decision complex, increasing the need for a comprehensive approach integrated with decision speed, which are two often-conflicting characteristics of the strategic decision process.[120]

Reverse engineering and the rate of technology diffusion in fast-cycle markets facilitate rapid imitation. A competitor uses reverse engineering to quickly gain the knowledge required to imitate or improve the organisation's products. Technology is diffused rapidly in fast-cycle markets, making it available to competitors in a short period. The technology often used by fast-cycle competitors isn't proprietary, nor

**Figure 5.4** **Gradual erosion of a sustained competitive advantage**




Source: Adapted from I. C. MacMillan, 1988, Controlling competitive dynamics by taking strategic initiative, *Academy of Management Executive*, 11(2): 111–18.

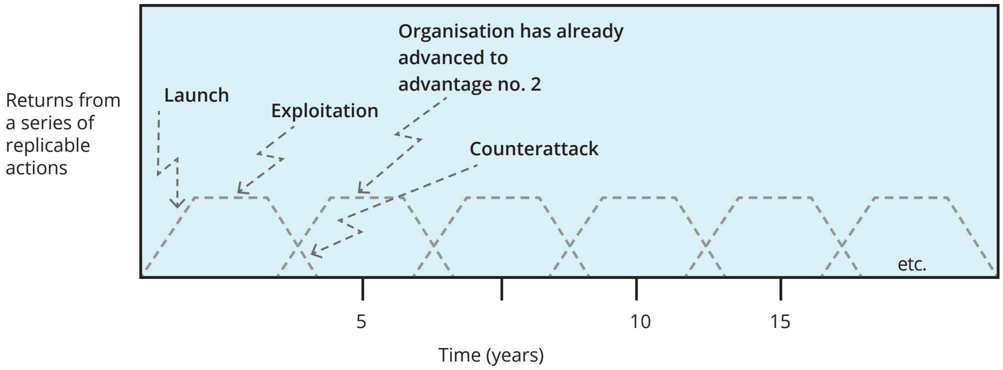
is it protected by patents as is the technology used by organisations competing in slow-cycle markets. For example, only a few hundred parts, which are readily available on the open market, are required to build a PC. Patents protect only a few of these parts, such as microprocessor chips. Interestingly, research also demonstrates that showing what an incumbent organisation knows and its research capability can be a deterrent to other organisations to enter the market.[121]

The reality of fast-cycle markets has led to the development of generational products. Such products usually start with a substantial technical advance in the performance of a product category and are followed with additional regular, though incremental, technological advances as new generations of products are introduced, as in Intel semiconductor logic chips or HP printer families.[122] Fast-cycle markets are more volatile than slow-cycle and standard-cycle markets. Indeed, the pace of competition in fast-cycle markets is almost frenzied, as companies rely on innovations as the engines of their growth. Because prices often decline quickly in these markets, companies need to profit quickly from their product innovations. Cloud computing is an example where change is happening rapidly as organisations seek to establish space in the market while it evolves rapidly.[123]

Fast-cycle market characteristics make it virtually impossible for companies in this type of market to develop sustainable competitive advantages. Recognising this reality, organisations avoid 'loyalty' to any of their products, preferring to cannibalise their own before competitors learn how to do so through successful imitation. This emphasis creates competitive dynamics that differ substantially from those found in slow-cycle markets. Instead of concentrating on protecting, maintaining and extending competitive advantages, as in slow-cycle markets, companies competing in fast-cycle markets focus on learning how to rapidly and continuously develop new competitive advantages that are superior to those they replace. They commonly search for fast and effective means of developing new products. For example, it is common in some industries for organisations to use strategic alliances to gain access to new technologies and thereby develop and introduce more new products into the market.[124] In recent years, many of these alliances have been offshore (with partners in foreign countries) in order to access appropriate skills while maintaining lower costs to compete. However, achieving the appropriate balance is important so that key capabilities are not lost in the offshoring and outsourcing process.[125]

The competitive behaviour of organisations competing in fast-cycle markets is shown in Figure 5.5. As suggested by the figure, competitive dynamics in this market type entail actions and responses that are oriented to rapid and continuous product introductions and the development of a stream of ever-changing competitive advantages. The organisation launches a product to achieve a competitive

**Figure 5.5** **Developing temporary advantages to create sustained advantage**




Source: Based on I. C. MacMillan, 1988, Controlling competitive dynamics by taking strategic initiative, *Academy of Management Executive*, 11(2): 111–18.

advantage and then exploits the advantage for as long as possible. However, the organisation also tries to develop another temporary competitive advantage before competitors can respond to the first one. Thus, competitive dynamics in fast-cycle markets often result in rapid product upgrades as well as quick product innovations.[126]

As our discussion suggests, innovation plays a critical role in the competitive dynamics in fast-cycle markets. For individual organisations, then, innovation is a key source of competitive advantage. Through innovation, the organisation can cannibalise its own products before competitors successfully imitate them and still maintain an advantage through next-generation products.

**Strategic focus | Sustainability**

## The emergence of competitive rivalry among battery manufacturers: who will establish the most attractive market position?

Although small in size today, the growth potential of the battery-storage market is substantial. ‘Utilities looking for less expensive alternatives to power plants that fire up during peak hours to meet power demands’ are a key customer for the manufacturers of large-scale battery-storage products. Utility companies encounter the challenge of having sufficient capacity to meet peak demand for energy consumption. Commonly, mornings and evenings are the times when customers use the greatest amounts of the product that utilities provide. At non-peak times though, utilities have idle capacity. Examining today’s competitive scene finds IHS Markit predicting that the global market for batteries in the power sector will expand annually by 14 per cent through at least 2025. Thus, energy storage on a large-scale basis is an attractive market.

Increasing levels of power generation from renewable energy sources such as wind and power and the need to store that energy influence the growth in large-scale battery-storage units. The challenge with wind and solar as energy sources is that they are intermittent energy sources. In this sense, power companies do not know exactly when the wind will blow (and for how long and at what velocity) and exactly when the sun will shine (and for how long and with what degree of intensity). Large-scale storage batteries address this issue by allowing the capture of wind- and solar-generated power when created and then storing it until needed to meet consumer demand. In the words of an industry expert: ‘With large grid systems, batteries can be attached directly to generation sources such as wind turbines and solar panels to store and release excess electricity

Tesla's battery storage facility can store a megawatt of alternative energy, allowing the district to use more 'green' power during peak times of the day.

Source: Alamy Stock Photo/ZUMA Press

that the grid can't absorb in that moment, or even be used in hybridizing conventional power generation (gas engines or turbines) in order to enhance the flexibility of and speed of response to grid intermittency.' The decreasing cost of lithium-ion batteries is increasing the attractiveness of large-scale, battery-storage systems. (Small versions of lithium-ion batteries power mobile phones and a host of other products.)

Tesla, Siemens AG and General Electric (GE) are primary competitors in the large-scale, battery-storage system market. The commercial attractiveness of this market elicits competition among these competitors as they jockey to establish the most attractive market position. In mid-2017, for example, Tesla announced that in partnership with Neoen, a French renewable energy provider, it would build, deliver and install the world's largest lithium battery to a location north of Jamestown, South Australia, in 100 days. Tesla fulfilled this promise and delivered a battery-storage product that runs constantly and provides stability services for renewable energy sources and is available for emergency backup power in case of an energy shortfall. Early operational results from using this product have been positive.

Recognising the importance of battery-storage size in what is an attractive market and to compete against Tesla, Siemens and AES combined their efforts to form an energy storage start-up called Fluence Energy. This partnership commenced operations on 1 January 2018; the organisation immediately became the 'supplier of AES' Alamitos power center energy storage project in Long Beach, California serving Southern California Edison and the Western Los Angeles area'. Fluence's battery-storage project was to be the largest in the world, exceeding the size of Tesla's project in South Australia.

Trying to catch up to rivals Tesla and Siemens, GE announced in early 2018 that it would establish a giant energy-storage platform called GE Reservoir. This platform 'is expected to store electricity generated by wind turbines and solar panels for later use'.

How do GE, Tesla and Siemens' products differ? What position will each organisation's product allow it to establish in the large-scale battery-storage market? With respect to GE, some analysts observe that 'one of GE's biggest challenges will be differentiating its battery products from those offered by competitors such as Fluence'. Early responses to this challenge suggest that GE's Reservoir platform lasts approximately 15 per cent longer than competitors' products; faster installation of the platform is a second differentiator. Thus, product longevity and installation ease may be the foundation for GE's effort to 'stake out' a viable market position. For Tesla, being a first mover (this concept is discussed later in the chapter) and being very willing to collaborate with governmental agencies to install products may be sources of differentiation (Tesla and Neoen partnered with the South Australian Government to establish their battery-storage system). Siemens uses a 'holistic approach' to serve battery-storage customers. In this sense, the organisation notes that it offers 'customers in the battery industry solutions comprising software, automation and drives spanning the entire value chain'. Thus, integrated technology solutions may be a marketplace differentiator for Siemens and for Fluence, the start-up formed by Siemens and AES.

Going forward, these three major competitors will encounter competition from additional entrants to a very attractive market. Overall, 'competition in the energy storage market will only improve the industry, forcing companies like Tesla and the newly-established Fluence (and GE) to continue being innovative'. Thus, energy customers throughout the world will benefit from the competitive rivalry occurring among organisations seeking to establish the most attractive market position.

Sources: 2018, Siemens backs efficient digitalized large-scale production of batteries, Siemens Homepage, http://www.siemens.co, 22 February; E. Ailworth, 2018, GE Power, in need of a lift, chases Tesla and Siemens in batteries, *Wall Street Journal*, http://www.wsj.com, 7 March; J. Cropley, 2018, GE rolls out battery-based energy storage product, *Daily Gazette*, http://www.dailygazette.com, 7 March; T. Kellner, 2018, Making waves: GE unveils plans to build an offshore wind turbine the size of a skyscraper, the world's most powerful, Renewables, http://www.ge.com, 1 March; F. Lambert, 2018, AES and Siemens launch new energy storage startup to compete with Tesla Energy, will supply new world's biggest battery project, Electrek, http://www.electrek.com, 11 January; C. Mimms, 2018, The battery boost we've been waiting for is only a few years out, *Wall Street Journal*, http://www.wsj.com, 18 March; S. Patterson & R. Gold, 2018, There's a global race to control batteries – and China is winning, *Wall Street Journal*, http://www.wsj.com, 11 February; B. Spaen, 2018, New 'Fluence Energy' builds world's biggest storage system in California, GreenMatters, http://www.greenmatters.com, 12 January; B. Fung, 2017, Tesla's enormous battery in Australia, just weeks old, is already responding to outages in 'record' time, *Washington Post*, http://www.washingtonpost.com, 26 December; I. Slav, 2017, Tesla is facing stiff competition in the energy storage war, OilPrice.com, http://www.oilprice.com, 17 July.

## Standard-cycle markets

**standard-cycle markets**
markets in which the organisation's competitive advantages are moderately shielded from imitation and where imitation is moderately costly

**Standard-cycle markets** are markets in which the organisation's competitive advantages are partially shielded from imitation, and imitation is moderately costly. Competitive advantages are partially sustainable in standard-cycle markets, but only when the organisation is able to continuously upgrade the quality of its capabilities to stay ahead of competitors. The competitive actions and responses in standard-cycle markets are designed to seek large market shares, to gain customer loyalty through brand names and to carefully control an organisation's operations in order to consistently provide the same positive experience for customers.[127]

Standard-cycle companies serve many customers in competitive markets. Because the capabilities and core competencies on which their competitive advantages are based are less specialised, imitation is faster and less costly for standard-cycle organisations than for those competing in slow-cycle markets. However, imitation is slower and more expensive in these markets than in fast-cycle markets. Thus, competitive dynamics in standard-cycle markets rest midway between the characteristics of dynamics in slow-cycle and fast-cycle markets. Imitation comes less quickly and is more expensive for standard-cycle competitors when an organisation is able to develop economies of scale by combining coordinated and integrated design and manufacturing processes with a large sales volume for its products.

Because of large volumes, the size of mass markets and the need to develop scale economies, the competition for market share is intense in standard-cycle markets. In some markets associated with consumer electronics, fast cycles occur, such as in smartphones and tablet sales. However, in other consumer segments such as the television market, the cycles are more placid and closer to standard-cycle markets. Nonetheless, rivalry is intense as new technologies emerge. For example, prices came down in the flat-panel television market as competition in this market become relatively more stable. The steady increase in screen resolution and technology has led to 4K and 8K models, with relatively stable prices. The biggest changes over the past 10 years have been with OLED (organic light emitting diode) and QLED (quantum-dot light emitting diode) displays, particularly with the web-connected nature of 'smart' TVs. Smart TVs, a connected convergence of TVs, set-top boxes and computers, have integrated and interactive Web 2.0 features to browse the internet, view photos and stream music or videos. Sony, LG Electronics and Samsung are highly competitive rivals in this market.[128]

Innovation can also drive competitive actions and responses in standard-cycle markets, especially when rivalry is intense. Some innovations in standard-cycle markets are incremental rather than radical in nature (incremental and radical innovations are discussed in Chapter 13). For example, consumer foods producers are innovating within their lines of healthy products. Overall, many organisations are relying on innovation as a means of competing in standard-cycle markets and earning above-average returns.

Overall, innovation has a substantial influence on competitive dynamics as it affects the actions and responses of all companies competing within a slow-cycle, fast-cycle or standard-cycle market. We have emphasised the importance of innovation to the organisation's strategic competitiveness in earlier chapters and do so again in Chapter 13. These discussions highlight the importance of innovation in most types of markets.

# STUDY TOOLS

## SUMMARY

**LO1** Competitors are organisations competing in the same market, offering similar products and targeting similar customers. Competitive rivalry is the ongoing set of competitive actions and competitive responses occurring between competitors as they compete against each other for an advantageous market position. The outcomes of competitive rivalry influence the organisation's ability to sustain its competitive advantages as well as the level (average, below average or above average) of its returns on investment.

The set of competitive actions and responses that an individual organisation takes while engaged in competitive rivalry is called competitive behaviour. Competitive dynamics is the set of actions and responses taken by all organisations that are competitors within a particular market. Remember that strategy is like a game of chess.

**LO2** A competitor analysis is the first step the organisation takes to be able to predict its competitors' actions and responses. In Chapter 2, we discussed what organisations do to *understand* competitors. This discussion was extended in this chapter to describe what the organisation does to *predict* competitors' market-based actions. Thus, understanding precedes prediction. Market commonality (the number of markets in which competitors are jointly involved and their importance to each) and resource similarity (how comparable competitors' resources are in terms of type and amount) are studied to complete a competitor analysis. In general, the greater the market commonality and resource similarity, the more organisations acknowledge that they are direct competitors.

**LO3** Market commonality and resource similarity shape the organisation's awareness (the degree to which it and its competitors understand their mutual interdependence), motivation (the organisation's incentive to attack or respond) and ability (the quality of the resources available to the organisation to attack and respond). Having knowledge of these characteristics of a competitor increases the quality of the organisation's predictions about that competitor's actions and responses.

**LO4** Organisations study competitive rivalry in order to predict the competitive actions and responses that each of their competitors likely will take. Competitive actions are either strategic or tactical in nature. The organisation takes competitive actions to defend or build its competitive advantages or to improve its market position. Competitive responses are taken to counter the effects of a competitor's competitive action. A strategic action or a strategic response requires a significant commitment of organisational resources, is difficult to successfully implement and is difficult to reverse. By contrast, a tactical action or a tactical response requires fewer organisational resources and is easier to implement and reverse. For example, for an airline company, entering major new markets is an example of a strategic action or a strategic response, while changing its prices in a particular market is an example of a tactical action or a tactical response.

**LO5** In addition to market commonality, resource similarity, awareness, motivation and ability, three more-specific factors affect the likelihood a competitor will take competitive actions. The first of these concerns first-mover incentives. First movers – those taking an initial competitive action – often gain loyal customers and earn above-average returns until competitors can successfully respond to their action. Not all organisations can be first movers in that they may lack the awareness, motivation or ability required to engage in this type of competitive behaviour. Moreover, some organisations prefer to be a second mover (the organisation responding to the first mover's action). One reason for this is that second movers, especially those acting quickly, can successfully compete against the first mover. By evaluating the first mover's product, customers' reactions to it and the responses of other competitors to the first mover, the second mover can avoid the early entrant's mistakes and find ways to improve upon the value created for customers by the first mover's good or service. Late movers (those that respond a long time after the original action was taken) commonly are lower performers and are much less competitive.

Organisational size, the second factor, tends to reduce the variety of competitive actions that large organisations launch, while it increases the variety of actions undertaken by smaller competitors. Ideally, the organisation would prefer to initiate a large number of diverse actions when engaged in competitive rivalry.

The third factor, quality, is a base denominator to competing successfully in the global economy. It is a necessary prerequisite to achieving competitive parity, and is a necessary but insufficient condition for gaining an advantage.

**LO6** To predict a competitor's response to its actions, an organisation should examine the type of action (strategic or tactical) it took, the competitor's reputation for the nature of its competitive behaviour, and that competitor's dependence on the market in which the action was taken. In general, the number of tactical responses taken exceeds the number of strategic responses. Competitors respond more frequently to the actions taken by the organisation with a reputation for predictable and understandable competitive behaviour, especially if that organisation is a market leader. In general, the organisation can predict that when its competitor is highly dependent for its revenue and profitability on the market in which the organisation took a competitive action, that competitor is likely to launch a strong response. However, organisations that are more diversified across markets are less likely to respond to a particular action that affects only one of the markets in which they compete.

**LO7** In slow-cycle markets, where competitive advantages can be maintained for at least a period of time, the competitive dynamics often include organisations taking actions and responses intended to protect, maintain and extend their proprietary advantages. In fast-cycle markets, competition is substantial as organisations concentrate on developing a series of temporary competitive advantages. This emphasis is necessary because organisations' advantages in fast-cycle markets aren't proprietary and, as such, are subject to rapid and relatively inexpensive imitation. Standard-cycle markets have a level of competition between that in slow-cycle and fast-cycle markets; organisations are moderately shielded from competition in these markets as they use capabilities that produce competitive advantages that are moderately sustainable. Competitors in standard-cycle markets serve mass markets and try to develop economies of scale to enhance their profitability. Innovation is vital to competitive success in each of the three types of markets. Companies should recognise that the set of competitive actions and responses taken by all organisations differs by type of market.

## KEY TERMS

competitive action
competitive advantage
competitive behaviour
competitive dynamics
competitive response
competitive rivalry
competitors
fast-cycle markets
first mover
late mover
market commonality
multi-market competition
quality
resource similarity
second mover
slow-cycle markets
standard-cycle markets
strategic action or strategic response
strategic competitiveness
strategy
tactical action or tactical response

## REVIEW QUESTIONS

1. Who are competitors? How are competitive rivalry, competitive behaviour and competitive dynamics defined in the chapter?
2. What is market commonality? What is resource similarity? What does it mean to say that these concepts are the building blocks for a competitor analysis?
3. How do awareness, motivation and ability affect the organisation's competitive behaviour?
4. What factors affect the likelihood an organisation will take a competitive action?
5. What factors affect the likelihood an organisation will initiate a competitive response to the action taken by a competitor?

6. What competitive dynamics can be expected among organisations competing in slow-cycle markets? In fast-cycle markets? In standard-cycle markets?
7. How do competitive dynamics apply in non-commercial organisations and sectors?

# EXPERIENTIAL EXERCISES

### Exercise 1: Tragedy of the commons

The tragedy of the commons is a dilemma that encompasses elements from social psychology and competitive behaviour, among other disciplines. The concept first appeared in 1968 in an article by Garrett Hardin in the journal *Science*. The dilemma arises from a situation in which individuals act in ways that may not necessarily be in everyone's long-term interests. In general, the tragedy of the commons occurs when individuals all have equal access to a shared resource and each individual seeks to maximise his or her own self-interest. For a contemporary example, think about global warming in general, or localised pollution in particular, as instances of the dilemma: there is a distinct advantage for one country, state or business to pollute, which in turn imperils society as a whole.

As explained by De Young,[129] ecologist Garrett Hardin's parable involves a pasture 'open to all'. He asks us to imagine the grazing of animals on a common ground. Individuals are motivated to add to their flocks to increase personal wealth. Yet, every animal added to the total degrades the commons a small amount. Although the degradation for each additional animal is small relative to the gain in wealth for the owner, if all owners follow this pattern, the commons will ultimately be destroyed. And, being rational actors, each owner is motivated to add to their flock: 'Therein is the tragedy. Each man is locked into a system that compels him to increase his herd without limit – in a world that is limited. Ruin is the destination toward which all men rush, each pursuing his own interest in a society that believes in the freedom of the commons'.[130]

In this exercise, the instructor needs four volunteers to participate. You will be asked to come to the front of the class and demonstrate the concept through a short exercise. You should be familiar with the tragedy of the commons. There are many good resources in the library and you are encouraged to read Hardin's original 1968 article in *Science* (vol. 162, pages 1243–48), titled 'The tragedy of the commons' before attending class.

### Exercise 2: Is being the first mover usually advantageous?

Henry Ford is often credited with saying that he would rather be the first person to be second. This is strange coming from the innovator of the mass-produced automobile in the USA. So is the first mover advantage really a myth or is it something that every organisation should strive for?

First movers are typically considered to be the ones that initially introduce an innovative product or service into a market segment (in other words, the first to market in a new product or service segment). The notion subscribed to first movers is that doing so creates an almost impenetrable competitive advantage that later entrants find difficult to overcome. However, history is replete with situations where second or later movers find success. If the best way to succeed in the future is to understand the past, then an understanding of why certain first movers succeeded and others failed should be instructive. Accordingly, this exercise requires you to investigate a first mover and identify specifically why, or why not, it was able to hold onto its first-mover advantage.

## Part 1

Pick an industry that you find interesting. This assignment can be done individually or in a team. Research that industry and identify one or two instances of a first mover, and research the introduction of a new offering into new market segments. For example, you might pick consumer electronics and look for organisations that initiated new products in new market segments. Your choice of industry must be approved in advance by your instructor as duplication of industries is to be avoided.

## Part 2

Each individual or team is to present their findings, with the discussion centring on the following at a minimum:

- Provide a brief history and description of the industry chosen; for example, was this a fast-, standard- or slow-cycle market at the time the first mover initiated its strategic action?

- Identify how the innovation of new products has traditionally been accomplished in this industry: through new organisations entering the market or by existing organisations launching new offerings?
- Identify one or two first movers and provide a review of what happened. If the product or offering is still considered successful, describe why. If not, why is it not?
- What did you learn as a result of this exercise? Do you consider the first mover a wise strategy, and is your answer dependent upon industry, timing or luck?

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# Corporate-level strategy

CHAPTER 6

## Learning Objectives

Studying this chapter should provide you with the strategic management knowledge needed to:

**LO1** define corporate-level strategy and discuss its purpose

**LO2** describe different levels of diversification with different corporate-level strategies

**LO3** explain three primary reasons organisations diversify

**LO4** describe how organisations can create value by using a related diversification strategy

**LO5** explain the two ways value can be created with an unrelated diversification strategy

**LO6** discuss the incentives and resources that encourage diversification

**LO7** describe motives that can encourage managers to over-diversify an organisation, unintentionally reducing value.

# OPENING CASE STUDY

## The quintessential diversified organisation

The world has many very large corporations. Australia's Wesfarmers, which started as a farmers cooperative, is relatively small by world standards but owns an array of significant business units, including Bunnings, Officeworks, Kmart, Target and a range of industrial firms, covering chemicals, energy and fertilisers in one division, and general industrial and safety in another. It previously owned the Coles empire (Coles, BI-LO, Liquorland, etc.) and is extremely well regarded as a diversified organisation. General Electric (GE) is much larger; it would be easier to list business areas in which it does *not* compete than to list those in which it sells products. GE competes in 16 different industries: appliances, aviation, consumer electronics, electrical distribution, energy, entertainment, finance, gas, health care, lighting, locomotives, oil, software, water, weapons and wind turbines. As can be seen from this list, these industries are quite diverse. Yet there are similarities among several of them. In fact, GE's businesses are grouped in four divisions: GE Capital, GE Energy, GE Technology Infrastructure and GE Home & Business Solutions. In recent years, more than 50 per cent of GE's annual revenue has come from its financial services businesses. Thus, it could be labelled a services company with a strong industrial component. In 2015 GE was ranked the eighth-largest corporation in the Fortune 500, but dropped to 18th by 2018, 21st by 2019 and 33rd by 2020. In June 2018, it lost its coveted position as the only remaining original company that was listed in the initial Dow Jones Industrial Average in 1896. For the past 124 years, GE has achieved an average annual increase in its stock value of 5.8 per cent, but has been recently burdened by debt and exposure to a turbulent market.

These data suggest that despite recent troubles, GE has an impressive history and has experienced a significant amount of success. It is one of only a few widely diversified organisations to achieve such success. GE is a highly influential global corporation. Its former CEO, Jeffrey Immelt, was selected by US President Barack Obama to chair an advisory group on economic and job creation concerns. However, GE has experienced some 'bumps in the road' along the way. This is to be expected because it is difficult to manage a large, widely diversified set of businesses. In the past, GE was criticised for the poor environmental records of some of its businesses. Finally, it had reductions in stock value during the first two decades of the 21st century. GE has bounced back from some of these problems. It has worked hard to overcome and correct its environmental problems. Today, it is a major player in the 'clean energy' industry, such as wind turbines and solar power. GE is also beginning to experience strong growth from its investments in emerging economies such as China and Brazil. In both of these countries, GE has made major business investments working with local partners and has developed R&D centres as well.

General Electric wind turbines at Silverton Wind Farm, New South Wales, (similar to those above) each produce 3.4 megawatts of energy.

Source: iStock.com/istock80

A common strategy to achieve growth (and diversification) for GE over the years has been mergers and acquisitions. For example, in 2011 GE acquired French company Converteam for US$3.2 billion. This company will provide support equipment for GE's wind turbine business. The years 2014 and 2015 were also lively for GE. In this period, it acquired French organisation Alstom for US$17 billion, announced it would sell its property portfolio, and sold most of its finance units and also its health care finance units.

After many decades of acquisitions, recent years have been populated more by divestments, with the September 2017 announcement of the US$2.6 billion sale of its Industrial Solutions business to ABB. The deal closed on 30 June 2018.

Sources: Wesfarmers, 2020, Wesfarmers industrial and safety, https://www.wesfarmers.com.au/our-businesses/industrials, 23 January; Fortune 500, 2020, General Electric company profile Fortune 500 # 33, *Fortune*, https://fortune.com/company/general-electric/fortune500, 30 August; Wikipedia, 2020, General Electric, https://en.wikipedia.org/wiki/General_Electric; General Electric, 2020, Fact sheet, http://www.ge.com/about-us/fact-sheet; T. Gryta & T. Mann, 2018, GE powered the American century – then it burned out, *Wall Street Journal*, https://www.wsj.com/articles/ge-powered-the-american-centurythen-it-burned-out-11544796010, 14 December; C. Loomis, 2011, The really, really, really long-term record for GE, *Fortune*, http://www.fortune.com, 14 May; T. Woody, 2011, GE's new ecomagination chief: Green tech innovation goes global, *Forbes*, http://www.forbes.com, 3 May; S. Pearson, 2011, GE targets Latin America for growth, *Financial Times*, http://www.ft.com, 1 May; E. Crooks, 2011, GE says growth outlook is very strong, *Financial Times*, http://www.ft.com, 28 April; B. Sechler, 2011, GE plan will tap solar power, *Wall Street Journal*, http://online.wsj.com, 8 April; T. Zeller, 2011, GE to buy French company for $3.2 billion, *New York Times*, http://dealbook.nytimes.com, 29 March; R. Layne, 2011, General Electric agrees to buy Converteam for $3.2 billion, *Bloomberg Businessweek*, http://www.businessweek.com, 29 March; General Electric plans to invest $2 billion in China, *Bloomberg Businessweek*, 2010, http://www.businessweek.com, 9 November; D. Zax, 2010, GE and Siemens outpacing wind pioneers, becoming clean energy's new oligopoly, *Fast Company*, http://www.fastcompany.com, 2 November.

Our discussions of business-level strategies (Chapter 4) and the competitive rivalry and competitive dynamics associated with them (Chapter 5) have concentrated on organisations competing in a single industry or product market.[1] In this chapter, we introduce you to corporate-level strategies, which are strategies organisations use to *diversify* their operations from a single business competing in a single market into several product markets – most commonly, into several businesses.

# Purpose of corporate-level strategies

A **corporate-level strategy** specifies actions an organisation takes to gain a competitive advantage by selecting and managing a group of different businesses competing in different product markets. Corporate-level strategies help companies to select new strategic positions – positions that are expected to increase the organisation's value.[2] As explained in the opening case, General Electric competes in 16 widely diverse industries and Wesfarmers in 10 (depending on how you define industries).

**corporate-level strategy**
specifies actions an organisation takes to gain a competitive advantage by selecting and managing a group of different businesses competing in different product markets

As is the case with GE, organisations use corporate-level strategies as a means to grow revenues and profits, but there can be different strategic intents in addition to growth. Organisations can pursue defensive or offensive strategies that realise growth but have different strategic intents. Organisations can also pursue market development by moving into different geographic markets (this approach is discussed in Chapter 8). Organisations can acquire competitors (horizontal integration) or buy a supplier or customer (vertical integration). These strategies are discussed in Chapter 7. The basic corporate strategy, the topic of this chapter, focuses on diversification.

The decision to take actions to pursue growth is never a risk-free choice for organisations. Indeed, as the opening case explored, GE's environmental record likely suffered because of a lack of adequate oversight and the strong interest in producing returns for the shareholders. Effective organisations carefully evaluate their growth options (including the different corporate-level strategies) before committing organisation resources to any of them.[3]

Because the diversified organisation operates in several different and unique product markets, and likely in several businesses, it forms two types of strategies: corporate-level (or company-wide) and business-level (or competitive).[4] Corporate-level strategy is concerned with two key issues: in what product markets and businesses the organisation should compete and how corporate headquarters should manage those businesses.[5] For the diversified corporation, a business-level strategy (see Chapter 4) must be selected for each of the businesses in which the organisation has decided to compete. In this regard, each of GE's product divisions uses different business-level strategies; while most focus on differentiation, its consumer electronics business has products that compete in market niches to include some that are intended to serve the average-income consumer. Thus, cost must also be an issue along with some level of quality.

As is the case with a business-level strategy, a corporate-level strategy is expected to help the organisation earn above-average returns by creating value.[6] Some suggest that few corporate-level strategies actually create value.[7] As the opening case indicates, realising value through a corporate strategy can be achieved but it is challenging to do so. In fact, GE and Wesfarmers are some of the few widely diversified and large organisations that have been successful over time.

Evidence suggests that a corporate-level strategy's value is ultimately determined by the degree to which 'the businesses in the portfolio are worth more under the management of the company than they would be under any other ownership'.[8] Thus, an effective corporate-level strategy creates, across all of an organisation's businesses, aggregate returns that exceed what those returns would be without the strategy[9] and contributes to the organisation's strategic competitiveness and its ability to earn above-average returns.[10]

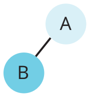
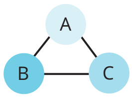
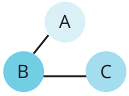
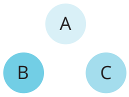
Product diversification, a primary form of corporate-level strategies, concerns the scope of the markets and industries in which the organisation competes as well as 'how managers buy, create and sell different businesses to match skills and strengths with opportunities presented to the firm'.[11] Successful diversification is expected to reduce variability in the organisation's profitability as earnings are generated from different businesses.[12] Diversification can also provide organisations with the flexibility to shift their investments to markets where the greatest returns are possible rather than being dependent on only one or a few markets.[13] Because organisations incur development and monitoring costs when diversifying, the ideal portfolio of businesses balances diversification's costs and benefits. CEOs and their top-management teams are responsible for determining the best portfolio for their company.[14]

We begin this chapter by examining different levels of diversification (from low to high). After describing the different reasons organisations diversify their operations, we focus on two types of related diversification (related diversification signifies a moderate-to-high level of diversification for the organisation). When properly used, these strategies help create value in the diversified organisation, either through the sharing of resources (the related constrained strategy) or the transferring of core competencies across the organisation's different businesses (the related linked strategy). We then discuss unrelated diversification, which is another corporate-level strategy that can create value. The chapter then shifts to the topic of incentives and resources that may stimulate diversification that is value neutral. However, managerial motives to diversify, the final topic in the chapter, can actually destroy some of the organisation's value.

# Levels of diversification

Diversified organisations vary according to their level of diversification and the connections between and among their businesses. Figure 6.1 lists and defines five categories of businesses according to increasing levels of diversification. The single- and dominant-business categories denote relatively low levels of diversification; more fully diversified organisations are classified into related and unrelated categories. An organisation is related through its diversification when its businesses share several links; for example, businesses may share products (goods or services), technologies or distribution channels. The more links among businesses, the more 'constrained' is the relatedness of diversification. 'Unrelated' refers to the absence of direct links between businesses.

**Figure 6.1** **Levels and types of diversification**

| | | |
|---|---|---|
| **Low levels of diversification** | | |
| Single business: | More than 95 per cent of revenue comes from a single business. |   |
| Dominant business: | Between 70 and 95 per cent of revenue comes from a single business. |   |
| **Moderate to high levels of diversification** | | |
| Related constrained: | Less than 70 per cent of revenue comes from the dominant business, and all businesses share product, technological and distribution linkages. |   |
| Related linked (mixed related and unrelated): | Less than 70 per cent of revenue comes from the dominant business, and there are only limited links between businesses. |   |
| **Very high levels of diversification** | | |
| Unrelated: | Less than 70 per cent of revenue comes from the dominant business, and there are no common links between businesses. |   |

Source: Adapted from R. P. Rumelt, 1974, *Strategy, Structure and Economic Performance*, Boston, MA: Harvard Business School

## Low levels of diversification

An organisation pursuing a low level of diversification uses either a single- or a dominant-business, corporate-level diversification strategy. A *single-business diversification strategy* is a corporate-level strategy wherein the organisation generates 95 per cent or more of its sales revenue from its core business area.[15] For example, Wm. Wrigley Jr Company, the world's largest producer of chewing and bubble gums, historically used a single-business strategy while operating in relatively few product markets. Wrigley's trademark chewing gum brands include Spearmint, Doublemint and Juicy Fruit, although the organisation produces other products as well. Sugar-free Extra chewing gum was introduced in 1984.

In 2005, Wrigley shifted from its traditional focused strategy when it acquired the confectionery brands of Kraft Foods Inc., including the well-known brand Life Savers. As Wrigley expanded, it may have intended to use the dominant-business strategy with the diversification of its product lines beyond gum; however, Wrigley was acquired by Mars, a privately held global confectionery company (the maker of Mars bars and M&Ms).[16]

With the *dominant-business diversification strategy*, the organisation generates between 70 and 95 per cent of its total revenue within a single business area. United Parcel Service (UPS) uses this strategy. Recently, UPS generated 65 per cent of its revenue from its US package delivery business and 22 per cent from its international package business, with the remaining 13 per cent coming from the organisation's non-package business.[17] Organisations that focus on one or very few businesses and markets can earn positive returns, because they develop capabilities useful for these markets and can provide superior service to their customers. Additionally, there are fewer challenges in managing one or a very small set of businesses, allowing them to gain economies of scale and efficiently use their resources.[18] Family-owned and controlled businesses are commonly less diversified. They prefer the focus because the family's reputation is related closely to that of the business. Thus, family members prefer to provide quality goods and services, which a focused strategy better allows.[19]

## Moderate and high levels of diversification

An organisation generating more than 30 per cent of its revenue outside a dominant business and whose businesses are related to each other in some manner uses a related diversification corporate-level strategy. When the links between the diversified organisation's businesses are rather direct, a *related constrained diversification strategy* is being used. Campbell's Soup, Procter & Gamble (P&G) and Merck & Company all use a related constrained strategy, as do some large cable companies. With a related constrained strategy, an organisation shares resources and activities between its businesses.

### Strategic focus | Globalisation

### Acciona's related diversification and renewable energy growth

While household brands such as Tesla have dominated headlines in the 'green economy' boom in the past decade, one should also pay attention to the activities of existing organisations in responding to the changing technological, financial and economic environment regarding green energy.

Acciona is a Spanish conglomerate group with extensive experience in infrastructure and renewable energy. While the current entity was founded in 1997, its origin can be traced back to 1862. Acciona is among the first large organisations to have an exclusive focus on renewable energy. With the motto of 'Business as unusual', and its desire to lead the transition to a low carbon economy, Acciona is one of the earliest energy operators utilising renewable energy exclusively. With total sales in the energy sector at 2 billion euros, it has created one of the largest 'green fortunes' for its chairman, José Manuel Entrecanales, since 2004.

Acciona has five core business divisions: construction, concessions, water, services and energy. While each core business is distinct, similar competencies are utilised in construction and equipment. Therefore, there is a transfer of knowledge across these businesses, with construction expertise assisting the development and deployment of energy projects. Acciona is involved in wind power, solar photovoltaic and concentrating technologies, hydropower and biomass projects as part of its global presence in 40 countries.

Its early commitment to sustainability has borne fruit, and capitalising on environmental concerns, global warming and political commitments to create a clean energy sector are all significant drivers of growth. Increasingly, the conventional wisdom that renewable energy is economically unviable in comparison with fossil fuel alternatives is being proven wrong, and this can be observed through Acciona's financial performance, as it has recorded significant sales growth in 2017 and 2018, with the energy sector comprising 60.6 per cent of its EBITDA (earnings before interest, taxes, depreciation and amortisation) while only comprising 28.7 per cent of total revenue in 2018. With a diverse portfolio of projects, supported by friendly renewable energy policies, and a significant global presence, there is still significant growth potential.

As a percentage of revenue, Acciona is among the most innovative companies in the energy and utilities space, investing 2.7 per cent of its revenue into R&D activities. This allows Acciona to maintain its competitive edge, particularly as a leader in the wind energy value chain. A combination of innovation and commitment to sustainability means that Acciona is recognised as one of the top 100 sustainable organisations in the S&P Global 100 index.

With renewable energy becoming increasingly competitive against traditional fuel sources such as fossil fuels, natural gas and nuclear, Acciona is well-suited to capitalise on the renewable energy boom. However, with the emergence of other major players in the renewable energy sector, particularly those coming from mainland China, it remains to be seen if Acciona's track record in the renewable energy sector can still be maintained.

Sources: B. Jaruzelski, 2020, The 2018 Global Innovation 1000 study, PwC, https://www.strategyand.pwc.com/gx/en/insights/innovation1000.html, 11 February; CK Staff, 2019, 2019 Global 100 results, Corporate Knights, https://www.corporateknights.com/reports/

global-100/2019-global-100-results-15481152, 22 January; G. Wetstone, 2019, Renewable energy is booming. Here's how to keep it going, *Fortune*, https://fortune.com/2019/07/02/renewable-solar-wind-energy-investment, 3 July; T. Metcalf & P. Y. Mak, 2020, These billionaires made their fortunes by trying to stop climate change, Bloomberg Green, https://www.bloomberg.com/features/2020-green-billionaires, 22 January; G. Parkinson, 2020, New CSIRO, AEMO study confirms wind, solar and storage beat coal, gas and nuclear, Renew Economy, https://reneweconomy.com.au/new-csiro-aemo-study-confirms-wind-solar-and-storage-beat-coal-gas-and-nuclear-57530, 6 February; Acciona, 2020, Clean energy for a sustainable world, https://www.acciona-energia.com/?language=en, 12 February; J. Entrecanales, 2018, *Acciona Annual Report*, https://annualreport2018.acciona.com/#_ga=2.151524921.1094319634.1581121579-1988099629.1580279385.

The diversified company with a portfolio of businesses that have only a few links between them is called a mixed related and unrelated organisation and is using the *related linked diversification strategy* (see Figure 6.1). As displayed in the opening case, GE uses this corporate-level diversification strategy, as does Wesfarmers. Compared with related constrained organisations, related linked organisations share fewer resources and assets between their businesses, concentrating instead on transferring knowledge and core competencies between the businesses. GE has four strategic business units (see Chapter 11 for a definition of SBUs) that it calls 'divisions', each composed of related businesses. There are no relationships among the strategic business units, only within them. As with organisations using each type of diversification strategy, companies implementing the related linked strategy constantly adjust the mix in their portfolio of businesses as well as make decisions about how to manage these businesses.[20] Managing a diversified organisation such as GE is highly challenging, but GE appears to have been well managed over the years given its success (see also the 'Opening case study' in Chapter 11 for another perspective on GE's performance).

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GE's diversification strategy

A highly diversified organisation that has no relationships between its businesses follows an *unrelated diversification strategy*. Samsung and CK Hutchison Holdings Limited (CKH) are examples of organisations using this type of corporate-level strategy. Commonly, organisations using this strategy are called conglomerates. Samsung is a well-known and highly diversified conglomerate. CKH is a leading international corporation with five core businesses: ports and related services; property and hotels; retail; energy, infrastructure, investments and others; and telecommunications. These businesses are not related to each other and the organisation makes no effort to share activities or to transfer core competencies between or among them. Each of these five businesses is quite large; for example, the retailing arm of the retail and manufacturing business has more than 15 700 stores in 25 countries. Groceries, cosmetics, electronics, wine and airline tickets are some of the product categories featured in these stores. This organisation's size and diversity suggest the challenge of successfully managing the unrelated diversification strategy. However, CK Hutchison's former CEO, Li Ka-shing, was successful at not only making smart acquisitions but also at divesting businesses with good timing.[21]

# Reasons for diversification

An organisation uses a corporate-level diversification strategy for a variety of reasons (see Table 6.1). Typically, a diversification strategy is used to increase the organisation's value by improving its overall performance. Value is created either through related diversification or through unrelated diversification when the strategy allows a company's businesses to increase revenues or reduce costs while implementing their business-level strategies.

Other reasons for using a diversification strategy may have nothing to do with increasing the organisation's value; in fact, diversification can have neutral effects or even reduce an organisation's value. Value-neutral reasons for diversification include a desire to match and thereby neutralise a competitor's market power (such as to neutralise another organisation's advantage by acquiring a similar distribution outlet). Decisions to expand an organisation's portfolio of businesses to reduce managerial risk can have a negative effect on the organisation's value. Greater amounts of diversification reduce managerial risk in

**Table 6.1 Reasons for diversification**

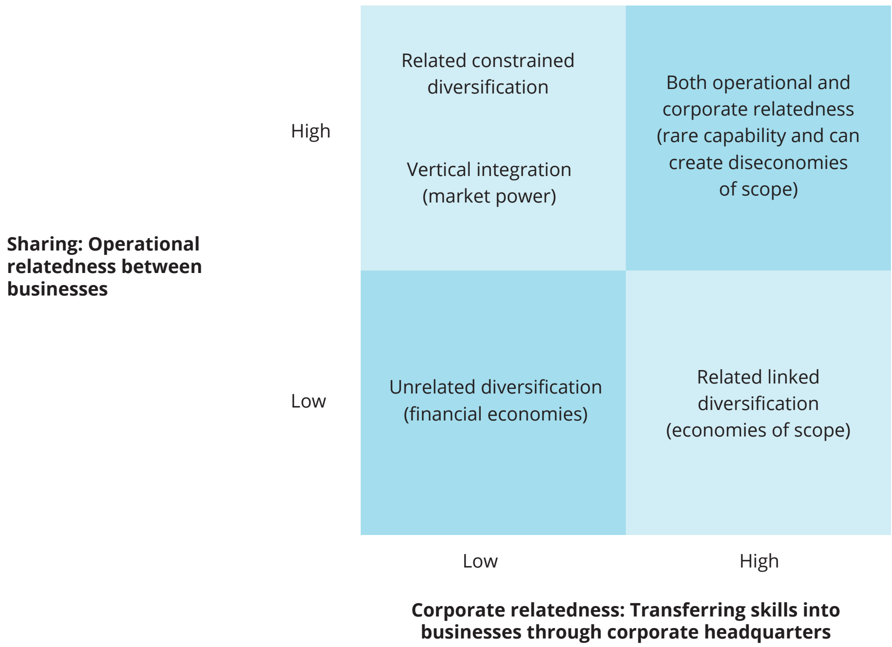
| | |
|---|---|
| **Value-creating diversification** | • Economies of scope (related diversification)<br>• Sharing activities<br>• Transferring core competencies<br>• Market power (related diversification)<br>• Blocking competitors through multi-point competition<br>• Vertical integration<br>• Financial economies (unrelated diversification)<br>• Efficient internal capital allocation<br>• Business restructuring |
| **Value-neutral diversification** | • Antitrust regulation<br>• Tax laws<br>• Low performance<br>• Uncertain future cash flows<br>• Risk reduction for organisation<br>• Tangible resources<br>• Intangible resources |
| **Value-reducing diversification** | • Diversifying managerial employment risk<br>• Increasing managerial compensation |

that if one of the businesses in a diversified organisation fails, the top executive of that business does not risk total failure by the corporation. As such, this reduces the top executives' employment risk. In addition, because diversification can increase an organisation's size and thus managerial compensation, managers have motives to diversify an organisation to a level that reduces its value.[22] Diversification rationales that may have a neutral or negative effect on the organisation's value are discussed later in the chapter.

Operational relatedness and corporate relatedness are two ways diversification strategies can create value (see Figure 6.2). Studies of these independent relatedness dimensions show the importance of resources and key competencies.[23] The figure's vertical dimension depicts opportunities to share operational activities between businesses (operational relatedness) while the horizontal dimension suggests opportunities for transferring corporate-level core competencies (corporate relatedness). The organisation with a strong capability in managing operational synergy, especially in sharing assets between its businesses, falls in the upper left quadrant, which also represents vertical sharing of assets through vertical integration. The lower right quadrant represents a highly developed corporate capability for transferring one or more core competencies across businesses.

This capability is located primarily in the corporate headquarters office. Unrelated diversification is also illustrated in Figure 6.2 in the lower left quadrant. Financial economies (discussed later), rather than either operational or corporate relatedness, are the source of value creation for organisations using the unrelated diversification strategy.

**Figure 6.2** **Value-creating diversification strategies: operational and corporate relatedness**




# Value-creating diversification: related constrained and related linked diversification

With the related diversification corporate-level strategy, the organisation builds upon or extends its resources and capabilities to build a competitive advantage by creating value for customers.[24] The company using the related diversification strategy wants to develop and exploit economies of scope between its businesses.[25] Available to companies operating in multiple product markets or industries,[26] **economies of scope** are cost savings that the organisation creates by successfully sharing some of its resources and capabilities or transferring one or more corporate-level core competencies that were developed in one of its businesses to another of its businesses.

**economies of scope**
cost savings that the organisation creates by successfully sharing some of its resources and capabilities or transferring one (or more) corporate-level core competence that was developed in one of its businesses to another of its businesses

As illustrated in Figure 6.2, organisations seek to create value from economies of scope through two basic kinds of operational economies: sharing activities (operational relatedness) and transferring corporate-level core competencies (corporate relatedness). The difference between sharing activities and transferring competencies is based on how separate resources are jointly used to create economies of scope. To create economies of scope, tangible resources – such as plant and equipment or other business-unit physical assets – often must be shared. Less-tangible resources, such as manufacturing know-how and technological capabilities, can also be shared.[27] However, know-how transferred between separate activities with no physical or tangible resource involved is a transfer of a corporate-level core competence, not an operational sharing of activities.[28]

## Operational relatedness: sharing activities

Organisations can create operational relatedness by sharing either a primary activity (such as inventory delivery systems) or a support activity (such as purchasing practices) – see discussion of the value chain in Chapter 3. Organisations using the related constrained diversification strategy share activities in order to create value. P&G uses this corporate-level strategy. P&G's paper towel business and nappy business both use paper products as a primary input to the manufacturing process. The organisation's paper production plant produces inputs for both businesses and is an example of a shared activity. In addition, because they both produce consumer products, these two businesses are likely to share distribution channels and sales networks.


The merger of BHP and Billiton created a global mining giant (see also the detailed discussion about acquisition and restructuring in Chapter 7).

Source: Getty Images/Carla Gottgens/Bloomberg

Activity sharing is also risky because ties among an organisation's businesses create links between outcomes. For instance, if demand for one business's product is reduced, it may not generate sufficient revenues to cover the fixed costs required to operate the shared facilities. These types of organisational difficulties can reduce activity-sharing success. Additionally, activity sharing requires careful coordination between the businesses involved. The coordination challenges must be managed effectively for the appropriate sharing of activities.[29]

Although activity sharing across businesses is not risk-free, research shows that it can create value. For example, studies of acquisitions of organisations in the same industry (horizontal acquisitions), such as the banking industry and software, found that sharing resources and activities and thereby creating economies of scope contributed to post-acquisition increases in performance and higher returns to shareholders.[30] Additionally, organisations that sold off related units in which resource sharing was a possible source of economies of scope have been found to produce lower returns than those that sold off businesses unrelated to the organisation's core business.[31] Still other research discovered that organisations with closely related businesses have lower risk.[32] These results suggest that gaining economies of scope by sharing activities across an organisation's businesses may be important in reducing risk and in creating value. Further, more-attractive results are obtained through activity sharing when a strong corporate headquarters office facilitates it.[33]

## Corporate relatedness: transferring of core competencies

Over time, the organisation's intangible resources, such as its know-how, become the foundation of core competencies. **Corporate-level core competencies** are complex sets of resources and capabilities that link different businesses, primarily through managerial and technological knowledge, experience and expertise.[34] Organisations seeking to create value through corporate relatedness use the related linked diversification strategy, as exemplified by GE.

**corporate-level core competencies**
complex sets of resources and capabilities that link different businesses, primarily through managerial and technological knowledge, experience and expertise

In at least two ways, the related linked diversification strategy helps organisations to create value.[35] First, because the expense of developing a core competence has already been incurred in one of the organisation's businesses, transferring this competence to a second business eliminates the need for that business to allocate resources to develop it. Such is the case at Hewlett-Packard (HP), where the organisation transferred its competence in ink printers to high-end copiers. Rather than the standard laser printing technology in most high-end copiers, HP uses ink-based technology. One manager liked the product because, as he noted, 'We are able to do a lot better quality at less price.'[36] This capability gives HP the opportunity to sell more ink products and create higher profit margins.

Resource intangibility is a second source of value creation through corporate relatedness. Intangible resources are difficult for competitors to understand and imitate. Because of this difficulty, the unit receiving a transferred corporate-level competence often gains an immediate competitive advantage over its rivals.[37]

A number of organisations have successfully transferred one or more corporate-level core competencies across their businesses. Virgin Group Ltd transfers its marketing core competence across airlines, cosmetics, music, drinks, mobile phones, health clubs and a number of other businesses.[38] Honda has developed and transferred its competence in engine design and manufacturing among its businesses making products such as motorcycles, lawnmowers, cars and trucks. Company officials state that Honda is a major manufacturer of engines and is focused on providing products for all forms of human mobility.[39]


Woolworths supermarkets are part of a larger corporation that includes, among other holdings, Big W, Dan Murphy's and BWS.

Source: Getty Images/Brendon Thorne/Bloomberg

One way managers facilitate the transfer of corporate-level core competencies is by moving key people into new management positions.[40] However, the manager of an older business may be reluctant to transfer key people who have accumulated knowledge and experience critical to the business's success. Thus, managers with the ability to facilitate the transfer of a core competence may come at a premium, or the key people involved may not want to transfer. Additionally, the top-level managers from the transferring business may not want the competencies transferred to a new business to fulfil the organisation's diversification objectives.[41] Research also suggests too much dependence on outsourcing can lower the usefulness of core competencies and thereby reduce their useful transferability to other business units in the diversified organisation.[42]

## Market power

Organisations using a related diversification strategy may gain market power when successfully using a related constrained or related linked strategy. **Market power** exists when an organisation is able to sell its products above the existing competitive level or to reduce the costs of its primary and support activities below the competitive level, or both.[43] Mars' acquisition of the Wrigley assets was part of its related constrained diversification strategy and added market share to the Mars–Wrigley integrated organisation, as it realised 14.4 per cent of the market share. This catapulted Mars–Wrigley above Cadbury and Nestlé, which had 10.1 and 7.7 per cent of the market share, respectively, at the time; and left Hershey with only 5.5 per cent of the market.[44]

**market power**
exists when an organisation is able to sell its products above the existing competitive level or to reduce the costs of its primary and support activities below the competitive level, or both

In addition to efforts to gain scale as a means of increasing market power, as Mars did when it acquired Wrigley, organisations can create market power through multi-point competition and vertical integration. **Multi-point competition** exists when two or more diversified organisations simultaneously compete in the same product areas or geographic markets.[45] Coles' and Woolworths' operations are classic examples of this. They compete in a wide variety of product markets as well as all geographical markets right across Australia, and together they control over 70 per cent of the Australian supermarket market. Some organisations using a related diversification strategy engage in vertical integration to gain market power. **Vertical integration** exists when a company produces its own inputs (backward integration) or owns its own source of output distribution (forward integration). In some instances, organisations partially integrate their operations, producing and selling their products by using company businesses as well as outside sources.[46]

**multi-point competition**
exists when two or more diversified organisations simultaneously compete in the same product areas or geographic markets

**vertical integration**
exists when a company produces its own inputs (backward integration) or owns its own source of output distribution (forward integration)

Vertical integration is commonly used in the organisation's core business to gain market power over rivals. Market power is gained as the organisation develops the ability to save on its operations, avoid market costs, improve product quality, possibly protect its technology from imitation by rivals and potentially exploit underlying capabilities to handle special resources (e.g. sophisticated chemicals or technologies).[47] Market power also is created when organisations have strong ties between their assets for which no market prices exist. Establishing a market price would result in high search and transaction costs, so organisations seek to vertically integrate rather than remain separate businesses.[48]

Vertical integration has its limitations. For example, an outside supplier may produce the product at a lower cost. As a result, internal transactions from vertical integration may be expensive and reduce profitability relative to competitors.[49] Also, bureaucratic costs can be present with vertical integration.[50] Because vertical integration can require substantial investments in specific technologies, it may reduce the organisation's flexibility, especially when technology changes quickly. Finally, changes in demand create capacity, balance and coordination problems. If one business is building a part for another internal business but achieving economies of scale requires the first division to manufacture quantities that are beyond the capacity of the internal buyer to absorb, it would be necessary to sell the parts outside the organisation as well as to the internal business. Thus, although vertical integration can create value, especially through market power over competitors, it is not without risks and costs.[51]

As noted in the following 'Strategic focus' feature, Google's parent company, Alphabet, is diversifying into new markets that allow it to engage in multi-point competition. For example, Google is competing with Microsoft and Apple in several markets. All of its competitors know that Google is a formidable rival with significant resources to invest in the competition. As such, the competitors have reacted, some with substantive actions and others in less positive ways. For example, Apple acquired Siri, a small voice search organisation, to help it compete with Google's search business.[52] Siri has since become a household word and brand, competing strongly against Amazon's Alexa and Microsoft's Cortana. Microsoft filed a complaint with the European Union (EU) about potential antitrust violations by Google; Yahoo! has undertaken advertising that criticises Google; and Facebook hired a public relations organisation to plant negative stories in the press about Google.[53] Some of Google's diversification moves represent a form of vertical integration because the new business areas build on the company's substantial search business (forward integration).

Although Google appears to be increasing its vertical integration, many manufacturing organisations have been reducing vertical integration as a means of gaining market power.[54] In fact, deintegration is the focus of most manufacturing organisations, such as Intel and Dell, and even some large vehicle companies, such as Ford and General Motors, as they develop independent supplier networks.[55] Flex (formerly known as Flextronics), an electronics contract manufacturer, represents a new breed of large contract manufacturers that is helping to foster this revolution in supply-chain management.[56] Such organisations often manage their customers' entire product lines and offer services ranging from inventory management to delivery and after-sales service.

## Strategic focus | Technology

### Alphabet's evolution through diversification

Alphabet, through its most famous product, Google, dominates the internet search engine business and as a result has substantial market power. In 2018, the company's total revenue was US$136.819 billion with a net income of US$30.736 billion, representing 23 per cent revenue growth from 2017 and 207 per cent growth from 2014. Its strong emphasis on R&D and significant liquidity in the form of cash and marketable securities provide opportunities for the organisation to diversify into new markets. Through these channels, Alphabet has been diversifying through acquisitions (using its cash reserves) and internal development (e.g. R&D).

Alphabet is diversifying in several ways that extend the services it provides. It has a related link type of diversification strategy, but acquisitions are reducing the relatedness of its businesses. While acquisition has slowed over the years, it has permitted Alphabet to expand into areas such as humanoid robots, traffic detection software, airborne wind turbines, computer vision, robot arms, robot wheel, gesture recognition technology, movement tracking (through Fitbit), autonomous vehicles and more. It has also expanded into hardware manufacturing and is reaping the benefits of increased exposure. Some of the new services create multi-point competition with prominent competitors (e.g. Microsoft, Facebook, Apple, Netflix and Amazon) and some appear to represent a form of vertical integration. For example, Google has been developing a subscription service for YouTube. Termed YouTube Premium, it aims to transform YouTube to operate like a network, in that it presents a variety of topics such as entertainment, news and politics, and sports.

Through Google's new market entries in recent years, it has 'locked horns' with substantial competitors such as Microsoft (e.g. office software, laptop, browsers, internet access, email and cloud computing), Apple (e.g. search services, smartphones and digital payment), Netflix (film distribution) and Amazon (digital distribution and cloud computing). All of these competitors watch Google's moves closely and often react with moves of their own. While Google has been one of the pioneers in cloud computing through its Google Cloud Platform, it has been facing stiff competition from Amazon and Microsoft, through Amazon Web Services and Microsoft Azure, respectively. It must also contend with the entry of Chinese organisations such as Baidu and Huawei in the global arena, having dominated the world's largest market.

Another noteworthy example of stiff competition is in the field of intelligent virtual assistants. Virtually every major technology player is involved, with Google Assistant, Apple's Siri, Amazon's Alexa, Microsoft's Cortana and Samsung's Bixby. The competition spans both hardware and software, with each organisation either licensing their virtual assistants on other hardware platforms or manufacturing their own hardware. With the market projected to reach US$21 billion by 2026, the competition is still heating up.

While Alphabet's rate of diversification has slowed, its reputation for aggressiveness has forced other


Source: Google and the Google logo are registered trademarks of Google Inc., used with permission.

huge and resourceful corporations to learn to respect and fear it. However, it remains to be seen how Alphabet will operate in the rapidly changing technology landscape, where competitive advantage rapidly erodes, and where many previously prominent organisations have faded to irrelevance.

Sources: Market Study Report LLC, 2019, Intelligent virtual assistant market size is set to grow 21,523.6 million USD by 2026, Market Watch, https://www.marketwatch.com/press-release/intelligent-virtual-assistant-market-size-is-set-to-grow-215236-million-usd-by-2026-2019-10-24, 24 October; Alphabet Investor Relations, 2020, Alphabet announces date of fourth quarter 2019 financial results conference call, https://abc.xyz/investor, 3 February; C. Gartenberg, Google buys Fitbit for $2.1 billion, The Verge, https://www.theverge.com/2019/11/1/20943318/google-fitbit-acquisition-fitness-tracker-announcement, 1 November; M. A. Azevedo, 2019, As Google buys Fitbit, a look at its M&A and investment history, Crunchbase News, https://news.crunchbase.com/news/as-google-buys-fitbit-a-look-at-its-ma-and-investment-history, 1 November; J. Alexander, 2018, YouTube Premium is changing because it has to, The Verge, https://www.theverge.com/2018/11/29/18116154/youtube-premium-free-ads-subscription-red, 29 November; K. Wiggers, 2020, Why Google Assistant supports so many more languages than Siri, Alexa, Bixby, and Cortana, VB, https://venturebeat.com/2020/01/29/google-assistant-siri-alexa-bixby-cortana, 29 January; L. Dignan, 2019, Top cloud providers 2019: AWS, Microsoft Azure, Google Cloud; IBM makes hybrid move; Salesforce dominates SaaS, ZD Net, https://www.zdnet.com/article/top-cloud-providers-2019-aws-microsoft-azure-google-cloud-ibm-makes-hybrid-move-salesforce-dominates-saas, 15 August; S. Wise, 2018, Blockbuster failed to master this 1 thing, and it made the company irrelevant, https://www.inc.com/sean-wise/blockbuster-failed-to-master-this-1-thing-it-made-company-irrelevant.html, Inc., 31 October; N. Somasundaram & C. Liu, 2019, Baidu: 'China's Google' looks for a way forward, Nikkei Asia, https://asia.nikkei.com/Business/China-tech/Baidu-China-s-Google-looks-for-a-way-forward, 28 October.

## Simultaneous operational relatedness and corporate relatedness

As Figure 6.2 suggests, some organisations simultaneously seek operational and corporate relatedness to create economies of scope.[57] The ability to simultaneously create economies of scope by sharing activities (operational relatedness) and transferring core competencies (corporate relatedness) is difficult for competitors to understand and learn how to imitate. However, if the cost of realising both types of relatedness is not offset by the benefits created, the result is diseconomies, because the cost of organisation and incentive structure is very expensive.[58]

STRATEGY NOW

Walt Disney Co.

Walt Disney Co. uses a related diversification strategy to simultaneously create economies of scope through operational and corporate relatedness. Within the organisation's Studio Entertainment business, for example, Disney can gain economies of scope by sharing activities among its different film distribution companies such as Touchstone Pictures and 20th Century Studios. Broad and deep knowledge about its customers is a capability on which Disney relies to develop corporate-level core competencies in terms of advertising and marketing. With these competencies, Disney is able to create economies of scope through corporate relatedness as it cross-sells products that are highlighted in its films through the distribution channels that are part of its Parks and Resorts and Consumer Products businesses. Thus, characters created in films become figures that are marketed through Disney's retail stores (which are part of the Consumer Products business). In addition, themes established in films become the source of new rides in the organisation's theme parks, which are part of the Parks and Resorts business and provide themes for clothing and other retail business products.[59]

Thus, Walt Disney Co. has been able to successfully use related diversification as a corporate-level strategy through which it creates economies of scope by sharing some activities and by transferring core competencies. However, it can be difficult for investors to actually observe the value created by an organisation (such as Walt Disney Co.) as it shares activities and transfers core competencies. For this reason, the value of the assets of an organisation using a diversification strategy to create economies of scope often is discounted by investors.

# Unrelated diversification

Organisations do not seek either operational relatedness or corporate relatedness when using the unrelated diversification corporate-level strategy. An unrelated diversification strategy (see Figure 6.2) can create value through two types of financial economies. **Financial economies** are cost savings realised through improved allocations of financial resources based on investments inside or outside the organisation.[60]

**financial economies**
cost savings realised through improved allocations of financial resources based on investments inside or outside the organisation

Efficient internal capital allocations can lead to financial economies and reduce risk among the organisation's businesses; for example, by leading to the development of a portfolio of businesses with different risk profiles. The second type of financial economy concerns the restructuring of acquired assets. Here, the diversified organisation buys another company, restructures that company's assets in ways that allow it to operate more profitably, and then sells the company for a profit in the external market.[61] Next, we discuss the two types of financial economies in greater detail.

## Efficient internal capital market allocation

In a market economy, capital markets are thought to efficiently allocate capital. Efficiency results as investors take equity positions (ownership) with high expected future cash-flow values. Capital is also allocated through debt as shareholders and debt holders try to improve the value of their investments by taking stakes in businesses with high growth and profitability prospects.

In large diversified organisations, the corporate headquarters office distributes capital to its businesses to create value for the overall corporation. The nature of these distributions may generate gains from internal capital market allocations that exceed the gains that would accrue to shareholders as a result of capital being allocated by the external capital market.[62] Because those in an organisation's corporate headquarters generally have access to detailed and accurate information regarding the actual and prospective performance of the company's portfolio of businesses, they have the best information to make capital distribution decisions.

Compared with corporate office personnel, external investors have relatively limited access to internal information and can only estimate the performances of individual businesses as well as their future prospects. Moreover, although businesses seeking capital must provide information to potential suppliers (such as banks or insurance companies), organisations with internal capital markets may have at least two informational advantages. First, information provided to capital markets through annual reports and other sources may not include negative information, instead emphasising positive prospects and outcomes. External sources of capital have a limited ability to understand the operational dynamics of large organisations. Even external shareholders who have access to information have no guarantee of full and complete disclosure.[63] Second, although an organisation must disseminate information, that information also becomes simultaneously available to the organisation's current and potential competitors. With insights gained by studying such information, competitors might attempt to duplicate an organisation's value-creating strategy. Thus, an ability to efficiently allocate capital through an internal market may help the organisation protect the competitive advantages it develops while using its corporate-level strategy as well as its various business-unit-level strategies.

If intervention from outside the organisation is required to make corrections to capital allocations, only significant changes are possible, such as forcing the organisation into bankruptcy or changing the top management team. Alternatively, in an internal capital market, the corporate headquarters office can fine-tune its corrections, such as choosing to adjust managerial incentives or suggesting strategic changes in one of the organisation's businesses.[64] Thus, capital can be allocated according to more specific criteria than is possible with external market allocations. Because it has less accurate information, the external capital market may fail to allocate resources adequately to high-potential investments. The corporate headquarters office of a diversified company can more effectively perform such tasks as disciplining underperforming management teams through resource allocations.[65] Wesfarmers (discussed in the opening case) has done an exceptionally good job of allocating capital across its many businesses. Although a related linked organisation, it differentially allocates capital across its major strategic business units.

Large, highly diversified businesses often face what is known as the 'conglomerate discount'. This discount results from analysts not knowing how to value a vast array of large businesses with complex financial reports. To overcome this discount, some unrelated diversified or industrial conglomerates have sought to establish a brand for the parent company. For instance, United Technologies initiated a brand development approach with the slogan 'United Technologies. You can see everything from here'. United Technologies suggested that its earnings multiple (PE ratio) compared with its stock price is only average, even though its performance has been better than other conglomerates in its group. It is hoping that the 'umbrella' brand advertisement will raise its PE to a level comparable to its competitors.[66] In another attempt to sway investors on the value of a large diversified company, United Technologies CEO Louis Chenevert stated that 'our future success depends on our ability to innovate – to find new and better ways to serve our customers. And, our ability to innovate relies on our ability to leverage the power of diverse inputs'.[67]

In spite of the challenges associated with it, a number of corporations continue to use the unrelated diversification strategy, especially in Europe and in emerging markets. Siemens, for example, is a large German conglomerate with a highly diversified approach. Its former CEO argued: 'When you are in an up-cycle and the capital markets have plenty of opportunities to invest in single-industry companies ...

investors savor those opportunities. But when things change pure plays go down faster than you can look'.[68] In economic downturns, diversification can help some companies improve future performance.[69]

The Achilles heel for organisations using the unrelated diversification strategy in a developed economy is that competitors can imitate financial economies more easily than they can replicate the value gained from the economies of scope developed through operational relatedness and corporate relatedness. This issue is less of a problem in emerging economies, where the absence of a 'soft infrastructure' (including effective financial intermediaries, sound regulations and contract laws) supports and encourages use of the unrelated diversification strategy.[70] In fact, in emerging economies such as those in South Korea, India and Chile, research has shown that diversification increases the performance of organisations affiliated with large, diversified business groups.[71]

## Restructuring of assets

Financial economies can also be created when organisations learn how to create value by buying, restructuring and then selling the restructured companies' assets in the external market.[72] As in the real estate business, buying assets at low prices, restructuring them and selling them at a price that exceeds their cost generates a positive return on the organisation's invested capital.

Unrelated diversified companies that pursue this strategy try to create financial economies by acquiring and restructuring other companies' assets, but it involves significant trade-offs. For example, the success of umbrella corporation Danaher requires a focus on mature manufacturing businesses because of the uncertainty of demand for high-technology products.[73] In high-technology businesses, resource allocation decisions are highly complex, often creating information-processing overload on the small corporate headquarters offices that are common in unrelated diversified organisations. High-technology businesses are often human-resource dependent; these people can leave or demand higher pay and thus appropriate or deplete the value of an acquired organisation.[74]

Buying and then restructuring service-based assets so they can be profitably sold in the external market is also difficult. Sales in such instances are often a product of close personal relationships between a client and the representative of the organisation being restructured. Thus, for both high-technology organisations and service-based companies, relatively few tangible assets can be restructured to create value and sell profitably. It is difficult to restructure intangible assets such as human capital and effective relationships that have evolved over time between buyers (customers) and sellers (organisation personnel). Care must be taken in an economic downturn to restructure and buy and sell at appropriate times. A downturn can present opportunities but also some risks. Ideally, executives will follow a strategy of buying businesses when prices are lower, such as in the midst of a recession, and selling them at late stages in an expansion.[75]

# Value-neutral diversification: incentives and resources

The objectives organisations seek when using related diversification and unrelated diversification strategies all have the potential to help the organisation create value by using a corporate-level strategy. However, these strategies, as well as single- and dominant-business diversification strategies, are sometimes used with value-neutral rather than value-creating objectives in mind. As we discuss next, different incentives to diversify sometimes exist, and the quality of the organisation's resources may permit only diversification that is value neutral rather than value creating.

## Incentives to diversify

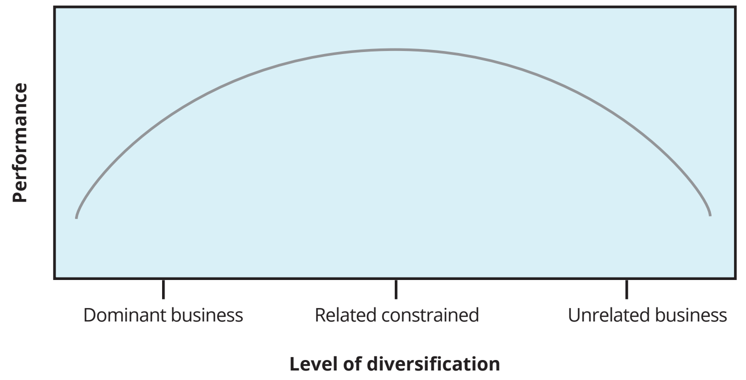
Incentives to diversify come from both the external environment and an organisation's internal environment. External incentives include antitrust regulations and tax laws. Internal incentives include low performance, uncertain future cash flows, and the pursuit of synergy and reduction of risk for the organisation.

### Low performance

Some research shows that low returns are related to greater levels of diversification.[76] If 'high performance eliminates the need for greater diversification',[77] then low performance may provide an incentive for diversification. In 2005, eBay acquired Skype for US$3.1 billion in hopes that it would create synergies and improve communication between buyers and sellers. However, within three years, eBay decided to sell Skype because it had failed to increase cash flow for its core e-commerce business, and the expected synergies were not realised. In 2011, eBay sold Skype to Microsoft for US$8.5 billion. Although analysts thought the premium paid by Microsoft may have been too high, one review in the *Financial Times* suggested that Skype could play a prominent role in Microsoft's multimedia strategy. Thus, the potential synergies between Skype and Microsoft may be greater than those with eBay.[78] The poor performance may be because of errors made by top managers (such as eBay's original acquisition of Skype) and thus led to divestitures similar to eBay's action.[79] From 2013 to 2015, Microsoft phased out (divested) Windows Live Messenger and Lync due to poor performance relative to Skype, and from 2016 Microsoft steadily moved Skype's focus away from voice calling to text-based messaging, which better suited Microsoft's product suite such as Azure.[80] The major benefit for Microsoft was the development of Microsoft Teams in 2017, which integrates with Skype, and was only possible because of the knowledge gained from Skype.[81]

Research evidence and the experience of a number of organisations suggest that an overall curvilinear relationship, as illustrated in Figure 6.3, may exist between diversification and performance.[82] Although low performance can be an incentive to diversify, organisations that are more broadly diversified compared with their competitors may have overall lower performance.

**Figure 6.3** **The curvilinear relationship between diversification and performance**



As an organisation's product line matures or is threatened, diversification may be an important defensive strategy.[83] Small organisations and companies in mature or maturing industries sometimes find it necessary to diversify for long-term survival.[84] For example, music retailers began to diversify as CD sales started to decline. By the end of 2009, CD sales had declined by about 50 per cent from their peak. Ten years later in 2019, CD sales had slumped to 5 per cent of that peak (46.5 million in 2019 compared to 943 million in 2000 for the US).[85]

Diversifying into other product markets or into other businesses can reduce the uncertainty about an organisation's future cash flows. Merck decided to expand into the biosimilars business (production of drugs that are similar to approved drugs) in hopes of stimulating its prescription drug business due to expected lower results as many of its drug patents expire.[86] Thus, in 2009 it purchased Insmed's portfolio of follow-on biologics for US$130 million. It continued to carry out the development of biologics that prevent infections in cancer patients receiving chemotherapy. In 2020, Merck announced it would spin off a specialist company in 2021 to market its biosimilar products.[87]

## Synergy and organisation risk reduction

**synergy** exists when the value created by business units working together exceeds the value that those same units create working independently

Diversified organisations pursuing economies of scope often have investments that are too inflexible to realise synergy between business units. As a result, a number of problems may arise. **Synergy** exists when the value created by business units working together exceeds the value that those same units create working independently. But as an organisation increases its relatedness between business units, it also increases its risk of corporate failure, because synergy produces joint interdependence between businesses that constrains the organisation's flexibility to respond. This threat may force two basic decisions.

First, the organisation may reduce its level of technological change by operating in environments that are more certain. This behaviour may make the organisation risk averse and thus uninterested in pursuing new product lines that have potential but are not proven. Alternatively, the organisation may constrain its level of activity sharing and forgo potential benefits of synergy. Either or both decisions may lead to further diversification.[88] The former likely leads to related diversification into industries in which more certainty exists.[89] The latter may produce additional, but unrelated, diversification. Research suggests that an organisation using a related diversification strategy is more careful in bidding for new businesses, whereas an organisation pursuing an unrelated diversification strategy may be more likely to overprice its bid, because an unrelated bidder is less likely to have full information about the acquired organisation.[90] However, organisations using either a related or an unrelated diversification strategy must understand the consequences of paying large premiums.[91] In the situation with eBay, former CEO Meg Whitman received heavy criticism for paying such a high price for Skype, especially when the organisation did not realise the synergies it was seeking. However, eBay sold Skype six years later at 175 per cent of the price at which it purchased the business. The question is whether Microsoft paid too high a premium to achieve positive returns from the acquisition of Skype. In hindsight, the then record price of US$8.5 billion seems reasonable, given the rise and prominence of IP-based videoconferencing in 2020 during the Covid-19 pandemic, and the synergy between Skype and Microsoft Teams, with Microsoft Teams jumping 70 per cent in a month to 75 million daily active users.[92]

# Resources and diversification

As already discussed, organisations may have several value-neutral incentives as well as value-creating incentives (such as the ability to create economies of scope) to diversify. However, even when incentives to diversify exist, an organisation must have the types and levels of resources and capabilities needed to successfully use a corporate-level diversification strategy.[93] Although both tangible and intangible resources facilitate diversification, they vary in their ability to create value. Indeed, the degree to which resources are valuable, rare, difficult to imitate and non-substitutable (see Chapter 3) influences an organisation's ability to create value through diversification. For instance, free cash flows are a tangible financial resource that may be used to diversify the organisation. However, compared with diversification that is grounded in intangible resources, diversification based on financial resources only is more visible to competitors and thus more imitable and less likely to create value on a long-term basis.[94] Tangible resources usually include the plant and equipment necessary to produce a product and tend to be less-flexible assets. Any excess capacity often can be used only for closely related products, especially those requiring highly similar manufacturing technologies. For example, large computer makers such as Dell and HP underestimated the demand for tablet computers, especially Apple's iPad. Apple developed the iPad and many expected it to eventually replace the personal computer (PC). In fact, HP's and Dell's sales of their PCs have been declining since the introduction of the iPad. In-between their launch and 2014, 225 million iPads were sold, hurting sales by computer companies. Then, in 2015, the rise of the 'phablet' (basically a unit sized in-between an iPad and a phone) bit into iPad sales – high tech is a tricky landscape to negotiate.[95] However, after little sales growth from 2015 to 2019, Apple recorded strong growth again with iPad sales up 22 per cent in the third quarter of 2019, and further strong growth to the third quarter of 2020.[96]

Excess capacity of other tangible resources, such as a sales force, can be used to diversify more easily. Again, excess capacity in a sales force is more effective with related diversification, because it may be utilised to sell similar products. The sales force would be more knowledgeable about related-product characteristics, customers and distribution channels.[97] Tangible resources may create resource interrelationships in production, marketing, procurement and technology, defined earlier as activity sharing. Intangible resources are more flexible than tangible physical assets in facilitating diversification. Although the sharing of tangible resources may induce diversification, intangible resources such as tacit knowledge could encourage even more diversification.[98]

Sometimes, however, the benefits expected from using resources to diversify the organisation for either value-creating or value-neutral reasons are not gained.[99] After not gaining the desired and required value from its diversified portfolio, GE has recently undergone successive years of major divestments, with US$8.4 billion of divestments in 2018, US$10.4 billion in 2019 and a huge US$58.7 billion in 2020.[100]

# Value-reducing diversification: managerial motives to diversify

Managerial motives to diversify can exist independent of value-neutral reasons (i.e. incentives and resources) and value-creating reasons (e.g. economies of scope). The desire for increased compensation and reduced managerial risk are two motives for top-level executives to diversify their organisation beyond value-creating and value-neutral levels.[101] In other words, top-level executives may diversify an organisation in order to diversify their own employment risk, as long as profitability does not suffer excessively.[102]

Diversification provides additional benefits to top-level managers that shareholders do not enjoy. Research evidence shows that diversification and organisation size are highly correlated, and as organisation size increases, so does executive compensation.[103] Because large organisations are complex, difficult-to-manage organisations, top-level managers commonly receive substantial levels of compensation to lead them.[104] Greater levels of diversification can increase an organisation's complexity, resulting in still more compensation for executives to lead an increasingly diversified organisation. Governance mechanisms – such as the board of directors, monitoring by owners, executive compensation practices and the market for corporate control – may limit managerial tendencies to over-diversify. These mechanisms are discussed in more detail in Chapter 10.

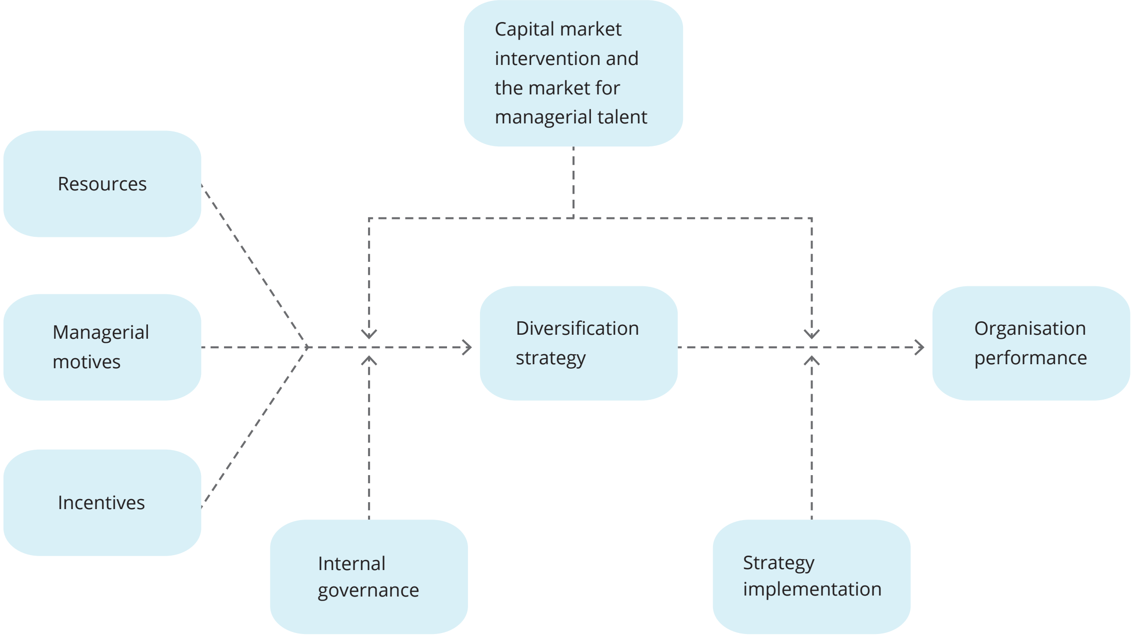
In some instances, though, an organisation's governance mechanisms may not be strong, resulting in a situation in which executives may diversify the organisation to the point that it fails to earn even average returns.[105] The loss of adequate internal governance may result in poor relative performance, thereby triggering a threat of takeover. Although takeovers may improve efficiency by replacing ineffective managerial teams, managers may avoid takeovers through defensive tactics, such as ‘poison pills’, or may reduce their own exposure with ‘golden parachute’ agreements.[106] Therefore, an external governance threat, although restraining managers, does not flawlessly control managerial motives for diversification.[107]

Most large publicly held organisations are profitable because the managers leading them are positive stewards of organisation resources, and many of their strategic actions, including those related to selecting a corporate-level diversification strategy, contribute to the organisation’s success.[108] As mentioned, governance mechanisms should be designed to deal with exceptions to the managerial norms of making decisions and taking actions that will increase the organisation’s ability to earn above-average returns. Thus, it is overly pessimistic to assume that managers usually act in their own self-interest as opposed to their organisation’s interest.[109]

Top-level executives’ diversification decisions may also be held in check by concerns for their reputation. If a positive reputation facilitates development and use of managerial power, a poor reputation may reduce it. Likewise, a strong external market for managerial talent may deter managers from pursuing inappropriate diversification.[110] In addition, a diversified organisation may police other organisations by acquiring those that are poorly managed in order to restructure its own asset base. Knowing that their organisations could be acquired if they are not managed successfully encourages executives to use value-creating, diversification strategies.

As shown in Figure 6.4, the level of diversification that can be expected to have the greatest positive effect on performance is based partly on how the interaction of resources, managerial motives and incentives affects the adoption of particular diversification strategies. As indicated earlier, the greater the

**Figure 6.4** **Summary model of the relationship between diversification and organisation performance**




Source: Adapted from R. E. Hoskisson & M. A. Hitt, 1990, Antecedents and performance outcomes of diversification: A review and critique of theoretical perspectives, *Journal of Management*, 16: 498.

incentives and the more flexible the resources, the higher the level of expected diversification. Financial resources (the most flexible) should have a stronger relationship to the extent of diversification than either tangible or intangible resources. Tangible resources (the most inflexible) are useful primarily for related diversification.

As discussed in this chapter, organisations can create more value by effectively using diversification strategies. However, diversification must be kept in check by corporate governance (see Chapter 10). Appropriate strategy implementation tools, such as organisational structures, are also important (see Chapter 11).

We have described corporate-level strategies in this chapter. In the next chapter, we discuss mergers and acquisitions as prominent means for organisations to diversify and to grow profitably. These trends towards more diversification through acquisitions, which have been partially reversed due to restructuring (see Chapter 7), indicate that learning has taken place regarding corporate-level diversification strategies.[111] Accordingly, organisations that diversify should do so cautiously, choosing to focus on relatively few, rather than many, businesses. In fact, some research suggests that although unrelated diversification has decreased, related diversification has increased, possibly due to the restructuring that continued into the 1990s and early 21st century. This sequence of diversification followed by restructuring took place in Europe and other places such as South Korea, mirroring actions of organisations in the USA and the UK.[112] Recent research shows that whether diversification is related or unrelated, the core drivers of increasing business revenue, reducing costs and avoiding risks still apply, and the focus should be on building effective business models.[113] Organisations can improve their strategic competitiveness when they pursue a level of diversification that is appropriate for their resources (especially financial resources) and core competencies, and the opportunities and threats in their country's institutional and competitive environments.[114]

# STUDY TOOLS

## SUMMARY

**LO1** A corporate-level strategy specifies actions an organisation takes to gain a competitive advantage by selecting and managing a group of different businesses competing in different product markets. Organisations use corporate-level strategies to diversify their operations across several product markets. Thus, corporate-level strategies help companies to select new strategic positions that are expected to increase the organisation's value.

**LO2** Using a single- or dominant-business corporate-level strategy may be preferable to seeking a more diversified strategy, unless a corporation can develop economies of scope or financial economies between businesses, or unless it can obtain market power through additional levels of diversification. Economies of scope and market power are the main sources of value creation when the organisation diversifies by using a corporate-level strategy with moderate-to-high levels of diversification.

**LO3** Organisations may diversify to create additional value, for value-neutral reasons, or to reduce the value of the organisation.

**LO4** The related diversification corporate-level strategy helps the organisation create value by sharing activities or transferring competencies between different businesses in the company's portfolio.

Sharing activities usually involves sharing tangible resources between businesses. Transferring core competencies involves transferring core competencies developed in one business to another business. It also may involve transferring competencies between the corporate headquarters office and a business unit. Sharing activities is usually associated with the related constrained diversification corporate-level strategy. Activity sharing is costly to implement and coordinate, may create unequal benefits for the divisions involved in the sharing, and can lead to fewer managerial risk-taking behaviours.

Transferring core competencies is often associated with related linked (or mixed related and unrelated) diversification, although organisations pursuing both sharing activities and transferring core competencies can also use the related linked strategy.

**LO5** Efficiently allocating resources or restructuring a target organisation's assets and placing them under rigorous financial controls are two ways to accomplish successful unrelated diversification. Organisations using the unrelated diversification strategy focus on creating financial economies to generate value.

**LO6** Diversification is sometimes pursued for value-neutral reasons. Incentives from tax and antitrust government policies, risk reduction, performance disappointments or uncertainties about future cash flow are examples of value-neutral reasons that organisations may choose to become more diversified.

**LO7** Managerial motives to diversify (including to increase compensation) can lead to over-diversification and a subsequent reduction in an organisation's ability to create value. Evidence suggests, however, that many top-level executives seek to be good stewards of the organisation's assets and avoid diversifying the organisation in ways that destroy value.

Managers need to pay attention to their organisation's internal organisation and its external environment when making decisions about the optimum level of diversification for their company. Of course, internal resources are important determinants of the direction that diversification should take. However, conditions in the organisation's external environment may facilitate additional levels of diversification, as might unexpected threats from competitors.

## KEY TERMS

corporate-level core competencies
corporate-level strategy
economies of scope
financial economies
market power
multi-point competition
synergy
vertical integration

## REVIEW QUESTIONS

1. What is corporate-level strategy and why is it important?
2. What are the different levels of diversification organisations can pursue by using different corporate-level strategies?
3. How does diversification create economies of scope? What level of diversification is typically associated with economies of scope?
4. What are three primary reasons organisations choose to diversify their operations?
5. How do organisations create value when using a related diversification strategy? How does this differ from an unrelated diversification strategy?
6. What are the two ways to obtain financial economies when using an unrelated diversification strategy?
7. What incentives and resources encourage diversification?
8. What motives might encourage managers to over-diversify their organisation?

## EXPERIENTIAL EXERCISES

### Exercise 1: What's my corporate-level strategy and how did I get this way?

Your text defines corporate-level strategy as 'actions an organisation takes to gain a competitive advantage by selecting and managing a group of different businesses competing in different product markets'. However, these actions are dynamic and longitudinal – they evolve over time. How did GE, Ford Motor Company or IBM arrive at the corporate-level strategies they use today, and what are those strategies?

#### Part 1

Form teams of four or five students and select a publicly traded organisation, preferably one that has been in existence for a few decades.

#### Part 2

Complete a poster that can be displayed in class. Your poster should represent the organisation and its evolution as far back in its history as you can fit on one poster. The goal is to highlight the organisation's beginnings, its acquisitions and divestiture activity, and its movement from one corporate-level strategy to another. You will need to do some extensive research on the organisation to identify common linkages between operating units.

Be prepared to answer the following questions:

- How has the organisation's corporate-level strategy evolved over time?
- What is the current corporate-level strategy and what links, if any, exist between operating units?
- How successful is the current corporate-level strategy (e.g. too much diversification, too little, just right)? Why is this so?

### Exercise 2: How does the organisation's portfolio stack up?

The Boston Consulting Group (BCG) product portfolio matrix has been around for decades and was introduced by the BCG as a way for organisations to understand the priorities that should be given to various segments within their mix of businesses. It is based on a matrix with two vertices: organisation market share and projected market growth rate. Each organisation therefore can categorise its business units as follows:

- Stars: High growth and high market share. These business units generate large amounts of cash but also use large amounts of cash. These are often the focus of the organisation's priorities as this segment has a potentially bright future.
- Cash cows: Low market growth coupled with high market share. Profits and cash generated are high, and need for new cash is low. Cash cows provide a foundation for the organisation from which it can launch new initiatives.
- Dogs: Low market growth and low market share. This is usually a situation organisations seek to avoid. These

units are quite often the target of a turnaround plan or liquidation effort.

- Question marks: High market growth but low market share. It is difficult to say what the organisation should do in this quadrant. It creates a need to move strategically because of high demands on cash due to market needs yet low cash returns because of the low organisation market share.

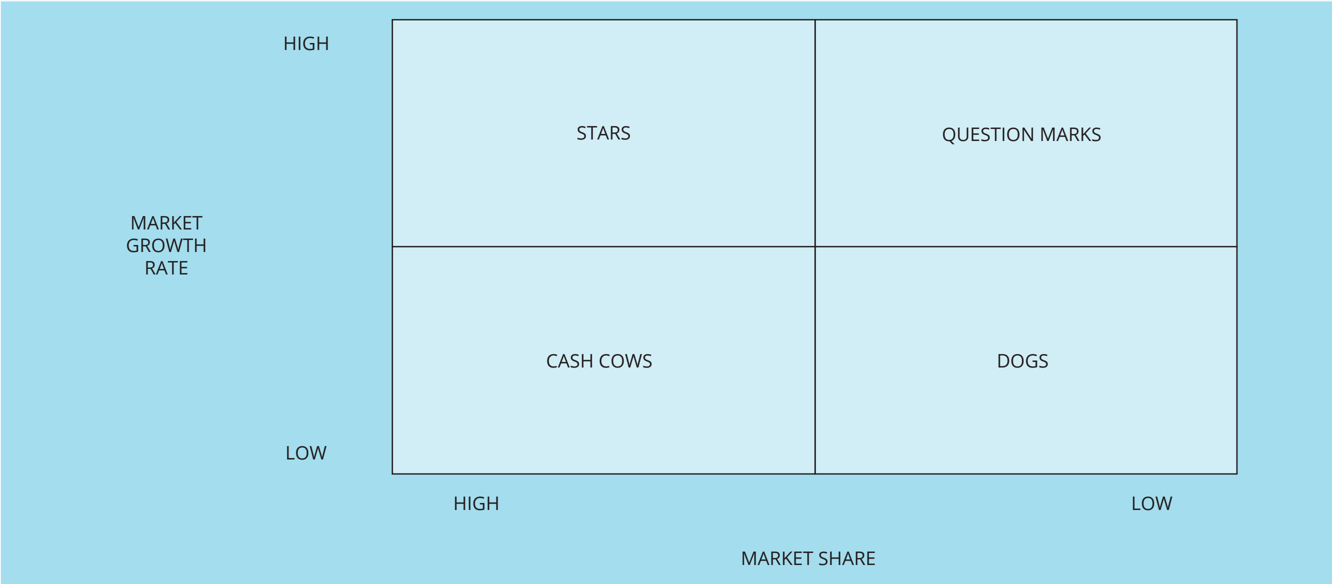
Using this matrix to analyse an organisation's corporate-level strategy or the way in which it rewards and prioritises its business units has come under some criticism. For one, market share is not the only way in which an organisation should view success or potential success; second, market growth is not the only indicator for the attractiveness of a market; and third, sometimes 'dogs' can earn as much cash as 'cows'.

## Part 1

Select a publicly traded organisation that has a diversified corporate-level strategy. The more unrelated the segments, the better.

## Part 2

Analyse the organisation utilising the BCG matrix. In order to do this, you will need to develop market share ratings for each operating unit and assess the overall market attractiveness for that segment.

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# Acquisition and restructuring strategies

CHAPTER 7

## Learning Objectives

Studying this chapter should provide you with the strategic management knowledge needed to:

**LO1** explain the popularity of merger and acquisition strategies in organisations competing in the global economy

**LO2** discuss reasons why organisations use an acquisition strategy to achieve strategic competitiveness

**LO3** describe seven problems that work against achieving success when using an acquisition strategy

**LO4** name and describe the attributes of effective acquisitions

**LO5** define and understand the restructuring strategy and the long- and short-term outcomes of its common forms.

# OPENING CASE STUDY

## Strategic acquisitions and a people-focused integration of those acquisitions are vital capabilities of Atlassian

Atlassian is in the business of creating solutions that allow for more effective team management. As the internet – and how the business world utilises the internet – evolved, Atlassian's business was required to change with this evolution. As part of its advancement, Atlassian has used an acquisition strategy to build its products and extend its reach into new areas, both related and unrelated. With work increasingly moving online, teams dispersed geographically and team complexity constantly on the rise due to increasing responsibilities, the nature of workplace collaboration has evolved and, as such, requires software solutions that can facilitate digital collaboration effectively and securely.

The new digital workplace requires software solutions that integrate disparate teams and projects in formats that allow for effective tracking, planning and supporting. There are solutions needed for collaboration online, within and between workplaces, and internationally. The systems must also be open enough to allow for tailored and proprietary solutions to be developed for client organisations. The open nature of the internet, however, makes it vulnerable to cyber attacks, so it is critical to ensure strong digital security.

Atlassian has evolved from its original software platform and flagship product Jira to a broader suite of businesses through a mix of in-house development as well as targeted acquisitions. This required the transformation of Jira, a project and issue tracker software, from a software suite dedicated for developers to a platform that can be used by all organisations. It also required the development of a suite of software and relevant infrastructure to enhance and supplement existing capabilities and deliver superior results to teams. For example, in 2017 Atlassian acquired Trello, a Kanban-style list-making application from Fog Creek Software. Through this acquisition, Atlassian operates within its core project management capabilities while expanding its reach to smaller-scale clients and individual users.

With its original intention to support software developers, Atlassian also expanded its capabilities by acquiring Bitbucket, a service for code collaboration. Other complementary services include Sourcetree, Bamboo, Fisheye and Crucible, all of which offer different solutions to software developers, such as code collaboration, integration, deployment and release management, and improving code quality. The company also delivers security solutions through Atlassian Access and Crowd.

While several of these acquisitions have worked well for Atlassian, others represent business reversals. An example is Atlassian's foray into the business communication market. In 2015, Atlassian acquired HipChat, a web-based service for internal private online chat and instant messaging. In 2017, Atlassian introduced Stride in complement with HipChat, intended as a competitor to Slack, the dominant player in the business communication space. However, with a lack of demand for both HipChat and Stride, Atlassian decided to enter a strategic partnership with Slack in 2018, selling relevant IP to Slack, shutting down HipChat and Stride, and invested in Slack's equity, effectively exiting the business communication space.

As Atlassian itself noted, merger and acquisition is part of its strategy for growth. With 20 companies acquired for approximately US$1 billion, it has noted its ability to integrate acquisitions. Atlassian emphasises the importance of people and culture in its integration process as well as the critical role of communication to ensure successful integration. It has noted that the M&A process is outdated, inefficient and unnecessarily combative, and this creates friction and mistrust. To create certainty for the acquired firm and future potential acquisition targets, Atlassian made public its term sheet, which strives to make it more favourable to selling companies and to be fair to future team members.

Atlassian's integration practices also align with this acquisition practice of openness and transparency. While popular perceptions of integration tend to focus on the size of the transaction and the high-profile personalities involved, it is the successful integration of people and culture that help to ensure long-term success for any organisation. While most of the due diligence is conducted with the finance and legal teams, it also works to start integration before the deal itself is announced. Integration means significant uncertainty for people working with the acquired organisation, particularly with work arrangements, which were significantly influenced by existing work culture. According to Betty Jane Hess, an acquisition specialist from Arrow Electronics, 'The first 30 days of any acquisition is hell, because no matter how much you try, no matter how much you plan, stuff goes wrong'.

As such, a people-focused and values-driven understanding of the acquired business is core to its successful integration. This is important for identifying the differences of the acquired company, identifying pain points and therefore understanding what can be done moving forward. An example from Atlassian was its acquisition of Trello, which was found to have a remote work policy. While Atlassian does not have a remote work policy, it did not force this change onto Trello, and it even piloted a few new remote work programs itself. From a people perspective, Atlassian emphasised transparency through engaging with its acquisition from the start. Through this engagement, Atlassian aims to answer employees' most pressing questions, understand their work requirements and find hidden leaders, on whom Atlassian can lean to support the eventual integration. This constant interaction creates trust and paves the way to the eventual introduction and integration of Atlassian's own culture.

Sources: Atlassian, 2020, Products for teams, from startup to enterprise, https://www.atlassian.com/software; T. Kennedy & C. Hecht, 2019, The M&A process is broken, Atlassian, https://www.atlassian.com/blog/technology/atlassian-term-sheet, 17 June; T. Middleton, 2019, What 20 acquisitions taught us about post-merger integration, Atlassian, https://www.atlassian.com/blog/teamwork/post-merger-integration-tips, 14 August; C. Aiello, 2018, Atlassian exits business communications space, surrenders to Slack, CNBC, https://www.cnbc.com/2018/07/26/atlassian-surrenders-slack.html, 26 July; F. Lardinois, 2017, Atlassian acquires Trello for $425M, TechCrunch, https://techcrunch.com/2017/01/09/atlassian-acquires-trello, 10 January.

We examined corporate-level strategy in Chapter 6, focusing on types and levels of product diversification strategies that organisations derive from their core competencies to create competitive advantages and value for stakeholders. As noted in that chapter, diversification allows an organisation to create value by productively using excess resources.[1] In this chapter, we explore merger and acquisition strategies. Organisations throughout the world use these strategies, often in concert with diversification strategies, to become more diversified and improve **economies of scale** or economies of scope. As noted in the opening case, merger and acquisition strategies remain popular as a source of organisation growth and, hopefully, of above-average returns.

STRATEGY NOW
Atlassian's acquisition of Trello

**economies of scale**
average cost (i.e. cost per unit of output) decreases as output volume increases

Most corporations are very familiar with merger and acquisition strategies. For example, the latter half of the 20th century found major companies using these strategies to grow and to deal with the competitive challenges in their domestic markets as well as those emerging from global competitors. Today, smaller organisations also use merger and acquisition strategies to grow in their existing markets and to enter new markets.[2]

Not unexpectedly, many mergers and acquisitions fail to fulfil their promise.[3] Accordingly, explaining how organisations can successfully use merger and acquisition strategies to create stakeholder value[4] is a key purpose of this chapter. To do this, we first explain the continuing popularity of merger and acquisition strategies as a choice organisations evaluate when seeking growth and strategic competitiveness. As part of this explanation, we describe the differences between mergers, acquisitions and takeovers. We next discuss specific reasons organisations choose to use acquisition strategies and some of the problems organisations may encounter when implementing them. We then describe the characteristics associated with effective acquisitions before closing the chapter with a discussion of different types of restructuring strategies. Restructuring strategies are commonly used to correct or deal with the results of ineffective mergers and acquisitions.

# The popularity of merger and acquisition strategies

Merger and acquisition (M&A) strategies have been popular for many years. Some believe that these strategies played a central role in the restructuring of businesses during the 1980s and 1990s and that they continue to generate these types of benefits in the 21st century.[5]

Although popular, and appropriately so, as a means of growth with the potential to lead to strategic competitiveness, it is important to emphasise that changing conditions in the external environment influence the type of M&A activity organisations pursue. During the global financial crisis (GFC) of 2008–09, tightening credit markets made it more difficult for organisations to complete 'megadeals' (those costing US$10 billion or more). However, the flow of deals picked up in 2011 in the USA, where 'first-quarter deal volume rose a healthy 45 per cent to $290.8 billion, compared with $200.6 billion' in 2010, while 2014 was the strongest year for deal making since 2007, and cross-border acquisitions led the way.[6] A relatively weak currency increases the interest of organisations from other nations with a strong currency to pursue cross-border acquisitions in the country where the currency is weaker.[7]

In the final analysis, organisations use M&A strategies to improve their ability to create more value for all stakeholders, including shareholders. As suggested by Figure 1.1 (page 5), this reasoning applies equally to all of the other strategies (e.g. business-level, corporate-level, international and cooperative) an organisation may formulate and then implement.

However, evidence suggests that using M&A strategies in ways that consistently create value is challenging. This is particularly true for acquiring organisations, in that some research results indicate that shareholders of acquired organisations often earn above-average returns from acquisitions, while shareholders of acquiring organisations typically earn returns that are close to zero.[8] Moreover, in approximately two-thirds of all acquisitions, the acquiring organisation's stock price falls immediately after the intended transaction is announced. This negative response reflects investors' scepticism about the likelihood that the acquirer will be able to achieve the synergies required to justify the premium.[9] Premiums can sometimes appear to be excessive, as in the acquisition of National Semiconductor by Texas Instruments (TI). One analyst suggested that the 85 per cent premium 'indicated the level of confidence TI execs have in both the purchase and the ability to rapidly boost the flagging growth rate of National's product sales'.[10] Obviously, creating the amount of value required to account for this type of premium is not going to be easy. Overall then, those leading organisations that are using M&A strategies must recognise that creating more value for their stakeholders by doing so is indeed difficult.[11]

## Mergers, acquisitions and takeovers: what are the differences?

**merger**
a strategy through which two organisations agree to integrate their operations on a relatively coequal basis

A **merger** is a strategy through which two organisations agree to integrate their operations on a relatively coequal basis. In 2001, the biggest mining company in the world was created with the merger of Australia's BHP and Billiton, a South Africa–based miner. At the time, the message in world mining was 'get big or get out'.[12] More recently and locally in 2018, Nine Entertainment and Fairfax Media merged two $2 billion companies to control television (Channel 9), newspapers (*Sydney Morning Herald*, *The Age*, *Australian Financial Review*), radio (2GB, 3AW) and online media (Stan).[13]

The reality is that few true (pure) mergers actually take place. The main reason for this is that one party to the transaction is usually dominant in regard to various characteristics such as market share, size or value of assets. In the BHP Billiton example, BHP was the dominant partner. Another reason is that, even if the organisations are equal in terms of size or market share, the merged entity only needs one board, one CEO, one CFO and one information technology (IT) system, so the entity that controls most of these shapes the future direction of the merged organisation.

An **acquisition** is a strategy through which one organisation buys a controlling, or 100 per cent, interest in another organisation with the intent of making the acquired organisation a subsidiary business within its portfolio. After completing the transaction, the management of the acquired organisation reports to the management of the acquiring organisation.

**acquisition**
a strategy through which one organisation buys a controlling, or 100 per cent, interest in another organisation with the intent of making the acquired organisation a subsidiary business within its portfolio

Although most of the mergers that are completed are friendly in nature, acquisitions can be friendly or unfriendly. A **takeover** is a special type of acquisition wherein the target organisation does not solicit, or even opposes, the acquiring organisation's bid; thus, takeovers are unfriendly acquisitions, and are usually described as hostile. Nearly one-third of all public company M&A deals announced in Australia in 2017 were hostile takeover bids. For example, in 2017 Downer EDI launched a successful $1.26 billion hostile takeover of Spotless. The bid was rejected by the board of Spotless until Downer achieved shareholder acceptances and equity control of over 65 per cent, after which the Spotless board had little choice but to accept the takeover. There are thresholds under Australian law that apply to takeovers, including a 5 per cent equity control for public disclosure, a 20 per cent equity control for takeover laws to apply, and a >50 per cent equity threshold for board control.[14]

**takeover**
a special type of acquisition strategy wherein the target organisation does not solicit the acquiring organisation's bid

Research evidence reveals that 'pre-announcement returns' of hostile takeovers 'are largely anticipated and associated with a significant increase in the bidder's and target's share prices'.[15] This evidence provides a rationale for why some organisations are willing to pursue buying another company even when that organisation is not interested in being bought. Often, determining the price the acquiring organisation is willing to pay to 'take over' the target organisation is the core issue in these transactions. In Downer's hostile takeover of Spotless, Downer offered $1.15 per share for Spotless, which was 59 per cent more than Spotless' closing price before the deal was announced.[16]

On a comparative basis, acquisitions are more common than mergers and takeovers. Accordingly, we focus the remainder of this chapter's discussion on acquisitions.

# Reasons for acquisitions

In this section, we discuss reasons organisations decide to acquire another company. Although each reason can provide a legitimate rationale, acquisitions are not always as successful as the involved parties want them to be. Later in the chapter, we examine problems organisations may encounter when seeking growth and strategic competitiveness through acquisitions.

## Increased market power

Achieving greater market power is a primary reason for acquisitions.[17] Defined in Chapter 6, *market power* exists when an organisation is able to sell its goods or services above competitive levels or when the costs of its primary or support activities are lower than those of its competitors. Market power usually is derived from the size of the organisation and its resources and capabilities to compete in the marketplace;[18] it is also affected by the organisation's share of the market. Therefore, most acquisitions that are designed to achieve greater market power entail buying a competitor, a supplier, a distributor or a business in a highly related industry to allow the exercise of a core competence and to gain competitive advantage in the acquiring organisation's primary market.

If an organisation achieves enough market power, it can become a market leader, which is the goal of many organisations. Next, we discuss how organisations use horizontal, vertical and related types of acquisitions to increase their market power.

### Horizontal acquisitions

The acquisition of a company competing in the same industry as the acquiring organisation is a *horizontal acquisition*. Horizontal acquisitions increase an organisation's market power by exploiting cost-based and revenue-based synergies.[19] These synergies are often described as economies of scale, and typically rely on decreasing the long-run average costs of the combined entity.

Research suggests that horizontal acquisitions result in higher performance when the organisations have similar characteristics,[20] such as strategy, managerial styles and resource allocation patterns. Similarities in these characteristics, as well as previous alliance management experience, support efforts to integrate the acquiring and the acquired organisation. Horizontal acquisitions are often most effective when the acquiring organisation integrates the acquired organisation's assets with its own assets, but only after evaluating and divesting excess capacity and assets that do not complement the newly combined organisation's core competencies.[21] Duplication needs to be identified and reduced, and benefits need to be harvested by divesting the excess capacity and assets.

## Vertical acquisitions

A *vertical acquisition* refers to an organisation acquiring a supplier or distributor of one or more of its goods or services.[22] Through a vertical acquisition, the newly formed organisation controls additional parts of the value chain (see Chapters 3 and 6),[23] which is how vertical acquisitions lead to increased market power.

As a result of increased market power, vertical acquisitions are not encouraged in some Australian sectors, with both the Australian Competition and Consumer Commission (ACCC) and the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Banking Royal Commission) opposing attempts by Australian banks to expand into supplying the financial services products they recommend.[24] In contrast, the agricultural and technology sectors are more positive when it comes to vertical acquisitions. Beef and commercial cannabis production are two agricultural sectors with recent successful vertical acquisitions.[25]

Internationally, Larry Ellison, executive chairman of Oracle Corporation, pursued many acquisitions of other software organisations, most of which were horizontal acquisitions. However, he also orchestrated vertical acquisitions. For example, Oracle acquired Sun Microsystems, a computer hardware producer (backward vertical integration). With the deal, Sun also gained significant software expertise that is important for developing cloud computing expertise. Oracle has also made vertical acquisitions of producers in particular markets that facilitate distribution into industries in which it does not have a strong presence; for example, Oracle 'got into healthcare through its purchase of Relsys, a maker of analytics applications for the life sciences industry'.[26]

## Related acquisitions

Acquiring an organisation in a highly related industry is called a *related acquisition*. Through a related acquisition, organisations seek to create value through the synergy that can be generated by integrating some of their resources and capabilities. For example, Amazon acquires related businesses to build its retail services beyond books, music, DVDs and appliances. It acquired an online entertainment business, LOVEFiLM International, known as the Netflix of Europe, at a price of US$555 million. This was an important move for Amazon as DVD sales make up about 20 per cent of its revenues, and online video delivery is likely to displace much of this revenue in the future.[27] In addition, Amazon keeps market power dominance by acquisition in its core business area, in 2011 acquiring Book Depository, its UK-based global competition in internet-based book selling; while in 2012 it acquired Kiva systems (a warehouse robot system company), and in 2014 it bought Twitch (a video platform for games). All add directly to the core business.[28]

Horizontal, vertical and related acquisitions that organisations complete to increase their market power are subject to regulatory review as well as to analysis by financial markets.[29] Thus, organisations seeking growth and market power through acquisitions must understand the political/legal segment of the general environment (see Chapter 2) in order to successfully use an acquisition strategy.

## Overcoming entry barriers

*Barriers to entry* (introduced in Chapter 2) are factors associated with a market or with the organisations currently operating in it that increase the expense and difficulty new organisations encounter when trying to enter that particular market. For example, well-established competitors may have economies of scale in the manufacture or service of their products. In addition, enduring relationships with customers often create product loyalties that are difficult for new entrants to overcome. When facing differentiated products, new entrants typically must spend considerable resources to advertise their products and may find it necessary to sell below competitors' prices to entice new customers. Another entry barrier can be an otherwise closed contract with suppliers or customers. Suppliers might have limitations on who they will supply to or customers might have a pre-qualified group of suppliers they will buy from. This can take the form of a panel or period contract that represents an attractive asset and target for the acquiring organisation. A good example is the Australian Government Digital Marketplace panel for IT-related services, where membership of the panel is considered a valuable asset for suppliers wishing to do business with the Australian Government.[30]

Facing the entry barriers that economies of scale and differentiated products create, a new entrant may find acquiring an established company to be more effective than entering the market as a competitor offering a product that is unfamiliar to current buyers. In fact, the higher the barriers to market entry, the greater the probability that an organisation will acquire an existing organisation to overcome them.

As this discussion suggests, a key advantage of using an acquisition strategy to overcome entry barriers is that the acquiring organisation gains immediate access to a market. This advantage can be particularly attractive for organisations seeking to overcome entry barriers associated with entering international markets.[31] Large multinational corporations from developed economies seek to enter emerging economies such as Brazil, Russia, India and China (the so-called BRIC economies) because they are among the fastest-growing economies in the world.[32] As discussed next, completing a cross-border acquisition of a local target allows an organisation to quickly enter fast-growing economies such as these.

### Cross-border acquisitions

Acquisitions made between companies with headquarters in different countries are called *cross-border acquisitions*.[33] The purchase of UK car makers Jaguar and Land Rover by India's Tata Motors is an example of a cross-border acquisition.

There are other interesting changes taking place in terms of cross-border acquisition activity. Historically, North American and European companies were the most active acquirers of companies outside their domestic markets. However, the current global competitive landscape is one in which organisations from other nations may use an acquisition strategy more frequently than do their counterparts in North America and Europe. In this regard, Chinese companies, in particular, are well positioned for cross-border acquisitions. Chinese corporations are typically well capitalised, with strong balance sheets and cash reserves, and they have learned from their past failures.[34] In the 'Strategic focus' feature, we also describe cross-border acquisitions by some Indian and Brazilian companies and how their approaches differ. As you will see, many of the deals cited are horizontal acquisitions through which the acquiring companies seek to increase their market power. This demonstrates a trend over more than 20 years of cross-border acquisitions, where non-American and non-European organisations have increasingly adopted this approach over the past decade.

**Strategic focus** | Globalisation

## Cross-border acquisitions by organisations from emerging economies: leveraging resources to gain a larger global footprint and market power

Historically, large multinational organisations from North America and Europe have pursued international acquisitions in emerging and developing countries in order to establish stronger economies of scale for domestic brands as well as provide opportunities for the sourcing of scarce resources. Although the Spanish economy is in the doldrums, Spanish organisations have used this strategy relatively recently to expand, first into Latin America and then into other European countries. Telefonica and Banco Santander are Spanish companies that have extended their reach, especially through cross-border acquisitions. For instance, Telefonica is now the world's fifth-largest telecommunications provider in terms of revenue, and Santander is the fourth-largest bank on the same metric and has become Latin America's largest retail bank.

Like these Spanish organisations, many emerging economy organisations are seeking to build a global footprint through acquisitions. For example, after China was accepted into the World Trade Organization in 2000, many Chinese cross-border mergers and acquisitions were attempted. However, many Chinese companies that made cross-border acquisitions saw them end in failure on their first attempts. In 2003, there was US$1.6 billion spent on acquisitions, which swelled to US$18.2 billion by 2006. However, TLC Corporation's acquisition of France's Thomson Electronics, SAIC's takeover of South Korea's SsangYong Motor Company, Ping An's investment in the Belgian–Dutch financial services group Fortis and Ningbo Bird's strategic partnership with France's Sajan ended in stunning failures, where the Chinese either pulled out or had to sell off much of their acquired assets. The Chinese, however, have learned from their mistakes. Instead of buying global brands, sales networks and goodwill in branded products, they are now mainly trying to acquire concrete assets such as mineral deposits, state-of-the-art technologies or R&D facilities. This strategy was encouraged by the Chinese Government after pulling back from the various failed acquisitions. As the economy around the world depreciated assets and as the RMB (China's currency) appreciated relative to developed economies, the strategy focused on hard assets because this made better investing sense, rather than seeking to buy established branded products in which organisations did not always have managerial capability to realise successful performance. Interestingly, research suggests that India's acquiring companies (comparative to Chinese companies) have focused on buying competitors (horizontal acquisitions) in less-developed nations to build global market power.

Bimbo is the world's largest bakery company, formed in 1945 by a Spanish immigrant to Mexico. Initially, Bimbo expanded its operations throughout Latin America from its Mexican base. However, in 1996 it made its first acquisition in the USA. By 2012, it had acquired more than a dozen US organisations, including the bakery operations of Sara Lee, Weston Foods. Under Sara Lee, Weston Foods had declined because of a lack of focus on efficient execution in the low-margin bread and bakery business. Bimbo's leaders are continually on the road looking for ways to improve productivity. For instance, in China Bimbo used tricycle delivery bikes in urban areas where streets are too narrow for trucks, a practice first honed and implemented in Latin America. At the same time, its trucks are equipped with sophisticated computer systems that optimise delivery routes. In the process of developing better strategic execution, it has also created better ways of integrating new acquisitions into its operating procedures honed in emerging economies. As such, Bimbo is likely to increase the efficiency of the Weston Foods baker operations.

Similarly, Orascom Group, a Cairo-based Egyptian conglomerate, has used the construction business as a base platform and has prospered by pursuing acquisitions in countries that others shun. Orascom has entered a set of turbulent countries, including Jordan, Yemen, Pakistan, Zimbabwe, Algeria, Tunisia, Iraq, Bangladesh, North Korea, Burundi, Central African Republic and Lebanon. Its entry into North Korea in 2007 was due to the desire to use North Korean labour on a project already underway in China. Orascom agreed to a US$150 million modernisation of a North Korean cement plant in exchange for 50 per cent equity in its operation and permission to use North Korean labour. Through this agreement, Orascom built trust with North Korean officials and, more importantly, gained insight into North Korea's infrastructure plans. Since 2007, it has diversified into partial ownership of a North Korean bank and also helped build the Ryugyong Hotel, a 105-floor skyscraper in Pyongyang. Other diversifications have included a large mobile phone business in Egypt as well as other emerging countries' economies, mostly through acquisitions and subsequent internal development.

Brazil is another country with a large emerging economy whose companies have significant acquisition activity. In 2013, Natura Cosméticos, a Brazilian beauty products organisation, acquired 65 per cent ownership of Australian-based Emeis Holdings, owner of luxury beauty brand Aesop. Emeis sells Aesop-branded products in more than 60 stores in 11 countries. In 2010, Marfrig, a Brazilian meat packer, acquired Keystone Foods for US$1.25 billion. Keystone is a top supplier to American fast-food chains such as Subway and McDonald's. JBS, now the world's largest meat packer, bought Pilgrim's Pride for US$800 million as well as Swift for US$1.4 billion. Both of these organisations are meat packing operations, which gives JBS significant exposure in the USA. These acquisitions in large part were made possible by Brazil's national development bank (BNDES), which supports Brazilian organisations in developing their international operations.

In 2019, according to a KPMG survey published by the *Valor Econômico* newspaper, there were 1231 M&A transactions in Brazil, which is the largest number since the beginning of the consulting company's historical series in 1999. Major deals announced in 2018 (and implemented in 2019) with Brazilian involvement included:

- Boeing's US$4.2 billion joint venture with Embraer
- Rhône Capital's acquisition of Fogo de Chão for US$560 million
- Kroton Educacional's acquisition of Somos Educação for US$1.5 billion
- Suzano Papel e Celulose's merger with Fibria Celulose, with a value of 36.7 billion reals.

Spanish telecommunications company Telefonica has extended its market reach through cross-border acquisitions.

Source: Getty Images/Denis Doyle/Bloomberg

Although acquisitions allow emerging market organisations to enter foreign developed-country markets as well as industries outside their domestic market, such acquisitions come at a price. Research suggests that emerging economy organisations pay a higher premium than other organisations. Perhaps these organisations feel they have to pay this premium in order to win the deal and persuade regulators that they are not a threat, especially in industries that domestic politics indicate are strategic. Much of the research suggests that government ownership leads organisations to overpay and that the overpayment reduces value for minority shareholders (non-government shareholders). Many of these acquisitions are also becoming less focused on infrastructure development and more on consumer market acquisitions because the organisations cannot only extend their power into developed companies, but they can help to improve technology in their own domestic market, where a large middle class is emerging with consumers having more buying power. It is expected that this trend of acquisitions from emerging economies to developed economies will continue.

Sources: Latin America Business Stories, 2020, Brazil's number of mergers and acquisitions is the greatest in 21 years, https://labs.ebanx.com/en/news/business/mergers-acquisitions-brazil-2019-total, 17 January; A. C. Branco, C. M. Oksenberg & J. M. Cavalcanti, Jr, 2019, *The Mergers & Acquisitions Review – Edition 13: Brazil*, https://thelawreviews.

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**STRATEGY NOW**

International mergers and acquisitions

Organisations headquartered in India are also completing more cross-border acquisitions than in the past. Favourable government policies towards cross-border acquisitions are supporting Indian companies' desire to rapidly become more global, although in some cases they are more careful than other emerging market counterparts, such as those found in China.[35] In addition to rapid market entry, Indian companies typically seek access to product innovation capabilities and new brands and distribution channels when acquiring organisations outside their domestic market.

Organisations using an acquisition strategy to complete cross-border acquisitions should understand that these transactions are not risk free. For example, organisations seeking to acquire companies in China must recognise that China remains a challenging environment for foreign investors. Political and legal obstacles make acquisitions in China risky and difficult.[36] Due diligence is problematic as well because corporate governance and transparency of financial statements are often obscure. Thus, organisations must carefully study the risks as well as the potential benefits when contemplating cross-border acquisitions.

## Cost of new product development and increased speed to market

Developing new products internally and successfully introducing them into the marketplace often requires significant investment of an organisation's resources, including time, making it difficult to quickly earn a profitable return.[37] Because an estimated 88 per cent of innovations fail to achieve adequate returns, organisation managers are also concerned with achieving adequate returns from the capital invested to develop and commercialise new products. Potentially contributing to these less-than-desirable rates of return is the successful imitation of approximately 60 per cent of innovations within four years after the patents are obtained. These types of outcomes may lead managers to perceive internal product development as a high-risk activity.[38]

Acquisitions are another means an organisation can use to gain access to new products and to current products that are new to the organisation. Compared with internal product development processes, acquisitions provide more predictable returns as well as faster market entry. Returns are more predictable because the performance of the acquired organisation's products can be assessed prior to completing the acquisition.[39]

Medtronic is the world's largest medical device maker with US$30 billion in sales in 2019. While most pharmaceutical organisations invent many of their products internally, most of Medtronic's products are acquired from surgeons or other outside inventors.[40] Research confirms that it can be a good strategy to buy early-stage products, especially if the organisation has a strong R&D capability, even though there is risk and uncertainty in doing so.[41]

A number of pharmaceutical organisations use an acquisition strategy besides internal development because of the cost of new product development. Acquisitions can enable organisations to enter markets quickly and to increase the predictability of returns on their investments.

## Lower risk compared to developing new products

Because the outcomes of an acquisition can be estimated more easily and accurately than the outcomes of an internal product development process, managers may view acquisitions as being less risky.[42] However, organisations should exercise caution when using acquisitions to reduce their risks relative to the risks the organisation incurs when developing new products internally. Indeed, even though research suggests acquisition strategies are a common means of avoiding risky internal ventures (and therefore risky R&D investments), acquisitions may also become a substitute for innovation. Accordingly, acquisitions should always be strategic rather than defensive in nature.

## Increased diversification

Acquisitions are also used to diversify organisations. Based on experience and the insights resulting from it, organisations typically find it easier to develop and introduce new products in markets they are currently serving. By contrast, it is difficult for companies to develop products that differ from their current lines for markets in which they lack experience.[43] Thus, it is relatively uncommon for an organisation to develop new products internally to diversify its product lines.[44]

For example, Xerox purchased Affiliated Computer Services, an outsourcing organisation, to bolster its services business. Xerox is seen primarily as a hardware technology company, selling document management equipment. However, over time, Xerox has sought to diversify into helping organisations to manage business processes and technology services. As such, through this acquisition it seeks to have more and more of its business in the technology service sector. Ursula Burns, who became CEO of Xerox in 2009 (and was the first African American female to head a Fortune 500 company), indicated that Xerox is helping organisations to focus on their real business while it 'takes care of the document-intensive business processes behind the scenes'.[45]

Acquisition strategies can be used to support use of both unrelated and related diversification strategies (see Chapter 6).[46] For example, United Technologies Corp. (UTC) uses acquisitions as the foundation for implementing its unrelated diversification strategy. Since the mid-1970s it has been building a portfolio of stable and non-cyclical businesses, including Otis Elevator Co. (lifts, escalators and moving walkways) and Carrier Corporation (heating and air-conditioning systems) in order to reduce its dependence on the volatile aerospace industry. Pratt & Whitney (aircraft engines), Hamilton Sundstrand (aerospace and industrial systems), Sikorsky (helicopters), UTC Fire & Security (fire safety and security products and services) and UTC Power (fuel cells and power systems) are the other businesses in which UTC competes as a result of using its acquisition strategy. While each business acquired by UTC manufactures industrial and/or commercial products, many have a relatively low focus on technology (e.g. lifts, air conditioners and security systems).[47]

In contrast to UTC, Cisco Systems pursues related acquisitions. Historically, these acquisitions have helped the organisation build its network components business that is focused on producing network backbone hardware. However, Cisco purchased IronPort Systems Inc., a company focused on producing security software for networks. This acquisition helped Cisco diversify its operations beyond its original expertise in network hardware and network management software into network security software. Other acquisitions have focused on software to facilitate video conferences (the Tandberg acquisition)[48] and helping client organisations manage cloud computing applications (the newScale acquisition).[49]

Organisations using acquisition strategies should be aware that, in general, the more related the acquired organisation is to the acquiring organisation, the greater is the probability that the acquisition will be successful.[50] Thus, horizontal acquisitions and related acquisitions tend to contribute more to the organisation's strategic competitiveness than do acquisitions of companies operating in product markets that are quite different from those in which the acquiring organisation competes, although complementary acquisitions in different industries can help expand an organisation's capabilities.[51]

## Reshaping the organisation's competitive scope

As discussed in Chapter 2, the intensity of competitive rivalry is an industry characteristic that affects the organisation's profitability.[52] To reduce the negative effect of an intense rivalry on their financial performance, organisations may use acquisitions to lessen their dependence on one or more products or markets. Reducing a company's dependence on specific markets shapes the organisation's competitive scope.

Each time UTC enters a new business (such as UTC Power, the organisation's most recent business segment), the corporation reshapes its competitive scope. In a more subtle manner, Procter & Gamble's acquisition of Gillette reshaped its competitive scope by giving P&G a stronger presence in some products for which men are the target market. Xerox's purchase of Affiliated Computer Services likewise reshaped Xerox's competitive scope to focus more on services, and Cisco has become more focused on software through its latest acquisitions. Thus, using an acquisition strategy reshaped the competitive scope of each of these organisations.

## Learning and developing new capabilities

Organisations sometimes complete acquisitions to gain access to capabilities they lack. For example, acquisitions may be used to acquire a special technological capability. Research shows that organisations can broaden their knowledge base and reduce inertia through acquisitions.[53] For example, research suggests that organisations increase the potential of their capabilities when they acquire diverse talent through cross-border acquisitions.[54] Of course, organisations are better able to learn these capabilities if they share some similar properties with the organisation's current capabilities. Thus, organisations should seek to acquire companies with different but related and complementary capabilities in order to build their own knowledge base.[55]

A number of large pharmaceutical organisations are acquiring the ability to create 'large molecule' drugs, also known as biological drugs, by buying biotechnology organisations. Thus, these organisations are seeking access to both the pipeline of possible drugs and the capabilities that these organisations have to produce them. Such capabilities are important for large pharmaceutical organisations because these biological drugs are more difficult to duplicate by chemistry alone (the historical basis on which most pharmaceutical organisations have expertise). Biotech organisations are focused on DNA research and have a biology base rather than a chemistry base. As an example, Sanofi-Aventis acquired biotech company Genzyme for US$20 billion. Sanofi's hope was that Genzyme would help it keep rare-disease drugs in the pipeline without losing sales to more generic competition (those drugs that have lost patent protection). It is critical in an acquisition such as this to keep experimental drug projects moving forward, and this requires science-based and research-oriented employees to stay in the merged organisation. Sanofi's intention was to transfer Genzyme's expertise in genetics and biomarkers back to Sanofi. Such biomarkers 'are biological substances in the body that help show the body is responding to disease and drug'.[56] If such an acquisition is successful, there is added competitive advantage. Biological drugs must clear more regulatory barriers or hurdles, but once this is accomplished it adds more to the advantage the acquiring organisation develops.

When P&G acquired Gillette, it gained a foothold in the men's razor segment.

Source: Getty Images/Mario Tama

# Problems in achieving acquisition success

Acquisition strategies based on reasons described in this chapter can increase strategic competitiveness and help organisations earn above-average returns. However, even when pursued for value-creating reasons, acquisition strategies are not problem-free. Reasons for the use of acquisition strategies and potential problems with such strategies are shown in Figure 7.1.

Research suggests that perhaps 20 per cent of all mergers and acquisitions are successful, approximately 60 per cent produce disappointing results, and the remaining 20 per cent are clear failures; evidence on technology acquisitions reports even higher failure rates.[57] In general, though, companies appear to be increasing their ability to effectively use acquisition strategies. One analyst suggests: 'Accenture research and subsequent work with clients show that half of large corporate mergers create at least marginal returns – an improvement from a decade ago, when many studies concluded that as many as three-quarters of all mergers destroyed shareholder value as measured two years after the merger announcement'.[58] Greater acquisition success accrues to organisations able to select the 'right' target, avoid paying too high a premium (doing appropriate due diligence), and effectively integrate the operations of the acquiring and target organisations.[59] In addition, retaining the target organisation's human capital is foundational to efforts by employees of the acquiring organisation to fully understand the target organisation's operations and the capabilities on which those operations are based.[60] The Sanofi-Aventis acquisition of Genzyme noted above is an example of the importance of retaining the right employees. As summarised in Figure 7.1, the discussion in the following sections ('Integration difficulties' through to 'Too large') outlines the seven key problems that may prevent successful acquisitions.

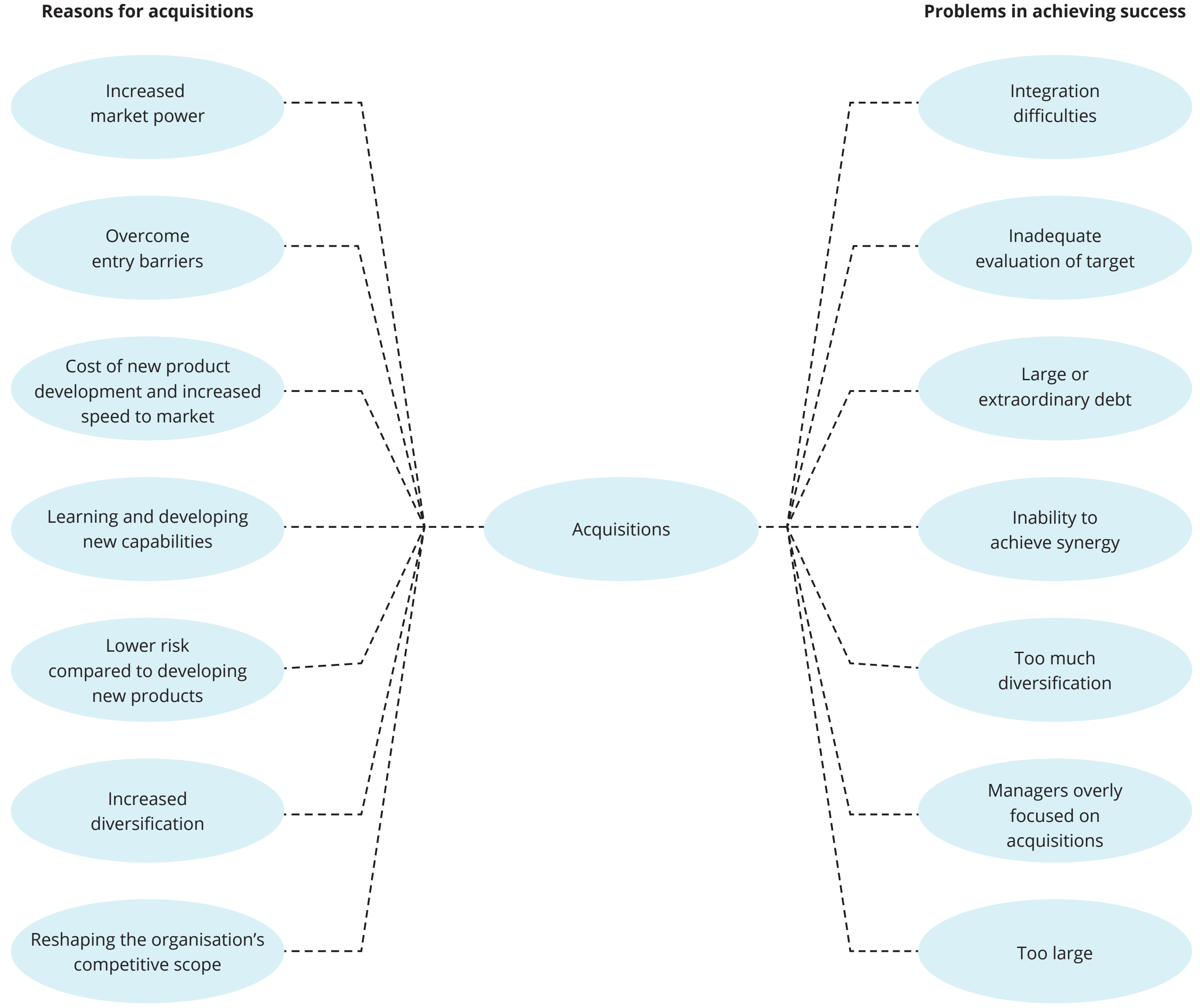
## Integration difficulties

The importance of a successful integration should not be underestimated.[61] As suggested by a researcher studying the process, 'Managerial practice and academic writings show that the post-acquisition integration phase is probably the single most important determinant of shareholder value creation (and equally of value destruction) in mergers and acquisitions'.[62]

Although critical to acquisition success, organisations should recognise that integrating two companies following an acquisition can be quite difficult. Melding two corporate cultures, linking different financial and control systems, building effective working relationships (particularly when management styles differ) and resolving problems regarding the status of the newly acquired organisation's executives are examples of the integration challenges organisations often face.[63]

Integration is complex and involves a large number of activities, which if overlooked can lead to significant difficulties.[64] For example, when United Parcel Service (UPS) acquired Mail Boxes Etc., a large retail shipping chain, it appeared to be a merger that would generate benefits for both organisations. The problem was that most of the Mail Boxes Etc. outlets were owned by franchisees. Following the merger, the franchisees lost the ability to deal with other shipping companies such as FedEx, which reduced their competitiveness. Furthermore, franchisees complained that UPS often built company-owned shipping stores close by franchisee outlets of Mail Boxes Etc. Additionally, a culture clash evolved between the free-wheeling entrepreneurs who owned the franchises of Mail Boxes Etc. and the efficiency-oriented corporate approach of the UPS operation, which focused on managing a large fleet of trucks and an information system to efficiently pick up and deliver packages. Also, Mail Boxes Etc. was focused on retail traffic, whereas UPS was focused more on the logistics of wholesale pickup and delivery. Although 87 per cent of Mail Boxes Etc. franchisees decided to rebrand under the UPS name, many formed an owners' group and even filed suit against UPS in regard to the unfavourable nature of the franchisee contract.[65]

**Figure 7.1** Reasons for acquisitions and problems in achieving success




## Inadequate evaluation of target

*Due diligence* is a process through which a potential acquirer evaluates a target organisation for acquisition. In an effective due-diligence process, hundreds of items are examined in areas as diverse as the financing for the intended transaction, differences in cultures between the acquiring and target organisation, tax consequences of the transaction, and actions that would be necessary to successfully meld the two workforces. Due diligence is commonly performed by investment bankers such as Deutsche Bank, Goldman Sachs and Morgan Stanley, as well as accountants, lawyers and management consultants specialising in that activity, although organisations actively pursuing acquisitions may form their own internal due-diligence team. Although due diligence often focuses on evaluating the accuracy of the financial position and accounting standards used (a financial audit), due diligence also needs to examine the quality of the strategic fit and the ability of the acquiring organisation to effectively integrate the target to realise the potential gains from the deal.[66]

The failure to complete an effective due-diligence process may easily result in the acquiring organisation paying an excessive premium for the target company. Interestingly, research shows that in times of high or increasing stock prices, due diligence is relaxed; organisations often overpay during these periods and long-run performance of the newly formed organisation suffers.[67] Research also shows that without due diligence, 'the purchase price is driven by the pricing of other "comparable" acquisitions rather than by a rigorous assessment of where, when, and how management can drive real performance gains. [In these cases], the price paid may have little to do with achievable value'.[68]

In addition, organisations sometimes allow themselves to enter a 'bidding war' for a target, even though they realise that their current bids exceed the parameters identified through due diligence. Earlier, we mentioned Downer's hostile takeover of Spotless, and the 59 per cent premium paid for Spotless' shares. We cannot be sure that Downer overpaid, but the point is that rather than enter a bidding war, organisations should only extend bids that are consistent with the results of their due-diligence process. It could be that Spotless will provide Downer with a new platform for growth (i.e. defence facilities management contracts) and over time this deal will look cheap, but the key is doing a strategic analysis along with rational due diligence so that both the strategic fit and financials make sense.[69]

## Large or extraordinary debt

To finance a number of acquisitions completed during the 1980s and 1990s, some companies significantly increased their levels of debt. A financial innovation called junk bonds helped make this possible. *Junk bonds* are a financing option through which risky acquisitions are financed with money (debt) that provides a large potential return to lenders (bondholders). Because junk bonds are unsecured obligations that are not tied to specific assets for collateral, interest rates for these high-risk debt instruments sometimes reached between 18 and 20 per cent during the 1980s.[70] Some prominent financial economists viewed debt as a means to discipline managers, causing them to act in the shareholders' best interests.[71] Managers holding this view are less concerned about the amount of debt their organisation assumes when acquiring other companies.

Junk bonds are now used less frequently to finance acquisitions, and the conviction that debt disciplines managers is less strong.[72] Nonetheless, organisations sometimes still take on what turns out to be too much debt when acquiring companies. Caterpillar Inc., betting on a long-term boom and global demand for mining equipment, purchased Bucyrus International, Inc., a maker of mining equipment, for US$7.6 billion in 2011. It was expected that rapid growth in emerging economies such as China, India, Brazil and other developing economies over the next decade would push demand for coal, copper, iron ore and 'everything that comes out of the ground',[73] which, despite inevitable hiccups, remains the basis for the prosperity of the Australian economy. Caterpillar paid a 32 per cent premium for Bucyrus. Furthermore, Bucyrus had also bought Terex Corp., for US$1.3 billion, in February 2010. Bucyrus' debt, because of previous acquisitions, was significant and forced Caterpillar not only to issue new stock but to absorb this additional debt. As noted earlier, organisations often pay rich premiums and possibly 'overpay', partly because they have to take on additional debt. This had happened before – Bucyrus went through a leveraged buyout and had to file for bankruptcy in the mid-1990s because it took on more debt than it could handle at the time. Because of the assumption of debt for this deal, the price tag increased from US$7.6 billion to US$8.6 billion. As such, this is a significant increase in the premium noted earlier because of the assumption of debt.[74] Thus, organisations using an acquisition strategy must be certain that their purchases do not create a debt load that overpowers the company's ability to remain solvent.

## Inability to achieve synergy or harvest benefits

Derived from *synergos*, a Greek word that means 'working together', *synergy* exists when the value created by units working together exceeds the value those units could create working independently (see Chapter 6). That is, synergy exists when assets are worth more when used in conjunction with each other than when they are used separately. For shareholders, synergy generates gains in their wealth that they could not duplicate or exceed through their own portfolio diversification decisions.[75] Synergy is created by the efficiencies derived from economies of scale and economies of scope and by sharing resources (e.g. human capital and knowledge) across the businesses in the merged organisation.[76] If those economies of scale and scope via shared resources are not harvested, then the benefits (such as long-run average cost reduction) are not realised. After an acquisition, duplication of roles and resources needs to be removed. Duplicate IT systems need to be decommissioned, and duplicate roles (such as a second CFO) need to be removed.

An organisation develops a competitive advantage through an acquisition strategy only when a transaction generates private synergy. *Private synergy* is created when combining and integrating the acquiring and acquired organisations' assets yield capabilities and core competencies that could not be developed by combining and integrating either organisation's assets with another company. Private synergy is possible when organisations' assets are complementary in unique ways; that is, the unique type of asset complementarity is not possible by combining either company's assets with another organisation's assets.[77] Because of its uniqueness, private synergy is difficult for competitors to understand and imitate. However, private synergy is difficult to create.

An organisation's ability to account for costs that are necessary to create anticipated revenue and cost-based synergies affects its efforts to create private synergy. Organisations experience several expenses when trying to create private synergy through acquisitions. Called transaction costs, these expenses are incurred when organisations use acquisition strategies to create synergy.[78] Transaction costs may be direct or indirect. Direct costs include legal fees and charges from investment bankers who complete due diligence for the acquiring organisation. Indirect costs include managerial time to evaluate target organisations and then to complete negotiations, as well as the loss of key managers and employees following an acquisition.[79] Organisations tend to underestimate the sum of indirect costs when the value of the synergy that may be created by combining and integrating the acquired organisation's assets with the acquiring organisation's assets is calculated.

## Too much diversification

As explained in Chapter 6, diversification strategies can lead to strategic competitiveness and above-average returns. In general, organisations using related diversification strategies outperform those employing unrelated diversification strategies. However, conglomerates formed by using an unrelated diversification strategy also can be successful, as demonstrated by UTC.

At some point, however, organisations can become over-diversified. The level at which over-diversification occurs varies across companies because each organisation has different capabilities to manage diversification. Recall from Chapter 6 that related diversification requires more information processing than does unrelated diversification. Because of this additional information processing, related diversified organisations become over-diversified with a smaller number of business units than do organisations using an unrelated diversification strategy.[80] Regardless of the type of diversification strategy implemented, however, over-diversification leads to a decline in performance, after which business units are often divested.[81] Commonly, such divestments, which tend to reshape an organisation's competitive scope, are part of an organisation's restructuring strategy. (We discuss the strategy in greater detail later in this chapter.)

Even when an organisation is not over-diversified, a high level of diversification can have a negative effect on its long-term performance. For example, the scope created by additional amounts of diversification often causes managers to rely on financial rather than strategic controls to evaluate business units' performance (we define and explain financial and strategic controls in Chapters 11 and 12). Top-level executives often rely on financial controls to assess the performance of business units when they do not have a rich understanding of business units' objectives and strategies. The use of financial controls, such as return on investment (ROI), causes individual business-unit managers to focus on short-term outcomes at the expense of long-term investments. When long-term investments are reduced to increase short-term profits, an organisation's overall strategic competitiveness may be harmed.[82]

Another problem resulting from too much diversification is the tendency for acquisitions to become substitutes for innovation. As we noted earlier, pharmaceutical organisations such as Sanofi-Aventis must be aware of this tendency as they acquire other organisations to gain access to their products and capabilities. Typically, managers have no interest in acquisitions substituting for internal R&D efforts and the innovative outcomes that they can produce. However, a reinforcing cycle evolves. Costs associated with acquisitions may result in fewer allocations to activities such as R&D that are linked to innovation. Without adequate support, an organisation's innovation skills begin to atrophy. Without internal innovation skills, the only option available to an organisation to gain access to innovation is to complete still more acquisitions. Evidence suggests that an organisation using acquisitions as a substitute for internal innovations eventually encounters performance problems.[83]

## Managers overly focused on acquisitions

Typically, a considerable amount of managerial time and energy is required for acquisition strategies to be used successfully. Activities with which managers become involved include searching for viable acquisition candidates, completing effective due-diligence processes, preparing for negotiations and managing the integration process after completing the acquisition.

Top-level managers do not personally gather all of the data and information required to make acquisitions. However, these executives do make critical decisions on the organisations to be targeted, the nature of the negotiations and so forth. Company experiences show that participating in and overseeing the activities required for making acquisitions can divert managerial attention from other matters that are necessary for long-term competitive success, such as identifying and taking advantage of other opportunities and interacting with important external stakeholders.[84]

Both theory and research suggest that managers can become overly involved in the process of making acquisitions.[85] One observer suggested: 'Some executives can become preoccupied with making deals – and the thrill of selecting, chasing and seizing a target'.[86] The over-involvement can be surmounted by learning from mistakes and by not having too much agreement in the boardroom. Dissent is helpful to make sure that all sides of a question are considered (see Chapter 10).[87] When failure does occur, leaders may be tempted to blame the failure on others and on unforeseen circumstances rather than on their excessive involvement in the acquisition process.

The acquisitions strategy of Citigroup is a classic case in point. Citigroup's CEO, John Reed, in a merger between Citicorp and Travelers Group (CEO Sanford I. Weill), set out to cross-sell financial services to the same customer and thereby reduce sales costs. Weill ultimately became the CEO. The merged organisation focused on a set of acquisitions including insurance and private equity investing beyond traditional banking services. However, as noted by one commentator:

> More than once, ambitious executives, such as Sanford Weill of Citigroup fame, have assembled 'financial supermarkets', and thinking that customers' needs for credit cards, checking accounts, wealth management services, insurance and stock brokerage could be furnished most efficiently and effectively by the same company. Those efforts have failed, over and over again. Each function fulfills a different job that arises at a different point in a customer's life, so a single source for all of them holds no advantage.[88]

Ultimately, Vikram Pandit, the CEO who took over after Charles Prince at Citigroup, was forced to sell off a lot of those peripheral financial service businesses.

## Too large

Most acquisitions create a larger organisation, which should help increase its economies of scale. These economies can then lead to more efficient operations; for example, two sales organisations can be integrated using fewer sales representatives because such sales personnel can sell the products of both organisations (particularly if the products of the acquiring and target organisations are highly related).[89] Size can also increase the complexity of the management challenge and create diseconomies of scope; that is, there is not enough economic benefit to outweigh the costs of managing the more complex organisation created through acquisitions. This was the case in a failed merger between DaimlerChrysler and Mitsubishi; it became too costly to integrate the operations of Mitsubishi to derive the necessary benefits of economies of scale in the merged organisation.[90]

Many organisations seek increases in size because of the potential economies of scale and enhanced market power (discussed earlier). At some level, the additional costs required to manage the larger organisation will exceed the benefits of the economies of scale and additional market power. The complexities generated by the larger size often lead managers to implement more bureaucratic controls to manage the combined organisation's operations. *Bureaucratic controls* are formalised supervisory and behavioural rules and policies designed to ensure consistency of decisions and actions across different units of an organisation. However, through time, formalised controls often lead to relatively rigid and standardised managerial behaviour.[91] Certainly, in the long run, the diminished flexibility that accompanies rigid and standardised managerial behaviour may produce less innovation. Because of the importance of innovation to competitive success, the bureaucratic controls resulting from a large organisation (i.e. built by acquisitions) can have a detrimental effect on performance. For this reason, Cisco announced an internal restructuring to reduce bureaucracy after its numerous acquisitions: 'It will dispense with most of a network of internal councils and associated boards that have been criticised for adding layers of bureaucracy and wasting managers' time'.[92] As one analyst noted, 'Striving for size per se is not necessarily going to make a company more successful. In fact, a strategy in which acquisitions are undertaken as a substitute for organic growth has a bad track record in terms of adding value'.[93]

# Effective acquisitions

Earlier in the chapter, we noted that acquisition strategies do not always lead to above-average returns for the acquiring organisation's shareholders.[94] Nonetheless, some companies are able to create value when using an acquisition strategy.[95] The probability of success increases when the organisation's actions are consistent with the attributes of successful acquisitions shown in Table 7.1.

STRATEGY NOW →
Cisco acquisitions

Cisco Systems appears to pay close attention to the attributes listed in Table 7.1 when using its acquisition strategy. In fact, Cisco is admired for its ability to complete successful acquisitions and integrate them quickly, although as noted this has created a larger organisation.[96] A number of other network companies pursued acquisitions to build up their ability to sell into the network equipment binge, but only Cisco has retained much of its value in the post-bubble era. Many organisations, such as Lucent, Nortel and Ericsson, teetered on the edge of bankruptcy after the dot-com bubble burst in the 2000s. When it makes an acquisition:

> Cisco has gone much further in its thinking about integration. Not only is retention important, but Cisco also works to minimise the distractions caused by an acquisition. This is important, because the speed of change is so great that if the target firm's product development teams are distracted, they will be slowed, contributing to acquisition failure. So, integration must be rapid and reassuring.[97]

Cisco published specific work stream structures and process flows to assist with integration of corporate acquisitions, and has been recognised for its successful corporate integrations.[98]

Results from a research study shed light on the differences between unsuccessful and successful acquisition strategies and suggest that a pattern of actions improves the probability of acquisition success.[99] The study shows that when the target organisation's assets are complementary to the acquired organisation's assets, an acquisition is more successful. With complementary assets, the integration of two organisations' operations has a higher probability of creating synergy. In fact, integrating two

**Table 7.1 Attributes of successful acquisitions**

| Attributes | Results |
|---|---|
| 1 Acquired organisation has assets or resources that are complementary to the acquiring organisation's core business. | 1 High probability of synergy and competitive advantage by maintaining strengths. |
| 2 Acquisition is friendly. | 2 Faster and more effective integration and possibly lower premiums. |
| 3 Acquiring organisation conducts effective due diligence to select target organisations and evaluate the target organisation's health (financial, cultural and human resources). | 3 Organisations with strongest complementarities are acquired and overpayment is avoided. |
| 4 Acquiring organisation has financial slack (cash or a favourable debt position). | 4 Financing (debt or equity) is easier and less costly to obtain. |
| 5 Merged organisation maintains low-to-moderate debt position. | 5 Lower financing cost, lower risk (e.g., of bankruptcy) and avoidance of trade-offs that are associated with high debt. |
| 6 Acquiring organisation has sustained and consistent emphasis on R&D and innovation. | 6 Maintain long-term competitive advantage in markets. |
| 7 Acquiring organisation manages change well and is flexible and adaptable. | 7 Faster and more effective integration facilitates achievement of synergy. |

organisations with complementary assets frequently produces unique capabilities and core competencies. With complementary assets, the acquiring organisation can maintain its focus on core businesses and leverage the complementary assets and capabilities from the acquired organisation. In effective acquisitions, targets are often selected and 'groomed' by establishing a working relationship prior to the acquisition.[100] As discussed in Chapter 9, strategic alliances are sometimes used to test the feasibility of a future merger or acquisition between the involved organisations.[101]

The study's results also show that friendly acquisitions facilitate integration of the organisations involved in an acquisition. Through friendly acquisitions, organisations work together to find ways to integrate their operations to create synergy.[102] In hostile takeovers, animosity often results between the two top-management teams, a condition that in turn affects working relationships in the newly created organisation. As a result, more key personnel in the acquired organisation may be lost, and those who remain may resist the changes necessary to integrate the two organisations.[103] With effort, cultural clashes can be overcome, and fewer key managers and employees will become discouraged and leave.[104]

Additionally, effective due-diligence processes involving the deliberate and careful selection of target organisations and an evaluation of the relative health of those organisations (financial health, cultural fit and the value of human resources) contribute to successful acquisitions.[105] Financial slack in the form of debt equity or cash, in both the acquiring and acquired organisations, also frequently contributes to acquisition success. Even though financial slack provides access to financing for the acquisition, it is still important to maintain a low or moderate level of debt after the acquisition to keep debt costs low. When substantial debt was used to finance the acquisition, companies with successful acquisitions reduced the debt quickly, partly by selling off assets from the acquired organisation, especially non-complementary or poorly performing assets. For these organisations, debt costs do not prevent long-term investments such as R&D, and managerial discretion in the use of cash flow is relatively flexible.

Another attribute of successful acquisition strategies is an emphasis on innovation, as demonstrated by continuing investments in R&D activities.[106] Significant R&D investments show a strong managerial commitment to innovation, a characteristic that is increasingly important to overall competitiveness in the global economy as well as to acquisition success.

Flexibility and adaptability are the final two attributes of successful acquisitions. When executives of both the acquiring and the target organisations have experience in managing change and learning from acquisitions, they will be more skilled at adapting their capabilities to new environments.[107] As a result, they will be more adept at integrating the two organisations, which is particularly important when organisations have different organisational cultures.

As we have learned, organisations use an acquisition strategy to grow and achieve strategic competitiveness. Sometimes, though, the actual results of an acquisition strategy fall short of the projected results. When this happens, organisations consider using restructuring strategies.

# Restructuring

**restructuring**
a strategy through which an organisation changes its set of businesses or its financial structure

**Restructuring** is a strategy through which an organisation changes its set of businesses or its financial structure.[108] Restructuring is a global phenomenon.[109] From the 1970s into the early 2020s, divesting businesses from company portfolios and downsizing has accounted for a large percentage of organisations' restructuring strategies. Commonly, organisations focus on a lesser number of products and markets following restructuring. The words of an executive describe this typical outcome: 'Focus on your core business, but don't be distracted; let other people buy assets that aren't right for you'.[110]

Although restructuring strategies are generally used to deal with acquisitions that are not reaching expectations, organisations sometimes use these strategies because of changes they have detected in their external environment.[111] For example, opportunities sometimes surface in an organisation's external environment that a diversified organisation can pursue because of the capabilities it has formed by integrating organisations' operations. In such cases, restructuring may be appropriate to position the organisation to create more value for stakeholders, given the environmental changes.[112] As discussed next, organisations use three types of restructuring strategies: downsizing, downscoping and leveraged buyouts.

## Downsizing

*Downsizing* is a reduction in the number of an organisation's employees and, sometimes, in the number of its operating units, but it may or may not change the composition of businesses in the company's portfolio. Thus, downsizing is an intentional proactive management strategy whereas 'decline is an environmental or organisational phenomenon that occurs involuntarily and results in erosion of an organisation's resource base'.[113] Downsizing is often a part of acquisitions that fail to create the value anticipated when the transaction was completed. Downsizing is often used when the acquiring organisation paid too high a premium to acquire the target organisation.[114] Once thought to be an indicator of organisational decline, downsizing is now recognised as a legitimate restructuring strategy.

Reducing the number of employees and/or the organisation's scope in terms of products produced and markets served occurs in organisations to enhance the value being created as a result of completing an acquisition. When integrating the operations of the acquired organisation and the acquiring organisation, managers may not at first appropriately downsize. This is understandable in that 'no-one likes to lay people off or close facilities'.[115] However, downsizing may be necessary because acquisitions often create a situation in which the newly formed organisation has duplicate organisational functions such as sales, manufacturing, distribution, human resource management and so forth. Failing to downsize appropriately may lead to too many employees doing the same work and prevent the new organisation from realising the cost synergies it anticipated. Managers should remember that as a strategy, downsizing will be far more effective when they consistently use human resource practices that ensure procedural justice and fairness in downsizing decisions.[116]

## Downscoping

*Downscoping* refers to divestiture, spin-off or some other means of eliminating businesses that are unrelated to an organisation's core businesses. Downscoping has a more positive effect on organisation performance than does downsizing[117] because organisations commonly find that downscoping causes them to refocus on their core business.[118] Managerial effectiveness increases because the organisation has become less diversified, allowing the top management team to better understand and manage the remaining businesses.[119] Interestingly, sometimes the divested unit can also take advantage of unforeseen opportunities not recognised while under the leadership of the parent organisation.[120] Organisations often use downscoping and downsizing strategies simultaneously. In Citigroup's restructuring it has used both downscoping and downsizing, as have many large financial institutions in the recession.[121] However, when doing this, organisations need to avoid lay-offs of key employees, as such lay-offs might lead to a loss of one or more core competencies. Instead, an organisation that is simultaneously downscoping and downsizing becomes smaller by reducing the diversity of businesses in its portfolio.[122]

In general, US organisations use downscoping as a restructuring strategy more frequently than do European companies; in fact, the trend in Europe, Latin America and Asia has been to build conglomerates. In Latin America, these conglomerates are called *grupos*. Many Asian and Latin American conglomerates have begun to adopt Western corporate strategies in recent years and have been refocusing on their core businesses. This downscoping has occurred simultaneously with increasing globalisation and with more open markets that have greatly enhanced competition. By downscoping, these organisations have been able to focus on their core businesses and improve their competitiveness.[123]

## Leveraged buyouts

A *leveraged buyout* (LBO) is a restructuring strategy whereby a party (typically a private equity organisation) buys all of an organisation's assets in order to take the organisation private. Once the transaction is completed, the company's stock is no longer traded publicly. Traditionally, LBOs were used as a restructuring strategy to correct for managerial mistakes or because the organisation's managers were making decisions that primarily served their own interests rather than those of shareholders.[124] However, some organisations use buyouts to build organisation resources and expand rather than simply restructure distressed assets.[125]

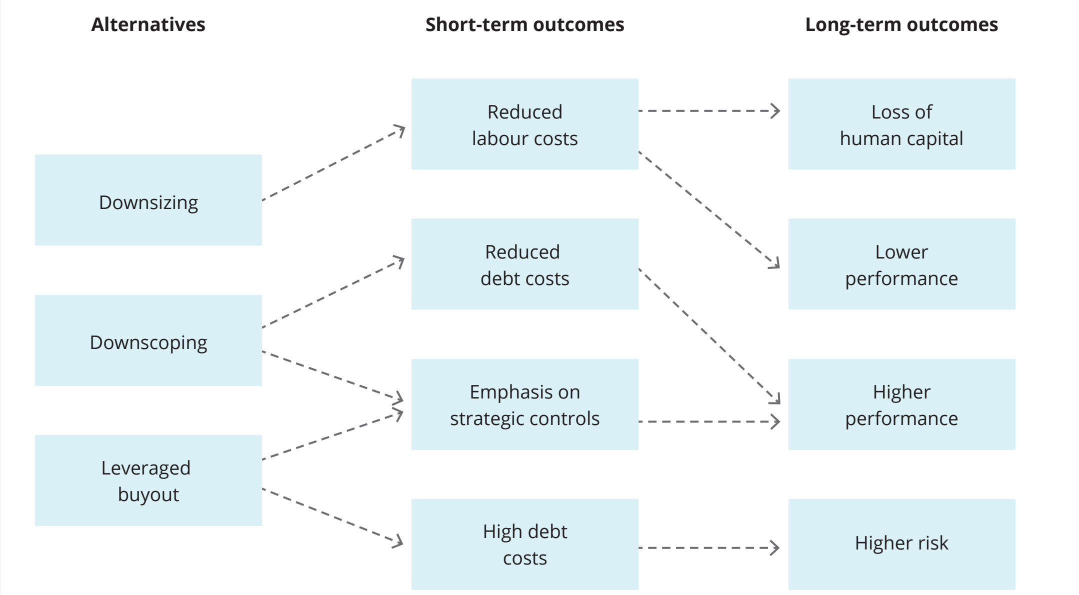
However, significant amounts of debt are commonly incurred to finance a buyout, hence the term *leveraged* buyout. To support debt payments and to downscope the company to concentrate on the organisation's core businesses, the new owners may immediately sell a number of assets.[126] It is not uncommon for those buying an organisation through an LBO to restructure the organisation to the point that it can be sold at a profit within a five- to eight-year period.

Management buyouts (MBOs), employee buyouts (EBOs) and whole-organisation buyouts, in which one company or partnership purchases an entire company instead of a part of it, are the three types of LBOs. In part because of managerial incentives, MBOs, more so than EBOs and whole-organisation buyouts, have been found to lead to downscoping, increased strategic focus and improved performance.[127] Research shows that management buyouts can lead to greater entrepreneurial activity and growth.[128] As such, buyouts can represent a form of organisation rebirth to facilitate entrepreneurial efforts and stimulate strategic growth and productivity.[129]

## Restructuring outcomes

The short- and long-term outcomes associated with the three restructuring strategies are shown in Figure 7.2. As indicated, downsizing typically does not lead to higher organisation performance.[130] In fact, some research results show that downsizing contributes to lower returns for organisations. The stock markets in the organisations' respective nations evaluated downsizing negatively, believing that it would have long-term negative effects on the organisations' efforts to achieve strategic competitiveness. Investors also seem to conclude that downsizing occurs as a consequence of other problems in a company.[131] This assumption may be caused by an organisation's diminished corporate reputation when a major downsizing is announced.[132]

**Figure 7.2** Restructuring and outcomes




The loss of human capital is another potential problem of downsizing (see Figure 7.2). Losing employees with many years of experience with the organisation represents a major loss of knowledge. As noted in Chapter 3, knowledge is vital to competitive success in the global economy. Research also suggests that such loss of human capital can also spill over into dissatisfaction of customers.[133] Thus, in general, research evidence and corporate experience suggest that downsizing may be of more tactical (or short-term) value than strategic (or long-term) value,[134] meaning that organisations should exercise caution when restructuring through downsizing.

Downscoping generally leads to more positive outcomes in both the short and long term than does downsizing or a leveraged buyout. Downscoping's desirable long-term outcome of higher performance is a product of reduced debt costs and the emphasis on strategic controls derived from concentrating on the organisation's core businesses. In so doing, the refocused organisation should be able to increase its ability to compete.[135]

Although whole-organisation LBOs have been hailed as a significant innovation in the financial restructuring of organisations, they can involve negative trade-offs.[136] First, the resulting large debt increases an organisation's financial risk, as was evidenced by the number of companies that filed for bankruptcy in the 1990s after executing a whole-organisation LBO. Sometimes, the intent of the owners to increase the efficiency of the bought-out organisation and then sell it within five to eight years creates a short-term and risk-averse managerial focus.[137] As a result, these organisations may fail to invest adequately in R&D or take other major actions designed to maintain or improve the company's core competence.[138] Research also suggests that in organisations with an entrepreneurial mindset, buyouts can lead to greater innovation, especially if the debt load is not too great.[139] However, because buyouts more often result in significant debt, most LBOs have been completed in mature industries where stable cash flows are possible.

# STUDY TOOLS

## SUMMARY

**LO1** Although the number of mergers and acquisitions completed declined in 2008 and 2009 – largely because of the GFC – merger and acquisition strategies became more frequent in 2010–20 as a path to organisation growth and earning strategic competitiveness. Globalisation and deregulation of multiple industries in many economies are two of the factors making mergers and acquisitions attractive to large corporations and small organisations.

**LO2** Organisations use acquisition strategies to make a step change to the scope and boundaries of their operations and market. An acquisition offers the opportunity to increase the size, market power and economies of scale of an existing market, or to quickly enter new markets. It can lower average costs and reshape an organisation in terms of concentration or diversification.

**LO3** Despite the potential advantages, many acquisitions fail to deliver the promised benefits for stakeholders – customers, staff and particularly owners/investors. Acquisitions are complex, time-consuming and difficult to plan and execute. The value, synergy and benefits can be overestimated, and harvesting the benefits relies on reducing duplication by divesting the excess capacity and assets.

**LO4** Effective acquisitions are more likely to be friendly (mutually sought), have complementary resources and capabilities, and invest in change management and innovation. The acquisition deal should be based on thorough due diligence, take into account the equity or debt requirements, and have a clear plan to harvest the benefits.

**LO5** Restructuring is used to improve an organisation's performance by correcting for problems created by ineffective management. Restructuring by downsizing involves reducing the number of employees and hierarchical levels in the organisation. Although it can lead to short-term cost reductions, they may be realised at the expense of long-term success, because of the loss of valuable human resources (and knowledge) and overall corporate reputation. Restructuring by downscoping reduces diversification and focuses on the core business.

- Through a leveraged buyout (LBO), an organisation is purchased so that it can become a private entity. LBOs usually are financed largely through debt. Management buyouts (MBOs), employee buyouts (EBOs) and whole-organisation LBOs are the three types of LBOs. Because they provide clear managerial incentives, MBOs have been the most successful of the three. Often, the intent of a buyout is to improve efficiency and performance to the point where the organisation can be sold successfully within five to eight years.
- Commonly, restructuring's primary goal is gaining or re-establishing effective strategic control of the organisation. Of the three restructuring strategies, downscoping is aligned most closely with establishing and using strategic controls and usually improves performance more on a comparative basis.

## KEY TERMS

| | | |
|---|---|---|
| acquisition | merger | takeover |
| economies of scale | restructuring | |

## REVIEW QUESTIONS

1. Why are merger and acquisition strategies popular in many organisations competing in the global economy? What are the economic reasons and the non-economic reasons for the popularity of M&A as a strategy?
2. What reasons account for organisations' decisions to use acquisition strategies as a means of achieving strategic competitiveness?

3. What are the seven primary problems that affect an organisation's efforts to successfully use an acquisition strategy?
4. What are the attributes associated with a successful acquisition strategy?
5. What are the typical reasons why M&A benefits are not realised?
6. Why can it be stated that there is no such thing as an equal merger, and that all M&A deals are effectively acquisitions?
7. What is the restructuring strategy and what are its common forms?
8. What are the short- and long-term outcomes associated with the different restructuring strategies?

## EXPERIENTIAL EXERCISES

### Exercise 1: How did the deal work out?

The text argues that mergers and acquisitions are a popular strategy for businesses. However, returns for acquiring organisations do not always live up to expectations. This exercise seeks to address this notion by analysing, pre and post hoc, the results of actual acquisitions. By looking at the notifications of a deal beforehand, categorising that deal and then following it for a year, you will be able to learn about actual deals and their implications for strategists.

Working in teams, identify a merger or acquisition that was completed in the last few years. Each team must have their M&A choice approved in advance to avoid duplicates.

To complete this assignment, you should be prepared to complete the following:

1. Describe the environment for this arrangement at the time it was completed. Using concepts discussed in the text, focus on management's representation to shareholders, the industry environment and the overall rationale for the deal.
2. Did the acquirer pay a premium for the target organisation? If so, how much? In addition, search for investor comments regarding the wisdom of this agreement. Attempt to identify how the market reacted to the announcement of the deal (LexisNexis typically provides an article that will address this issue).
3. Describe the merger or acquisition. Use concepts from the text such as, but not limited to:
   a the reason for the merger or acquisition (i.e. market power, overcoming entry barriers, etc.)
   b any problems in achieving acquisition success
   c whether you would categorise this deal as successful as of the time of your research, giving the reasons why or why not.
4. Produce a 10–15 minute presentation for your class. Organise the presentation as if you were updating the shareholders of the newly combined organisation.

## NOTES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CHAPTER 8

# International strategy

## Learning Objectives

Studying this chapter should provide you with the strategic management knowledge needed to:

LO1 explain incentives for organisations to use an international strategy and identify three basic benefits of successful strategy implementation

LO2 explore the determinants of national advantage as the basis for international business-level strategies

LO3 describe the three main international corporate-level strategies

LO4 discuss environmental trends affecting the choice of international strategies, particularly international corporate-level strategies

LO5 explain the five modes organisations use to enter international markets

LO6 discuss the two major risks of using international strategies

LO7 understand the challenges of increased organisation size and operation complexity in achieving positive outcomes as well as the limitations of international expansion

LO8 discuss the strategic competitiveness outcomes associated with international strategies, particularly with an international diversification strategy.

# OPENING CASE STUDY

## An international strategy powers ABB's future

ABB is a Swiss–Swedish multinational corporation headquartered in Zurich, Switzerland, operating mainly in robotics, power, heavy electrical equipment and automation technology areas. It ranked 341st in the Fortune Global 500 list of 2018 and has been a Fortune 500 company for 24 years. ABB is a major competitor in the power and automation technologies industries across the major markets globally. It has 147 000 employees operating in more than 100 countries. It has five major businesses – electrification (power products), industrial automation, motion (drives and motors), robotics and discrete automation and power grids. It operates in eight major regions: (1) Northern Europe, (2) Central Europe, (3) the Mediterranean, (4) North America, (5) South America, (6) India, the Middle East and Africa, (7) North Asia and (8) South Asia. Over time, ABB has been a successful company, using its geographic diversification across the globe to its advantage. However, it also exemplifies the difficulty of managing an international strategy and operations. For example, its power business has experienced performance problems in recent years due to poor performance in some countries. As a result, ABB reduced or eliminated operations in Lithuania, Nigeria, the Philippines, Slovakia and six additional countries. The CEO stated that the returns from these operations had not justified the investments made. A major divestment is scheduled for 2020–21, with the sale of the power grid business to Hitachi. The company divested several other businesses from 2014 to 2017, including its cable business to NKT in 2017, US cable factory to Southwire Company LLC in 2015, and steel manufacturing to Trinity Industries and services businesses to Nordic Capital in 2014.

In recent years, most of ABB's entries into new markets and expansions in existing markets have come from acquisitions of existing businesses in those markets. It acquired automotive welding business AB Rotech and GE Industrial Solutions in 2018, communication networks business KEYMILE and machine and factory automation specialist Bernecker + Rainer (B&R) in 2017, and Sweden's robotic automation company SVIA in 2016. ABB also uses other modes of entry and expansion, exemplified by its 2013 joint venture with China's Jiangsu Jinke Smart Electric Company to design, manufacture and provide follow-up service on high-voltage instrument transformers. It also procured major contracts for business in Brazil and South Africa.

Partly due to the global recession that began in 2008, weak economic performance and some poor expansion decisions, ABB's performance in 2010–13 was weaker than expected. As a result, the CEO and chief technology officer announced their resignations in 2013. The new CEO shifted focus from power to the automation technology sector, and launched a series of small international acquisitions. The focus on automation technology and a more targeted international strategy have improved financial performance over recent years. ABB remains a highly respected global brand, and even in turbulent times, ABB's future looks bright.

Sources: ABB, 2020, Meet our five focused leading businesses, https://new.abb.com/about/our-businesses, 3 June; ABB, 2020, Acquisitions and disposals, https://new.abb.com/investorrelations/calendar-events-and-publications/acquisitions-and-disposals, 3 June; Crunchbase, 2020, ABB acquisitions, https://www.crunchbase.com/organization/abb, 4 June; Mergr, 2020, ABB mergers and acquisitions summary, https://mergr.com/abb-acquisitions, 4 June; Zacks Equity Research, 2013, ABB procures contract in Brazil, http://www.zacks.com, 14 May; Zacks Equity Research, 2013, ABB's South African project, http://www.zacks.com, 13 May; P. Winters, 2013, ABB loses Banerjee after Hogan's decision to step down, *Bloomberg Businessweek*, http://www.businessweek.com, 13 May; J. Revill & A. Morse, 2013, ABB CEO to resign, *Wall Street Journal*, http://www.wsj.com, 10 May; Zacks Equity Research, 2013, ABB strengthens footprints in China, http://www.zacks.com, 10 May.

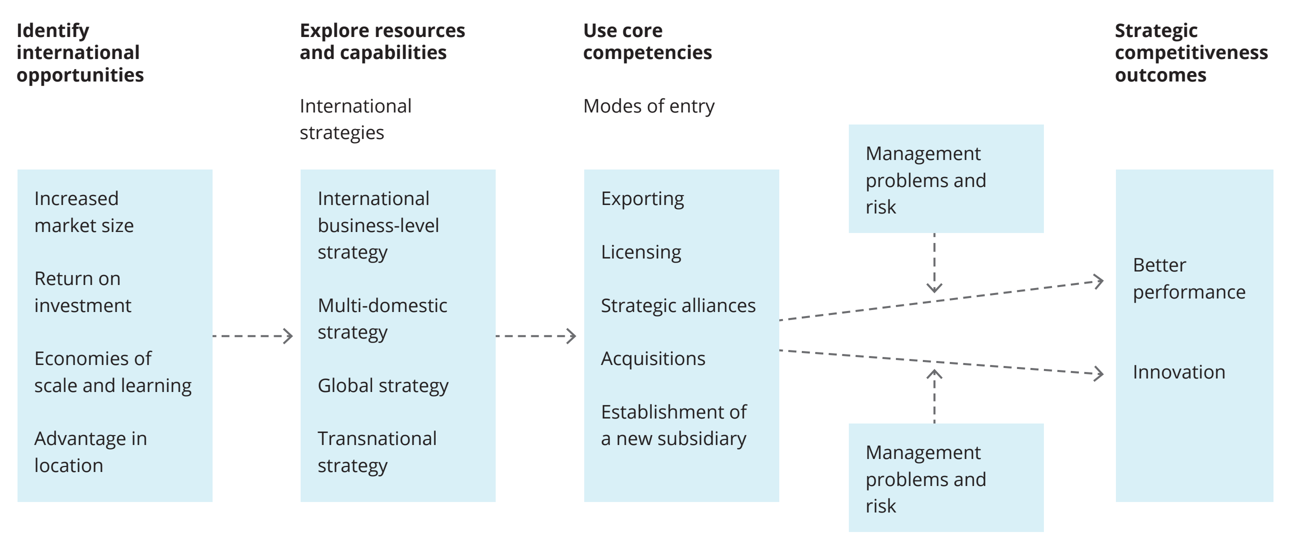
This chapter's opening case highlights the increasing importance of international markets to ABB, an international powerhouse. However, being able to effectively compete in countries and regions outside an organisation's domestic market is increasingly important to organisations of all types. One reason for this is that the effects of globalisation continue to reduce the number of industrial and consumer markets in which only domestic organisations can compete successfully. In place of what historically were relatively stable and predictable domestic markets, organisations across the globe find they are now competing in globally oriented industries – industries in which organisations must compete in all world markets where a consumer or commercial good or service is sold in order to be competitive.[1] Unlike domestic markets, global markets are relatively unstable and unpredictable. The disruption of international supply chains and international travel in 2020–21 due to the Covid-19 pandemic is a good example of the unpredictable nature of global markets. This has had a major negative impact on Australian organisations such as Qantas,[2] whereas some Australian organisations, such as Emperor Champagne, have experienced major growth.[3]

**STRATEGY NOW**

ABB's international acquisitions and joint ventures

The purpose of this chapter is to discuss how international strategies can be a source of strategic competitiveness for organisations competing in global markets. To do this, we examine a number of topics (see Figure 8.1). After describing factors or incentives that influence organisations to identify international opportunities, we discuss three basic benefits that can accrue to organisations that successfully use international strategies. We then turn our attention to the international strategies available to organisations. Specifically, we examine both international business-level strategies and international corporate-level strategies. The five modes of entry organisations consider when deciding how to enter international markets as a foundation for implementing their chosen international strategies are then considered. Organisations encounter economic and political risks when using international strategies. These risks must be effectively managed if the organisation is to achieve the strategic competitiveness outcomes of improved performance and enhanced innovation. After discussing the outcomes organisations seek when using international strategies, the chapter closes with mention of two cautions about international strategy that should be kept in mind.

**Figure 8.1** Opportunities and outcomes of international strategy



# Identifying international opportunities

An **international strategy** is a strategy through which the organisation sells its goods or services outside its domestic market.[4] In some instances, organisations using an international strategy become quite diversified geographically as they compete in numerous countries or regions outside their domestic market. This is the case for ABB in that it competes in over 100 countries. In other cases, organisations experience less geographic or international diversification in that they only compete in a small number of markets outside their 'home' market.

**international strategy** a strategy through which the organisation sells its goods or services outside its domestic market

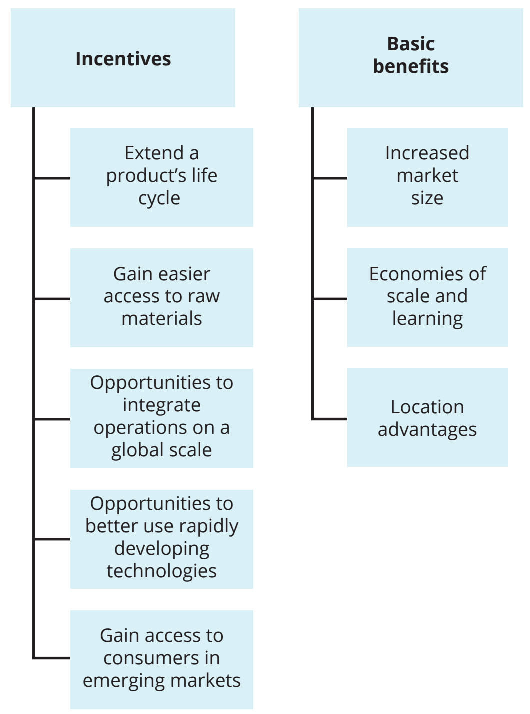
There are incentives for organisations to use an international strategy and to diversify their operations geographically, and they can gain three basic benefits when they successfully do so.[5] We show the incentives and benefits of international strategy in Figure 8.2.

## Incentives to use international strategy

Raymond Vernon expressed the classic rationale for an international strategy.[6] He suggested that typically an organisation discovers an innovation in its home-country market, especially in advanced economies such as those in Australia, Germany, France, Japan, Sweden, Canada and the USA. Often, demand for the product then develops in other countries, causing an organisation to export products from its domestic operations to fulfil that demand. Continuing increases in demand can subsequently justify an organisation's decision to establish operations outside of its domestic base. As Vernon noted, taking these actions in the form of international strategy has the potential to help an organisation extend the life cycle of its product(s).

Gaining access to needed and potentially scarce resources is another reason organisations use an international strategy. Key supplies of raw material – especially minerals and energy – are critical to organisations' efforts in some industries to manufacture their products. Of course, energy and mining companies have operations throughout the world to gain access to the raw materials they sell to manufacturers requiring those resources. Rio Tinto is a leading international mining group. Operating as a global organisation, the organisation indicates that 'most of [its] assets are in Australia and North America, but that [the organisation] also operates in Europe, South America, Asia and Africa'. Rio Tinto extracts the raw materials it sells from various sources including 'open pit and underground mines, mills, refineries and smelters'.[7] In other industries where labour costs account for a significant portion of a company's expenses, organisations may choose to establish facilities in other countries to gain access to less expensive labour. Clothing and electronics manufacturers are examples of organisations pursuing an international strategy for this reason.

**Figure 8.2** Incentives and basic benefits of international strategy




Increased pressure to integrate operations on a global scale is another factor influencing organisations to pursue an international strategy. As nations industrialise, the demand for some products and commodities appears to become more similar. This borderless demand for globally branded products such as those Starbucks provides may be due to similarities in lifestyle in developed nations.

Increases in global communications also facilitate the ability of people in different countries to visualise and model lifestyles in different cultures.[8] With over 211 000 employees, and 433 stores in 52 countries, IKEA has become a global retail brand selling a wide variety of furniture and related products. Using operations (including marketing and advertising) that are integrated globally, IKEA sells all of its furniture in components that can be packaged in flat packs and assembled by consumers after purchase. This business model allows for easy shipping and handling, which in turn facilitates development of a global brand. Winning the international Webby Award in 2018 for best social media campaign, being a finalist in the 2018 Cannes Lions, and winning the prestigious Cannes Lions 2011 Advertiser of the Year Award for its 'creative and effective global advertising efforts' are indicators of IKEA's effectiveness at integrating its operations on a global basis.[9]

In an increasing number of industries, technology drives globalisation because the economies of scale necessary to reduce costs to the lowest level often require an investment greater than that needed to meet domestic market demand. Moreover, in emerging markets the increasingly rapid adoption of technologies such as the internet and mobile applications permits greater integration of trade, capital, culture and labour. In this sense, technologies are the foundation for efforts to bind together disparate markets and operations across the world. International strategy makes it possible for organisations to use technologies and global connectedness to organise their operations into a seamless whole.[10]

The potential of large demand for goods and services from people in emerging markets such as China and India is another strong incentive for organisations to use an international strategy.[11] China and India offer the potential for two billion customers, which has been an attractive proposition for the physical retail and supermarket category. The world's largest physical retailers, Walmart and France's Carrefour Group, entered the Chinese market but have struggled. In 2011, Carrefour acquired minority stakes in three mainland Chinese retailers to strengthen its presence, but by 2019 chose to exit the market by selling an 80 per cent stake in its 210 retail stores to Chinese competitor Suning.[12] Walmart has been more successful, and has grown to over 420 stores, but recent performance indicates it is struggling to compete with the strong online market led by Alibaba and JD.com.[13]

Even though India, another emerging market economy, differs from Western countries in many respects – including culture, politics and the precepts of its economic system – it also offers a huge potential market and its government is becoming more supportive of foreign direct investment.[14] However, differences among Chinese, Indian and Western-style economies and cultures make the successful use of an international strategy challenging. In particular, organisations seeking to meet customer demands in emerging markets must learn how to manage an array of political and economic risks,[15] such as those we discuss later in the chapter.

We have now discussed incentives that influence organisations to use international strategies. Organisations derive three basic benefits by successfully using international strategies: increased market size, increased economies of scale and learning, and development of a competitive advantage through location (e.g. access to low-cost labour, critical resources or customers). These benefits are examined here in terms of both their costs (such as higher coordination expenses and limited access to knowledge about host country political influences)[16] and their challenges.

## Three basic benefits of international strategy

As noted, effectively using one or more international strategies can result in three basic benefits for the organisation. These benefits facilitate the organisation's effort to achieve strategic competitiveness (see Figure 8.1) when using an international strategy.

### Increased market size

Organisations can expand the size of their potential market – sometimes dramatically – by using an international strategy to establish stronger positions in markets outside their domestic market. As noted, access to additional consumers is a key reason many sectors see China as a major source of growth.

Takeda, a large Japanese pharmaceutical company, acquired Swiss drug maker Nycomed for US$13.7 billion in 2011. Buying Nycomed made Takeda a major player in European markets. More significantly, the acquisition broadened Takeda's distribution capability in emerging markets 'at a time when pharmaceutical firms world-wide were wrestling with the impact on revenue from the expiration of patents'. In fact, the Nycomed deal was thought to increase Takeda's sales in China about fourfold.[17] Along with Starbucks, Walmart and Takeda are two additional companies relying on international strategy as the path to increased market size in China.

Organisations such as ABB, Walmart and Takeda understand that effectively managing different consumer tastes and practices linked to cultural values or traditions in different markets is challenging. Nonetheless, they accept this challenge because of the potential to enhance the organisation's performance. Other organisations accept the challenge of successfully implementing an international strategy largely because of limited growth opportunities in their domestic market. This appears to be at least partly the case for major competitors Coca-Cola and PepsiCo, organisations that have not been able to generate significant growth in their home (North American) markets for some time. Indeed, most of these organisations' growth is occurring in international markets. These two organisations approach international growth somewhat differently. PepsiCo, the world's largest snack-food maker as a result of its Frito-Lay division, relies on its 'global beverage business, and the only component struggling is its North America unit' and that international 'combined snacks and beverage portfolios also synergistically help the company when working with retailers and food service operators'.[18] Less diversified than PepsiCo in terms of products, but not in terms of geography, Coca-Cola is the world's largest producer of soft drink concentrates and syrups and the world's largest producer of juice and juice-related products. Selling its products in more than 200 countries, Coca-Cola derives only approximately 32 per cent of its revenue from sales in North America, suggesting that the organisation's international strategies are critical to its efforts to be competitively successful, and that it does not rely on sales in North America as the cornerstone of its efforts to outperform PepsiCo, its chief rival.[19]

An international market's overall size also has the potential to affect the degree of benefit an organisation can accrue as a result of using an international strategy. In general, larger international markets offer higher potential returns and thus pose less risk for the organisation choosing to invest in those markets. Relatedly, the strength of the science base of the international markets in which an organisation may compete is important in that scientific knowledge and the human capital needed to use that knowledge can facilitate efforts to more effectively sell and/or produce products that create value for customers.[20]

## Economies of scale and learning

By expanding the number of markets in which they compete, organisations may be able to enjoy economies of scale, particularly in their manufacturing operations. More broadly, organisations able to standardise the processes used to produce, sell, distribute and service their products across country borders enhance their ability to learn how to continuously reduce costs while hopefully increasing the value their products create for customers. For example, rivals Airbus SAS and Boeing have multiple manufacturing facilities and outsource some activities to organisations located throughout the world, partly for the purpose of developing economies of scale as a means of being able to create value for customers.

Economies of scale are critical in a number of settings in addition to the airline manufacturing industry. Automobile manufacturers certainly seek economies of scale as a benefit of their international strategies. Competing in markets throughout the world, Ford Motor Company 'is counting on rapid growth in Asia to fuel a dramatic expansion of sales and boost profits over the next several years'.[21] Overall, Ford seeks to increase the annual number of products it sells outside of North America to eight million units (up from about 5.3 million sold internationally in 2010). Ford is using a global corporate-level international strategy to reach this objective (this strategy is discussed later in the chapter). Demonstrating the use of this international strategy is the fact that Ford is now run as a single global business developing cars and trucks that can be built and sold throughout the world. The organisation intends for about 75 per cent of all the vehicles it sells globally to be variants of five basic sets of manufacturing platforms, and will rely on these to reduce costs by increasing economies of scale. Ford continues to strive to reduce the number of platforms it uses for its vehicles. The goal in 2015 was bold, and it intended to increase the number of product types it sells in China from five to 15 and in India from five to eight. Sales peaked in China in 2016 with 965 800 units across the five Ford Lincoln products, but have significantly decreased since with competition from German and local Chinese competitors.[22]

Organisations may also be able to exploit core competencies in international markets through resource and knowledge sharing between units and network partners across country borders.[23] By sharing resources and knowledge in this manner, organisations can learn how to create synergy, which in turn can help each organisation learn how to produce higher-quality products at a lower cost. This may be the case for the members of the International Aero Engines (IAE) consortium: Pratt & Whitney, Rolls-Royce, Japanese Aero Engines and MTU Aero Engines. Relying on their members' joint capabilities and core competencies, IAE developed an innovative PurePower geared turbofan (GTF) engine platform. One version of this engine is in some of Airbus' A320neo aircraft, which the consortium sees as a positive reaction to its innovation.[24] Working in multiple international markets also provides organisations with new learning opportunities,[25] perhaps even in terms of research and development (R&D) activities. Increasing the organisation's R&D ability can contribute to its efforts to enhance innovation, which is critical to both short- and long-term success. However, research results suggest that to take advantage of international R&D investments, organisations need to already have a strong R&D system in place to absorb knowledge resulting from effective R&D activities.[26]

**polycentric strategy**
strategy based on the belief that the local people, customs and traditions are best suited to business in that country. This means hiring or promoting local staff, and adopting many local processes rather than a single standardised global approach

**ethnocentric strategy**
strategy based on the belief that the people, customs and traditions of your own race or nationality are better than those of others. In business, this means hiring or promoting staff from the country of the headquarters, and standardising based on the HQ country's processes

**'glocalisation' strategy**
strategy based on the belief that products or services should be developed and distributed globally but is also adjusted to accommodate the user or consumer in a local market. Glocalisation is a combination of the words 'globalisation' and 'localisation'

### Location advantages

Locating facilities in markets outside their domestic market can sometimes help organisations reduce costs. This benefit of an international strategy accrues to the organisation when its facilities in international locations provide easier access to lower-cost labour, energy and other natural resources. Other location advantages include access to critical supplies and to customers. Once positioned favourably with an attractive location, organisations must manage their facilities effectively to gain the full benefit of a location advantage.[27]

An organisation's costs, particularly those dealing with manufacturing and distribution, as well as the nature of international customers' needs, affect the degree of benefit it can capture through a location advantage.[28] Cultural influences may also affect location advantages and disadvantages. International business transactions are less difficult for an organisation to complete when there is a strong match among the cultures with which the organisation is involved while implementing its international strategy.[29] Finally, physical distances influence organisations' location choices as well as how to manage facilities in the chosen locations.[30]

## International strategy types

Organisations choose to use one or both basic types of international strategy: business-level international strategy and corporate-level international strategy. At the business level, organisations select from among the generic strategies of cost leadership, differentiation, focused cost leadership, focused differentiation and integrated cost leadership/differentiation. At the corporate level, multi-domestic (**polycentric strategy**), global (**ethnocentric strategy**) and transnational (**'glocalisation' strategy**) international strategies (transnational is a combination of the global/ethnocentric and local multi-domestic/polycentric strategies) are considered. To contribute to the organisation's efforts to achieve strategic competitiveness in the form of improved performance and enhanced innovation (see Figure 8.1), each international strategy the organisation uses must be based on one or more core competencies.[31]

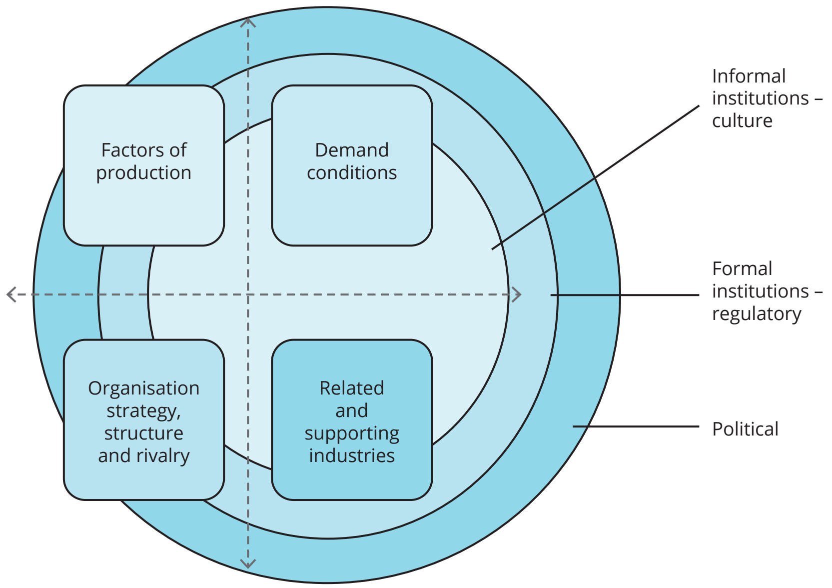
## International business-level strategy

Organisations considering the use of any international strategy first develop domestic-market strategies (at the business level and at the corporate level if the organisation has diversified at the product level). One reason this is important is that the organisation may be able to use some of the capabilities and core competencies it has developed in its domestic market as the foundation for competitive success in international markets.[32] However, research results indicate that the value created by relying on capabilities and core competencies developed in domestic markets as a source of success in international markets diminishes as an organisation's geographic diversity increases.[33]

As we know from our discussion of competitive dynamics in Chapter 5, organisations do not select and then use strategies in isolation from market realities. In the case of international strategies, conditions in an organisation's domestic market affect the degree to which the organisation can build on capabilities and core competencies it established in that market to create capabilities and core competencies in international markets. The reason for this is grounded in Michael Porter's analysis of why some nations are more competitive than other nations and why and how some industries within nations are more competitive relative to those industries in other nations. Porter's core argument is that conditions or factors in an organisation's home base – that is, in its domestic market – either hinder the organisation's efforts to use an international business-level strategy for the purpose of establishing a competitive advantage in international markets, or support those efforts. Porter identifies four factors as determinants of a national advantage that some countries possess (see Figure 8.3).[34] Interactions among these four factors influence an organisation's choice of international business-level strategy.

The first determinant of national advantage is factors of production. This determinant refers to the inputs necessary for an organisation to compete in any industry. Labour, land, natural resources, capital and infrastructure (such as transportation, postal and communication systems) are examples of such inputs. There are basic factors (e.g. natural and labour resources) and advanced factors (e.g. digital communication systems and a highly educated workforce). Other production factors are generalised (highway systems and the supply of debt capital) and specialised (skilled personnel in a specific industry, such as the workers in a

**Figure 8.3** **Determinants of national advantage**



port that specialise in handling bulk chemicals). If a country possesses advanced and specialised production factors, it is likely to serve an industry well by spawning strong home-country competitors that also can be successful global competitors.

Ironically, countries often develop advanced and specialised factors because they lack critical basic resources. For example, some Asian countries, such as South Korea, lack abundant natural resources but have a workforce with a strong work ethic, a large number of engineers, and systems of large organisations to create an expertise in manufacturing. Similarly, Germany developed a strong chemical industry, partially because Hoechst and BASF spent years creating a synthetic indigo dye to reduce their dependence on imports, unlike Britain, whose colonies provided large supplies of natural indigo.[35]

The second factor or determinant of national advantage – demand conditions – is characterised by the nature and size of customers' needs in the home market for the products organisations competing in an industry produce. Meeting the demand generated by a large number of customers creates conditions through which an organisation can develop scale-efficient facilities and refine the capabilities, and perhaps core competencies, required to use those facilities. Once refined, the probability that the capabilities and core competencies will benefit the organisation as it diversifies geographically increases.

This may be the case for some Chinese manufacturing companies that have spent years building their businesses in China and developing economies of scale and scale-efficient facilities in the process of doing so. Today, many of these organisations hope to be able to rely on these facilities and the capabilities and core competencies they have developed to use those facilities to become 'global players', capable of using international business-level strategies to profitably sell their products in multiple international markets.[36]

The third factor in Porter's model of the determinants of national advantage is related and supporting industries. Italy has become the leader in the shoe industry because of related and supporting industries. For example, a well-established leather-processing industry provides the leather needed to construct shoes and related products. Also, many people travel to Italy to purchase leather goods, providing support in distribution. Supporting industries in leather-working machinery and design services also contribute to the success of the shoe industry. In fact, the design services industry supports its own related industries, such as ski boots, fashion apparel and furniture. In Japan, cameras and copiers are related industries. Similarly, it is argued that the creative resources associated with 'popular cartoons such as manga and the animation sector along with technological knowledge from the consumer electronics industry facilitated the emergence of a successful video game industry in Japan'.[37] In a like manner, Germany is known for the quality of its machine tools and eastern Belgium is known for skilled manufacturing (supporting and related industries are important in these two settings, too).[38]

Organisation strategy, structure and rivalry make up the final determinant of national advantage and also foster the growth of certain industries. The types of strategy, structure and rivalry among organisations vary greatly from nation to nation. The excellent technical training system in Germany fosters a strong emphasis on continuous product and process improvements. In Japan, unusual cooperative and competitive systems facilitate the cross-functional management of complex assembly operations. In Italy, the national pride of the country's designers spawns strong industries not only in shoes but also sports cars, fashion apparel and furniture. In the USA, competition among computer manufacturers and software producers contributes to further development of these industries.

The four determinants of national advantage (see Figure 8.3) emphasise the structural characteristics of a specific economy that contribute to some degree to national advantage and that influence the organisation's selection of an international business-level strategy. Individual governments' policies also affect the nature of the determinants as well as how organisations compete within the boundaries governing bodies establish and enforce within a particular economy.[39] While studying their external environment (see Chapter 2), organisations considering the possibility of using an international strategy need to gather information and data that will allow them to understand the effects of governmental policies and their enforcement on their nation's ability to establish advantage relative to other nations. This also relates to the degree of competitiveness on a global basis of the industry in which organisations might compete on a global scale.

Those leading companies should recognise that an organisation based in a country with a national competitive advantage is not guaranteed success as it implements its chosen international business-level strategy. The actual strategic choices managers make may be the most compelling reasons for success or failure as organisations diversify geographically. Accordingly, the factors illustrated in Figure 8.3 are likely to produce the foundation for an organisation's competitive advantages only when it develops and implements an appropriate international business-level strategy that takes advantage of distinct country factors. Thus, these distinct country factors should be thoroughly considered when making a decision about the international business-level strategy the organisation will use. In a competitive rivalry sense, the organisation will then make continuous adjustments to its international business-level strategy in light of the nature of competition it encounters in different international markets and in light of customers' needs. Lexus, for example, did not have the share of the luxury car market in China that it desired in 2011. Accordingly, Toyota (Lexus' manufacturer) adjusted how it implemented its international differentiation business-level strategy in China to better serve customers. The organisation is doing this by 'turning to the feature that cemented its early success in the USA: extreme customer service. Showroom amenities such as cappuccino machines, wi-fi, Lego tables for the kids, and airport shuttles for busy executives dropping off their cars for servicing are examples of the services now being offered to customers in China'.[40] Lexus had double-digit growth in China from 2015–20 and, in April 2019, Lexus sold more vehicles in China than in the USA.[41]

# International corporate-level strategy

An organisation's international business-level strategy is also based at least partially on its international corporate-level strategy. Some international corporate-level strategies give individual country units the authority to develop their own business-level strategies, while others dictate the business-level strategies in order to standardise the organisation's products and sharing of resources across countries.[42]

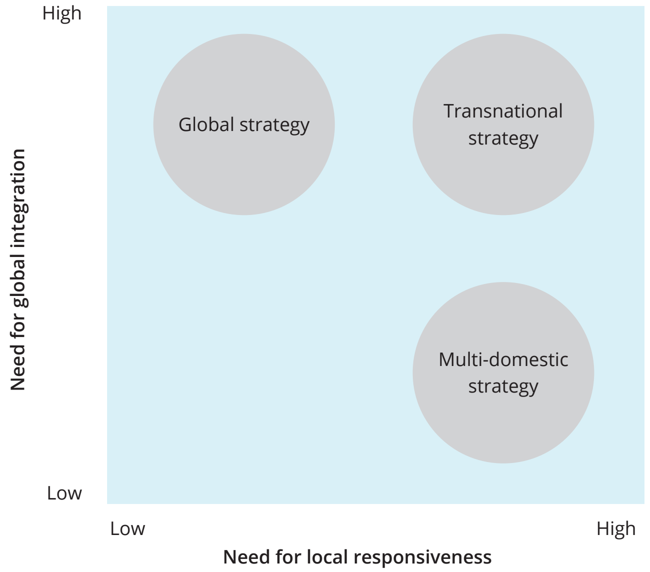
International corporate-level strategy focuses on the scope of an organisation's operations through geographic diversification.[43] International corporate-level strategy is required when the organisation operates in multiple industries that are located in multiple countries or regions (e.g. South-East Asia or the European Union (EU)) and in which they sell multiple products. The headquarters unit guides the strategy, although, as noted, business- or country-level managers can have substantial strategic input depending on the type of international corporate-level strategy the organisation uses. We show the three international corporate-level strategies in Figure 8.4. As shown, the international corporate-level strategies vary in terms of two dimensions: the need for global integration and the need for local responsiveness.

## Multi-domestic strategy

A **multi-domestic strategy** is an international strategy in which strategic and operating decisions are decentralised to the strategic business units in individual countries or regions for the purpose of allowing each unit the opportunity to tailor products to the local market.[44] This is also known as a polycentric strategy (poly meaning many). With this strategy, the organisation's need for local responsiveness is high while its need for global standardisation or integration is low. Influencing these needs is the organisation's belief that consumer needs and desires, industry conditions (e.g. the number and type of competitors), political and legal structures, and social norms vary by country. Thus, a multi-domestic strategy focuses on competition within each country in that market needs are thought to be segmented by country boundaries. To meet the specific needs and preferences of local customers, country or regional managers have the autonomy to customise the organisation's products. This approach often extends to human resource (HR) practices and business processes. Therefore, these strategies should maximise an organisation's competitive response to the idiosyncratic requirements of each market.[45] The multi-domestic strategy is most appropriate for use when the differences between the markets an organisation serves and the customers in them are significant.

**multi-domestic strategy**
an international strategy in which strategic and operating decisions are decentralised to the strategic business unit in each country so as to allow that unit to tailor products to the local market. See also polycentric strategy

**Figure 8.4** **International corporate-level strategies**




The use of multi-domestic strategies usually expands the organisation's local market share because the organisation can pay attention to the local clientele's needs. However, using a multi-domestic strategy results in less knowledge sharing for the corporation as a whole because of the differences across markets, decentralisation and the different international business-level strategies employed by local units.[46] Moreover, multi-domestic strategies do not allow the development of economies of scale and thus can be more costly.

Unilever is a large European consumer products company selling products in over 180 countries. The organisation has more than 400 global brands that are grouped into three business units: foods, home care and personal care. Historically, Unilever has used a highly decentralised approach for the purpose of managing its global brands. This approach allows regional managers considerable autonomy to adapt the characteristics of specific products to satisfy the unique needs of customers in different markets. However, more recently, Unilever has sought to increase the coordination between its independent subsidiaries in order to establish an even stronger global brand presence.[47] As such, Unilever may be transitioning from a multi-domestic strategy (polycentric) to a transnational strategy ('glocalisation').

## Global strategy

**global strategy**
an international strategy through which the organisation offers standardised products across country markets, with competitive strategy being dictated by the home office

A **global strategy** is an international strategy in which an organisation's home office determines the strategies business units are to use in each country or region.[48] This is also known as an *ethnocentric strategy*. This strategy indicates that the organisation has or values a high need for global integration and a low need for local responsiveness. These needs indicate that, compared with a multi-domestic strategy, a global strategy seeks greater levels of standardisation of products across country markets. This standardisation often extends to HR practices and business processes. The organisation using a global strategy seeks to develop economies of scale as it produces the same or virtually the same products for distribution to customers throughout the world who are assumed to have similar needs. The global strategy offers greater opportunities to take innovations developed at the corporate level or in one market and apply them in other markets.[49] Improvements in global accounting and financial reporting standards facilitate use of this strategy.[50] A global strategy is most effective when the differences between markets and the customers the organisation is serving are insignificant.

Efficient operations are required to successfully implement a global strategy. Increasing the efficiency of an organisation's international operations mandates resource sharing and greater coordination and cooperation across market boundaries. Centralised decision making, as designed by headquarters, details how resources are to be shared and coordinated across markets. Research results suggest that the outcomes an organisation achieves by using a global strategy become more desirable when the strategy is used in areas where regional integration among countries is occurring.[51]

Cemex is a global building materials company that uses the international strategy. Cemex is the world's leading supplier of ready-mix concrete and one of the world's largest producers of white Portland cement. Cemex sells to customers in more than 50 countries in multiple regions, including the Americas, Europe, Africa the Middle East and Asia. With annual sales of more than US$18 billion, the organisation employs more than 42 000 people. To implement its global strategy, Cemex has centralised a number of its activities. The shared services model is an example of how this organisation centralises operations in order to gain scale economies, among other benefits. According to company documents, this model 'converges, centralises, and streamlines back-office services – such as human resources and payroll, information technology, and transactional and financial services – for our operations across regions'.[52] In essence, the shared services model integrates and centralises some support functions from the organisation's value chain (see Chapter 3). This integration and centralisation brings about the types of benefits sought by organisations when using a global strategy. Significant cost savings, increases in the productivity of the involved support functions, the fostering of economies of scale and the freeing up of resources to enable an improved focus on core tasks are examples of the benefits Cemex is accruing by using its shared services model.

Because of increasing global competition and the need to simultaneously be cost-efficient and produce differentiated products, the number of organisations using a transnational international corporate-level strategy is increasing.

## Transnational strategy

A **transnational strategy** is an international strategy through which an organisation seeks to achieve both global efficiency and local responsiveness. This is also known as *'glocalisation' strategy* (combination of global and local). With this strategy, the organisation has strong needs for both global integration and local responsiveness. Starbucks is using the transnational strategy to pursue profitable growth in international markets. For example, in China, Starbucks is trying to standardise its operations (global integration) while it simultaneously decentralises some decision-making responsibility to local levels so products can be made to meet customers' unique needs (local responsiveness). Chai tea lattes, green tea frappuccinos with black sesame, and black bean muffins are examples of products Starbucks has adapted to meet local tastes in China.[53] In Australia, McDonald's tailors its product range to Australian tastes, and even puts beetroot in its Aussie burger.

**transnational strategy**
an international strategy through which the organisation seeks to achieve both global efficiency and local responsiveness

Realising the twin goals of global integration and local responsiveness is difficult in that global integration requires close global coordination while local responsiveness requires local flexibility. *Flexible coordination* – building a shared vision and individual commitment through an integrated network – is required to implement the transnational strategy. Such integrated networks allow an organisation to manage its connections with customers, suppliers, partners and other parties more efficiently rather than using arm's-length transactions.[54] The transnational strategy is difficult to use because of its conflicting goals (see Chapter 11 for more on the implementation of this and other corporate-level international strategies). On the positive side, effectively implementing a transnational strategy often produces higher performance than does implementing either the multi-domestic or global strategy.[55]

Transnational strategies are becoming increasingly necessary to successfully compete in international markets. Reasons for this include the fact that continuing increases in the number of viable global competitors challenge organisations to reduce their costs. Simultaneously, the increasing sophistication of markets with greater information flows made possible largely by the diffusion of the internet, and the desire for specialised products to meet consumers' unique needs, pressures organisations to differentiate their products in local markets. Differences in culture and institutional environments also require organisations to adapt their products and approaches to local environments. However, some argue that transnational strategies are not required to successfully compete in international markets. Those holding this view suggest that most multinational organisations try to compete at the regional level (e.g. the EU) rather than at the country level. To the degree this is the case, the need for the organisation to simultaneously offer unique products that are adapted to local markets and to produce those products at lower costs permitted by developing scale economies is reduced.[56]

Next we discuss trends in the global environment that are affecting the choices organisations make when deciding which international corporate-level strategies to use and in which international markets to compete.

# Environmental trends

Although the transnational strategy is difficult to implement, an emphasis on global efficiency is increasing as more industries and the companies competing within them encounter intensified global competition. Magnifying the scope of this issue is the fact that, simultaneously, organisations are experiencing demands for local adaptations of their products. These demands can be from customers (for products to satisfy their tastes and preferences) and from governing bodies (for products to satisfy a country's regulations). In addition, most multinational organisations desire coordination and sharing of resources across country markets to hold down costs, as illustrated by the Cemex example.[57]

Because of these conditions, some large multinational organisations with diverse products use a multi-domestic strategy with certain product lines and a global strategy with others when diversifying geographically. Many multinational organisations may require this type of flexibility if they are to be strategically competitive, in part due to trends that change over time.

Liability of foreignness and regionalisation are two important trends influencing an organisation's choice and use of international strategies, particularly international corporate-level strategies. We discuss these trends next.

## Liability of foreignness

Disney executives learned from their mistakes with Disneyland Paris when entering other foreign markets, such as Hong Kong.

Source: Alamy Stock Photo/Howard Harrison

The dramatic success of Japanese organisations such as Toyota and Sony in the 1980s was a powerful jolt to many managers and awakened them to the importance of international competition and the fact that many markets were rapidly becoming globalised. In the 21st century, Brazil, Russia, India and China (BRIC) represent major international market opportunities for organisations from many countries, including the USA, Japan, South Korea and members of the EU.[58] However, even if foreign markets seem attractive, as appears to be the case with the BRIC countries, there are legitimate concerns for organisations considering entering these markets. This is the *liability of foreignness*,[59] a set of costs associated with various issues organisations face when entering foreign markets, including unfamiliar operating environments; economic, administrative and cultural differences; and the challenges of coordination over distances.[60] Four types of distances commonly associated with liability of foreignness are cultural, administrative, geographic and economic.[61]

Walt Disney Company's experience while opening theme parks in countries outside the USA demonstrates the liability of foreignness. For example, Disney suffered 'lawsuits in France, at Disneyland Paris, because of the lack of fit between its transferred personnel policies and the French employees charged to enact them'.[62] Disney executives learned from this experience in building the organisation's theme park in Hong Kong as the company 'went out of its way to tailor the park to local tastes'.[63] Thus, as with Walt Disney Company, organisations thinking about using an international strategy to enter foreign markets must be aware of the four types of distances they will encounter when doing so and determine actions to take to reduce the potentially negative effects associated with those distances.

# Regionalisation

Regionalisation is a second global environmental trend influencing an organisation's choice and use of international strategies. This trend is becoming prominent largely because where an organisation chooses to compete can affect its strategic competitiveness.[64] As a result, the organisation considering using international strategies must decide if it should enter individual country markets or if it would be better served by competing in one or more regional markets rather than in individual country markets. This is also known as a **regiocentric strategy**. The growing popularity of a regiocentric approach almost warrants this being considered along with the 'big three' approaches of ethnocentric, polycentric and glocalisation.

**regiocentric strategy**
strategy based on the belief that the regional people, customs and traditions are best suited to business in that region. This means hiring or promoting staff from, or with knowledge of, that region, and adopting regional processes that apply across multiple countries in the region rather than a single standardised global approach or an individual country approach

Currently, the global (ethnocentric) international strategy is used less frequently. It remains difficult to successfully implement even when the organisation uses internet-based strategies.[65] In addition, the amount of competition vying for a limited amount of resources and customers can limit organisations' focus to a specific region rather than on country-specific markets that are located in multiple parts of the world. A regional (regiocentric) focus allows organisations to marshal their resources to compete effectively rather than spreading their limited resources across multiple country-specific international markets.[66]

However, an organisation that competes in industries where the international markets differ greatly (in which it must employ a multi-domestic strategy) may wish to narrow its focus to a particular region of the world. In so doing, it can better understand the cultures, legal and social norms, and other factors that are important for effective competition in those markets. For example, an organisation may focus on East Asian markets only rather than competing simultaneously in the Middle East, Europe and East Asia. Or the organisation may choose a region of the world where the markets are more similar and some coordination and sharing of resources would be possible. In this way, the organisation may be able not only to better understand the markets in which it competes, but also to achieve some economies, even though it may have to employ a multi-domestic strategy. For instance, research suggests that most large retailers are better at focusing on a particular region rather than being truly global.[67] Organisations commonly focus much of their international market entries on countries adjacent to their home country, which might be referred to as their home region.[68]

Countries that develop trade agreements to increase the economic power of their regions may promote regional strategies. The Association of Southeast Asian Nations (ASEAN) – which includes around 647 million people – the EU and South America's Organization of American States (OAS) are associations of countries that have developed trade agreements to promote the flow of trade across country boundaries within their respective regions.[69] Many European organisations acquire and integrate their businesses in Europe to better coordinate pan-European brands as the EU creates more unity in European markets. With this process likely to continue as new countries join the EU, some international organisations may prefer to focus on regions rather than multiple country markets when entering international markets.

Most organisations enter regional markets sequentially, beginning in markets with which they are more familiar. They also introduce their largest and strongest lines of business into these markets first, followed by other product lines once the initial efforts are deemed successful. The additional product lines typically are introduced in the original investment location.[70] However, research also suggests that the size of the market and industry characteristics can influence this decision.[71]

After selecting its business- and corporate-level international strategies, the organisation determines how it will enter the international markets in which it has chosen to compete. We turn to this topic next.

# Choice of international entry mode

Five modes of entry into international markets are available to organisations. We show these entry modes and their characteristics in Figure 8.5. Each means of market entry has its advantages and disadvantages, suggesting that the choice of entry mode can affect the degree of success the organisation achieves by implementing an international strategy. Large organisations competing in multiple markets commonly use more than one and may use all five entry modes.

## Exporting

For many organisations, exporting is the initial mode of entry used.[72] *Exporting* is an entry mode through which the organisation sends products it produces in its domestic market to international markets. For example, Populous was the 2019 winner of the Australian Exporter of the Year award. The company provides

**Figure 8.5** Modes of entry and their characteristics

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

sport and entertainment venue design. Populous' impressive portfolio includes iconic venues such as Suncorp Stadium in Brisbane, Tottenham Hotspur Stadium in London and Yankee Stadium in New York.[73]

By exporting, organisations avoid the expense of establishing operations in host countries (i.e. in countries outside their home country) in which they have chosen to compete. However, organisations must establish some means of marketing and distributing their products when exporting. Usually, contracts are formed with host-country organisations to handle these activities. Potentially high transportation costs to export products to international markets and the expense of tariffs placed on the organisation's products as a result of host countries' policies are examples of exporting costs. The loss of some control when the organisation contracts with local companies in host countries for marketing and distribution purposes is another disadvantage of exporting. Moreover, contracting with local companies can be expensive, making it harder for the exporting organisation to earn profits.[74] Evidence suggests that, in general, using an international cost leadership strategy when exporting to developed countries has the most positive effect on organisation performance, while using an international differentiation strategy with a larger scale when exporting to emerging economies leads to the greatest amount of success.[75]

Organisations export mostly to countries that are closest to their facilities because of the lower transportation costs and the usually greater similarity between geographic neighbours. For example, around 17 per cent of New Zealand's goods exports and 21 per cent of services exports are to Australia and 29 per cent of its services imports are from Australia.[76] The internet has also made exporting easier. Organisations of any size can use the internet to access critical information about foreign markets, examine a target market, research the competition and find lists of potential customers.[77] Governments also use the internet to support the efforts of those applying for export and import licences, facilitating international trade among countries while doing so.

## Licensing

*Licensing* is an entry mode in which an agreement is formed that allows a foreign company to purchase the right to manufacture and sell an organisation's products within a host country's market or a set of host countries' markets.[78] The licensor is normally paid a royalty on each unit produced and sold. The licensee takes the risks and makes the monetary investments in facilities for manufacturing, marketing and distributing products. As a result, licensing is possibly the least costly form of international diversification. As with exporting, licensing is an attractive entry mode option for smaller organisations, and potentially for newer organisations as well.[79]

China, which accounts for almost one-third of all cigarettes smoked worldwide, is obviously a huge market for this product. Foreign cigarette organisations want to have a strong presence in China but have had trouble entering this market, largely because of successful lobbying by state-owned tobacco organisations against such entry. Because of these conditions, cigarette manufacturer Philip Morris International (PMI) had an incentive to form a deal with these state-owned organisations. Accordingly, PMI and the China National Tobacco Corporation (CNTC) completed a licensing agreement at the end of 2005. This agreement provides CNTC access to the most famous brand in the world, Marlboro.[80] Because it is a licensing agreement rather than a foreign direct investment by PMI, China maintains control of distribution. However, the Chinese state-owned tobacco monopoly, as part of the agreement, also gains PMI's help in distributing its own brands in select foreign markets. The result of this distribution approach for Chinese cigarettes is uncertain though. An analyst made the following observation about this distribution arrangement: 'The question is whether it can pluck three cigarette brands – RGD, Harmony and Dubliss – from relative obscurity and elevate them to an international, or at least regional, presence'.[81] The licence agreement and PMI's future appear to depend on a transition to less harmful product options (assuming that is possible with cigarettes).[82]

Another potential benefit of licensing as an entry mode is the possibility of earning greater returns from product innovations by selling the organisation's innovations in international markets as well as in the domestic market.[83] EDU-Science, a Hong Kong-based manufacturer of educational toys that have a base in science, is doing this through its multiyear licensing agreement with *Scientific American* magazine. *Scientific American*, founded in 1845 and the oldest continuously published magazine in the USA, remains an important science publication. The agreement called for EDU-Science to produce a *Scientific American*-branded toy line ranging from 'Science Fair Projects' to 'How Things Work Today'. Using some of its existing innovative products, in addition to others the organisation may develop, the EDU-Science toys that are part of the *Scientific American* brand are 'distributed internationally and to all retail channels'.[84]

Licensing also has disadvantages. For example, once an organisation licenses its product or brand to another party, it has little control over selling and distribution. Developing licensing agreements that protect the interests of both parties while supporting the relationship embedded within an agreement helps deal with this potential disadvantage.[85] In addition, licensing provides the least potential returns because returns must be shared between the licensor and the licensee. Another disadvantage is that the international organisation may learn the technology of the party with whom it formed an agreement and then produce and sell a similar competitive product after the licensing agreement expires. Komatsu, for example, first licensed much of its technology from International Harvester, Bucyrus-Erie and Cummins Engine to compete against Caterpillar in the earth-moving equipment business. Komatsu then dropped these licences and developed its own products using the technology it had gained from the US companies.[86] Because of potential disadvantages such as those we have discussed, the parties to a licensing arrangement should formally finalise an agreement only after they are convinced that both parties' best interests are protected.

## Strategic alliances

Increasingly popular as an entry mode among organisations using international strategies,[87] a *strategic alliance* finds an organisation collaborating with another company in a different setting in order to enter one or more international markets.[88] Organisations share the risks and the resources required to enter international markets when using strategic alliances.[89] Moreover, because partners bring their unique resources together for the purpose of working collaboratively, strategic alliances can facilitate developing new capabilities and possibly core competencies that may contribute to the organisation's strategic competitiveness.[90] Indeed, developing and learning how to use new capabilities and/or competencies (particularly those related to technology) is often a key purpose for which organisations use strategic alliances as an entry mode.[91] Organisations should be aware that establishing trust between partners is critical for developing and managing technology-based capabilities while using strategic alliances.[92]

French-based Limagrain is the fourth-largest seed company in the world through its subsidiary Vilmorin & Cie. An international agricultural cooperative group specialising in field seeds, vegetable seeds and cereal products, part of Limagrain's strategy calls for it to enter additional international markets. Limagrain is using strategic alliances as an entry mode. The organisation formed a strategic alliance with the Brazilian seed company Sementes Guerra in Brazil. Corn is the focus of the alliance between these companies. Guerra is a family-owned company engaged in seed research, the production of corn, wheat and soybeans, and the distribution of those products to farmers in Brazil and neighbouring countries. Commenting about the purpose of this alliance, a Limagrain official said: 'Our investment in research, combined with Guerra's knowledge of the Brazilian market and its commercial network, will extend the range of varieties [of seeds and corn] proposed to farmers'.[93]

Not all alliances formed for the purpose of entering international markets are successful.[94] Incompatible partners and conflict between the partners are primary reasons for failure when organisations use strategic alliances as an entry mode. Another issue here is that international strategic alliances are especially difficult to manage. Trust is an important aspect of alliances and must be carefully managed. The degree of trust between partners strongly influences alliance success. The probability of alliance success increases as the amount of trust between partners expands. Efforts to build trust are affected by at least four fundamental issues: the initial condition of the relationship, the negotiation process to arrive at an agreement, partner interactions and external events.[95] Trust is also influenced by the country cultures involved in the alliance.[96] Organisations should be aware of these issues when trying to appropriately manage trust.

Research has shown that equity-based alliances over which an organisation has more control are more likely to produce positive returns.[97] (We discuss equity-based and other types of strategic alliances in Chapter 9.) However, if trust is required to develop new capabilities through an alliance, equity positions can serve as a barrier to the necessary relationship building. If conflict in a strategic alliance formed as an entry mode is not manageable, using acquisitions to enter international markets may be a better option.[98]

## Acquisitions

When an organisation acquires another company to enter an international market, it has completed a cross-border acquisition. Specifically, a *cross-border acquisition* is an entry mode through which an organisation from one country acquires a stake in, or purchases all of, an organisation located in another country.

As free trade expands in global markets, organisations throughout the world are completing a larger number of cross-border acquisitions. The ability of cross-border acquisitions to provide rapid access to new markets is a key reason for their growth. In fact, of the five entry modes, acquisitions often are the quickest means for organisations to enter international markets.[99]

Today, there is a broad range of cross-border acquisitions being completed by a diverse set of companies. Increasingly, Chinese companies are acquiring organisations in other nations as a means of entering international markets. LDK Solar Co., with headquarters in Hi-Tech Industrial Park, Xinyu City, Jiangxi province in China, is a leading vertically integrated manufacturer of photovoltaic products as well as a leading manufacturer of solar wafers in terms of capacity. On acquiring 70 per cent of US-based Solar Power Inc. (SPI), which is also a vertically integrated photovoltaic solar developer, LDK Solar's CEO commented, 'This transaction … expands our downstream vertical integration opportunities and provides LDK Solar and SPI the opportunity to jointly explore opening manufacturing operations in the US to further enhance SPI's competitive advantage in North America'.[100] Thus, the expectation was that both organisations would benefit from this transaction.

JA Solar is another Chinese company involved with solar power that is using cross-border acquisitions as an entry mode. One of the world's largest manufacturers of high-performance solar cells and solar power products, JA Solar acquired 100 per cent of Silver Age Holdings, 'a British Virgin Islands company that owns 100 per cent of Solar Silicon Valley Electronic Science and Technology Co. Ltd'.[101] A JA Solar official commented about the expected benefits of this acquisition: 'By boosting JA Solar's internal wafer capacity through this acquisition, we expect to achieve greater economies of scale and improve the company's profitability'.[102]

Interestingly, organisations use cross-border acquisitions less frequently to enter markets where corruption affects business transactions and, hence, the use of international strategies. Organisations' preference is to use joint ventures to enter markets in which corruption is an issue rather than using acquisitions. (Discussed fully in Chapter 9, a joint venture is a type of strategic alliance in which two or more organisations create a legally independent company and share their resources and capabilities to operate it.) However, these ventures fail more often, although this is less frequently the case for organisations experienced with entering 'corrupt' markets. When acquisitions are made in such countries, acquirers commonly pay smaller premiums to buy organisations in different markets.[103]

Although increasingly popular, acquisitions as an entry mode are not without costs, nor are they easy to successfully complete and operate. Cross-border acquisitions carry some of the disadvantages of domestic acquisitions (see Chapter 7). In addition, they often require debt financing to complete, which carries an extra cost. Another issue for organisations to consider is that negotiations for cross-border acquisitions can be exceedingly complex and are generally more complicated than are the negotiations associated with domestic acquisitions. Dealing with the legal and regulatory requirements in the target organisation's country and obtaining appropriate information to negotiate an agreement are also frequent problems.

Finally, the merging of the new organisation into the acquiring organisation is often more complex than is the case with domestic acquisitions. The organisation completing the cross-border acquisition must deal not only with different corporate cultures but also with potentially different social cultures and practices.[104] These differences make integrating the two organisations after the acquisition more challenging; it is difficult to capture the potential synergy when integration is slowed or stymied because of cultural differences.[105] Therefore, while cross-border acquisitions are popular as an entry mode primarily because they provide rapid access to new markets, organisations considering this option should be fully aware of the costs and risks associated with using it.

## New wholly owned subsidiaries

**greenfield venture**
the establishment of a new wholly owned subsidiary

A **greenfield venture** is an entry mode through which an organisation invests directly in another country or market by establishing a new wholly owned subsidiary. The process of creating a greenfield venture is often complex and potentially costly, but this entry mode affords maximum control to the organisation and has the greatest amount of potential to contribute to the organisation's strategic competitiveness as it implements international strategies. This potential is especially true for organisations with strong intangible capabilities that might be leveraged through a greenfield venture.[106] Moreover, having additional control over its operations in a foreign market is especially advantageous when the organisation has proprietary technology.

Research also suggests that 'wholly owned subsidiaries and expatriate staff are preferred' in service industries where 'close contacts with end customers' and 'high levels of professional skills, specialised know-how, and customisation' are required.[107] Other research suggests that as investments, greenfield ventures are used more prominently when the organisation's business relies significantly on the quality of its capital-intensive manufacturing facilities. By contrast, cross-border acquisitions are more likely to be used as an entry mode when an organisation's operations are human capital intensive; for example, if a strong local union and high cultural distance would cause difficulty in transferring knowledge to a host nation through a greenfield venture.[108]

The risks associated with greenfield ventures are significant in that the costs of establishing a new business operation in a new country or market can be substantial. To support the operations of a newly established operation in a foreign country, the organisation may have to acquire knowledge and expertise about the new market by hiring either host-country nationals, possibly from competitors, or through consultants, which can be costly. This new knowledge and expertise often is necessary to facilitate the building of new facilities, establishing distribution networks and learning how to implement marketing strategies that can lead to competitive success in the new market.[109] Importantly, while taking these actions the organisation maintains control over the technology, marketing and distribution of its products. Research also suggests that when the country risk is high, organisations prefer to enter with joint ventures instead of greenfield investments. However, if organisations have previous experience in a country, they prefer to use a wholly owned greenfield venture rather than a joint venture.[110]

The globalisation of the air cargo industry has implications for companies such as United Parcel Service (UPS) and FedEx. The impact of this globalisation is especially pertinent to China and the Asia-Pacific region. China's air cargo market is expected to grow by 11 per cent per year until 2023. Accordingly, UPS and FedEx opened new hub operations in Shanghai and Guangzhou, respectively. These hubs supported the organisations' distribution and logistics business during the Olympics in Beijing in 2008. The investments are wholly owned because these organisations need to maintain the integrity of their IT and logistics systems in order to maximise efficiency. Greenfield ventures also help these two organisations maintain the proprietary nature of their systems.[111]

## Dynamics of mode of entry

Several factors affect the organisation's choice about how to enter international markets. Market entry is often achieved initially through exporting, which requires no foreign manufacturing expertise and investment only in distribution. Licensing can facilitate the product improvements necessary to enter foreign markets, as in the Komatsu example. Strategic alliances are a popular entry mode because they allow an organisation to connect with an experienced partner already in the market. Partly because of this, geographically diversifying organisations often use alliances in uncertain situations, such as an emerging economy where there is significant risk (e.g. Venezuela and Colombia).[112] However, if intellectual property rights in the emerging economy are not well protected, the number of organisations in the industry is growing fast and the need for global integration is high, other entry modes such as a joint venture (see Chapter 9) or a wholly owned subsidiary are preferred.[113] In the final analysis though, all three modes – export, licensing and strategic alliance – can be effective means of initially entering new markets and for developing a presence in those markets.

STRATEGY NOW
Walmart's international growth strategy

Acquisitions, greenfield ventures and sometimes joint ventures are used when organisations want to establish a strong presence in an international market. Aerospace organisations Airbus and Boeing have used joint ventures, especially in large markets, to facilitate entry, while military equipment organisations such as Thales SA have used acquisitions to build a global presence. Japanese vehicle manufacturer Toyota has established a presence in the USA through both greenfield ventures and joint ventures. Because of Toyota's highly efficient manufacturing processes, the organisation wants to maintain control over manufacturing when possible. To date, Toyota has established manufacturing facilities in over 20 countries. Demonstrating the importance of greenfield ventures and joint ventures to Toyota's international diversification strategy is the fact that the organisation opened its first new manufacturing plant in Japan in over 20 years in 2011, whereas a new international plant was opened in Mexico as recently as December 2019.[114] Both acquisitions and greenfield ventures are likely to come at later stages in the development of an organisation's international strategies.

Thus, to enter a global market, an organisation selects the entry mode that is best suited to the situation at hand. In some instances, the various options will be followed sequentially, beginning with exporting and ending with greenfield ventures. In other cases, the organisation may use several, but not all, of the different entry modes, each in different markets. The decision regarding which entry mode to use is primarily a result of the industry's competitive conditions, the country's situation and government policies, and the organisation's unique set of resources, capabilities and core competencies.

The giant US retailer Walmart Stores Inc.'s operations are divided into three divisions: Walmart Stores US, Sam's Club and Walmart International. Through Walmart International, this organisation is diversified geographically and uses several entry modes to enter the international markets it serves. Of course, Walmart uses the international cost leadership business-level strategy and, historically at least, has used the global (ethnocentric) strategy as its international corporate-level strategy.

## Mondelez International: a global leader in snack foods

**Strategic focus** | Globalisation

In 2012, with 80 per cent of its sales in faster-growing international markets, Kraft Foods decided that it needed to split into two separate companies – a North American grocery business and an international snack foods company. The business focused on North America would sell well-known, traditional Kraft brands such as Velveeta, Kraft Macaroni & Cheese, and Oscar Mayer. These goods were profitable despite being low growth. The snack food company would focus on such power brands as Oreo, Cadbury and Ritz. It would also promote local brands tailored to the idiosyncratic needs of local markets.

The snack foods business was named Mondelez by combining two words, *monde* (meaning 'world') and *delez* (a new word meaning 'delicious'), to communicate the meaning of products that are 'world delicious'. The separation into different businesses has allowed each to use its own specialised strategy that best suits its products and markets, and the competitive landscape it faces. Mondelez International is the global market leader in biscuits, chocolate, candy and powdered beverages and holds the number two position in the global markets for chewing gum and coffee. About 45 per cent of its sales come from fast-growing emerging markets. Some of the local brands designed for customers in the emerging markets include Barni (soft biscuits) sold in Russia, Bubbalo (bubble gum) sold in India, Mexico, Portugal and Spain, and Corte Noire (coffee) sold in France, Ireland, Russia, Ukraine and the UK. Mondelez is reinvesting profits into emerging markets seeking more growth.

In the years since Mondelez formed in 2012, sales revenue, net income and assets have declined, particularly in the US. The combined international net revenues for Asia-Pacific, Eastern Europe, Africa, Latin America and the Middle East have grown (excluding the effects of foreign currency valuation changes). Performance was especially strong in the BRIC countries, with double-digit growth. Mondelez is listed on the NASDAQ (as MDLZ), and the share price has more than doubled from US$23 in 2012 to US$52 in 2020.

Despite its success in the emerging markets and several international acquisitions, Mondelez's revenue and net income has declined recently due to lower coffee prices and a reduction in demand for chewing gum and candy. The CEO and other top executives suggested that volatility in global markets also has affected the organisation's results. These are problems experienced by most of the companies that enter and compete in global markets. Without its international presence, Mondelez would be relying on US domestic performance alone, and would be unlikely to have the same share price growth.

Sources: Mondelez International, 2020, Reporting first quarter 2020 earnings, http://www.mondelezinternational.com, 7 June; Mondelez Investor Relations, 2020, *Mondelēz International Reports 2018 Results*, https://ir.mondelezinternational.com/news-releases/news-release-details/mondelez-international-reports-2018-results, 7 June; N. Munshi, 2013, Mondelez targets emerging markets growth, *Financial Times*, http://www.ft.com, 7 May; D. Gelles, D. McCrum & N. Munshi, Activists hope to profit when cookie crumbles, *Financial Times*, http://www.ft.com, 14 April; 2013, Kraft and Mondelez: Snacks and snags, *Financial Times*, http://www.ft.com, 8 April; S. Strom, 2012, For Oreo, Cadbury and Ritz, a new parent company, *New York Times*, http://www.nytimes.com, 23 May; 2012, Kraft Foods proposes Mondelez International Inc. as new name for global snacks company, *PR Newswire*, http://www.printthis.clickability.com, 21 March; M. J. de la Merced, 2012, Kraft, 'Mondelez' and the art of corporate rebranding, *New York Times Dealbook*, http://dealbook.nytimes.com, 21 March.

STRATEGY NOW

Mondelez International

# Risks in an international environment

International strategies are risky, particularly those that would cause an organisation to become substantially more diversified in terms of the geographic markets served. Political and economic risks cannot be ignored by organisations using international strategies (see specific examples of political and economic risks in Figure 8.6).

## Political risks

Political risks 'denote the probability of disruption of the operations of multinational enterprises by political forces or events whether they occur in host countries, home country, or result from changes in the international environment'.[115] Possible disruptions to an organisation's operations when seeking to implement its international strategy create numerous problems, including uncertainty created by government regulation, the existence of many (possibly conflicting) legal authorities or corruption, and the potential nationalisation of private assets.[116] Organisations investing in other countries when implementing their international strategy may have concerns about the stability of the national government and the effects of unrest and government instability on their investments or assets.[117] To deal with these concerns, organisations should conduct a political risk analysis of the countries or regions they may enter using one of the five entry modes. Through political risk analysis, the organisation examines potential sources and factors of non-commercial disruptions of their foreign investments and the operations flowing from them.[118]

Russia has experienced a relatively high level of institutional instability in the years following its transition to a more democratic government. Decentralised political control and frequent changes in policies created chaos for many, but especially for those in the business landscape. In an effort to regain more central control and reduce the chaos, Russian leaders took actions such as prosecuting powerful private

**Figure 8.6** **Risks in the international environment**

| | |
|---|---|
| **Risks** | • Political<br>• Economic |
| **Political** | • China's use of economic and trade power to achieve political objectives<br>• Global military engagements (e.g. Afghanistan, Syria)<br>• Nationalist and protectionist political trends<br>• Shifts in the geopolitical power balance causing uncertainty and conflict<br>• Regions with political instability (e.g. Middle East, South China Sea)<br>• Social disruption due to political changes (e.g. Hong Kong) |
| **Economic** | • Economic impact of climate change and extreme weather events<br>• Cyber security threats and incidents<br>• Economic impacts of Covid-19 pandemic<br>• Disruption to global supply chains<br>• High national debt of various regions and countries<br>• Trade disputes, tariffs and trade protectionism<br>• Failure of countries to pay debt obligations<br>• Economic impacts of terrorism<br>• Currency and exchange rate fluctuations |

organisation executives, seeking to gain state control of organisation assets and not approving some foreign acquisitions of Russian businesses. The initial institutional instability, followed by the actions of the central government, caused some organisations to delay or avoid significant foreign direct investment in Russia. Although leaders in Russia have tried to reassure potential investors about their property rights, prior actions, the fact that other laws (e.g. environmental and employee laws) are weak, and commonplace government corruption make organisations wary of investing in Russia.[119]

## Economic risks

Economic risks include fundamental weaknesses in a country's or region's economy with the potential to cause adverse effects on organisations' efforts to successfully implement their international strategies. As illustrated in the example of Russian institutional instability and property rights, political risks and economic risks are interdependent. If organisations cannot protect their intellectual property, they are highly unlikely to use a means of entering a foreign market that involves significant and direct investments. Therefore, countries need to create, sustain and enforce strong intellectual property rights in order to attract foreign direct investment.

Another economic risk is the perceived security risk of a foreign organisation acquiring organisations that have key natural resources or organisations that may be considered strategic in regard to intellectual property. For instance, many Chinese organisations have been buying natural resource organisations in Australia and Latin America as well as manufacturing assets in the USA. This has made the governments of the key resource organisations nervous about such strategic assets falling under the control of state-owned Chinese organisations.[120] Terrorism has also been of concern. Indonesia, for example, has difficulty competing for investment against China and India, countries that are viewed as having fewer security risks.

As noted earlier, the differences and fluctuations in the value of currencies are among the foremost economic risks of using an international strategy.[121] This is especially true if the level of the organisation's geographic diversification increases to the point where the organisation is trading in a large number of currencies. The value of the local currency relative to other currencies determines the value of the international assets and earnings of organisations. An increase in the value of the dollar can harm an organisation's exports to international markets because of the price differential of the products. Thus, government oversight and control of economic and financial capital in a country affect not only local economic activity but also foreign investments in the country. Certainly, the significant political and policy changes in Eastern Europe since the early 1990s have stimulated much more foreign direct investment there.[122]

# The challenge of international strategies

Effectively using international strategies creates basic benefits and contributes to the organisation's strategic competitiveness. However, for several reasons, attaining these positive outcomes is difficult.

## Managing international strategies: size and complexity

Pursuing international strategies, particularly an international diversification strategy, typically leads to growth in an organisation's size and the complexity of its operations. In turn, larger size and greater operational complexity make an organisation more difficult to manage. At some point, size and complexity either cause organisations to become virtually unmanageable or increase the cost of their management beyond the value that using international strategies creates. Different cultures and institutional practices (such as those associated with governmental agencies) that are part of the countries in which an organisation competes when using an international strategy also can create difficulties.[123]

Toyota's experiences over the past decade appear to demonstrate the relationship between organisation size and managerial complexity. Toyota became the world's largest car manufacturer at the end of 2008, surpassing General Motors (GM had been the largest automobile manufacturer for 77 years). As is always the case, however, larger size makes an organisation harder to manage successfully. In spite of its legendary focus on and reputation for quality, Toyota experienced product quality problems, particularly in the all-important US market, after becoming the world's largest manufacturer. Perhaps the increased difficulty of managing a larger organisation contributed to Toyota's product quality problems. However, Toyota recovered from these difficulties and continues seeking additional growth through its international strategy. Saying that 'India is an integral part of [the organisation's] global growth strategy', Toyota introduced the Etios Liva as a competitor in India's small car market. From 2012 to 2020, Toyota sold more than 10 million vehicles per year.[124]

Interestingly, Volkswagen-Porsche has replaced Toyota as the world's largest car and truck manufacturer. Highly diversified, this company's portfolio of passenger cars includes Audi, Bentley, Bugatti, Lamborghini, SEAT and Skoda, in addition to Porsche and VW. Time will tell if this organisation is now of a size and complexity level that will make it difficult to successfully manage its international strategies.

The VW emissions scandal that was uncovered in the USA in 2015 has affected all VW diesel sales. In what has been called the 'diesel dupe' or 'dieselgate', the US Environmental Protection Agency (EPA) found that many VW cars being sold in America had a 'defeat device' in diesel engines, or hidden software, that could detect when they were being tested, and then change the performance to improve emission results. On the road, the engines then went back to greater emissions than the standard. The German car giant has since admitted cheating these tests. Volkswagen took a €16.2 billion hit to its 2015 results and slashed its dividend to help pay for the emissions-test cheating scandal. There have also been impacts on other car companies, with a regulatory clampdown on other German-based automakers, including Mercedes-Benz and Opel, agreeing to recall a total of 630 000 cars to fix diesel-engine technology blamed for high pollution. VW has already agreed a settlement with US authorities to buy back or fix about half a million cars fitted with illegal test-fixing software, and has also set up environmental and consumer compensation funds. These consumer compensation funds have been put to active use with substantial fines and payouts to VW owners in various countries. In 2019, VW settled two major class actions with Australian VW owners for between A$87 million and A$147 million. In 2020, Canadian prosecutors proposed a fine of C$196 million, and the UK High Court ruled that VW software was a 'defeat device' under EU rules. Globally, the scandal had cost VW over €30 billion in fines, penalties, payouts and buybacks by 2020.[125]

## Limits to international expansion

Learning how to effectively manage an international strategy improves the likelihood of achieving positive outcomes such as enhanced performance. However, at some point the degree of geographic and (possibly) product diversification the organisation's international strategies bring about causes the returns from using the strategies to level off and eventually become negative.[126]

There are several reasons that explain the limits to the positive effects of the diversification associated with international strategies. First, greater geographic dispersion across country borders increases the costs of coordination between units and the distribution of products. Second, trade barriers, logistical costs, cultural diversity and other differences by country (e.g. access to raw materials and different employee skill levels) greatly complicate the implementation of an international strategy.

Institutional and cultural factors can be strong barriers to the transfer of an organisation's core competencies from one market to another. Marketing programs often have to be redesigned and new distribution networks established when organisations expand into new markets. In addition, organisations may encounter different labour costs and capital expenses. In general, it becomes increasingly difficult to effectively implement, manage and control an organisation's international operations with increases in geographic diversity.

The amount of diversification in an organisation's international operations that can be managed varies from company to company and is affected by managers' abilities to deal with ambiguity and complexity. The problems of central coordination and integration are mitigated if the organisation's international operations find it competing in friendly countries that are geographically close and have cultures similar to its own country's culture. In that case, the organisation is likely to encounter fewer trade barriers, the laws and customs are better understood, and the product is easier to adapt to local markets.[127]

Relationships between the organisation using an international strategy and the governments in the countries in which the organisation is competing can also be constraining.[128] The reason for this is that the differences in host countries' governmental policies and practices can be substantial, creating a need for the focal organisation to learn how to manage what can be a large set of different enforcement policies and practices. At some point, the differences create too many problems for the organisation to be successful. Using strategic alliances is another way organisations can deal with this limiting factor. Partnering with companies in different countries allows the focal organisation to rely on its partner to help deal with local laws, rules, regulations and customs. But these partnerships are not risk free and managing them tends to be difficult.[129]

The Mexican organisation FEMSA, detailed in the 'Strategic focus' feature, demonstrates how international expansion can benefit an organisation. It also shows how organisations need to be aware of regional economic and political differences.

### Mexico's FEMSA: building its international prowess

**Strategic focus** | General

Fomento Economico Mexicano SAB de CV (FEMSA) has a market capitalisation of US$39.02 billion. It has more than 180 000 employees and is a major competitor in the beverage industry, convenience stores and drugstores/pharmacies. In fact, Coca-Cola FEMSA SAB is the largest bottler of Coke not only in Latin America but in the entire world. In 2013, it continued to add to its strength in this business with the purchase of a regional bottler, Grupo Yoli, which was the largest soft drink bottler in southern Mexico. In 2008, FEMSA decided to expand its convenience store chain, Oxxo, to other countries outside of Mexico. It now operates more than 10 600 stores in Mexico and Colombia. In 2012, it opened 1040 new stores, which amounts to almost three per day. Oxxo is the largest and fastest-growing chain of convenience stores in Latin America.

Until 2010, FEMSA was a major beer producer in Mexico, with operations in Brazil (which it entered through the acquisition of Kaiser Brewery) as well. However, Heineken acquired the FEMSA brewery business at that time. Yet because the sale involved an exchange of equity, FEMSA now holds 20 per cent of the equity in the Heineken Group (the second-largest equity stake in this company).

Although FEMSA continues to promote organic growth, most of its major advances in size have come from acquisitions. For example, in 2013 FEMSA made its first foray outside of Latin America. It acquired a 51 per cent stake (controlling interest) in Coca-Cola's bottling operations in the Philippines. It now has operations in nine countries, including eight in Latin America. In 2013, it also expanded its drugstore/pharmacy chain with the acquisition by its retail subsidiary, FEMSA Comercio, of Farmacias FM Moderno. At the time of its acquisition, Farmacias FM Moderno operated more than 100 stores in Mexico's western state of Sinaloa.

Therefore, FEMSA is a multibillion-dollar business that has used its stash of cash to build substantial growth through acquisitions. It has expanded its presence in Mexico but also in all of the economies in Latin America (e.g. Brazil, Argentina, Colombia, Guatemala, Ecuador, Uruguay, Chile and Venezuela).

Sources: FEMSA, 2020, Strategic business, http://femsa.com/en; FEMSA, 2020, Our history, https://www.femsa.com/en/about-femsa/our-history, 7 June; *New York Times*, 2013, Fomento Economico Mexicano SAB de CV, DealBook, http://dealbook.on.nytimes.com, 16 May; E. Garcis, 2013, Mexico's FEMSA: From convenience stores to pharmacies, *Financial Times*, http://blogs.ft.com, 15 May; Zacks Equity Research, 2013, FEMSA expands drugstore chain, http://finance.yahoo.com, 14 May; *Market Wire*, 2013, FEMSA announces acquisition of Farmacias FM Moderno, http://www.nbcnews.com, 13 May; B. Case, 2013, Coca-Cola FEMSA expands with $700 million Yoli purchase, *Bloomberg Businessweek*, http://www.businessweek.com, 18 January; A. Thomson, 2012, Mexico's FEMSA eyes Coca-Cola's Philippines unit, *Financial Times*, http://blogs.ft.com, 21 February; M. J. de la Merced & C. V. Nicholson, 2010, Heineken in deal to buy a big Mexican brewer, *New York Times*, http://www.nytimes.com, 12 January; D. D. Stanford & T. Black, 2008, Mexico's Oxxo convenience stores to branch out, *Houston Chronicle*, http://www.chron.com, 22 February.

# Strategic competitiveness outcomes

As previously discussed, international strategies can result in three basic benefits (increased market size, economies of scale and learning, and location advantages) for organisations. These basic benefits are gained when the organisation successfully manages political and economic risks while implementing its international strategies; in turn, these benefits are critical to the organisation's efforts to achieve strategic competitiveness (as measured by improved performance and enhanced innovation – see Figure 8.1). Overall, the degree to which organisations achieve strategic competitiveness through international strategies is expanded or increased when they successfully implement an international diversification strategy. As an extension or elaboration of international strategy, an **international diversification strategy** is a strategy through which an organisation expands the sales of its goods or services across the borders of global regions and countries into a potentially large number of geographic locations or markets. Instead of entering one or just a few markets, the international diversification strategy finds organisations using international business-level and international corporate-level strategies for the purpose of entering multiple regions and markets in order to sell their products.

**international diversification strategy**
a strategy through which an organisation expands the sales of its goods or services across the borders of global regions and countries into different geographic locations or markets

## International diversification and returns

Evidence suggests numerous reasons for organisations to use an international diversification strategy,[130] meaning that international diversification should be related positively to organisations' performance as measured by the returns they earn on their investments. Research has shown that as international diversification increases, an organisation's returns decrease initially but then increase quickly as it learns how to manage the increased geographic diversification it has created.[131] In fact, the stock market is particularly sensitive to investments in international markets. Organisations that are broadly diversified into multiple international markets usually achieve the most positive stock returns, especially when they diversify geographically into core business areas.[132]

Many factors contribute to the positive effects of international diversification, such as private versus government ownership, potential economies of scale and experience, location advantages, increased market size and the opportunity to stabilise returns. The stabilisation of returns helps reduce an organisation's overall risk.[133] Large, well-established organisations and entrepreneurial ventures can both achieve these positive outcomes by successfully implementing an international diversification strategy.

Based in Tokyo, Asahi Group Holdings Ltd is a Japanese global beer, spirits, soft drinks and food business group. Asahi has used an international diversification strategy as it acquires companies in foreign markets. Anheuser-Busch InBev (InBev) sold its Dutch business Grolsch Brewery, Italian business Peroni Brewery and the UK's craft Meantime Brewery and Miller Brands UK to Asahi for €2.3 billion in 2016.[134] Asahi has acquired all or part of companies in Australia, New Zealand and China, and plans to acquire companies in other markets in the years to come for the purpose of expanding its geographic scope, strengthening its product portfolio and gaining economies of scale, particularly in supply chain management.

## Enhanced innovation

In Chapter 1, we indicated that developing new technology is at the heart of strategic competitiveness. As noted in our discussion of the determinants of national advantage (see Figure 8.3), a nation's competitiveness depends, in part, on the capacity of its industries to innovate. Eventually and inevitably, competitors outperform organisations that fail to innovate. Therefore, the only way for individual nations and individual organisations to sustain a competitive advantage is to upgrade it continually through innovation.[135]

An international diversification strategy and the geographic diversification it brings about create the potential for organisations to achieve greater returns on their innovations (through larger or more numerous markets) while reducing the often substantial risks of R&D investments. Additionally, international diversification may be necessary to generate the resources required to sustain a large-scale R&D operation. An environment of rapid technological obsolescence makes it difficult to invest in new technology and the capital-intensive operations necessary to compete in such an environment. Organisations operating solely in domestic markets may find such investments difficult because of the length of time required to recoup the original investment. However, diversifying into a number of international markets improves an organisation's ability to achieve additional returns from innovation before competitors can overcome the initial competitive advantage created by the innovation. In addition, organisations moving into international markets are exposed to new products and processes. If they learn about those products and processes and integrate this knowledge into their operations, further innovation can be developed. To incorporate the learning into their own R&D processes, organisations must manage those processes effectively in order to absorb and use the new knowledge to create further innovations.[136] For a number of reasons then, international strategies and certainly an international diversification strategy provide incentives for organisations to innovate.[137]

The relationship among international geographic diversification, innovation and returns is complex. Some level of performance is necessary to provide the resources the organisation needs to diversify geographically; in turn, geographic diversification provides incentives and resources to invest in R&D. Effective R&D should enhance the organisation's returns, which then provide more resources for continued geographic diversification and investment in R&D. Of course, the returns generated from these relationships increase through effective managerial practices. Evidence suggests that more culturally diverse top management teams often have a greater knowledge of international markets and their idiosyncrasies, but their orientation to expand internationally can be affected by the nature of their compensation.[138] Moreover, managing the business units of a geographically diverse multinational organisation requires skill, not only in managing a decentralised set of businesses but also in coordinating diverse points of view emerging from businesses located in different countries and regions. Organisations able to do this increase the likelihood of outperforming their rivals.[139]


Japan's Asahi Group Holdings Ltd seeks to become one of the world's top 10 food and beverage companies. It includes alcoholic beverages, soft drinks, infant formulas, dietary supplements, soups and confectionery in its portfolio.

Source: Alamy Stock Photo/ © Lenscap

# STUDY TOOLS

## SUMMARY

**LO1** The use of international strategies is increasing. When used effectively, international strategies yield three basic benefits (increased market size, economies of scale and learning, and location advantages) that facilitate the organisation's efforts to achieve strategic competitiveness.

**LO2** International business-level strategies are usually grounded in one or more home-country advantages. Research suggests that there are four determinants of national advantage: factors of production; demand conditions; related and supporting industries; and patterns of organisation strategy, structure and rivalry.

**LO3** There are three main types of international corporate-level strategies. (1) A multi-domestic strategy (polycentric strategy) focuses on competition within each country in which the organisation competes. Organisations using a multi-domestic strategy decentralise strategic and operating decisions to the business units operating in each country, so that each unit can tailor its products and processes to local conditions. (2) A global strategy (ethnocentric strategy) assumes more standardisation of products across country boundaries; therefore, a competitive strategy is centralised and controlled by the home office. Commonly, large multinational organisations, particularly those with multiple diverse products being sold in many different markets, use a multi-domestic strategy with some product lines and a global strategy with others. (3) A transnational strategy ('glocalisation' strategy) seeks to integrate characteristics of both global and multi-domestic strategies for the purpose of being able to simultaneously emphasise global integration and local responsiveness.

**LO4** Two global environmental trends – liability of foreignness and regionalisation – influence organisations' choices of international strategies as well as their implementation. Liability of foreignness challenges organisations to recognise that four types of distance between their domestic market and international markets affect how they compete. Some organisations choose to concentrate their international strategies on regions (e.g. the EU and the North American Free Trade Agreement zone) rather than on individual country markets.

**LO5** Organisations can use one or more of five entry modes to enter international markets: exporting, licensing, strategic alliances, acquisitions and new wholly owned subsidiaries (often referred to as greenfield ventures). Most organisations begin with exporting or licensing, because of their lower costs and risks, but later they might use strategic alliances and acquisitions as well. The most expensive and risky means of entering a new international market is establishing a new wholly owned subsidiary, but it can offer maximum control and greater returns if successful.

**LO6** Organisations encounter a number of risks when implementing international strategies. The two major categories of risks organisations need to understand and address when diversifying geographically through international strategies are political risks (risks concerned with the probability an organisation's operations will be disrupted by political forces or events, whether they occur in the organisation's domestic market or in the markets the organisation has entered to implement its international strategies) and economic risks (risks resulting from fundamental weaknesses in a country's or a region's economy with the potential to adversely affect an organisation's ability to implement its international strategies).

**LO7** Several issues or conditions affect an organisation's use of international strategies to pursue strategic competitiveness. Some limits also constrain the ability to manage international expansion effectively. International diversification increases coordination and distribution costs, and management problems are exacerbated by trade barriers, logistical costs and cultural diversity, among other factors.

**LO8** Successful use of international strategies (especially an international diversification strategy) contributes to an organisation's strategic competitiveness in the form of improved performance and enhanced innovation. International diversification facilitates innovation in an organisation because it provides a larger market to gain greater and faster returns from investments in R&D and innovation. Effectively implemented and well-managed international diversification can generate the resources, economies of scope and learning necessary to generate and sustain improved performance.

## KEY TERMS

ethnocentric strategy
global strategy
'glocalisation' strategy
greenfield venture
international diversification strategy
international strategy
multi-domestic strategy
polycentric strategy
regiocentric strategy
transnational strategy

## REVIEW QUESTIONS

1. What incentives influence organisations to use international strategies?
2. What are some examples of global markets being unstable and unpredictable?
3. What are the three basic benefits organisations can achieve by successfully using an international strategy?
4. What four factors are determinants of national advantage and serve as a basis for international business-level strategies?
5. What are the three main international corporate-level strategies? What are the advantages and disadvantages associated with these individual strategies? Which alternative is emerging as a potential fourth international corporate-level strategy?
6. What are some global environmental trends affecting the choice of international strategies, particularly international corporate-level strategies?
7. What five entry modes do organisations consider as paths to use to enter international markets? What is the typical sequence in which organisations use these entry modes?
8. What are political risks and what are economic risks? How should organisations approach dealing with these risks?
9. What are two important issues that can potentially affect an organisation's ability to successfully use international strategies?
10. What are the strategic competitiveness outcomes organisations can reach through international strategies, and particularly through an international diversification strategy?

## EXPERIENTIAL EXERCISES

### Exercise 1: Multi-domestic or transnational strategy?

McDonald's is one of the world's best-known brands: The company has approximately 38 000 restaurants located in more than 117 countries, and serves 69 million customers *every day*. McDonald's opened its first international restaurant in Japan in 1971. Its 'golden arches' are featured prominently in two former bastions of communism: Pushkin Square in Moscow, Russia, and Tiananmen Square in Beijing, China.

What strategy has McDonald's used to achieve such visibility? For this exercise, each group will be asked to conduct some background research on the organisation and then make a brief presentation to identify the international strategy (i.e. global, multi-domestic or transnational) that McDonald's is implementing.

### Individual

Search the internet to find examples of menu variations in different countries. How much do menu items for a McDonald's restaurant differ across regions?

### Group

Review the characteristics of global, multi-domestic and transnational strategies. Conduct additional research to assess the strategy that best describes the one McDonald's is using. Prepare a flip chart with a single page of bullet points to explain your reasoning.

### Whole class

Each group should have 5–7 minutes to explain its reasoning. Following a Q&A for each group, each class member should vote for his or her respective strategy choice.

### Exercise 2: Where next?

In this exercise, you are to consider your team to be a consultant to a multinational fast-food restaurant company that is trying to increase its international exposure in the coming years. As you recall from the chapter, an international strategy is one in which 'the organisation sells its goods or services outside its domestic market'. The choices to do so are varied and include exporting, licensing, alliance, acquisition and creating a new wholly owned subsidiary. The reasons are just as varied as the entry modes.

To identify a suitable candidate for analysis, consult research databases such as Datamonitor or Business Source Complete. For example, Jack in the Box operates over 2700 units but they are all in the USA, which provides advantages as well as disadvantages. Compare this with McDonald's, the world's largest food-service retailing chain. You will also find SWOT (strengths, weaknesses, opportunities and threats) analysis on companies through databases such as those mentioned above.

Your consulting organisation has been retained by the fast-food retailer to investigate the feasibility of expanding internationally. You should be prepared to address the following questions:

1. Which international location(s) seem to fit best based on your research?
2. Which entry mode seems the most reasonable for the organisations to use?
3. What macro environmental and industry trends support your recommendations? Economic characteristics include gross national product, wages, unemployment and inflation. Trend analysis of these data (e.g. are wages rising or falling, rate of change in wages, etc.) is preferable to single point-in-time snapshots.
4. What country risks seem most problematic? The following additional internet resources may be useful in your research:
   - The Library of Congress has a collection of country studies.
   - *BBC News* offers country profiles.
   - The *Economist Intelligence Unit* (http://www.eiu.com) offers country profiles.
   - Both the United Nations and International Monetary Fund provide statistics and research reports.
   - The *CIA World Factbook* has profiles of different regions.
   - The *Global Entrepreneurship Monitor* provides reports with detailed information about economic conditions and social aspects for a number of countries.
   - Links can be found at http://www.countryrisk.com to a number of resources that assess both political and economic risk for individual countries.
   - For US data, see http://www.census.gov.
   Be prepared to discuss and defend your recommendations in class.

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CHAPTER 9

# Cooperative strategy

## Learning Objectives

Studying this chapter should provide you with the strategic management knowledge needed to:

**LO1** define cooperative strategies and explain why organisations use them

**LO2** define and discuss the three major types of strategic alliances

**LO3** understand that collusive and other types of competition-reducing strategies are deemed illegal and opposed by many governments around the world

**LO4** name the four main business-level cooperative strategies and describe their use

**LO5** discuss the use of corporate-level cooperative strategies in diversified organisations

**LO6** understand the importance of cross-border strategic alliances as an international cooperative strategy

**LO7** understand that some organisations use a network cooperative strategy where several organisations agree to form multiple partnerships

**LO8** understand the high probability of failure in cooperative strategies and explain cooperative strategies' risks

**LO9** describe cost minimisation and opportunity maximisation as key approaches used to manage cooperative strategies.

# OPENING CASE STUDY

## Global cars, with a twist

The academic literature on alliances has some interesting findings. One of these findings is the rationale that because organisations are often located in the same country, and often in the same region of the country, it is easier for them to collaborate on major projects. As such, they compete globally but may cooperate locally. Historically, organisations have learned to collaborate by establishing strategic alliances and forming cooperative strategies when there is intensive competition. This interesting paradox is due to several reasons. First, when there is intense rivalry, it is difficult to maintain market power. As such, cooperative strategy can reduce market power through better norms of competition; this pertains to the idea of *mutual forbearance* (this idea will be discussed later in the chapter). Another rationale that has emerged is based on the resource-based view of the organisation (see Chapter 3). To compete, organisations often need resources that they don't have but which may be found in other organisations in or outside the focal organisation's home industry. As such, these 'complementary resources' are another rationale for why large organisations form joint ventures and strategic alliances within the same industry or in vertically related industries (this idea also will be more clearly explained later in the chapter).

Because organisations are co-located and have similar needs, it is easier for them to jointly work together; for example, to produce engines and transmissions as part of the power train. This is evident in the European alliance between Peugeot-Citroën and Opel-Vauxhall (owned by General Motors). It is also the reason for the US alliance between Ford and General Motors to develop upgraded nine- and 10-speed transmissions, as well as 11- and 12-speed automatic transmissions to improve fuel efficiency and help them to meet federal guidelines.

In regard to resource complementarity, a very successful alliance was formed in 1999 by French-based Renault and Japan-based Nissan. Each of these organisations lacked the necessary size to develop economies of scale and economies of scope that were critical to succeed in the 1990s and beyond in the global automobile industry. When the alliance was formed, each organisation took an ownership stake in the other. The larger of the two companies, Renault, holds a 43.3 per cent stake in Nissan, while Nissan has a 15 per cent stake in Renault. It is interesting to note that the two companies shared a joint CEO until 2017. The alliance changed its name to Renault–Nissan–Mitsubishi in 2017, a year after Nissan acquired a controlling interest in Mitsubishi. Over time, this corporate-level synergistic alliance (we discuss this type of alliance later in the chapter) has developed three values to guide the relationship: (1) *trust* (work fairly, impartially and professionally), (2) *respect* (honour commitments, liabilities and responsibilities) and (3) *transparency* (be open, frank and clear). Largely due to these established principles, the Renault–Nissan–Mitsubishi alliance is a recognised success. One could argue that the main reason for the success of this alliance is the complementary assets that the organisations bring to the alliance; Nissan and Mitsubishi are strong in Asia while Renault is strong in Europe. Together they have been able to establish other production locations, such as those in Latin America, which they may not have obtained independently.

Some organisations enter alliances because they are 'squeezed in the middle'; that is, they have moderate volumes, mostly for the mass market, but need to collaborate to establish viable economies of scale. For example, Fiat-Chrysler needs to boost its annual sales from US$4.3 billion to something like US$6 billion and likewise needs to strengthen its presence in the booming Asian market to have enough global market power. As such, it is entering joint ventures with two undersized Japanese carmakers, Mazda and Suzuki; however, the past history of Mazda and Suzuki with alliances may be a reason for their not being overly enthusiastic about the prospects of the current alliances. Fiat broke up with GM, Chrysler with Daimler, and Mazda with Ford.

In France, Peugeot-Citroën and Opel-Vauxhall had an agreement to share platforms and engines to raise the capital necessary for investment in future models. As in the previous examples, they needed additional market share, but also enough capital to make the investment necessary to realise more market power to compete. This agreement evolved into an equity alliance with the formation of Groupe PSA (Peugeot Société Anonyme), which owns Peugeot, Citroën, DS, Opel and Vauxhall. Fiat Chrysler and Groupe PSA have signed a binding merger agreement, solidifying a US$73 billion deal that will create the world's third- or fourth-largest automaker.

In summary, there are a number of rationales why competitors not only compete but also cooperate in establishing strategic alliances and joint ventures in order to meet strategic needs for increased market power, take advantage of complementary assets, and cooperate with close neighbours, often in the same region of the country.

Sources: Renault–Nissan–Mitsubishi, 2020, A global automotive alliance founded in 1999, https://www.alliance-2022.com/about-us, 8 June; C. Barry, 2019, The $73b company with no name: Fiat Chrysler, Peugeot seal merger, *Sydney Morning Herald*, https://www.smh.com.au/business/companies/fiat-chrysler-peugeot-merge-to-create-73b-car-giant-20191219-p53lcg.html, 19 December; C. Riley, 2019, Fiat Chrysler and Peugeot owner agree deal to create world's third largest automaker, https://edition.cnn.com/2019/12/18/business/fiat-chrysler-peugeot/index.html, *CNN Business*, 18 December; PSA Groupe Media Centre, 2017, Opel/Vauxhall to join PSA Group, https://web.archive.org/web/20170306210707/http://media.groupe-psa.com/en/press-releases/group/opelvauxhall-join-psa-group, 6 March; *Economist*, 2013, Markets and makers: Running harder, 20 April, ss4–ss7; T. Yu, M. Subramaniam & A. A. Cannella, Jr, 2013, Competing globally, allying locally: Alliances between global rivals and host-country factors, *Journal of International Business Studies*, 44: 117–37; W. Lim, 2012, The voyage of the Renault–Nissan Alliance: A successful venture, *Advances In Management*, 5(9): 25–9.

STRATEGY NOW

The Renault–Nissan–Mitsubishi strategic alliance

**cooperative strategy**
a strategy in which organisations work together to achieve a shared objective

As explained in the opening case, car companies have formed corporate-level cooperative strategies as a means of improving performance. Additionally, each company is independently using a number of cooperative strategies at the business-unit level with the same objective in mind: to improve the performance of the individual organisations. In all of these instances, the organisations are trying to use their resources and capabilities in ways that will create the greatest amount of value for stakeholders.[1]

Forming a cooperative strategy like the 1999 one between Renault and Nissan (which from 2017 has also included Mitsubishi), or between other global automobile companies (e.g. between Fiat Chrysler and Groupe PSA in 2019),[2] has the potential to be a viable engine of organisation growth.[3] Specifically, a **cooperative strategy** is a means by which organisations collaborate for the purpose of working together to achieve a shared objective.[4] Cooperating with other organisations is a strategy organisations use to create value for a customer that it likely could not create by itself. For example, in describing a Fiat-designed and developed compact car that Chrysler builds and sells in the USA under its own name, an automobile industry analyst said that a product such as this is 'why the two auto makers … have a relationship'.[5]

Organisations also try to create competitive advantages when using a cooperative strategy. A competitive advantage developed through a cooperative strategy often is called a *collaborative* or *relational* advantage,[6] denoting that the relationship that develops among collaborating partners is commonly the basis on which a competitive advantage is built. Importantly, successful use of cooperative strategies finds an organisation outperforming its rivals in terms of strategic competitiveness and above-average returns,[7] often because they've been able to form a competitive advantage.

We examine several topics in this chapter. First, we define and offer examples of different strategic alliances as primary types of cooperative strategies. We focus on strategic alliances because organisations use them more frequently than other types of cooperative relationships. We highlight that not all cooperative strategies are welcome, and that collusive strategies designed to reduce competition are deemed illegal. Next, we discuss the extensive use of cooperative strategies in the global economy and reasons for their use. In succession, we describe business-level, corporate-level, international and network cooperative strategies. The chapter closes with a discussion of the risks of using cooperative strategies as well as how effectively managing the strategies can reduce those risks.

# Strategic alliances as a primary type of cooperative strategy

**strategic alliance**
a cooperative strategy in which organisations combine some of their resources and capabilities to create a competitive advantage

A **strategic alliance** is a cooperative strategy in which organisations combine some of their resources and capabilities for the purpose of creating a competitive advantage.[8] Strategic alliances involve organisations with some degree of exchange and sharing of resources and capabilities to co-develop, sell and service goods or services.[9] In addition, organisations use strategic alliances to leverage their existing resources and capabilities while working with partners to develop additional resources and capabilities as the foundation for new competitive advantages.[10] The reality today is that 'strategic alliances have become a cornerstone of many firms' competitive strategy'.[11] This means that for many organisations, and particularly for large global competitors, strategic alliances are potentially many in number but are always important to efforts to outperform competitors.

Consider the case of BMW Group. Focusing exclusively on premium products (its entry car is the Mini), this organisation uses an international focused differentiation business-level strategy (see Chapter 8) to sell its cars, trucks and motorcycles in multiple geographic regions. According to the company's CEO, this organisation relies in part on a host of strategic alliances 'to further shape (BMW's) future, which involves topics such as technology leadership'.[12] Among BMW Group's current alliances are: a purchasing cooperation with Daimler AG; a joint venture with the SGL Group to produce carbon fibres (SGL Group is one of the world's leading producers of carbon-based products); and a joint venture with Groupe PSA (BMW Peugeot Citroën Electrification) to produce four-cylinder engines and hybrid components.

Before describing three types of major strategic alliances and reasons for their use, we need to note that for all cooperative strategies, success is more likely when partners behave cooperatively. Actively solving problems, being trustworthy and consistently pursuing ways to combine partners' resources and capabilities to create value are examples of cooperative behaviour known to contribute to alliance success.[13] Recall that *trust*, *respect* and *transparency* are three core values on which the Renault–Nissan–Mitsubishi corporate-level cooperative strategy is based. Perhaps these values are instrumental to the success that is credited to this cooperative relationship.

## Types of major strategic alliances

Joint ventures, equity strategic alliances and non-equity strategic alliances are the three major types of strategic alliances organisations use. The ownership arrangement is a key difference among these alliances.

A **joint venture** is a strategic alliance in which two or more organisations create a legally independent company to share some of their resources and capabilities for the purpose of developing a competitive advantage. Some evidence suggests that economic difficulties arising from the global financial crisis (GFC; 2008–09) increased the attractiveness of this type of strategic alliance: 'Joint ventures have become a more prevalent way for companies to gain access to new capabilities, products, and geographies since the start of the most recent economic downturn'.[14] Often formed to improve an organisation's ability to compete in uncertain competitive environments, such as those associated with economic downturns,[15] joint ventures are effective in establishing long-term relationships and in transferring tacit knowledge. Because it cannot be codified, tacit knowledge, which is increasingly critical to organisations' efforts to develop core competencies, is learned through experiences such as those taking place when people from partner organisations work together in a joint venture.[16] Overall, a joint venture may be the optimal type of cooperative arrangement when organisations need to combine their resources and capabilities to create a competitive advantage that is substantially different from any they possess individually and when the partners intend to enter highly uncertain, hypercompetitive markets.

**joint venture**
a strategic alliance in which two or more organisations create a legally independent company to share some of their resources and capabilities to develop a competitive advantage

Typically, partners in a joint venture own equal percentages and contribute equally to the venture's operations. When established in 1999, Germany's Siemens AG and Japan's Fujitsu Ltd each owned 50 per cent of the joint venture Fujitsu Siemens Computers BV. Based in Maarssen, the Netherlands, this collaboration was the last major European-based computer manufacturer. This joint venture was established primarily to enable Fujitsu and Siemens to combine their technology-based resources and capabilities to compete in an uncertain market (computer manufacturing). On 1 April 2009, though, this company became Fujitsu Technology Solutions after Fujitsu bought Siemens' share of the joint venture. As this outcome suggests, joint ventures are not necessarily permanent in nature. There are different reasons for the lack of permanence, including dissatisfaction by one or all parties with the partnership's outcomes or changes in the strategic direction one or more partners wish to pursue. The agreement reached to end the joint venture was very amicable and served the emerging interests of Fujitsu and Siemens.

**Strategic focus | Technology**

## Samsung Electric is using diversifying alliances to reduce its dependence on Google's Android operating system

Samsung has a diverse range of alliances and partnerships to develop and support its diverse range of products. Samsung was one of the driving forces behind Tizen, an operating system designed to use HTML5 apps, and target mobile and embedded platforms such as netbooks, smartphones, tablets, smart TVs and in-car entertainment systems. This appears to be a strategy to reduce its reliance on Google's Android operating system (OS), especially after the internet search company acquired handset maker Motorola, which could potentially be a competitor for Samsung. The Tizen association (a strategic partnership) was formed in 2012 by executives from Intel, Samsung, NTT DoCoMo, NEC Casio, SK Telecom and Vodafone Group PLC to support an open-source software association, which has led to the Tizen operating system being available for mobile devices. Because Google is devoting more attention to producing mobile hardware devices as its rivalry with Apple accelerates, this has led to a reaction from Samsung, Intel and others to make sure they are not too dependent upon any one operating system. While not gaining significant inroads in the smartphone mobile OS space, Tizen has become the most popular operating system for smart TVs, with a 25 per cent market share in 2018–19.

Samsung and Mozilla have also developed a strategic alliance to build a new mobile web browser, based on Android and ARM (Advanced RISC Machine) software architecture. The mobile web browser, called Servo, is still at an experimental stage as of 2020. Samsung and Mozilla are also bringing Microsoft, Google and the W3C (World Wide Web Consortium) together to create cross-browser documentation. The goal is to consolidate information about web development for multiple browsers.

It seems that Samsung is concerned about being overly dependent on Google's Android system even though it shipped more than 250 million handsets every year from 2012–19 using this OS. Furthermore, it leads the industry with over 20 per cent of the global market share in smartphones (2012–19), so why would it be bothered with developing an alternative browser to Google Chrome as well as possibly pursuing a new mobile OS? Additional evidence of this diversification is that Samsung intended to produce mobile devices managed by Microsoft's Windows Phone OS. Again, it is seen by one analyst as a hedge against the company's overdependence on Android: 'Samsung continues to have a strategic weakness in its reliance on an ecosystem that the company does not own'. However, as of 2020, there is not much progress in the space, as the race for mobile operating systems is dominated by two main operating systems, Apple's iOS and Google's Android, with the Windows Phone OS discontinued in 2015.

Samsung also uses alliances to develop global industry standardisation for products that provide reduced costs across the industry. For instance, to reduce dependence on the Wireless Power Consortium's Qi standard, in 2012 it established 'an alliance for wireless power (A4WP) initialised between Qualcomm Inc. and Samsung Group (and other vendors) to promote global standardisation of a wireless power transfer technology, which could be utilised for mobile phones, electric vehicles and other devices'. Now known as the Rezence interface, it is poised to capitalise on the increasing levels of commercialisation of the technology, which has been growing by 30 per cent and is poised to reach US$27 billion by 2025. While the technology is currently limited to charging mobile devices, there is potential in other fields, given the increasing rate of electric vehicles adoptions and the research being conducted to scale wireless charging to electric cars.

Samsung is also developing partnerships to help sell its hardware. For instance, Samsung developed a strategic partnership with Houghton Mifflin Harcourt Publishing Co. (HMH) through its Samsung Electronics America Inc. subsidiary. It partners with HMH to develop 'educational content and solutions on the Android-powered tablet device of Samsung'. This partnership helps power technology transformation in schools in the use of educational text material. Likewise, the partnership helps promote Samsung

Android-powered tablets in schools and provides schools with 'special pricing, services, and support' besides helping them to implement their mobile education goals. The Samsung devices use the 'learning hub', an exclusive Samsung platform for educational content that is available worldwide.

As can be seen from these examples, Samsung is using alliances to diversify away from its dependence on the Android OS and also to have an edge in selling new devices based on new operating systems if they become popular. Likewise, it is using alliances to develop new sources of components, such as an alliance for wireless power, and new sources of distribution, such as its alliance with HMH. As such, it uses alliances as a form of corporate strategy to diversify among various operating systems to sell devices as well as for relationships with suppliers of parts and software (Mozilla) and distributors (HMH). One should also be mindful that not all efforts at diversification or alliances will succeed, and some may have unintended end uses, as the case of the Tizen OS can attest.

Sources: B. Munson, 2019, Samsung's Tizen OS dominates global smart TV market, https://www.fiercevideo.com/video/samsung-s-tizen-os-dominates-global-smart-tv-market, Questex, 25 March; A. Spivak, 2017, Mozilla brings Microsoft, Google, the W3C, Samsung together to create cross-browser documentation on MDN, The Mozilla Blog, https://blog.mozilla.org/blog/2017/10/18/mozilla-brings-microsoft-google-w3c-samsung-together-create-cross-browser-documentation-mdn, 18 October; IDC, 2020, Worldwide top 5 smartphone company unit market share (%), https://www.idc.com/promo/smartphone-market-share/vendor, 8 June; C. Wood, 2020, Researchers work on the next generation of wireless charging for electric vehicles and mobile devices, *CNBC*, https://www.cnbc.com/2020/06/08/researchers-work-on-the-next-generation-of-wireless-charging-for-evs.html, 8 June; *Educational Marketer*, 2013, HMH partners with Samsung, 11 February, 1–7; J. Lee, 2013, Samsung to sell Tizen-based handsets after Motorola deal, *Bloomberg*, http://www.bloomberg.com, 3 January; J. Paczkowski, 2013, Samsung buddies up with Mozilla on new Android browser tech, *All Things D*, http://www.allthingsd.com, 3 April; J. Paczkowski, 2013, Samsung plans multiple Tizen smartphones for 2013, *All Things D*, http://www.allthingsd.com, 3 January; *Energy Daily*, 2012, Samsung, Qualcomm establish wireless charging alliance, 14 May.

An **equity strategic alliance** is an alliance in which two or more organisations own different percentages of the company they have formed by combining some of their resources and capabilities for the purpose of creating a competitive advantage. Many foreign direct investments, such as those that companies from multiple countries are making in China, are completed through equity strategic alliances.[17]

**equity strategic alliance**
an alliance in which two or more organisations own different percentages of the company they have formed by combining some of their resources and capabilities to create a competitive advantage

Panasonic invested US$30 million in Tesla to accelerate battery technology for Tesla's electric vehicles and support the growth of the electric car industry overall. This growth is clearly in Panasonic's interests as a major supplier of electric vehicle batteries. The alliance between the two organisations grew to include other electric technology such as solar cells. In 2017, Panasonic announced it and Tesla would start making batteries at a lithium-ion battery plant outside of Reno, Nevada.[18] The alliance's focus on solar cells has decreased, but the electric vehicle lithium-ion battery production focus has strengthened the market for both organisations.

A **non-equity strategic alliance** is an alliance in which two or more organisations develop a contractual relationship to share some of their resources and capabilities for the purpose of creating a competitive advantage.[19] In this type of alliance, organisations do not establish a separate independent company and therefore do not take equity positions. For this reason, non-equity strategic alliances are less formal, demand fewer partner commitments than do joint ventures and equity strategic alliances, and generally do not foster an intimate relationship between partners; nonetheless, research evidence indicates that they can create value for the involved organisations.[20] The relative informality and lower commitment levels characterising non-equity strategic alliances make them unsuitable for complex projects where success requires effective transfers of tacit knowledge between partners.[21] Licensing agreements, distribution agreements and supply contracts are examples of non-equity strategic alliances.

**non-equity strategic alliance**
an alliance in which two or more organisations develop a contractual relationship to share some of their unique resources and capabilities to create a competitive advantage

A number of technology-based organisations form non-equity strategic alliances. Hewlett-Packard (HP) actively uses this type of cooperative strategy to license some of its intellectual property. Xerox formed an initial six-year relationship with HCL Technologies. This non-equity alliance saw HCL handling disaster recovery, data centre hosting and migration, virtualisation and consolidation tasks across Xerox's data centres in North America and Europe. Describing the reason for this alliance, Xerox's chief information officer said: 'Data centre environments are the heart of our business operations and we look to partner with companies that can manage our centres and take them to the next level.'[22] In 2019, building on the decade-long product engineering relationship, Xerox and HCL signed a US$1.3 billion managed services arrangement which 'positions HCL to transform Xerox's shared services globally, resulting in greater operational efficiency, automation and enhanced service levels'.[23]

Commonly, outsourcing commitments are specified in the form of a non-equity strategic alliance. (Discussed in Chapter 3, *outsourcing* is the purchase of a value chain activity or a support function activity from another organisation.) Home décor and fashion brand Laura Ashley and delivery services company FedEx have a long-standing (20-year) non-equity strategic alliance where Laura Ashley outsources its global supply chain and logistics to FedEx. Laura Ashley gains from FedEx's services and expertise, and FedEx gained an entry to Europe and the sector. The alliance is well-known for its informal nature, mutual trust and lack of complicated contracts.

Dell Inc. and most other computer organisations outsource most or all of their production of laptop computers and often form non-equity strategic alliances to detail the nature of the relationship with organisations to whom they outsource. Interestingly, many of these organisations that outsource introduce modularity that prevents the contracting partner or outsourcee from gaining too much knowledge or from sharing certain aspects of the business the outsourcing organisation does not want revealed.[24]

## Reasons organisations develop strategic alliances

Cooperative strategies are an integral part of the competitive landscape and are quite important to many companies and even to educational institutions. In fact, many organisations are cooperating with educational institutions to help commercialise ideas flowing from basic research projects completed at universities.[25] In for-profit organisations, many executives believe that strategic alliances are central to their organisation's growth and success.[26] The fact that alliances can account for up to 25 per cent or more of an organisation's sales revenue demonstrates their importance. Also highlighting alliances' importance is the fact that in some settings, such as the global airline industry, competition is increasingly between large alliances rather than between large companies.[27]

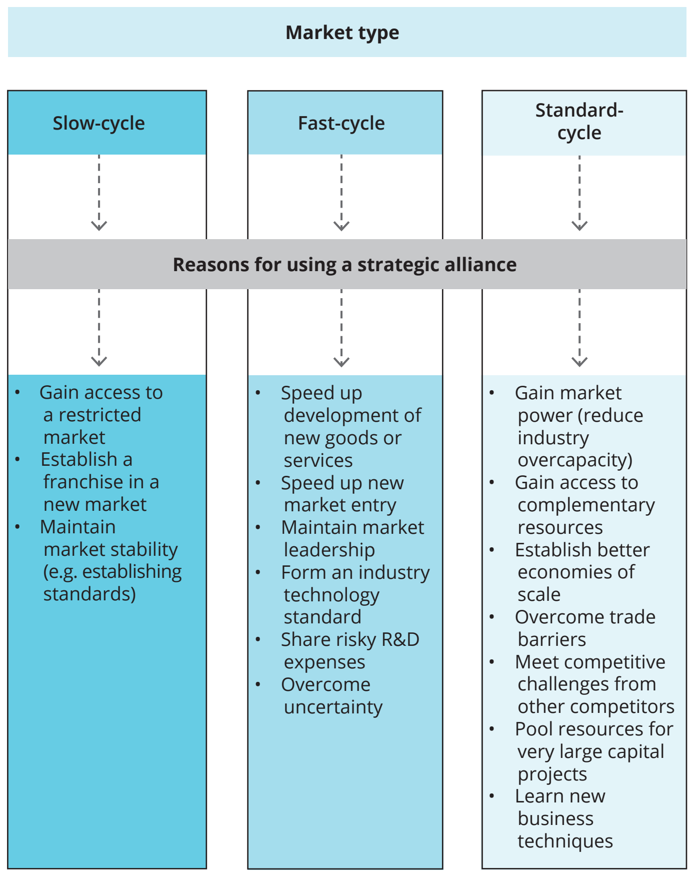
Among other benefits, strategic alliances allow partners to create value that they couldn't develop by acting independently and to enter markets more quickly and with greater market penetration possibilities.[28] For example, South America's largest retailer by market value, Chilean organisation SACI Falabella, is seeking to establish a foothold in Brazil through its Sodimac home-improvement unit by taking a 51 per cent ownership position in Dicico, a chain of home-improvement stores owned by Construdecor SA. Falabella owns department stores, supermarkets, shopping malls and home improvement stores in Chile, Colombia, Peru and Argentina. Falabella's chief executive, CEO Sandro Solari, said, 'We see good value in having a [local] partner' in managing Dicico. Falabella purchased its ownership position from previous part-owner Markinvest Gestao de Participaceos Limitada. The Brazilian entry is important for Falabella because Brazil is home to half of South America's population and has a large and growing middle class.[29]

Another reason to form strategic alliances is that most (if not all) organisations lack the full set of resources and capabilities needed to reach their objectives, which indicates that partnering with others will increase the probability of reaching organisation-specific performance objectives. This may be especially true for small businesses – ones in which capital is scarce. Given constrained resources, small organisations can collaborate for a number of purposes, including those of reaching new customers and broadening the distribution of their products without adding significantly to their cost structures.[30]

Unique competitive conditions characterise slow-cycle, fast-cycle and standard-cycle markets.[31] We discussed these three market types in Chapter 5 while examining competitive rivalry and competitive dynamics. These unique conditions find organisations using strategic alliances to reach objectives that differ slightly by market type (see Figure 9.1).

*Slow-cycle markets* are markets where the organisation's competitive advantages are shielded from imitation for relatively long periods of time and where imitation is costly. These markets are close to monopolistic conditions. Railroads and, historically, telecommunications, utilities and financial services are industries characterised as slow-cycle markets. In *fast-cycle markets*, the organisation's competitive

**Figure 9.1** **Reasons for strategic alliance by market type**




advantages are not shielded from imitation, preventing their long-term sustainability. Competitive advantages are moderately shielded from imitation in *standard-cycle markets*, typically allowing them to be sustained for a longer period of time than in fast-cycle market situations, but for a shorter period of time than in slow-cycle markets.

## Slow-cycle markets

Organisations in slow-cycle markets often use strategic alliances to enter restricted markets or to establish franchises in new markets. For example, because of consolidating acquisitions, the American steel industry has two remaining major players: US Steel and Nucor (competitors ArcelorMittal USA, AK Steel, Carpenter Technology, Commercial Metals Company and Steel Dynamics are significantly smaller). To improve their ability to compete successfully in the global steel market, these companies are forming cooperative relationships. They have formed strategic alliances in Europe and Asia and are invested in ventures in South America and Australia.

One of Nucor's alliances with an organisation outside its US domestic market is its joint venture with Italian-based Duferco Group's subsidiary Duferdofin. Each organisation has a 50 per cent ownership of the venture, called Duferdofin–Nucor S.r.l. Through this collaboration, the organisations are producing steel joists and beams in Italy and then selling them in Europe and North Africa. The resources and capabilities contributed by each partner are suggested by the following comment from Nucor's CEO:

'[This venture] combines Nucor's world-recognised know-how in the efficient production of structural shapes with Duferdofin's strong management team and strategic locations in Italy'.[32] On the domestic front, Nucor formed a long-term strategic alliance with Truswal Systems Corporation, 'a leading supplier of engineered products and state of the art software for the building components industry'. The purpose of this collaboration is the development of proprietary design, engineering and layout software.[33]

Slow-cycle markets are becoming rare in the 21st-century competitive landscape for several reasons, including the privatisation of industries and economies, the rapid expansion of the internet's capabilities for quick dissemination of information, and the speed with which advancing technologies make quickly imitating even complex products possible.[34] Organisations competing in slow-cycle markets, including steel manufacturers, should recognise the future likelihood that they will encounter situations in which their competitive advantages become partially sustainable (in the instance of a standard-cycle market) or unsustainable (in the case of a fast-cycle market). Cooperative strategies can help organisations transition from relatively sheltered markets to more competitive ones.[35]

## Fast-cycle markets

Fast-cycle markets are unstable, unpredictable and complex; in a word, they are hypercompetitive.[36] Combined, these conditions virtually preclude establishing long-lasting competitive advantages, forcing organisations to constantly seek sources of new competitive advantages while creating value by using current ones. Alliances between organisations with current excess resources and capabilities and those with promising capabilities help companies compete in fast-cycle markets to effectively transition from the present to the future and to gain rapid entry into new markets. As such, a 'collaboration mindset' is paramount.[37] Samsung's moves to outflank the Android system provide an example of this.

The entertainment business is fast becoming a new digital marketplace as television content is now available on the web. This has led the entertainment business into a fast-cycle market where collaboration is important not only to succeed but also to survive. Many of the organisations that have digital video content have also sought to make a profit through digital music and have had difficulties in profiting from their earlier ventures. To address issues such as these, General Electric's NBC Universal and News Corporation formed Hulu.com in 2007. Walt Disney Company joined this equity strategic alliance in 2009 (and subsequently took control in 2019 after acquiring 21st Century Fox and buying other minority stakes from shareholders). This web-based cooperative relationship is an alliance between organisations that are direct competitors. To support Hulu, ABC (owned by Disney) makes much of its content available on the Hulu site, as do the other content providers, including NBC Universal. As digital video content moves onto the web, it is interesting to see the evolution of competition and cooperation between these organisations.[38]

Telecommunications and software organisations also compete in fast-cycle markets and use strategic alliances as a means of doing so. When Microsoft and Nokia formed a comprehensive collaboration, the organisations' CEOs described the agreed-upon arrangement: 'Our two companies [have] plans for a broad strategic partnership that combines the respective strengths of our companies and builds a new global mobile ecosystem. The partnership increases our scale, which will result in significant benefits for consumers, developers, mobile operators and businesses around the world. We both are incredibly excited about the journey we are on together'.[39]

**Strategic focus | Globalisation**

### Industrial clusters: geographic centres for collaborative partnering

Clusters or *industrial districts* are geographic concentrations of a set of interconnected companies, often with specialised suppliers and service providers, and with education, government and trade association institutions focused on a particular industrial sector and agglomerated in a specific geographic region. Often these clusters begin because they increase company productivity, enabling them to lower costs and facilitate innovation. Developing such regions is important to government officials looking to increase economic development, as well as for companies seeking to co-locate with other reputable companies, often with government tax incentives and institutions, such as universities to facilitate training of students with increased employment opportunities for graduates.

Research, in fact, shows that where there is cluster-driven agglomeration, there is also higher employment growth and higher wage growth, growth in the number of new establishments, and an increase in innovation and patenting. The strength of a dominant cluster, such as California's Silicon Valley, also strengthens related clusters in the region and adjacent regions. Often, new industries emerge where there is a strong cluster environment. As such, there are good reasons why governments are interested in incentivising strong cluster growth in their geographic area.

For instance, African nations are increasingly seeking economic growth, and some have used innovation hubs to accelerate start-up company growth. Kenya, for example, has over 40 per cent of its population living on the equivalent of US$2 a day, and political corruption, crippling droughts and power outages have plagued the country. However, the Kenyan Government revised its constitution in 2010 to create more transparency and better institutions supporting business. As such, a number of high-tech companies developed an iHub in central Nairobi, with supporting partners from Intel, Samsung, Google, Facebook, Oracle, Microsoft and others in the cluster. It also created mLab and NaiLab as incubators to foster growth-oriented start-ups focused on mobile software and hardware applications. In 2019, after many successful start-ups, Kenya's iHub was acquired by Nigeria's CcHub to create a mega Africa tech incubator.

Research, however, suggests that such clusters or hubs have been implemented around the world, with varied results. Studies indicate that specialising in one area of R&D without added diversification often leads to eventual failure. As such, clusters with businesses, suppliers, think tanks, universities, multiple industries and trade associations co-located in an industrial park or innovation cluster work best for stimulating economic growth and innovation. Accordingly, companies with a variety of purposes and specialisations co-located with network suppliers, customers and support services facilitate new and more innovative products and services and thus are more successful.

Sometimes these clusters are driven by specific regional geographic strengths. For example, large data storage centres for high-tech companies using cloud resources have located such centres in Prineville, The Dalles and other small towns in Oregon. Such locations in Oregon allow for more natural cooling of such large computer systems. Facebook executive Jay Park states that Prineville is 'an ideal location for the crew and system Facebook uses for its data storage center'. Other locations were chosen for more idiosyncratic reasons. Microsoft and the software cluster associated with it in Seattle were located there because Bill Gates, Microsoft's founder, was born in Seattle.

Research suggests that workers who began their career in industrial hub locations, such as people in the hedge fund industry who previously worked in New York and London, outperform their peers once they leave these districts. As such, there is an individual effect on the human capital development in these industrial hubs. Furthermore, research also suggests there is a collective impact on the organisations that are in centralised positions (i.e. have connections to more organisations, suppliers and customers in the industrial district); the more central organisations have more and better innovation. Those who connect organisations to each other (bridging ties) have a positive impact on innovation, but not as impactful as those that are more centralised in the hub.

Geographic clusters are being developed around the world focused on creating a vast database of genetic information. It took nearly 13 years and almost US$14 million in government and private funding for the Human Genome Project to complete the first map of a person's genome. Now, for US$1000, a company in Iceland will chart a person's genetic propensities for 47 different diseases and traits. New preventative measures from this project 'will save patients, insurers, and employers money, and studies project genomic medicine will generate US$350 billion worth of economic activity and millions of jobs'. But the industry is a long way from having the ability to fully utilise the data encoded in our chromosomes. The question is, where will the various clusters be found around the world? There are a number in the USA and Canada – one in Vancouver, British Columbia, and one around La Jolla, California. The cluster at La Jolla includes the University of California-San Diego, the Salk Institute, the Scripps Research Institute, the Venter Institute, Synthetic Genomics and 30 or 40 companies all within a few square kilometres and all using genomic methods and research. There are also clusters growing in the Boston area, the Cambridge area in the UK and the Genomics Institute in Beijing, China. Thus, the history of industrial districts is positive overall, and they are now being planned with more precision.

Sources: J. Bright, 2019, Nigeria's CcHub acquires Kenya's iHub to create mega Africa incubator, *TechCrunch*, https://techcrunch.com/2019/09/26/nigerias-cchub-acquires-kenyas-ihub-to-create-mega-africa-incubator, 26 September; C. Casanueva, I. Castro & J. L. Galán, 2013, Information networks and innovation in mature industrial clusters, *Journal of Business Research*, 66(5): 603–13; R. J. P. De Figueiredo, P. Meyer-Doyle & E. Rawley, 2013, Inherited agglomeration effects in hedge fund spawns, *Strategic Management Journal*, 34(7): 843–62; L. Dobusch & E. Schübler, 2013, Theorizing path dependence: A review of positive feedback mechanisms in technology markets, regional clusters, and organizations, *Industrial & Corporate Change*, 22(3): 617–47; E. Francis, 2013, Building an auto industry hub through value creation, *Automotive Industries*, January, 111–12; G. Holden, 2013, Kenya's fertile ground for tech innovation, *Research Technology Management*, 56(3): 7–8; H. Milanov & D. A. Shepherd, 2013, The importance of the first relationship: The ongoing influence of initial network on future status, *Strategic Management Journal*, 34(6): 727–50; *Economist*, 2012, Not a cloud in sight, 27 October, 19–20; F. Ghadar, J. Sviokla & D. A. Stephan, 2012, Why life science needs its own Silicon Valley, *Harvard Business Review*, 90(7/8): 25–7.

## Standard-cycle markets

In standard-cycle markets, alliances are more likely to be made by partners that have complementary resources and capabilities. The alliances formed by airline companies are an example of standard-cycle market alliances.

When initially established decades ago, these alliances were intended to allow organisations to share their complementary resources and capabilities to make it easier for passengers to fly between secondary cities in the USA and Europe. Today, airline alliances are mostly global in nature and are formed primarily so members can gain marketing clout, have opportunities to reduce costs and have access to additional international routes.[40] Of these reasons, international expansion by having access to more international routes is the most important because these routes are the path to increased revenues and potential profits. To support efforts to control costs, alliance members jointly purchase some items and share facilities when possible, such as passenger gates, customer service centres and airport passenger lounges. For passengers, airline alliances 'offer simpler ticketing and smoother connections on intercontinental trips as well as the chance to earn and redeem frequent-flier miles on other member carriers'.[41]

There are three major airline alliances operating today. Star Alliance is the largest, with 26 members. With 13 members, OneWorld Alliance is the smallest (it includes Qantas), while 19-member SkyTeam Alliance sits in-between. Given the geographic areas where markets are growing, these global alliances are adding partners from Asia.

In addition to the three major alliances, a host of other alliances exist among airline carriers. For example, ANA (All Nippon Airways) and Deutsche Lufthansa AG are both members of the Star Alliance. However, these organisations decided to launch a joint venture at the end of 2011 for the purpose of combining their resources to serve routes between Japan and Europe. Sharing revenue, coordinating flight schedules and working together on joint product sales are examples of how the organisations' resources and capabilities are to be shared through the joint venture.[42] Similarly, Singapore Airlines, a member of Star Alliance, and Virgin Australia announced plans for a wide-ranging alliance. Under the alliance, Singapore Airlines (which has been seeking access to the Pacific route for many years) would have access to Virgin Australia's routes to New Zealand and the US west coast. At the same time, Virgin Australia was planning to complete alliances with Air New Zealand and Etihad Airways PJSC, based in Abu Dhabi.[43] In general, most airline alliances such as the ones we have described are formed to help organisations gain economies of scale and meet competitive challenges (see Figure 9.1).

# Competition-reducing strategy

Before we discuss the key business-level cooperative strategies, it is important to note that not all cooperative strategies are welcome in the market, and some are deemed illegal and are actively policed and opposed by many governments around the world. Used to reduce competition, *collusive strategies* (also known as anti-competitive strategies) differ from strategic alliances in that collusive strategies are often an illegal type of cooperative strategy. Explicit collusion and tacit collusion are the two types of collusive strategies.

*Explicit collusion* exists when two or more organisations negotiate directly to jointly agree about the amount to produce as well as the prices for what is produced.[44] Explicit collusion strategies are illegal in most developed economies (except in regulated industries). Accordingly, companies choosing to use explicit collusion as a strategy should recognise that competitors and regulatory bodies might challenge the acceptability of their competitive actions.

*Tacit collusion* exists when several organisations in an industry indirectly coordinate their production and pricing decisions by observing each other's competitive actions and responses.[45] Tacit collusion results in production output that is below fully competitive levels and above fully competitive prices. Unlike explicit collusion, organisations engaging in tacit collusion do not directly negotiate output and pricing decisions. However, research suggests that joint ventures or cooperation between two organisations can lead to less competition in other markets in which both organisations operate.[46]

Tacit collusion tends to be used as a competition-reducing business-level strategy in industries with a high degree of concentration, such as the airline and breakfast cereal industries. Research in the airline industry suggests that tacit collusion reduces service quality and on-time performance.[47] Organisations in these industries recognise their interdependence, which means that their competitive actions and responses significantly affect competitors' behaviour towards them. Understanding this interdependence and carefully observing competitors can lead to tacit collusion.

*Mutual forbearance* is a form of tacit collusion in which organisations do not take competitive actions against rivals they meet in multiple markets. Rivals learn a great deal about each other when engaging in multi-market competition, including how to deter the effects of their rivals' competitive attacks and responses. Given what they know about each other as competitors, organisations choose not to engage in what could be destructive competition in multiple product markets.[48]

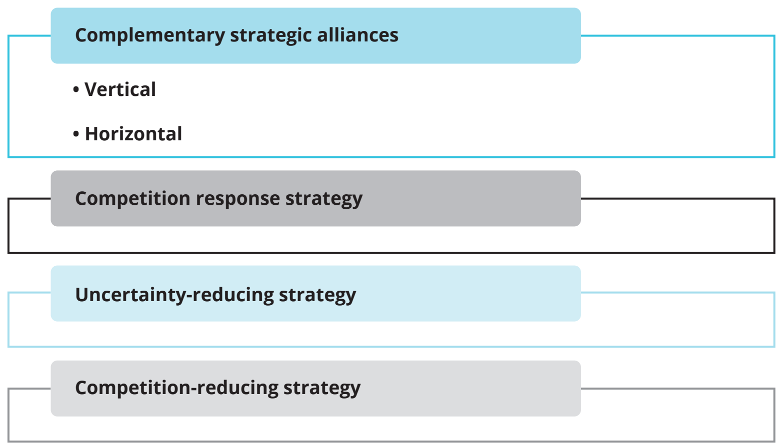
In general, governments in free-market economies seek to determine how rivals can form cooperative strategies for the purpose of increasing their competitiveness without violating established regulations about competition.[49] However, this task is challenging when evaluating collusive strategies, particularly tacit ones. For example, the regulation of pharmaceutical and biotech organisations that collaborate to meet global competition might lead to too much price fixing, meaning that regulation is required to make sure that the balance is 'right' (though sometimes the regulation gets in the way of efficient markets).[50] In turn, individual companies must analyse the effect of a competition-reducing strategy on their performance and competitiveness and decide if pursuing such a strategy is an overall facilitator of their competitive success.

# Business-level cooperative strategy

A **business-level cooperative strategy** is a strategy through which organisations combine some of their resources and capabilities for the purpose of creating a competitive advantage by competing in one or more product markets. As discussed in Chapter 4, business-level strategy details what the organisation intends to do to gain a competitive advantage in specific product markets. Thus, the organisation forms a business-level cooperative strategy when it believes that combining some of its resources and capabilities with those of one or more partners will create competitive advantages that it cannot create by itself and will lead to success in a specific product market. We list the four business-level cooperative strategies in Figure 9.2.

**business-level cooperative strategy**
used to help the organisation improve its performance in individual product markets

**Figure 9.2** **Business-level cooperative strategies**




# Complementary strategic alliances

**complementary strategic alliances** business-level alliances in which organisations share some of their resources and capabilities in complementary ways to develop competitive advantages

**Complementary strategic alliances** are business-level alliances in which organisations share some of their resources and capabilities in complementary ways for the purpose of creating a competitive advantage.[51] Vertical and horizontal are the two types of complementary strategic alliances (see Figure 9.2).

## Vertical complementary strategic alliance

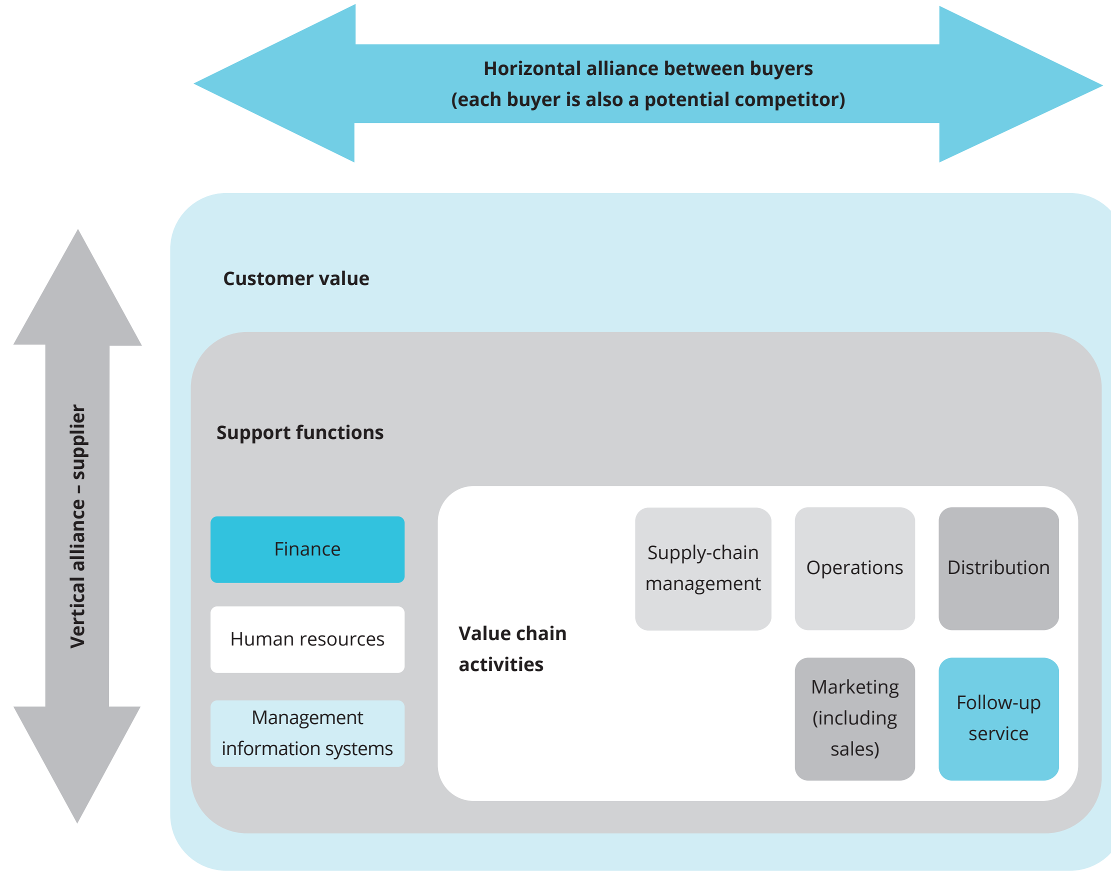
In a *vertical complementary strategic alliance*, organisations share some of their resources and capabilities from different stages of the value chain for the purpose of creating a competitive advantage (see Figure 9.3).[52] Often, vertical complementary alliances are formed to adapt to environmental changes;[53] sometimes the changes represent an opportunity for partnering organisations to innovate while adapting.[54]

Operating with four segments (EA Games, EA Sports, The Sims and EA Casual Entertainment), Electronic Arts (EA) develops, markets, publishes and distributes video game software, mobile games and online interactive games in more than 35 countries, meaning that the organisation is geographically diversified as well as diversified with its product lines.

Vertical strategic alliances are a key part of how EA competes, including the alliances the organisation has formed with Nintendo and Hasbro. EA produces software and games for Nintendo's Wii game console through the alliance it has with that organisation. Through the alliance with Hasbro, EA offers *Monopoly Millionaires* on Facebook. An EA executive described the organisation's alliance with Hasbro in this manner: 'We strive to continually re-imagine Hasbro brands digitally in creative ways and *Monopoly Millionaires* is no exception. We're bringing the world's favorite game brand into the new era of social gaming, offering an accessible and enjoyable experience for Facebook users worldwide'.[55]

Sometimes, private–public sector vertical collaborations are formed, such as the alliance Novartis AG and the World Health Organization (WHO) developed in 2001. The purpose of the 10-year alliance was to battle malaria in developing countries. The agreement called for Novartis to provide one of its drugs, Coartem, at an average price of US$1.57 per treatment for adults and at a substantially discounted price for children, who are most vulnerable to malaria. Using the distribution part of the value chain, WHO evaluated requests for Coartem and then distributed the drug through government agencies of malaria-endemic countries.

**Figure 9.3** Vertical and complementary strategic alliances




The terms of the original alliance between Novartis and WHO expired in May 2011. However, at that time Norvartis announced that because of its long-term commitment to battling malaria, it would 'continue to provide Coartem to public health systems in developing countries on the same terms as before'.[56]

## Horizontal complementary strategic alliance

A *horizontal complementary strategic alliance* is an alliance in which organisations share some of their resources and capabilities from the same stage (or stages) of the value chain for the purpose of creating a competitive advantage. Commonly, organisations use complementary strategic alliances to focus on joint long-term product development and distribution opportunities.[57] As noted previously, Hulu is a joint website that GE's NBC Universal, News Corporation and Walt Disney Company formed for the purpose of distributing video content. Although now majority-owned and fully controlled by Disney, the alliance's partners provide content (one stage of the value chain) to Hulu for distribution (another part of the value chain).

Pharmaceutical companies form a number of horizontal alliances. For example, as health care reform takes place, large pharmaceutical organisations seek relationships with generic drug producers. Pfizer formed an alliance with Santaris Pharma A/S to develop and commercialise RNA-targeted medicines using Santaris Pharma A/S's locked nucleic acid (LNA) drug platform. (Santaris is a clinical-stage biopharmaceutical company.)[58]

Novartis AG's orientation to collaborations reflects the perspective of many pharmaceutical manufacturers. Supporting Norvartis' collaborations is the belief that 'the path from scientific breakthrough to successful pharmaceutical brand depends on mobilizing the best global resources, expertise and experience'.[59] Thus, as noted earlier in the chapter, cooperative strategies are used largely to enable organisations (such as pharmaceutical manufacturers) to combine the 'world's best' resources, capabilities and core competencies in the pursuit of competitive success.

Many horizontal complementary strategic alliances are formed in the automobile manufacturing industry. For example, Renault, Nissan and Mitsubishi formed a corporate-level synergistic strategic alliance. A number of horizontal complementary strategic alliances the three organisations have developed support implementation of their corporate-level alliance. The Renault alliance with Bajaj Auto Ltd of India is an example of the horizontal relationships the organisation is forming. Even more broadly, cooperative strategies of all types are instrumental to automobile manufacturers' efforts to successfully compete globally.

## Competition response strategy

As discussed in Chapter 5, competitors initiate competitive actions to attack rivals and launch competitive responses to their competitors' actions. Strategic alliances can be used at the business level to respond to competitors' attacks. Because they can be difficult to reverse and expensive to operate, strategic alliances are primarily formed to take strategic rather than tactical actions and to respond to competitors' actions in a like manner.

## Uncertainty-reducing strategy

Organisations sometimes use business-level strategic alliances to hedge against risk and uncertainty, especially in fast-cycle markets.[60] These strategies are also used where uncertainty exists, such as in entering new product markets and especially those of emerging economies.

As large global automobile organisations manufacture more hybrid vehicles, there is insufficient industry capacity to meet the demand for the type of batteries used in these vehicles. In turn, the lack of a sufficient supply of electric batteries creates uncertainty for automobile manufacturers. To reduce this uncertainty, automobile organisations are forming alliances. For example, Volkswagen formed an agreement with Samuel Electric and Toshiba Corp. of Japan to manufacture lithium-ion batteries used in hybrid vehicles (since 2017, Volkswagen has manufactured lithium-ion batteries for all battery cells in the Volkswagen Group).[61] Renault–Nissan established a joint venture with the French Government in 2009 to make batteries. However, this venture was dissolved in mid-2011 due to the French Government deciding not to contribute to financing the plant.[62]

## Assessing business-level cooperative strategies

Organisations use business-level cooperative strategies to develop competitive advantages that can contribute to successful positions in individual product markets. Evidence suggests that complementary business-level strategic alliances, especially vertical ones, have the greatest probability of creating a competitive advantage and possibly even a sustainable one.[63] Horizontal complementary alliances are sometimes difficult to maintain because often they are formed between organisations that compete against each other at the same time they are cooperating. Renault, Nissan and Mitsubishi still compete against each other with some of their products while collaborating to produce and sell other products. In a case such as this, partnering organisations may feel a 'push' towards and a 'pull' from alliances. Airline organisations, for example, want to compete aggressively against others serving their markets and target their customers. However, the need to develop scale economies and to share resources and capabilities (such as scheduling systems) dictates that alliances be formed so the organisations can compete by using cooperative actions and responses while they simultaneously compete against one another through competitive actions and responses. The challenge in these instances is for each organisation to find ways to create the greatest amount of value from both their competitive and cooperative actions. It seems that Renault, Nissan and Mitsubishi may have learned how to achieve this balance.

Although strategic alliances designed to respond to competition and to reduce uncertainty can also create competitive advantages, these advantages often are more temporary than those developed through complementary (both vertical and horizontal) alliances. The primary reason for this is that complementary alliances have a stronger focus on creating value than do competition-reducing and uncertainty-reducing alliances, which are formed to respond to competitors' actions or reduce uncertainty rather than to attack competitors.

Of the four business-level cooperative strategies, the competition-reducing strategy has the lowest probability of creating a competitive advantage. For example, research suggests that organisations following a foreign direct investment strategy using alliances as a follow-the-leader imitation approach may not have strong strategic or learning goals. Thus, such investment could be attributable to tacit collusion among the participating organisations rather than trying to develop a competitive advantage (which should be the core objective).

# Corporate-level cooperative strategy

A **corporate-level cooperative strategy** is a strategy through which an organisation collaborates with one or more companies for the purpose of expanding its operations. The alliance between Itochu Corp. and Drummond Company, for example, aims to 'allow Itochu to diversify its coal assets to a new geographic region and grow its trading activities'.[64] As such, this is a corporate-level cooperative strategy between these two organisations. Diversifying alliances, synergistic alliances and franchising are the most commonly used corporate-level cooperative strategies (see Figure 9.4).

**corporate-level cooperative strategy**
used by the organisation to help it diversify in terms of products offered or markets served, or both

**Figure 9.4** Corporate-level cooperative strategies


Organisations use diversifying and synergistic alliances to improve their performance by diversifying their operations through a means other than or in addition to internal organic growth or a merger or acquisition.[65] When an organisation seeks to diversify into markets in which the host nation's government prevents mergers and acquisitions, alliances become an especially appropriate option. Corporate-level strategic alliances are also attractive compared with mergers and, particularly, acquisitions, because they require fewer resource commitments[66] and permit greater flexibility in terms of efforts to diversify partners' operations.[67] An alliance can be used as a way to determine whether the partners might benefit from a future merger or acquisition between them. This 'testing' process often characterises alliances formed to combine organisations' unique technological resources and capabilities.[68]

## Diversifying strategic alliance

A **diversifying strategic alliance** is a strategy in which organisations share some of their resources and capabilities to engage in product and/or geographic diversification. The agreement between Itochu and Drummond is a diversifying strategic alliance.

**diversifying strategic alliance**
a corporate-level cooperative strategy in which organisations share some of their resources and capabilities to diversify into new product or market areas

The spread of high-speed wireless networks and devices with global positioning chips and the popularity of website applications running on various companies' smartphones indicate that consumers are more frequently and intensely accessing mobile information. Equipped with this knowledge, Alcatel-Lucent entered the market through mobile advertising, which allows a mobile phone carrier to alert customers about the location of a favourite store or the closest ATM.[69] The partners pursued this alliance with 1020 Placecast, a California-based developer of mobile phone online ads associated with user locations. Hyatt, FedEx and Avis were especially interested in using the service. The ads also include a link to coupons or other promotions. Alcatel-Lucent and Millicom Ghana Ltd 'under the brand of Tigo, one of Ghana's leading mobile network operators, [formed] a partnership to introduce the first permission- and preference-based mobile advertising service in Ghana'. The Tigo partnership then merged with Airtel in November 2017 to form AirtelTigo, which is now the second-largest mobile network operator in Ghana.[70] Through this partnership, AirtelTigo's customers are able to receive targeted promotions on their phones. Overall, these networks are trying to gain a share of the profits that would normally be out of their reach through revenue-sharing models with companies that are advertising as well as the ad-producing service companies.

## Synergistic strategic alliance

**synergistic strategic alliance**
a corporate-level cooperative strategy in which organisations share some of their resources and capabilities to create economies of scope

A **synergistic strategic alliance** is a strategy in which organisations share some of their resources and capabilities to create economies of scope. Similar to the business-level horizontal complementary strategic alliance, synergistic strategic alliances create synergy across multiple functions or multiple businesses between partner organisations. The Renault–Nissan–Mitsubishi collaboration we discussed in this chapter's opening case is a synergistic strategic alliance in that, among other outcomes, the organisations seek to create economies of scope by sharing their resources and capabilities to develop manufacturing platforms that can be used to produce cars that will be Renaults, Nissans or Mitsubishis. The cooperative arrangement between Fiat and Chrysler is also a synergistic alliance. As noted earlier, Chrysler will produce a Fiat-designed and developed compact car in its Illinois facility. Reflecting the complexity of synergistic alliances and their 'twin' horizontal complementary alliances at the business-unit level is the fact that Fiat used the same underpinnings for what will be a car carrying the Dodge brand that it uses to produce the Alfa Romeo Giulietta.[71] (Alfa Romeo is a part of Fiat SpA, which is part of the Groupe PSA and Fiat Chrysler merger.) Without economies of scope such as those Fiat seeks by using the same underpinnings for a car carrying the Dodge brand and the Alfa Romeo brand, the probability of success with a synergistic alliance is substantially reduced.

## Franchising

**franchising**
a corporate-level cooperative strategy in which an organisation (the franchisor) uses a franchise as a contractual relationship to describe and control the sharing of its resources and capabilities with partners (the franchisees)

**Franchising** is a strategy in which an organisation (the franchisor) uses a franchise as a contractual relationship to describe and control the sharing of its resources and capabilities with its partners (the franchisees).[72] A *franchise* is a 'contractual agreement between two legally independent companies whereby the franchisor grants the right to the franchisee to sell the franchisor's product or do business under its trademarks in a given location for a specified period of time'.[73] Often, success is determined in these strategic alliances by how well the franchisor can replicate its success across multiple partners in a cost-effective way.[74]

Franchising is a popular strategy. In Australia, franchises employ over 598 000 people and have revenues of over A$180 billion per year. There are more than 101 000 businesses in the sector, and 91 per cent of the franchises are Australian in origin.[75] In the USA in 2019, 773 600 franchises supported 8.4 million direct jobs, provided US$787 billion of economic output for the economy, and represented 3 per cent of total gross domestic product (GDP).[76] Already frequently used in developed nations, franchising is also expected to account for significant portions of growth in emerging economies in the 21st century.[77] As with diversifying and synergistic strategic alliances, franchising is an alternative to pursuing growth through mergers and acquisitions. McDonald's, Jim's Group (Jim's Mowing, Jim's Cleaning, Jim's Dog Wash, etc.), Hilton International, Marriott International, Subway and Harvey Norman (which operates a model where there are several franchisees for each store) are well-known examples of organisations using the franchising corporate-level cooperative strategy.

For the franchisee, the model has many benefits: the business model is available, the brand is established, training and systems are usually provided, and they know others have been successful in that franchise area. It can be relatively expensive to get into one, though. For McDonald's in Australia, a franchisee has to make a 20-year commitment, undertake 12 months of unpaid training and have A$1 200 000 in 'unencumbered funds' available. They may be told to go to any region in the country to set up their franchise and will be part of a very tightly controlled franchise operation from that time on.[78] At the other end of the scale, a Jim's franchise costs typically less than A$100 000, and the franchisee has much more control over their own business.

Franchising is a particularly attractive strategy to use in fragmented industries, such as retailing, hotels and motels, and commercial printing. In fragmented industries, a large number of small and medium-sized organisations compete as rivals; however, no organisation or small set of organisations has a dominant share, making it possible for a company to gain a large market share by consolidating independent companies through the contractual relationships that are a part of a franchise agreement.

In the most successful franchising strategy, the partners (the franchisor and the franchisees) work closely together.[79] A primary responsibility of the franchisor is to develop programs to transfer to the franchisees the knowledge and skills that are needed to successfully compete at the local level.[80] In return, franchisees should provide feedback to the franchisor regarding how their units could become more effective and efficient.[81] Working cooperatively, the franchisor and its franchisees find ways to strengthen the core company's brand name, which is often the most important competitive advantage for franchisees operating in their local markets.[82]

## Assessing corporate-level cooperative strategies

Costs are incurred to implement each type of cooperative strategy.[83] Compared with their business-level counterparts, corporate-level cooperative strategies commonly are broader in scope and more complex, making them relatively more challenging and costly to use.

In spite of these costs, organisations can create competitive advantages and value for customers by effectively using corporate-level cooperative strategies.[84] Internalising successful alliance experiences makes it more likely that the strategy will attain the desired advantages. In other words, those involved with forming and using corporate-level cooperative strategies can also use them to develop useful knowledge about how to succeed in the future. To gain maximum value from this knowledge, organisations should organise that knowledge and verify that it is always properly distributed to those involved with forming and using alliances.

We explained in Chapter 6 that organisations answer two questions when dealing with corporate-level strategy: in which businesses and product markets will the organisation choose to compete, and how will those businesses be managed? These questions are also answered as organisations form corporate-level cooperative strategies. Thus, organisations able to develop corporate-level cooperative strategies and manage them in ways that are valuable, rare, imperfectly imitable and non-substitutable (see Chapter 3) develop a competitive advantage that is in addition to advantages gained through the activities completed to implement individual cooperative strategies. (Later in the chapter, we further describe alliance management as another potential competitive advantage.)

# International cooperative strategy

The new competitive landscape finds organisations using cross-border transactions for several purposes. In Chapter 7, we discussed cross-border acquisitions: actions through which a company located in one country acquires an organisation located in a different country. In Chapter 8, we described how organisations use cross-border acquisitions as a way of entering international markets. Here in Chapter 9, we examine cross-border strategic alliances as a type of international cooperative strategy. Thus, organisations engage in cross-border activities to achieve several related objectives.

**cross-border strategic alliance**

an international cooperative strategy in which organisations with headquarters in different nations combine some of their resources and capabilities to create a competitive advantage

A **cross-border strategic alliance** is a strategy in which organisations with headquarters in different countries decide to combine some of their resources and capabilities for the purpose of creating a competitive advantage. Taking place in virtually all industries, the number of cross-border alliances organisations are completing continues to increase.[85] These alliances are sometimes formed instead of mergers and acquisitions, which can be riskier. Even though cross-border alliances can themselves be complex and hard to manage,[86] they have the potential to help organisations use some of their resources and capabilities to create value in locations outside their home market.

Limited domestic growth opportunities and foreign government economic policies are key reasons organisations use cross-border alliances. As discussed in Chapter 8, local ownership is an important national policy objective in some nations. In India and China, for example, governmental policies reflect a strong preference to license local companies. Thus, in some countries, the full range of entry mode choices we described in Chapter 8 may not be available to organisations seeking to geographically diversify into a number of international markets. Indeed, investment by foreign organisations in these instances may be allowed only through a partnership with a local organisation, such as in a cross-border alliance. Also important is the fact that strategic alliances with local partners can help organisations overcome certain liabilities of moving into a foreign country, including those related to a lack of knowledge of the local culture or institutional norms.[87] A cross-border strategic alliance can also help foreign partners from an operational perspective, because the local partner has significantly more information about factors contributing to competitive success such as local markets, sources of capital, legal procedures and politics.[88] Interestingly, research results suggest that organisations with foreign operations have longer survival rates than domestic-only organisations, although this is reduced if there are competition problems between foreign subsidiaries.[89]

As a result of two major global trends – increasing fuel costs and tougher environmental regulations – airlines are deeply interested in flying planes that are powered by more fuel-efficient engines. Manufacturers of aeroplane engines have responded to this strong customer interest and are pushing 'the frontiers of technology by building lighter planes and borrowing essential engine-design advances from the automobile industry, like automatic transmissions'.[90] To build these engines, manufacturers are forming strategic alliances, many of which are cross-border alliances. For example, Volvo Aero (which was a wholly owned subsidiary of Sweden's AB Volvo before being acquired by British engineering conglomerate GKN in 2012) and US-based Pratt & Whitney (one of Raytheon Technologies Corporation's divisions) formed a cross-border strategic alliance to collaborate on the PW1100G engine, an engine that 'is a part of Pratt & Whitney's Next Generation Product Family of engines which contain geared turbofan (GTF) technology'.[91] Through this collaboration – which was not the first between these two organisations – Volvo Aero designed and manufactured two components that are critical to Pratt & Whitney's engine. As we noted in Chapter 8, this engine initially was designed for use in the A320neo family, the updated version of the Airbus A320, with the aim to reduce fuel consumption, carbon dioxide and nitric oxide emissions, and noise, as well as lowering running and operating costs significantly. The engine was demonstrated at the Paris Air Show in 2013.[92]

In general, then, cross-border strategic alliances are more complex and risky than are domestic strategic alliances, especially when used in emerging economies. However, the fact that organisations competing internationally tend to outperform domestic-only competitors suggests the importance of learning how to geographically diversify into international markets. Compared with mergers and acquisitions, cross-border alliances may be a better way to learn this process, especially in the early stages of an organisation's geographic diversification efforts.

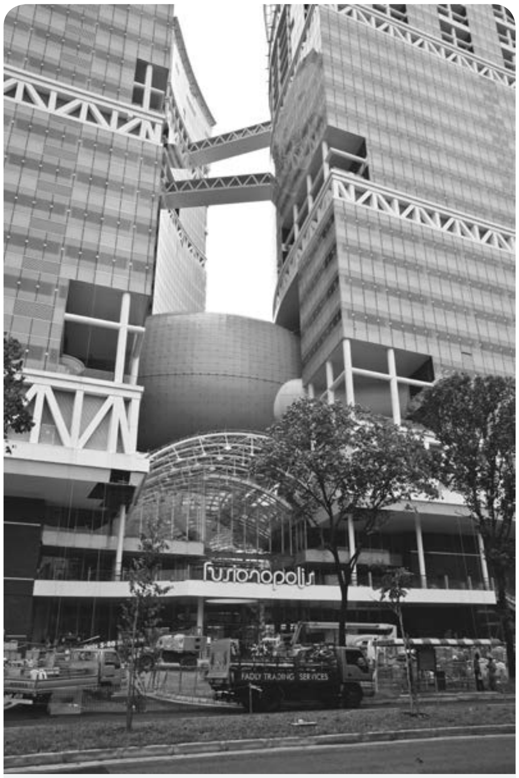
**network cooperative strategy**

a cooperative strategy wherein several organisations agree to form multiple partnerships to achieve shared objectives

# Network cooperative strategy

In addition to forming their own alliances with individual companies, an increasing number of organisations are collaborating in multiple networks.[93] A **network cooperative strategy** is a strategy wherein several organisations agree to form multiple partnerships for the purpose of achieving shared objectives.

Through its Global Partner Network, Cisco has formed alliances with a host of individual companies, including IBM, Microsoft, Accenture, Emerson, Fujitsu, Intel and Nokia. According to Cisco, partnering allows an organisation to 'drive growth and differentiate [its] business by extending [its] capabilities to meet customer requirements'.[94] Demonstrating the complexity of network cooperative strategies is the fact that Cisco also competes against a number of the organisations with which it has formed cooperative agreements. For example, Cisco is competing against IBM as it now sells and services servers. Although a new business line for Cisco, sales revenue for Cisco's servers exceeded US$900 million in 2010, and grew to US$4 billion by 2019.[95] At the same time, Cisco and IBM's alliance is very active as the organisations seek to help customers 'maximise (their) business results by uniting IBM's vast industry, business process and implementation expertise with Cisco's world-class unified communications and networking technologies'.[96] Overall, in spite of their complexity, as the IBM–Cisco example shows, organisations are using network cooperative strategies more extensively as ways of creating value for customers by offering many goods and services in many geographic (domestic and international) markets.



Singapore's Fusionopolis complex represents the collaboration of physical sciences and engineering to tackle global science and technology challenges.

Source: Alamy Stock Photo/© Gregory Bergman

A network cooperative strategy is particularly effective when it is formed by geographically clustered organisations,[97] as in California's Silicon Valley (where 'the culture of Silicon Valley encourages collaborative webs')[98] and Singapore's Biopolis (in the biomedical sciences) and Fusionopolis (collaborations in 'physical sciences and engineering to tackle global science and technology challenges').[99] Effective social relationships and interactions among partners while sharing their resources and capabilities make it more likely that a network cooperative strategy will be successful,[100] as does having a productive *strategic centre organisation* (we discuss strategic centre organisations in detail in Chapter 11). Organisations involved in networks gain information and knowledge from multiple sources. They can use these heterogeneous knowledge sets to produce more and better innovation. As a result, organisations involved in networks of alliances tend to be more innovative.[101] However, there are disadvantages to participating in networks because an organisation can be locked into its partnerships, precluding the development of alliances with others. In certain network configurations, such as Japanese *keiretsus*, organisations in a network are expected to help other organisations in that network whenever support is required. Such expectations can become a burden and negatively affect the focal organisation's performance over time.[102]

## Alliance network types

An important advantage of a network cooperative strategy is that organisations gain access to their partners' other partners. Having access to multiple collaborations increases the likelihood that additional competitive advantages will be formed as the set of shared resources and capabilities expands.[103] In turn, being able to develop new capabilities further stimulates product innovations that are critical to strategic competitiveness in the global economy.

The set of strategic alliance partnerships organisations develop when using a network cooperative strategy is called an *alliance network*. Companies' alliance networks vary by industry characteristics. A *stable alliance network* is formed in mature industries where demand is relatively constant and predictable. Through a stable alliance network, organisations try to extend their competitive advantages to other settings while continuing to profit from operations in their core, relatively mature industry. Thus, stable networks are built primarily to *exploit* the economies (scale and/or scope) that exist between the partners, such as in the airline industry.[104]

*Dynamic alliance networks* are used in industries characterised by frequent product innovations and short product life cycles.[105] For instance, the pace of innovation in the information technology (IT) industry (as well as other fast-cycle market industries) is too fast for any one company to be successful across time if it only competes independently. Another example is the film industry, in which organisations participate in a number of networks for the purpose of producing and distributing films.[106] In dynamic alliance networks, partners typically *explore* new ideas and possibilities with the potential to lead to product innovations, entries to new markets and the development of new markets.[107] Often, large organisations in industries such as software and pharmaceuticals create networks of relationships with smaller entrepreneurial start-up organisations in their search for innovation-based outcomes.[108] An important outcome for small organisations successfully partnering with larger organisations in an alliance network is the credibility they build by being associated with their larger collaborators.[109]

# Competitive risks with cooperative strategies

Stated simply, many cooperative strategies fail. In fact, evidence shows that two-thirds of cooperative strategies have serious problems in their first two years and that as many as 50 per cent of them fail. This failure rate suggests that even when the partnership has potential complementarities and synergies, alliance success is elusive.[110] Although failure is undesirable, it can be a valuable learning experience, meaning that organisations should carefully study a cooperative strategy's failure to gain insights into how to form and manage future cooperative arrangements.[111] We show prominent cooperative strategy risks in Figure 9.5.

One cooperative strategy risk is that an organisation may act in a way that its partner thinks is opportunistic. Amylin Pharmaceuticals seems to believe that this is the case with Eli Lilly & Co., its partner in an alliance formed in 2002. Developing and commercialising the type 2 diabetes drug exenatide, which is sold as a twice-daily injection under the brand Byetta, is a major outcome of this alliance. However, Lilly signed an agreement with another organisation for the purpose of jointly developing and commercialising several diabetes drugs – including Tradjenta, a drug the US Food and Drug Administration has approved – is creating a situation in which Amylin appeared to conclude that Lilly is acting opportunistically. This led Amylin to file a lawsuit (subsequently withdrawn) against Lilly, 'alleging [that] Lilly's recent diabetes venture with Boehringer Ingelheim GmbH breaches the terms of Lilly's older partnership with Amylin to market other drugs for the disease'.[112]

In general, opportunistic behaviours surface either when formal contracts fail to prevent them or when an alliance is based on a false perception of partner trustworthiness. Not infrequently, the opportunistic organisation wants to acquire as much of its partner's tacit knowledge as it can.[113] Full awareness of what

**Figure 9.5** **Managing competitive risks in cooperative strategies**

a partner wants in a cooperative strategy reduces the likelihood that an organisation will suffer from another's opportunistic actions.[114]

Some cooperative strategies fail when it is discovered that an organisation has misrepresented the competencies it can bring to the partnership. This risk is more common when the partner's contribution is grounded in some of its intangible assets. Superior knowledge of local conditions is an example of an intangible asset that partners often fail to deliver. An effective way to deal with this risk may be to ask the partner to provide evidence that it does possess the resources and capabilities (even when they are largely intangible) it will share in the cooperative strategy.[115]

An organisation's failure to make available to its partners the resources and capabilities (such as the most sophisticated technologies) that it committed to the cooperative strategy is a third risk. For example, the effectiveness of the collaboration between BP Plc and OAO Rosneft is dependent on each organisation contributing some of its seismic and drilling-related resources and capabilities as the foundation for efforts to develop three blocks in Russia's Arctic Ocean. A failure by either partner to contribute needed resources and capabilities to this alliance has the potential to diminish the likelihood of success. This particular risk surfaces most commonly when organisations form an international cooperative strategy, especially in emerging economies.[116] In these instances, different cultures and languages can cause misinterpretations of contractual terms or trust-based expectations.

A final risk is that one organisation may make investments that are specific to the alliance while its partner does not. For example, the organisation might commit resources and capabilities to develop manufacturing equipment that can be used only to produce items coming from the alliance. If the partner is not also making alliance-specific investments, the organisation is at a relative disadvantage in terms of returns earned from the alliance compared with investments made to earn the returns.

# Managing cooperative strategies

Cooperative strategies are an important means of organisation growth and enhanced performance, but these strategies are difficult to effectively manage. Because the ability to effectively manage cooperative strategies is unevenly distributed across organisations in general, assigning managerial responsibility for an organisation's cooperative strategies to a high-level executive or to a team improves the likelihood that the strategies will be well managed. In turn, being able to successfully manage cooperative strategies can itself be a competitive advantage.[117]

Those responsible for managing the organisation's cooperative strategies should take the actions necessary to coordinate activities, categorise knowledge learned from previous experiences, and make certain that what the organisation knows about how to effectively form and use cooperative strategies is in the hands of the right people at the right time. Organisations must also learn how to manage both the tangible and intangible assets (such as knowledge) that are involved with a cooperative arrangement. Too often, partners concentrate on managing tangible assets at the expense of taking action to also manage the cooperative relationship's intangible assets.[118]

Cost minimisation and opportunity maximisation are the two primary approaches organisations use to manage cooperative strategies[119] (see Figure 9.5). In the *cost-minimisation approach*, the organisation develops formal contracts with its partners. These contracts specify how the cooperative strategy is to be monitored and how partner behaviour is to be controlled. The alliance between BP Plc and OAO Rosneft, through which the organisations aimed to develop three blocks in Russia's Arctic Ocean to search for oil, was managed largely through contracts.[120] (The perils of geopolitical rivalry made this alliance difficult.) The goal of the cost-minimisation approach is to minimise the cooperative strategy's cost and to prevent opportunistic behaviour by a partner.

Maximising a partnership's value-creating opportunities is the focus of the *opportunity-maximisation approach*. In this case, partners are prepared to take advantage of unexpected opportunities to learn from each other and to explore additional marketplace possibilities. Less formal contracts, with fewer constraints on partners' behaviours, make it possible for partners to explore how their resources and capabilities can be shared in multiple value-creating ways. This is the approach Renault, Nissan and Mitsubishi use to manage their collaborative relationship. The values of *trust*, *respect* and *transparency* on which this alliance is based facilitate use of the opportunity-maximisation management approach.

Organisations can successfully use both approaches to manage cooperative strategies. However, the costs to monitor the cooperative strategy are greater with cost minimisation, in that writing detailed contracts and using extensive monitoring mechanisms is expensive, even though the approach is intended to reduce alliance costs. Although monitoring systems may prevent partners from acting in their own best interests, they also often preclude positive responses to new opportunities that surface to productively use alliance partners' resources and capabilities. Thus, formal contracts and extensive monitoring systems tend to stifle partners' efforts to gain maximum value from their participation in a cooperative strategy and require significant resources to be put into place and used.[121]

The relative lack of detail and formality that is a part of the contract developed when using the opportunity-maximisation approach means that organisations need to trust that each party will act in the partnership's best interests. The psychological state of *trust* in the context of cooperative arrangements is the belief that an organisation will not do anything to exploit its partner's vulnerabilities, even if it has an opportunity to do so. When partners trust each other, there is less need to write detailed formal contracts to specify each organisation's alliance behaviours[122] and the cooperative relationship tends to be more stable.[123]

On a relative basis, trust tends to be more difficult to establish in international cooperative strategies compared with domestic ones. Differences in trade policies, cultures, laws and politics that are part of cross-border alliances account for the increased difficulty. When trust exists, monitoring costs are reduced and opportunities to create value are maximised. Essentially, in these cases, the organisations have built social capital.[124] Renault, Nissan and Mitsubishi have built social capital through their alliance by building their relationship on the mutual trust between the partners as well as their adherence to operating within the framework of agreed-upon confidentiality rules.[125]

Research showing that trust between partners increases the likelihood of success when using alliances highlights the benefits of the opportunity-maximisation approach to managing cooperative strategies. Trust may also be the most efficient way to influence and control alliance partners' behaviours. Research indicates that trust can be a capability that is valuable, rare, imperfectly imitable and often non-substitutable.[126] Thus, organisations known to be trustworthy can have a competitive advantage in terms of how they develop and use cooperative strategies. Increasing the importance of trust in alliances is the fact that it is not possible to specify all operational details of a cooperative strategy in a formal contract. As such, being confident that its partner can be trusted reduces the organisation's concern about the inability to contractually control all alliance details.

# STUDY TOOLS

## SUMMARY

**LO1** A cooperative strategy is one in which organisations work together to achieve a shared objective. The reasons organisations use cooperative strategies vary by slow-cycle, fast-cycle and standard-cycle market conditions. To enter restricted markets (slow cycle), to move quickly from one competitive advantage to another (fast cycle) and to gain market power (standard cycle) are among the reasons organisations choose to use cooperative strategies.

**LO2** The main type of cooperative strategy is strategic alliance, where organisations combine some of their resources and capabilities for the purpose of creating a competitive advantage. Joint ventures (where organisations create and own equal shares of a new venture), equity strategic alliances (where organisations own different shares of a newly created venture) and non-equity strategic alliances (where organisations cooperate through a contractual relationship) are the three major types of strategic alliances. Outsourcing, discussed in Chapter 3, commonly occurs as organisations form non-equity strategic alliances.

**LO3** Collusive strategies are the second type of cooperative strategy. In many economies, explicit collusive strategies are illegal unless sanctioned by government policies. Increasing globalisation has led to fewer government-sanctioned situations of explicit collusion. Tacit collusion is a cooperative strategy through which organisations tacitly cooperate to reduce industry output below the potential competitive output level, thereby raising prices above the competitive level.

**LO4** Four business-level cooperative strategies are used to help the organisation improve its performance in individual product markets. Of these, complementary alliances have the highest probability of helping an organisation form a competitive advantage; competition-reducing alliances have the lowest probability.

The four strategies are: (1) through vertical and horizontal complementary alliances, companies combine some of their resources and capabilities to create value in different parts (vertical) or the same parts (horizontal) of the value chain; (2) competition response strategies are formed to respond to competitors' actions, especially strategic actions; (3) uncertainty-reducing strategies are used to hedge against the risks created by the conditions of uncertain competitive environments (such as new product markets); and (4) competition-reducing strategies are used to avoid excessive competition while the organisation marshals its resources and capabilities to improve its strategic competitiveness.

**LO5** Organisations use corporate-level cooperative strategies to engage in product and/or geographic diversification. Through diversifying strategic alliances, organisations agree to share some of their resources and capabilities to enter new markets or produce new products. Synergistic alliances are ones where organisations share some of their resources and capabilities to develop economies of scope. Synergistic alliances are similar to business-level horizontal complementary alliances where organisations try to develop operational synergy, except that synergistic alliances are used to develop synergy at the corporate level. Franchising is a corporate-level cooperative strategy where the franchisor uses a franchise as a contractual relationship to specify how resources and capabilities will be shared with franchisees.

**LO6** As an international cooperative strategy, a cross-border strategic alliance is used for several reasons, including the performance superiority of organisations competing in markets outside their domestic market and governmental restrictions on an organisation's efforts to grow through mergers and acquisitions. Commonly, cross-border strategic alliances are riskier than their domestic counterparts, particularly when partners are not fully aware of each other's purpose for participating in the partnership.

**LO7** In a network cooperative strategy, several organisations agree to form multiple partnerships to achieve shared objectives. An organisation's opportunity to gain access to its partner's other partnerships is a primary benefit of a network cooperative strategy. Network cooperative strategies are used to form either a stable alliance network or a dynamic alliance network. Used in mature industries, stable networks are used to extend competitive advantages into new areas. In rapidly changing environments where frequent product innovations occur, dynamic networks are used primarily as a tool of innovation.

**LO8** Cooperative strategies are not risk free. If a contract is not developed appropriately, or if a partner misrepresents its competencies or fails to make them available, failure is likely. Furthermore, an organisation may be held hostage through asset-specific investments made in conjunction with a partner, which may be exploited.

**LO9** Trust is an increasingly important aspect of successful cooperative strategies. Organisations place high value on opportunities to partner with companies known for their trustworthiness. When trust exists, a cooperative strategy is managed to maximise the pursuit of opportunities between partners. Without trust, formal contracts and extensive monitoring systems are used to manage cooperative strategies. In this case, the interest is 'cost minimisation' rather than 'opportunity maximisation'.

## KEY TERMS

business-level cooperative strategy
complementary strategic alliances
cooperative strategy
corporate-level cooperative strategy
cross-border strategic alliance
diversifying strategic alliance
equity strategic alliance
franchising
joint venture
network cooperative strategy
non-equity strategic alliance
strategic alliance
synergistic strategic alliance

## REVIEW QUESTIONS

1. What is the definition of cooperative strategy? Why is this strategy important to organisations competing in the 21st-century competitive landscape?
2. What is a strategic alliance? What are the three major types of strategic alliances organisations form for the purpose of developing a competitive advantage?
3. What are two main types of competition-reducing strategies? How and why might governments monitor or regulate them?
4. What are the four business-level cooperative strategies? What are the key differences among them?
5. What are the three corporate-level cooperative strategies? How do organisations use each of these strategies for the purpose of creating a competitive advantage?
6. Which organisations represent examples of long-standing successful cooperative strategies?
7. Why do organisations use cross-border strategic alliances?
8. Why do organisations sometimes adopt network cooperative strategies? What are the alliance network types typically used?
9. What risks are organisations likely to experience as they use cooperative strategies?
10. What are the differences between the cost-minimisation approach and the opportunity-maximisation approach to managing cooperative strategies?

## EXPERIENTIAL EXERCISES

### Exercise 1: What is it – television, internet or both?

Hulu (http://www.hulu.com) is a website and cooperative alliance that offers commercially supported content of television (video on demand) shows through the internet. The name is derived from a Chinese word that means 'holder of precious things'. The alliance has many different partners that are related in interesting ways and from very different market types.

Working in groups, complete the following:

1. Describe the original alliance partners. Characterise the market type as slow, fast or standard cycle.

2. Characterise the type of strategic alliance Hulu has become.
3. In what type of market is Hulu competing?
4. Why did this alliance form? List some competitive pressures that made this alliance a necessity for its partners.
5. How has this alliance changed? What does the future hold for this alliance?

### Exercise 2: Airlines and alliances

According to your text, a strategic alliance 'is a partnership between organisations whereby their resources and capabilities are combined to create a competitive advantage'. So what is in an alliance for an airline company such as United, American or British Airways? In this exercise, your instructor will assign one of the three main alliances (OneWorld, Star or SkyTeam) and your teams will be requested to investigate the alliance and be prepared to discuss the following issues:

1. In general, why do airlines form an alliance with one another (particularly internationally) rather than expanding by acquisition?
2. What is the history of the alliance to which you were assigned?
3. Describe the main benefits that airlines hope to gain through membership. What is the competitive advantage of your particular alliance (if you find there is one)?
4. Categorise the alliance in terms of the three types of strategic alliance. Also describe the cooperative strategy of a member organisation in relation to its business-level and corporate-level strategy.
5. Think through issues of the future of airline alliances. If you were the CEO of a major US airline, what might worry you about your particular alliance, if anything?

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# PART 3

## STRATEGIC ACTIONS: STRATEGY IMPLEMENTATION

CHAPTER 10

# Corporate governance

## Learning Objectives

Studying this chapter should provide you with the strategic management knowledge needed to:

**LO1** define corporate governance and explain why it is used to monitor and control executive managers' decisions

**LO2** explain why ownership is largely separated from managerial control in organisations

**LO3** define an agency relationship and managerial opportunism and describe their strategic implications

**LO4** explain the use of three internal governance mechanisms to monitor and control managers' decisions

**LO5** discuss the types of compensation executive managers receive and their effects on managerial decisions

**LO6** describe how the external corporate governance mechanism – the market for corporate control – restrains executive managers' decisions

**LO7** discuss the nature and use of corporate governance in international settings, especially in Australia, Germany, Japan, Spain and China

**LO8** describe how corporate governance fosters the making of ethical decisions by an organisation's executive managers.

# OPENING CASE STUDY

## General Electric's complex diversification strategy makes evaluation difficult for board directors

As noted in Chapter 6, diversified organisations can be complex, given the number of businesses an organisation is trying to manage simultaneously. This is not only a difficult task for managers, but is more difficult for board directors, especially when they come from outside the organisation. Outside directors largely have to depend on the analyses managers present, given the overall complexity of large diversified organisations. Concerning General Electric (GE), former CEO Jack Welch formed a large set of businesses in the 1980s and 1990s. Although his successor, Jeffery Immelt, largely dealt with the financial crisis and the divestiture of GE Capital, there were still significant problems from the excess diversification. In December 2016, the earnings reports started raising alarms. Nelson Peltz, from Trian Partners, had invested heavily in the organisation in 2015. When this investment began to decrease in value in 2016, Trian and other activist shareholders forced Immelt's dismissal, and John Flannery took over as CEO. Flannery was subsequently replaced by Lawrence Culp Jr. Edward Garden of Trian Partners subsequently became a board member to watch over Trian's investment, which had shrunk to US$1.7 billion from its original US$2.5 billion in value.

In early 2018, as Flannery sought to overcome GE's performance difficulties, nine new board members were proposed on GE's proxy statement, which meant half of the board was targeted for replacement. Although there had already been significant restructuring under Immelt – including selling the majority of GE Capital, NBCUniversal and GE's appliance business – Flannery announced that he would seek to sell more assets worth an additional US$80 billion as well as propose layoffs and other cost improvements. In addition, GE had been paying a significant dividend and buying back shares, but much of this capital came from increased debt. To deal with this, Flannery reduced the dividend payment and became more transparent with how GE used its free cash flow. Garden's board seat gave Trian access to the board's deliberations and detailed financial results just as the organisation was conducting a strategic review of its business portfolio and deciding how to cut costs and spend its cash flow. GE also took a large US$6 billion charge against its earnings in early 2018 associated with its insurance business, which was part of the legacy GE Capital business. Interestingly, when Lawrence Culp Jr took over the leadership of GE, overnight the share price increased approximately 10 per cent.

Apparently, along with the increased debt burden and this US$6 billion charge, the board had failed to monitor other things carefully, including an extra private plane used by Mr Immelt. Additionally, there were problems with earnings calculations that the board failed to catch, so much so that GE had to restate its earnings from 2016 and 2017. These failings led to significant governance restructuring – particularly, the replacement of the nine outside board members, including an activist board member, Mr Garden.

In late 2017, Flannery announced that GE would focus on three core segments going forward: aviation, power and power distribution, and health care. One of the difficulties in restructuring the organisation was that GE was saddled with US$97.5 billion in debt. Furthermore, it had US$31 billion in unfunded pension liabilities. To fund the debt and pension liabilities, GE needed substantial cash flow from its remaining businesses, making it difficult to sell all the assets, so Flannery sought to

John Flannery was let go by the GE board in October of 2018, after a 14-month stint as CEO.

Source: Getty Images/Bloomberg/Prashanth Vishwanathan restructure. To deal with this dilemma GE set up a new board committee focused on restructuring its portfolio and working through the legal ramifications. When you build a business such as GE, you build it for specific strategic reasons; breaking it up cannot be readily undone, despite shareholder wishes or demands.

In summary, GE was in a bind, largely because the board members seemed not to understand the complexity that the organisation's strategic leaders were pursuing. Because they missed the warning signs, they could not shelter the organisation from bad strategic acquisitions. More painful decisions are probably ahead.

Sources: R. Clough, N. Buhayar & T. Black, 2018, Conglomerates don't work, *Bloomberg Businessweek*, 5 February, 14–16; R. Messenbock, Y. Morieux, J. Backx & D. Wunderlich, 2018, How complicated is your company? http://www.bcg.com, 16 January; A. Narayanan, 2018, If General Electric breaks up should you break up with GE stocks?, *Investor's Business Daily*, http://www.investors.com, 19 January; B. Sutherland, 2018, The slow ugly unraveling of GE, *Bloomberg Businessweek*, 22 January, 30; 2017, The right mechanic? *Economist*, 18 November, 54–5; T. Gryta, D. Benoit & J. S. Lublin, 2017, GE gives activist Trian a seat on the board, *Wall Street Journal*, http://www.wsj.com, 9 October; T. Gryta, 2017, GE probed who knew about spare jet for Immelt, *Wall Street Journal*, http://www.wsj.com, 13 December; D. Z. Morris, 2017, General Electric to lose 9 board members, *Fortune*, http://www.fortune.com, 19 November; G. Roumeliotis, 2017, General Electric faces long road to pruning assets, Reuters, http://www.reuters.com, 13 November; L. Shen, 2017, Biggest breakup: General Electric, *Fortune*, http://www.fortune.com, 20 December.

As the opening case suggests, corporate governance involves a number of activities dealing with how organisations operate. Given that we are concerned with the strategic management process organisations use, our focus in this chapter is on corporate governance in organisations. Corporate governance is concerned with various activities, including those intended to:

1. strengthen the effectiveness of an organisation's board of directors
2. verify the transparency of an organisation's operations
3. enhance accountability to shareholders
4. effectively incentivise executives
5. in an overall sense, maximise the organisation's ability to create value for stakeholders and especially for shareholders.

Comprehensive in scope and complex in nature, corporate governance is a responsibility that challenges organisations and their leaders. Successfully dealing with this challenge is important, as evidence suggests that corporate governance is critical to organisations' performance and success. Because of this, governance is an increasingly important part of the strategic management process.[1] For example, if the board makes the wrong decisions in selecting, governing and compensating the organisation's CEO as its key strategic leader, the shareholders and the organisation suffer. Recent cases on point include former CEOs of Westpac Group, National Australia Bank and Bellamy's, and former CEO and Chair of AMP, all of whom resigned due to reputational damage suffered by the organisations under their leadership and shareholder and stakeholder concerns. Conversely, when CEOs are motivated to act in the best interests of the organisation – in particular, the shareholders – the organisation's value should increase. Additionally, effective succession plans and appropriate monitoring and direction-setting efforts by the board of directors contribute positively to an organisation's performance.

**corporate governance**
the set of mechanisms used to manage the relationship among stakeholders and to determine and control the strategic direction and performance of organisations

**Corporate governance** is the set of mechanisms used to manage the relationship among stakeholders and determine and control the strategic direction and performance of organisations, and is widely accepted as the most fitting for current global context: '… [corporate governance represents] the system by which companies are directed and controlled. Board of Directors are responsible for the governance of their companies, ensuring that they are well run'.[2] The significance of corporate governance was captured in a broader definition authored by Sir Adrian Cadbury, who noted that the governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources.[3] At its core, corporate governance is concerned with three important issues. The first issue is the monitoring of the organisation. The second issue is setting the tone for the strategic appetite of the organisation as well as the strategic direction, ensuring that strategic decisions are made effectively and that they facilitate an organisation's efforts to achieve strategic competitiveness.[4] The third issue is the appointment and removal of the CEO (or equivalent) of the organisation.

In modern corporations – especially those in nations with 'Westernised' business practices such as Australia, the USA and the UK – ensuring that executive managers' interests are aligned with other stakeholders' interests, particularly those of shareholders, is another primary objective of corporate governance. Thus, corporate governance involves oversight in areas where owners, managers and members of boards of directors may have conflicts of interest. Processes used to elect members of the organisation's board of directors, the general supervision of CEO pay and more focused supervision of director pay, and the organisation's overall strategic direction, are examples of areas in which oversight is sought.[5] Because corporate governance is an ongoing process concerned with how an organisation is to be managed, its nature evolves in light of the types of never-ending changes in an organisation's external environment that we discussed in Chapter 2.

The emphasis on corporate governance that is occurring across the globe stems mainly from the apparent failure of corporate governance mechanisms to adequately monitor and control executive managers' decisions. Relevant examples of corporate governance failures internationally and in Australia include: Enron, Lehman Brothers, HIH, Dick Smith, Thomas Cook Travel, Blockbuster Video, Toys R Us, AMP, Commonwealth Bank of Australia and Westpac Group. A second and more positive reason for this interest comes from evidence that a well-functioning corporate governance system can create a competitive advantage for an individual organisation.[6]

Corporate governance is of concern to nations as well as to individual organisations.[7] Although corporate governance reflects organisational standards, it also collectively reflects the societal standards of nations.[8] Commenting about governance-related changes being made in Singapore, an official noted: 'Good corporate governance plays an important role in ensuring the effective functioning of Singapore's capital markets'.[9] Ensuring the independence of board members and practices a board should follow to exercise effective oversight of an organisation's internal control efforts are examples of recent changes to governance standards being applied in Singapore. Efforts such as these are important because research shows that how nations choose to govern their organisations does affect organisations' investment decisions. In other words, organisations seek to invest in nations with national governance standards that are acceptable to them.[10] This is particularly the case when organisations consider the possibility of geographically expanding into emerging markets.

In the chapter's first section, we describe the relationship on which the modern organisation is built: namely, the relationship between owners and managers. We use the majority of the chapter to explain various mechanisms owners use to govern managers and to ensure that they comply with their responsibility to satisfy stakeholders' needs, especially those of shareholders.

Three internal governance mechanisms and a single external one are used in the modern organisation. The three internal governance mechanisms we describe in this chapter are ownership concentration, represented by types of shareholders and their different incentives to monitor managers; the board of directors; and executive compensation. We then consider the market for corporate control, which is an external corporate governance mechanism. Essentially, this market is a set of potential owners seeking to acquire undervalued organisations and earn above-average returns on their investments by replacing ineffective executive management teams.[11] The chapter's focus then shifts to the issue of international corporate governance. We briefly describe governance approaches used in Australian, German, Japanese, Chinese and Spanish organisations. In part, this discussion suggests that the structures used to govern global companies competing in both developed and emerging economies are becoming more, rather than less, similar. Closing our analysis of corporate governance is a consideration of the need for these control mechanisms to encourage and support ethical behaviour in organisations.

# Separation of ownership and managerial control

Historically, organisations were managed by founder-owners and their descendants. In these cases, corporate ownership and control resided in the same individuals. As organisations grew larger, 'the managerial revolution led to a separation of ownership and control in most large corporations, where control of the firm shifted from entrepreneurs to professional managers while ownership became dispersed among thousands of unorganised stockholders who were removed from the day-to-day management of the firm'.[12] These changes created the modern public corporation, which is based on the efficient separation of ownership and managerial control. Supporting the separation is a basic legal premise suggesting that the primary objective of an organisation's activities is to increase the corporation's profit and, thereby, the owners' (shareholders') financial gains.[13]

The separation of ownership and managerial control allows shareholders to purchase shares, which entitles them to income (residual returns) from the organisation's operations after paying expenses. This right, however, requires that shareholders take a risk that the organisation's expenses may exceed its revenues. To manage this investment risk, shareholders maintain a diversified portfolio by investing in several companies to reduce their overall risk.[14] The poor performance or failure of any one organisation in which they invest has less overall effect on the value of the entire portfolio of investments. Thus, shareholders specialise in managing their investment risk.

Commonly, those managing small organisations also own a significant percentage of the organisation. In such instances, there is less separation between ownership and managerial control. Moreover, in a large number of family-owned organisations, ownership and managerial control are not separated at all. Research shows that family-owned organisations perform better when a member of the family is the CEO than when the CEO is an outsider.[15]

In many regions, including Latin America, Asia and some parts of Europe, family-owned organisations still dominate the competitive landscape.[16] The primary purpose of most of these organisations is to increase the family's wealth, which explains why a family CEO often is perceived as better than an outside CEO. Family-controlled organisations face at least two critical issues related to corporate governance. First, as they grow, they may not have access to all of the skills needed to effectively manage the organisation and maximise returns for the family. Thus, outsiders (or 'independent directors', as they are commonly known in other Western countries) may be required to facilitate growth. Also, as the organisation grows, the family-owners may need to seek outside capital and thus give up some of their ownership. In these cases, protecting the minority owners' rights becomes important.[17] To avoid these potential problems, when family organisations grow and become more complex, their owner-managers may contract managerial specialists. These managers make major decisions in the owners' organisation and are compensated on the basis of their decision-making skills. Research suggests that organisations in which families own enough equity to have influence without major control tend to make the best strategic decisions.[18]

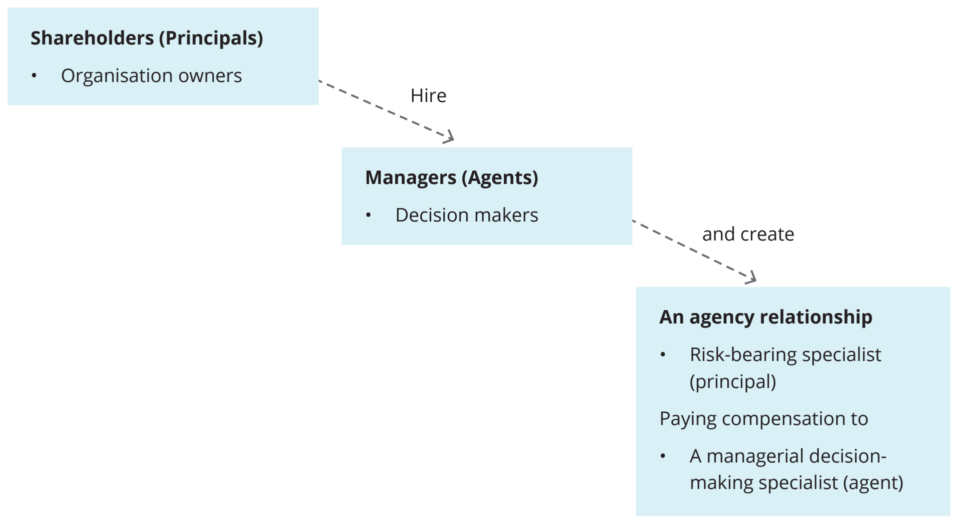
Without owner (shareholder) specialisation in risk bearing and management specialisation in decision making, an organisation may be limited by its owners' abilities to simultaneously manage it and make effective strategic decisions relative to risk. Thus, the separation and specialisation of ownership (risk bearing) and managerial control (decision making) should produce the highest returns for the organisation's owners.

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

## Agency relationships

The separation between owners and managers creates an agency relationship. An **agency relationship** exists when one or more persons (the principal or principals) hire another person or persons (the agent or agents) as decision-making specialists to perform a service.[19] Thus, an agency relationship exists when one party delegates decision-making responsibility to a second party for compensation (see Figure 10.1).

**Figure 10.1** An agency relationship




In addition to shareholders and executive managers, other examples of agency relationships are consultants and clients, insured and insurer, or real estate agents and vendors. Moreover, within organisations an agency relationship exists between managers and their employees, as well as between executive managers and the organisation's owners.[20] However, in this chapter we focus on the agency relationship between the organisation's owners (the principals) and executive managers (the principals' agents) because these managers are responsible for formulating and implementing the organisation's strategies, which have major effects on organisation performance.[21]

The separation between ownership and managerial control can be problematic. Research evidence documents a variety of agency problems in the modern corporation.[22] Problems can surface because the principal and the agent have different interests and goals or because shareholders lack direct control of large, publicly traded corporations. Problems also surface when an agent makes decisions that result in pursuing goals that conflict with those of the principals. Thus, the separation of ownership and control potentially allows divergent interests (between principals and agents) to occur, which can lead to managerial opportunism.

**Managerial opportunism** is the seeking of self-interest with guile (i.e. cunning or deceit).[23] Opportunism is both an attitude (e.g. an inclination) and a set of behaviours (i.e. specific acts of self-interest).[24] Principals do not know beforehand which agents will or will not act opportunistically. An executive manager's reputation is an imperfect predictor; moreover, opportunistic behaviour cannot be observed until it has occurred. Thus, principals establish governance and control mechanisms to prevent agents from acting opportunistically, even though only a few are likely to do so. Interestingly, research suggests that when CEOs feel constrained by governance mechanisms, they are more likely to seek external advice, which in turn helps them make better strategic decisions.[25]

**managerial opportunism**
the seeking of self-interest with guile (i.e. cunning or deceit)

The agency relationship suggests that any time principals delegate decision-making responsibilities to agents, the opportunities for conflicts of interest exist. Executive managers, for example, may make strategic decisions that maximise their personal welfare and minimise their personal risk.[26] Decisions such as these prevent the maximisation of shareholder wealth. Decisions regarding product diversification demonstrate this situation.

## Product diversification as an example of an agency problem

As explained in Chapter 6, a corporate-level strategy to diversify the organisation's product lines can enhance an organisation's strategic competitiveness and increase its returns, both of which serve the interests of all stakeholders and certainly shareholders and executive managers. However, product diversification can create two benefits for executive managers that shareholders do not enjoy, meaning that they may prefer product diversification more than shareholders do.[27]

The fact that product diversification usually increases the size of an organisation and that size is positively related to executive compensation is the first of the two benefits of additional diversification that may accrue to executive managers. Diversification also increases the complexity of managing an organisation and its network of businesses, possibly requiring additional managerial remuneration because of this complexity.[28] Thus, increased product diversification provides an opportunity for executive managers to increase their compensation.[29]

The second potential benefit is that product diversification and the resulting diversification of the organisation's portfolio of businesses can reduce executive managers' employment risk. Managerial employment risk is the risk of job loss, loss of compensation and loss of managerial reputation.[30] These risks are reduced with increased diversification because this makes an organisation and its upper-level managers less vulnerable to the reduction in demand associated with a single or limited number of product lines or businesses. Events occurring at Bellamy's Australia Limited demonstrate these issues.

In December 2016, Bellamy's, an organic infant formula and baby food producer, announced to the Australian Securities Exchange (ASX) that it would continue to grow from strength to strength across Asia to diversify its limited product range beyond two businesses. Bellamy's recognised that opportunities in China were vast. Yet less than a month later, Bellamy's shares had declined by more than one-third after it terminated its CEO and slashed its profit guidance for the coming six months. The organisation had emerged from a 40-day trading halt announcing an overhaul of its leadership team. The board announced CEO Laura McBain had been replaced by chief operating officer Andrew Cohen. During the trading halt, the organisation faced a push from shareholders to replace a number of independent non-executive directors.

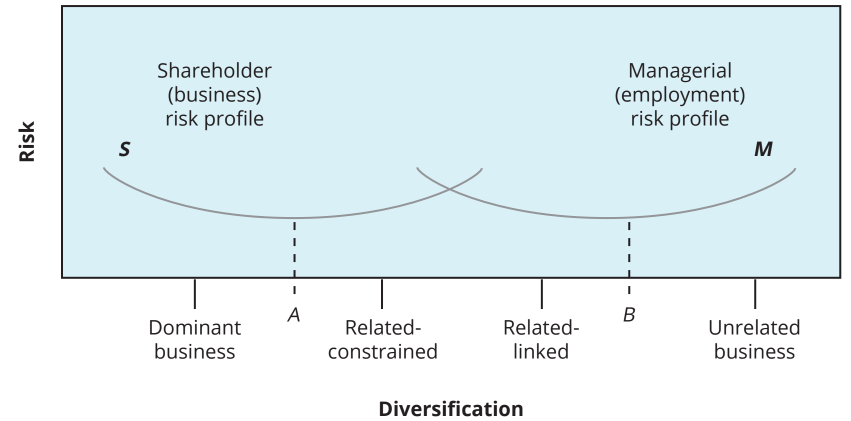
In a statement to the ASX, Bellamy's said it had shaken up its contract with Fonterra, allowing it to cut production. It was expecting its net profit after tax to be between 4 and 6 per cent of revenue, due to lower sales volumes, high interest costs and increased costs of organic ingredients. Shares in Bellamy's fell more than 40 per cent on 2 December 2017, when the organisation announced new Chinese regulations were crimping sales and depressing prices. The dairy organisation had been a favourite of the ASX with shares worth more than $15.00. The organisation's shares were halted, and then suspended, from trade on the ASX. Shares were worth $6.68 when the organisation entered the halt.[31]

Free cash flow is the source of another potential agency problem. Calculated as operating cash flow minus capital expenditures, free cash flow represents the cash remaining after the organisation has invested in all projects that have positive net present value within its current businesses.[32] Executive managers may decide to invest free cash flow in product lines that are not associated with the organisation's current lines of business to increase the organisation's degree of diversification. However, when managers use free cash flow to diversify the organisation in ways that do not have a strong possibility of creating additional value for stakeholders, and certainly for shareholders, the organisation is over-diversified. Over-diversification is an example of self-serving and opportunistic managerial behaviour. In contrast to managers, shareholders may prefer that free cash flow be distributed to them as dividends, so they can control how the cash is invested.[33]

In Figure 10.2, Curve *S* shows shareholders' optimal level of diversification. As the organisation's owners, shareholders seek the level of diversification that reduces the risk of the organisation's total failure while simultaneously increasing its value by developing economies of scale and scope (see Chapter 6).

Of the four corporate-level diversification strategies shown in Figure 10.2, shareholders likely prefer the diversified position noted by point *A* on Curve *S* – a position that is located between the dominant business and related-constrained diversification strategies. Of course, the optimum level of diversification owners seek varies from organisation to organisation.[34] Factors that affect shareholders' preferences include the organisation's primary industry, the intensity of rivalry among competitors in that industry, and the top management team's experience with implementing diversification strategies and its effects on other organisation strategies, such as its entry into international markets.[35]

**Figure 10.2 Manager and shareholder risk and diversification**




As is the case for principals, executive managers – as agents – also seek an optimal level of diversification. Declining performance resulting from too much diversification increases the probability that external investors (representing the market for corporate control) will purchase a substantial percentage of the organisation (or the entire organisation) for the purpose of controlling it. If an organisation is acquired, the employment risk for its executive managers increases significantly. Furthermore, these managers' employment opportunities in the external managerial labour market (discussed in Chapter 12) are affected negatively by an organisation's poor performance. Therefore, executive managers prefer that the organisations they lead be diversified. However, their preference is that the organisation's diversification falls short of the point at which it increases their employment risk and reduces their employment opportunities.[36] Curve *M* in Figure 10.2 shows that executive managers prefer higher levels of product diversification than do shareholders. Executive managers might find the optimal level of diversification as shown by point *B* on Curve *M*.

In general, shareholders prefer riskier strategies and more-focused diversification. Shareholders reduce their risk by holding a diversified portfolio of investments. Alternatively, managers cannot balance their employment risk by working for a diverse portfolio of organisations; therefore, managers may prefer a level of diversification that maximises organisation size and their compensation while also reducing their employment risk. Product diversification, therefore, is a potential agency problem that could result in principals incurring costs to control their agents' behaviours.

## Agency costs and governance mechanisms

The potential conflict between shareholders and executive managers shown in Figure 10.2, coupled with the fact that principals cannot easily predict which managers might act opportunistically, demonstrates why principals establish governance mechanisms. However, the organisation incurs costs when it uses one or more governance mechanisms. **Agency costs** are the sum of incentive costs, monitoring costs,

**agency costs**
the sum of incentive costs, monitoring costs, enforcement costs and individual financial losses incurred by principals because governance mechanisms cannot guarantee total compliance by the agent

enforcement costs and individual financial losses incurred by principals because governance mechanisms cannot guarantee total compliance by the agent. Because monitoring the activities taking place within an organisation is difficult, the principals' agency costs are larger in diversified organisations given the additional complexity of diversification.[37]

In general, managerial interests may prevail when governance mechanisms are weak and as such, ineffective; this is exemplified in situations where managers have a significant amount of autonomy to make strategic decisions. If, however, the board of directors controls managerial autonomy, or if other strong governance mechanisms are used, the organisation's strategies should better reflect stakeholders', and certainly shareholders', interests.

In the USA, observers of organisations' governance practices have been concerned about more egregious behaviour beyond mere ineffective corporate strategies, such as that discovered at Enron and WorldCom. Partly in response to these behaviours, the US Congress enacted the Sarbanes-Oxley (SOX) Act in 2002 and passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) in mid-2010.[38]

One of the main challenges for leaders today is to maintain the board of directors' key role in the governance system. The clear ramifications for governance for Australian boards of directors from an agency perspective is that adequate monitoring or control mechanisms need to be established to protect shareholders from management's conflict of interest – the so-called 'agency costs' of modern capitalism.[39] This chapter supports the notion that, in most instances, the board of directors is an important mechanism to alleviate agency problems in principal–agent relationships. Legally, the board of directors monitors the board's functions and represents the shareholders' interests. The board of directors is elected by shareholders and has the ultimate decision-making and voting rights over the organisation's assets. In general, the CEO reports directly to the board.

Next we explain the effects of the three internal governance mechanisms on managerial decisions regarding the organisation's strategies.

# Ownership concentration

**ownership concentration** refers to both the number of large-block shareholders and the total percentage of shares they own

**large-block shareholders** typically own at least 5 per cent of a corporation's issued shares

**Ownership concentration** is defined by the number of large-block shareholders and the total percentage of the organisation's shares they own. **Large-block shareholders** typically own at least 5 per cent of an organisation's issued shares. For example, BHP's top shareholders are a mix of investment funds and banks.[40] Ownership concentration as a governance mechanism has received considerable interest because large-block shareholders are increasingly active in their demands that organisations adopt effective governance mechanisms to control managerial decisions so that they will best represent owners' interests.[41] In recent years, the number of individuals who are large-block shareholders has declined. Institutional owners such as banks have replaced individuals as large-block shareholders.

In general, diffuse ownership (a large number of shareholders with small holdings and few, if any, large-block shareholders) produces weak monitoring of managers' decisions. One reason for this is that diffuse ownership makes it difficult for owners to effectively coordinate their actions. As noted earlier, diversification beyond the shareholders' optimum level can result from ineffective monitoring of managers' decisions. Higher levels of monitoring could encourage managers to avoid strategic decisions that harm shareholder value, such as too much diversification. Research evidence suggests that ownership concentration is associated with lower levels of organisation product diversification.[42] Thus, with high degrees of ownership concentration, the probability is greater that managers' decisions will be designed to maximise shareholder value.[43]

The importance of boards of directors to mitigate excessive appropriation of minority shareholder value has been found in organisations with strong family ownership wherein family members have incentives to appropriate shareholder wealth, especially in the second generation after the founder has departed.[44]

## Ownership structures of companies in Australia

Australian corporations must be registered by the Australian Securities and Investments Commission (ASIC) and they legally operate under the *Corporations Act 2001* (Cth). In relation to limitation of liability of an organisation in Australia there are two different types: 'limited by guarantee' (i.e. the liability of members is restricted to an amount set out in the organisation constitution) and 'limited by shares'. Contemporary literature refers primarily to two model types for corporate governance: namely, the outsider and insider models.[45] Solomon points out that:

> Every country exhibits a unique system of corporate governance: there are as many corporate governance systems as there are countries. The system of corporate governance presiding in any one country is determined by a wide array of internal factors including ownership structure, the state of the economy, the legal system, and government policies.[46]

## The increasing influence of institutional owners

A classic work published in the 1930s argued that a separation of ownership and control had come to characterise the 'modern' organisation.[47] This change occurred primarily because growth prevented founder-owners from maintaining their dual positions in what were increasingly complex companies. More recently, another shift has occurred: ownership of many modern corporations is now concentrated in the hands of institutional investors rather than individual shareholders.[48]

**Institutional owners** are financial institutions such as mutual funds and superannuation funds that control large-block shareholder positions. Because of their prominent ownership positions, institutional owners, as large-block shareholders, have the potential to be a powerful governance mechanism. In 2017, it was estimated that institutional owners held roughly 80 per cent of all the market value of the US broad-market Russell 3000 Index and 80 per cent of the large-cap S&P 500 Index. In dollars, that is approximately US$21.7 trillion and US$18 trillion, respectively.[49] The importance of pension/superannuation funds to an entire economy is suggested by this comment: 'Pension funds are critical drivers of growth and economic activity because they are one of the only significant sources of long-term, patient capital'.[50]

**institutional owners**
financial institutions such as stock mutual funds and superannuation funds that control large-block shareholder positions

These percentages suggest that, as investors, institutional owners have both the size and the incentive to discipline ineffective executive managers and that they can significantly influence an organisation's choice of strategies and strategic decisions.[51] Research evidence indicates that institutional and other large-block shareholders are becoming more active in their efforts to influence a corporation's strategic decisions, unless they have a business relationship with the organisation. Initially, these shareholder activists and institutional investors concentrated on the performance and accountability of CEOs and contributed to the dismissal of a number of them. Activists often target the actions of boards more directly via proxy vote proposals that are intended to give shareholders more decision rights because they believe board processes have been ineffective.[52] To date, research suggests that institutional activism may not have a strong direct effect on organisation performance but may indirectly influence a targeted organisation's strategic decisions, including those concerned with international diversification and innovation. Thus, to some degree at least, institutional activism has the potential to discipline managers and to enhance the likelihood of an organisation taking future actions that are in shareholders' best interests.[53]

# Board of directors

**board of directors**
a group of elected individuals whose primary responsibility is to act in the owners' interests by formally monitoring and controlling the organisation's executives

Shareholders elect the members of an organisation's board of directors. The **board of directors** is a group of elected individuals whose primary responsibility is to act in the owners' best interests by formally monitoring and controlling the organisation's executive managers.[54] Those elected to an organisation's board of directors are expected to oversee managers and to ensure that the organisation operates in ways that will best serve stakeholders' interests, and particularly the owners' interests. Helping board members reach their expected objectives are their powers to direct the affairs of the organisation and to reward and discipline executive managers.

Though important to all shareholders, an organisation's individual shareholders with small ownership percentages are very dependent on the board of directors to represent their interests.

The structure of a board of directors concerns the size, composition and skill sets that influence the effectiveness of a board and determine the ability of the board members to work together.[55] Each of these three factors will be discussed in turn:

1. *Size:* Size could be a hindrance on governance capacity and performance. Some research recommends a limit of eight directors as any larger number will interfere with group dynamics and inhibit a board of directors' performance, and a larger board brings greater levels of bureaucracy.[56] The viewpoints of others have been less definitive, with results of alternative research noting that it is not the size of the board of directors that is critical, in relation to governance, but rather the number of outside members of the board.[57] Notwithstanding this viewpoint, it has been noted that the key consideration should be around whether there are enough directors to provide the skills that the board of directors needs at the boardroom table.[58] All these researchers raise valid points and it is recommended in the Australian context that regardless of whether it is a commercial, superannuation or not-for-profit board of directors, the size should not exceed eight or nine board members with the prerequisite skills and experience that should be expected around a boardroom table.
2. *Board composition:* Board of directors composition does matter. The board's composition and leadership structure can influence a variety of organisational outcomes.[59] Factors such as culture and ownership structure impact on composition.[60] Related studies on the issue of the diversity of boards of directors have identified that the large majority of directors are white males from a managerial or professional background, aged in their fifties or sixties, and that a number of observations could be made about their personalities, including a personality profile to be much less risk averse than a diverse board.[61]
3. *Trustee or director skill set:* Trustee competence is gained from experience, skills, attitudes and knowledge. Behavioural competencies also influence the relationships around the boardroom table – in particular, between the board of directors and management and between trustees or directors.[62] The area of directors' skills and capabilities is an extremely important one in Australia and has not been given the attention that it deserves.

Unfortunately, evidence suggests that many boards have not been highly effective in monitoring and controlling executive managers' decisions and subsequent actions.[63] Because of their relatively ineffective performance, and as a consequence of the 2008–09 global financial crisis (GFC), boards are continuing to experience increasing pressure from shareholders, lawmakers and regulators to be more forceful in their oversight role to prevent executive managers from acting in their own best interests. Moreover, in addition to their monitoring role, board members increasingly are expected to provide resources to the organisations they serve. These resources include their personal knowledge and expertise, and their relationships with a wide variety of organisations.[64]

Generally, board members (often called directors) are classified into one of three groups (see Table 10.1). *Insiders* are active executive managers in the organisation who are elected to the board because they are a source of information about the organisation's day-to-day operations.[65] *Related outsiders* have some relationship with the organisation, contractual or otherwise, that may create questions about their independence, but these individuals are not involved with the corporation's day-to-day activities. *Outsiders* provide independent counsel to the organisation and may hold executive managerial positions in other companies or may have been elected to the board prior to the beginning of the current CEO's tenure.[66]

Historically, inside managers dominated an organisation's board of directors. A widely accepted view is that a board with a significant percentage of its membership from the organisation's executive managers

**Table 10.1** **Classification of board of directors' members**

| |
|---|
| Insiders |
| • The organisation's CEO and other executive managers |
| Related outsiders |
| • Individuals not involved with the organisation's day-to-day operations, but who have a relationship with the organisation |
| Outsiders |
| • Individuals who are independent of the organisation in terms of day-to-day operations and other relationships |

provides relatively weak monitoring and control of managerial decisions.[67] With weak board monitoring, managers sometimes use their power to select and compensate directors and exploit their personal ties with them. Critics advocate reforms to ensure that independent outside directors are a significant majority of a board's total membership; research suggests this has been accomplished.[68] However, others argue that having outside directors is not enough to resolve the problems in that CEO power can strongly influence a board's decision. One proposal, and this is common practice in Australia, is to reduce the power of the CEO by separating the chair's role and the CEO's role on the board so that the same person does not hold both positions.[69] A situation in which an individual holds both the CEO and chair of the board title is called *CEO duality*. Yet, having a board that actively monitors executive managers' decisions and actions does not ensure high performance. The value that the directors bring to the organisation also influences the outcomes. For example, boards with members having significant relevant experience and knowledge are the most likely to help the organisation formulate and implement effective strategies.[70]

Alternatively, having a large number of outside (also commonly known as 'independent') board members can also create some problems. For example, because independent directors typically do not have contact with the organisation's day-to-day operations and do not have ready access to detailed information about managers and their skills, they may lack the insights required to fully and effectively evaluate their decisions and initiatives.[71] Independent directors can, however, obtain valuable information through frequent interactions with inside board members and during board meetings to enhance their understanding of managers and their decisions.

Because they work with and lead the organisation daily, insiders have access to information that facilitates forming and implementing appropriate strategies. Accordingly, some evidence suggests that boards with a critical mass of insiders typically are better informed about intended strategic initiatives, the reasons for the initiatives and the outcomes expected from pursuing them.[72] Without this type of information, independent (outsider)-dominated boards may emphasise financial, as opposed to strategic, controls to gather performance information to evaluate managers' and business units' performances. A virtually exclusive reliance on financial evaluations shifts risk to executive managers who, in turn, may make decisions to maximise their interests and reduce their employment risk. Reducing investments in research and development (R&D), further diversifying the organisation and pursuing higher levels of compensation are some of the results of managers' actions to reach the financial goals set by outsider-dominated boards.[73] Additionally, boards can make mistakes regarding CEO succession decisions because of the lack of important information about candidates as well as the organisation's specific needs. Overall, knowledgeable and balanced boards are likely to be the most effective over time.[74]

Table 10.2 provides some insight into the sorts of expertise available by different types of directors or trustees. Notwithstanding this, research that investigated over 100 boards of directors over a five-year period found that many boards lack competent members.[75]

**Table 10.2** **Expertise of different type of directors or trustees**

| Director category | Areas of resources provided | Type of director or trustee |
|---|---|---|
| **Insiders** | • Expertise on the organisation, its strategy and direction<br>• Specific knowledge in areas such as finance and law | • Current and former officers of the organisation |
| **Business experts** | • Expertise on competition decision making and problem solving in large organisations<br>• Serve as 'sounding boards' for ideas<br>• Alternative viewpoints on problems<br>• Channels of communication between organisations<br>• Legitimacy | • Current and former senior officers of other large for-profit organisations<br>• Directors of other large for-profit organisations |
| **Support specialists** | • Specialised expertise on law, banking, insurance and public relations<br>• Channels of communication to large and powerful suppliers or government agencies<br>• Ease of access to vital resources, such as financial capital and legal support<br>• Legitimacy | • Lawyers<br>• Bankers (commercial and investment)<br>• Insurance organisation representatives<br>• Public relations experts |
| **Community influentials** | • Non-business perspectives on issues, problems and ideas<br>• Influence with powerful stakeholders<br>• Representation of interests outside competitive products or supply markets<br>• Legitimacy | • Political leaders<br>• University faculty<br>• Members of clergy<br>• Leaders of social or community organisations |

Source: A. J. Hillman, A. A. Cannella & R. L. Paetzold, 2000, The resource dependence role of corporate directors: Strategic adaptation of board composition in response to environmental change, *Journal of Management Studies*, 37(2): 235–56, https://doi.org/10.1111/1467-6486.00179.

There is no perfect board structure. The structure of each board of directors needs to be determined by the characteristics of each entity in isolation,[76] and it has been acknowledged that '...each organisation must put a Board of Directors in place with a composition and shape – tailored to fit its legal environment, the organisation's size and development stage, and the personality of its Chairman and CEO'.[77] Regardless of the country of origin, board of director roles, such as monitoring and ratifying,[78] supervisory and management functions,[79] and strategic and control roles identified by leading international academics, remain relevant to the Australian context.

## Board of directors process

The board of directors process is another element that should be recognised in any corporate governance framework. Process variables include: frequency and length of meetings; formality of proceedings; evaluations; professional development; and meeting agendas, minutes and committees. These processes are important in the overall context of corporate governance in Australia.[80]

Important responsibilities for the board of directors, as discussed previously, are: the strategic vision, setting the strategy and direction of the organisation; monitoring of the organisation; and the recruitment, performance management and termination (if necessary) of the CEO. In summary, most boards deal with both the strategic direction and trying to maintain the sustainable competitive advantage of the organisation in an ever-changing economic landscape; whereas the CEO and other senior managers would deal on a daily basis with the operational matters of the business. There is considerable debate about whether the board develops or ratifies the strategy of the organisation; research has outlined the different arguments pertaining to this notion.[81] For the sake of completeness, it is noteworthy that the board of directors in Australia can comprise both independent and non-executive directors; the ASX definition states that:

> An independent director is a non-executive director who is not a member of management and who is free of any business or other relationship that could materially interfere with – or could reasonably be perceived to materially interfere with – the independent exercise of their judgment.[82]

Boards of directors need to consider a suitable mix of independent directors for the board composition.[83] In Australia, the ASX Corporate Governance Council recommends that a majority of the board of directors should be independent directors and that the roles of the chair and the CEO should not be exercised by the same individual.[84] In Australia, a director's legal duty is to the organisation itself and they are not to act for any personal gain. Company law in Australia sets out directors' general duties imposed by the Corporations Act. These include:

- the duty to exercise their powers and duties with the care and diligence that a reasonable person would have, which includes taking steps to ensure they are properly informed about the financial position of the organisation and ensuring the organisation does not trade if it is insolvent
- the duty to exercise their powers and duties in good faith in the best interests of the organisation
- the duty not to improperly use their position to gain an advantage for themselves or someone else, or to cause detriment to the organisation
- a duty not to improperly use information obtained through their position to gain an advantage for themselves or to cause detriment to the organisation. Directors have a positive duty to prevent their organisation trading if it is insolvent.[85]

ASIC has issued a regulatory guide on the duty to prevent insolvent trading for directors.

## Enhancing the effectiveness of the board of directors

Because of the importance of boards of directors in corporate governance and as a result of increased scrutiny from shareholders – in particular, large institutional investors – the performances of individual board members and of entire boards are being evaluated more formally and with greater intensity.[86] The demand for greater accountability and improved performance is stimulating many boards to make changes voluntarily. Among these changes are:

1. increases in the diversity of the backgrounds of board members (e.g. a greater number of ethnic minorities, varying ages and women)
2. the strengthening of internal management and accounting control systems
3. establishing and consistently using formal processes to evaluate the board's performance
4. modifying the compensation of directors, especially reducing or eliminating share options as a part of their package
5. creating the 'lead director' role[87] that has strong powers with regard to the board agenda and oversight of non-management board member activities.

In today's rapidly changing landscape, diversity in the boardroom (gender, ethnicity, age and socioeconomic background) remains an important issue for shareholders and institutional investors. An increase in the board's involvement with an organisation's strategic decision-making processes creates the need for effective collaboration between board members and executive managers. Some argue that improving the processes used by boards to make decisions and monitor managers and organisation outcomes is important for board effectiveness.[88] Moreover, because of the increased pressure from owners and the potential conflict among board members, procedures are necessary to help boards function effectively while seeking to discharge their responsibilities.

Research suggests that diverse boards help organisations make more effective strategic decisions and perform better over time.[89] Although questions remain about whether more independent and diverse boards enhance board effectiveness, the trends for greater independence and increasing diversity among board members are likely to continue.

## Executive compensation

The compensation of executive managers, and especially of CEOs, generates a great deal of interest and strongly held opinions. Some believe that top-management team members and certainly CEOs have a great deal of responsibility for an organisation's performance and that they should be rewarded accordingly.[90] Others conclude that these individuals (and again, especially CEOs) are greatly overpaid and that their compensation is not as strongly related to organisation performance as should be the case.[91] One of the three internal governance mechanisms seeks to deal with these issues. Specifically, **executive compensation** is a governance mechanism that seeks to align the interests of managers and owners through salaries, bonuses and long-term incentives, such as stock awards and options.[92]

**executive compensation**
a governance mechanism that seeks to align the interests of managers and owners through salaries, bonuses and long-term incentive compensation, such as stock awards and options

Long-term incentive plans (typically involving share options) are an increasingly important part of compensation packages for executive managers. Theoretically, using long-term incentives facilitates the organisation's efforts (through the board of directors' pay-related decisions) to avoid potential agency problems by linking managerial compensation to the wealth of common shareholders.[93] Effectively designed long-term incentive plans have the potential to prevent large-block stockholders (e.g. institutional investors) from pressing for changes in the composition of the board of directors and the top-management team in that they assume that, when exercised, the plans will ensure executive managers will act in shareholders' best interests. Additionally, shareholders typically assume that executive managers' pay and the organisation's performance are more properly aligned when outsiders are the dominant block of a board's membership. Research results suggesting that fraudulent behaviour can be associated with share option incentives, such as earnings manipulation,[94] demonstrate the importance of the organisation's board of directors (as a governance mechanism) actively monitoring the use of executive compensation as a governance mechanism.

Effectively using executive compensation as a governance mechanism is particularly challenging for organisations implementing international strategies. For example, the interests of the owners of multinational corporations may be best served by less uniformity in the organisation's foreign subsidiaries' compensation plans.[95] Developing an array of unique compensation plans requires additional monitoring, potentially increasing the organisation's agency costs. Importantly, pay levels vary by region of the world. For example, managerial pay is highest in the USA, high in Australia and much lower in Asia.

Qantas CEO Alan Joyce was the highest-paid chief executive officer in Australia in 2018, taking home A$23.9 million, which is greater than 275 times the full-time average wage. However, Joyce's ranking changed considerably in 2019 (see Table 10.3). A report by the Australian Council of Superannuation Investors (ACSI) noted that most of the nation's top 100 CEOs received a huge bonus in the 2018 financial year, and two CEOs realised more than A$20 million, these being Joyce and Macquarie's Nicholas Moore (who has since been replaced by Shemara Wikramanayake as CEO).[96]

**Table 10.3** **Ten highest-paid ASX200 CEOs on a realised-pay basis in financial year 2019**

| Rank | CEO | Company | Realised pay |
|---|---|---|---|
| 1 | Andrew Barkla | IDP Education | $37 761 322 |
| 2 | Paul Perreault | CSL | $30 526 634 |
| 3 | Philippe Wolgen | Clinuvel Pharmaceuticals | $20 624 450 |
| 4 | Michael Clarke | Treasury Wine Estates | $19 853 177 |
| 5 | John Guscic | Webjet | $16 498 937 |
| 6 | Greg Goodman | Goodman Group | $14 967 391 |
| 7 | Robert Kelly | Steadfast Group | $14 419 677 |
| 8 | Alan Joyce | Qantas Airways | $12 217 400 |
| 9 | Colin Goldschmidt | Sonic Healthcare | $11 912 450 |
| 10 | J. S. Jacques | Rio Tinto | $10 323 975 |

*Webjet CEO realised pay includes share options which are currently valued to be significantly lower.

Source: N. Khadem, 2020, IDP Education CEO Andrew Barkla tops ACSI's list of highest-paid bosses in 2019, *ABC News*, https://www.abc.net.au/news/2020-08-07/idp-education-ceo-andrew-barkla-tops-acsi-list-of-highest-paid/12531862, updated 10 August.

There is growing pressure for companies to be more open and transparent with shareholders about CEO remuneration. ACSI is calling for Australia to consider a UK model where CEO pay is measured against that of their organisation's average worker.

Historically, compensation for executive managers has been lower in countries such as India, partly because many of the largest organisations have strong family ownership and control.[97] Also, acquiring organisations in other countries increases the complexity associated with a board of directors' efforts to use executive compensation as an effective internal corporate governance mechanism.[98]

## The effectiveness of executive compensation

As an internal governance mechanism, executive compensation – especially long-term incentive compensation – is complicated, for several reasons. First, the strategic decisions executive managers make are complex and non-routine, meaning that direct supervision (even by the organisation's board of directors) is likely to be ineffective as a means of judging the quality of their decisions. The result is a tendency to link executive managers' compensation to outcomes the board can easily evaluate, such as the organisation's financial performance. This leads to a second issue in that, typically, the effects of executive managers' decisions are stronger on the organisation's long-term than its short-term performance. This reality makes it difficult to assess the effects of their decisions on a regular basis, such as annually. Third, a number of other factors affect an organisation's performance besides executive managerial decisions and behaviour. Unpredictable changes in segments (economic, demographic, political/legal, etc.) in the organisation's general environment (see Chapter 2) make it difficult to separate out the effects of executive managers' decisions and the effects (both positive and negative) of changes in the organisation's external environment on the organisation's performance.

Properly designed and used incentive compensation plans for executive managers may increase the value of an organisation in line with shareholder expectations, but such plans are subject to managerial manipulation.[99] Additionally, annual bonuses may provide incentives to pursue short-term objectives at the expense of the organisation's long-term interests. Although long-term performance-based incentives may reduce the temptation to under-invest in the short term, they increase executive exposure to risks associated with uncontrollable events, such as market fluctuations and industry decline. The longer term the focus of incentive compensation, the greater are the long-term risks borne by executive managers. Also, because long-term incentives tie a manager's overall wealth to the organisation in a way that is inflexible, such incentives and ownership may not be valued as highly by a manager as by outside investors who have the opportunity to diversify their wealth in a number of other financial investments.[100] Thus, organisations may have to overcompensate for managers using long-term incentives.

As the 'Strategic focus' feature suggests, internal governance mechanisms are likely to continue receiving a great deal of scrutiny. One issue is the degree to which executive compensation practices promote a long-term versus a short-term focus on the part of CEOs.

**Strategic focus | Ethics**

## Has more governance scrutiny made large CEO compensation packages more reasonable?

This question often circulates in the media regarding the large compensation packages that CEOs receive as leaders of large publicly traded organisations. Reporters in the media are often focused on the growing inequality between top executives' pay and the average wages of workers. In 1983, average pay for leaders of the six largest US banks was 40 times the average of all US workers, while the average pay for leaders of the largest Fortune 500 companies was about 38 times. However, CEO compensation has grown significantly compared to the average worker, and now the median CEO-to-median-worker pay ratio in the USA stands at 140 to 1. It is easy to see why the media would focus on this issue.

For example, Marathon Corporation, the second-largest oil refiner in the USA, paid its CEO, Gary Heminger, US$19.7 million in 2017. His salary is 900 times that of the average employee. However, Marathon runs Speedway retail gas stations with many part-time and low-wage employees; if the Speedway workers are excluded, employee median pay at Marathon shoots up to nearly US$126 000 per year, which translates into a CEO-to-worker pay ratio of 156 to 1, much closer to the overall median. As noted, there are large differences within sectors. For example: 'Processed food giant Kraft Heinz Co. last year paid its CEO $4.2 million, about 91 times its median worker's $46 000 compensation. Kellogg Co., a smaller food maker, paid its CEO an annualized $7.3 million, or 183 times its median employee, who was paid about $40 000.'

Of course, as explained in this chapter, CEO compensation is more complex than might be deduced from media headlines. However, because of the increased transparency, organisations and boards of directors making compensation decisions for CEOs are more sensitive to issues associated with executive compensation. Notwithstanding the complexities, CEO compensation continues to rise, although not as much as in the pre-GFC period, primarily due to the emphasis on long-term incentive compensation versus cash compensation (salary and annual bonus). Research from the finance discipline finds that the makeup of the pay package that most top executives receive has been changing. Instead of an over-

Gary Heminger, CEO of Marathon, earned a salary in 2017 that was 156 times that of the average employee, partly because the organisation has a lot of low-wage part-time employees.

Source: Goodney/Bloomberg/Getty Images

emphasis on stock options, top executives have been receiving compensation that is based on restricted stock ownership, which cannot be realised unless they meet significant performance targets over time. As such, research finds that managers are taking much more measured risks now than before, with far less of the oversized risk taking that can result in disastrous consequences for a large organisation.

In summary, executive compensation worldwide is a complex issue that cannot be simply determined by the overall size of the package. Although executive compensation has grown dramatically, there are both legitimate and illegitimate reasons for such huge pay packages. Each case needs to be examined closely. However, the perception will certainly linger that top management executive compensation relative to the average worker has added to inequality in society. As such, care should be taken to manage this issue from a policy point of view. Managerial human capital should be rewarded for its capability and the value it creates, but lower-level workers and their human capital should also have opportunities to make progress.

Sources: K. Bouslah, J. Liñares-Zegarra, B. M'Zali & B. Scholtens, 2018, CEO risk-taking incentives and socially irresponsible activities, *British Accounting Review*, 50: 76–92; T. Francis & V. Fuhrmans, 2018, Are you underpaid? In a first, U.S. organisations reveal how much they pay workers, *Wall Street Journal*, http://www.wsj.com, 11 March; T. Francis & V. Fuhrmans, 2018, Median CEO pay hit record of nearly $12 million in 2017, juiced by markets, *Wall Street Journal*, http://www.wsj.com, 21 March; B. Tuttle, 2018, This CEO makes 900 times more than his typical employee, *Money*, http://www.time.com/money, 12 March; A. Gande & S. Kalpathy, 2017, CEO compensation and risk-taking at financial organisations: Evidence from U.S. federal loan assistance, *Journal of Corporate Finance*, 47: 131–50; M. Grosse, S. Kean & T. Scott, 2017, Shareholder say on pay and CEO compensation: Three strikes and the board is out. *Accounting & Finance*, 57(3): 701–25; K. Shue & R. R. Townsend, 2017, Growth through rigidity: An explanation for the rise in CEO pay, *Journal of Financial Economics*, 123: 1–21; H. Wang, S. Zhao & G. Chen, 2017, Organisation-specific knowledge assets and employment arrangements: Evidence from CEO compensation design and CEO dismissal, *Strategic Management Journal*, 38(9): 1875–94; T. Greckhamer, 2016, CEO compensation in relation to worker compensation across countries: The configurational impact of country-level institutions, *Strategic Management Journal*, 37(4): 793–815.

When designed properly and used effectively, each of the three internal governance mechanisms can contribute positively to the organisation operating in ways that best serve stakeholders', and especially shareholders', interests. By the same token, because none of the three mechanisms is perfect in design or execution, the market for corporate control, an external governance mechanism, is sometimes needed.

STRATEGY NOW
'Say on pay' initiatives

# Market for corporate control

The **market for corporate control** is an external governance mechanism that is active when an organisation's internal governance mechanisms fail.[101] The market for corporate control is composed of individuals and organisations that buy ownership positions in or purchase all of potentially undervalued corporations typically for the purpose of forming new divisions in established companies or merging two previously separate organisations. Because the executive managers are assumed to be responsible for the undervalued organisation's poor performance, they are usually replaced. An effective market for corporate control ensures that ineffective and/or opportunistic executive managers are disciplined.[102]

**market for corporate control**
an external governance mechanism that becomes active when an organisation's internal controls fail

Commonly, target organisation managers and board members are sensitive about takeover bids emanating from the market for corporate control in that being a target suggests that they have been ineffective with efforts to fulfil their responsibilities. For executive managers, a board's decision to accept an acquiring organisation's offer typically finds them losing their jobs because the acquirer usually wants different people to lead the organisation. At the same time, rejection of an offer also increases the risk of job loss for executive managers because the pressure from the board and shareholders for them to improve the organisation's performance becomes substantial.[103]

In summary, the market for corporate control may appear to be a blunt instrument for corporate governance; nonetheless, this governance mechanism does have the potential to represent shareholders' best interests. Accordingly, executive managers want to lead their organisations in ways that make disciplining by activists outside the organisation unnecessary and/or inappropriate.

There are a number of defence tactics executive managers can choose to use to fend off a takeover attempt. Managers leading a target organisation that is performing well are almost certain to use tactics to thwart the takeover attempt. Even in instances when the target organisation is underperforming compared with its peers, managers might use defence tactics to protect their own interests. In general, managers' use of defence tactics is thought to be self-serving in nature.

An awareness on the parts of executive managers of the existence of external investors in the form of individuals or groups (e.g. hedge funds) often positively influences them to align their interests with those of the organisation's stakeholders, especially the shareholders. Moreover, when active as an external governance mechanism, the market for corporate control has brought about significant changes in many organisations' strategies and, when used appropriately, has served shareholders' interests. Next, we describe international governance practices to explain how they differ across regions and countries.

# International corporate governance

Corporate governance is an increasingly important issue in economies globally, including emerging economies. Globalisation in trade, investments and equity markets increases the potential value of organisations throughout the world using similar mechanisms to govern corporate activities. Moreover, because of globalisation, major companies want to attract foreign investment. For this to happen, foreign investors must be confident that adequate corporate governance mechanisms are in place to protect their investments.

Although globalisation is stimulating an increase in the intensity of efforts to improve corporate governance and potentially to reduce the variation in regions' and nations' governance systems,[104] the reality remains that different nations do have different governance systems in place. Recognising and understanding differences in various countries' governance systems, as well as changes taking place within those systems, improves the likelihood an organisation will be able to compete successfully in the international markets it chooses to enter. To highlight the general issues of differences and changes taking place in governance systems, we discuss corporate governance practices in two developed economies (Germany and Japan), in China, an emerging economy, and, lastly, in Spain. First, though, we look at the system used in Australia.

## Corporate governance in Australia

To date, corporate governance in Australia has been studied from a variety of theoretical perspectives, in particular: agency theory; stewardship theory; resource dependency theory; shareholder theory; and stakeholder theory.[105] The myriad approaches to the topic have resulted in many normative definitions in the Australian context (these might best be described as a set of descriptive statements about what corporate governance 'may include' or 'might do' rather than a sound theoretical basis for promoting corporate transparency). Cadbury's definition of corporate governance, highlighted at the start of this chapter, is still widely accepted as the most fitting for the egalitarian Australian context.[106]

### Overview of the legal framework of corporate governance in Australia

In Australia, a board of directors is a legal requirement set out in the Corporations Act. Boards of directors are fundamental to corporate governance, with legislation outlining certain powers and responsibilities to be carried out for the best interests of the relevant shareholders (and indirectly to the entire market). In terms of its prime directive, the legal framework in Australia is not primarily concerned with adding value to the organisation (although it does attempt to protect shareholder rights); instead, it is based on the traditional conventions of Anglo-Saxon trust law. The Corporations Act provides a mandatory legal requirement that all Australian companies must have directors. There are different requirements for a proprietary organisation that has at least one director (s. 201A(1)) compared to a public organisation, which must have a minimum of three directors (s. 201A(2)). According to ASX CGC Principle 2 (effective January 2020):

> The board of a listed entity should be of an appropriate size and collectively have the skills, commitment and knowledge of the entity and the industry in which it operates, to enable it to discharge its duties effectively and to add value.[107]

The importance of corporate governance in Australia was initially recognised in 1995, with the ASX introducing Listing Rule 3c(3)(i), which required listed companies to include in their annual report a statement of the main corporate governance practices they had adopted.[108] Subsequently, and in response to criticism following the aftermath of corporate collapses in the 1990s, the ASX Corporate Governance Council (ASX CGC) released the first version of the *ASX Corporate Governance Principles and Recommendations* (ASX Guidelines) in March 2003. These guidelines have been further revised and are designed to provide best practice corporate governance measures for ASX-listed entities. They are based on eight central principles (see Table 10.4) and 29 specific recommendations published by the ASX CGC, and represent an important document outlining key elements of corporate governance; they were subsequently updated in 2019.[109]

**Table 10.4** **The principles of the ASX-CGC**

| | |
|---|---|
| 1 | Lay solid foundations for management and oversight |
| 2 | Structure the board to be effective and add value |
| 3 | Instil a culture of acting lawfully, ethically and responsibly |
| 4 | Safeguard the integrity of corporate reports |
| 5 | Make timely and balanced disclosure |
| 6 | Respect the rights of security holders |
| 7 | Recognise and manage risk |
| 8 | Remunerate fairly and responsibly |

Source: ASX Corporate Governance Council, 2019, *Corporate Governance Principles and Recommendations*, 4th edn, https://www.asx.com.au/documents/regulation/cgc-principles-and-recommendations-fourth-edn.pdf, p. 2. © Copyright 2020 ASX Corporate Governance Council

Despite that fact that the principles and recommendations were only intended to apply to ASX-listed entities (albeit not mandatorily), many other Australian entities have adopted them (as appropriate) to form part of their own governance strategies.

In order to achieve contemporary 'corporate governance goals', a number of Australian-specific laws and institutions have emerged in the period post-1970: legislation (in particular, the *Competition and Consumer Act 2010* (Cth)), as well as the establishment of the ACCC, ASIC, ASX and its company listing rules, and Standards Australia; plus the influence of shareholder activists and influential 'financial media' attention. These institutions act together to apply the appropriate pressures to organisations (and their boards) to achieve important societal goals as well as the maximisation of returns on shareholder funding.

## Competition and Consumer Act

The *Competition and Consumer Act 2010* (Cth) replaced the *Trade Practices Act 1974* and includes a wide-ranging set of provisions including:

1. a national unfair contract terms law covering standard form consumer and small business contracts
2. a national law guaranteeing consumer rights when buying goods and services
3. a national product safety law and enforcement system
4. a national law for unsolicited consumer agreements covering door-to-door sales and telephone sales
5. simple national rules for lay-by agreements
6. penalties, enforcement powers and consumer redress options.[110]

## Australian Competition and Consumer Commission (ACCC)

The ACCC was formed on 6 November 1995 by the merger of the Trade Practices Commission and the Prices Surveillance Authority. Its formation was an important step in the implementation of the national competition policy reform program agreed on by the Council of Australian Governments. The ACCC's consumer protection work complements that of state and territory consumer affairs agencies, which administer the mirror legislation of their jurisdictions and the Consumer Affairs Division of Treasury.[111]

The ACCC's influence in Australia extends beyond direct action into policy. For example, the ACCC will soon examine the experiences of Australian consumers, developers, suppliers and others in a new report scrutinising mobile app stores. Issues to be examined include the use and sharing of data by apps, the extent of competition between Google's and Apple's app stores, and whether more pricing transparency is needed in Australia's mobile apps market. This is part of a five-year ACCC inquiry examining markets for the supply of digital platform services in Australia, and it plans to produce reports every six months.[112]

## Australian Securities and Investments Commission (ASIC)

ASIC, another independent Commonwealth Government body, was established by the *Australian Securities and Investments Commission Act 1989*. It began in 1991 as the Australian Securities Commission to administer the Corporations Law. In July 1998, it received new consumer protection responsibilities and its current name. ASIC is the single national regulator of Australia's companies.

ASIC performs the following generic functions with regard to corporate governance: it protects investors, superannuants, depositors and insurance policy holders from financial harm arising from poor management practices; it regulates and enforces laws that promote honesty and fairness in financial markets, products and services and in Australian companies; it serves to underpin the strength, growth and international reputation of Australia's financial markets; and it maintains a public database on Australia's companies to provide certainty in commercial dealings.[113]

## Australian Securities Exchange (ASX) listing rules

The ASX imposes a series of important regulatory guidelines on all listed companies in Australia. In particular, in order for a company to be publicly listed, it must conform to a series of specific reporting procedures that it would not be required to follow otherwise. For example, an ASX-listed company must:

1. institute a board of directors
2. undertake annual general meetings with shareholders
3. produce an annual report for all shareholders, as well as for the ASX
4. undertake continuous and periodic disclosure of business activities.[114]

The full listing of ASX rules and requirements can be found at http://www.asx.com.au/regulation/rules-guidance-notes-and-waivers.htm and provides an indication of the governance implications for all listed companies.

ASX formed the Corporate Governance Council (CGC) in 2002 with a view to developing an industry-wide framework for corporate governance that would provide a guide for listed companies, government and the community. In March 2003, the CGC published its *Principles for Good Corporate Governance and Best Practice Recommendations*. In 2019, this was revised and became *Corporate Governance Principles and Recommendations* (4th edition), which now forms the basis for reporting by listed companies as to corporate governance matters. This material can be found at https://www.asx.com.au/documents/asx-compliance/cgc-principles-and-recommendations-fourth-edn.pdf.

In addition, and as a result of the ASX's own listing on the stock exchange, the ASX Supervisory Review was formed. This ASX subsidiary body was established in order to dispel any perceived conflicts of interest that may exist between the ASX (a regulatory body itself) and its own listing on the ASX.

## Standards Australia

Standards Australia has produced a set of corporate governance standards that complement the ASX Best Practice Recommendations and that target small and medium enterprises and the not-for-profit sector. The standards (AS8000–8004) deal with good governance principles, fraud control, ethical codes of conduct and whistleblower protection programs.

## Shareholders' rights protection

There are various types of shareholders in Australia, ranging from small 'mum and dad investors' to wealthy private individuals and large institutional investors (such as superannuation funds). The Corporations Act sets out the rights pertaining to all shareholders in Australia. The Corporations Law deals with becoming a shareholder and ceasing to be a shareholder in sections 117, 120 and 601AA–601AD of the Corporations Act. Australian companies may have different classes of shares. The rights and restrictions attached to the shares in a class distinguish it from other classes of shares and are covered in sections 254A–254B of the Corporations Act. Section 252D, which deals with the calling of meetings under the Corporations Act, allows for members to call meetings of all shareholders or meetings of only those shareholders who hold a particular class of shares. Shareholders who hold at least 5 per cent of the votes that may be cast at a general meeting of an organisation have the power to call and hold a meeting themselves or to require the directors to call and hold a meeting. Meetings may be held regularly or to resolve specific questions about the management or business of the organisation. The Corporations Act sets out rules dealing with shareholders' meetings. A shareholder of an organisation may ask the organisation for a copy of the record of a meeting or of a decision of shareholders taken without a meeting. Different rights to vote at meetings of shareholders may attach to different classes of shares. This is dealt with under sections 250E and 254A–254B of the Corporations Act. The buying and selling of shares in Australia is dealt with under sections 1091D–1091E. A shareholder may sell their shares but only if the sale does not breach the corporation's constitution.[115]

## Shareholder activists

Shareholder activism refers to the extent to which individual shareholders (albeit as a group) are willing (or even perhaps able) to influence a corporation's board of directors. In Australia, the main organisation of such shareholders is the Australian Shareholders' Association (ASA). The ASA has established an annual general meeting monitoring service for its members, employing analysts to review corporate resolutions and make recommendations on how to vote on the same. Shareholder activists tend to become more visible during the round of annual general meetings. The focus has increased to include a greater number of directors and a wider range of issues. For example, the ASA now has policies that include the following areas of shareholder concern: poor performance; executive remuneration; accounting policies; conflicts of interest; disclosure and share ownership limits.[116]

STRATEGY NOW
Shareholder activism

## Corporate governance in Germany and Japan

In many private German organisations, the owner and manager may be the same individual. In these instances, agency problems are not present.[117] Even in publicly traded German corporations, a single shareholder is often dominant. Thus, the concentration of ownership is an important means of corporate governance in Germany, as it is in the USA.[118]

Historically, banks occupied the centre of the German corporate governance system. This is the case in other European countries as well, such as Italy and France. As lenders, banks become major shareholders when companies they have financed seek funding on the stock market or default on loans. Although the stakes are usually less than 10 per cent, banks can hold a single ownership position up to but not exceeding 15 per cent of the bank's capital. Although shareholders can tell banks how to vote their ownership position, they generally do not do so. The banks monitor and control managers, both as lenders and as shareholders, by electing representatives to supervisory boards.

German organisations with more than 2000 employees are required to have a two-tiered board structure that places the responsibility for monitoring and controlling managerial (or supervisory) decisions and actions in the hands of a separate group.[119] All the functions of strategy and management are the responsibility of the management board (the *Vorstand*); however, appointment to the *Vorstand* is the responsibility of the supervisory tier (the *Aufsichtsrat*). Employees, union members and shareholders appoint members to the *Aufsichtsrat*. Proponents of the German structure suggest that it helps prevent corporate wrongdoing and rash decisions by 'dictatorial CEOs'. However, critics maintain that it slows decision making and often ties a CEO's hands. The corporate governance practices in Germany also make it difficult to restructure companies quickly. Because of the role of local government (through the board structure) and the power of banks in Germany's corporate governance structure, private shareholders rarely have major ownership positions in German organisations. Large institutional investors, such as pension funds and insurance companies, are also relatively insignificant owners of corporate stock. Thus, at least historically, German executives generally have not been dedicated to maximising shareholder wealth to the degree that is the case for executive managers in the UK and the USA.[120]

However, corporate governance practices used in Germany are changing. A manifestation of these changes is that a number of German organisations are beginning to gravitate towards US governance mechanisms. Recent research suggests that the traditional system in Germany produced some agency costs because of a lack of external ownership power. Interestingly, German organisations with listings on US stock exchanges have increasingly adopted executive stock option compensation as a long-term incentive pay policy.[121]

The concepts of obligation, family and consensus affect attitudes towards corporate governance in Japan. In Japan, an obligation 'may be to return a service for one rendered or it may derive from a more general relationship, for example, to one's family or old alumni, or one's company (or ministry), or the country. This sense of particular obligation is common elsewhere but it feels stronger in Japan'.[122] As part of an organisation family, individuals are members of a unit that envelops their lives; families command the attention and allegiance of parties throughout corporations. Moreover, a *keiretsu* (group of organisations tied together by cross-shareholdings) is more than an economic concept; it, too, is a family. Some believe, though, that extensive cross-shareholdings impede the type of structural change that is needed to improve Japan's corporate governance practices.[123] Consensus, another important influence in Japanese corporate governance, calls for the expenditure of significant amounts of energy to win the hearts and minds of people whenever possible, as opposed to executive managers issuing edicts.[124] Consensus is highly valued, even when it results in a slow and cumbersome decision-making process. Japanese corporate governance has been identified as a stakeholder governance system in a code law (civil law) country[125] and is in contrast to governance systems dominant in common law countries. With the stakeholder governance system, other stakeholders may influence management through cross-sharing among affiliated organisations, trading partners and the main banks.[126]

STRATEGY NOW
Global governance

As in Germany, banks in Japan have an important role in financing and monitoring large public organisations.[127] Because it owns the largest share of stocks and holds the largest amount of debt, the main bank has the closest relationship with an organisation's executive managers. The main bank provides financial advice to the organisation and also closely monitors managers. Thus, Japan has a bank-based financial and corporate governance structure, whereas the USA has a market-based financial and governance structure.[128]

Aside from lending money, a Japanese bank can hold up to 5 per cent of an organisation's total stock; a group of related financial institutions can hold up to 40 per cent. In many cases, main-bank relationships are part of a horizontal *keiretsu*. A *keiretsu* organisation usually owns less than 2 per cent of any other member organisation; however, each organisation typically has a stake of that size in every organisation in the *keiretsu*. As a result, somewhere between 30 and 90 per cent of an organisation is owned by other members of the *keiretsu*. Thus, a *keiretsu* is a system of relationship investments.

After a series of corporate scandals in Japan, including Kanebo (2004), Seibu Railway (2004), Livedoor (2005) and Olympus Corporation (2011), a corporate governance reform was initiated under the Japanese Government's Revitalisation Policy. The revised Company Act of 2014 established more stringent requirements on outside (independent) directors and outside statutory auditors (*kansayaku*). In 2016, the Japan Exchange Group noted that 414 listed organisations had chosen the new system and transitioned into a new organisation with audit and supervisory committees. Under the new legislation, Japanese companies had a choice of three different types of organisational structure: a company with three committees; a company with a *kansayaku*; board or a company with audit and supervisory committees. A company with a *kansayaku* board, as well as a board of directors and an accounting auditor, is a governance system unique to Japan.

Japan's corporate governance practices are changing accordingly. Japanese banks are continuing to develop as economic organisations, as their role in the monitoring and control of managerial behaviour and organisation outcomes is less significant than in the past.[129] Also, deregulation in the financial sector has reduced the cost of mounting hostile takeovers.[130] As such, deregulation facilitated additional activity in Japan's market for corporate control, which had been nonexistent in preceding years. Interestingly, CEOs of both public and private companies in Japan receive similar levels of compensation and their compensation is tied closely to observable performance goals.[131]

## Corporate governance in China

'China has a unique and large, socialist, market-oriented economy. The government has done much to improve the corporate governance of listed companies.'[132] This comment denotes that corporate governance practices in China are changing and the country is experiencing increasing privatisation of businesses and the development of equity markets. However, the stock markets in China remain young and are continuing to develop. In their early years, these markets were weak because of significant insider trading, but with stronger governance these markets have improved.[133]

There has been a gradual decline in China in the equity held in state-owned enterprises, and both the number and percentage of private organisations have grown, but the state still relies on direct and/or indirect controls to influence the strategies organisations use. In terms of long-term success, these conditions may affect organisations' performances in that research shows that organisations with higher state ownership tend to have lower market value and more volatility in that value across time. This is because of agency conflicts in the organisations and because the executives do not seek to maximise shareholder returns given that they must also seek to satisfy social goals placed on them by the government.[134] This suggests a potential conflict between the principals, particularly the state owner and the private equity owners of such enterprises.[135]

Some evidence suggests that corporate governance in China may be tilting towards the Western model. Changing a nation's governance systems is a complicated task that will inevitably encounter setbacks. Still, corporate governance in Chinese companies continues to evolve and likely will do so for some time to come as parties (e.g. the Chinese Government and those seeking further movement towards free-market economies) interact to form governance mechanisms that are best for their nation, businesses and citizens. However, along with changes in the governance systems of specific countries, multinational companies' boards and managers are also evolving. For example, organisations that have entered more international markets are likely to have more top executives with greater international experience and to have a larger proportion of foreign owners and foreign directors on their boards.[136]

## Corporate governance in Spain

Spain has been influenced by the European and international lens to establish recommendations through codes of good governance for listed companies. These codes may be followed or not in Spain. Spanish Company Law (Royal Legislative Decree) (Art. 538) establishes that listed companies must make an annual corporate governance report that details the degree of fulfilment of the code of governance recommendations.

The first code of corporate governance was the Olivencia Report (1998), followed five years later by the Aldama Report (2003). In 2006, the Unified Good Governance Code was approved with subsequent updates in 2009 and 2013. Further amendments in 2014 to the Spanish Company Law incorporated basic corporate governance guidelines, which were mandated from 2015 into a new code, Good Governance of Listed Companies. This corporate governance framework was based on two main principles:

1. the binding provisions contained in the Spanish Company Law and other applicable law
2. the corporate governance recommendations contained in the Good Governance of Listed Companies (which contains 64 recommendations).[137]

This code has contributed to the continued development of corporate governance best practice in Spain.

# Governance mechanisms and ethical behaviour

The three internal and one external governance mechanisms are designed to ensure that the agents of the organisation's owners (i.e. the organisation's executive managers) make strategic decisions that best serve the interests of all stakeholders. In the USA and trending that way in Australia, shareholders are commonly recognised as the organisation's most significant stakeholders. Increasingly, though, executive managers are expected to lead their organisations in ways that will also serve the needs of product market stakeholders (e.g. customers, suppliers and host communities) and organisational stakeholders (e.g. managerial and non-managerial employees).[138] Therefore, the organisation's actions and the outcomes flowing from them should result in, at least, minimal satisfaction of the interests of all stakeholders; otherwise, a dissatisfied stakeholder may withdraw its support from the organisation and provide it to another (e.g. customers will purchase products from a supplier offering an acceptable substitute).

Some believe that the internal corporate governance mechanisms designed and used by ethically responsible companies increase the likelihood the organisation will be able to, at least, minimally satisfy all stakeholders' interests.[139] Governance scandals at companies such as Rio Tinto, AMP and Bellamy's Organic, among others, illustrate the negative effects of poor ethical behaviour on an organisation's efforts to satisfy stakeholders. The issue of ethical behaviour by executive managers as a foundation for best serving stakeholders' interests is being taken seriously in countries throughout the world.[140]

The decisions and actions of the board of directors can be an effective deterrent to unethical behaviours by executive managers. Indeed, evidence suggests that the most effective boards set boundaries for their organisations' business ethics and values.[141] Once the boundaries for ethical behaviour are determined and likely formalised in a code of ethics, the board's ethics-based expectations must be clearly communicated to the organisation's executive managers and to other stakeholders (e.g. customers and suppliers) with whom interactions are necessary for the organisation to produce and sell its products. Moreover, as agents of the organisation's owners, executive managers must understand that the board, acting as an internal governance mechanism, will hold them fully accountable for developing and supporting an organisational culture in which only ethical behaviours are permitted. As explained in Chapter 12, CEOs can be positive role models for improved ethical behaviour.

Through effective governance that results from well-designed internal mechanisms and the appropriate use of the market for corporate control as an external mechanism, executive managers, working with others, are able to assist their organisation in selecting and using strategies with a high probability of resulting in strategic competitiveness and earning above-average returns. While some organisations' governance mechanisms have been ineffective – for example, Bellamy's, Westpac Group, AMP and Commonwealth Bank in Australia – other companies are recognised for the quality of their governance activities.

World Finance, which evaluates the corporate governance practices of companies throughout the world and commends companies with a track record of excellence in governance, has acknowledged that investors are still seeking boards with a strong sense of leadership and solid moral alignment. In 2019, World Finance Best Corporate Governance Awards by country were given to Bank of Cyprus (Cyprus), Total (France), Piraeus Bank (Greece), Oberoi (India), Enel (Italy), Jordan Islamic Bank (Jordan), Boursa Kuwait (Kuwait), FBN Holdings (Nigeria), NattoPharma (Norway), PKO Bank Polski (Poland), Commercial Bank of Qatar (Qatar), Credit Bank of Moscow (Russia), Iberdrola (Spain), Swiss Re (Switzerland), Kasikornbank (Thailand) and AVANGRID (USA). These awards are determined by analysing a number of issues concerned with corporate governance, such as board accountability and financial disclosure, executive compensation, shareholder rights, ownership base, takeover provisions, corporate behaviour and overall responsibility exhibited by the organisation.[142]

As the discussion in this chapter suggests, corporate governance mechanisms are pivotal to organisations' overall success and sustainable competitive advantage.

## Rewarding top executives of one of the most poorly governed banks in the world: Westpac

**Strategic focus** | Globalisation

AUSTRAC, Australia's anti-money-laundering and terrorism financing regulator, has today applied to the Federal Court of Australia for civil penalty orders against Westpac Banking Corporation (Westpac). The civil penalty orders relate to systemic non-compliance with the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (AML/CTF Act). AUSTRAC alleges Westpac contravened the AML/CTF Act on over 23 million occasions.

AUSTRAC Chief Executive Officer, Nicole Rose, noted that AUSTRAC's decision to commence civil penalty proceedings was determined following an investigation into Westpac's non-compliance. It is alleged that Westpac's oversight of the banking and designated services provided through its correspondent banking relationships was deficient. Westpac's oversight of its AML/CTF Program, intended to identify, mitigate and manage the money laundering and terrorism financing risks of its designated services, was also deficient. These failures in oversight resulted in serious and systemic non-compliance with the AML/CTF Act.

Westpac failed to:

1 appropriately assess and monitor the ongoing money laundering and terrorism financing risks associated with the movement of money into and out of Australia through correspondent banking relationships. Westpac has allowed correspondent banks to access its banking environment and the Australian Payments System without conducting appropriate due diligence on those correspondent banks and without appropriate risk assessments and controls on the products and channels offered as part of that relationship
2 report over 19.5 million International Funds Transfer Instructions (IFTIs) to AUSTRAC over nearly five years for transfers both into and out of Australia. The late incoming IFTIs received from four correspondent

banks alone represent over 72% of all incoming IFTIs received by Westpac in the period November 2013 to September 2018 and amounts to over $11 billion. IFTIs are a key source of information from the financial services sector that provides vital information into AUSTRAC's financial intelligence to protect Australia's financial system and the community from harm

3 pass on information about the source of funds to other banks in the transfer chain. This conduct deprived the other banks of information they needed to understand the source of funds to manage their own AML/CTF risks

4 keep records relating to the origin of some of these international funds transfers

5 carry out appropriate customer due diligence on transactions to the Philippines and South East Asia that have known financial indicators relating to potential child exploitation risks. Westpac failed to introduce appropriate detection scenarios to detect known child exploitation typologies, consistent with AUSTRAC guidance and their own risk assessments.

'These AML/CTF laws are in place to protect Australia's financial system, businesses and the community from criminal exploitation. Serious and systemic non-compliance leaves our financial system open to being exploited by criminals,' Ms Rose said.

'The failure to pass on information about IFTIs to AUSTRAC undermines the integrity of Australia's financial system and hinders AUSTRAC's ability to track down the origins of financial transactions, when required to support police investigations.'

AUSTRAC's approach to regulation is based on building resilience in the financial system and on educating the financial services sector to ensure they understand, and are able to comply with, their compliance and reporting obligations. Businesses are the first line of defence in protecting the financial system from abuse.

'We have been, and will continue to work with Westpac during these proceedings to strengthen their AML/CTF processes and frameworks,' Ms Rose said.

'Westpac disclosed issues with its IFTI reporting, has cooperated with AUSTRAC's investigation and has commenced the process of uplifting its AML/CTF controls.'

Following on from AUSTRAC Chief Executive Officer's statement, on 26 November 2019 Westpac Group Chairman Lindsay Maxted announced to the ASX a number of significant executive changes.

Despite healthy profits and leaving the bank in a strong financial position with each business number one or number two in their markets, Mr Hartzer (CEO) has now left after scandals around anti-money laundering and other financial crimes.

The Board accepted the seriousness of the issues raised by AUSTRAC and Ewen Crouch will not seek re-election as a Director at the AGM. Westpac Group had sought feedback from all of its stakeholders, including shareholders, and through this process it decided that board and management changes were in the best interest of the bank, with the chair of the board noting that the bank had fallen short of both their own and regulator's standards. 'We are determined to fix these issues and lift our standards to ensure our anti-money laundering and other financial crime processes are industry leading. As a major bank we play a critical role in helping law enforcement agencies prevent criminals from carrying out illegal activity.' He further noted that the board recognised the seriousness of the events and an external expert would be appointed to oversight the process. The Chair further noted that over the past two years the organisation has recognised the gaps and taken a number of steps to improve its monitoring of financial crime and other serious crime. Despite numerous completed actions such as consolidating different financial crime systems into a single, group-wide technology system and doubling the resourcing dedicated to financial crime to around 750 people. Despite all the turmoil at Westpac and lack of internal governance throughout the business, the current CEO stood down from Westpac in December 2019. Mr Hartzer was provided with a 12 months' notice period and it was intended he would be paid his fixed remuneration of $2.686 million over the period.

Sources: AUSTRAC, 2019, AUSTRAC applies for civil penalty orders against Westpac, Media release, https://www.austrac.gov.au/about-us/media-release/civil-penalty-orders-against-westpac, 20 November, © AUSTRAC for the Commonwealth of Australia; Westpac, 2019, Westpac announces response plan, Media release, https://www.westpac.com.au/about-westpac/media/media-releases/2019/24-november, 24 November; Westpac, 2019, Westpac board announces CEO and board changes, Media release, https://www.westpac.com.au/about-westpac/media/media-releases/2019/26-november, 26 November.

# Corporate governance and organisation performance

The topic of corporate governance and organisation performance represents a comprehensive and growing area of research internationally. In an Australian context, as elsewhere, there is a major difficulty in determining a causal relationship between corporate governance and organisation performance (especially when it comes to the more subjective indicators of social, environmental and innovative performance). The results of empirical research in Australia remain divided between 'some support', 'inconclusive support' and 'no relationship' between corporate governance and organisational performance (largely depending on the independent and proxy dependent variables chosen to represent the relationship). James Psaros provided a comprehensive meta-analysis on the link between corporate governance and economic performance and outlined the positive indirect relationship that corporate governance provides as a *facilitator* of economic performance. It was noted by Psaros that the '... editorial from the journal *Corporate Governance: An International Review* provides an endorsement for the economic merits of corporate governance'[143] stating:

> There has been much discussion recently about whether corporate governance makes a difference to the bottom line, that is, does corporate governance improve shareholder value? In my view, the evidence, both academic and practitioner, points on balance towards the opinion that good corporate governance helps realise value and create competitive advantage.[144]

In an Australian context, research examined whether corporate governance was directly related to organisation performance and measured this by the Howarth Corporate Governance Score. It was found that there was no significant relationship between corporate governance and traditional measures of organisation performance.[145] Despite these findings, scholars, legislators, managers and investors alike remain convinced that corporate governance practices are nonetheless important measures for sustainable societal outcomes.

# Corporate social responsibility

Corporate social responsibility (CSR) has become a major factor in corporate governance internationally. In the practitioner sphere, the examination of CSR performance measures (specifically as corporate governance criteria) has been researched by a range of commercial organisations,[146] as well as peak and professional bodies (e.g. Business Council of Australia, Centre for Corporate Public Affairs, CPA Australia and Volunteering Australia). As a result, a variety of indices have been developed to evaluate the CSR performance of Australian companies, most notably the St James Ethics Centre's Corporate Responsibility Index, the Reputex SR Index and the Australian CSR Standards (AS 8003). In support of all these indices, the Australian Institute of Social and Ethical Accountability and Models of Success and Sustainability (MOSS) has emerged to provide guidance for corporations to implement, measure and report their CSR performance measures more effectively.[147]

A recent example of the failure of CSR practices and procedures was witnessed with the destruction of the ancient Indigenous site at the Juukan Gorge caves in Western Australia by Rio Tinto. Rio Tinto chairman Simon Thompson said in a statement:

> What happened at Juukan was wrong and we are determined to ensure that the destruction of a heritage site of such exceptional archaeological and cultural significance never occurs again at a Rio Tinto operation... We are also determined to regain the trust of the Puutu Kunti Kurrama and Pinikura [PKKP] people and other Traditional Owners.[148]

Australian Indigenous history was destroyed by blasts at Juukan Gorge, WA.

Source: Alamy Stock Photo/Suzanne Long

In Spain, the responsibility to approve an organisation's social responsibility policy falls within the ambit of board of directors duties. Being more progressive in CSR than many nations, the CBGSC (2015) provided three specific recommendations concerning CSR, namely: a CSR Committee (with the responsibility to supervise the CSR policy concurrently with good governance principles); setting the goals of the CSR policy and the corporate strategy in respect of sustainability; and the environment and social issues. Finally, in the interests of openness and transparency, the organisation must report in a separate document (or management report) matters related to CSR, acknowledging that internationally accepted methodologies should be considered.

# STUDY TOOLS

## SUMMARY

**LO1** Corporate governance is a relationship among stakeholders that is used to determine an organisation's direction and control its performance. How organisations monitor and control executive managers' decisions and actions affects the implementation of strategies. Effective governance that aligns managers' decisions with shareholders' interests can help produce a competitive advantage for the organisation.

**LO2** Ownership is separated from control in the modern corporation. Owners (principals) hire managers (agents) to make decisions that maximise the organisation's value. As risk-bearing specialists, owners diversify their risk by investing in multiple corporations with different risk profiles. Owners expect their agents (the organisation's executive managers, who are decision-making specialists) to make decisions that will help to maximise the value of their organisation. Thus, modern corporations are characterised by an agency relationship that is created when one party (the organisation's owners) hires and pays another party (executive managers) to use its decision-making skills.

**LO3** Separation of ownership and control creates an agency problem when an agent pursues goals that conflict with the principals' goals. Principals establish and use governance mechanisms to control this problem.

**LO4** Three internal governance mechanisms are used in the modern corporation: ownership concentration, the board of directors and executive compensation. The market for corporate control is an external governance mechanism influencing managers' decisions and the outcomes resulting from them.

Ownership concentration is based on the number of large-block shareholders and the percentage of shares they own. With significant ownership percentages, institutional investors often are able to influence executive managers' strategic decisions and actions. Institutional investors are a powerful force globally and actively use their positions of concentrated ownership to force managers and boards of directors to make decisions that best serve shareholders' interests.

**LO5** Executive compensation is a highly visible and often-criticised governance mechanism. Salary, bonuses and long-term incentives are used for the purpose of aligning managers' and shareholders' interests. An organisation's board of directors is responsible for determining the effectiveness of the organisation's executive compensation system. An effective system elicits managerial decisions that are in shareholders' best interests.

**LO6** Evidence suggests that shareholders and boards of directors have become more vigilant in controlling managerial decisions. Nonetheless, these mechanisms are often insufficient. When the internal mechanisms fail, the market for corporate control – as an external governance mechanism – becomes important. Although it too is imperfect, the market for corporate control has been effective in causing corporations to combat inefficient diversification and to implement more effective strategic decisions.

**LO7** The Australian system of governance has a backbone of strong legislation, including the Australian Consumer Law, and is also strongly influenced by an active financial media presence and recent shareholder activism. Corporate governance structures in Germany, Japan, Spain and China differ from each other and from the structures used in Australia, the UK and the USA. Historically, US governance structure focused on maximising shareholder value. In Germany, employees, as a stakeholder group, take a more prominent role in governance. By contrast, until recently, Japanese shareholders played virtually no role in monitoring and controlling executive managers. However, Japanese organisations are now being challenged by 'activist' shareholders. In China, the central government still plays a major role in corporate governance practices. Internationally, all of these systems are becoming increasingly similar, as are many governance systems both in developed countries, such as France and Spain, and in transitional economies, such as Russia and India.

**LO8** Effective governance mechanisms ensure that the interests of all stakeholders or shareholders are served. Thus, strategic competitiveness results when organisations are governed in ways that permit, at least, minimal satisfaction of capital market stakeholders (e.g. shareholders), product market stakeholders (e.g. customers and suppliers) and organisational stakeholders (e.g. managerial and non-managerial employees; see also Chapter 2). Moreover, effective governance produces ethical behaviour and consideration of CSR principles in the formulation and implementation of strategies.

## KEY TERMS

agency costs
agency relationship
board of directors
compensation
corporate governance
executive
institutional owners
large-block shareholders
managerial opportunism
market for corporate control
ownership concentration

## REVIEW QUESTIONS

1. What is corporate governance? Why is governance necessary to control managers' decisions?
2. What is meant by the statement that ownership is separated from managerial control in the corporation? Why does this separation exist?
3. What is an agency relationship? What is managerial opportunism? What assumptions do owners of corporations make about managers as agents?
4. How are each of the three internal governance mechanisms – ownership concentration, boards of directors and executive compensation – used to align the interests of managerial agents with those of the organisation's owners?
5. What trends exist regarding executive compensation? What is the effect of the increased use of long-term incentives on executive managers' strategic decisions?
6. What is the market for corporate control? What conditions generally cause this external governance mechanism to become active? How does this mechanism constrain executive managers' decisions and actions?
7. What is the nature of corporate governance in Germany, Japan, Spain and China?
8. How can corporate governance foster ethical decisions and behaviours on the part of managers as agents?
9. What is the legislative basis to the Australian system of governance?
10. What is CSR? How is CSR linked to corporate governance?

## EXPERIENTIAL EXERCISES

### Exercise 1: Governance – does it matter competitively?

Governance mechanisms are effective when they meet the needs of all stakeholders. Governance mechanisms are also a key way in which to ensure that strategic decisions are made effectively. As a potential employee, how would you go about investigating an organisation's governance structure, and would that investigation weigh in your decision to become an employee? Identify an organisation that you currently would like to join or one that you find interesting. Working individually, research the following aspects of your target organisation:

1. Find a copy of the organisation's most recent proxy statement. Typically, proxy statements are sent to shareholders prior to each year's annual general meeting and contain detailed information about the organisation's governance and issues on which a shareholder vote might be held. Proxy statements are typically available from an organisation's website (look for an 'Investors' submenu). Alongside the proxy you should also be able to access the organisation's annual report. Here you will find information concerning performance, governance and the organisation's outlook, among other matters.
2. Identify one of the organisation's main competitors for comparison. You can find one of the organisation's main

competitors by using organisation analysis tools such as Datamonitor.

The topics that you should examine include:

- compensation plans (for both the CEO and board members; be sure to look for the difference between fixed and incentive compensation)
- directors' fees
- board composition (e.g. board size, insiders and outsiders, interlocking directorates, functional experience, how many active CEOs, how many retired CEOs, what is the demographic makeup, and age diversity)
- committees (e.g. how many, composition and compensation)
- stock ownership by officers and directors – identify beneficial ownership from stock owned (you will need to look through the notes of the ownership tables to comprehend this)
- ownership concentration – how much of the organisation's outstanding stock is owned by institutions, individuals, insiders? How many large-block shareholders are there (5 per cent or more owners)?

Also consider the following questions:

a How many directors are independent of the organisation?

b What activities are there by activist shareholders regarding corporate governance issues of concern?

c Are there any managerial defence tactics employed by the organisation? For example, what does it take for a shareholder proposal to come to a vote and be adopted?

d Does the organisation have a code of conduct? If so, what is it?

Prepare a report summarising the results of your findings that compares your target organisation and its competitor side by side. Your memo should include the following topics:

- Summarise the key aspects of the organisations' governance mechanisms.
- Create a single graph covering the last 10-year historical stock performance for both companies. If applicable, find a representative index to compare both with, such as S&P.
- Highlight key differences between your target organisation and its competitor.
- Based on your review of the organisation's governance, did you change your opinion of the organisation's desirability as an employer? Why or why not? How does the target organisation compare to the main competitor you identified?

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# Organisational structure and controls

CHAPTER 11

## Learning Objectives

Studying this chapter should provide you with the strategic management knowledge needed to:

LO1 define organisational structure and controls and discuss the difference between strategic and financial controls

LO2 describe the relationship between strategy and structure

LO3 discuss the functional structures used to implement business-level strategies

LO4 explain the use of three versions of the multi-divisional (M-form) structure to implement different diversification strategies

LO5 discuss the organisational structures used to implement three international strategies

LO6 define strategic networks and discuss how strategic centre organisations implement such networks at the business, corporate and international levels.

# OPENING CASE STUDY

## Changing McDonald's organisational structure and controls: a path to improved performance

McDonald's is a huge fast-food restaurant chain – several times larger than Burger King and Wendy's, its closest competitors. In addition to the USA and Canada, McDonald's is present in over 100 countries worldwide. However, Steve Easterbrook, the former CEO, appointed in 2015, worked to adjust the organisation's strategy and structure. The strategic direction continued to remain sustainable under the leadership of Chris Kempczinski, who was appointed in 2019. As outlined in the 'Opening case' in Chapter 2, the external and competitive environments of McDonald's are turbulent. Its established competitors are fierce and others are entering the market; for example, International House of Pancakes (IHOP) placed an advertisement suggesting it may change its name to IHOb, International House of Burgers, signalling that it is now competing with McDonald's and others. This is probably due to McDonald's and others offering their breakfast menu items any time during the day. Chapter 4 also indicated that McDonald's is pursuing a low-cost strategy to deal with its competitive environment. To improve its performance, McDonald's needs structures and controls that match the strategy it is seeking to implement. At the same time, McDonald's is largely financed by franchisees who purchase a franchise contract to manage one or many locations worldwide. (Franchising is an alliance strategy that was outlined in Chapter 9.) The effectiveness of this alliance strategy is dependent on how well the franchisor can replicate its success across multiple partners in a cost-effective way.

This is especially important to the low-cost strategy McDonald's employs, where it is desirable for customers to have a similar experience at any of its locations. The organisation is reducing the number of layers between the CEO and the franchisee from eight to six, especially in the regional structure. There will be a number of unspecified layoffs to reduce costly bureaucracy. The remaining regional and corporate staff will 'spend more time helping operators figure out ways to boost restaurant profitability rather than just grading restaurants on such things as cleanliness, customer


Chris Kempczinski, CEO of McDonald's

Source: Getty Images/Bloomberg

service and order accuracy'. As noted above, the focus of the controls has largely been on enforcing replicability across franchisees. The company is now fine-tuning its corporate controls to focus on supply chain and process innovation at the franchisee level, giving more support to franchisees rather than penalising them for not meeting exact specifications.

For example, 'McDonald's assembled a panel of sensory experts consisting of suppliers, chefs and employees to compare rivals' burgers against theirs. They discovered that McDonald's burgers just weren't hot and fresh enough'. So, they adjusted 'the supply chain and distribution system to handle fresh – rather than frozen – hamburger patties' and 'McDonald's also altered its grilling methods, began toasting its buns longer and changed its preparation procedures so that burgers would be cooked upon request rather than held in warming cabinets'.

For a number of years, McDonald's was structured around geographic segments including the USA, Europe, Asia-Pacific, the Middle East and Africa (APMEA). Easterbrook wants to strip away the bureaucracy at McDonald's so the organisation can anticipate trends as a foundation for moving nimbly, and fully understand and appropriately respond to customers' interests. Additionally, Easterbrook specified that the new structure should be built on 'commercial logic' rather than simply geography.

McDonald's has implemented this new organisational structure as part of its effort to increase revenues and profitability and improve its stock value. Corporate officials are confident the new structure will enable individual segments to identify and successfully address what are common needs of their markets and customers, and that those operating units within each segment will have the flexibility they need to innovate in ways that will create value for customers and, in turn, for the entire corporation.

As the new structure and controls reduce costs and increase effectiveness, McDonald's is using some of these cost savings to implement a digital transition to online ordering and in-store kiosks. Thus, not only are the structure and control more simplified and effective, but technology is speeding up and improving the customer experience.

Sources: H. Detrick, 2018, McDonald's new Chicago headquarters is officially open. Why it moved back to the city after 47 years, *Fortune*, http://www.fortune.com, 5 June; L. Grossman, 2018, Wendy's got all savage on McDonald's with the perfect meme, *Time*, http://www.time.com, 9 May; J. Jargon, 2018, McDonald's shares details of restructuring plan in new memo, *Wall Street Journal*, http://www.wsj.com, 12 June; L. Patton, 2018, McDonald's high-tech makeover is stressing workers out, *Bloomberg*, http://www.bloomberg.com, 13 March; B. Peters, 2018, McDonald's plans more corporate job cuts amid tech push: Report, *Investor's Business Daily*, http://www.investor.com, 7 June; J. Sperling, 2018, McDonald's plans to eliminate a number of corporate jobs as part of reorganization plan, *Fortune*, http://www.fortune.com, 7 June; C. Choi, 2015, McDonald's to simplify structure, focus on customers, Spokesman, http://www.spokesman.com, 5 May; R. Neate, 2015, McDonald's plans huge shakeup as CEO admits: 'Our performance has been poor', *The Guardian*, http://www.theguardian.com, 4 May.

As we explained in Chapter 4, all organisations use one or more business-level strategies. In Chapters 6–9, we discussed other strategies organisations may choose to use (corporate-level, international and cooperative). After they are selected, strategies must be implemented effectively to make them work. Organisational structure and controls, which are this chapter's topic, provide the framework within which strategies are implemented and used in both for-profit organisations and not-for-profit agencies.[1] However, as we explain, separate structures and controls are required to successfully implement different strategies. In all organisations, executive managers have the final responsibility for ensuring that the organisation has matched each of its strategies with the appropriate organisational structure and that both change when necessary. The former CEO of McDonald's, Steve Easterbrook, was responsible for changing its organisational structure to effectively implement its business- or corporate-level strategy. The match or degree of fit between strategy and structure influences the organisation's attempts to earn above-average returns.[2] The ability to select an appropriate strategy and match it with the appropriate structure is an important characteristic of effective strategic leadership.[3]

This chapter opens with an introduction to organisational structure and controls. We then provide more details about the need for the organisation's strategy and structure to be properly matched. Affecting organisations' efforts to match strategy and structure is their influence on each other.[4] As we discuss, strategy has a more important influence on structure, although once in place, structure influences strategy.[5] Next, we describe the relationship between growth and structural change that successful organisations experience. We then discuss the different organisational structures organisations use to implement separate business-level, corporate-level, international and cooperative strategies. A series of figures highlights the different structures organisations match with strategies. Across time and based on their experiences, organisations – especially large and complex ones – customise these general structures to meet their unique needs.[6] Typically, the organisation tries to form a structure that is complex enough to facilitate use of its strategies, but simple enough for all parties to understand and implement.[7] When strategies become more diversified, an organisation must adjust its structure to deal with the increased complexity.

# Organisational structure and controls

Research shows that organisational structure and the controls that are a part of the structure affect organisation performance.[8] In particular, evidence suggests that performance declines when the organisation's strategy is not matched with the most appropriate structure and controls.[9] Even though mismatches between strategy and structure do occur, research indicates that managers try to act rationally when forming or changing their organisation's structure.[10] This chapter's opening case highlights challenges McDonald's has encountered when trying to deal with rapid changes that are occurring in the external environment. As noted, the organisation is changing its controls and processes to better meet the competition, and changes have been made to the organisational structure with the expectation that these will lead to enhanced organisational performance. Defined comprehensively below, organisational structure essentially specifies the functions that must be completed so the organisation can implement its strategy. The leadership at McDonald's believes that changes being made to the organisation's structure will increase its efficiency (i.e. its daily operations will improve) and its effectiveness (i.e. it will better serve customers' needs).

## Organisational structure

**organisational structure**
specifies the organisation's formal reporting relationships, procedures, controls, and authority and decision-making processes

**Organisational structure** specifies the organisation's formal reporting relationships, procedures, controls, and authority and decision-making processes.[11] Developing an organisational structure that effectively supports the organisation's strategy is difficult, especially because of the uncertainty (or unpredictable variation)[12] about cause–effect relationships in the global economy's rapidly changing and dynamic competitive environments.[13] When a structure's elements (e.g. reporting relationships and procedures) are properly aligned with one another, the structure facilitates effective use of the organisation's strategies.[14] Thus, organisational structure is a critical component of effective strategy implementation processes.[15]

An organisation's structure specifies the work to be done and how to do it, given the organisation's strategies. Thus, organisational structure influences how managers work and the decisions resulting from that work. Supporting the implementation of strategies, structure is concerned with processes used to complete organisational tasks.[16] Having the right structure and process is important. For example, many product-oriented organisations have been moving to develop service businesses associated with those products. However, research suggests that developing a separate division for such services in product-oriented companies, rather than managing the service business within the product divisions, leads to additional growth and profitability in the service business.

Effective structures provide the stability an organisation needs to successfully implement its strategies and maintain its current competitive advantages while simultaneously providing the flexibility to develop advantages it will need in the future.[17] *Structural stability* provides the capacity the organisation requires to consistently and predictably manage its daily work routines,[18] while *structural flexibility* provides the opportunity to explore competitive possibilities and then allocate resources to activities that will shape the competitive advantages the organisation will need for it to be successful in the future.[19] An effectively flexible organisational structure allows the organisation to *exploit* current competitive advantages while *developing* new ones that can potentially be used in the future.[20] Alternatively, an ineffective structure that is inflexible may drive good employees away because of frustration and an inability to complete their work in the best way possible. As such, it can lead to a loss of knowledge for the organisation, sometimes referred to as a knowledge spillover, which benefits competitors.[21]

Modifications to the organisation's current strategy or selection of a new strategy call for changes to its organisational structure. However, research shows that, once in place, organisational inertia often inhibits efforts to change structure, even when the organisation's performance suggests that it is time to do so.[22] In his pioneering work, Alfred Chandler found that organisations change their structures when inefficiencies force them to do so.[23] Chandler's contributions to our understanding of organisational structure and its relationship to strategies and performance are quite significant. Indeed, some believe that Chandler's emphasis on 'organisational structure so transformed the field of business history that some call the period before Chandler's work was published "B.C.", meaning "before Chandler"'.[24]

Organisations seem to prefer the structural status quo and its familiar working relationships until the organisation's performance declines to the point where change is absolutely necessary.[25] For example, necessity was clearly the case for General Motors given that it went into bankruptcy a decade ago to force a required restructuring.[26] Leading Australian icon brands on the brink of collapse include Seafolly, which appointed a voluntary administrator due to the crippling impact of the Covid-19 pandemic on its business. The administrators continued to trade the business due to the quality of the brand and its strong reputation. Aussie Disposals also went into administration in 2020, citing the pandemic as the contributing factor.[27] Unfortunately, it was too late for fashion label Tigerlily, which foreclosed in early 2020.[28]

Executive managers often hesitate to conclude that the organisation's structure (or its strategy) is the problem, because doing so suggests that their previous choices were not the best ones. Because of these inertial tendencies, structural change is often induced by actions from stakeholders (e.g. those from the capital market and customers; see Chapter 2) who are no longer willing to tolerate the organisation's performance. This happened at Bellamy's, for example. Evidence shows that appropriate timing of structural change happens when executive managers recognise that a current organisational structure no longer provides the coordination and direction needed for the organisation to successfully implement its strategies.[29] Interestingly, many organisational changes take place in an economic downturn, as has occurred during the Covid-19 pandemic, apparently because poor performance reveals organisational weaknesses. As we discuss next, effective organisational controls help managers recognise when it is time to adjust the organisation's structure.

# Organisational controls

Organisational controls are an important aspect of structure.[30] **Organisational controls** guide the use of strategy, indicate how to compare actual results with expected results, and suggest corrective actions to take when the difference is unacceptable. When fewer differences separate actual from expected outcomes, the organisation's controls are more effective.[31] It is difficult for the company to successfully exploit its competitive advantages without effective organisational controls.[32] Properly designed organisational controls provide clear insights regarding behaviours that enhance organisation performance.[33] Organisations employ both strategic controls and financial controls to support the implementation and use of their strategies.

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

**Strategic controls** are largely subjective criteria intended to verify that the organisation is using appropriate strategies for the conditions in the external environment and the company's competitive advantages. Thus, strategic controls are concerned with examining the fit between what the organisation *might do* (as suggested by opportunities in its external environment) and what it *can do* (as indicated by its competitive advantages). Effective strategic controls help the organisation understand what it takes to be successful.[34] Strategic controls demand rich communications between managers responsible for using them to judge the organisation's performance and those with primary responsibility for implementing the organisation's strategies (such as middle and first-level managers). These frequent exchanges are both formal and informal in nature.[35]

**strategic controls**
largely subjective criteria intended to verify that the organisation is using appropriate strategies for the conditions in the external environment and the company's competitive advantages

Strategic controls are also used to evaluate the degree to which the organisation focuses on the requirements to implement its strategies. For a business-level strategy, for example, the strategic controls are used to study primary and support activities to verify that the critical activities are being emphasised and properly executed. Nokia failed to employ effective strategic controls, leading to a fight for survival that was further exacerbated as it struggled to keep pace with its Chinese competitors Huawei and ZTE. The evolution of the current trade war also made it difficult for Nokia to win Chinese contracts, causing its sales in China to decrease by 15 per cent in 2020.[36]

With related corporate-level strategies, strategic controls are used by corporate strategic leaders to verify the sharing of appropriate strategic factors such as knowledge, markets and technologies across businesses. To effectively use strategic controls when evaluating related diversification strategies, headquarter executives must have a deep understanding of each unit's business-level strategy.[37]

**financial controls** largely objective criteria used to measure the organisation's performance against previously established quantitative standards

**Financial controls** are largely objective criteria used to measure the organisation's performance against previously established quantitative standards. Accounting-based measures such as return on investment (ROI) and return on assets (ROA), as well as market-based measures such as economic value added, are examples of financial controls. Partly because strategic controls are difficult to use with extensive diversification,[38] financial controls are emphasised to evaluate the performance of the organisation using the unrelated diversification strategy. The unrelated diversification strategy's focus on financial outcomes (see Chapter 6) requires using standardised financial controls to compare performances between business units and associated managers.[39]

When using financial controls, organisations evaluate their current performance against previous outcomes, as well as against competitors' performance and industry averages. In the global economy, technological advances are being used to develop highly sophisticated financial controls, making it possible for organisations to more thoroughly analyse their performance results, and to assure compliance with regulations.

Both strategic and financial controls are important aspects of each organisational structure and, as we noted previously, any structure's effectiveness is determined by using a combination of strategic and financial controls. However, the relative use of controls varies by type of strategy. For example, companies and business units of large diversified organisations using the cost leadership strategy emphasise financial controls (such as quantitative cost goals), while companies and business units using the differentiation strategy emphasise strategic controls (such as subjective measures of the effectiveness of product development teams).[40] As previously explained, a corporation-wide emphasis on sharing among business units (as called for by related diversification strategies) results in an emphasis on strategic controls, while financial controls are emphasised for strategies in which activities or capabilities are not shared (e.g. in an unrelated diversification strategy).

As organisations consider controls, the important point is to properly balance the use of strategic and financial controls. Indeed, over-emphasising one at the expense of the other can lead to performance declines. According to Michael Dell, an overemphasis on financial controls to produce attractive short-term results contributed to performance difficulties at Dell Inc. In addressing this issue, Dell said the following: 'The company was too focused on the short term, and the balance of priorities was way too leaning towards things that deliver short-term results'.[41] Executives at Dell have now achieved a more appropriate emphasis on the long term as well as the short term due to a re-emphasis on strategic controls, continuing the organisation's focus on recapturing market share and leadership in the personal computer (PC) market.

# Relationships between strategy and structure

Strategy and structure have a reciprocal relationship.[42] This relationship highlights the interconnectedness between strategy formulation (Chapters 4 and 6–9) and strategy implementation (Chapters 10–13). In general, this reciprocal relationship finds structure flowing from or following selection of the organisation's strategy. Once in place, though, structure can influence current strategic actions as well as choices about future strategies. The new structure being adopted at McDonald's has the potential to influence implementation of strategies that are better aimed at identifying and satisfying customers' changing needs. The general nature of the strategy–structure relationship means that changes to the organisation's strategy create the need to change how the organisation completes its work.

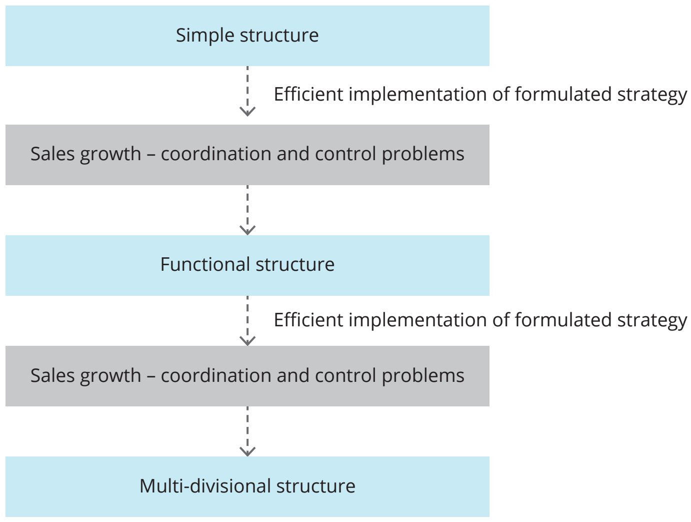
Alternatively, because structure likely influences strategy by constraining the potential alternatives considered, organisations must be vigilant in their efforts to verify how their structure not only affects implementation of the chosen strategies, but also the limits the structure places on future strategies to be considered. Research shows, however, that 'strategy has a much more important influence on structure than the reverse'.[43]

Regardless of the strength of the reciprocal relationships between strategy and structure, those choosing the organisation's strategy and structure should be committed to matching each strategy with a structure that provides the stability needed to use current competitive advantages, as well as the flexibility required to develop future advantages. Therefore, when changing strategies, the organisation should simultaneously consider the structure that will be needed to support use of the new strategy; properly matching strategy and structure can create a competitive advantage.[44]

# Evolutionary patterns of strategy and organisational structure

Research suggests that most organisations experience a certain pattern of relationships between strategy and structure. Chandler[45] found that organisations tend to grow in somewhat predictable patterns: 'first by volume, then by geography, then integration (vertical, horizontal), and finally through product/business diversification'[46] (see Figure 11.1). Chandler interpreted his findings as an indication that an organisation's growth patterns determine its structural form.

**Figure 11.1** **Strategy and structure growth pattern**




As shown in Figure 11.1, sales growth creates coordination and control problems that the existing organisational structure cannot efficiently handle. Organisational growth creates the opportunity for the organisation to change its strategy to try to become even more successful. However, the existing structure's formal reporting relationships, procedures, controls, and authority and decision-making processes lack the sophistication required to support using the new strategy.[47] A new structure is needed to help decision makers gain access to the knowledge and understanding required to effectively integrate and coordinate actions to implement the new strategy.[48]

Organisations choose from among three major types of organisational structures – simple, functional and multi-divisional – to implement strategies. Across time, successful organisations move from the simple to the functional to the multi-divisional structure to support changes in their growth strategies.[49]

## Simple structure

**simple structure**
a structure in which the owner-manager makes all major decisions and monitors all activities while the staff serves as an extension of the manager's supervisory authority

The **simple structure** is a structure in which the owner-manager makes all major decisions and monitors all activities, while the staff serves as an extension of the manager's supervisory authority.[50] Typically, the owner-manager actively works in the business on a daily basis. Informal relationships, few rules, limited task specialisation and unsophisticated information systems characterise this structure. Frequent and informal communications between the owner-manager and employees make coordinating the work to be done relatively easy. The simple structure is matched with focus strategies and business-level strategies, as organisations implementing these strategies commonly compete by offering a single product line in a single geographic market. Local restaurants, repair businesses and other specialised enterprises are examples of organisations using the simple structure.

As the small organisation grows larger and becomes more complex, managerial and structural challenges emerge. For example, the amount of competitively relevant information requiring analysis substantially increases, placing significant pressure on the owner-manager. Additional growth and success may cause the organisation to change its strategy. Even if the strategy remains the same, the organisation's larger size dictates the need for more sophisticated workflows and integrating mechanisms. At this evolutionary point, organisations tend to move from the simple structure to a functional organisational structure.[51]

## Functional structure

**functional structure**
consists of a chief executive officer and a limited corporate staff, with functional line managers in dominant organisational areas, such as production, accounting, marketing, research and development, engineering and human resources

The **functional structure** consists of a chief executive officer (CEO) and a limited corporate staff, with functional line managers in dominant organisational areas, such as production, accounting, marketing, R&D, engineering and human resources.[52] This structure allows for functional specialisation,[53] thereby facilitating active sharing of knowledge within each functional area. Knowledge sharing facilitates career paths as well as professional development of functional specialists. However, a functional orientation can negatively affect communication and coordination among those representing different organisational functions. For this reason, the CEO must verify that the decisions and actions of individual business functions promote the entire organisation rather than a single function. The functional structure supports implementing business-level strategies and some corporate-level strategies (e.g. single or dominant business) with low levels of diversification. When changing from a simple to a functional structure, organisations should avoid introducing value-destroying bureaucratic procedures such as failing to promote innovation and creativity.[54]

## Multi-divisional structure

With continuing growth and success, organisations often consider greater levels of diversification. Successfully using a diversification strategy requires analysing substantially greater amounts of data and information when the organisation offers the same products in different markets (market or geographic diversification) or offers different products in several markets (product diversification). In addition, trying to manage high levels of diversification through functional structures creates serious coordination and control problems,[55] a fact that commonly leads to a new structural form.[56]

**multi-divisional (M-form) structure**
consists of operating divisions, each representing a separate business or profit centre in which the top corporate officer delegates responsibilities for day-to-day operations and business-unit strategy to division managers

The **multi-divisional (M-form) structure** consists of a corporate office and operating divisions, with each operating division representing a separate business or profit centre in which the top corporate officer delegates responsibilities for day-to-day operations and business-unit strategy to division managers. Each division represents a distinct, self-contained business with its own functional hierarchy.[57] As initially designed, the M-form was thought to have three major benefits: '(1) it enabled corporate officers to more accurately monitor the performance of each business, which simplified the problem of control; (2) it facilitated comparisons between divisions, which improved the resource allocation process; and (3) it stimulated managers of poorly performing divisions to look for ways of improving performance'.[58] Active monitoring of performance through the M-form increases the likelihood that decisions made by managers heading individual units will be in stakeholders' best interests. Because diversification is a dominant corporate-level strategy used in the global economy, the M-form is a widely adopted organisational structure.[59]

Used to support implementation of related and unrelated diversification strategies, the M-form assists organisations to successfully manage diversification's many demands.[60] Chandler viewed the M-form as an innovative response to coordination and control problems that surfaced during the 1920s in the functional structures then used by large organisations such as DuPont and General Motors. A more contemporary example is the Virgin Australia Group – the parent company of Virgin Australia domestic, Tiger Airlines (which in March 2020 had suspended operations due to the impact of the Covid-19 pandemic) and Velocity. The new organisational structure integrates the corporate, operational and commercial functions of Virgin Australia Airlines.[61] Research shows that the M-form is appropriate when the organisation grows through diversification.[62] Partly because of its value to diversified corporations, some consider the multi-divisional structure to be one of the 20th century's most significant organisational innovations.[63]

No one organisational structure (simple, functional or multi-divisional) is inherently superior to the others.[64] Peter Drucker says the following about this matter: 'There is no one right organisation … Rather the task … is to select the organisation for the particular task and mission at hand'.[65] This statement suggests that the organisation must select a structure that is 'right' for successfully using the chosen strategy. Because no single structure is optimal in all instances, managers concentrate on developing proper matches between strategies and organisational structures rather than searching for an 'optimal' structure. We now describe the strategy–structure matches that evidence shows positively contribute to organisation performance.

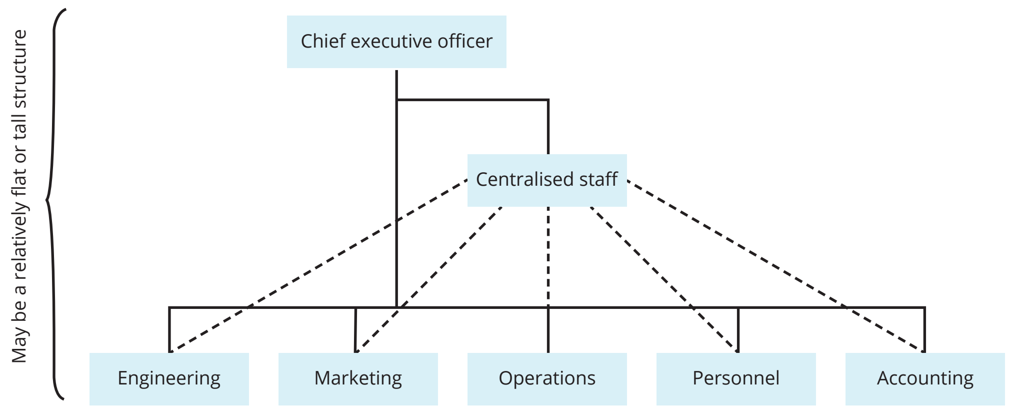
## Matches between business-level strategies and the functional structure

Organisations use different forms of the functional organisational structure to support implementing the cost leadership, differentiation and integrated cost leadership/differentiation strategies. The differences in these forms are accounted for primarily by different uses of three important structural characteristics: *specialisation* (concerned with the type and number of jobs required to complete work),[66] *centralisation* (the degree to which decision-making authority is retained at higher managerial levels)[67] and *formalisation* (the degree to which formal rules and procedures govern work).[68]

### Using the functional structure to implement the cost leadership strategy

Organisations using the cost leadership strategy sell large quantities of standardised products to an industry's typical customers, such as McDonald's, Target and Kmart. Organisations using this strategy need a structure and capabilities that allow them to achieve efficiencies and produce their goods at costs lower than those of competitors.[69] Simple reporting relationships, few layers in the decision-making and authority structure, a centralised corporate staff and a strong focus on process improvements through the manufacturing function rather than the development of new products by emphasising product R&D help to achieve the efficiencies and thus characterise the cost leadership form of the functional structure[70] (see Figure 11.2). This structure contributes to the emergence of a low-cost culture – a culture in which employees constantly try to find ways to reduce the costs incurred to complete their work.[71] They can do this through the development of a product architecture that is simple and easy to manufacture, as well as through the development of efficient processes to produce the goods.[72]

**Figure 11.2** **Functional structure for implementing a cost leadership strategy**




Notes:
- Operations is the main function.
- Process engineering is emphasised, rather than new product R&D.
- A relatively large centralised staff coordinates functions.
- Formalised procedures allow for emergence of a low-cost culture.
- The overall structure is mechanical; job roles are highly structured.

In terms of centralisation, decision-making authority is centralised in a staff function to maintain a cost-reducing emphasis within each organisational function (engineering, marketing, etc.). While encouraging continuous cost reductions, the centralised staff also verifies that further cuts in costs in one function will not adversely affect the productivity levels in other functions.[73]

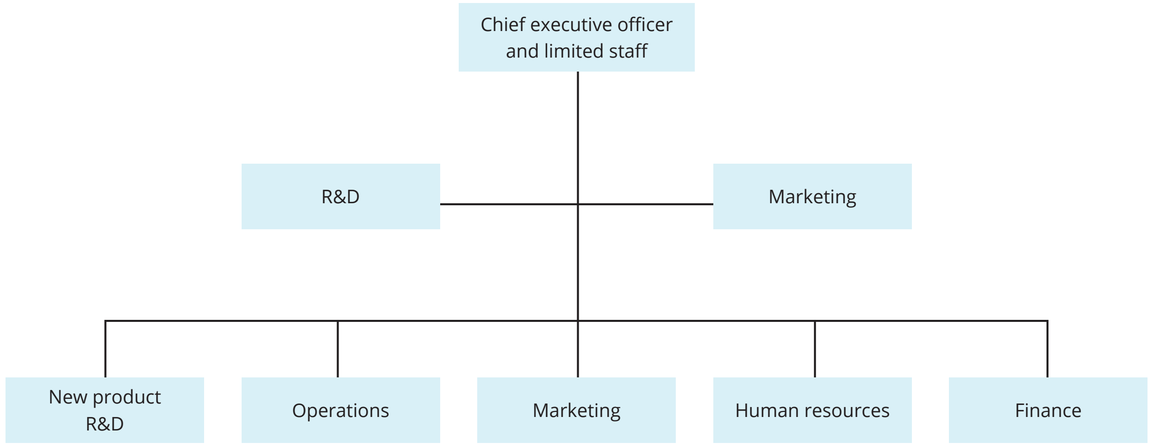
Jobs are highly specialised in the cost leadership functional structure; work is divided into homogeneous subgroups. Organisational functions are the most common subgroup, although work is sometimes batched on the basis of products produced or clients served. Specialising in their work allows employees to increase their efficiency, resulting in reduced costs. Guiding individuals' work in this structure are highly formalised rules and procedures, which often emanate from the centralised staff.

Woolworths Group Ltd uses the functional structure to implement cost leadership strategies in each of its core businesses (Woolworths supermarkets, Woolworths Insurance, Countdown (NZ) and Endeavour Group Ltd comprising Dan Murphy's, BWS, Cellarmasters, Langton's and ALH Group). In the Woolworths Group segment, the cost leadership strategy is used in the organisation's retailing formats.[74] The stated purpose of Woolworths Group from the beginning has been: 'we create better experiences together for a better tomorrow'.[75] It continues using the functional organisational structure in its divisions to drive costs lower. Woolworths Group manages some of Australia's most recognised and trusted brands. JB Hi-Fi also aims for a match of strategy and structure, as do many other low-cost organisations in the world; the problem is achieving it and maintaining a sustainable competitive advantage, but this appears to have been successful for JB Hi-Fi during the Covid-19 pandemic, when its share price more than doubled between late March and the end of August 2020.[76]

## Using the functional structure to implement the differentiation strategy

Organisations using the differentiation strategy produce products that customers hopefully perceive as being different in ways that create value for them. With this strategy, the organisation wants to sell non-standardised products to customers with unique needs. Relatively complex and flexible reporting relationships, frequent use of cross-functional product development teams and a strong focus on marketing and product R&D rather than manufacturing and process R&D (as with the cost leadership form of the functional structure) characterise the differentiation form of the functional structure (see Figure 11.3). From this structure emerges a development-oriented culture in which employees try to find ways to further differentiate current products and to develop new, highly differentiated products.[77]

**Figure 11.3** **Functional structure for implementing a differentiation strategy**




Notes:
- Marketing is the main function for keeping track of new product ideas.
- New product R&D is emphasised.
- Most functions are decentralised; however, R&D and marketing may have centralised staffs that work closely with each other.
- Formalisation is limited so that new product ideas can emerge easily and change is more readily accomplished.
- The overall structure is organic; job roles are less structured.

Continuous product innovation demands that people throughout the organisation interpret and take action based on information that is often ambiguous, risky, incomplete and uncertain. Following a strong focus on the external environment to identify new opportunities, employees often gather this information from people external to the organisation (e.g. customers and suppliers). Commonly, rapid responses to the possibilities indicated by the collected information are necessary, suggesting the need for decentralised decision-making responsibility and authority. It also requires building a strong technological capability and strategic flexibility, which allow the organisation to take advantage of opportunities created by changes in the market.[78] To support the creativity needed and the continuous pursuit of new sources of differentiation and new products, jobs in this structure are not highly specialised. This lack of specialisation means that workers have a relatively large number of tasks in their job descriptions. Few formal rules and procedures also characterise this structure. Low formalisation, decentralisation of decision-making authority and responsibility, and low specialisation of work tasks combine to create a structure in which people interact frequently to exchange ideas about how to further differentiate current products while developing ideas for new products that can be crisply differentiated.

## Using the functional structure to implement the integrated cost leadership/differentiation strategy

Organisations using the integrated cost leadership/differentiation strategy sell products that create value because of their relatively low cost and reasonable sources of differentiation. The cost of these products is low 'relative' to the cost leader's prices, while their differentiation is 'reasonable' when compared with the clearly unique features of the differentiator's products.

Although challenging to implement, the integrated cost leadership/differentiation strategy is used frequently in the global economy by organisations such as IKEA. The challenge of using this strategy is due largely to the fact that different primary and support activities (see Chapter 3) are emphasised when using the cost leadership and differentiation strategies. To achieve the cost leadership position, production and process engineering need to be emphasised, with infrequent product changes. To achieve a differentiated position, marketing and new product R&D need to be emphasised, while production and process engineering are not. Thus, effective use of the integrated strategy depends on the organisation's successful combination of activities intended to reduce costs with activities intended to create additional differentiation features. As a result, the integrated form of the functional structure must have decision-making patterns that are partially centralised and partially decentralised. Additionally, jobs are semi-specialised, and rules and procedures call for some formal and some informal job behaviour. All of this requires a measure of flexibility to emphasise one or the other set of functions at any given time.

## Matches between corporate-level strategies and the multi-divisional structure

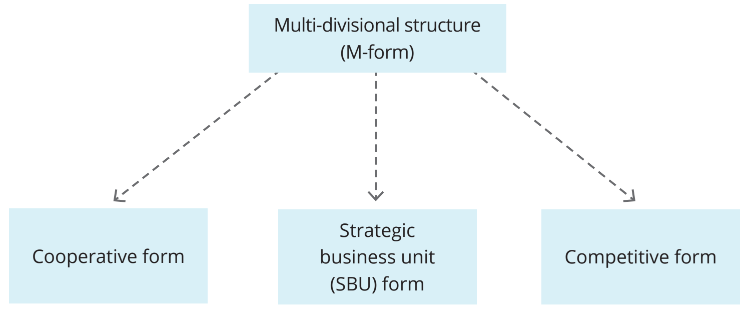
As explained earlier, Chandler's research shows that the organisation's continuing success leads to product or market diversification or both.[79] The organisation's level of diversification is a function of decisions about the number and type of businesses in which it will compete as well as how it will manage the businesses (see Chapter 6). Geared to managing individual organisational functions, increasing diversification eventually creates information processing, coordination and control problems that the functional structure cannot handle. Thus, using a diversification strategy requires the organisation to change from the functional structure to the multi-divisional structure to develop an appropriate strategy–structure match.

As defined in Figure 6.1, corporate-level strategies have different degrees of product and market diversification. The demands created by different levels of diversification highlight the need for a unique organisational structure to effectively implement each strategy (see Figure 11.4).

**STRATEGY NOW →** Constellation Brands

The computer company Cisco must use a differentiation strategy in order to compete in its several high-technology product market segments. However, given the presence of major competitors in those markets, such as Hewlett-Packard (HP) and Huawei, and its loss of market share in its core market of routers, Cisco must also be sensitive to costs. Thus, the horizontal structure can be useful to integrate the two disparate dimensions of structure needed to implement Cisco's integrated cost leadership/differentiation strategy. In addition, Cisco needs to coordinate several related product units, and the horizontal structure should facilitate this cooperation. Therefore, Cisco's approach is similar to the cooperative M-form structure, discussed next.

**Figure 11.4** **Three variations of the multi-divisional structure**



## Globalisation and beer

**Strategic focus** | Globalisation

In 2005, the global beer industry was highly fragmented, with Anheuser-Busch's (AB) 8.5 per cent market share enough to make it the global leader. Since then, a steady process of consolidation via mergers and acquisition has taken place. Much of this was around cost-cutting opportunities, including the US$60 billion merger of AB and InBev, completed in 2008. Also, there were moves geared towards acquiring attractive emerging market assets in Asia; for example, Heineken's US$24 billion acquisition of Asia Pacific Breweries, completed in 2012. In late 2014, AB InBev had an estimated 21 per cent global market share. Today's top five companies represent more than 50 per cent of the global market (versus 32 per cent for the top five players in 2003).

Consolidation means it is hard to know who owns a beer brand; Coopers is the only major independent beer producer in Australia, and major brands dominate all over the Asia-Pacific region. To demonstrate how hard it is to know what goes on, take Little Creatures as an example. It is a craft beer out of Fremantle in Western Australia. And it is a subsidiary of Little World, which is a subsidiary of Lion Nathan, itself a subsidiary of Kirin, the Japanese brewer, which is part of the Mitsubishi group! Complex ownership patterns such as this and changes in strategy also require changes in organisation structure, as the case of Constellation Brands in the USA demonstrates.

In 2013, Constellation Brands Inc. became the third-largest beer producer in the USA behind AB InBev and MillerCoors. An opportunity appeared for Constellation through a merger between AB InBev and Mexico's Grupo Modelo. The US Justice Department would not allow the merger to take place unless Grupo Modelo's top import brand, Corona, was divested. This is the asset that Constellation acquired with the associated brewery over the Texas border in Mexico with distribution rights in the USA. Constellation had already signed a 50/50 joint venture with Modelo in 2007 to distribute the Mexican company's beer in the USA. As such, Constellation got to continue its distribution rights but also became a producer with the acquisition of the large brewery. Through this acquisition, Constellation will control nearly 50 per cent of US beer imports. Even though beer distribution is shrinking relative to other segments of overall alcohol sales, imported beers are a growing segment. In part, this is due to the growth of the Hispanic population in the USA.

Constellation started out as a small family wine producer in upstate New York. Through acquisitions, Constellation Brands has become the largest wine producer in the world. In particular, it has the largest share of premium wine distribution in the USA, the UK, Australia and Canada, and the second-largest in New Zealand. It also has a large set of brands in the spirits category. For instance, it owns Svedka Vodka and competes with Grey Goose, owned by Bacardi Limited, and Smirnoff, owned by Diageo. It also owns other spirit brands including Black Velvet Canadian Whisky and Paul Masson Grande Amber Brandy.

Because it has three different types of producing technologies in wine, spirits and beer, it must understand each of these processes and be able to have strategic control of these separate operations. Accordingly, the appropriate structure for these three types of operations requires the SBU (strategic business unit) structure such that the wine, spirits and beer operations are combined into three different business groups with divisional structures for each brand within the group. Being the producer of only wines to being a producer of spirits and beer as well, meant Constellation had to change its operating structure because it moved from being a related constrained diversifier to a related linked diversifier (mixed-related-unrelated). With this change, the better fit between strategy and structure would be the installation of the SBU structure and a move away from the cooperative structure. It may be possible to run the premium wine and spirits in the same group because they have similar distribution outlets. However, because there is not much production or operational relatedness in these business units, it may be better to keep them separate. Beer is both distributed differently (more of a consumer product) and produced differently than wine and spirits. Robert Sands, CEO of Constellation, acknowledges that 'Constellation has a lot to learn about mixing barley and hops', but he notes 'the brewery is highly automated'. He also sees some cost benefits across the whole corporation in being able to strike cheaper procurement deals for 'glass bottles, cardboard, and freight, three big input costs, and improve its negotiation position with retailers by offering a full menu of alcohol'.

Constellation Brands has to change its structure due to its diversification strategy. This industry is highly competitive and has further competition from China. Interestingly, China has overtaken the USA as the largest beer economy. Increased globalisation has contributed to a convergence in alcohol consumption patterns across countries. China's beer industry was booming until the Covid-19 pandemic, which closed down bars and restaurants and has significantly affected sales.

Sources: M. Smith, 2020, China's beer brewers bitter at Australian barley tariff plan, *Financial Review*, 12 May; cbrands.com, 2020, *Summary Annual Report 2020*; Wikipedia, 2015, List of Breweries in Australia, https://en.wikipedia.org/wiki/List_of_breweries_in_Australia; M. Boesler, 2014, How the global beer industry has consolidated over the last 10 years, *Business Insider Australia*, http://www.businessinsider.com.au/global-beer-industry-consolidation-2014-2; A. Collins, 2013, Strategic buyer AB InBev sells US rights and other Modelo brands to Constellation, *Mergers & Acquisitions Report*, 25 February, 5; A. Deckert, 2013, Constellation Brands gears up for changes, *Rochester Business Journal*, 12 April, 3; M. Esterl, 2013, New US brewing giant is crowned, *Wall Street Journal*, 7 June, B6; B. Kindle, 2013, Constellation wants legal role in beer merger battle, *Wall Street Journal*, 11 February, B5.

**STRATEGY NOW**

Implications of News Corp's restructuring

Another example of diversification is News Corporation, which in 2013 approved a split of its media businesses into many organisations. Over many years, it had acquired a number of businesses both in television and print. It had been organised into an SBU-type of organisation given its focus in different areas. In the split-up, the print media company is called News Corp and has newspaper assets including *The Australian*, the *Wall Street Journal*, *New York Post* and *The Times* of London. It also has the book publisher HarperCollins. The other business is called 21st Century Fox and includes the Fox broadcast and cable networks and 20th Century Fox studio, which produces film and television programs.[80] The companies in New Corp's global network in 2020 included News UK, Dow Jones, *New York Post*, HarperCollins Publishers, News America Marketing, Move, Storyful and News Corp Australia. News Corp Australia is a majority shareholder of merged entities Foxtel and FOX SPORTS Australia. News Corp Australia also has 100 per cent ownership of Australian News Channel Pty Ltd, which operates Sky News Australia, a 24 hour multi-channel, multi-platform news service. News Corp Australia's other brands include *The Australian*, *Daily Telegraph*, *Sunday Telegraph*, *Herald Sun*, *Herald Sun Sunday*, *Courier Mail*, *Sunday Mail*, *The Advertiser*, *NT News*, *Sunday Territorian*, *Mercury*, REA Group, news.com.au, Taste, punters.com.au, Delicious and Sky News.

REA Group Limited is a subsidiary company of News Corp. It is a multinational digital advertising company specialising in property, and operates in the Australian residential, commercial and share property websites realestate.com.au, realcommercial.com.au and flatmates.com.au, Chinese property site myfun.com and iProperty Group, which owns a number of leading property portals in Asia. News Corp Australia also has 100 per cent ownership of punters.com.au and racenet.com.au providing specialised racing content and industry news. News Corp is an excellent example of a diversification strategy used globally.[81]

## Using the cooperative form of the multi-divisional structure to implement the related constrained strategy

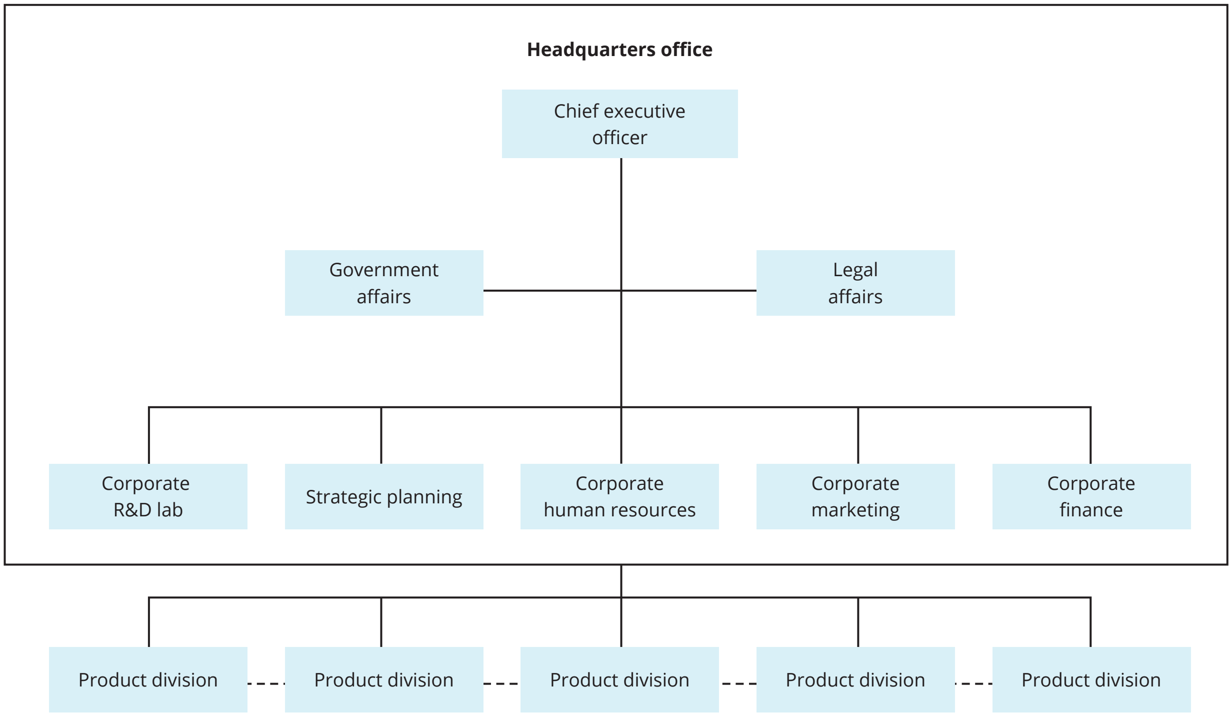
**cooperative form**

a structure in which horizontal integration is used to bring about interdivisional cooperation

The **cooperative form** is an M-form structure in which horizontal integration is used to bring about interdivisional cooperation. Divisions in an organisation using the related constrained diversification strategy commonly are formed around products, markets or both. In Figure 11.5, we use product divisions as part of the representation of the cooperative form of the multi-divisional structure, although market divisions could be used instead of, or in addition to, product divisions to develop the figure. Using this structure, formal coordination devices are used to achieve cooperation.[82]

Sharing divisional competencies facilitates the corporation's efforts to develop economies of scope. As explained in Chapter 6, economies of scope (cost savings resulting from the sharing of competencies developed in one division with another division) are linked with successful use of the related constrained strategy. Interdivisional sharing of competencies depends on cooperation, suggesting the use of the cooperative form of the multi-divisional structure.[83] News Corp's new structure and processes were able to accomplish this.

**Figure 11.5** **Cooperative form of the multi-divisional structure for implementing a related constrained strategy**




Notes:
- Structural integration devices create tight links among all divisions.
- Corporate office emphasises centralised strategic planning, human resources and marketing to foster cooperation between divisions.
- R&D is likely to be centralised.
- Rewards are subjective and tend to emphasise overall corporate performance, in addition to divisional performance.
- The culture emphasises cooperative sharing.

The cooperative structure uses different characteristics of structure (centralisation, standardisation and formalisation) as integrating mechanisms to facilitate interdivisional cooperation. Frequent, direct contact between division managers, another integrating mechanism, encourages and supports cooperation and the sharing of knowledge, capabilities or other resources that could be used to create new advantages.[84]

Ultimately, a matrix organisation may evolve in organisations implementing the related constrained strategy. A *matrix organisation* is an organisational structure in which there is a dual structure combining both functional specialisation and business product or project specialisation.[85] Although complicated, an effective matrix structure can lead to improved coordination among an organisation's divisions.[86]

The success of the cooperative multi-divisional structure is significantly affected by how well divisions process information. However, because cooperation among divisions implies a loss of managerial autonomy, division managers may not readily commit themselves to the type of integrative information-processing activities that this structure demands. Moreover, coordination among divisions sometimes results in an unequal flow of positive outcomes to divisional managers. In other words, when managerial rewards are based at least in part on the performance of individual divisions, the manager of the division that is able to benefit the most by the sharing of corporate competencies might be viewed as receiving relative gains at others' expense. Strategic controls are important in these instances, as divisional managers' performance can be evaluated at least partly on the basis of how well they have facilitated interdivisional cooperative efforts. In addition, using reward systems that emphasise overall company performance, besides outcomes achieved by individual divisions, helps overcome problems associated with the cooperative form. Still, the costs of coordination and inertia in organisations limit the amount of related diversification attempted (i.e. they constrain the economies of scope that can be created).[87]

## Using the strategic business unit form of the multi-divisional structure to implement the related linked strategy

Organisations with fewer links or less constrained links among their divisions use the related-linked diversification strategy. The strategic business unit form of the multi-divisional structure supports implementation of this strategy. The **strategic business unit (SBU) form** is an M-form structure consisting of three levels: corporate headquarters, strategic business units (SBUs) and SBU divisions (see Figure 11.6). The SBU structure is used by large organisations and can be complex, given associated organisation size and product and market diversity.

**strategic business unit (SBU) form**
consists of three levels: corporate headquarters, strategic business units (SBUs) and SBU divisions

The divisions within each SBU are related in terms of shared products or markets, or both, but the divisions of one SBU have little in common with the divisions of the other SBUs. Divisions within each SBU share product or market competencies to develop economies of scope and possibly economies of scale. The integrating mechanisms used by the divisions in this structure can be equally well used by the divisions within the individual strategic business units that are part of the SBU form of the multi-divisional structure. In this structure, each SBU is a profit centre that is controlled and evaluated by the headquarters office. Although both financial and strategic controls are important, on a relative basis financial controls are vital to headquarters' evaluation of each SBU, while strategic controls are critical when the heads of SBUs evaluate their divisions' performances. Strategic controls are also critical to the headquarters' efforts to determine whether the company has formed an effective portfolio of businesses and whether those businesses are being successfully managed. Therefore, there is need for strategic structures that promote exploration to identify new products and markets, but also for actions that exploit the current product lines and markets.[88]

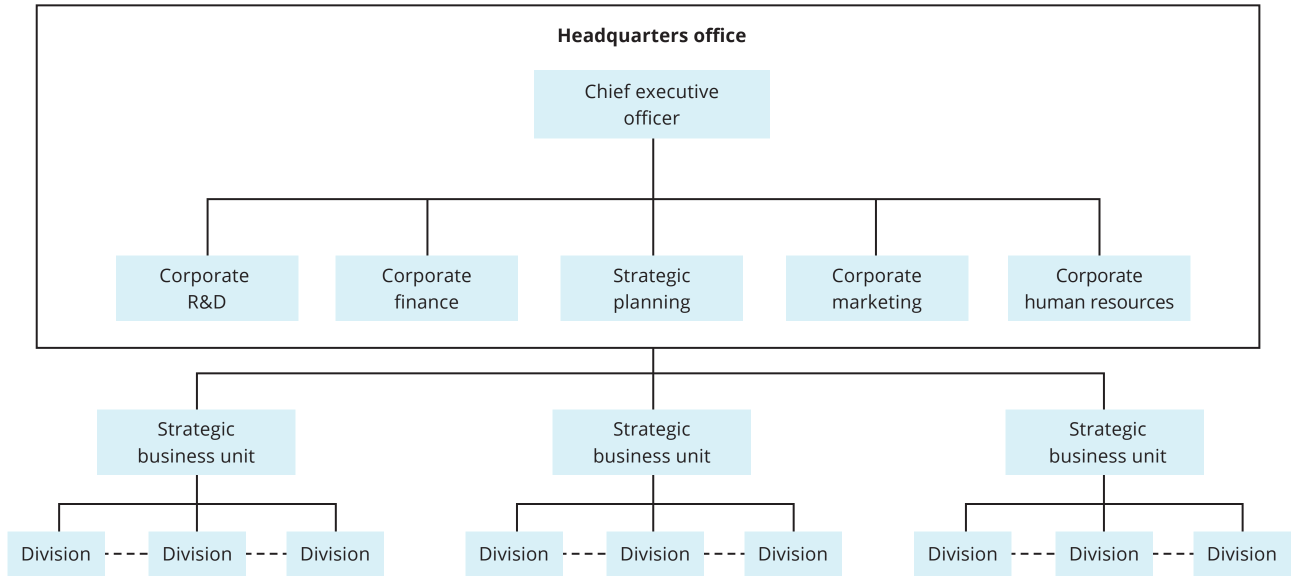
STRATEGY NOW
Wesfarmers

Wesfarmers operates an SBU system. It has a 'Retail' SBU that includes a number of very significant business units. Bunnings Warehouse (home improvement), Officeworks (office supplies), Kmart (variety) and Target (clothing) are included. Another SBU is even more varied; termed 'Industrial and Other' it includes insurance, resources, industrial and safety, part of a bank, a sawmill and the property trust that owns the Bunnings warehouses.[89]

Sharing competencies among units within an SBU is an important characteristic of the SBU form of the multi-divisional structure (see the 'Notes' to Figure 11.6). For Wesfarmers this is more evident in the Retail unit than in the disparate holdings of the Industrial and Other unit.

A drawback to the SBU structure is that multifaceted businesses often have difficulties in communicating this complex business model to shareholders.[90] Furthermore, if coordination between SBUs is needed, problems can arise because the SBU structure, similar to the competitive form discussed next, does not readily foster cooperation across SBUs.

**Figure 11.6** **SBU form of the multi-divisional structure for implementing a related linked strategy**




Notes:

- There is structural integration among divisions within SBUs, but independence across SBUs.
- Strategic planning may be the most prominent function in headquarters for managing the strategic planning approval process of SBUs for the chief executive officer.
- Each SBU may have its own budget for staff to foster integration.
- Corporate headquarters staff serve as consultants to SBUs and divisions, rather than having direct input to product strategy, as in the cooperative form.

## Using the competitive form of the multi-divisional structure to implement the unrelated diversification strategy

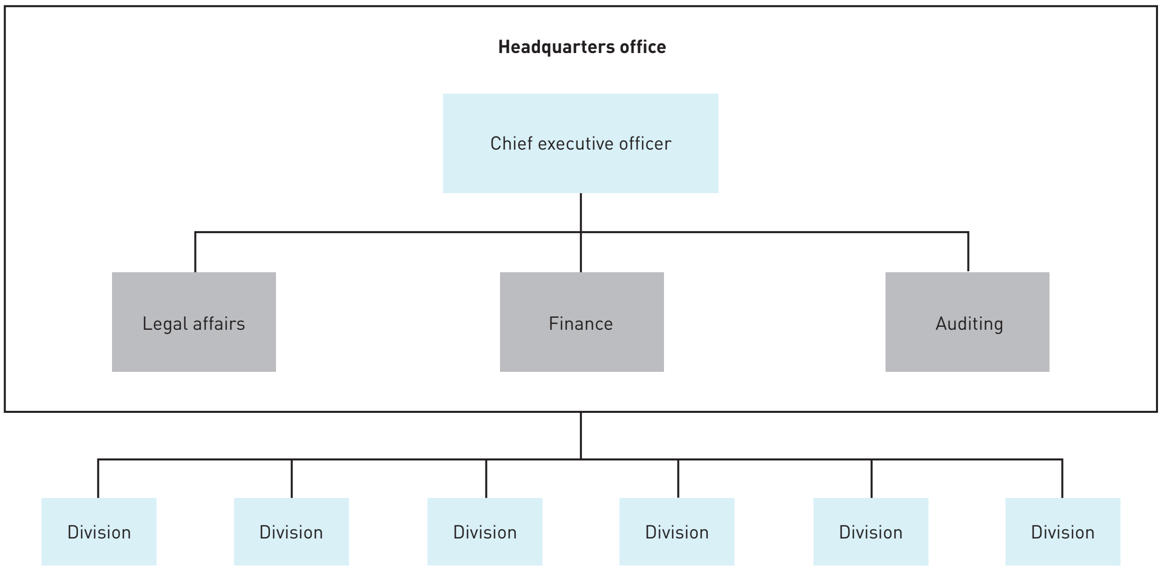
Organisations using the unrelated diversification strategy want to create value through efficient internal capital allocations or by restructuring, buying and selling businesses.[91] The competitive form of the multi-divisional structure supports implementation of this strategy.

The **competitive form** is an M-form structure characterised by complete independence among the organisation's divisions that compete for corporate resources (see Figure 11.7). Unlike the divisions included in the cooperative structure, divisions that are part of the competitive structure do not share common corporate strengths. Because strengths are not shared, integrating devices are not developed for use by the divisions included in the competitive structure.

**competitive form**
a structure in which there is complete independence among the organisation's divisions

The efficient internal capital market that is the foundation for using the unrelated diversification strategy requires organisational arrangements emphasising divisional competition rather than cooperation.[92] Three benefits are expected from the internal competition. First, internal competition creates flexibility (e.g. corporate headquarters can have divisions working on different technologies and projects to identify those with the greatest potential). Resources can then be allocated to the division appearing to have the most potential to fuel the entire organisation's success. Second, internal competition challenges the status quo and inertia, because division heads know that future resource allocations are a product of excellent current performance as well as superior positioning in terms of future performance. Third, internal competition motivates effort in that the challenge of competing against internal peers can be as great as the challenge of competing against external rivals.[93] In this

**Figure 11.7** **Competitive form of the multi-divisional structure for implementing an unrelated strategy**




Notes
- Corporate headquarters has a small staff.
- Finance and auditing are the most prominent functions in the headquarters office to manage cash flow and assure the accuracy of performance data coming from divisions.
- The legal affairs function becomes important when the organisation acquires or divests assets.
- Divisions are independent and separate for financial evaluation purposes.
- Divisions retain strategic control, but cash is managed by the corporate office.
- Divisions compete for corporate resources.

structure, organisational controls (primarily financial controls) are used to emphasise and support internal competition among separate divisions and as the basis for allocating corporate capital based on divisions' performances.

The three major forms of the multi-divisional structure should each be paired with a particular corporate-level strategy. Table 11.1 shows these structures' characteristics. Differences exist in the degree of centralisation, the focus of the performance evaluation, the horizontal structures (integrating mechanisms) and the incentive compensation schemes. The most centralised and most costly structural form is the cooperative structure. The least centralised, with the lowest bureaucratic costs, is the competitive structure. The SBU structure requires partial centralisation and involves some of the mechanisms necessary to implement the relatedness between divisions. Also, the divisional incentive compensation awards are allocated according to both SBUs and corporate performance.

The huge Korean technology business LG Company (formerly called Lucky Goldstar) operates like a holding company and appears to use a competitive multi-divisional structure. The different units are operating in significantly different industries. LG Electronics, one of the companies in the LG Company portfolio, has several businesses operating in different consumer products businesses (e.g. LG Home Appliance and Air Solution Company, LG Home Entertainment Company, LG Mobile Communication Company and LG Vehicle Component Solutions Company). LG Company issues financial controls to govern and evaluate the different corporations in its portfolio.[94]

**Table 11.1 Characteristics of the structures necessary to implement the related constrained, related linked and unrelated diversification strategies**

| | Overall structural form | | |
|---|---|---|---|
| Structural characteristics | Cooperative M-form (related constrained strategy) | SBU M-form (related linked strategy) | Competitive M-form (unrelated diversification strategy)[a] |
| Centralisation of operations | Centralised at corporate office | Partially centralised (in SBUs) | Decentralised to divisions |
| Use of integration mechanisms | Extensive | Moderate | Non-existent |
| Divisional performance evaluation | Emphasises subjective (strategic) criteria | Uses a mixture of subjective (strategic) and objective (financial) criteria | Emphasises objective (financial) criteria |
| Divisional incentive compensation | Linked to overall corporate performance | Mixed linkage to corporate, SBU and divisional performance | Linked to divisional performance |

[a] Strategy implemented with structural form.

## General Electric's decline, new strategy and reorganisation

**Strategic focus** | Technology

As noted in Chapter 6, General Electric (GE) has been declining and has had to restructure its portfolio of businesses. In doing so, GE CEO John Flannery announced a new orientation in its implemented structure. How did it get to this point of significant peril, requiring such restructuring?

GE has been historically run from the top; its many acquisitions over the years had to be approved by top managers, and often were businesses outside areas that GE had run before and whose acquisitions were ill timed. 'GE became the great counterexample to a growing skepticism among investors and economists about giant diversified companies. During the 1980s, as conglomerates were increasingly written off as lumbering and opaque, GE was lauded as what researchers at the Boston Consulting Group called a "premium conglomerate" – focused despite its diversity, nimble despite its scale, and armored against cyclical downturns in individual industries'. However, in the wake of the dot-com bubble and right before the terrorist attacks of 11 September 2001, a new CEO, Jeffrey Immelt, took over the company. Under pressure from Wall Street to do something impressive, he undertook a series of splashy acquisitions; for example, paying US$5.5 billion for the entertainment assets of Vivendi Universal and US$9.5 billion for the British medical imaging company, Amersham. Although there were bargains, such as Enron Corp.'s wind-turbine business (picked up in a bankruptcy auction), for the most part the deals proved more expensive and less synergistic than promised. One analyst calculated that GE's total return on Immelt's acquisitions turned out to be half what the company would have earned by simply investing in stock index mutual funds.

During the global financial crisis (GFC), many problems appeared in GE Capital's financial businesses and Immelt sought to divest them, while at the same time trying to return the company to its industrial roots. While GE Capital was severely downsized, Immelt acquired a US$10 billion power turbine business from

French company Alstom. GE made a massive investment in natural gas power plants just as the market for them was contracting. Similarly, in oil and gas, GE bought Vetco Gray, Dresser and Lufkin Industries, and then tried to merge them with Baker-Hughes at a time when oil and gas extraction revenues were depressed.

This legacy has continued to weigh GE down under its new CEO. In order to change the strategy and structure of the organisation, Flannery announced in June of 2018 that GE 'will spin off its core health business within 12–18 months, fully separate Baker Hughes (BHGE), and narrow its focus to aviation, power and renewable energy, among the most salient portfolio changes'. Thus, GE's strategic approach will be much less diversified. Although health care is still a good business, it has 'the least amount of synergies with the rest of GE'. Meanwhile, the aviation and power businesses 'share engine technology synergies', with the former boasting growth while the latter has a path to recovery.


In October 2018, GE Aviation reported eight consecutive quarters of double-digit growth.

Source: Alamy Stock Photo/Jonathan Weiss

At the same time, Flannery noted that 'his plan calls for GE to change how it is run, shifting from a centralized, top-down approach to a culture where the business units are the center of gravity'. He is quoted as saying GE's business has been run 'from the center for decades', but that is being inverted. With fewer businesses to run, the headquarters should be much smaller, and resources and investment responsibility would be pushed out to the business units to make sure that acquisitions are more in line with business segment strategies. As such, the new structure appears to be more in line with the competitive M-form rather than the former SBU M-form structure that has been the historic structural form at GE.

Sources: 2018, John Flannery gets down to business restructuring General Electric, *Economist*, http://www.economist.com, 27 June; D. Bennett & R. Clough, 2018, What the hell is wrong with General Electric? *Bloomberg Businessweek*, http://www.bloombergbusinessweek.com, 5 February; J. Collins, 2018, GE Capital's painful legacy curbs my enthusiasm for the company's restructuring, *Forbes*, http://www.forbes.com, 26 June; G. Colvin, 2018, What the hell happened at GE?, *Fortune*, http://www.fortune.com, 24 May; E. Crook, 2018, Flannery resists pressure for quick fixes at GE, *Financial Times*, http://www.ft.com, 25 June; T. Gryta, 2018, Q&A: GE CEO explains strategy, smaller HQ, *Wall Street Journal*, http://www.wsj.com, 27 June; T. Gryta, J. S. Lublin & D. Benoit, 2018, How Jeffrey Immelt's 'success theater' masked the rot at GE. *Wall Street Journal*, http://www.wsj.com, 22 February; A. Narayanan, 2018, GE finishes restructuring, but another sharp dividend cut is expected, *Investor's Business Daily*, http://www.investors.com, 26 June.

## Matches between international strategies and worldwide structure

As explained in Chapter 8, international strategies are becoming increasingly important for long-term competitive success[95] in what is becoming an increasingly borderless global economy.[96] Among other benefits, international strategies allow the organisation to search for new markets, resources, core competencies and technologies as part of its efforts to outperform competitors.[97]

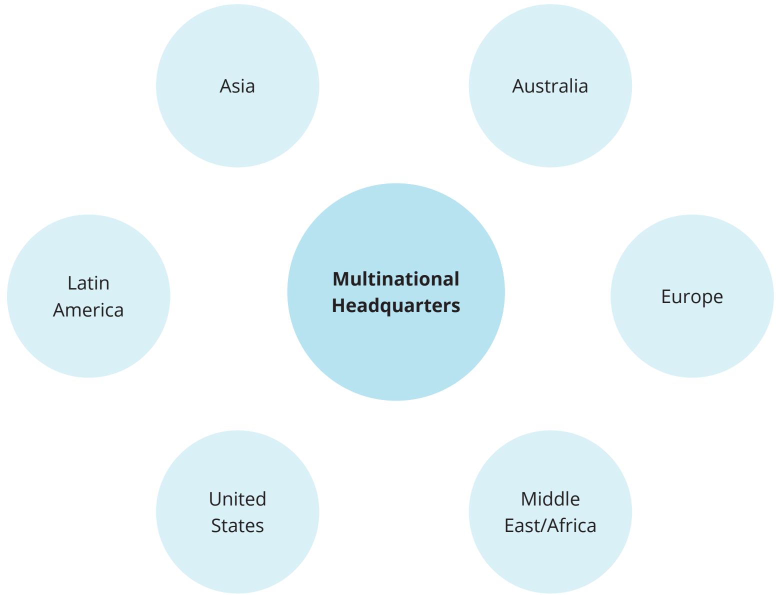
As with business-level and corporate-level strategies, unique organisational structures are necessary to successfully implement the different international strategies.[98] Forming proper matches between international strategies and organisational structures facilitates the organisation's efforts to effectively coordinate and control its global operations. More importantly, research findings confirm the validity of the international strategy–structure matches we discuss here.[99]

### Using the worldwide geographic area structure to implement the multi-domestic strategy

The *multi-domestic strategy* decentralises the organisation's strategic and operating decisions to business units in each country so that product characteristics can be tailored to local preferences. Organisations using this strategy try to isolate themselves from global competitive forces by establishing protected market positions or by competing in industry segments that are most affected by differences among local countries. The worldwide geographic area structure is used to implement this strategy. The **worldwide geographic area structure** emphasises national interests and facilitates the organisation's efforts to satisfy local differences (see Figure 11.8).

**worldwide geographic area structure**
emphasises national interests and facilitates the organisation's efforts to satisfy local or cultural differences

**Figure 11.8** **Worldwide geographic area structure for implementing a multi-domestic strategy**




Notes:
- The perimeter circles indicate decentralisation of operations.
- Emphasis is on differentiation by local demand to fit an area or country culture.
- Corporate headquarters coordinates financial resources among independent subsidiaries.
- The organisation is like a decentralised federation.

Although the US car industry is doing poorly in global markets, on a relative basis Ford Europe is doing better than other car organisations in Europe within the same middle market segment strategy. This is due to the fact that Ford implemented a worldwide geographic area structure more than a decade ago to give local European managers more autonomy to manage their operations. One analysis called Ford 'the most efficient volume carmaker in Europe'.[100] Furthermore, Ford has an efficient set of designs matched responsively to the European market. Ford has kept costs down by partnering with European automakers such as Fiat and France's PSA Peugeot-Citroën on chassis and engine production. Using the multi-domestic strategy requires little coordination between different country markets, meaning that integrating mechanisms among divisions around the world are not needed. Coordination among units in an organisation's worldwide geographic area structure is often informal. As mentioned earlier, this may be the most effective form of cooperation.

The multi-domestic strategy–worldwide geographic area structure match evolved as a natural outgrowth of the multicultural European marketplace. Friends and family members of the main business who were sent as expatriates into foreign countries to develop the independent country subsidiary often used this structure for the main business. The relationship to corporate headquarters by divisions took place through informal communication among 'family members'.[101]

A key disadvantage of the multi-domestic strategy–worldwide geographic area structure match is the inability to create strong global efficiency. With an increasing emphasis on lower-cost products in international markets, the need to pursue worldwide economies of scale has also increased. These changes foster use of the global strategy and its structural match, the worldwide product divisional structure.

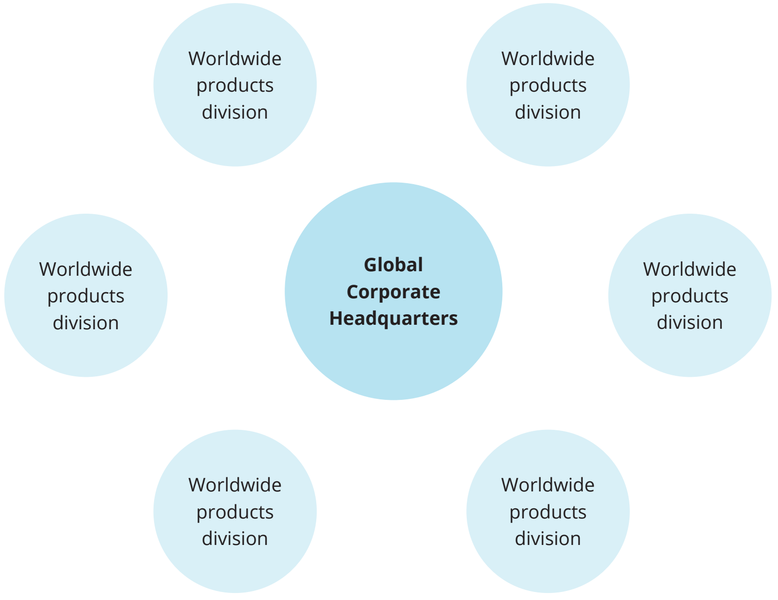
## Using the worldwide product divisional structure to implement the global strategy

With the corporation's home office dictating competitive strategy, the *global strategy* is one through which the organisation offers standardised products across country markets. The organisation's success depends on its ability to develop economies of scope and economies of scale on a global level. Decisions to outsource or maintain integrated subsidiaries may in part depend on the country risk and institutional environment into which the organisation is entering.[102]

**worldwide product divisional structure**
decision-making authority is centralised in the worldwide division headquarters to coordinate and integrate decisions and actions among divisional business units

The worldwide product divisional structure supports use of the global strategy. In the **worldwide product divisional structure**, decision-making authority is centralised in the worldwide division headquarters to coordinate and integrate decisions and actions among divisional business units (see Figure 11.9). This structure is often used in rapidly growing organisations seeking to manage their diversified product lines effectively. Avon Products, Inc. is an example of an organisation using the worldwide product divisional structure.

**Figure 11.9** **Worldwide product divisional structure for implementing a global strategy**




Notes:
- The 'Global corporate headquarters' circle indicates centralisation to coordinate information flow among worldwide products.
- Corporate headquarters uses many inter-coordination devices to facilitate global economies of scale and scope.
- Corporate headquarters also allocates financial resources in a cooperative way.
- The organisation is like a centralised federation.

Integrating mechanisms are important in the effective use of the worldwide product divisional structure. Direct contact between managers, liaison roles between departments, and both temporary task forces and permanent teams are examples of these mechanisms. One researcher describes the use of these mechanisms in the worldwide structure: 'There is extensive and formal use of task forces and operating committees to supplement communication and coordination of worldwide operations'.[103] The disadvantages of the global strategy–worldwide structure combination are the difficulties involved with coordinating and integrating decisions and actions across country borders and the inability to quickly respond to local needs and customer preferences. A solution is to develop a regional approach in addition to the product focus, which might be similar to the combination structure discussed next.[104]

## Using the combination structure to implement the transnational strategy

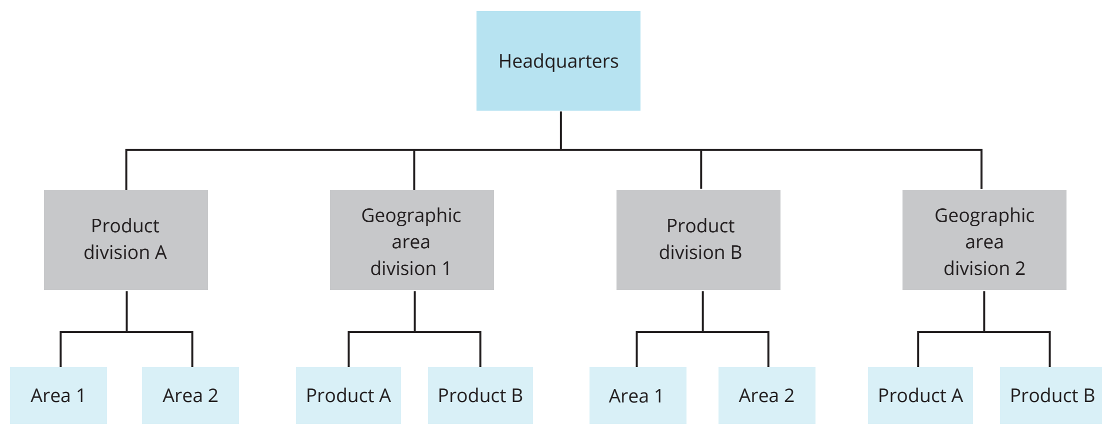
The *transnational strategy* calls for the organisation to combine the multi-domestic strategy's local responsiveness with the global strategy's efficiency. Organisations using this strategy are trying to gain the advantages of both local responsiveness and global efficiency.[105] The combination structure is used to implement the transnational strategy. The **combination structure** is a structure drawing characteristics and mechanisms from both the worldwide geographic area structure and the worldwide product divisional structure. The transnational strategy is often implemented through two possible combination structures: a global matrix structure and a hybrid global design.[106]

**combination structure**
a structure drawing characteristics and mechanisms from both the worldwide geographic area structure and the worldwide product divisional structure

The global matrix design brings together both local market and product expertise into teams that develop and respond to the global marketplace. The global matrix design (the basic matrix structure was defined earlier) promotes flexibility in designing products and responding to customer needs. However, it has severe limitations in that it places employees in a position of being accountable to more than one manager. At any given time, an employee may be a member of several functional or product group teams. Relationships that evolve from multiple memberships can make it difficult for employees to be simultaneously loyal to all of them. Although the matrix places authority in the hands of managers who are most able to use it, it creates problems in regard to corporate reporting relationships that are so complex and vague that it is difficult and time-consuming to receive approval for major decisions.

We illustrate the hybrid structure in Figure 11.10. In this design, some divisions are oriented towards products while others are oriented towards market areas. Thus, in cases when the geographic area is more important, the division managers are area-oriented. In other divisions where worldwide product coordination and efficiencies are more important, the division manager is more product-oriented.

**Figure 11.10** Hybrid form of the combination structure for implementing a transnational strategy



The fit between the multi-domestic strategy and the worldwide geographic area structure and between the global strategy and the worldwide product divisional structure is apparent. However, when an organisation wants to implement the multi-domestic and global strategies simultaneously through a combination structure, the appropriate integrating mechanisms are less obvious. The structure used to implement the transnational strategy must be simultaneously centralised and decentralised, integrated and non-integrated, and formalised and non-formalised.

IKEA has done a good job of balancing these organisation aspects in implementing the transnational strategy.[107] IKEA, a global furniture retailer with more than 300 outlets in 39 countries and regions, focuses on lowering its costs and understanding its customers' needs, especially younger customers. It has been able to manage these seemingly opposite characteristics through its structure and management process. It has also been able to encourage its employees to understand the effects of cultural and geographic diversity on organisation operations. The positive results from this are evident in the more than 600 million visitors to IKEA stores.[108] IKEA's system also has internal network attributes, which are discussed next in regard to external inter-organisational networks.

## Matches between cooperative strategies and network structures

As discussed in Chapter 9, a network strategy exists when partners form several alliances in order to improve the performance of the alliance network itself through cooperative endeavours.[109] The greater levels of environmental complexity and uncertainty facing companies in today's competitive environment are causing more organisations to use cooperative strategies such as strategic alliances and joint ventures.[110]

The breadth and scope of organisations' operations in the global economy create many opportunities for organisations to cooperate.[111] In fact, an organisation can develop cooperative relationships with many of its stakeholders, including customers, suppliers and competitors. When an organisation becomes involved with combinations of cooperative relationships, it is part of a strategic network, or what others call an alliance constellation or portfolio.[112]

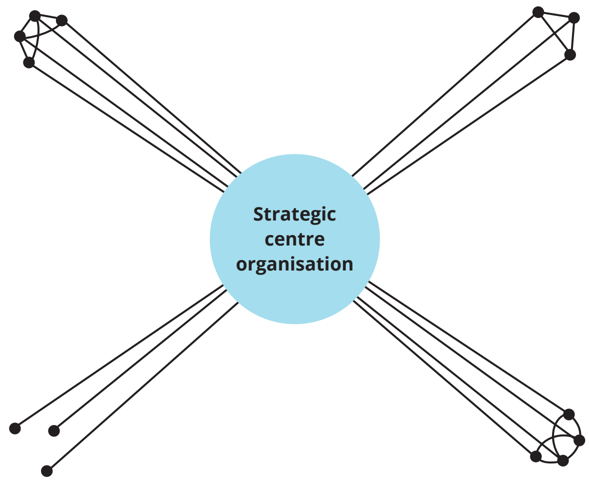
A *strategic network* is a group of organisations that has been formed to create value by participating in multiple cooperative arrangements. An effective strategic network facilitates discovering opportunities beyond those identified by individual network participants. A strategic network can be a source of competitive advantage for its members when its operations create value that is difficult for competitors to duplicate and that network members cannot create by themselves.[113] Strategic networks are used to implement business-level, corporate-level and international cooperative strategies.

Commonly, a strategic network is a loose federation of partners participating in the network's operations on a flexible basis. At the core or centre of the strategic network, the *strategic centre organisation* is the one around which the network's cooperative relationships revolve (see Figure 11.11).

Because of its central position, the strategic centre organisation is the foundation for the strategic network's structure. Concerned with various aspects of organisational structure, such as formal reporting relationships and procedures, the strategic centre organisation manages what are often complex, cooperative interactions among network partners. To perform the tasks discussed next, the strategic centre organisation must make sure that incentives for participating in the network are aligned so that network organisations continue to have a reason to remain connected.[114] The strategic centre organisation is engaged in four primary tasks as it manages the strategic network and controls its operations:[115]

1 *Strategic outsourcing:* The strategic centre organisation outsources and partners with more organisations than other network members. At the same time, the strategic centre organisation requires network partners to be more than contractors. Members are expected to find opportunities for the network to create value through its cooperative work.

**Figure 11.11** **A strategic network**




2 *Competencies:* To increase network effectiveness, the strategic centre organisation seeks ways to support each member's efforts to develop core competencies with the potential of benefiting the network.

3 *Technology:* The strategic centre organisation is responsible for managing the development and sharing of technology-based ideas among network members. The structural requirement that members submit formal reports detailing the technology-oriented outcomes of their efforts to the strategic centre organisation facilitates this activity.[116]

4 *Race to learn:* The strategic centre organisation emphasises that the principal dimensions of competition are between value chains and between networks of value chains. Because of this interconnection, the strategic network is only as strong as its weakest value chain link. With its centralised decision-making authority and responsibility, the strategic centre organisation guides participants in efforts to form network-specific competitive advantages. The need for each participant to have capabilities that can be the foundation for the network's competitive advantages encourages friendly rivalry among participants seeking to develop the skills needed to quickly form new capabilities that create value for the network.[117]

Interestingly, strategic networks are being used more frequently, partly because of the ability of a strategic centre organisation to execute a strategy that effectively and efficiently links partner organisations. Improved information systems and communication capabilities (e.g. the internet) make such networks possible.

# Implementing business-level cooperative strategies

As noted in Chapter 9, the two types of business-level complementary alliances are vertical and horizontal. Organisations with competencies in different stages of the value chain form a vertical alliance to cooperatively integrate their different, but complementary, skills. Organisations combining their competencies to create value in the same stage of the value chain are using a horizontal alliance. Vertical complementary strategic alliances, such as those developed by Toyota Motor Company, are formed more frequently than horizontal alliances.[118]

A strategic network of vertical relationships, such as the network in Japan between Toyota and its suppliers, often involves a number of implementation issues.[119] First, the strategic centre organisation encourages subcontractors to modernise their facilities and provides them with technical and financial assistance to do so, if necessary. Second, the strategic centre organisation reduces its transaction costs by promoting longer-term contracts with subcontractors, so that supplier-partners increase their long-term productivity. This approach is diametrically opposed to that of continually negotiating short-term contracts based on unit pricing. Third, the strategic centre organisation enables engineers in upstream companies (suppliers) to have better communication with those companies with whom it has contracts for services. As a result, suppliers and the strategic centre organisation become more interdependent and less independent.

The lean production system (a vertical complementary strategic alliance) pioneered by Toyota and others has been diffused throughout the global automobile industry.[120] In vertical complementary strategic alliances, such as the one between Toyota and its suppliers, the strategic centre organisation is obvious, as is the structure that organisation establishes. However, the same is not always true with horizontal complementary strategic alliances where organisations try to create value in the same part of the value chain. For example, airline alliances are commonly formed to create value in the marketing and sales primary activity segment of the value chain. Because air carriers commonly participate in multiple horizontal complementary alliances, such as the Oneworld Alliance that includes Air Berlin, American Airlines, British Airways, Cathay Pacific, Finnair, Qantas, Japan Airlines and many others, and the Star Alliance between Lufthansa, US Airways, Thai Airways, Air Canada, SAS, Singapore Airlines and others, it is difficult to determine the strategic centre organisation.[121] Moreover, participating in several alliances can cause organisations to question partners' true loyalties and intentions. Also, if rivals band together in too many collaborative activities, one or more governments may suspect the possibility of illegal collusive activities. For these reasons, the horizontal complementary alliance is used less often and less successfully than its vertical counterpart, although there are examples of success; for instance, among automobile and aircraft manufacturers.

# Implementing corporate-level cooperative strategies

Corporate-level cooperative strategies (such as franchising) are used to facilitate product and market diversification. As a cooperative strategy, franchising allows the organisation to use its competencies to extend or diversify its product or market reach, but without completing a merger or an acquisition.[122] Research suggests that knowledge embedded in corporate-level cooperative strategies facilitates synergy.[123] For example, McDonald's Corporation and KFC (within Yum Brands, which also runs Pizza Hut and Taco Bell) pursue a franchising strategy, emphasising a limited value-priced menu in many countries.

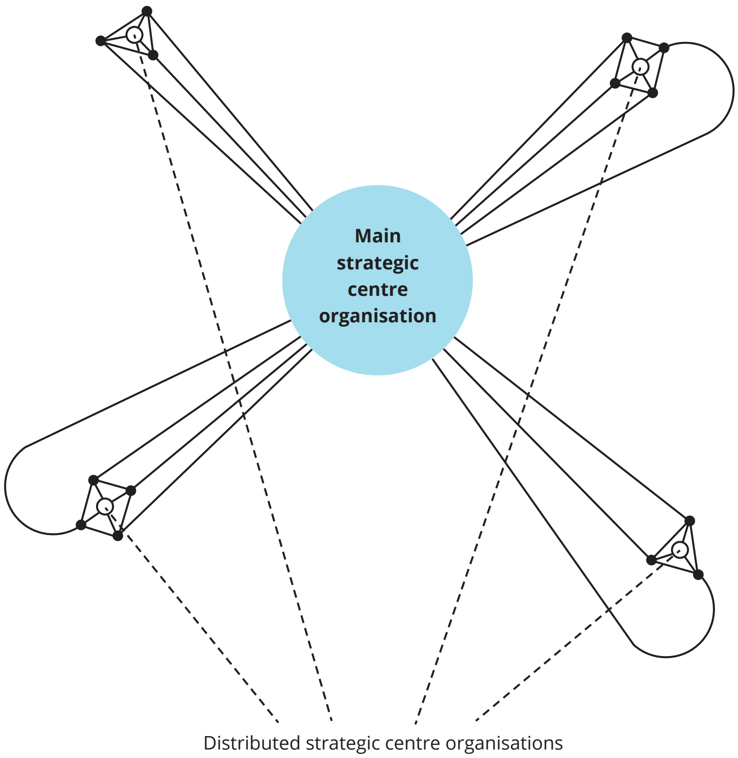
The McDonald's franchising system is a strategic network. McDonald's headquarters serves as the strategic centre organisation for the network's franchisees. The headquarters office uses strategic and financial controls to verify that the franchisees' operations create the greatest value for the entire network. An important strategic control issue for McDonald's is the location of its franchisee units. Because it believes that its greatest expansion opportunities are international, the organisation has decided to continue expanding in countries such as China and India, where it often needs to adjust its menu according to the local culture. For example, 'McDonald's adapts its restaurants in India to local tastes; in a nation that is predominantly Hindu and reveres the cow, beef is not on the menu, for instance, replaced by chicken burgers and vegetable patties'.[124] As the strategic centre organisation around the globe for its restaurants, McDonald's is devoting the majority of its capital expenditures to develop units in non-US markets.

# Implementing international cooperative strategies

Strategic networks formed to implement international cooperative strategies result in organisations competing in several countries.[125] Differences among countries' regulatory environments increase the challenge of managing international networks and verifying that, at a minimum, the network's operations comply with all legal requirements.[126]

*Distributed strategic networks* are the organisational structures used to manage international cooperative strategies. As shown in Figure 11.12, several regional strategic centre organisations are included in the distributed network to manage partner organisations' multiple cooperative arrangements.[127] The structure used to implement the international cooperative strategy is complex and demands careful attention to be used successfully.

**Figure 11.12** **A distributed strategic network**



# STUDY TOOLS

## SUMMARY

**LO1** Organisational structure specifies the organisation's formal reporting relationships, procedures, controls, and authority and decision-making processes. Essentially, organisational structure details the work to be done in an organisation and how that work is to be accomplished. Organisational controls guide the use of strategy, indicate how to compare actual and expected results, and suggest actions to take to improve performance when it falls below expectations. A proper match between strategy and structure can lead to a competitive advantage. Strategic controls (largely subjective criteria) and financial controls (largely objective criteria) are the two types of organisational controls used to implement a strategy. Both controls are critical, although their degree of emphasis varies based on individual matches between strategy and structure.

**LO2** Strategy and structure influence each other. Overall, though, strategy has a stronger influence on structure than vice versa. Research indicates that organisations tend to change structure when declining performance forces them to do so. Effective managers anticipate the need for structural change and quickly modify structure to better accommodate the organisation's strategy when evidence calls for that action.

**LO3** The functional structure is used to implement business-level strategies. The cost leadership strategy requires a centralised functional structure – one in which manufacturing efficiency and process engineering are emphasised. The differentiation strategy's functional structure decentralises implementation-related decisions, especially those concerned with marketing, to those involved with individual organisational functions. Focus strategies, often used in small organisations, require a simple structure until such time that the organisation diversifies in terms of products and/or markets.

**LO4** Unique combinations of different forms of the multi-divisional structure are matched with different corporate-level diversification strategies to properly implement these strategies. The cooperative M-form, used to implement the related constrained corporate-level strategy, has a centralised corporate office and extensive integrating mechanisms. Divisional incentives are linked to overall corporate performance to foster cooperation among divisions. The related linked SBU M-form structure establishes separate profit centres within the diversified organisation. Each profit centre or SBU may have divisions offering similar products, but the SBUs are often unrelated to each other. The competitive M-form structure, used to implement the unrelated diversification strategy, is highly decentralised, lacks integrating mechanisms and utilises objective financial criteria to evaluate each unit's performance.

**LO5** The multi-domestic strategy, implemented through the worldwide geographic area structure, emphasises decentralisation and locates all functional activities in the host country or geographic area.

The worldwide product divisional structure is used to implement the global strategy. This structure is centralised in order to coordinate and integrate different functions' activities so as to gain global economies of scope and economies of scale. Decision-making authority is centralised in the organisation's worldwide division headquarters.

The transnational strategy – a strategy through which the organisation seeks the local responsiveness of the multi-domestic strategy and the global efficiency of the global strategy – is implemented through the combination structure. Because it must be simultaneously centralised and decentralised, integrated and non-integrated, and formalised and non-formalised, the combination structure is difficult to organise and successfully manage. However, two structural designs are suggested: the matrix and the hybrid structure with both geographic and product-oriented divisions.

**LO6** Increasingly important to competitive success, cooperative strategies are implemented through organisational structures framed around strategic networks. Strategic centre organisations play a critical role in managing strategic networks. Business-level strategies are often employed in vertical and horizontal alliance networks. Corporate-level cooperative strategies are used to pursue product and market diversification. Franchising is one type of corporate strategy that uses a strategic network to implement this strategy. This is also true for international cooperative strategies, where distributed networks are often used.

## KEY TERMS

combination structure
competitive form
cooperative form
financial controls
functional structure
multi-divisional (M-form) structure
organisational controls
organisational structure
simple structure
strategic business unit (SBU) form
strategic controls
worldwide geographic area structure
worldwide product divisional structure

## REVIEW QUESTIONS

1. What is organisational structure and what are organisational controls? What are the differences between strategic controls and financial controls? What is the importance of these differences?
2. Is there a close relationship between strategy and structure? Does strategy influence structure or does structure influence strategy?
3. What are the characteristics of the functional structures used to implement the cost leadership, differentiation, integrated cost leadership/differentiation and focused business-level strategies?
4. What are the differences among the three versions of the multi-divisional (M-form) organisational structures that are used to implement the related constrained, the related linked and the unrelated corporate-level diversification strategies?
5. What organisational structures are used to implement the multi-domestic, global and transnational international strategies?
6. What is a strategic network? How are strategic networks used in international cooperative strategies?

## EXPERIENTIAL EXERCISES

### Exercise 1: Organisational structure and business-level strategy

The purpose of this exercise is to apply the concepts introduced in this chapter to live examples of business-level strategies and to examples of how various organisations actually structure their organisations to compete. Your instructor will assign a business-level strategy, such as differentiation or cost leadership, to teams of students. After you have your category assigned, identify an organisation that exemplifies this strategy and pictorially represent its corporate structure.

You will need to present the results of your investigation by comparing your organisation's organisational chart with the one in your text identified for your particular business-level strategy (see Figure 11.3).

Be prepared to address the following issues:

1. Describe your organisation's business-level strategy. Why do you consider it to be a cost leader or a differentiator?
2. What is the mission statement and/or vision statement of this organisation? Are there specific goals that you can identify that this organisation is targeting?
3. Using the text examples for a functional structure, how does your organisation differ, if it does?
4. Summarise your conclusions. Does your team believe that this organisation is structured appropriately, considering its goals for the future?

### Exercise 2: Is structure contagious?

Form two teams to analyse and recommend changes (if any) regarding pairs of competitors. Are these competitors, such as Coles and Woolworths, structured similarly or differently? How do their strategies and board structure compare?

## Part 1

Select a pair of competitors. You have wide latitude in this choice, such as Coles and Woolworths, or Virgin Australia and Qantas. Another option is to select two competitors that reside in your town that may be small-to-medium-sized organisations. The important thing is that the organisations should be competitors and roughly comparable in size.

## Part 2

Research these organisations and be prepared to address the following issues:

1. Describe the strategies of the two organisations – differences and similarities.
2. Present the two organisations' organisational structures and note differences and similarities.
3. Does structure follow strategy, as Chandler argues?
4. Are the boards of directors structured similarly between the pair as far as board meetings and titles?
5. Which one of these organisations would you most likely desire to work for, all else being equal?

Be prepared to discuss your findings in a PowerPoint presentation to the class.

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# Strategic leadership

CHAPTER 12

## Learning Objectives

Studying this chapter should provide you with the strategic management knowledge needed to:

**LO1** define strategic leadership and describe executive managers' importance

**LO2** explain what executive management teams are and how they affect organisational performance

**LO3** describe the managerial succession process using internal and external managerial labour markets

**LO4** discuss the value of strategic leadership in determining the organisation's strategic direction

**LO5** describe the importance of strategic leaders in managing the organisation's resources

**LO6** define organisational culture and explain what must be done to sustain an effective culture

**LO7** explain what strategic leaders can do to establish and emphasise ethical practices

**LO8** describe the importance of leadership and corporate social responsibility

**LO9** discuss the importance and use of organisational controls.

# OPENING CASE STUDY

## Meg Whitman: a pioneering strategic leader

Meg Whitman, the only female to serve as the CEO for two major US corporations, announced in November 2017 that she would step down from her CEO position at Hewlett Packard Enterprise Co. on 1 February 2018. Saying that she was returning to what she considers her 'start-up roots', she had decided to join with Hollywood executive and long-time friend Jeffrey Katzenberg to run a mobile-video company called WndrCo NewTV. This organisation is part of Katzenberg's WndrCo LLC, a media and tech venture that plans to develop a portfolio of companies. In her position, Whitman is to build 'an online service, securing production partnerships and building a team at NewTV, which will target the 18- to 34-year-olds who have driven the rise in mobile-video viewing over the past several years'. In essence, the organisation intends to develop a platform through which high-budget short videos will be available to users to watch while standing in a line, riding a bus and so forth. Some videos will be one-off stories while others will be part of richer and longer stories.

The path Whitman travelled to become one of the most prominent women in American business and an experienced CEO in Silicon Valley is enlightening. Her path as a leader demonstrates increasing levels of responsibility and decision-making authority while moving from one opportunity to another.

A graduate of Harvard Business School, Whitman started her career at Procter & Gamble. She later worked as a consultant in Bain & Company's San Francisco office, rising to a position as senior vice president in that organisation. In 1989, she accepted a position as vice president for strategic planning at Walt Disney Corporation. She met Katzenberg while working for Disney. After two years, she joined Stride Rite Corporation prior to becoming president and CEO of Florists' Transworld Delivery in 1995. After another two years, she accepted the role of General Manager for Hasbro's Playskool division, where she had responsibility for global management and marketing for two brands targeted to children – Playskool and Mr Potato Head. From Hasbro, Whitman became CEO of eBay (the pioneering company that made it possible for strangers to exchange goods online) in March 1998. At the time,


Meg Whitman, former CEO of Hewlett-Packard, led the turnaround plan to split HP into two companies: Hewlett Packard Enterprises (HPE) and Hewlett Packard Inc. (HPQ).

Source: Getty Images/VCG

the organisation had only 30 employees and annual revenue of approximately US$4 million. Prior to resigning as eBay's CEO in November 2007, the organisation's revenues had increased to US$8 billion annually and the workforce numbered around 15 000. Whitman became CEO of Hewlett-Packard in September 2011. She remained in this role for a bit over six years. During those years, 'she led a turnaround plan that involved the largest split in corporate history, tens of thousands of layoffs, $18 billion in write-offs and a leadership shake-up'. Deciding in 2015 to split Hewlett-Packard into Hewlett Packard Enterprises (HPE) and Hewlett Packard Inc. (HPQ) was the most prominent strategic action she took as HP's CEO. HPQ took the printer and PC businesses while business-focused HPE works in a variety of markets such as servers, storage, networking, consulting and support, and financial services.

Whitman, her team and HP's board chose to split the organisation into two companies because of declining sales in what was a complicated conglomerate. The leaders believed that breaking the organisation into two units would allow each to focus more as a means of unlocking the full value embedded in the portfolios that formed the two new organisations. Results achieved across time will show if the decision to break HP into two organisations was one of Whitman's best strategic actions or one that failed to deliver increased value to shareholders. As is the case for virtually all leaders serving as a CEO, Whitman's career is not without controversy. During her tenure at eBay, for example, the organisation paid roughly US$4.1 billion to acquire Skype in 2005. Later admitting that the premium she and her team agreed to pay for Skype was too large, eBay sold Skype to a group of investors for US$2.75 billion. In Whitman's view, failing to recognise the market potential for eBay in Japan was a major error. Instead of investing in Japan, Whitman chose to invest in eBay's existing website. At the time, Japan was the world's second-largest internet consumer market. In commenting about this, Whitman said 'I had a sense that the technology underpinning eBay was not going to help us scale where we needed to. That miss of eBay Japan is one of the big failures of my time at eBay'. Some also question a few decisions Whitman made during her tenure as HP's CEO: 'Meg Whitman's tenure at Hewlett-Packard was marked by a series of splits and sales that reshaped the storied Silicon Valley company. Now, her successor Antonio Neri must take the remnants and reignite innovation.' Many view Whitman's career as a strategic leader as one through which she played a major role in commercialising the internet industry.

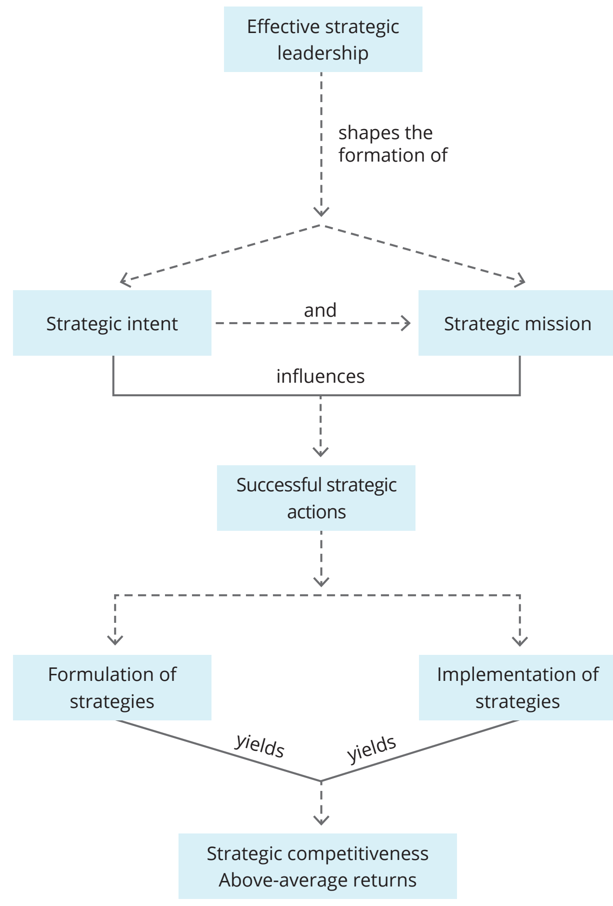
Sources: D. Gallagher, 2018, New HPs give fresh life to old businesses, *Wall Street Journal*, http://www.wsj.com, 23 February; E. Shwartzel, 2018, Meg Whitman to lead mobile-video startup NewTV, *Wall Street Journal*, http://www.wsj.com, 24 January; D. Gallagher, 2017, Meg Whitman's latest turn signal, *Wall Street Journal*, http://www.wsj.com, 22 November; R. King, 2017, Can Antonio Neri revive HP Enterprise after Meg Whitman? *Wall Street Journal*, http://www.wsj.com, 30 November; R. King, 2017, Meg Whitman to step down as Hewlett Packard Enterprise CEO, *Wall Street Journal*, http://www.wsj.com, 21 November; G. Hall, 2014, Hewlett Packard CEO talks biggest fails, bizwomen, http://www.bizjournals.com, 2 May; M. Ames & Y. Levine, 2010, How Meg Whitman failed her way to the top at eBay, collecting billions while nearly destroying the company, Alternet, http://www.alternet.org, 25 October; M. Mangalindan, 2008, EBay chief Whitman, web pioneer, plans to retire, *Wall Street Journal*, http://www.wsj.com, 22 January.

As the opening case implies, strategic leaders' work is demanding, challenging and requires balancing short-term performance with long-term goals. Regardless of how long they remain in their positions, strategic leaders (and most prominently CEOs) can make a major difference in how an organisation performs.[1] If a strategic leader can create a strategic vision for the organisation using forward thinking, they may be able to energise the organisation's human capital and achieve positive outcomes. However, the challenge of strategic leadership is significant and should never be underestimated.

A major message in this chapter is that effective strategic leadership is the foundation for successfully using the strategic management process. As is implied in Figure 1.1, strategic leaders guide the organisation in ways that result in forming a vision and mission (see Chapter 1). Often this guidance finds leaders thinking of ways to create goals that stretch everyone in the organisation to improve performance.[2] Moreover, strategic leaders facilitate the development of appropriate strategic actions and determine how to implement them. As we show in Figure 12.1, these actions are the path to strategic competitiveness and above-average returns.[3]

We begin this chapter with a definition of strategic leadership; we then discuss its importance as a potential source of competitive advantage as well as effective strategic leadership styles. Next we examine top management teams and their effects on innovation, strategic change and organisation performance. Following this discussion, we analyse the internal and external managerial labour markets from which strategic leaders are selected. Closing the chapter are descriptions of the five key components of effective strategic leadership: determining a strategic direction, effectively managing the organisation's resource portfolio (which includes exploiting and maintaining core competencies, along with developing human capital and social capital), sustaining an effective organisational culture, emphasising ethical practices and establishing balanced organisational controls.

**Figure 12.1** **Strategic leadership and the strategic management process**




# Strategic leadership and style

**strategic leadership**
the ability to anticipate, envision, maintain flexibility and empower others to create strategic change as necessary

**Strategic leadership** is the ability to anticipate, envision, maintain flexibility and empower others to create strategic change as necessary. Multifunctional in nature, strategic leadership involves managing through others, managing an entire organisation rather than a functional subunit, and coping with change that continues to increase in the global economy. Because of the global economy's complexity, strategic leaders must learn how to effectively influence human behaviour, often in uncertain environments. By word or by personal example, and through their ability to envision the future, effective strategic leaders meaningfully influence the behaviours, thoughts and feelings of those with whom they work.[4]

The ability to attract and then manage human capital may be the most critical of the strategic leader's skills,[5] especially because the lack of talented human capital constrains organisation growth. Increasingly, leaders throughout the global economy possess or are developing this skill. Some believe, for example, that leaders now surfacing in Chinese companies understand the rules of competition in market-based economies and are leading in ways that will develop their organisations' human capital.[6]

In the 21st century, intellectual capital that the organisation's human capital possesses, including the ability to manage knowledge and create and commercialise innovation, affects a strategic leader's success.[7] Effective strategic leaders also establish the context through which stakeholders (such as employees, customers and suppliers) can perform at peak efficiency.[8] Being able to demonstrate these skills is important, given that the crux of strategic leadership is the ability to manage the organisation's operations effectively and sustain high performance over time.[9]

An organisation's ability to achieve a sustainable competitive advantage and earn above-average returns (or surplus revenue in the context of a not-for-profit organisation) is compromised when strategic leaders fail to respond appropriately and quickly to changes in the complex global competitive environment. The inability to respond or to identify the need for change in the competitive environment is one of the reasons some CEOs fail. For example, the past CEO of Myer, Richard Umbers, quit after failing to turn the company around financially in 2018.[10] When it became obvious to the Myer board that the execution of its strategy was undeliverable with an improved financial performance, hard decisions were made to implement significant leadership changes within the existing executive team (or leadership structure) to remove the incumbent CEO. In addition, Myer also hired a new chief merchandise officer and a new chief financial officer. As a result of its leadership structure at the time, tumbling share price and poor financial performance, Myer was bumped out of the benchmark ASX200 Index in March 2018. Its share price in the last quarter of 2020 continued to tumble due to Covid-19 restrictions, and operationally the pandemic forced the temporary closure of its Melbourne stores. Uncertainty lingers in relation to Myer's future in Australia, with the organisation yet to issue an update to shareholders on its current financial position in late 2020.[11]

Conversely, Qantas CEO Alan Joyce tried to remain on the front foot when he took hard decisions in an attempt to handle a changed environment for the heritage airline and deal with government-imposed Covid-19 restrictions that significantly impacted on the global business.[12] All strategic leaders must learn how to deal with diverse and complex environmental situations. Individual judgement is an important part of learning about and analysing the organisation's competitive environment.[13] In particular, effective strategic leaders build strong ties with external stakeholders to gain access to information and advice on the events in the external environment.[14]

The primary responsibility for effective strategic leadership rests at the top, in particular with the CEO. Other commonly recognised strategic leaders include members of the board of directors, the executive management team and divisional general managers. In reality, any individual with responsibility for the performance of human capital and/or a part of the organisation (e.g. a production unit) is a strategic leader. Regardless of their title and organisational function, strategic leaders have substantial decision-making responsibilities that cannot be delegated.[15] Strategic leadership is a complex but critical form of leadership. Strategies cannot be formulated and implemented for the purpose of achieving above-average returns without effective strategic leaders.[16]

The styles used to provide leadership often affect the productivity of those being led. Transformational leadership is the most effective strategic leadership style. This style entails motivating followers to exceed the expectations others have of them, to continuously enrich their capabilities, and to place the interests of the organisation above their own.[17] Transformational leaders develop and communicate a vision for the organisation and formulate a strategy to achieve the vision. They make followers aware of the need to achieve valued organisational outcomes and encourage them to continuously strive for higher levels of achievement. These types of leaders have a high degree of integrity (e.g. Ray Kroc, founder of McDonald's, was a strategic leader valued for his high degree of integrity by all but vegetarians)[18] and character. Speaking about character, one CEO said: 'Leaders are shaped and defined by character. Leaders inspire and enable others to do excellent work and realise their potential. As a result, they build successful, enduring organisations'.[19] Additionally, transformational leaders have emotional intelligence. Emotionally intelligent leaders understand themselves well, have strong motivation, are empathetic with others and have effective interpersonal skills.[20] As a result of these characteristics, transformational leaders are especially effective in promoting and nurturing innovation in organisations.[21]

# The role of executive managers

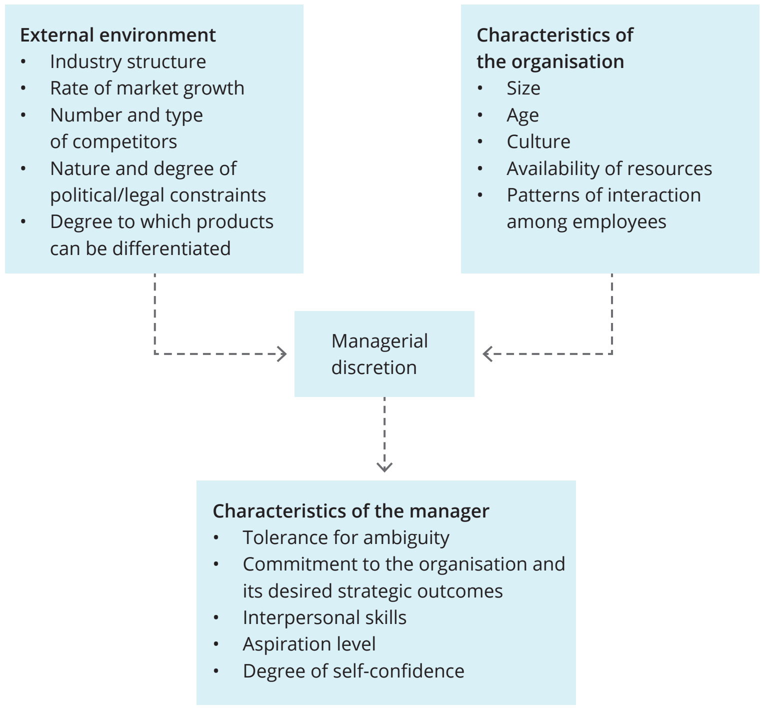
Executive managers also play a critical role in that they are charged to make certain their organisation is able to effectively formulate and implement strategies.[22] Executive managers' strategic decisions influence how the organisation is designed and how goals will be achieved. Thus, a critical element of organisational success is having an executive management team with superior managerial skills.[23]

Managers often use their discretion (or latitude for action) when making strategic decisions, including those concerned with effectively implementing strategies.[24] Managerial discretion differs significantly across industries. The primary factors that determine the amount of decision-making discretion held by a manager (especially an executive (or senior) manager) are:

1. external environmental sources such as the industry structure, the rate of market growth in the organisation's primary industry and the degree to which products can be differentiated
2. characteristics of the organisation, including its size, age, resources and culture
3. characteristics of the manager, including commitment to the organisation and its strategic outcomes, tolerance for ambiguity, skills in working with different people, and aspiration levels (see Figure 12.2).

Because strategic leaders' decisions are intended to help the organisation gain a competitive advantage, how managers exercise discretion when determining appropriate strategic actions is critical to the organisation's success.[25] In addition to determining new strategic initiatives, executive managers develop an organisational structure and reward systems. Executives also have a major effect on an organisation's culture. Evidence suggests that managers' values are critical in shaping an organisation's cultural values.[26]

**Figure 12.2** **Factors affecting managerial discretion**




Source: Adapted from S. Finkelstein & D. C. Hambrick, 1996, *Strategic Leadership: Top Executives and Their Effects on Organizations*, St Paul, MN: Western Publishing Company.

Accordingly, executive managers have an important effect on organisational activities and performance.[27] The challenges executives face mean they often are more effective when they operate as executive management teams and an inability to collaborate may have disastrous effects for not only the organisational culture but the financial performance of the organisation as well.

# Executive management teams

In most organisations, the complexity of challenges and the need for substantial amounts of information and knowledge require strategic leadership by a team of executives. Using a team to make strategic decisions also helps to avoid another potential problem when these decisions are made by the CEO alone: namely, managerial hubris. Research evidence shows that when CEOs begin to believe glowing press accounts and to feel that they are unlikely to make errors, they are more likely to make poor strategic decisions.[28] Senior executives need to have self-confidence, but they must guard against allowing it to become arrogance and a false belief in their own invincibility.[29] To guard against CEO overconfidence and poor strategic decisions, organisations often use an executive management team to consider strategic opportunities and problems and to make strategic decisions. The **executive management team** comprises the key individuals who are responsible for selecting and implementing the organisation's strategies. Typically, the executive management team includes the officers of the corporation, defined by the title of chief (such as chief executive officer, chief financial officer, chief strategy officer, chief information officer or head of people and culture) or by service as a member of the board of directors.[30] The quality of the strategic decisions made by an executive management team affects the organisation's ability to innovate and engage in effective strategic change.[31]

**executive management team**
composed of the key managers who are responsible for selecting and implementing the organisation's strategies

## Executive management team, organisation performance and strategic change

The job of executives is complex and requires a broad knowledge of the organisation's operations, as well as the three key parts of the organisation's external environment: the general, industry and competitor environments (as discussed in Chapter 2). Therefore, organisations try to form an executive management (or executive) team that has the knowledge and expertise needed to operate the internal organisation, yet that also can deal with all the organisation's stakeholders as well as its competitors.[32] To have these characteristics normally requires a **heterogeneous management team**. A heterogeneous management team is composed of individuals with different cultural backgrounds, experience and education.

**heterogeneous management team**
composed of individuals with different cultural backgrounds, experience and education

Members of a heterogeneous executive management team benefit from discussing the different perspectives advanced by team members.[33] In many cases, these discussions increase the quality of the team's decisions, especially when a synthesis emerges within the team after evaluating the diverse perspectives.[34] The net benefit of such actions by heterogeneous teams has been positive in terms of market share, above-average returns or surpluses. Research shows that more heterogeneity among executive management team members promotes debate, which often leads to better strategic decisions. In turn, better strategic decisions produce higher organisation performance.[35]

It is also important for executive management team members to function cohesively. In general, the more heterogeneous and larger the executive management team is, the more difficult it is for the team to effectively implement strategies.[36] Comprehensive and long-term strategic plans can be inhibited by communication difficulties among executives who have different backgrounds and different cognitive skills.[37] Alternatively, communication among diverse executive management team members can be facilitated through electronic communications, sometimes reducing the barriers before face-to-face meetings.[38] However, a group of senior executives with diverse backgrounds may inhibit the process of decision making if it is not effectively managed by the CEO, or in some instances the CEO may knowingly or unconsciously create divisiveness among its executive team. In such cases, executive management teams may fail to comprehensively examine threats and opportunities, leading to a sub-optimal strategic decision. Thus, the CEO must attempt to achieve behavioural integration among the team members.[39]

Having members with substantive expertise in the organisation's core functions and businesses is also important to an executive management team's effectiveness.[40] In a high-technology industry, it may be critical for an organisation's executive management team members to have R&D or innovation expertise, particularly when growth strategies are being implemented. Yet their eventual effect on strategic decisions depends not only on their expertise and the way the team is managed, but also on the context in which they make the decisions (the governance structure, incentive compensation, etc.).[41]

The characteristics of an executive management team and even the personalities of the CEO and other team members are related to innovation and strategic change.[42] For example, more heterogeneous executive management teams are positively associated with innovation and strategic change. The heterogeneity may force the team or some of its members to 'think outside of the box' and thus be more creative in making decisions.[43]

Therefore, organisations that need to change their strategies are more likely to do so if they have executive management teams with diverse backgrounds and expertise. When a new CEO is hired from outside the industry, the probability of strategic change is greater than if the new CEO is from inside the organisation or inside the industry.[44] Also, there can sometimes be significant change if the new CEO is from outside the organisation but from within the industry. Although hiring a new CEO from outside the industry adds diversity to the team, the executive management team must be managed effectively to use the diversity in a positive way. Thus, to successfully create strategic change, the CEO should exercise transformational leadership to shape the new capabilities needed for implementation of the change.[45] An executive management team with various areas of expertise is more likely to identify environmental changes (opportunities and threats) or changes within the organisation, suggesting the need for a different strategic direction.

In the current competitive environment, an understanding of international markets is vital. Interestingly, research suggests that only about 15 per cent of the executives in US Fortune 500 organisations have global leadership expertise.[46] Executives generally gain this knowledge by working in one of the organisation's international subsidiaries; however, they can also gain some knowledge by working with international alliance partners.[47]

## The CEO and executive management team power

As noted in Chapter 10, the board of directors is an important governance mechanism for monitoring an organisation's strategic direction and for representing stakeholders' interests, especially those of shareholders.[48] In fact, higher performance normally is achieved when the board of directors is more directly involved in shaping an organisation's strategic direction.[49]

Boards of directors, however, may find it difficult to direct the strategic actions of powerful CEOs and executive management teams.[50] An excellent example of this played out in recent times with Commonwealth Australia Bank, which was investigated in the Prudential Inquiry into the Commonwealth Bank of Australia. The resulting report by the Australian Prudential Regulation Authority (APRA) noted that interviews with board directors and group executives at the Commonwealth Bank, together with the board's own evaluation, indicated that 'there was not sufficient challenge from the Board to Group Executives. The feedback cited a somewhat "intimidating" environment with a highly intelligent Executive team and a propensity for positive and assuring messaging from optimistic senior leadership that made constructive challenge more difficult'.[51]

Often a powerful CEO appoints a number of sympathetic independent directors or members to the board, or the CEO may have inside board members who are also on the executive management team and report to her or him, which would be a direct conflict of interest.[52] In either case, the CEO may significantly influence or manipulate the board's actions. Thus, the amount of discretion a CEO has in making strategic decisions is related to the relationship it has with the board of directors and how the board chooses to oversee the actions of the CEO and the executive management team.[53]

CEOs and executive management team members can achieve power in other ways. A CEO who also holds the position of chairperson of the board – as is common in the USA but not in Australia – has more power than the CEO who does not.[54] For example, Alan Joyce at Qantas initially had as chairman the ex-CEO Geoff Dixon, someone who also understood the industry. Some analysts and corporate 'watchdogs' criticise the American practice of CEO duality (when the CEO and the chairperson of the board are the same) because it can lead to poor performance and slow the response to change, partly because the board tends to engage in less monitoring of the CEO's decisions and actions.[55]

Executive management team members and CEOs who have long tenure – on the team and in the organisation – have a greater influence on board decisions. CEOs with greater influence may take actions in their own best interests, the outcomes of which increase their compensation from the company.[56] As reported in Chapter 10, there have been negative reactions from the public and within the media regarding excessive executive compensation, especially during poor economic times when some people are losing their jobs because of ineffective strategic decisions made by these same managers.

In summary, the relative degrees of power held by the board and executive management team members should be examined in light of an individual organisation's situation. For example, the abundance of resources in an organisation's external environment and the volatility of that environment may affect the ideal balance of power between the board and the executive management team. Moreover, a volatile and uncertain environment may create a situation where a powerful CEO is needed to move quickly, but a diverse executive management team may create less cohesion among team members and prevent or stall necessary strategic actions. With effective working relationships, boards, CEOs and other executive management team members have the foundation required to select arrangements with the highest probability of best serving stakeholders' interests.[57]

# Managerial succession

The choice of senior executives – especially CEOs – is a critical decision for the board of directors and has important implications for the overall organisational performance.[58] Many organisations use leadership screening systems to identify individuals with managerial and strategic leadership potential as well as to determine the criteria individuals should satisfy to be candidates for the CEO position.[59]

The most effective of these systems assesses people within the organisation and gains valuable information about the capabilities of other companies' managers, particularly their strategic leaders.[60] Based on the results of these assessments, training and development programs are provided for current individuals in an attempt to preselect and shape the skills of people who may become tomorrow's leaders. Notwithstanding the many excellent leadership programs on offer within organisations globally, there are, however, many organisations that do not have succession plans for their senior executives.

Organisations select managers and strategic leaders from two types of managerial labour markets: internal and external.[61] An **internal managerial labour market** consists of an organisation's opportunities for managerial positions and the qualified employees within that organisation. An **external managerial labour market** is the collection of managerial career opportunities and the qualified people who are external to the organisation in which the opportunities exist.

**internal managerial labour market**
consists of an organisation's opportunities for managerial positions and the qualified employees within that organisation

**external managerial labour market**
the collection of managerial career opportunities and the qualified people who are external to the organisation in which the opportunities exist

Several benefits are thought to accrue to an organisation when the internal labour market is used to select an insider as the new CEO. Because of their experience with the organisation and the industry environment in which it competes, insiders are familiar with company products, markets, technologies and operating procedures. Also, internal hiring produces lower turnover among existing personnel, many of whom possess valuable organisation-specific knowledge. When the organisation is performing well, internal succession is favoured to sustain high performance. It is assumed that hiring from inside keeps the important knowledge necessary to sustain performance.

Results of work completed by management consultant Jim Collins support the value of using the internal labour market when selecting a CEO. Collins found that high-performing organisations almost always appoint an insider to be the new CEO. He argues that bringing in a well-known outsider, whom he refers to as a 'white knight', is a recipe for mediocrity.[62]

Employees commonly prefer the internal managerial labour market when selecting executive management team members and a new CEO. In the past, companies have also had a preference for insiders to fill executive management positions because of a desire for continuity and a continuing commitment to the organisation's current vision, mission and chosen strategies.[63] For example, Campbell Soup Company has had relatively stable leadership, with only 13 CEOs since it was founded in 1869. This represents a CEO succession about every 11 years on average. In 2019, former Pinnacle Foods CEO, Mark Clouse, was appointed as Campbell's current CEO.[64]

However, an insider is not guaranteed success. Because of a changing competitive landscape and varying levels of performance, an increasing number of boards of directors are turning to outsiders to succeed CEOs. An organisation often has valid reasons to select an outsider as its new CEO. In some situations, long tenure with an organisation may reduce strategic leaders' level of commitment to pursue innovation. Given innovation's importance to organisation success (see Chapter 13), this hesitation could be a liability for a strategic leader. In Figure 12.3, we show how the composition of the executive management team and the CEO succession (managerial labour market) interact to affect strategy. For example, when the executive management team is homogeneous (i.e. its members have similar functional experiences and educational backgrounds) and a new CEO is selected from inside the organisation, the organisation's current strategy is unlikely to change. Conversely, when a new CEO is selected from outside the organisation and the executive management team is heterogeneous, the probability is high that strategy will change. When the new CEO is from inside the organisation and a heterogeneous executive management team is in place, the strategy may not change but innovation is likely to continue. An external CEO succession with a homogeneous team creates a more ambiguous situation. Furthermore, outside CEOs who lead moderate change often achieve increases in performance, but high strategic change by outsiders frequently leads to declines in performance.[65]

**Figure 12.3** **Effects of CEO succession and executive management team composition on strategy**

| | | **Managerial labour market: CEO succession** | |
|---|---|---|---|
| | | Internal CEO succession | External CEO succession |
| **Top management team composition** | Homogeneous | Stable strategy | Ambiguous: possible change in top management team and strategy |
| | Heterogeneous | Stable strategy with innovation | Strategic change |

When organisations do not have a formal managerial succession plan, they will sometimes appoint an interim CEO until a new CEO is identified and in place.[66] The advantage of using an interim CEO is that it allows adequate time to do a thorough executive search to find the best candidate. Most interim CEOs perform the basic functions and keep the organisation operating; however, rarely will they make major strategic decisions. Therefore, interim CEOs are generally only used when the CEO departs unexpectedly and abruptly.

Succession plans are very important to maintain the desired course for the organisation when there is a change in the CEO. Yet only slightly more than one-third of companies are prepared for a succession of the CEO. Because of the importance of the CEO position and the influence CEOs have on the organisation's share price or stakeholders, investors have been placing increasing pressure on boards to develop formal succession plans for the executive management positions. Formal succession plans often call for the use of external executive search organisations (sometimes referred to as headhunters). Research suggests that executive search organisations primarily target executives in large, reputable and high-performing organisations. However, these organisations often identify the executives to target based largely on their job title instead of their known capabilities, reputation or individual performance. The executives who agree to be candidates in the search frequently have less tenure and experience and hold positions in less successful organisations.[67] Therefore, executive search organisations may not always provide the best pool of candidates.

Including talent from all parts of both the internal and external labour markets increases the likelihood that the organisation will be able to form an effective executive management team. Evidence suggests that women are a qualified source of talent as strategic leaders who have been somewhat overlooked.

**Strategic focus | General**

## Women in leadership

The latest *Gender Diversity Progress Report* released by the Australian Institute of Company Directors highlighted that at the end of January 2020 the percentage of women holding director roles on Australian boards listed in the top 200 listed companies has increased for the first time to 30.7 per cent. Elizabeth Proust, one of Australia's most successful business women, recently commented that there should be a greater number of women on boards. Proust is currently the Chair of the Bank of Melbourne, Nestlé Australia and a non-executive director of Lendlease. She encourages women to become better at networking and has recognised that this is something she struggled with at the beginning of her career. 'A lot of women believe if they work hard and put their head down, they will get ahead. While I wish that was the case, you do need to make sure your work is recognised.' Proust notes that people do not need to necessarily network via drinking with colleagues after work; however, it does mean taking part in work functions, such as CPA events, to develop networks.

### Australian women CEOs speak

With only 14 female CEOs in the ASX200, corporate Australia has been a challenging environment for women to succeed in strategic leadership roles. The Korn Ferry Institute in 2017 researched the careers of CEO women in US companies and its latest report in collaboration with the Australian Institute of Company Directors is an extension of that work. The Institute conducted structured interviews with 21 Australian women: current and former CEOs, as well as women who had experience heading professional services organisations, government departments and universities – all CEO-equivalent roles. The report concluded that the women who made it to the top leadership roles did so by leveraging a particular combination of personality, skills and approaches that is different in key ways from the global norms.

The study also highlighted the importance of exposure to the board for the women on the path to the top job. The Chief Executive Women census of the ASX200 highlights the overall percentage of women in the C-suite is not only low but there is an obvious lack of women in line-management roles that will deeply impact the succession talent pool for CEO and board roles for years to come.

Sources: Australian Institute of Company Directors, 2020, *Gender Diversity Progress Report: October 2019 to January 2020*, https://aicd.companydirectors.com.au/-/media/cd2/resources/advocacy/board-diversity/pdf/final-07649-gender-diversity-report-2020-2020-jan-2020-a4-v5.ashx; Korn Ferry Institute, 2020, Australian women CEOs speak: How female leaders rise and how organisations can help, https://www.kornferry.com/insights/articles/australian-women-ceos-speak; CPA Australia, 2019, Elizabeth Proust is used to being the only woman in the boardroom. Now she wants more women to join her, *In The Black*, https://www.intheblack.com/articles/2019/12/01/elizabeth-proust-only-woman-in-the-boardroom, December; Korn Ferry Institute, 2017, Women CEOs speak: Strategies for the next generation of female executives and how companies can pave the road, https://engage.kornferry.com/womenceosspeak/about-the-report-735Y4-26367F.html; Australian Institute of Company Directors, 2017, Boards for balance: Your leadership shadow, http://aicd.companydirectors.com.au/advocacy/board-diversity/boards-for-balance-your-leadership-shadow, May.

| Arriving well prepared | Arriving well prepared | Chief executive impulse | Improvising up the ladder |
|---|---|---|---|
| **48%** | **70%** | **43%** | **75%** |
| had postgraduate degrees in business | had overseas work experience | always wanted to be a CEO | said some part of their career path was improvised |

Source: Korn Ferry Institute, 2020, Australian women CEOs speak: how female leaders rise and how organisations can help, https://www.kornferry.com/insights/articles/australian-women-ceos-speak, 8.

# Key strategic leadership actions

Certain actions characterise effective strategic leadership; we present the most important ones in Figure 12.4. Many of the actions interact with each other. For example, managing the organisation's resources effectively includes developing human capital[68] and contributes to establishing a strategic direction, fostering an effective culture, exploiting core competencies, using effective organisational control systems and establishing ethical practices and corporate social responsibility. The most effective strategic leaders create viable options for making decisions regarding each of the key strategic leadership actions.[69]

## Determining strategic direction

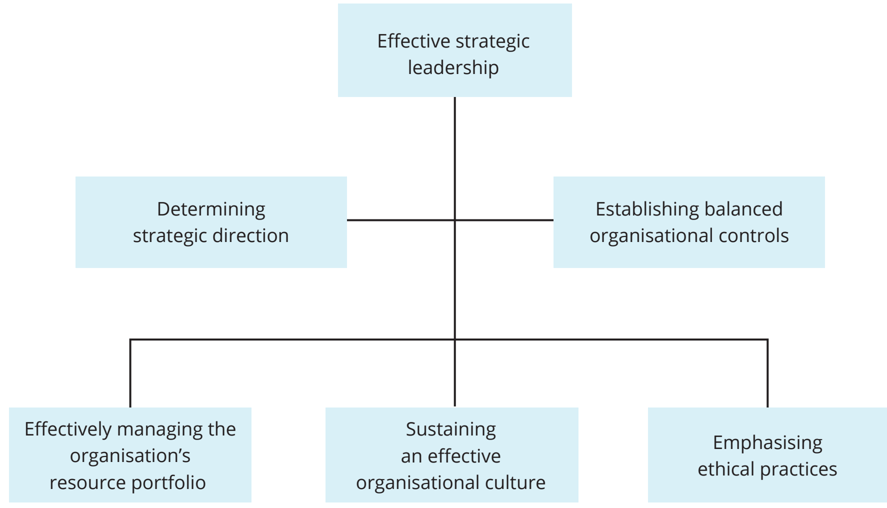
**strategic direction**
the image and character the organisation seeks to develop over time

Determining **strategic direction** involves specifying the vision and the strategy to achieve this vision over time.[70] The strategic direction is framed within the context of the conditions (i.e. opportunities and threats) strategic leaders expect their organisation to face in roughly the next three to five years. The strategic issues faced by Qantas demonstrate this.

The ideal long-term strategic direction has two parts: a core ideology and an envisioned future. The core ideology motivates employees through the company's heritage, but the envisioned future encourages employees to stretch beyond their expectations of accomplishment and requires significant change and progress to be realised.[71] The envisioned future serves as a guide to many aspects of an organisation's strategy implementation process, including motivation, leadership, employee empowerment and organisational design. The strategic direction could include such actions as entering new international markets and developing a set of new suppliers to add to the organisation's value chain.[72]

Most changes in strategic direction are difficult to design and implement; however, GE CEO Jeffrey Immelt had an even greater challenge. GE performed exceptionally well in terms of profit and share price rises under Jack Welch's leadership. Although change was necessary because the competitive landscape

**Figure 12.4** **Exercise of strategic leadership**




had shifted significantly, shareholders accustomed to Welch and high performance had problems accepting Immelt's changes (e.g. changes to the organisation's corporate-level strategy and structure). It is difficult for new leaders to follow successful leaders such as Welch and Steve Jobs (Apple). On succeeding Jobs as CEO, Tim Cook changed course a little at Apple. He announced the payment of dividends (for the first time since 1995; Jobs was not a fan of dividend payments), visited factories where Apple machines are made to ensure they were safe, and made donations of US$50 million to Stanford hospitals (a very unApple act).[73] Whatever the changes made by new CEOs, information regarding the organisation's strategic direction must be consistently and clearly communicated to all affected parties.[74]

Some strategic leaders, however, may not choose the best strategy for the organisation to follow given its competitive environment. For example, some executives are committed to the status quo. This risk-averse stance is common in organisations that have performed well in the past and for CEOs who have been in their jobs for extended periods of time.[75] Research also suggests that some CEOs are erratic or even ambivalent in their choices of strategic direction, especially when their competitive environment is turbulent and it is difficult to identify the best strategy.[76] Of course, these behaviours are unlikely to produce high performance and may then lead to CEO turnover. Interestingly, research has found that incentive compensation in the form of share options encourages talented executives to select the best strategies and thus achieve the highest performance. However, the same incentives used with less talented executives produce lower performance.[77]

A charismatic CEO may foster stakeholders' commitment to a new vision and strategic direction. Nonetheless, it is important not to lose sight of the organisation's strengths and weaknesses when making changes required by a new strategic direction. The organisation must take advantage of resource strengths and overcome or avoid actions requiring capabilities in areas where the organisation is weak.[78] To do this requires senior managers to develop the capability to analyse complex conditions and understand the interrelationships that exist in order to design the most effective strategy.[79] In the current global competitive landscape, senior managers also need to be ambicultural. In other words, they need to be able to identify the best managerial and strategic practices, regardless of their cultural origin, and meld them to create the best strategic approach for their organisation wherever they operate across the globe.[80] The goal is to pursue the organisation's short-term need to adjust to a new vision and strategic direction while maintaining its long-term survivability by effectively managing its portfolio of resources.

## Effectively managing the organisation's resource portfolio

Effectively managing the organisation's portfolio of resources may be the most important strategic leadership task. The organisation's resources are categorised as financial capital, human capital, social capital and organisational capital (including organisational culture).[81]

Clearly, financial capital is critical to organisational success, and strategic leaders understand this reality.[82] However, the most effective strategic leaders recognise the equivalent importance of managing each remaining type of resource as well as managing the integration of resources (e.g. using financial capital to provide training opportunities to enhance the capabilities embedded in human capital). Most importantly, effective strategic leaders manage the organisation's resource portfolio by organising the resources into capabilities, structuring the organisation to facilitate using those capabilities, and choosing strategies through which the capabilities are successfully leveraged to create value for customers.[83] Exploiting and maintaining core competencies and developing and retaining the organisation's human and social capital are actions taken to reach these important objectives.

## Exploiting and maintaining core competencies

Examined in Chapters 1 and 3, *core competencies* are capabilities that serve as a source of competitive advantage for an organisation over its rivals. Typically, core competencies relate to an organisation's functional skills, such as manufacturing, finance, marketing, and research and development (R&D). Strategic leaders must verify that the organisation's competencies are emphasised when implementing strategies. Intel, for example, has core competencies of *competitive agility* (an ability to act in a variety of competitively relevant ways) and *competitive speed* (an ability to act quickly when facing environmental and competitive pressures).[84] Another way of looking at core competencies is the uniqueness differentials that organisations build and enhance relative to the industry competitors. A good example is the retailer JB Hi-Fi. It operates in a competitive industry where brand recognition and service delivery are core capabilities. In JB Hi-Fi's case, its uniqueness is around simplicity and customer connectiveness. For instance, the handwritten sales discount signs and relaxed 'hip' service staff appeal to customers and differentiate its business model from competitors.

Capabilities are developed over time as organisations learn from their actions and enhance their knowledge about specific actions needed. For example, through repeated interactions, some organisations have formed a capability allowing them to fully understand customers' needs as they change.[85] Organisations with capabilities in R&D that develop into core competencies are rewarded by the market because of the critical nature of innovation in many industries.[86] To continuously develop current competencies and build new ones, organisations create a *dynamic capability*.[87]

Given the need for transformation, former General Motors (GM) CEO Dan Akerson built new capabilities in technology development and marketing, especially in customer service. His intent was to develop these into the new core competencies of GM; he was succeeded in January 2015 by Mary Barra, the first female CEO of a major car maker.[88] Since assuming this role, Barra has been trying to reorient GM's culture and structure towards superior performance in order to ward off serious competitive challenges. With a continuing focus on profitability, GM announced early in 2018 that it intended to close its factory in South Korea. This decision represents a step in a broad global downsizing implemented by Barra, who has closed, shrunk or sold unprofitable business units in India, Russia, Western Europe and South-East Asia. In all instances, Barra and her executive management team will need to implement various restructuring and downsizing decisions in ways that employees view as just and reasonable as well as necessary for GM to succeed. However, it has been noted that 'she has turned it into a market-leading manufacturer. GM is seen as innovative, powerful and successful – and its stock price has performed accordingly'.[89] Using the dynamic capability described earlier, organisations must continuously develop and, when appropriate, change their core competencies to outperform rivals. If they have a competence that provides an advantage, competitors will eventually imitate that competence and reduce or eliminate the organisation's competitive advantage. Additionally, organisations must guard against the competence becoming a liability, thereby preventing change.

As we discuss next, human capital is critical to an organisation's success. One reason it is so critical is that human capital is the resource through which core competencies are developed and used.

## Developing human capital and social capital

**human capital** refers to the knowledge and skills of an organisation's entire workforce

**Human capital** refers to the knowledge and skills of an organisation's entire workforce. From the perspective of human capital, employees are viewed as a capital resource requiring continuous investment.[90]

Investments made to acquire and develop high-quality human capital are productive, in that much of the development of Australian and Asian industries can be attributed to the effectiveness of their human resources. This fact suggests that 'as the dynamics of competition accelerate, people are perhaps the only truly sustainable source of competitive advantage'.[91] In all types of organisations – large and small, new and established – human capital's increasing importance suggests a significant role for the organisation's human resource management activities.[92] As a support activity (see Chapter 3), human resource management practices facilitate people's efforts to successfully select, and especially to use, the organisation's strategies.[93]

Effective training and development programs increase the probability of individuals becoming successful strategic leaders.[94] These programs are increasingly linked to organisation success as knowledge becomes more integral to gaining and sustaining a competitive advantage.[95] Additionally, such programs build knowledge and skills, inculcate a common set of core values and offer a systematic view of the organisation, thus promoting the organisation's vision and organisational cohesion.

Effective training and development programs also contribute positively to the organisation's efforts to form core competencies.[96] Furthermore, they help strategic leaders improve skills that are critical to completing other tasks associated with effective strategic leadership, such as determining the organisation's strategic direction, exploiting and maintaining the organisation's core competencies, and developing an organisational culture that supports ethical practices. Thus, building human capital is vital to the effective execution of strategic leadership. Indeed, some argue that the world's 'best companies are realising that no matter what business they're in, their real business is building leaders'.[97]

When human capital investments are successful, the result is a workforce capable of learning continuously. Continuous learning and leveraging the organisation's expanding knowledge base are linked with strategic success.[98]

Learning also can preclude making errors. Strategic leaders tend to learn more from their failures than their successes because they sometimes make the wrong attributions for the successes.[99] Sara Blakely, the youngest self-made female billionaire in the world, noted: 'Don't be intimidated by what you don't know. That can be your greatest strength and ensure that you do things differently from everyone else'.[100] We know that using teams to make decisions can be effective, but sometimes it is better for leaders to make decisions alone, especially when the decisions must be made and implemented quickly (e.g. in crisis situations).[101] As such, effective strategic leaders recognise the importance of learning from success *and* from failure.

Learning and building knowledge are important for creating innovation in organisations.[102] Innovation leads to competitive advantage.[103] Overall, organisations that create and maintain greater knowledge usually achieve and maintain competitive advantages. However, as noted with core competencies, strategic leaders must guard against allowing high levels of knowledge in one area to lead to myopia and overlooking knowledge development opportunities in other important areas of the business.

When facing challenging conditions, organisations sometimes decide to lay off some of their people. Strategic leaders must recognise, though, that lay-offs can result in a significant loss of the knowledge possessed by the organisation's human capital. Research shows that moderate-sized lay-offs may improve organisation performance, but large lay-offs produce stronger performance downturns in organisations because of the loss of people (human capital).[104] Although it is also not uncommon for restructuring organisations to reduce their expenditures on or investments in training and development programs, restructuring may actually be an important time to increase investments in these programs. The reason for increased focus on training and development is that restructuring organisations have less slack and cannot absorb as many errors; moreover, the employees who remain after lay-offs may find themselves in positions without all the skills or knowledge they need to perform the required tasks effectively.

Viewing employees as a resource to be maximised rather than as a cost to be minimised facilitates successful implementation of an organisation's strategies, as does the strategic leader's ability to approach lay-offs in a manner that employees believe is fair and equitable. A critical issue for employees is the fairness in the lay-offs and how they are treated in their jobs, especially relative to their peers.[105]

**social capital** involves relationships inside and outside the organisation that assist the organisation to accomplish tasks and create value for customers and shareholders

**Social capital** involves relationships inside and outside the organisation that help the organisation to accomplish tasks and create value for customers and shareholders.[106] Social capital is a critical asset for an organisation. Inside the organisation, employees and units must cooperate to get the work done. In multinational organisations, employees often must cooperate across country boundaries on activities such as R&D to achieve performance objectives (e.g. developing new products).[107]

External social capital is increasingly critical to organisation success. The reason for this is that few, if any, companies have all of the resources they need to successfully compete against their rivals. Organisations can use cooperative strategies such as strategic alliances (see Chapter 9) to develop social capital. Social capital can be built in strategic alliances as organisations share complementary resources. Resource sharing must be effectively managed to ensure that the partner trusts the organisation and is willing to share the desired resources.[108] This social capital has many benefits. For example, organisations with strong social capital are able to be more 'ambidextrous'; that is, they can develop or have access to multiple capabilities, providing them with the flexibility to take advantage of opportunities identified and to respond to significant challenges encountered.[109] Research evidence suggests that the success of many types of organisations may partially depend on social capital. Large multinational organisations often must establish alliances in order to enter new foreign markets. Likewise, entrepreneurial organisations often must establish alliances to gain access to resources, venture capital or other types of resources (e.g. special expertise that the entrepreneurial organisation cannot afford to maintain in-house).[110] Retaining quality human capital and maintaining strong internal social capital can be affected strongly by the organisation's culture.

## Sustaining an effective organisational culture

In Chapter 1, we defined organisational culture as a complex set of ideologies, symbols and core values that are shared throughout the organisation and influence the way business is conducted. Evidence suggests that an organisation can develop core competencies in terms of both the capabilities it possesses and the way the capabilities are leveraged when implementing strategies to produce desired outcomes. In other words, because the organisational culture influences how the organisation conducts its business and helps to regulate and control employees' behaviour, it can be a source of competitive advantage.[111] Given its importance, it may be that a vibrant organisational culture is the most valuable competitive differentiator for business organisations. Thus, shaping the context within which the organisation formulates and implements its strategies – that is, shaping the organisational culture – is an essential strategic leadership action.[112]

'Culture eats strategy for breakfast' is accredited to the late business management guru Peter Drucker to emphasise that a powerful and empowering culture is a safer route to organisational success. With that said, it is clear that we have now reached the next stage in the global business landscape, where all organisations should reflect on their own corporate culture if they want to maintain a sustainable business model. The bar has been raised in relation to organisational culture in Australia, with events such as the Misconduct in the Banking, Superannuation and Financial Services Industry Royal Commission (completed in 2019), and the ongoing Royal Commissions into Aged Care Quality and Safety, and Violence, Abuse, Neglect and Exploitation of People with Disability.[113]

In addition, APRA's inquiry into CBA further raised the stakes regarding the nature of corporate culture and its impact on the role of directors. APRA announced the Prudential Inquiry in 2017 to examine the frameworks and practices in relation to governance, culture and accountability within the CBA group, following a number of incidents that had damaged the reputation of the bank. Findings in the Final Report included several prominent cultural themes, such as a widespread sense of complacency, a reactive stance in dealing with risks, being insular and not learning from experiences and mistakes, and an overly collegial and collaborative working environment, which lessened the opportunity for constructive criticism, timely decision making and a focus on outcomes.[114]

## Entrepreneurial mindset

Especially in large organisations, an organisational culture often encourages (or discourages) strategic leaders from pursuing (or not pursuing) entrepreneurial opportunities.[115] This issue is important because entrepreneurial opportunities are a vital source of growth and innovation.[116] Accordingly, a key role of strategic leaders is to encourage and promote innovation by pursuing entrepreneurial opportunities.[117]

One way to encourage innovation is to invest in opportunities as real options; that is, to invest in an opportunity in order to provide the potential option of taking advantage of the opportunity at some point in the future.[118] For example, an organisation might buy a piece of land to have the option to build on it at some time in the future should the company need more space and should that location increase in value to the company. Organisations might enter strategic alliances for similar reasons. In this instance, an organisation might form an alliance to have the option of acquiring the partner later or of building a stronger relationship with it (e.g. developing a joint new venture).[119]

In Chapter 13, we describe how large organisations use strategic entrepreneurship to pursue entrepreneurial opportunities and to gain first-mover advantages. Small and medium-sized organisations also rely on strategic entrepreneurship when trying to develop innovations as the foundation for profitable growth. In organisations of all sizes, strategic entrepreneurship is more likely to be successful when employees have an entrepreneurial mindset.[120]

Five dimensions characterise an organisation's entrepreneurial mindset: autonomy, innovativeness, risk taking, proactiveness and competitive aggressiveness.[121] In combination, these dimensions influence the actions an organisation takes to be innovative and launch new ventures.

*Autonomy*, the first of an entrepreneurial orientation's five dimensions, allows employees to take actions that are free of organisational constraints and permits individuals and groups to be self-directed. The second dimension, *innovativeness*, 'reflects a firm's tendency to engage in and support new ideas, novelty, experimentation, and creative processes that may result in new products, services, or technological processes'.[122] Cultures with a tendency towards innovativeness encourage employees to think beyond existing knowledge, technologies and parameters to find creative ways to add value. *Risk taking* reflects a willingness by employees and their organisation to accept risks when pursuing entrepreneurial opportunities. Assuming significant levels of debt and allocating large amounts of other resources (e.g. people) to projects that may not be completed are examples of these risks. The fourth dimension of an entrepreneurial orientation, *proactiveness*, describes an organisation's ability to be a market leader rather than a follower. Proactive organisational cultures constantly use processes to anticipate future market needs and to satisfy them before competitors learn how to do so. Finally, *competitive aggressiveness* is an organisation's propensity to take actions that allow it to consistently and substantially outperform its rivals.[123]

## Changing the organisational culture and restructuring

Changing an organisation's culture is much more difficult than maintaining it; however, effective strategic leaders recognise when change is needed. Incremental changes to the organisation's culture typically are used to implement strategies.[124] More significant and sometimes even radical changes to organisational culture support selecting strategies that differ from those the organisation has implemented historically. Regardless of the reasons for change, shaping and reinforcing a new culture requires effective communication and problem solving, along with selecting the right people (those who have the values desired for the organisation), engaging in effective performance appraisals (establishing goals and measuring individual performance towards goals that fit in with the new core values) and using appropriate reward systems (rewarding the desired behaviours that reflect the new core values).[125]

'Changing the prevailing culture is often hard and it takes time. It starts with a realisation that what is occurring in the business is preventing the organization from performing at its peak.'[126] Evidence suggests that cultural changes succeed only when they are actively supported by the organisation's CEO, other key executive management team members and middle-level managers.[127] To effect change, middle-level managers in particular need to be highly disciplined to energise the culture and foster alignment with the strategic vision.[128] In addition, managers must be sensitive to the effects of other major strategic changes on organisational culture. For example, major downsizings or major growth can have negative effects on an organisation's culture, especially if they are not implemented in accordance with the dominant organisational values.[129]

**Strategic focus | Ethics**

## Organisational culture: is it really that important?

The answer to the title of this 'Strategic focus' is yes! The reason is that organisational culture has a significant influence on employees and, in turn, on an organisation's performance as it interacts with strategy and structure. In this regard, 'organisational culture sets the context for everything an enterprise does'. Strategic leaders recognise the important relationship among organisational culture, employees' actions and organisation performance. For example, based on its survey of CEOs, the US Conference Board reported that these leaders view culture and quality talent to be the critical enablers of organisational success. The CEOs also believe that an open and inclusive culture is one in which organisational talent can thrive.

Effective strategic leaders also know that the type of culture that leads to positive outcomes requires time and effort to build. Indeed, leaders must work diligently and consistently to build an effective organisational culture. Building this type of culture 'takes patience, sacrifice and vision. It requires that leaders have the passion to improve their organization and to motivate, engage, and inspire their people with more than simply words or perks'. Once developed, culture changes in response to efforts needed to implement the organisation's strategy within the context provided by the structures that are in place to support strategy execution efforts.

Research results support leaders' belief about culture's importance and its relationship with strategy and structure. Some researchers have found, for example, that 'the key to running a successful organization is to have a culture based on a strongly held and widely shared set of beliefs that are appropriately supported by strategy and structure'. Among other benefits, a strong culture informs employees how leaders want them to respond to situations that may develop; gives employees confidence that the responses they initiate will be the correct ones; and assures employees that they will be recognised and rewarded for acting in a manner that demonstrates the organisation's values as embedded in its culture. Thus, there is a strong link between leaders and the actions they take and the nature of an organisation's culture.

Building and supporting an effective culture yields multiple specific benefits for an organisation. As examples, culture (1) increases employee loyalty in that individuals working in an organisation with a strong culture like the challenges associated with their job and enjoy the atmosphere in which they work; (2) attracts and retains talent in that strong cultures are environments in which people want to work and are passionate about their role in helping an organisation reach its vision and mission; (3) reflects an organisation's identity in that it demonstrates 'how the company views itself and how the company wishes to be viewed by the outside world'; and (4) creates intrinsic motivation for employee behaviour.

The most effective strategic leaders understand that their organisation's culture can be a source of competitive advantage; as such, they proactively work to form an effective culture. At its best, 'culture expresses goals through values and beliefs and guides activity through shared assumptions and group norms'. Going a step further, Bain & Company consultants suggest that 'company culture is at the heart of competitive advantage, because it determines how things are done and how people behave'. Importantly, the consultants also say, culture 'is the hardest thing for competitors to copy'. Culture's imperfect imitability (see Chapter 3) explains why it can be a source of competitive advantage and perhaps a sustainable one.

To develop such a culture, leaders work with others to create an environment in which people have a passion to perform at high levels and to develop a culture with a unique personality and soul in the process of doing so. With an effective culture, organisations are able to attract and retain high-quality talent and serve loyal customers. Overall, developing and sustaining an effective organisational culture is indeed a key strategic leadership action.

Sources: 2018, Performance culture, Bain & Company, http://www.bain.com, 20 February; 2018, Understanding and developing organizational culture, Society for Human Resource Management, http://www.shrm.org, 12 February; B. Groysberg, J. Lee, J. Price & Y.-J. Cheng, 2018, The leader's guide to corporate culture, *Harvard Business Review*, 96(1): 44–57; 2017, Survey finds CEOs leaning on talent and organizational culture to survive and thrive amid global volatility, Conference Board, http://www.conference-board-org, 31 January; W. A. Levenson, 2017, Culture: A decisive competitive advantage, QualityDigest, http://www.qualitydigest.com, 3 October; S. Patel, 2017, The importance of building culture in your organization, Inc.com, http://www.inc.com, 24 October; D. Smith, 2017, How to define and build a great organizational culture in 2018, Medium.com, http://www.medium.com, 18 December.

## Emphasising ethical practices

The effectiveness of processes used to implement the organisation's strategies increases when they are based on ethical practices. Ethical companies encourage and enable people at all organisational levels to act ethically when doing what is necessary to implement strategies. In turn, ethical practices and the judgement on which they are based create 'social capital' in the organisation, increasing the 'goodwill available to individuals and groups' in the organisation.[130] Conversely, when unethical practices evolve in an organisation, they may become acceptable to many managers and employees.[131] One study found that in these circumstances, managers were particularly likely to engage in unethical practices to meet their goals when current efforts to meet them were insufficient.[132]

To properly influence employees' judgement and behaviour, ethical practices must shape the organisation's decision-making process and must be an integral part of organisational culture. In fact, research evidence suggests that a value-based culture is the most effective means of ensuring that employees comply with the organisation's ethical requirements.[133] The inaugural Global Director Survey completed in 2018 provides an overview of how worldwide directors view a range of issues, including ethical behaviour that impacts the organisations they govern. Two thousand directors from 17 member-based organisations located in Africa, the Middle East, the Americas, Asia-Pacific and Europe reported that ethical behaviour, health and safety and employee engagement were the three most social issues and risks facing directors.[134]

As we explained in Chapter 10, managers may act opportunistically, making decisions that are in their own best interests but not in the organisation's best interests when facing lax expectations regarding ethical behaviour. In other words, managers acting opportunistically take advantage of their positions, making decisions that benefit themselves to the detriment of the organisation's stakeholders.[135] But strategic leaders are most likely to integrate ethical values into their decisions when the organisation has explicit ethics codes, the code is integrated into the business through extensive ethics training, and shareholders expect ethical behaviour.[136]

Organisations should employ ethical strategic leaders: leaders who include ethical practices as part of their strategic direction for the organisation, who desire to do the right thing, and for whom honesty, trust and integrity are important.[137] Strategic leaders who consistently display these qualities inspire employees as they work with others to develop and support an organisational culture in which ethical practices are the expected behavioural norms.[138]

Strategic leaders can take several actions to develop an ethical organisational culture. Examples of these actions include:

1 establishing and communicating specific goals to describe the organisation's ethical standards (e.g. developing and disseminating a code of conduct)
2 continuously revising and updating the code of conduct, based on inputs from people throughout the organisation and from other stakeholders (e.g. customers and suppliers)
3 disseminating the code of conduct to all stakeholders to inform them of the organisation's ethical standards and practices
4 developing and implementing methods and procedures to use in achieving the organisation's ethical standards (e.g. using internal auditing practices that are consistent with the standards)
5 creating and using explicit reward systems that recognise acts of courage (e.g. rewarding those who use proper channels and procedures to report observed wrongdoings)
6 creating a work environment in which all people are treated with dignity.[139]

The effectiveness of these actions increases when they are taken simultaneously and thereby are mutually supportive. When strategic leaders and others throughout the organisation fail to take actions such as these – perhaps because an ethical culture has not been created – problems are likely to occur. For example, during the Australian men's cricket tour to South Africa in 2018, Cricket Australia considered that it was imperative to appoint the Ethics Centre to conduct an independent organisational review of an incident where Australian cricketers tampered with the cricket ball in an attempt to influence the outcome of a Test match being held in Cape Town.

> The Ethics Centre's scope of the review into Cricket Australia was as follows: consider whether any cultural, organisational and/or governance factors within the Australian Men's Team, Cricket Australia or Australian cricket may have contributed to the issues, either directly or indirectly; and recommend measures that Cricket Australia and Australian cricket should consider to ensure that any issues are addressed and that these or similar events never occur again.[140]

A culture of win-at-all-costs within the Australian men's cricket team left the board and executive of Cricket Australia to deal with the fallout from what escalated into an international scandal. This scandal also raised questions about the board's governance of culture and ethics. The reputational damage, loss of major sponsorship and departure of directors and the CEO resulted in Cricket Australia considering the 42 recommendations provided by the Ethics Centre and establishing the Australian Cricket Ethics Commission. The purpose of this Commission would be 'to hold all participants in Australian Cricket accountable to the ethical foundations for the game as played in Australia in accordance with How We Play, the Spirit of Cricket, the Laws of Cricket – and any successor documents that establish ethical standards for the game'.[141]

**corporate social responsibility (CSR)** requires companies to consider the interests of all stakeholders, including investors, suppliers, consumers, employees and the community, in going about its business

## Leadership and corporate social responsibility

**Corporate social responsibility (CSR)** has become a major interest and issue for many global organisations and a significant factor in corporate governance in Australia over the past two decades. The growing interest towards a sustainable society requires a new type of leadership that promotes the ideals of CSR, and we will watch with interest over coming years for advancement in the landscape of CSR. Notwithstanding, there are many organisations that have been committed to CSR for some time. For example, since 2014, CalPERS (California Public Employees' Retirement System) has worked with various partners to promote sustainability; one such example is the United Nations Environment Programme Finance Initiative, which is a global partnership to develop and promote linkages between sustainability and financial performance.

Although Australia does not have mandatory reporting on social and environmental performance, many companies report voluntarily on their performance in these areas to meet annual disclosure obligations and demonstrate a commitment to CSR. Stakeholders can have a huge influence and impact if they are dissatisfied with the day-to-day management or strategic direction of any organisation. For example, as touched on in Chapter 10, infuriated investors forced the board of Rio Tinto to terminate its CEO Jean-Sebastien Jacques, along with two of the senior executives partially responsible for the destruction of the Juukan Gorge caves in the Pilbara region of Western Australia, which contained evidence of human habitation 46 000 years ago.[142] Rio Tinto Chair Simon Thompson acknowledged that shareholder concerns played a significant role in the decision to part ways with the three executives who were accountable for the Juukan Gorge blasting, stating: 'We have listened to our stakeholders' concerns that a lack of individual accountability undermines the group's ability to rebuild that trust and to move forward to implement the changes identified in the board review'.[143]

In 2006, both the Parliamentary Joint Committee on Corporations and Financial Services and the Corporations and Markets Advisory Committee released reports examining the extent to which Australian companies should adopt CSR. The reports concluded that CSR can be an important means for companies to manage non-financial risks and maximise their long-term financial value. The St James Ethics Centre's Corporate Responsibility Index (2003), the Reputex SR Index (2005) and the Australian CSR Standards (AS 8003) are supported by the Australian Institute of Social and Ethical Accountability and Models of Success and Sustainability (MOSS), and have emerged to provide guidance for corporations to implement, measure and report their CSR performance measures more effectively.[144] Global companies in 2019 ranked by Forbes to have the best CSR reputation included BMW, Google, Daimler, Sony, Intel, Apple and Nestlé.[145]

## Establishing balanced organisational controls

Organisational controls are basic to a capitalistic system and have long been viewed as an important part of strategy implementation processes.[146] Controls are necessary to help ensure that organisations achieve their desired outcomes.[147] Defined as the 'formal, information based … procedures used by managers to maintain or alter patterns in organisational activities', controls help strategic leaders build credibility, demonstrate the value of strategies to the organisation's stakeholders, and promote and support strategic change.[148] Most critically, controls provide the parameters for implementing strategies as well as the corrective actions to be taken when implementation-related adjustments are required. The example of Rio Tinto and the destruction of the Juukan Gorge caves highlights a systemic failure of internal organisational controls.

In this chapter, we focus on two organisational controls – strategic and financial – that were introduced in Chapter 11. Strategic and financial controls are important because strategic leaders, especially those at the top of the organisation, are responsible for their development and effective use.

As we explained in Chapter 11, financial control focuses on short-term financial outcomes. By contrast, strategic control focuses on the *content* of strategic actions rather than their *outcomes*. Some strategic actions can be correct but still result in poor financial outcomes because of external conditions such as an economic recession, unexpected domestic or foreign government actions, natural disasters and other events with major impact, such as the Covid-19 pandemic. Therefore, emphasising financial controls often produces more short-term and risk-averse managerial decisions, because financial outcomes may be caused by events beyond managers' direct control. Alternatively, strategic control encourages lower-level managers to make decisions that incorporate moderate and acceptable levels of risk because outcomes are shared among the business-level executives making strategic proposals and the corporate-level executives evaluating them.

The challenge for strategic leaders is to achieve an appropriate balance of financial and strategic controls so that organisation performance improves. The balanced scorecard is a tool that helps strategic leaders to evaluate the effectiveness of the controls used.

## The balanced scorecard

**balanced scorecard**
a framework that organisations can use to verify that they have established both strategic and financial controls to assess their performance

The **balanced scorecard** is a framework organisations can use to evaluate whether they have achieved the appropriate balance among the strategic and financial controls to attain the desired level of organisation performance.[149] This technique is most appropriate for use in evaluating business-level strategies; however, it can also be used with the other strategies organisations implement (e.g. corporate level, international and cooperative).

The underlying premise of the balanced scorecard is that organisations jeopardise their future performance when financial controls are emphasised at the expense of strategic controls.[150] This occurs because financial controls provide feedback about outcomes achieved from past actions but do not communicate the drivers of future performance.[151] Thus, an overemphasis on financial controls may promote managerial behaviour that sacrifices the organisation's long-term, value-creating potential for short-term performance gains.[152] An appropriate balance of strategic controls and financial controls, rather than an overemphasis on either, allows organisations to achieve higher levels of performance.

Four perspectives are integrated to form the balanced scorecard framework: *financial* (concerned with growth, profitability and risk from the shareholders' perspective), *customer* (concerned with the amount of value customers perceive was created by the organisation's products), *internal business processes* (with a focus on the priorities for various business processes that create customer and shareholder satisfaction) and *learning and growth* (concerned with the organisation's effort to create a climate that supports change, innovation and growth). Thus, using the balanced scorecard framework allows the organisation to understand how it responds to shareholders (financial perspective), how customers view it (customer perspective), the processes it must emphasise to successfully use its competitive advantage (internal perspective) and what it can do to improve its performance in order to grow (learning and growth perspective).[153] Generally speaking, strategic controls tend to be emphasised when the organisation assesses its performance relative to the learning and growth perspective, whereas financial controls are emphasised when assessing performance in terms of the financial perspective.

Organisations use different criteria to measure their standing relative to the scorecard's four perspectives. We show sample criteria in Figure 12.5. The organisation should select the number of criteria that will allow it to have both a strategic understanding and a financial understanding of its performance without becoming immersed in too many details.[154] For example, we know from research that an organisation's innovation, quality of its goods and services, growth of its sales and its profitability are all interrelated.[155]

Strategic leaders play an important role in determining a proper balance between strategic controls and financial controls, whether they are in single-business organisations or large diversified organisations. A proper balance between controls is important, in that 'wealth creation for organisations where strategic leadership is exercised is possible because these leaders make appropriate investments for future viability [through strategic control], while maintaining an appropriate level of financial stability in the present [through financial control]'.[156] In fact, most corporate restructuring is designed to refocus the organisation on its core businesses, thereby allowing senior executives to re-establish strategic control of their separate business units.[157]

Successfully using strategic control frequently is integrated with appropriate autonomy for the various subunits so that they can gain a competitive advantage in their respective markets.[158] Strategic control can be used to promote the sharing of both tangible and intangible resources among interdependent businesses within an organisation's portfolio. In addition, the autonomy provided allows the flexibility necessary to take advantage of specific marketplace opportunities. As a result, strategic leadership promotes simultaneous use of strategic control and autonomy.[159]

The balanced scorecard is being used by car manufacturer Porsche. After this manufacturer of sought-after sports cars regained its market-leading position, it implemented a balanced scorecard approach in an effort to maintain this position. In particular, Porsche used the balanced scorecard to promote learning and continuously improve the business. For example, knowledge was collected from all Porsche dealerships throughout the world. The instrument used to collect the information was referred to as 'Porsche Key Performance Indicators'. The fact that Porsche is now one of the world's most profitable carmakers suggests the value the organisation gained, and continues to gain, by using the balanced scorecard as a foundation for simultaneously emphasising strategic and financial controls.[160]

As we have explained, strategic leaders are critical to an organisation's ability to successfully use all parts of the strategic management process.

**Figure 12.5** **Strategic controls and financial controls in a balanced scorecard framework**

| Perspectives | Criteria |
|---|---|
| Financial | • Cash flow<br>• Return on equity<br>• Return on assets |
| Customer | • Assessment of ability to anticipate customers' needs<br>• Effectiveness of customer service practices<br>• Percentage of repeat business<br>• Quality of communications with customers |
| Internal business processes | • Asset utilisation improvements<br>• Improvements in employee morale<br>• Changes in turnover rates |
| Learning and growth | • Improvements in innovation ability<br>• Number of new products compared to competitors'<br>• Increases in employees' skills |

# STUDY TOOLS

## SUMMARY

**LO1** Effective strategic leadership is a prerequisite of successfully using the strategic management process. Strategic leadership entails the ability to anticipate events, envision possibilities, maintain flexibility and empower others to create strategic change. Executive managers are an important resource for organisations to develop and exploit competitive advantages. In addition, when they and their work are valuable, rare, imperfectly imitable and non-substitutable, strategic leaders are also a source of competitive advantage.

**LO2** The executive management team is composed of key managers who play a critical role in selecting and implementing the organisation's strategies. Generally, they are senior officers of the organisation and/or the board of directors. The executive management team's characteristics, an organisation's strategies and its performance are all interrelated. For example, an executive management team with significant marketing and R&D knowledge positively contributes to the organisation's use of a growth strategy. Overall, having diverse skills increases most executive management teams' effectiveness. Typically, performance improves when the board of directors is involved in shaping an organisation's strategic direction. However, when the CEO has a great deal of power, the board may be less involved in decisions about strategy formulation and implementation. By appointing people to the board and simultaneously serving as CEO and chair of the board, CEOs increase their power.

**LO3** In managerial succession, strategic leaders are selected from either the internal or the external managerial labour market. Because of their effect on organisation performance, selection of strategic leaders has implications for an organisation's effectiveness. There is a variety of reasons that companies select the organisation's strategic leaders from either internal or external sources. In most instances, the internal market is used to select the CEO, but the number of outsiders chosen is increasing. Outsiders often are selected to initiate major changes in strategy.

**LO4** Effective strategic leadership has five major components: determining the organisation's strategic direction, effectively managing the organisation's resource portfolio (including exploiting and maintaining core competencies and managing human capital and social capital), sustaining an effective organisational culture, emphasising ethical practices, establishing balanced organisational controls and corporate social responsibility.

Strategic leaders must develop the organisation's strategic direction. The strategic direction specifies the image and character the organisation wants to develop over time. To form the strategic direction, strategic leaders evaluate the conditions (e.g. opportunities and threats in the external environment) they expect their organisation to face over the next three to five years.

**LO5** Strategic leaders must ensure that their organisation exploits its core competencies, which are used to produce and deliver products that create value for customers, when implementing its strategies. In related diversified and large organisations in particular, core competencies are exploited by sharing them across units and products. The ability to manage the organisation's resource portfolio and manage the processes used to effectively implement the organisation's strategy are critical elements of strategic leadership. Managing the resource portfolio includes integrating resources to create capabilities and leveraging those capabilities through strategies to build competitive advantages. Human capital and social capital are perhaps the most important resources.

As a part of managing the organisation's resources, strategic leaders must develop an organisation's human capital. Effective strategic leaders view human capital as a resource to be maximised – not as a cost to be minimised. Such leaders develop and use programs designed to train current and future strategic leaders to build the skills needed to nurture the rest of the organisation's human capital. Effective strategic leaders build and maintain internal and external social capital. Internal social capital promotes cooperation and coordination within and across units in the organisation. External social capital provides access to resources the organisation needs to compete effectively.

**LO6** Shaping the organisation's culture is a central task of effective strategic leadership. An appropriate organisational culture encourages the development of an entrepreneurial orientation among employees and an ability to change the culture as necessary.

**LO7** In ethical organisations, employees are encouraged to exercise ethical judgement and to always act ethically. Improved ethical practices foster social capital. Setting specific goals to meet the organisation's ethical standards, using a code of conduct, rewarding ethical behaviours and creating a work environment where all people are treated with dignity are actions that facilitate and support ethical behaviour.

**LO8** The concept of corporate social responsibility is generally understood to mean that corporations have a degree of responsibility not only for the economic consequences of their activities, but also for the social and environmental implications.

**LO9** Developing and using balanced organisational controls are the final components of effective strategic leadership. The balanced scorecard is a tool that measures the effectiveness of the organisation's strategic and financial controls. An effective balance between strategic and financial controls allows for flexible use of core competencies, but within the parameters of the organisation's financial position.

## KEY TERMS

- balanced scorecard
- corporate social responsibility (CSR)
- executive management team
- external managerial labour market
- heterogeneous management team
- human capital
- internal managerial labour market
- social capital
- strategic direction
- strategic leadership

## REVIEW QUESTIONS

1. What is strategic leadership? In what ways are executive managers considered important resources for an organisation?
2. What is an executive management team, and how does it affect an organisation's performance and its abilities to innovate and design and implement effective strategic changes?
3. What is the effect of strategic leadership on determining the organisation's strategic direction?
4. How do strategic leaders effectively manage their organisation's resource portfolio to exploit its core competencies and leverage the human capital and social capital to achieve a competitive advantage?
5. What is organisational culture? What must strategic leaders do to develop and sustain an effective organisational culture?
6. What actions might a leader take to demonstrate that their interest in diversity goes beyond rhetoric?
7. As a strategic leader, what actions should leaders take to establish and emphasise ethical practices in the organisation?
8. What are organisational controls? Why are strategic controls and financial controls important aspects of the strategic management process?
9. How can CSR practices be encouraged and implemented within an organisation?

## EXPERIENTIAL EXERCISES

### Exercise 1: The CEO and executive management team

Chapter 10 discussed corporate governance and the fiduciary role that the board plays in overseeing the affairs of the company. The composition of the executive management team is critical in assessing the strategic direction of an organisation. It is not uncommon for a powerful CEO and senior management team to thwart the desires of the board. There are various ways in which a CEO may become powerful: it may be the result of equity ownership, tenure, expertise or by appointing sympathetic board members, for example. This exercise will allow you to assess the power of a CEO and his or her team and develop your thoughts regarding their relationship to the board.

## Part 1

Identify with your team the organisation you would like to analyse. Pick an organisation that is publicly traded on the Australian Securities Exchange (ASX) so that you have adequate information about the executives.

## Part 2

Explore the power relationship between the CEO and the executive management team and the board. You should at a minimum be able to address the following points:

1. What is the tenure of the CEO?
2. What is the tenure of the executive management team? Is there any diversity within the executive management team? if so, explain what the diversity is (age, gender or cultural)?
3. What is the relationship between the executive management team and the CEO (i.e. were they hired by the CEO or a predecessor)?
4. What is the board member tenure and composition (i.e. does the board structure possess only independent directors)?
5. Describe the CEO and the executive management team in terms of experience and networks. For example, do they sit on other organisations' boards of directors, and are there any overlaps with their employer's board?
6. What conclusions do you reach regarding the power relationship between the CEO and the board? Be prepared to discuss this utilising a PowerPoint presentation of your findings and conclusions.

### Exercise 2: Strategic leadership is tough!

We define strategic leadership as 'the ability to anticipate, envision, maintain flexibility and empower others'. Accordingly, this exercise combines the practical elements of leadership in an experiential exercise. You are asked to replicate leaders and followers in the attainment of a defined goal.

Divide the class into teams of three to five individuals. Each team should choose a leader (and by that decision, who will be the followers). It is important to choose wisely. The classroom instructor will then assign the task to be completed. Students should be prepared to debrief the rest of the class when the assignment is completed. Your instructor will guide this discussion.

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CHAPTER 13

# Strategic entrepreneurship

## Learning Objectives

Studying this chapter should provide you with the strategic management knowledge needed to:

LO1 define strategic entrepreneurship and corporate entrepreneurship

LO2 define entrepreneurship and entrepreneurial opportunities and explain their importance

LO3 define invention, innovation and imitation, and describe the relationships among them

LO4 describe entrepreneurs and the entrepreneurial mindset

LO5 explain international entrepreneurship and its importance in improving organisation performance

LO6 describe how organisations internally develop and implement innovations

LO7 explain how organisations use cooperative strategies to innovate

LO8 describe how organisations use acquisitions as a means of innovation

LO9 explain how strategic entrepreneurship helps organisations create value.

# OPENING CASE STUDY

## Today it is gas and diesel: tomorrow it is likely to be electric vehicles, plug-in hybrids, and driverless cars and trucks

As explained in this chapter, organisations engaging in strategic entrepreneurship concentrate on advantage-seeking and opportunity-seeking behaviours simultaneously. In essence, this concentration finds organisations seeking entrepreneurial opportunities in their external environment that they can exploit through innovations and by successfully executing their chosen strategies. When engaging in strategic entrepreneurship, organisations develop innovations through internal investments, by using cooperative strategies and acquisitions strategies. Focusing on advantage- and opportunity-seeking behaviours simultaneously is challenging in that, by doing so, an organisation concentrates on selling its current products while seeking to identify needs in the marketplace that it can serve by innovating. As an example, consider the fact that Ford Motor Co. earns the bulk of its profits by selling large pick-up trucks and sport-utility vehicles. However, for a number of reasons, including environmental sustainability, consumer demand and governmental regulations, the organisation sees electric and plug-in hybrids along with trucks as an opportunity that it should pursue through product innovations. To do this, Ford intends to allocate US$11 billion to R&D between 2018 and 2022 to develop new and innovative transportation products. Volkswagen AG likewise sees electric, plug-in hybrid and driverless products as an opportunity to pursue through innovation and chose to commit US$40 billion to R&D between 2018 and 2023 to develop these products.

The situation for global automobile manufacturers, such as Ford and Volkswagen, which are today earning the majority of their profits by selling gasoline- and diesel-powered cars and trucks, is likely to be far different in the future. Resulting from environmental concerns, some changes in consumer preferences and anticipated regulations are opportunities for these companies to innovate in ways that will result in competitive success. Demonstrating this opportunity are predictions of increases in the sales volume of electric and hybrid vehicles along with the continuing advances with driverless cars and trucks. At the end of 2017, for example, worldwide sales of electric and plug-in hybrid models exceeded three million units. Predictions at that time were that the total number of these units would exceed five million by the end of 2018 and that the rate of annual growth in sales of these types of vehicles beginning in 2019 and continuing would be significant. These predictions yield significant opportunities to innovate as a way to satisfy consumer and societal demands in terms of transportation vehicles.

Driverless vehicles are another opportunity for companies to pursue. In about 2007, General Motors was the first major automaker to envision driverless vehicles as a viable and important opportunity to pursue through innovation. Today, a multitude of companies, including internet organisations (e.g. Amazon), chipmakers (e.g. Microsoft) and software vendors (e.g. Cisco), see driverless vehicles as a viable opportunity to pursue by innovating. Organisations are using different approaches to pursue the driverless vehicle opportunity. Aptiv, the automotive-technology company previously named Delphi Automotive, initially partnered with Lyft, Inc., the ride-sharing organisation. Ford also established a partnership with Lyft as a means of testing its driverless products.


Sedric, the first autonomous automobile from Volkswagen, on display in Geneva, Switzerland.

Source: Getty Images/Bloomberg/Chris Ratcliffe

Given the complexity of the opportunity, driverless vehicles require additional testing and development before becoming a viable option for a significant number of customers. In 2018, some predicted that Ford and General Motors had the highest probability of first introducing a meaningful number of viable driverless products into global markets. Ford, in fact, intends to roll out a fleet of driverless vehicles in 2021 that provides ride-sharing and ride-hailing services.

Automotive companies are not the only ones visualising electric vehicles, plug-in hybrids and self-driving products as an opportunity to pursue. 3M, for example, is focusing on how to tailor many of its products for what it sees as 'auto electrification', such as developing cooling fluids for batteries. 3M also sees driverless vehicles as an opportunity. In early 2018, the organisation tested stickers that are 'transparent to the naked eye but actually contain bar codes that autonomous cars will be able to read' as a means of keeping track of their position. PPG Industries, the Pittsburgh-based paints and coatings manufacturer, is committed to developing car paints 'to become more visible to electronic sensors that guide autonomous vehicles'.

Sources: M. Colias, 2018, Ford increasing electric vehicle investment to $11 billion by 2022, *Wall Street Journal*, http://www.wsj.com, 14 January; T. Higgins, 2018, Driverless-car companies try to rev their engines on commercial prospects, *Wall Street Journal*, http://www.wsj.com, 8 January; T. Higgins, VW, Hyundai turn to driverless-car startup in Silicon Valley, *Wall Street Journal*, http://www.wsj.com, 4 January; A. Levy & L. Kolodny, 2018, Self-driving cars take over CES: Here's how big tech is playing the market, *CNBC News*, http://www.cnbc.com, 12 January; J. C. Reindl, 2018, Next step in driverless cars: Boot the driver, *USA Today*, http://www.usatoday.com, 10 January; D. Muoio, 2017, Ranked: The 18 companies most likely to get self-driving cars on the road first, *Business Insider*, http://www.businessinsider.com, 27 September; J. Stern & C. Mims, 2017, Tech that will change your life in 2018, *Wall Street Journal*, http://www.wsj.com, 27 December; A. Tangel, 2017, Latest entrants into electric car race: Makers of Post-It notes, paint, *Wall Street Journal*, http://www.wsj.com, 26 December.

In Chapter 1, we indicated that *organisational culture* refers to the complex set of ideologies, symbols and core values that are shared throughout the organisation and that influence how an organisation conducts its business. Hence, culture is the social energy that drives – or fails to drive – the organisation. As you can see, at Ford and General Motors the strategic value of innovation is disseminated throughout the business. For organisations to be truly innovative, there are a number of factors that need to be considered in the context of driving an innovative culture, such as setting values that truly depict a desire to be innovative, risk taking and creating, or supporting a learning environment by either a founder of a start-up business, a board of directors of a private or public company, and the CEO or executive team. This is witnessed at organisations such as Ford that use strategic entrepreneurship to integrate their actions to find opportunities, innovate and then implement strategies for the purpose of adding value to the organisation's bottom line. Leaders must leverage organisational structures and processes to build a culture of innovation and manage the perception of risk around innovating if they are to succeed at service innovation.[1]

**STRATEGY NOW**

Driverless cars – innovation at Ford

**strategic entrepreneurship**
taking entrepreneurial actions using a strategic perspective

**Strategic entrepreneurship** is taking entrepreneurial actions using a strategic perspective. In this process, the organisation tries to find opportunities in its external environment that it can try to exploit through innovations. Identifying opportunities to exploit through innovations is the *entrepreneurship* dimension of strategic entrepreneurship, while determining the best way to manage the organisation's innovation efforts is the *strategic* dimension. Thus, organisations engaging in strategic entrepreneurship integrate their actions to find opportunities and to successfully innovate in order to pursue them.[2] In the 21st-century competitive landscape, organisation survival and success depend on an organisation's ability to continuously find new opportunities and quickly produce innovations to pursue them.[3]

To examine strategic entrepreneurship, we consider several topics in this chapter. First, we examine entrepreneurship and innovation in a strategic context. Definitions of entrepreneurship, entrepreneurial opportunities and entrepreneurs as those who engage in entrepreneurship to pursue entrepreneurial opportunities are presented. We then describe international entrepreneurship, a phenomenon reflecting the increased use of entrepreneurship in economies throughout the world. After this discussion, the chapter shifts to descriptions of the three ways organisations innovate. Internally, organisations innovate through either autonomous or induced strategic behaviour. We then describe the actions organisations take to implement the innovations resulting from those two types of strategic behaviours.

In addition, organisations can also develop innovations by using cooperative strategies, such as strategic alliances, and by acquiring other companies to gain access to their innovations and innovative capabilities.[4] Most large, complex organisations use all three methods to innovate. The chapter closes with summary comments about how organisations use strategic entrepreneurship to create value and earn above-average returns.

As emphasised in this chapter, innovation and entrepreneurship are vital for young and old and for large and small organisations, for service companies as well as manufacturing organisations, and for high-technology ventures.[5] In the global competitive landscape, the long-term success of new ventures and established organisations is a function of their ability to meld entrepreneurship with strategic management.[6] A major portion of the material in this chapter is on innovation and entrepreneurship within established organisations. This phenomenon is called **corporate entrepreneurship**, which is the use or application of entrepreneurship within an established organisation.[7] Corporate entrepreneurship has become critical to the survival and success of established organisations.[8] Indeed, established organisations use entrepreneurship to strengthen their performance and to enhance growth opportunities.[9] Of course, innovation and entrepreneurship play a critical role in the degree of success achieved by start-up entrepreneurial ventures as well. Much of the content examined in this chapter is equally important in entrepreneurial ventures (sometimes called 'start-ups') and established organisations.[10]

**corporate entrepreneurship**
the use or application of entrepreneurship within an established organisation

# Entrepreneurship and entrepreneurial opportunities

**Entrepreneurial opportunities** are conditions in which new goods or services can satisfy a need in the market. These opportunities exist because of competitive imperfections in markets and among the factors of production used to produce them or because they were independently developed by entrepreneurs.[11] Strategic entrepreneurial opportunities come in many forms, such as the chance to develop and sell a new product and the chance to sell an existing product in a new market.[12] Organisations should be receptive to pursuing entrepreneurial opportunities whenever and wherever they may surface.[13]

**entrepreneurial opportunities**
conditions in which new goods or services can satisfy a need in the market

We study entrepreneurship at the level of the individual organisation. However, evidence suggests that entrepreneurship is the economic engine driving many nations' economies in the global competitive landscape.[14] Thus, entrepreneurship and the innovation it spawns are important for organisations competing in the global economy and for countries seeking to stimulate economic climates with the potential to enhance the living standards of their citizens.

# Innovation

Innovation is a complex interaction between a number of variables such as intellectual capital, corporate governance, financial performance, leadership, competitive intensity, industry/market and structure.[15] It covers a wide range of activities to improve organisation performance, including the implementation of a new or significantly improved product, service, distribution process, manufacturing process, marketing method or organisational method.[16] A broad definition of innovation is offered in the latest edition of the Oslo Manual and is most applicable to the context of strategic management.[17]

**innovation**
a new or improved product or process that differs from the previous product or process and that has been made available to potential users

**Innovation** is a new or improved product or process (or combination thereof) that differs significantly from the unit's previous products or processes and that has been made available to potential users (product) or brought into use by the unit (process). Innovation is a direct requirement of specific strategies such as differentiation (product innovation) and cost leadership (process innovation). Innovation is also associated with competitive dynamics, and effective innovation results in sustainable competitive advantage. Due to the link between the development of competitive advantages, many entities are interested in producing innovations and in effectively managing the **innovation process**. In relation to the management of the

**innovation process**
based on the need to commit resources and the consideration of the uncertainty of returns from innovative investments

innovation process in service organisations, innovation must be a strategic task; it must have a broad organisational process; and the innovation process should follow the four stage approach of idea generating, transformation into an innovation project, development and implementation.

The Oslo Manual defines four types of innovation, as described in Table 13.1.

**Table 13.1 Four types of innovation**

| Type of innovation | Definition |
|---|---|
| Product innovation | A good or service that is new or significantly improved. This includes significant improvements in technical specifications, components and materials, software in the product, user friendliness or other functional characteristics. |
| Process innovation | A new or significantly improved production or delivery method. This includes significant changes in techniques, equipment and/or software. |
| Marketing innovation | A new marketing method involving significant changes in product design or packaging, product placement, product promotion or pricing. |
| Organisational innovation | A new organisational method in business practices, workplace organisation or external relations. |

Source: Organisation for Economic Cooperation and Development (OECD), 2018, *Oslo Manual: Guidelines for Collecting and Interpreting Innovation Data*, 4th edn, Paris: OECD, pp. 20–1.

The innovation process is based on the need to commit resources and the consideration of the uncertainty of returns from innovative investments, which requires a need for a control of resources by the decision makers who shape the innovative process.[18] Peter Drucker argued that 'innovation is the specific function of entrepreneurship, whether in an existing business, a public service institution or a new venture started by a lone individual'.[19] Moreover, Drucker suggested that innovation is 'the means by which the entrepreneur either creates new wealth-producing resources or endows existing resources with enhanced potential for creating wealth'.[20] Thus, entrepreneurship and the innovation resulting from it are critically important for all organisations. The realities of competition in the competitive landscape of the 21st century suggest that to be market leaders, companies must regularly develop innovative products desired by customers. This means that innovation should be an intrinsic part of virtually all of an organisation's activities.[21]

Innovation is a key outcome organisations seek through entrepreneurship and is often the source of competitive success, especially in turbulent, highly competitive environments.[22] For example, research results show that organisations competing in global industries that invest more in innovation also achieve the highest returns.[23] In fact, investors often react positively to the introduction of a new product, thereby increasing the price of an organisation's shareholding. Furthermore, 'innovation may be required to maintain or achieve competitive parity, much less a competitive advantage in many global markets'.[24] Investing in the development of new technologies can increase the performance of organisations that operate in different but related product markets (refer to the discussion of related diversification in Chapter 6). In this way, the innovations can be used in multiple markets, and return on the investments is earned more quickly.[25] Innovation is largely market driven, but also is driven by organisational culture and should be related to the strategy of the organisation. There are a number of barriers to innovation including costs and legislative requirements.[26]

**invention**
the act of creating or developing a new product or process

In his classic work, Joseph Schumpeter argued that organisations engage in three types of innovative activities: invention, innovation and imitation.[27] **Invention** is the act of creating or developing a new product or process. *Innovation* is the process of creating a commercial product from an invention. It begins after an invention is chosen for development.[28] Thus, an invention brings something new into being, while an innovation brings something new into use. Accordingly, technical criteria are used to determine the success of an invention, whereas commercial criteria are used to determine the success of an innovation.[29] Finally, **imitation** is the adoption of a similar innovation by different organisations. Imitation usually leads to product or process standardisation, and products based on imitation often are offered at lower prices, but without as many features. Entrepreneurship is critical to innovative activity in that it acts as the linchpin between invention and innovation.[30]

**imitation**
the adoption of an innovation by similar organisations

## Product innovation

The term 'product' is defined in the System of National Accounts and encompasses both goods and services; products are the economic output of production activities.[31] They can be exchanged and used as inputs in the production of other goods and services, as final consumption by households or governments, or for investment, as in the case of financial products. A **product innovation** is a new or improved good or service that differs significantly from the organisation's previous goods or services and that has been introduced on the market.

**product innovation**
a good or service that is new or significantly improved, including significant improvements in technical specifications, components and materials, software in the product, user friendliness or other functional characteristics

Product innovations provide for significant improvements to one or more characteristics or performance specifications. This includes the addition of new functions, or improvements to existing functions or user utility. Relevant functional characteristics include quality, technical specifications, reliability, durability, economic efficiency during use, affordability, convenience, usability and user friendliness. Product innovations do not need to improve all functions or performance specifications. An improvement to or addition of a new function can also be combined with a loss of other functions or a decline in some performance specifications.

An additional characteristic of both goods and services that may influence usability or utility is product design. New designs or improved design features can influence the appearance or 'look' of a product and consequently enhance the user's utility; for example, through a substantial design change that creates a positive emotional response.[32]

Many organisations are able to create ideas that lead to inventions, albeit commercialising those inventions has, at times, proved difficult.[33] This difficulty is suggested by the fact that approximately 80 per cent of R&D occurs in large organisations, but these same organisations produce fewer than 50 per cent of the patents.[34] Patents are a strategic asset and the ability to regularly produce them can be an important source of competitive advantage, especially when an organisation intends to commercialise the invention and when the organisation competes in a knowledge-intensive industry (e.g. pharmaceuticals).[35]

**entrepreneurs**
individuals, acting independently or as part of an organisation, who see an entrepreneurial opportunity and then take risks to develop an innovation to pursue it

# Entrepreneurs

**Entrepreneurs** are individuals, acting independently or as part of an organisation, who perceive an entrepreneurial opportunity and then take risks to develop an innovation to exploit it. Entrepreneurs can be found throughout an organisation, from executive managers to those working to produce an organisation's goods or services. Entrepreneurs are found throughout organisations such as Amazon, Appen, Atlassian and Afterpay, for example. At Amazon many employees devote a portion of their time to developing ideas and innovations. Entrepreneurs tend to demonstrate several characteristics: they are highly motivated, willing to take responsibility for their projects, self-confident and often optimistic.[36] In addition, entrepreneurs tend to be passionate, have a vision and be emotional about the value and importance of their innovation-based ideas.[37] They are able to deal with uncertainty and risk, and are more alert to opportunities than others.[38] Interestingly, recent research found that genetic factors partly influence people to engage in entrepreneurship.[39] To be successful, entrepreneurs often need to have good social skills and be able to plan exceptionally well (e.g. to obtain venture capital).[40]

STRATEGY NOW
Entrepreneurship at Amazon

Entrepreneurship entails much hard work to create a vision and achieve success.

Evidence suggests that successful entrepreneurs have an entrepreneurial mindset. The person with an **entrepreneurial mindset** values uncertainty in the marketplace and seeks to continuously identify

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

opportunities with the potential to lead to important innovations.[41] Because it has the potential to lead to continuous innovations, an individual's entrepreneurial mindset can be a source of competitive advantage for an organisation.[42] Entrepreneurial mindsets are fostered and supported when knowledge is readily available throughout an organisation. Indeed, research has shown that units within organisations are more innovative when they have access to new knowledge.[43] Transferring knowledge, however, may be difficult, often because the receiving party must have adequate absorptive capacity (or the ability) to learn the knowledge.[44] Learning requires that the new knowledge be linked to the existing knowledge. Thus, managers need to develop the capabilities of their human capital to build on their current knowledge base while incrementally expanding that knowledge.[45]

# International entrepreneurship

**international entrepreneurship**
a process in which organisations creatively discover and exploit opportunities that are outside their domestic markets in order to develop a competitive advantage

**International entrepreneurship** is a process in which organisations creatively discover and exploit opportunities that are outside their domestic markets in order to develop a competitive advantage.[46] As the practices suggested by this definition show, entrepreneurship is a global phenomenon.[47] As noted earlier, approximately one-third of new ventures move into international markets early in their life cycle. Most large established organisations have significant foreign operations and often start new ventures in domestic and international markets. Large multinational companies, for example, generate approximately 54 per cent of their sales outside their domestic market, and more than 50 per cent of their employees work outside of the company's home country.[48]

A key reason that entrepreneurship has become a global phenomenon is that, in general, internationalisation leads to improved organisation performance.[49] Nonetheless, decision makers should recognise that the decision to internationalise exposes their organisations to various risks, including those of unstable foreign currencies, problems with market efficiencies, insufficient infrastructures to support businesses and limitations on market size.[50] Thus, the decision to engage in international entrepreneurship should be a product of careful analysis.

Even though entrepreneurship is a global phenomenon, the rate of entrepreneurship differs across countries.[51] A study of 43 countries found that adults involved in entrepreneurial activity ranged from a high of more than 45 per cent in Bolivia (although this appears incongruous compared with Bolivia's low prosperity) to a low of approximately 4.4 per cent in Russia. Importantly, this study also found a strong positive relationship between the rate of entrepreneurial activity and economic development in a country.[52]

Culture is one of the reasons for the differences in rates of entrepreneurship among different countries. The research suggests that a balance between individual initiative and a spirit of cooperation and group ownership of innovation is needed to encourage entrepreneurial behaviour. For organisations to be entrepreneurial, they must provide appropriate autonomy and incentives for individual initiative to surface, but they must also promote cooperation and group ownership of an innovation if it is to be implemented successfully. Thus, international entrepreneurship often requires teams of people with unique skills and resources, especially in cultures that highly value individualism or collectivism. In addition to a balance of values for individual initiative and cooperative behaviours, organisations must build the capabilities to be innovative and acquire the resources needed to support innovative activities.[53]

The level of investment outside of the home country made by young ventures is also an important dimension of international entrepreneurship. In fact, with increasing globalisation, a greater number of new ventures have been 'born global'.[54] Research has shown that new ventures that enter international markets increase their learning of new technological knowledge and thereby enhance their performance.[55]

The probability of entering international markets increases when the organisation has top executives with international experience, which increases the likelihood of the organisation successfully competing in those markets.[56] Because of the learning and economies of scale and scope afforded by operating in international markets, both young and established internationally diversified organisations often are stronger competitors in their domestic market as well. Additionally, as research has shown, internationally diversified organisations are generally more innovative.[57]

The ability of organisations to gain and sustain a competitive advantage may be based partly or largely on their capability to produce innovations. Thus, we next discuss different types of innovations.

# Internal innovation

In established organisations, most innovation comes from efforts in R&D. Effective R&D often leads to organisations filing for patents to protect their innovative work. Increasingly, successful R&D results from integrating the skills available in the global workforce. Thus, the ability to have a competitive advantage based on innovation is more likely to accrue to organisations capable of integrating the talent of human capital from countries around the world.[58]

Increasingly, it seems possible that in the 21st-century competitive landscape, R&D may be the most critical factor in gaining and sustaining a competitive advantage in some industries, such as pharmaceuticals. Larger, established organisations, and certainly those competing globally, often try to use their R&D labs to create disruptive new technologies and products. Being able to innovate in this manner can create a competitive advantage for organisations in many industries.[59] Although critical to long-term corporate success, the outcomes of R&D investments are uncertain and often not achieved in the short term, meaning that patience is required as organisations evaluate the outcomes of their R&D efforts.[60]

## Incremental and radical innovation

Organisations produce two types of internal innovations – incremental and radical innovations – when using their R&D activities. The division between incremental and radical innovations[61] is that incremental innovations, 'produce only small jumps'[62] while 'radical' innovations would create disruptive changes. Incremental innovation refers to 'do better' innovations, including extensions to original concepts. On the other hand, radical innovation describes, 'do different' innovations that are completely new ways of doing things.[63]

Most innovations are *incremental*; that is, they build on existing knowledge bases and provide small improvements in the current product lines. Incremental innovations are evolutionary and linear in nature.[64] 'The markets for incremental innovations are well defined, product characteristics are well understood, profit margins tend to be lower, production technologies are efficient, and competition is primarily on the basis of price.'[65] Adding a different kind of whitening agent to a soap detergent is an example of an incremental innovation, as are improvements in televisions over the past few decades. Organisations launch far more incremental innovations than radical innovations because they are less expensive, easier and faster to produce, and involve less risk, although even incremental innovation can be risky if it creates too much change for the organisation to absorb.[66]

Radical innovations, which are revolutionary and non-linear in nature, typically use new technologies to serve newly created markets. The development of the original personal computer (PC) was a radical innovation at the time, as was the cochlear implant to aid the severely deaf. Reinventing the computer by developing a 'radically new computer-brain chip' (e.g. with the capability to process a trillion calculations per second) is another example of a radical innovation. Obviously, such a radical innovation would seem to have the capacity to revolutionise the tasks computers can perform. In 2020, the joint venture between Intel and Nokia on silicon technology innovations for 5G New Radio and cloud infrastructure will be considered to be radical innovations.[67]

Because they establish new functionalities for users, radical innovations have strong potential to lead to significant growth in revenue and profits. For example, Toyota's innovation, embodied in the Prius, 'the first mass-produced hybrid-electric car', changed the industry in this segment.[68] Developing new processes is a critical part of producing radical innovations. Both types of innovations can create value, meaning that organisations should determine when it is appropriate to emphasise either incremental or radical innovation. However, radical innovations have the potential to contribute more significantly to an organisation's efforts to earn above-average returns, although they may be more risky.

Radical innovations are rare because of the difficulty and risk involved in developing them. The value of the technology and the market opportunities are highly uncertain.[69] Because radical innovation creates new knowledge and uses only some or little of an organisation's current product or technological knowledge, creativity is required.

Creativity is an outcome of using one's imagination. In the words of Jay Walker, founder of Priceline.com, 'Imagination is the fuel. You're not going to get innovation if you don't have imagination'. Imagination finds organisations thinking about what customers will want in a changing world. For example, Walker says, those seeking to innovate within an organisation could try to imagine 'what the customer is going to want in a world where, for instance, their cellphone is in their glasses'.[70] Imagination is more critical to radical than incremental innovations.

Surveys suggest that 'creativity and innovation are the number 1 strategic priorities for organizations the world over'.[71] However, creativity alone does not directly lead to innovation. Rather, creativity as generated through imagination discovers, combines or synthesises current knowledge, often from diverse areas.[72] Increasingly, when trying to innovate, organisations seek knowledge from current users to understand their perspective about what could be beneficial innovations to the organisation's products.[73] Collectively, employees use gathered knowledge to develop new, innovative products to introduce to new markets and to capture new customers, and gain access to new resources while doing so. Often, separate business units that start internal ventures produce the types of innovations that lead to these positive outcomes.

An Amazon Dash Button allows customers to quickly reorder household items.

Source: Newscom/Splash News/Amazon

Strong, supportive leadership is required for the type of creativity and imagination needed to develop radical innovations. The fact that creativity is 'messy, chaotic, sometimes even disgusting, and reeks of failure, experimentation, and disorganization'[74] is one set of reasons why leadership is so critical to its success.

Some companies have actually built creativity into their culture DNA; for example, Pixar/Disney Animation Studios has achieved legendary levels of creativity not only by hiring good individuals, but also in the way it designs and runs its teams.[75]

Internal corporate venturing is the name used to capture this set of deliberate activities – activities that organisations use to develop internal inventions and particularly internal innovations.[76]

# Implementing internal innovations

An entrepreneurial mindset is required to be innovative and to develop successful internal corporate ventures. Because of environmental and market uncertainty, individuals and organisations must be willing to take risks to commercialise innovations. Although they must continuously attempt to identify opportunities, they must also select and pursue the best opportunities and do so with discipline. Employing an entrepreneurial mindset entails not only developing new products and markets but also execution in order to do these things effectively. Often organisations will provide incentives to managers to be entrepreneurial and to commercialise innovations.[77]

Having processes and structures in place through which an organisation can successfully implement the outcomes of internal corporate ventures and commercialise the innovations is critical. In the context of internal corporate ventures, managers must allocate resources, coordinate activities, communicate with many different parties in the organisation, and make a series of decisions to convert the innovations resulting from either autonomous or induced strategic behaviours into successful market entries.[78] As we described in Chapter 11, organisational structures are the sets of formal relationships that support the processes managers use to commercialise innovations.

Effective integration of the various functions involved in innovation processes – from engineering to manufacturing and, ultimately, market distribution – is required to implement the incremental and radical innovations resulting from internal corporate ventures.[79] Increasingly, product development teams are being used to integrate the activities associated with different organisational functions. Such integration involves coordinating and applying the knowledge and skills of different functional areas in order to maximise innovation.[80] Teams must help to make decisions as to which projects should be commercialised and which ones should end. Although ending a project is difficult, sometimes because of emotional commitments to innovation-based projects, effective teams recognise when conditions change such that the innovation cannot create value as originally anticipated.

## Cross-functional product development teams

Cross-functional teams facilitate efforts to integrate activities associated with different organisational functions, such as design, manufacturing and marketing. These teams may also include representatives from major suppliers because they can facilitate the organisation's innovation processes.[81] In addition, new product development processes can be completed more quickly and the products more easily commercialised when cross-functional teams work effectively.[82] Using cross-functional teams, product development stages are grouped into parallel or overlapping processes to allow the organisation to tailor its product development efforts to its unique core competencies and to the needs of the market.

Horizontal organisational structures support the use of cross-functional teams in their efforts to integrate innovation-based activities across organisational functions.[83] Therefore, instead of being designed around vertical hierarchical functions or departments, the organisation is built around core horizontal processes that are used to produce and manage innovations. Some of the core horizontal processes that are critical to innovation efforts are formal; they may be defined and documented as procedures and practices. More commonly, however, these processes are informal. Such informal processes are critical to successful innovations and are supported properly through horizontal organisational structures more so than through vertical organisational structures.

Two primary barriers that may prevent the successful use of cross-functional teams as a means of integrating organisational functions are independent frames of reference of team members and organisational politics.[84] Team members working within a distinct specialisation (e.g. a particular organisational function) may have an independent frame of reference typically based on common backgrounds and experiences. They are likely to use the same decision criteria to evaluate issues such as product development efforts as they do within their functional units. Research suggests that functional departments vary along four dimensions: time orientation, interpersonal orientation, goal orientation and formality of structure.[85] Thus, individuals from different functional departments having different orientations on these dimensions can be expected to perceive product development activities in different ways. For example, a design engineer may consider the characteristics that make a product functional and workable to be the most important of the product's characteristics. Alternatively, a person from the marketing function may judge characteristics that satisfy customer needs to be most important. These different orientations can create barriers to effective communication across functions and even produce conflict in the team at times.[86]

Organisational politics is the second potential barrier to effective integration in cross-functional teams. In some organisations, considerable political activity may centre on allocating resources to different functions. Inter-unit conflict may result from aggressive competition for resources among those representing different organisational functions. This dysfunctional conflict between functions creates a barrier to their integration.[87] Methods must be found to achieve cross-functional integration without excessive political conflict and without changing the basic structural characteristics necessary for task specialisation and efficiency. One suggestion is the use of an organisational structure that is based on an *organic model* (rather than a mechanistic model) that uses cross-hierarchical and cross-functional teams, low formalisation, a comprehensive information network and high participation in decision making.

## Facilitating integration and innovation

Shared values and effective leadership are important for achieving cross-functional integration and implementing innovation.[88] Highly effective shared values are framed around the organisation's vision and mission and become the glue that promotes integration between functional units. Thus, the organisation's culture promotes unity and internal innovation.[89]

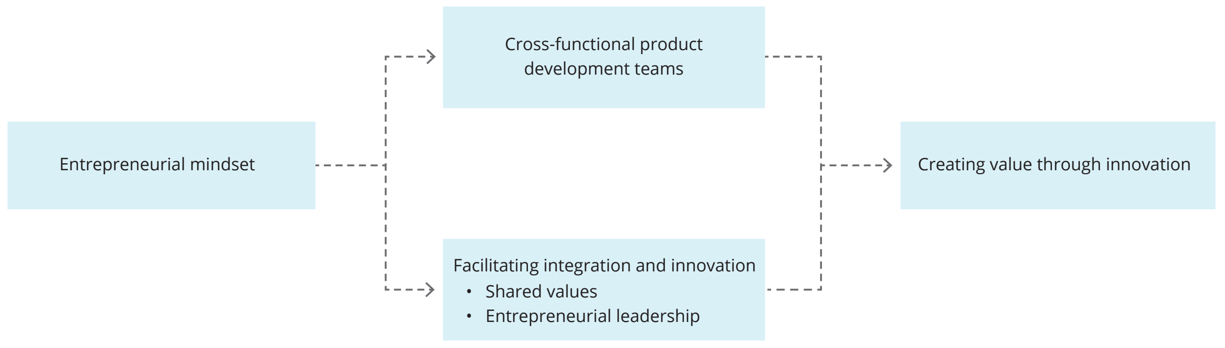
Strategic leadership is also highly important for achieving cross-functional integration and promoting innovation. Leaders set the goals and allocate resources. The goals include integrated development and commercialisation of new goods and services. Effective strategic leaders also ensure a high-quality communication system to facilitate cross-functional integration. A critical benefit of effective communication is the sharing of knowledge among team members. Effective communication thus helps create synergy and gains team members' commitment to an innovation throughout the organisation. Shared values and leadership practices shape the communication systems that are formed to support the development and commercialisation of new products.[90]

## Creating value from internal innovation

The model in Figure 13.1 shows how organisations can create value from the internal corporate venturing processes they use to develop and commercialise new goods and services. An entrepreneurial mindset is necessary so that managers and employees will consistently try to identify entrepreneurial opportunities the organisation can pursue by developing new goods and services and new markets. Cross-functional teams are important for promoting integrated new product design ideas and commitment to their subsequent implementation. Effective leadership and shared values promote integration and vision for innovation and commitment to it. The end result for the organisation is the creation of value for customers and shareholders by developing and commercialising new products.[91] We should acknowledge that not all entrepreneurial efforts succeed, even with effective management. Sometimes managers must exit the market as well to avoid value decline.[92]

In the next two sections, we discuss the other ways organisations innovate: by using cooperative strategies and by acquiring companies with potential to create innovation.

**Figure 13.1** **Creating value through innovation processes**



# Innovation through cooperative strategies

The majority of global organisations would lack the breadth and depth of resources (e.g. human capital and social capital) in the R&D activities needed to internally develop a sufficient number of innovations to meet the needs of the market and remain competitive. As indicated in this chapter's opening case, organisations must be open to using external resources to help produce innovations.[93] Alliances with other organisations can contribute to innovations in several ways. First, they provide information on new business opportunities and how to exploit them.[94] In other instances, organisations use cooperative strategies to align what they believe are complementary assets with the potential to lead to future innovations. (Refer to Chapter 9 for more detail about cooperative strategies.) In fact, research suggests that such innovation will lead to 'breakthroughs' and new product classes more often than other modes.[95]

The rapidly changing technologies of the 21st-century competitive landscape, globalisation and the need to innovate at world-class levels are primary influences on organisations' decisions to innovate by cooperating with other companies. Indeed, some believe that because of these conditions, organisations are becoming increasingly dependent on cooperative strategies as a path to successful competition in the global economy.[96] Even older organisations such as P&G and 3M have learned that they need help to create the innovations necessary to be competitive in a 21st-century environment; for example, P&G produces Glad-brand plastic bags in a joint venture with Clorox.[97]

Both entrepreneurial organisations and established organisations use cooperative strategies (e.g. strategic alliances and joint ventures) to innovate. An entrepreneurial organisation, for example, may seek investment capital as well as established organisations' distribution capabilities to successfully introduce one of its innovative products to the market.[98] Alternatively, more established companies may need new technological knowledge and can gain access to it by forming a cooperative strategy with entrepreneurial ventures.[99] Alliances between large pharmaceutical organisations and biotechnology companies increasingly have been formed to integrate their knowledge and resources to develop new products and bring them to market.[100]

Because of the importance of strategic alliances, particularly in the development of new technology and in commercialising innovations, organisations are beginning to build networks of alliances that represent a form of social capital to them.[101] Building social capital in the form of relationships with other organisations provides access to the knowledge and other resources necessary to develop innovations.[102] Knowledge from these alliances helps organisations develop new capabilities.[103] Some organisations seek other companies to participate in their internal new product development processes. It is not uncommon, for example, for organisations to have supplier or customer representatives on their cross-functional innovation teams because of the importance of their input to ensure quality materials for any new product developed.[104]

However, alliances formed for the purpose of innovation are not without risks. In addition to the conflict that is natural when organisations try to work together to reach a mutual goal, cooperative strategy participants also take the risk that a partner will appropriate an organisation's technology or knowledge and use it to enhance its own competitive abilities.[105] To prevent or at least minimise this risk, organisations (and particularly new ventures) need to select their partners carefully. The ideal partnership is one in which the organisations have complementary skills as well as compatible strategic goals.[106] However, because companies are operating in a network of organisations and thus may be participating in multiple alliances simultaneously, they encounter challenges in managing the alliances. Research has shown that organisations can become involved in too many alliances, which can harm rather than facilitate their innovation capabilities.[107] Thus, effectively managing a cooperative strategy to produce innovation is critical.

As explained in the 'Strategic focus' feature, social networking internet sites are highly popular with the general public and with professionals as well. Furthermore, entrepreneurs have begun to use them to facilitate their businesses. These sites provide many opportunities for businesses and especially for gaining access to ideas and information. Therefore, they can facilitate innovation. Organisations can use them to identify unique product ideas, conduct market research, and access new markets and new customers. As the 'Strategic focus' illustrates, they are also being used to facilitate innovation communities such as application development for iPhone and Android smartphones. As a result, social networking sites are highly valuable business mechanisms.

**Strategic focus** | Technology

## Social networking websites facilitate innovation: application software innovation

Social networks have been one of the major innovations in the first two decades of the 21st century. Among popular and important social networking internet sites are Facebook, Twitter, Instagram, WhatsApp, Snapchat, WeChat, Tumblr and LinkedIn. For example, Facebook is beginning to disrupt established internet companies such as Yahoo! and Google. It is now competing with Google and Microsoft for top engineering talent. It is the largest social network site globally and one of the most widely used sites daily. COO Sheryl Sandberg said, 'We think every industry is going to be rebuilt around social engagement'. Facebook boasts more than 1.66 billion daily active users, an increase of 9 per cent since 2018, and 2.5 billion users monthly as of December 2019, which is an increase of 8 per cent since 2018. Many users are doing online shopping through the Facebook portal, and its electronic payments rivals PayPal, Applepay and Afterpay.

As a social network site, Facebook has become popular to facilitate connections between game developers and application developers for Apple's iPhone and iPad, as well as for Google's Android platform. Also, Facebook executives are encouraging developers to write Facebook apps using a technology standard called HTML5. Facebook is using HTML5 to enhance its own mobile offering used on iPhones and Android phones. The HTML5 platform is compatible with Apple's iOS operating system and Google's Android system. As such, the Facebook applications can be written for browser users in different operating systems without completely rewriting the code for each system. Furthermore, Facebook is popular with software developers because it can help such developers gain greater visibility among social network peers and companies who are using their software. However, Facebook is far from being a dominant player in the mobile area because many of its software utilities are currently only on Facebook's website without mobile phone applications.

Besides being used for application software development networking, social networking sites are also being used to identify potential new employees and to make all types of professional and business contacts. They provide access to new ideas and information that can be useful for solving problems and even for making strategic decisions. The access to information and ideas makes these sites excellent sources in the innovation process. For example, the use of cross-functional teams and incorporating suppliers and customers to facilitate the development of new products has been valuable because of the integration of diverse ideas incorporating multiple and important perspectives. However, social networking sites provide access to many more diverse perspectives and ideas and can be used for these functions as well. In addition, the opportunity to perform virtual market tests with a large sample from the market exists with these sites. Finally, social networking sites provide the opportunity to identify new and different markets for existing and new product ideas. Therefore, if managed properly, they could be highly valuable in the innovation process, from the identification of new product ideas through market research, and to reach many new potential customers.

Sources: Facebook, 2019, *Facebook Annual Report 2019*, https://www.annualreports.com/Company/facebook; G. A. Fowler & Y. I. Kane, 2011, Digital media: Facebook seeks bigger role in software for mobile apps, *Wall Street Journal*, 17 June, B5; G. A. Fowler, 2011, Facebook's web of frenemies, *Wall Street Journal*, 15 February, B1; B. Stone, 2011, Why Facebook needs Sheryl Sandberg, *Bloomberg Businessweek*, http://www.businessweek.com, 16 May; Q. Hardy, 2011, Adobe is watching every click, *Forbes*, http://www.forbes.com, 11 April; J. Hempel, 2011, Trouble @ Twitter, *Fortune*, 2 May, 66; J. Light, 2011, Managing & careers – theory & practice: At mature techs, a young vibe – H-P, IBM, Microsoft pour on the charm to compete for talent with start-ups, *Wall Street Journal*, 13 June, B7; B. Remneland-Wikhamn, J. Ljungberg, N. Bergquist & J. Kuschel, 2011, Open innovation, generativity and the supplier as peer: The case of iPhone and Android, *International Journal of Innovation Management*, 15(1): 205–30; Q. Hardy, 2010, Google's Android attack, *Forbes*, http://forbes.com, 20 December.

# Innovation through acquisitions

Organisations sometimes acquire companies to gain access to their innovations and to their innovative capabilities. One reason organisations make these acquisitions is that the capital market values growth; acquisitions provide a means to rapidly extend one or more product lines and increase the organisation's revenues. Google has a constant stream of innovation-related acquisitions; since 2001 it has spent US$29 billion on its top 10 acquisitions.[108] Google purchased Motorola Mobility for US$12.5 billion in 2012, and Nest Labs for US$3.2 billion in 2014, which landed Google entry into the home automation space. DoubleClick was purchased in 2007 for US$3.1 billion, an acquisition intended to complement Google's existing advertising business. The Looker and Fitbit businesses were both acquired in 2019 for US$4.7 billion. Google has an expectation with the acquisition of Fitbit that it will strengthen its Wear OS efforts as it attempts to strategically catch up with Apple. YouTube, Waze, HTC, AdMob and ITA software were further acquisitions.[109] Acquisitions should always have a strategic rationale and be aligned to the strategic planning for the organisation.

Several large pharmaceutical organisations have made acquisitions for enhancing their growth proposition. A primary reason for acquisitions in this industry has been to acquire innovation capability – for example, new product development in terms of new drugs that can be commercialised for global markets. In this way, organisations strengthen their new product pipelines. For example, Teva Pharmaceuticals purchased Cephalon after outbidding Valeant Pharmaceuticals. Cephalon produces a medication for narcolepsy, a sleep disorder that causes excessive sleepiness, allowing Teva to expand into this remedy area.[110]

Similar to internal corporate venturing and strategic alliances, acquisitions are not a risk-free approach to innovating. A key risk of acquisitions is that an organisation may substitute an ability to buy innovations for an ability to produce innovations internally. Some analysts fear this is the case for Broadcom Ltd (described in the 'Strategic focus' feature) because the organisation focuses almost exclusively on acquiring other organisations to gain access to their innovations. Individuals with positions in the acquired companies sometimes indicate that, as part of the Broadcom integration process, fewer allocations flow to the research and development function.[111] Reducing allocations to R&D may result when an organisation concentrates on financial controls to identify, evaluate and then manage acquisitions. Of course, strategic controls are the ones through which an organisation identifies a strategic rationale to acquire another company as a means of developing innovations. Thus, the likelihood an organisation will achieve success through its efforts to innovate increases by developing an appropriate balance between financial and strategic controls. In support of this contention, research shows that organisations engaging in acquisitions introduce fewer new products into the market.[112] This substitution may take place because organisations lose strategic control and focus instead on financial control of their original and, especially, of their acquired business units. Yet the careful selection of companies to acquire – ones with complementary science and technology knowledge – can enhance innovation if the knowledge acquired is used effectively.[113]

We noted in Chapter 7 that organisations may also learn new capabilities from organisations they acquire. Thus, organisations may gain capabilities to produce innovation from an acquired company. Additionally, organisations that emphasise innovation and carefully select companies for acquisition that also emphasise innovation are likely to remain innovative.[114] Likewise, organisations must manage well the integration of the acquired organisation's technical capabilities so that they remain productive and continue to produce innovation after the acquired organisation is merged into the acquiring organisation.[115] Cisco has been highly successful with the integration of acquired technology organisations. Cisco managers take great care not to lose key personnel in the acquired organisation, realising they are the source of many innovations.

## Strategic focus | Technology

## Will these acquisitions lead to innovation success or to strategic failure?

As stakeholders, investors value corporate growth. Innovations have the capacity to contribute to organisation growth. Compared to internal innovation and innovation resulting from cooperative strategies, organisations grow quicker and have immediate access to another company's innovations when using an acquisition strategy. Because of this, acquisitions remain a popular approach to innovation, particularly for large established organisations.

In 2018, merger and acquisition activity was strong. Growing by gaining access to others' innovations and their innovating capabilities was seen as a key reason for this. At this time, the pharmaceuticals industry was engaged in what analysts called a 'deal frenzy', including such acquisitions as Celgene's intended purchase of cancer specialist Juno Therapeutics and Sanofi SA's decision to acquire Bioverativ Inc. Celgene agreed to pay an approximate 90 per cent premium to acquire Juno, while Sanofi paid a 63 per cent premium to purchase Bioverativ. Driving these acquisitions was Celgene's desire to gain access to Juno's innovative capabilities in the area of developing cancer treatments and, specifically, to acquire ownership of the organisation's new lymphoma treatment. Expected to gain regulatory approval in 2019, the treatment, called JCAR017, had the potential to reach US$3 billion in global sales quickly. To stimulate future innovations, Celgene planned to integrate some of the organisations' research and development capabilities into Juno's laboratories located in Seattle, WA. Speaking about the organisations' combined interest and skills, Celgene's CEO said that by acquiring Juno, he was 'bringing together two organizations with a shared vision to make cancer a chronic illness while we work toward a cure'. For Sanofi, its interest in part was to gain access to Bioverativ's haemophilia drugs. In commenting about this, an analyst said the following: 'Bioverativ's hemophilia drugs will fit in Sanofi's rare-disease business and complement the company's collaboration with biotech Alnylam Pharmaceuticals Inc. in developing a new kind of hemophilia therapy using an emerging technology called RNA interference'. Here then, the acquiring and acquired companies' innovation capabilities will be integrated partly to continue collaborating with a third company to develop innovative medical products.

The premiums these organisations paid to acquire innovations and innovative capabilities are significant. Nonetheless, they were consistent with the average premium of 89 per cent paid in the pharmaceutical industry at this time – a premium almost double the median paid in this industry in 2010. The premiums paid reflect the need for pharmaceutical companies to acquire others to plug holes in their product lines and to gain access to promising products and innovations. Also stimulating acquisitions here is the failure to develop new products through internal efforts. In 2018, for example, Pfizer Inc. announced that it would 'stop trying to discover new drugs for Alzheimer's disease and Parkinson's disease, abandoning costly but futile efforts to find effective treatments for the disorders'. The future might find Pfizer trying to acquire organisations with promising products and/or with capabilities to develop successful treatments for these diseases.


Mark Millar, comic book creator of iconic characters such as Thor, Peter Parker and Kick-Ass, speaks at Comic Con. In February 2018, Netflix and Millarworld announced that *The Magic Order* comic book would be the companies' first collaboration, which appeared in stores June of that year.

Source: ZUMA Wire/Future-Image/Susanne Doepke

Of course, organisations in industries other than pharmaceuticals acquire innovation. Netflix completed its first acquisition by buying Millarworld, a streaming media company. 'Millarworld is the independent comic publishing company founded by Mark Millar, a storied comic book creator who is behind a host of iconic characters and series, including Kick-Ass and Kingsman, as well as the creative force behind some of Marvel's best story arcs, including *The Ultimates* and *Old Man Logan*.' In essence, Netflix wanted access to Millarworld's innovative storytelling ability on a going-forward basis. In the short term, the organisation intended to bring Millarworld's portfolio to the screen through films, TV series and kids' shows.

In what many call 'the innovation obsessed technology industry', Broadcom Ltd CEO Hock Tan 'unapologetically favors surefire profits over visionary projects'. Through what analysts saw as an increasingly bold acquisition strategy, Tan made Broadcom the industry's most visible deal-maker. In building his organisation, Tan clearly prefers to acquire innovation rather than to develop it internally or via cooperative strategies.

Sources: C. Grant, 2018, High prices won't deter biotech deals, *Wall Street Journal*, http://www.wsj.com, 22 January; T. Greenwald, 2018, Is Broadcom's CEO, a champion deal maker, innovative enough? *Wall Street Journal*, http://www.wsj.com, 25 January; C. Lombardo, 2018, Celgene to buy Juno Therapeutics for $9 billion, *Wall Street Journal*, http://www.wsj.com, 22 January; J. D. Rockoff, 2018, Big drugmakers pay big prices for promising biotechs, *Wall Street Journal*, http://www.wsj.com, 22 January; J. D. Rockoff, 2018, Pfizer ends hunt for drugs to treat Alzheimer's and Parkinson's, *Wall Street Journal*, http://www.wsj.com, 6 January; J. D. Rockoff, D. Cimilluca & B. Dummett, 2018, Celgene nears deal to buy Impact Biomedicines for as much as $7 billion, *Wall Street Journal*, http://www.wsj.com, 7 January; A. Bylund, 2017, Netflix, Inc. just made its first-ever acquisition, Motley Fool, http://www.fool.com, 7 August.

This chapter closes with an assessment of how strategic entrepreneurship helps organisations create value for stakeholders through its operations.

# Creating value through strategic entrepreneurship

Newer entrepreneurial organisations often are more effective than larger established organisations in the identification of entrepreneurial opportunities.[116] As a consequence, entrepreneurial ventures often produce more radical innovations than do their larger, more established counterparts. Entrepreneurial ventures' strategic flexibility and willingness to take risks at least partially account for their ability to identify opportunities and then develop radical innovations to exploit them.

Alternatively, larger and well-established organisations often have more resources and capabilities to exploit identified opportunities.[117] Younger entrepreneurial organisations generally excel in the opportunity-seeking dimension of strategic entrepreneurship, while more established organisations generally excel in the advantage-seeking dimension. However, to compete effectively in the 21st-century competitive landscape, organisations must not only identify and exploit opportunities but also do so while achieving and sustaining a competitive advantage.[118] Thus, on a relative basis, newer entrepreneurial organisations must learn how to gain a competitive advantage (advantage-seeking behaviours), and older, more established organisations must relearn how to identify entrepreneurial opportunities (opportunity-seeking skills).

In some large organisations, action is being taken to deal with these matters. For example, an increasing number of large organisations have created a new executive managerial position, commonly titled Chief Strategic Officers, Director of Marketing or General Manager of Business Development, to consider and develop emerging brands. The essential responsibility of people holding these positions is to find entrepreneurial opportunities for their organisations. If a decision is made to pursue one or more of the identified opportunities, this person also leads the analysis to determine whether the innovations should be internally developed, pursued through a cooperative venture or acquired. The objective is to help organisations develop successful innovations.

To be entrepreneurial, organisations must develop an entrepreneurial mindset among their managers and employees. Managers must emphasise the management of their resources, particularly human capital and social capital.[119] The importance of knowledge to identify and exploit opportunities as well as to gain and sustain a competitive advantage suggests that organisations must have strong human capital.[120] Social capital is critical for access to complementary resources from partners in order to compete effectively in domestic and international markets.[121]

Many entrepreneurial opportunities continue to surface in international markets, a reality that is contributing to organisations' willingness to engage in international entrepreneurship. By entering global markets that are new to them, organisations can learn new technologies and management practices, and diffuse this knowledge throughout the entire enterprise. Furthermore, the knowledge that organisations gain can contribute to their innovations. Research has shown that organisations operating in international markets tend to be more innovative.[122] Entrepreneurial ventures and large organisations now regularly enter international markets. Both types of organisations must also be innovative to compete effectively. Thus, by developing resources (human and social capital), taking advantage of opportunities in domestic and international markets, and using the resources and knowledge gained in these markets to be innovative, organisations achieve competitive advantages. In so doing, they create value for their customers and shareholders.

Organisations practising strategic entrepreneurship contribute to a country's economic development. In fact, some countries have made dramatic economic progress by changing the institutional rules for businesses operating in the country. This approach could be construed as a form of institutional entrepreneurship. Likewise, organisations that seek to establish their technology as a standard, also representing institutional entrepreneurship, are engaging in strategic entrepreneurship because creating a standard produces a competitive advantage for the organisation.[123]

Research shows that because of its economic importance, individual motives and organisational sustainability, entrepreneurial activity has increased around the globe. For instance, during the Covid-19 pandemic, many organisations became innovative almost instantaneously in efforts to deal with restrictions globally and sustain their businesses in uncertain times. StartUs Insights analysed 4830 start-ups and emerging organisations to ascertain how they tackled the new challenges posed by the pandemic.[124] It found many excellent examples of innovation during this period, including Australian start-up Welcome Fit, which assists gyms, fitness studios and personal trainers to go online; a Ukrainian start-up, Prometheus, launched in March 2020 to make learning more flexible and adaptive by granting access via its platform to hundreds of open online mass courses taught by universities, non-profit and commercial organisations; and Replika, a US start-up specialising in loneliness management, applies artificial intelligence to build a full-time companion for people of all ages. Furthermore, more women are being recognised as entrepreneurs because of the economic opportunity entrepreneurship provides and the individual independence it affords. In relation to female entrepreneurship, access to capital appears to remain one of the main barriers for women, and still only represent 30 per cent of all entrepreneurs in Australia.[125]

After identifying opportunities, entrepreneurs must develop capabilities that will become the basis of their organisation's core competencies and competitive advantages. The process of identifying opportunities is entrepreneurial, but this activity alone is not sufficient to create maximum wealth or even to survive over time. As we learned in Chapter 3, to successfully exploit opportunities, an organisation must develop capabilities that are valuable, rare, difficult to imitate and non-substitutable. When capabilities satisfy these four criteria, the organisation has one or more competitive advantages to exploit the identified opportunities (as described in Chapter 3). Without a competitive advantage, the organisation's success will be only temporary (as explained in Chapter 1). An innovation may be valuable and rare early in its life, if a market perspective is used in its development. However, competitive actions must be taken to introduce the new product to the market and protect its position in the market against competitors to gain a competitive advantage.[126] These actions combined represent strategic entrepreneurship.

# STUDY TOOLS

## SUMMARY

**LO1** Strategic entrepreneurship is taking entrepreneurial actions using a strategic perspective. Organisations engaging in strategic entrepreneurship simultaneously engage in opportunity-seeking and advantage-seeking behaviours. The purpose is to continuously find new opportunities and quickly develop innovations to exploit them.

**LO2** Entrepreneurship is a process used by individuals, teams and organisations to identify entrepreneurial opportunities without being immediately constrained by the resources they control. Corporate entrepreneurship is the application of entrepreneurship (including the identification of entrepreneurial opportunities) within ongoing, established organisations. Entrepreneurial opportunities are conditions in which new goods or services can satisfy a need in the market. Increasingly, entrepreneurship positively contributes to individual organisations' performance and stimulates growth in countries' economies.

**LO3** Organisations engage in various types of innovative activities, for example: (1) invention, which is the act of creating a new good or process; (2) innovation, or the process of creating a commercial product from an invention; and (3) imitation, which is the adoption of similar innovations by different organisations. Invention brings something new into being while innovation brings something new into use.

**LO4** Entrepreneurs see or envision entrepreneurial opportunities and then take actions to develop innovations to exploit them. The most successful entrepreneurs (whether they are establishing their own venture or are working in an ongoing organisation) have an entrepreneurial mindset, which is an orientation that values the potential opportunities available because of marketplace uncertainties.

**LO5** International entrepreneurship, or the process of identifying and exploiting entrepreneurial opportunities outside the organisation's domestic markets, is important to organisations around the globe. Evidence suggests that organisations capable of effectively engaging in international entrepreneurship outperform those competing only in their domestic markets.

**LO6** Organisations innovate generally through incremental or radical internal innovation. Four types of innovation have been identified in this chapter: product innovation, process innovation, marketing innovation and organisational innovation.

**LO7** To gain access to the specialised knowledge commonly required to innovate in the complex global economy, organisations may form a cooperative relationship such as a strategic alliance with other companies, some of which may be competitors.

**LO8** Acquisitions are another means organisations use to obtain innovation. Innovation can be acquired through direct acquisition, or organisations can learn new capabilities from an acquisition, thereby enriching their internal innovation abilities.

**LO9** The practice of strategic entrepreneurship by all types of organisations, large and small, new and more established, creates value for all stakeholders, especially for shareholders and customers. Strategic entrepreneurship also contributes to the economic development of countries.

## KEY TERMS

corporate entrepreneurship
entrepreneurial mindset
entrepreneurial opportunities
entrepreneurs
imitation
innovation
innovation process
international entrepreneurship
invention
product innovation
strategic entrepreneurship

## REVIEW QUESTIONS

1. What is strategic entrepreneurship?
2. What is entrepreneurship, and what are entrepreneurial opportunities? Why are they important for organisations competing in the 21st-century competitive landscape?
3. What are invention, innovation and imitation? How are these concepts interrelated?
4. What are the different types of innovation available to organisations?
5. What is the difference between incremental innovation and radical innovation?
6. Why and how do organisations develop innovations internally?
7. How do organisations use cooperative strategies to innovate and to have access to innovative capabilities?
8. How does an organisation acquire other companies to increase the number of innovations it produces and improve its capability to produce innovations?
9. How does strategic entrepreneurship assist organisations to create value?

## EXPERIENTIAL EXERCISES

### Exercise 1: Is corporate entrepreneurship different from start-up entrepreneurship?

Your text argues that corporate entrepreneurship is 'the use or application of entrepreneurship within an established organisation'. In this exercise you will form groups and examine what you believe to be the major differences between becoming a start-up entrepreneur and doing entrepreneurship within a corporation with existing businesses. Each group will be called upon to describe what it perceives to be the main differences. Think in terms of careers, risks and money, and anything else your group finds important.

### Exercise 2: The social nature of entrepreneurship

Entrepreneurship is said to be as much about social connections and networks as it is about the fundamentals of running a new venture. The relationships that an entrepreneur can count on are also key resources of financial capital, human capital, mentoring and legal advice.

A popular blog covering social media and Web 2.0 recently identified what it considered to be the top 10 social networks for entrepreneurs. One of its bloggers took a stab at creating a top 10 list, identified as follows:

1. LinkedIn
2. Instagram
3. WhatsApp
4. Young Entrepreneur
5. Startup Nation
6. Go BIG Network
7. Biznik
8. Perfect Business
9. Cofounder
10. Entrepreneur Connect.

In teams, pick one social network from the list, or another you might favour (your instructor will ensure that there is a different choice for each team). Spend some time on this network's website reading the posts to get a feel for the types of information presented. Prepare a 10-minute presentation to the class on your network site and be sure to address the following, at a minimum:

1. Provide an overview of the site: what it is used for, how popular it is, features, types of conversations, etc.
2. What is unique about this site and why does it attract followers? What technologies are enabled here (RSS, Twitter, etc.)?
3. Describe the target audience for this website. Who would use it and what types of information are available to entrepreneurs?
4. How do you think this site maintains its presence? Does it support itself with ad revenue, corporate sponsors, not-for-profit sponsors or by some other means?
5. Would this site be useful for corporate entrepreneurs as well as start-up entrepreneurs? If so, how?

## NOTES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# PART 4

## CASE STUDIES

# INTRODUCTION

## A summary of the case analysis process

DALLAS HANSON

Case analysis is an essential part of a strategic management course and is also perhaps the most entertaining part of such a course.

Before we start, a word about attitude – make it a real exercise. You have a set of historical facts, so use a rigorous system to work out what strategies should be followed. All the cases are about real companies, and one of the entertaining things about the analysis process is to compare what you have said they should do with what they really have done. So, it is best not to check the internet to see current strategies until you have completed your analysis.

What follows is one analytical system, a fairly tight one that you may want to adapt according to how much time you have and the style of the case.

### EXTERNAL ANALYSIS

#### Step 1 What industry is it?

You must decide this early on. This is an important step because it changes the analysis; for example, your industry analysis will yield different conclusions depending on what industry you determine.

#### Step 2 General environment analysis

Analyse the seven generic elements – economic, physical, sociocultural, global, technological, political/legal and demographic – and work out what the important facts are. There may be many issues and facts in each element, but you put down only the important ones. It is also important to avoid the common error of over-emphasis on the organisation in question. If, for example, the organisation operates in the Australian ice-cream industry, the demographic analysis may have this comment: 'A large baby boomer generation is now becoming more health-conscious. This presents opportunities in health foods and healthy alternatives for conventional foods. It also presents opportunities for low-fat ice-creams'. Or, in analysing the demographics of David Jones, you may conclude that there is a good market of middle- to top-end income people in Australian cities that need stylish clothing from globally sourced manufacturers.

#### Step 3 The industry environment

Is this a mature industry? An emerging one? This carries with it messages about possible strategies.

Now, analyse the five forces (i.e. supplier power, buyer power, potential entrants, substitute products and rivalry among competitors) and explain briefly what is significant for each. For example, what are the issues involved regarding new entrants into the industry? For high-end retailing in Australia, the need for a brand, some large stores, scores of excellent clothing brands and the need for central city locations are big limitations on entry. This makes the industry hard to enter. Each force needs a brief discussion followed by a short conclusion.

One extra consideration before you pull the analysis together and work out if this is an attractive industry (the main conclusion) is whether there is a key force or forces in your industry. Porter argues that there is a key force in any industry, one that exerts more influence than the other forces.

Now, is it an attractive industry? You need to explain, briefly, why or why not. Bear in mind that it is often not a clear decision because the forces are mixed; for example, there may be little concern about new entrants, suppliers or substitutes, but buyers may be fickle and rivalry high. In such cases, the key force analysis is very important. It is also useful to think specifically about threats that the analysis has offered; for example, buyers or suppliers.

Remember: It is the industry you analyse, *not the organisation*.

#### Step 4 Competitive environment

Is there a strategic group that you need to take account of? What is the rivalry like in this group? What capabilities do the relevant organisations have? What strategies do they follow? What threats do they represent? A good example of how this may work is the New Zealand company Hubbards, which makes cereal for the NZ market. It is a relatively small organisation, and although it is well established and very well branded in NZ, it has severe price ceilings in its industry position: if it goes too high, competition will win with lower prices, and if it goes too low, the large competitors (Sanitarium and Uncle Tobys, for example) will kill it in the marketplace because they can.

#### Step 5 You now have material about opportunities and threats

It is easy to pull this together from the four steps you have now completed. There are opportunities in the general environment and also threats. The industry presents extra threats or sopportunities.

## INTERNAL ANALYSIS

### Step 6 The organisation's resources, tangible and intangible

List all relevant resources. It is useful to distinguish between tangible and intangible resources. Remember: organisations have many resources. Intangible resources are best because they are hard to imitate.

At this point, if you have the skills and time, you can analyse the financial information that almost all cases provide. This provides material for a financial resources paragraph.

### Step 7 Capabilities identification

Here you make a list of capabilities. Capabilities tell you what the organisation can do.

Remember: each organisation may have a dozen or more capabilities, so include some that are very unlikely to be core competencies. This is a difficult step because you must explain the capabilities carefully to indicate what the organisation really does. For example, the Australian organisation Cochlear manufactures high-tech hearing assistance devices that are implanted to help profoundly deaf people. It has a capability for research in cochlear implant-related technology. It does not have a generic research capability. Be careful to get the scale right, as capabilities are fairly limited in scope most of the time.

### Step 8 Core competency analysis

For each capability, indicate which of the four tests for a core competency it meets. An easy way to do this is through the use of a table such as the following.

| | Rare? | Valuable? | Costly to imitate? | Non-substitutable |
|---|---|---|---|---|
| Logistics management in retailing | Yes | Yes | No | No |
| Research knowledge and skill in cochlear-related areas | Yes | Yes | Yes | Yes |
| Etc. | | | | |

This is an important step because the core competencies are fundamental in the strategies you suggest – organisations use their core competencies. Furthermore, they cannot implement strategies if they lack the relevant capabilities, although if they have time they can sometimes develop them. For example, if an organisation wants to start selling via the internet, it can develop these capabilities by hiring the right people and buying the right systems, but it won't happen overnight; and as Barnes & Noble's struggles with e-book retailing indicate, it is often harder than it looks.

The *strengths* of the organisation are the core competencies, and, in some cases, the capabilities that are valuable and perhaps also hard to imitate, but not rare.

Note that an organisation may not have any core competencies. In a mature industry, it is very possible that no capabilities will be rare.

### Step 9 Value chain analysis

Analyse the primary and support activities for the organisation (see Chapter 3 for value chains). This does two things for you. You can check it against your capabilities – have you identified some you have left out of the capabilities list? And it is a good chance to see how external trends are affecting the organisation.

### Step 10 Weaknesses

What major weaknesses does the organisation have; for example, old technology, very limited finance and poor cash flow, or no succession planning? These are part of the capabilities analysis. What does the industry require that it does poorly?

### Step 11 Pulling it together

You now have all the material for an excellent SWOT (strengths, weaknesses, opportunities and threats) analysis. Pull together the earlier identification of opportunities and threats (step 5) with the internal analysis you have done. This resources-based, theory-oriented system gives you a powerful vocabulary to describe what simpler systems call 'strengths', and the other elements of the system allow you to systematically identify other significant factors in the mix.

### Step 12 Current strategies

Work out the organisation's current strategies. Explain why they have been adopted.

### Step 13 Strategies

Develop strategies that take advantage of opportunities and handle threats. You make use of core competencies to do this.

Depending on the case, you may need strategies at the business level, corporate level and international level (but it depends on the case). Also, bear in mind that you need to specify functional-level strategies to fit the generic strategies at the business level. For example, if your ice-cream company adopts a differentiation strategy, you must specify how it is differentiated (on what grounds – low fat?) and there must be associated innovation and marketing strategies (or, in the corporate-level strategy, a supporting acquisition strategy may be used to handle the innovation issue). It is not enough to say the organisation must differentiate – it may not have the resources or capabilities to do so. If not, how does it acquire or develop them? And, if you don't explain how the organisation will differentiate (on what basis), then the answer is incomplete.

Make a list of alternative possibilities and use the external and internal analyses that you have conducted to assess them. Choose one set of alternatives. How do these differ from current strategies?

*Make sure the strategies chosen fit in with your earlier analysis.* For example (and bear in mind that this is simplified to make the idea clearer), if you are in a rivalrous industry that has good growth prospects because of useful demographic change (an opportunity), and you have good financial resources and a good brand, you may argue for expansion into the new demographic segment with a differentiation strategy using available resources – the brand and finance. If the finances/ brand were not there, this strategy would be difficult to support. Do not try to implement a strategy for which you do not have the resources and capabilities.

The case writer often gives you a specific idea of what the question is. It is always about strategy, though, and the analysis we have just conducted is the background to a specific answer. For example, in the Australia Post case there is a central issue about the problem of running a letter delivery service when the world is moving away from the role provided by a traditional post office. You resolve this with reference to the full analysis and then make specific comment on that issue.

# CASE 1

## JB Hi-Fi Ltd acquisition of The Good Guys

GREG ZOOEFF

**CASE LINK:** This case applies concepts from Chapters 2, 3, 4, 5 , 6, 7 and 12.

### BACKGROUND

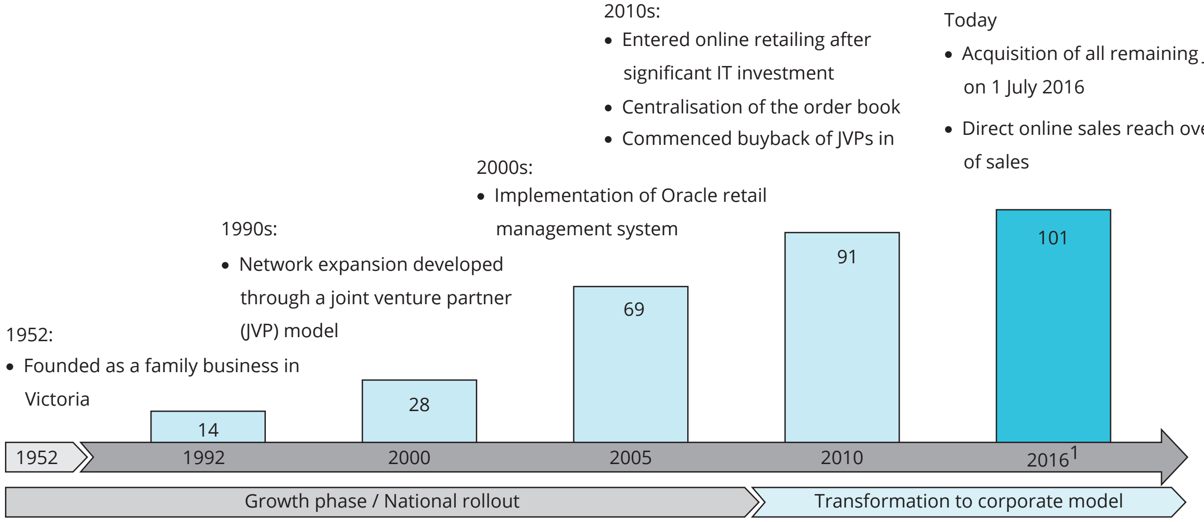
The Good Guys (TGG) was a family business that was founded in 1952 and began retailing electrical products in Melbourne, Australia.[1] Through physical store expansion, it had grown to 101 stores across Australia and generated revenue of A$2.09 billion by 2016.[2] The history of TGG is represented diagrammatically in Figure 1.

On 13 September 2016, JB Hi-Fi (JBH) announced to the stock market the acquisition of TGG. JBH had entered into a binding agreement to acquire TGG for a total cash consideration of A$870 million. At the time of the acquisition JBH CEO Richard Murray stated:

> The Good Guys is a high quality Australian retailer with an excellent track record. We are very impressed by what the owners and management have achieved with the business since its establishment and the leading market position they have created. The acquisition is a very attractive strategic opportunity for JB Hi-Fi since The Good Guys is a highly complementary business which is aligned with our management philosophy and significantly enhances our offering in the $4.6 billion home appliances market.[3]


Source: Shutterstock.com/Slow Walker

**Figure 1** History of The Good Guys




Source: JB Hi-Fi Limited, 2016, *Acquisition of The Good Guys*, 13 September 2016, JB Hi-Fi Limited Investor presentation, https://investors.jbhifi.com.au/wp-content/uploads/2019/11/Acquisition-of-The-Good-Guys_Sep16.pdf, p. 7.

## Acquisition of TGG

The strategic and financial logic of this business combination at the time were summarised as follows:

- similar approaches to retailing with a focus on value and customer service
- complementary customers, product portfolio and physical retail locations
- expansion in the home appliances market sector
- provides a platform for new growth opportunities and market share gains
- synergistic benefits for the combined business
- leveraging TGG's strong market position in the home appliance sector
- will provide JBH greater scale to optimise the supply chain and leverage the value from JBH and TGG.[4]

### *The acquisition of TGG: highlights*

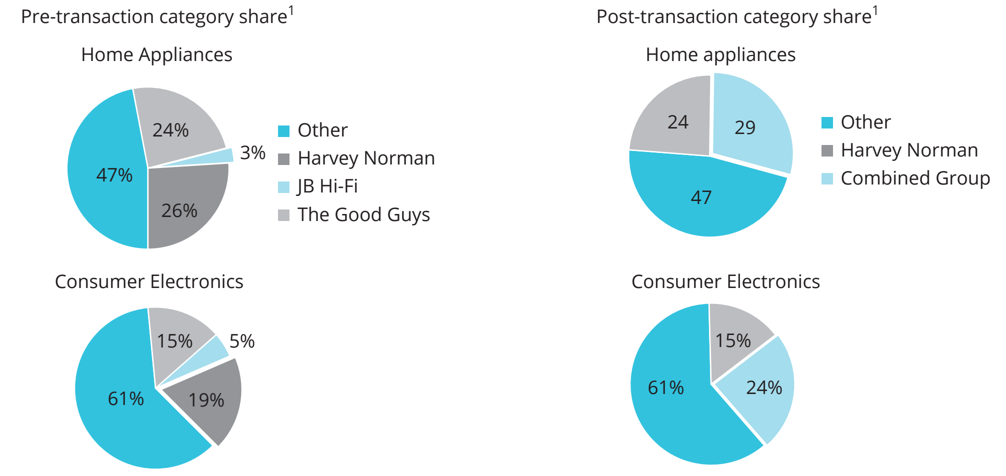
The highlights of the acquisition at the time were:

- Acquisition was for total cash consideration of A$870 million representing 11.7 x enterprise value (EV)/FY16 pro forma normalised earnings before interest and tax (EBIT) pre-synergies (JBH at the time was trading at 13.2 x EV/FY16 EBIT so the final acquisition price was below the JBH EBIT multiple, which was favourable to JBH shareholders).
- TGG and JBH had complementary businesses with the acquisition positioning JBH competitively in the home appliances market sector (see Figure 2 for the market share pre- and post-acquisition).
- The respective strong and well-recognised brands coupled with well-established and effective marketing strategies were a key factor in the acquisition.
- The expected synergies of A$15–20 million per annum to the combined business post-integration period were a key highlight. The synergies were expected to be realised from procurement, logistics and supply chain efficiencies as well as support function efficiencies.
- The implementation costs were expected to be approximately A$10–12 million primarily in the first 12 months post-completion, which were considered not excessive (~1% of the acquisition price).
- The transaction was earnings per share (EPS) accretive based on FY2016 pro forma EBIT and represented an 11.5 per cent increase for the combined group (pre-synergies, transaction and implementation costs).
- The acquisition was funded through equity and debt issuance with a combination of an entitlement offer (equity rights issue) of approximately A$394 million and A$450 million from a new acquisition debt facility and drawn down from existing debt facilities (A$500 million in total debt). The acquisition did increase JBH financial leverage but for the combined group pro forma net debt to FY2016 pro forma EBITDA was 1.6 x, which was not excessive.[5]

## JBH CORPORATE GOVERNANCE AND RISK MANAGEMENT

The JBH corporate governance framework has a number of elements, but it is bound by the company constitution and the

**Figure 2** Pre- and post-transaction category market shares




Source: JB Hi-Fi Limited, 2016, *Acquisition of The Good Guys, 13 September 2016*, JB Hi-Fi Limited Investor presentation, https://investors.jbhifi.com.au/wp-content/uploads/2019/11/Acquisition-of-The-Good-Guys_Sep16.pdf, p. 12.

*Corporations Act 2001*. The company has a board charter that provides a summary of the role and responsibilities of the board of directors in the business and affairs of JB Hi-Fi Limited and its controlled entities. The corporate governance framework has two principal committees: the Audit and Risk Committee and the Remuneration and Nomination Committee. The governance framework is supported by a number of policies, such as the Risk Management Policy. The board is required to ensure that the group has in place an appropriate risk management framework, which the board must approve at least annually. The board's role is summarised as follows:

> The Board determines the Group's risk tolerance, appetite and attitude, and in doing so, seeks to strike an appropriate balance between risk and reward in the Group's overall strategy. Additionally, at least annually the Board reviews the Group's Risk Management Framework. The Board is also responsible for reviewing the Group's policies on risk oversight and management, and must satisfy itself that Management has developed and implemented a sound system of risk management and internal control, and that the system is operating effectively. The Board has delegated much of the detailed work to the Audit & Risk Management Committee ... reviewing and, where appropriate, approving major corporate plans and actions (such as significant acquisitions and disposals)...[6]

## JB HI-FI BUSINESS AND OPERATING MODEL

The JBH Group includes the JB Hi-Fi and The Good Guys businesses. The group's sales are primarily from its branded retail store network (195 JB Hi-Fi/JB Hi-Fi Home stores in Australia, 14 JB Hi-Fi stores in New Zealand and 105 Good Guys stores in Australia as at 30 June 2020).[7] In addition, it has online businesses for JB Hi-Fi and The Good Guys as well as sales from its commercial and education businesses. Its products/services cover:

- consumer electronics including televisions, audio equipment, computers and cameras
- telecommunications products and services
- software (CDs, DVDs, Blu-ray, games) and musical instruments
- whitegoods, cooking products, heating and cooling products, small appliances and cooking accessories
- provides information and technology services.[8]

The JB Hi-Fi business model leverages the well-known brands (JB Hi-Fi and The Good Guys) and has distinct competitive advantages in its segments, namely: scale, low operating costs, quality locations, supplier partnerships and multi-channel capabilities (see Figure 3). Its value proposition is based on the best brands at lowest prices. However, JBH's scale and low-cost model provides valuable capability in absorbing margin pressure. The growing emergence of online competitors is a business risk to the JBH group.[9] However, JBH has a dual approach with an online strategy and a physical store network that provides a physical after-sales service. JBH benchmarks competitively against other global retailers. In 2017 JBH was ranked 181 in the top 250 global retailers and was ranked as the 32nd fastest growth rate in the top 50 growth retailers with five-year compound annual growth rate (FY2012–17) at 15.7 per cent.[10]

The benefits of scale and a low cost of doing business support increased buying power, ability to increase efficiencies and provide lower prices and compete against incumbents and new entrants. JBH benchmarks well in relation to the cost of doing business against other globally relevant international retailers[11] (see Figures 4 and 5).

## THE INDUSTRY AND EXTERNAL ENVIRONMENT

The markets that JBH operates in are highly competitive, and increased competition from industry incumbents and new entrants can lead to decline in sales and profitability. The market and industry performance is a strong function of consumer discretionary spending and changes in consumer demand can impact upon the execution of strategy and financial performance. The economic and business environment, regulatory impacts and changes in demand are key external factors for industry players. The growth in online competition is particularly important for JBH and it has developed an online strategy that complements its physical store network.

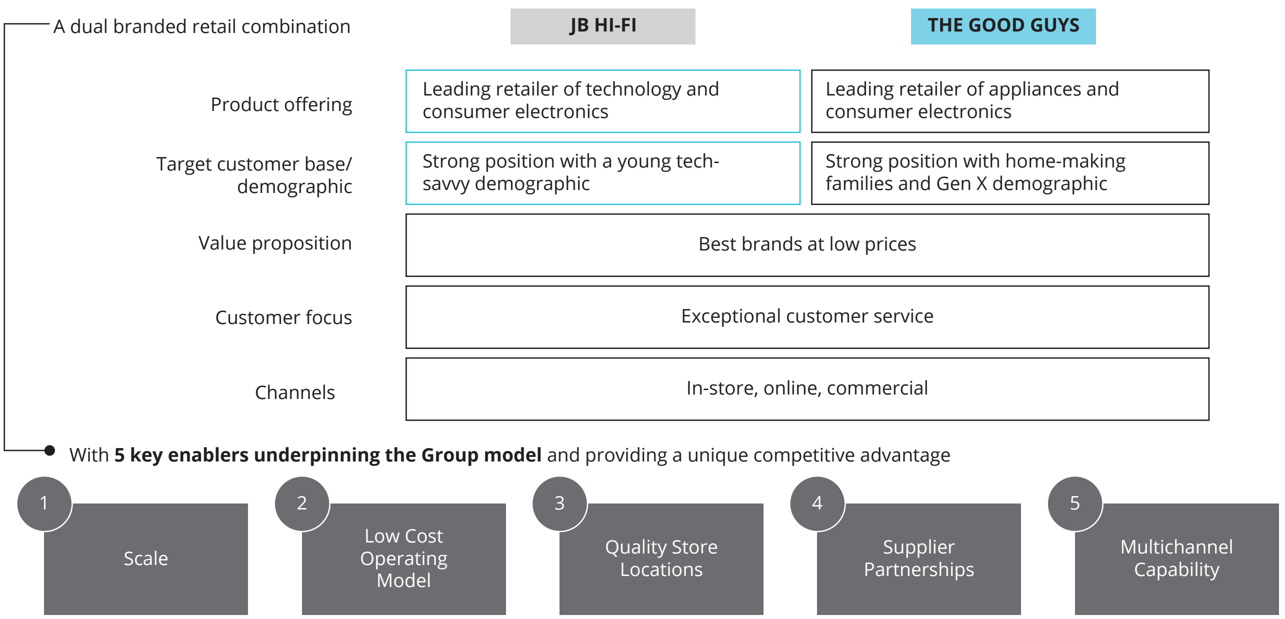
### The retail industry size in Australia

JBH's principal activities (including TGG) operate in electrical and electronic goods retailing, covering electrical, electronic and gas appliance retailing, computer and computer peripheral retailing, and other electrical and electronic goods retailing.

In the 12 months to June 2020, total household goods retailing turnover (seasonally adjusted) was A$63 billion (note Figure 6 includes electrical and electronic goods retailing covering the above segments).[12] In seasonally adjusted terms and during the Covid-19 pandemic lockdowns in Australia, the household retailing trend has increased dramatically from long run trend due to more people being inside the home and various factors, such as more people working from home, home-based education and leisure pursuits within the home environment, have increased sales of consumer electronic based products.[13]

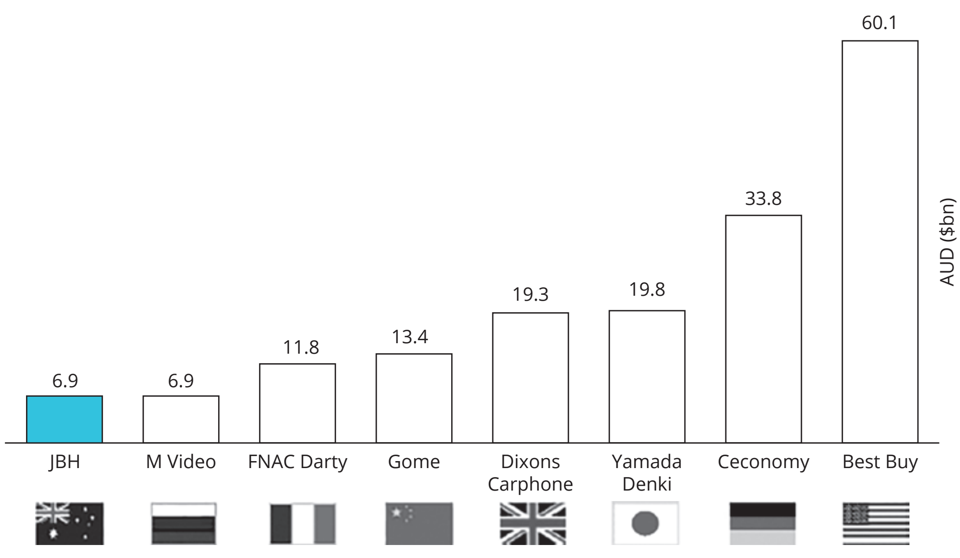
On 17 August 2020, JBH CEO Richard Murray announced to the market increased sales of 11.5 per cent year on year, 30.5 per cent increase in underlying EBIT and 33.2 per cent in

**Figure 3** **JBH business model**



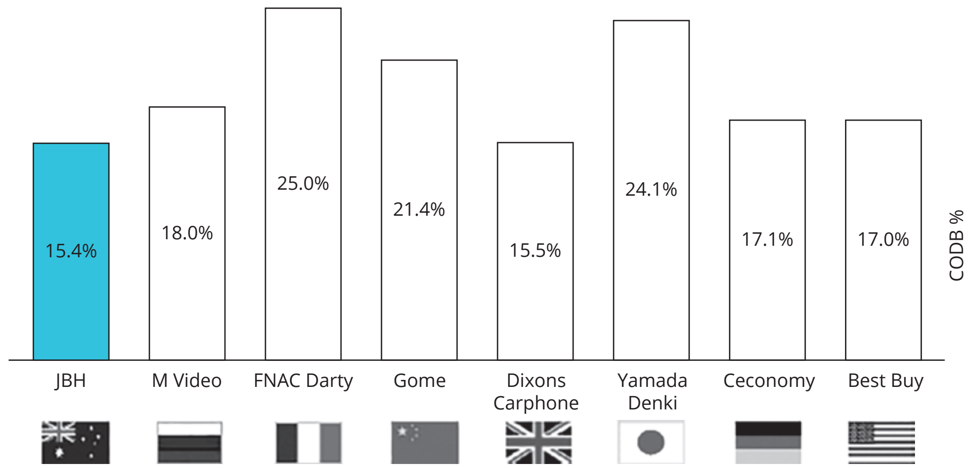

Source: JB Hi-Fi Limited, 2019, JB Hi-Fi Limited 2019 Macquarie Australia conference, https://investors.jbhifi.com.au/wp-content/uploads/2019/04/Macquarie-Australia-Conference-Presention-April-2019.pdf, p. 5.

**Figure 4** **JBH benchmarking – scale**




Source: JB Hi-Fi Limited, 2019, JB Hi-Fi Limited 2019 Macquarie Australia conference, https://investors.jbhifi.com.au/wp-content/uploads/2019/04/Macquarie-Australia-Conference-Presention-April-2019.pdf, p. 6.

**Figure 5** **JBH benchmarking – cost-of-doing-business**




Source: JB Hi-Fi Limited, 2019, JB Hi-Fi Limited 2019 Macquarie Australia conference, https://investors.jbhifi.com.au/wp-content/uploads/2019/04/Macquarie-Australia-Conference-Presention-April-2019.pdf, p. 7.

underlying net profit after tax to A$332 million as a result of the pandemic and people spending more time working, learning and entertaining at home.[14]

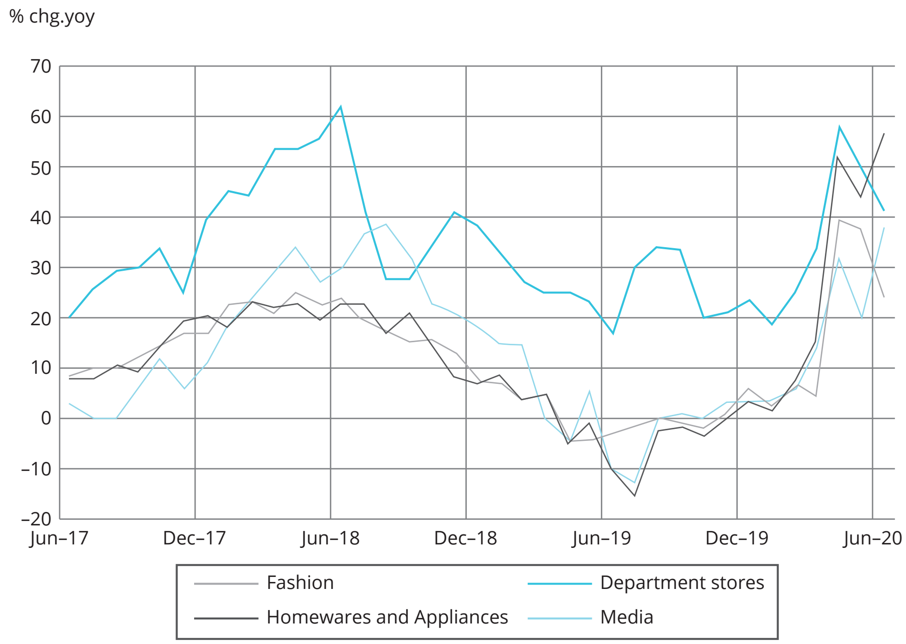
## External environment trends

In the 12 months to June 2020, the proportion of online retail sales was 10.7 per cent of all retail trade, which was 23.1 per cent higher than the corresponding period ending June 2019.[15] Figure 7 shows the growth rates for various categories accelerating substantially. In the 12 months ending June 2020, JBH online sales in Australia grew 56.6 per cent to A$404 million, or 7.6 per cent of total sales, with the fourth quarter growing at 155.2 per cent.[16] The penetration of online retail in

**Figure 6** **Total household goods retailing in Australia (A$ million per month)**


Source: Based on Australian Bureau of Statistics (ABS), 2020, *ABS 8501.0 Series – Retail Trade, Australia, June 2020*, https://www.abs.gov.au/statistics/industry/retail-and-wholesale-trade/retail-trade-australia/latest-release , © Commonwealth of Australia.

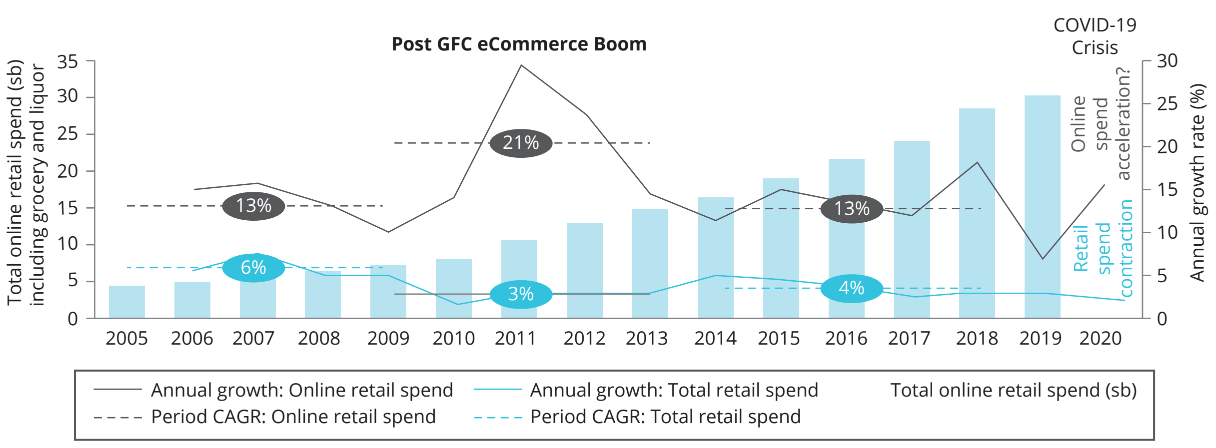
**Figure 7** Online retail sales by category year-on-year change (seasonally adjusted)




Source: National Australia Bank, 2020, National Australia Bank online retail sales index June 2020, https://business.nab.com.au/wp-content/uploads/2020/08/nab-online-retail-sales-index-june-2020.pdf, p. 3.

Australia lags other regions in the world.[17] The growth rates and total spend on retail in Australia is highlighted in Figure 8, which shows that since 2013 cumulative annual growth rate of online sales has been 13 per cent and represents further growth potential in online sales during the Covid-19 pandemic, and potentially beyond, as retail behaviours change and incumbents and new entrants increase digital platforms and modes.[18] Online competition is considered a key business risk by JBH, but it has taken a dual approach by providing online capability and leveraging its physical store network to provide customer optionality and after-sales service. It continually invests in online development and increasing online capability to increase

**Figure 8** Online retail penetration and growth rates in Australia




Source: KPMG, 2020, COVID-19: Retail's survival and revival, https://home.kpmg/au/en/home/insights/2020/04/coronavirus-covid-19-retail-survival-and-revival.html, 2 April.

user experience and multiple platforms (e.g. computer, tablet and phone).[19]

## JB HI-FI GROUP PERFORMANCE

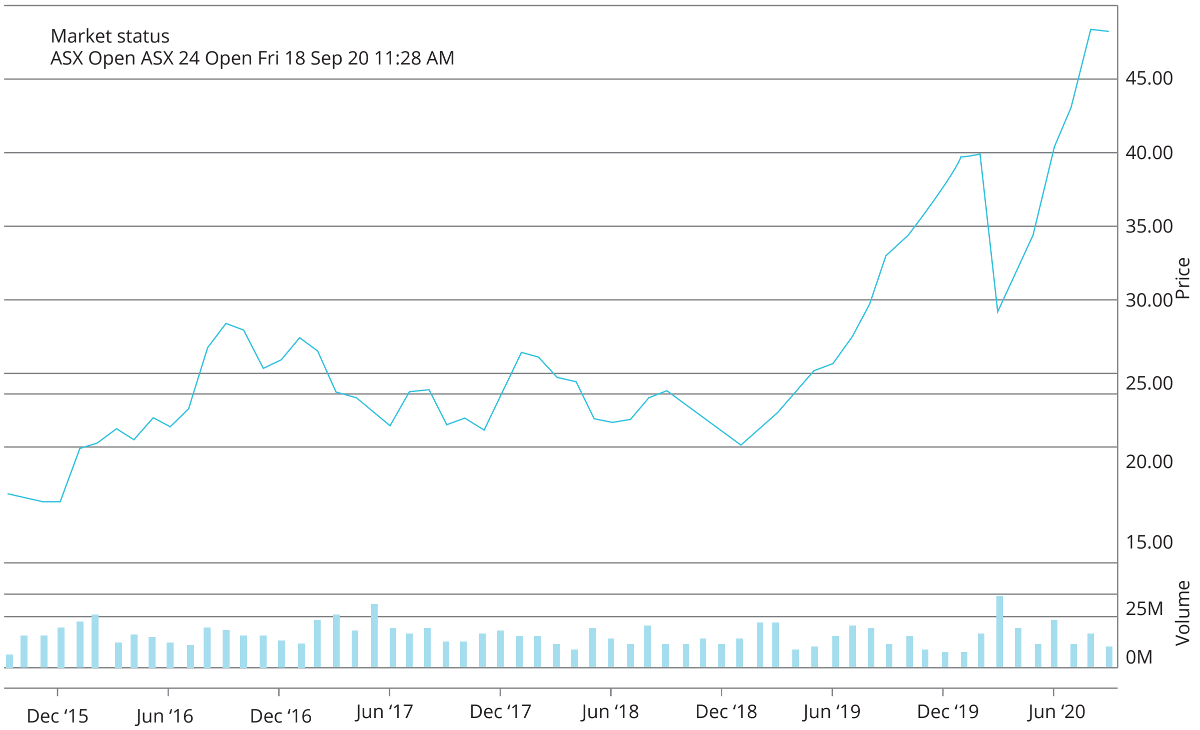
The financial performance of an organisation is an outcome of the strategic settings and key strategic actions – corporate level and business unit level. The primary objective is to deliver shareholder value, which is measured in terms of equity price growth and dividend growth. In the case of JBH, it embarked on a significant acquisition of TGG and has a defined strategy where it leverages a unique business model. The next sections review the equity price performance of JBH and its financial performance since the acquisition of TGG.

### JB Hi-Fi equity performance

A key aspect of strategy deployment and execution is to measure performance and the success or otherwise of strategy. One measure is to assess performance of the company's equity price using longitudinal equity market data. The equity price of a company is determined by market views of the future growth prospects and performance expectations. The JBH equity price has increased significantly since 2019, and even with the impact of the Covid-19 pandemic the JBH share price has staged a sharp recovery. The market capitalisation as at 17 September 2020 was at A$5.4 billion.[20] The JBH share price since the acquisition of TGG has increased by over 50 per cent and the JBH market capitalisation has increased by A$2.4 billion or 124 per cent since the end of June 2016.[21] This empirical evidence indicates strong equity market performance and an effective strategy. Figure 9 shows the equity price performance of JBH from September 2015 to September 2020.

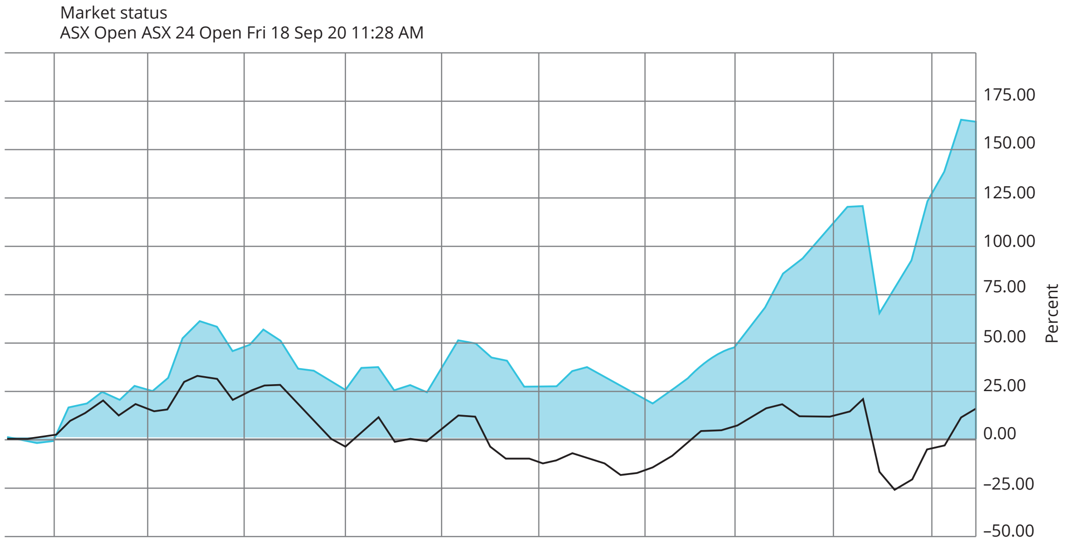
Furthermore, benchmarking a company's financial performance against competitors and/or broader market indices is another method to gauge performance and whether strategy requires realignment or redefinition. Figure 10 shows the comparative equity price performance with a major industry competitor, Harvey Norman (Australian Securities Exchange (ASX) code: HVN) in percentage change terms and demonstrates that JBH has significantly outperformed HVN. In terms of commonly used valuation metrics, the JBH

**Figure 9** **JBH equity price performance 17 September 2015 to 17 September 2020**




Source: © Copyright 2020 ASX Corporate Governance Council, ASX prices & research, https://www.asx.com.au/asx/markets/equityPrices.do.

**Figure 10** Relative percentage changes in equity price of JBH and HVN from 17 September 2015 to 17 September 2020




Source: © Copyright 2020 ASX Corporate Governance Council, ASX prices & research, https://www.asx.com.au/asx/markets/equityPrices.do.

price/earnings (P/E) ratio was 18.1 times and its EPS was A$2.63, while HVN has a P/E ratio of 11.1 times and an EPS of A$0.39 per share.[22] This indicates that JBH has superior valuation and growth prospects compared to its competitor Harvey Norman and its strategy is delivering shareholder value.

### JB Hi-Fi financial performance post-acquisition of TGG

Since the acquisition of TGG, the JBH group has exhibited improved financial performance. It has increased its EPS and the dividends per share by 44 per cent and 60 per cent, respectively. EBIT has increased by 52 per cent and sales revenue has materially increased by 40.7 per cent over this period. However, despite these increases, its EBIT margin (EBIT/Sales revenue) has only marginally increased, from 5.4 per cent to 5.9 per cent in FY2020. Tables 1 to 4 outline the key financial metrics for JBH since the acquisition of TGG (from FY2017 to FY2020 inclusive). The financial information is sourced from annual reports[23] and breaks down the group's divisional performance since the acquisition.

## CONCLUDING REMARKS ON JB HI-FI GROUP PERFORMANCE

JBH has exhibited year-on-year growth in headline sales and earnings since the acquisition of TGG. It has increased its earnings per share and the dividends per share by 44 per cent and 60 per cent, respectively. The JBH share price has

**Table 1** JBH Group financial performance

| Financial metric | FY 2020 | FY 2019 | FY 2018 | FY 2017[1] |
|---|---|---|---|---|
| Total sales (A$'m) | 7918.9 | 7095.3 | 6854.3 | 5628 |
| Earnings before interest and tax (A$'m) | 466.7 | 372.8 | 350.6 | 306.3 |
| Net profit after tax (A$'m) | 308.7 | 249.8 | 233.2 | 207.7 |
| Earnings per share (basic cents) | 268.7 | 217.4 | 203.1 | 186 |
| Dividend per share (cents) | 189 | 142 | 132 | 118 |

1 Underlying results which exclude transaction fees and implementation costs totalling $22.4 million associated with the acquisition of The Good Guys in November 2016 and goodwill and fixed asset impairment charges in relation to the JB Hi-Fi New Zealand business totalling $15.8 million.

FY2020 are underlying results excluding AASB 16 Leases and the NZ non-cash impairment of A$24 million (post-tax).

Source: *JB Hi-Fi Limited Annual Report 2020; JB Hi-Fi Limited Annual Report 2019; JB Hi-Fi Limited Annual Report 2018; JB Hi-Fi Limited Annual Report 2017.*

**Table 2** JBH Australia divisional results

| Financial metric | FY 2020 | FY 2019 | FY 2018 | FY 2017[1] |
|---|---|---|---|---|
| Total sales (A$'m) | 5318.9 | 4726 | 4539.7 | 4148.6 |
| Gross profit (A$'m) | 1169 | 1046.2 | 1006.5 | 922.8 |
| Gross margin (%) | 21.98 | 22.14 | 22.17 | 22.24 |
| Cost of doing business (%) | 14.09 | 14.89 | 14.82 | 14.96 |
| EBITDA (A$'m) | 419.5 | 342.3 | 333.6 | 302 |
| EBITDA margin (%) | 7.89 | 7.24 | 7.35 | 7.28 |
| EBIT (A$'m) | 380.8 | 301.7 | 292.3 | 262.4 |
| EBIT margin (%) | 7.16 | 6.38 | 6.44 | 6.33 |
| # stores | 195 | 196 | 193 | 185 |

1 Underlying results which exclude transaction fees and implementation costs associated with the acquisition of The Good Guys in November 2016.

FY2020 are underlying results and exclude the impact of AASB 16 Leases.

Source: *JB Hi-Fi Limited Annual Report 2020; JB Hi-Fi Limited Annual Report 2019; JB Hi-Fi Limited Annual Report 2018; JB Hi-Fi Limited Annual Report 2017.*

**Table 3** JBH New Zealand divisional results

| Financial metric | FY 2020 | FY 2019 | FY 2018 | FY 2017[1] |
|---|---|---|---|---|
| Total sales (NZ$'m) | 222.8 | 236.2 | 231.5 | 234 |
| Gross profit (NZ$'m) | 36.8 | 40.8 | 40.9 | 42.5 |
| Gross margin (%) | 16.54 | 17.29 | 17.66 | 18.15 |
| Cost of doing business (%) | 16.57 | 16.71 | 17.28 | 17.89 |
| EBITDA (NZ$'m) | (0.1) | 1.4 | 0.9 | 0.6 |
| EBITDA margin (%) | (0.03) | 0.58 | 0.38 | 0.26 |
| EBIT (NZ$'m) | (1.9) | (1.9) | (2.9) | (2.7) |
| EBIT margin (%) | (0.85) | (0.8%) | (1.24%) | (1.15%) |
| # stores | 14 | 14 | 15 | 16 |

1 Underlying results excluding goodwill and fixed asset impairment charges.

FY2020 are underlying results and exclude the impact of AASB 16 Leases and NZ impairment of which NZ$21.1 million is included in EBIT.

Source: *JB Hi-Fi Limited Annual Report 2020; JB Hi-Fi Limited Annual Report 2019; JB Hi-Fi Limited Annual Report 2018; JB Hi-Fi Limited Annual Report 2017.*

increased by over 50 per cent and the JBH market capitalisation has increased by $2.4 billion, or 124 per cent, since the end of June 2016. On this basis, the group has delivered value to shareholders and its integration of TGG and overall strategy has been successful to date. The impact of the Covid-19 pandemic and the resultant shift to home-based work and activities has provided a boost to earnings. However, strategy is a dynamic process and past performance is not a predictor of future success.

## Questions

1. In relation to the JBH acquisition of TGG, what type of corporate strategy was JBH adopting? Explain why organisations use this strategy. What can be inferred from the success or otherwise of its strategy with reference to its equity price performance?
2. While JBH has a multi-channel approach for its products, it has a significant physical store footprint. Discuss whether its 'bricks-and-mortar' approach can withstand online competition from other mega retailers and smaller nimble competitors in this industry.
3. Describe some of the key issues facing the acquirer in making the deal successful in merger and acquisition (M&A) transactions. In the case of TGG, what would be the key issues/risks facing JBH?
4. Review the financial performance of the TGG division since the acquisition in terms of sales revenue, EBIT and EBITDA growth and margins. Is TGG performing financially compared to the JBH Australia business? What can be inferred from the financial and strategic contribution of TGG to JBH? Based on this analysis, is TGG a candidate for any restructuring action by JBH?

**Table 4 The Good Guys divisional results**

| Financial metric | FY 2020 | FY 2019 | FY 2018 | FY 2017[1] |
|---|---|---|---|---|
| Total sales (A$'m) | 2388.8 | 2147.9 | 2101.3 | 1258.4 |
| Gross profit (A$'m) | 490.2 | 442.7 | 426.1 | 267.6 |
| Gross margin (%) | 20.52 | 20.61 | 20.28 | 21.27 |
| Cost of doing business (%) | 15.42 | 16.63 | 16.60 | 16.69 |
| EBITDA (A$'m) | 121.8 | 85.5 | 77.3 | 57.7 |
| EBITDA margin (%) | 5.1 | 3.98 | 3.68 | 4.6 |
| EBIT (A$'m) | 107.8 | 72.9 | 60.9 | 46.4 |
| EBIT margin (%) | 4.51 | 3.4 | 2.9 | 3.69 |
| # stores | 105 | 105 | 103 | 102 |

1 The Good Guys was acquired on 28 November 2016. The results presented are underlying results for the period of the group's ownership (28 November 2016 to 30 June 2017) and exclude transaction and implementation costs associated with the acquisition.

FY2020 underlying results exclude the impact of AASB 16 Leases

Source: *JB Hi-Fi Limited Annual Report 2020; JB Hi-Fi Limited Annual Report 2019; JB Hi-Fi Limited Annual Report 2018; JB Hi-Fi Limited Annual Report 2017.*

5. M&A transactions are not without risk. In the presentation to investors 'Acquisition of The Good Guys' a key risk highlighted was:

> Due Diligence in relation to The Good Guys. JBH has undertaken a due diligence review in respect of the Acquisition. JBH has not been able to verify the accuracy, reliability or completeness of all the information against independent data. There is a risk that information provided by TGG (including financial information) was incomplete, inaccurate or unreliable and there is no assurance that the due diligence was conclusive or identified all material issues in relation to the TGG business. Limited contractual representations and warranties have been obtained from the vendors of TGG (the vendors) in the acquisition agreement relating to the Acquisition (the Acquisition Agreement) regarding the accuracy of the materials disclosed during the due diligence process.[24]

6. What would be the consequences of poor or incomplete due diligence be in this case? The role of the board and corporate governance with respect to M&A proposals is set out in the JBH risk policy. What are the potential agency relationship issues with such an M&A transaction? Explain your answer.

## NOTES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# CASE 2

## Challenges at Australia Post

DALLAS HANSON

**CASE LINK:** This case applies concepts from Chapters 2, 3, 4, 5 and 7.

National post offices are globally prominent institutions and have been vital to trust-based communication since the industrial revolution. Without the trustworthy delivery of letters and parcels, it was impossible to communicate, negotiate or sell at a distance, and traditional post offices were well set up to meet those needs. They have therefore been key in the expansion of capitalism. The Royal Mail, the British post office, was established in 1516 under King Henry VIII. It was a basic tool in the expansion of British industry and its global trading empire. It was partly privatised by the Conservative government in 2010 (it kept 30 per cent of the shares) but in October 2015 the government sold its final shares. The Royal Mail has 11 500 branches and still has a 'public mission' to deliver mail.[1] The privatisation of national post offices is not uncommon because they are valuable organisations – while Japan Post's privatisation in 2015 has been the biggest such venture, it is not alone. All post offices are socially significant and resource rich but challenged by the digital age. Their challenges are instructive for Australia Post, which remains a government business.

Australia Post (AP) was officially started in 1809 in the colony of New South Wales. By the 1820s, overland mail routes were operating in the large landmass of Australia. In 1838 a service from Sydney to Melbourne was operating –around 900 km. The route from Melbourne to Yass (about halfway) was handled by a horseman called John Bourke. At one stage he stripped to cross the flooded Murray River and was then forced to climb a tree to escape from a pack of dogs. When he was rescued, he went into post office legend when he shouted to the rescuers, 'Don't fire. My name is Bourke. I am Her Majesty's mail'. Adhesive stamps were introduced in the 1850s and the huge Melbourne General Post office (GPO) was opened in 1867. When the railway was finally opened between Melbourne and Sydney, people began getting mail within a day or two of posting. On Federation in 1901, a national post office was created, with the famous kangaroo-on-a-map stamp produced two years later. Horses were not fully replaced as delivery vehicles until 1924, and then progress continued with air mail to Europe in 1934. The first multi-coloured stamps were produced in 1956, and in 1974 the organisation split into 'post' and 'telegraph'; that is, into AP and Telecom Australia (now Telstra). Since then, AP has continued with innovations regarding the speed sorting of mail and its delivery.[2]

By 2008, AP was serving one million customers each day, and given the large number of post offices, its retail network was Australia's biggest. It has a 'community service obligation', a duty owed to the public because of its government past. Specifically, it is to provide 'accessible, affordable and reliable letter services for all Australians wherever they reside'.[3] This government business enterprise, which is entirely self-funding, finds letter delivery financially draining. Still, it delivers over 60 million items per week, with almost all of it delivered on time. To deliver the mail, AP must have sorting systems, post offices and delivery people. It employs about 36 000 workers in 3832 communities and has 10 000 delivery contractors. There are 4406 post offices and 15 591 street post office boxes. AP has over 48 retail 'superstores' to aid business and is an agent for 750 businesses. This is a huge retail and service network.

The financial figures for 2010–14 indicate a steady growth in revenue but a drop in letter volume.

The board and management team are well qualified and experienced and have usefully diverse backgrounds. Staff are experienced in postal services and are now trained in handling the various financial and service agencies that AP operates. A post office worker is simultaneously a retailer of standard goods and an agent for various banks and some government organisations, a varied role indeed. They are, particularly in rural areas, an important community resource.

The world of communication has changed and challenges AP. Post was once the only way to communicate at a distance. When the telegraph came, it was in AP's domain – a bonus rather than a threat. Then, after telephones came into prominence as a central communication device, it lost Telstra and with it the new world of communications. As time has passed, this has become more important; mobile phones and text messaging comprise a new technology that benefits their old stablemate but also challenges it. In addition, communication by email is now routine and social media is pervasive. Only around 1 per cent of messages are now delivered by post and 97 per cent of those are government- or business-related mail. Mail deliveries are going down by about 5 per cent every year, with no end in sight. Delivering mail was once a profitable business but it now costs AP about A$150 million each year.

Ahmed Fahour was the CEO of AP from 2010 to 2017. He was aware of these issues. The federal government deregulated the price of stamps and that had yielded more revenue, but not enough to make letter delivery cost-neutral. Deliveries take a little longer and prices are higher, which saves on staff and therefore on costs.

The orientation of AP in 2015 can be gauged from its 'priorities' as outlined in the organisation's 2015 *Annual Report*. It is focused on the digital world while still having a foot in the traditional world of parcels and letters:

**Table 1** **Five-year trends**

| | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|
| Revenue ($m) | 4 856.2 | 4 986.5 | 5 126.2 | 5 893.2 | **6 383.3** |
| Profit before tax ($m)(3) | 103.0 | 332.3 | 366.7 | 210.7 | **103.0** |
| Profit after tax ($m)(3) | 89.5 | 241.2 | 281.2 | 177.4 | **116.2** |
| Profit/(loss) from reserved services ($m)(1)(3) | (250.1) | (66.5) | (114.4) | (198.0) | **(242.6)** |
| Return on equity (%)(2)(3) | 6.2 | 15.0 | 16.8 | 10.5 | **6.7** |
| Return on average operating assets (%)(3) | 3.8 | 10.9 | 11.5 | 6.2 | **3.4** |
| Debt to debt plus equity | 26.4 | 23.6 | 29.1 | 27.3 | **28.8** |
| Dividends declared ($m) | 79.1 | 173.2 | 213.7 | 192.7 | **78.8** |
| Interest cover (times)(3) | 4.6 | 10.9 | 10.8 | 7.7 | **3.6** |
| Reserved services letter volumes (m) | 3 876.6 | 3 738.8 | 3 545.3 | 3 305.7 | **3 173.5** |

(1) The 2014 balance includes the impact of organisational restructuring.

(2) Return on equity is calculated as profit after tax as a percentage of equity. Equity has been adjusted to remove the impact of the group's net superannuation liability/asset.

(3) Changes to AASB 119 *Employee Benefits* took effect on 1 July 2014. 2013 has been restated for like-for-like comparison. Years prior to 2013 have not been adjusted to reflect this change in accounting standard.

Source: Adapted from Australia Post, 2015, *Annual Report 2015*, 15.

As a leading eCommerce business, we will continue to grow through the pursuit of three key priorities.

First, we must continue to focus on winning in our current business through protecting the investment in our postal and parcels capabilities, while harnessing the full potential of our letters service.

We will also work to transform the post office into a destination that will provide eCommerce services to consumers and small business customers, regardless of where they live.

Second, we will instil a culture of innovation to power a new suite of leading eCommerce solutions, making it safe and easy for consumers to shop online while also creating opportunities for businesses to go online and grow.

At the same time, we will continue to extend our trusted services portfolio to support the digital transformation of Australia's government and corporate sectors.

Finally, we will continue to invest in growing our domestic and international eCommerce capability by creating a low-cost, high-quality parcel delivery model, as well as extending our supply chain solutions.[4]

A good start has been made to gain advantage in the digital world. The internet is used by many to order goods – for example, books are available from Amazon and Book Depository – and the order usually comes by post. This is a booming business. This part of AP is in the hands of a logistics veteran who understands that industry and is eager to expand it. The public already seems to think of AP as a delivery company: in a recent survey, 57 per cent saw it as a parcel company, 28 per cent as a letter company and 17 per cent associated it with post offices.[5] The trick is to make it easy to buy off the internet and get the stuff delivered. AP is very good at this and is expanding the market. It already provides a postal service in the USA that allows Australians to use a US postal address in order to obtain goods from there easily. Launched in October 2014, ShopMate is a 'convenient and secure international delivery and payment service for Australian online shoppers, enabling them to buy from US retailers who do not ship to Australia'. The service is part of AP's 'commitment to provide customers with trusted delivery services and secure online payment options for shipping, no matter where they purchase their items from'.[6]

There is competition in this profitable arena, with FedEx a huge, globally active courier organisation. It recently

**Table 2** **Consolidated statement of changes in equity for the year ended 30 June 2015**

| Consolidated ($m) | Contributed equity | Reserves | Retained profits | Total equity |
|---|---|---|---|---|
| Balance at 30 June 2013 | **400.0** | **10.3** | **1 271.7** | **1 682.0** |
| **Comprehensive income** | | | | |
| Profit for the year | – | – | 116.2 | 116.2 |
| Other comprehensive income | – | (3.7) | 156.2 | 152.5 |
| Tax on other comprehensive income | – | 1.1 | (46.8) | (45.7) |
| **Total comprehensive income for the year** | **–** | **(2.6)** | **225.6** | **223.0** |
| **Transactions with owners** | | | | |
| Distribution to owners (refer to note A6) | – | – | (142.3) | (142.3) |
| **Balance at 30 June 2014** | **400.0** | **7.7** | **1 355.0** | **1 762.7** |
| **Comprehensive income** | | | | |
| (Loss)/profit for the year | – | – | (221.7) | (221.7) |
| Other comprehensive income | – | (1.1) | 531.1 | 530.0 |
| Tax on other comprehensive income | – | 0.6 | (159.3) | (158.7) |
| **Total comprehensive income for the year** | **–** | **(0.5)** | **150.1** | **149.6** |
| **Transactions with owners** | | | | |
| Distribution to owners (refer to note A6) | – | – | – | – |
| **Balance at 30 June 2015** | **400.0** | **7.2** | **1 505.1** | **1 912.3** |

Ordinary shares are classified as equity. Reserves include asset revaluation, foreign currency translation and hedging reserves.

Source: Australia Post, 2015, *Annual Report 2015*, 66.

acquired TNT Express (for A$6.3 billion) and is now the world's fourth-largest logistics company (US Postal is the largest). TNT was founded in Australia in 1946 with Thomas National Transport's first truck. In the 1970s it underwent a global expansion, and in the 1980s it concentrated on Europe. By the 1990s it had 70 000 employees and was globally significant in transport. In the early 1990s it was acquired by the national Dutch post and telecommunications company, which had been privatised in 1989 after 200 years of success as a government organisation. TNT then expanded still more overseas with big moves into Asia, acquiring organisations in India and China, and also Brazil.[7] It is world class in transport, with fleets of trucks and planes and well-established systems to handle cargo.

FedEx's US executives have already said that they plan to use the TNT acquisition to create a more efficient global network, reducing pick-up and delivery costs, particularly with international parcel deliveries acquired through online shopping; every organisation in the industry is after that market. 'We think there is a tremendous opportunity in cross-border e-commerce', FedEx's global executive vice-president of market development and corporate communications, Michael Glenn (who retired in 2016), told analysts in 2014.[8] Australia may be the target market for the company. FedEx does not yet provide domestic express services in Australia, focusing solely on the international market, but it uses its own aircraft to fly between Sydney and a regional hub in Guangzhou, where packages are sorted for delivery elsewhere to the world, and it also uses commercial aircraft. And, it operates 250 trucks and vans in Australia, and has couriers in most capital cities as well as Newcastle and Wollongong. The next step may not be difficult.

**Table 3** **Consolidated statement of cash flows for the year ended 30 June 2015**

| Consolidated ($m) | Note | 2015 | 2014 |
|---|---|---|---|
| **Operating activities** | | | |
| **Cash received** | | | |
| Goods and services | | 6 911.2 | 6 886.1 |
| Interest | | 5.3 | 9.2 |
| **Total cash received** | | **6 916.5** | **6 895.3** |
| **Cash used** | | | |
| Employees | | 2 927.6 | 2 746.0 |
| Suppliers | | 3 411.2 | 3 335.8 |
| Financing costs | | 36.5 | 41.3 |
| Income tax | | 14.7 | 59.7 |
| Goods and services tax paid | | 247.8 | 250.8 |
| **Total cash used** | | **6 637.8** | **6 433.6** |
| **Net cash from operating activities** | A5 | **278.7** | **461.7** |
| **Investing activities** | | | |
| **Cash received** | | | |
| Proceeds from sales of property, plant and equipment | | 66.6 | 240.1 |
| Sundry items | | 1.1 | 4.3 |
| **Total cash received** | | **67.7** | **244.4** |
| **Cash used** | | | |
| Purchase for investment in controlled entities | | 7.9 | – |
| Purchase of investment property | | 0.5 | 5.5 |
| Purchase of property, plant and equipment | | 238.2 | 390.1 |
| Purchase of intangibles | | 103.3 | 127.5 |
| **Total cash used** | | **349.9** | **523.1** |
| **Net cash used by investing activities** | | **(282.2)** | **(278.7)** |
| **Financing activities** | | | |
| **Cash received** | | | |
| Proceeds from borrowings | | – | 425.0 |
| **Total cash received** | | – | **425.0** |

| Consolidated ($m) | Note | 2015 | 2014 |
|---|---|---|---|
| Cash used | | | |
| Repayment of borrowings | | – | 340.0 |
| Dividends paid | | – | 142.3 |
| **Total cash used** | | **–** | **482.3** |
| **Net cash used by financing activities** | | **–** | **(57.3)** |
| **Net increase/(decrease) in cash and cash equivalents** | | **(3.5)** | **125.7** |
| Cash and cash equivalents at beginning of the year | | 418.6 | 292.9 |
| **Cash and cash equivalents at end of the year** | | **415.1** | **418.6** |

Source: Australia Post, 2015, *Annual Report 2015*, 67.

Toll Holdings, which got its start in Newcastle in 1887, is another large competitor and has an excellent Australian network. It currently dominates the local market for courier pick-up and delivery services, with an 8.8 per cent market share, ahead of DHL Express, which has a 6.7 per cent market share.[9] It also operates globally using a well-organised network. In March 2015, Toll became part of Japan Post in a huge deal, giving it even more resources. Japan Post has now made a public offer to become fully commercial, and the Japanese Government aimed in late 2015 to raise US$11.6 billion from it. The company owns 24 000 offices and has 200 000 staff, and it is also the biggest banking unit in Japan.[10] The resource set is huge even though it is mainly located in Japan; the Toll acquisition is part of a global move to diversify.

China is a big market for deliveries. AP already has 49 per cent of Sai Cheng Logistics International, which is a Chinese export company that is 51 per cent owned by China Post. The idea was to facilitate deliveries to and from China but about one-third now come from other countries. The company owns five Chinese warehouses that operate as delivery centres.[11] Fahour sees great possibilities for Asian expansion. International competition, however, is hot, with globally efficient FedEx in action.

AP is partly a pure logistics company; that is, a company that facilitates the flow and storage of goods from suppliers to buyers. In line with this, in 2010 it acquired 50 per cent of Star Track Express from its joint venture partner Qantas; now it owns 100 per cent of the organisation. This is aimed at its business-to-business accounts and holds considerable promise for good profits. But while AP already does good business in this area, it does not yet have many big clients and competition in the industry is brisk. For example, Dulux uses Linfox for the delivery of paints, and Linfox also owns and runs the distribution centres used for this. AP may need to consider the idea of owning more distribution centres if it is to get more big-business customers.

The delivery of letters is sure to decline, especially if the federal government decides to go digital with electoral and other government information. This is likely, since it will save money. The price Australians are used to paying for letters (it was A70c and is now A$1) is very low by international standards; for example, in Denmark – a similarly prosperous country – the charge is $2.46 per letter and in France it is $1.60. But would another sharp rise in postal costs defy the social obligations of AP?

Post offices in Australia are already business and consumer centres. They handle banking, insurance and reloadable credit cards and serve as a bill-paying centre. They also sell an array of books, games, phones, and miscellaneous goods. There is scope to expand the range of goods offered as well as the service area, handling licences, Medicare claims etc. Perhaps AP could move into business registration as well. After all, it owns a huge network of shopfronts in all parts of the country, not only in cities. No other organisation is so well set for offering services in terms of coverage. A big issue with such an expansion, though, is gaining government permission. After all, these services are already handled by government staff, and they are often unionised, hence there may be major issues with a change. And, assuming the idea went ahead, the training of AP staff in complex new areas is a big challenge. The British Post Office, however, has gone some way towards such a transition, as it says in its *Strategy 2020* document:

> Our unique branch network will remain at the heart of what we do, maintained at its current size but benefiting from modernisation and longer opening hours. We are also offering and developing new products – in financial services, mails, telecoms and as

a key partner for the delivery of government services. All of this will put the Post Office on the path to securing financial sustainability in the long term. There is no better indicator that the Post Office is changing than the experiences of customers in cities, towns and villages across the UK. Hundreds of branches have been transformed since 2012 and the evidence is that these changes are meeting with approval: customer satisfaction with the new branch models runs at 95%. And we are now able to set out the crucial steps needed to drive forward our transformation.[12]

The task for Australia Post is a big one: how can AP advance? It has a social responsibility, it competes with a range of well-resourced organisations, and the external world is heading fast the wrong way for a traditional post office organisation. Does it have the resources and capabilities required by this world? Will it get fully privatised like so many other national post offices?

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# CASE 3

## Nyrstar NV: a case study in a failed vertical integration strategy

GREG ZOOEFF

**CASE LINK:** This case applies concepts from Chapters 2, 3, 4, 5, 6, 7 and 8.

Source: FairfaxPhotos.com/Tony Walters

### BACKGROUND

Nyrstar NV (Nyrstar) is a zinc smelting and mining company that was formed in 2007.[1] The company was formed by the combination of the carved-out zinc smelting assets of Zinifex Ltd (a zinc smelting and mining company) and the carved-out smelting assets of Belgium-based Umicore SA/NV.[2] Nyrstar NV was subsequently listed on the Euronext Brussels stock exchange and was incorporated in the Belgium jurisdiction.[3] Nyrstar is a global multi-metals business with leading positions in zinc, lead and other precious metals, such as gold and silver[4] (see Figure 1 for global locations). It operates a network of zinc smelters in Europe, Australia and the USA and a lead metal/multi-metals facility in Australia (the Nyrstar Port Pirie smelter). It is a capital-intensive business operating in competitive markets where profitability is strongly correlated to international commodity prices and foreign exchange rates. Nyrstar was originally formed as a 'pure play' smelting company whose intended strategy was to act as an industry consolidator in a fragmented zinc smelting industry.[5] This strategic intent was short-lived when in 2009, with a change in CEO, the corporate strategy changed and backward vertical integration became a core part of its diversification strategy.[6] Nyrstar CEO at the time, Roland Junck, stated:

> We undertook a comprehensive strategic review and announced the results of this review during June 2009. We believe that our new strategy provides Nyrstar with a clear direction to pursue our vision of becoming the partner of choice in essential resources for the development of a changing world. In the six months since we announced our new strategy we have completed a number of key acquisitions that will ensure both smelting and mining provide valuable contributions to our future earnings, and we continue to actively explore additional opportunities to deliver on our strategy.[7]

### VERTICAL INTEGRATION STRATEGY

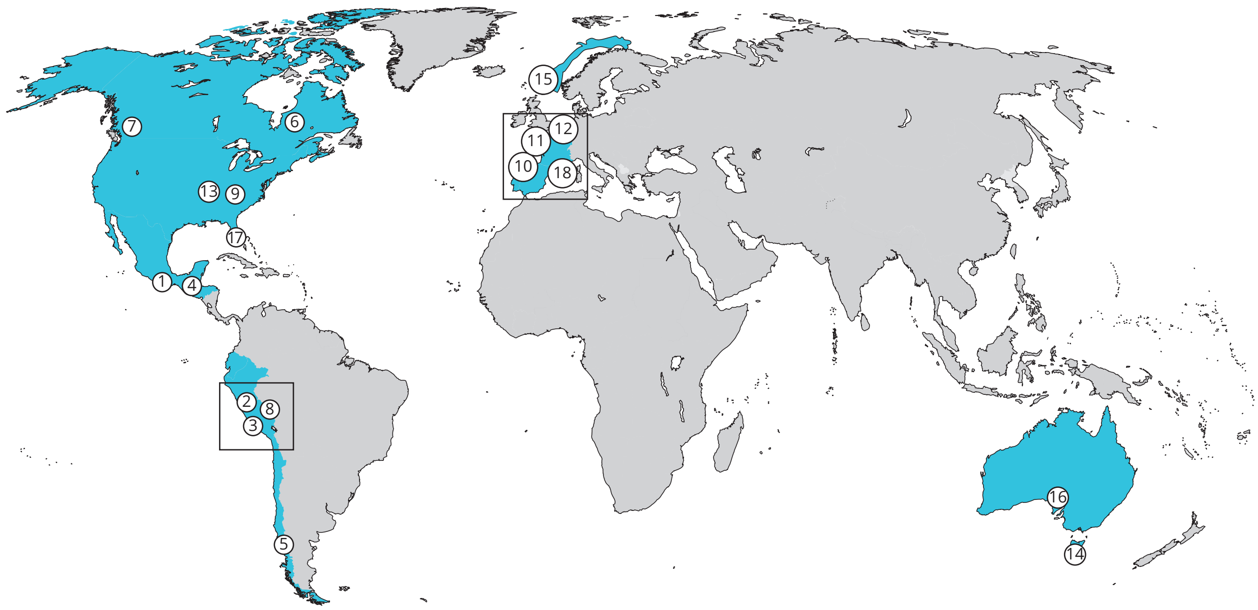
Nyrstar commenced acquiring zinc mining assets over a period of several years commencing in 2009.[8] The merger and acquisition (M&A) program resulted in several large acquisitions and a significant increase in financial leverage and debt to fund this vertical integration strategy. Mining assets were acquired in various geographies, but principally in South America and North America.

Several large transactions were completed, such as the acquisition of a zinc streaming agreement (a virtual mine) with a Finnish nickel mining company (Talvivaara) for US$335 million in 2009–10.[9] However, due to technical issues at the mine, the value of this agreement was eventually impaired and the asset value written off as Talvivaara entered a corporate reorganisation process in 2013.[10]

In 2010 Nyrstar acquired Farallon Mining Ltd, owner of the Campo Morado zinc-rich polymetallic mining operation in Mexico. At the time, Nyrstar completed an all-cash offer to acquire 100 per cent of the fully diluted common shares of Farallon by way of a friendly takeover bid for CN$0.80 per common share in cash, a total consideration of CN$409 million.[11]

In 2011 Nyrstar then acquired Breakwater Resources, which had operations in Canada, Honduras and Chile.[12] The Breakwater Resources transaction acquired all of the issued and outstanding shares of Breakwater with the takeover bid valued at CN$619m (US$636m).[13] The assets of Breakwater comprised four zinc polymetallic mines, including the El Toqui mine in Chile, the El Mochito mine in Honduras, and Myra Falls and Langlois mines in Canada.[14] These acquisitions significantly increased Nyrstar's

**Figure 1** **Nyrstar geographic reach**



(1) Campo Morado, Mexico
(2) Contonga, Peru
(3) Coricancha, Peru (Non-core asset)
(4) El Mochito, Honduras
(5) El Toqui, Chile
(6) Langlois, Canada
(7) Myra Falls, Canada
(8) Pucarajo, Peru (Non-core asset)
(9) Tennessee Mines, USA
(10) Auby, France
(11) Balen/Overpelt, Belgium
(12) Budel, The Netherlands
(13) Clarksville, USA
(14) Hobart, Australia
(15) Hoyanger, Norway
(16) Port Pirie, Australia
(17) Fort Lauderdale, Miami, USA
(18) Zurich, Switzerland

Source: *Nyrstar Annual Report 2014*, https://www.nyrstar.be/~/media/Files/N/Nyrstar-IR/shareholder-meetings/english/2015/7-nyrstar-ar14-en-planche.pdf, p. 40.

internal zinc concentrate production capability to 43 per cent of the group's concentrate requirement, based on all mining operations reaching full production.[15]

## ZINC SUPPLY VALUE CHAIN

The zinc supply value chain is represented in Figure 2. The raw material zinc concentrate is sourced by smelters locally and internationally. The metal value contained in zinc concentrates is typically shared between mines and smelters. The commercial arrangements involve a concentrate treatment charge (TC) being paid by mines to smelters, and smelters pay the mines the industry standard 85 per cent for the contained zinc metal value. Industry players often refer to this split as the concept of profit sharing.[16] The profitability of smelters is highly leveraged to the TC (and a smaller proportion of profitability at approximately 8–10 per cent from the metal price) but, for mines, profitability is mainly determined by the prevailing metal price for zinc metal as smelters pay 85 per cent of the zinc price for concentrate.[17] The TC terms are influenced by the respective bargaining power of mines and smelters, industry supply/demand dynamics, market phase (concentrate tightness vs surplus) and the quality of concentrate.[18]

Figure 3 summarises the dynamic and cyclical nature of zinc concentrate TCs with phase of the market cycle. It highlights that there are four distinct phases in the zinc market, where bargaining power shifts between the mines and smelters depending on the supply/demand balance for concentrate material, global metal inventories and industrial production (final end use demand). These cycles impact either favourably or unfavourably on the economics of the respective mining and smelting business. In the case where mines have bargaining power that is characterised by concentrate deficits, the TC will fall and smelter profitability will be negatively affected.[19] The opposite occurs when there is a surplus of concentrate material and smelters regain the bargaining power and TCs rise, thereby increasing smelter profitability, and smelters then aim to maximise the TC income and increase production. This, however, inevitably causes an increase in metal stocks and, with higher concentrate stocks, results in a decline in zinc metal prices, which is generally followed by a reduction in mine output as mines respond to the higher inventory of concentrate stocks with the objective to rebalance market prices.[20] The cycle then repeats itself. An organisation that is highly integrated with mine and smelting capacity can capture a higher proportion of the metal value through the TC and the metal price and reduce the exposure to the cyclical market risk. Thus a diversification strategy using vertical integration in the zinc industry can theoretically create greater value and minimise the risk to cash flows compared to a single business mining or smelting only company.

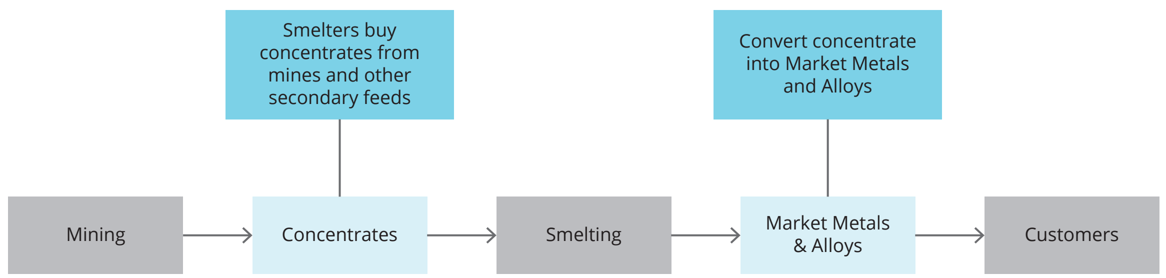
## ZINC SMELTING INDUSTRY STRUCTURAL CHARACTERISTICS

The zinc smelting industry is a highly fragmented industry with a low degree of concentration of production capacity. The top six zinc smelting companies accounted for 36.4 per cent of global capacity in 2017.[21] Global production in zinc smelting is dominated by Chinese producers where ownership is dispersed over a number of organisations but in aggregate accounts for 50 per cent of global capacity.[22] The zinc smelting industry is a mature industry. It has high exit costs, high capital cost requirements and a high degree of rivalry among incumbent organisations. The degree of product differentiation is low because commodity grade zinc is the principal industry product and is purchased through exchanges such as the London Metal Exchange. The bargaining power is relatively modest due to the low degree of industry supply concentration.

## NYRSTAR'S VERTICAL INTEGRATION AND VALUE CREATION STRATEGY

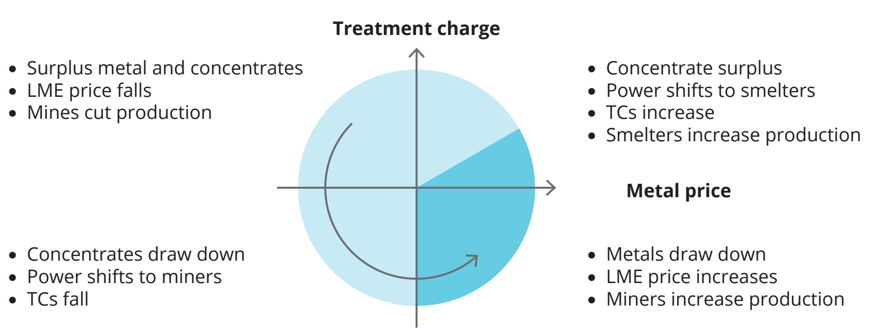
Vertical integration is a related diversification strategy in which an organisation seeks to increase market power by either producing the upstream inputs or owning the output distribution.[23] This approach can improve costs and protect the

**Figure 2** Zinc metal supply value chain




Source: Nyrstar, 2009, *Introduction to Zinc and Lead Smelting Business*, 25 November, https://www.nyrstar.be/~/media/Files/N/Nyrstar-IR/results-reports-and-presentations/english/2009/zincleadsmelting.pdf, p. 4.

**Figure 3** Zinc treatment charge dynamics




Source: Nyrstar, 2009, *Introduction to Zinc and Lead Smelting Business*, 25 November, https://www.nyrstar.be/~/media/Files/N/Nyrstar-IR/results-reports-and-presentations/english/2009/zincleadsmelting.pdf, p. 8.

core business. However, vertical integration can have limitations and risks.[24] The core competence of a company is a critical factor in the development and execution of diversification strategies such as vertical integration.[25] In Nyrstar's case, vertical integration was sought to:

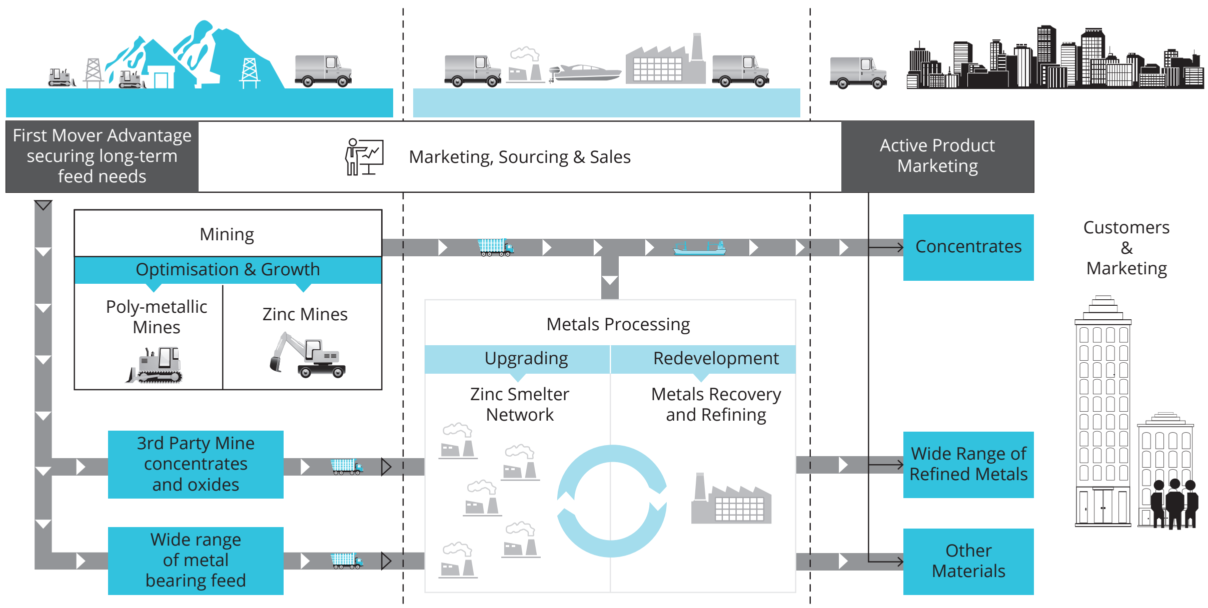
1. partially insulate from the dynamics of the TC cycle by owning upstream operating mines, thereby attaining more of the overall profit share from a consolidated group position
2. provide some self-sufficiency for raw material for the smelters, thereby reducing reliance on externally sourced concentrate and thus reducing supply risk
3. Nyrstar's competitors such as Glencore and others have backward integration strategies so without vertical integration Nyrstar would be at a competitive disadvantage and be exposed to the cyclical market risk when TCs were low
4. provide a source of other valuable metal by-product inputs such as silver, gold and copper, which could be recovered within its smelting division and sold, earning additional value.[26]

In 2013, Nyrstar announced a revised strategy to enhance the integration across the value chain, which is summarised diagrammatically in Figure 4.[27] Central to this was the redevelopment of the Nyrstar Port Pirie smelter. Nyrstar's mission was to capture the maximum value inherent in mineral resources through market insight and unique processing capabilities, generating superior returns to shareholders, but core to this was the newly acquired portfolio of mining assets.[28]

## FINANCIAL PERFORMANCE OF THE NYRSTAR GROUP IN 2015

In 2015 the Nyrstar Group delivered a gross profit of EUR 1336 million, driven principally by its Metals Processing segment (zinc smelting division including the Port Pirie multi-metals facility), and mainly due to the strength of the US dollar against the euro and improved zinc treatment charge terms, but offset by the effect of weaker commodity prices.[29] The underlying earnings before interest, tax, depreciation and amortisation (EBITDA) in 2015 was EUR 256 million, which represented an increase of EUR 19 million from 2014. However, non-cash, pre-tax impairment losses of EUR 564 million were recognised in 2015 (2014: EUR 255 million), which resulted in a full year loss of EUR 432 million[30] (see Table 1). The impairment losses related to pre-tax impairment charges on Nyrstar's mining assets of EUR 548 million (2014: EUR 246 million). The remaining impairment losses related to non-core operations of the Nyrstar Group of EUR 16 million (2014: EUR 1 million).[31]

**Figure 4** **Nyrstar's intended strategy in 2013**




Source: Nyrstar, 2013, *Nyrstar Annual Report 2013*, https://www.nyrstar.be/~/media/Files/N/Nyrstar-IR/results-reports-and-presentations/english/2014/nyrstar-annualreport13-en.pdf, p. 13.

The company's net debt at the end of 2015 was EUR 761 million, which was an increase of 74 per cent from EUR 438 million for the year 2014.[32] The increase in net debt was due to the capital expenditure for the Metals Processing segment and negative cash flow from the Mining segment. The cash on hand at the end of 2015 was EUR 116 million, which was lower than 2014, where the EUR 499 million figure was due to cash flows from refinancing activities with an issue of new convertible notes and rights issue.[33] The draw-down on the cash balance during 2015 was principally due to the investment in the Nyrstar Port Pirie Smelter Redevelopment project, among other smelting segment investments. The gearing and net debt to EBITDA materially deteriorated between 2014 and 2015 (see Table 1).[34]

## MINING SEGMENT PERFORMANCE – FY2015

The mining division financial performance is outlined in Table 2. The mining segment performance recorded materially lower gross profit and EBITDA due to commodity prices and mine output underperformance.[35] In 2015, the Nyrstar mines produced approximately 234 kt of zinc in concentrate, a decrease of 16 per cent compared to 2014, which was impacted by the suspension of operations at Campo Morado, the suspension at the Myra Falls mine and the suspension of US mines in Tennessee.[36] The impairment losses related to pre-tax impairment charges on Nyrstar's mining assets of EUR 548 million. At 30 June 2015, Nyrstar tested all of its mining assets for impairment and recognised a non-cash, pre-tax impairment loss of EUR 418 million, which was related to the full write-down of the carrying value of the Campo Morado mine of EUR 376 million. In part, this was due to uncertainty related to the restart of the mine related to security risks in the Mexican state of Guerrero, with the remainder due to the decrease in carrying values for the El Toqui, Langlois and Myra Falls mines.[37] On 31 December 2015, with further deterioration in commodity prices, Nyrstar conducted further impairments of its mining assets and recognised an additional non-cash, pre-tax impairment loss of EUR 146 million.[38]

## NYRSTAR'S STRATEGY RESET AND MINING DIVESTMENT STRATEGY

In 2014–15 Nyrstar revised its strategy to reposition the business for a sustainable future as a leading metals processing business through its unique processing capabilities. To realise

**Table 1** Key financial metrics FY2015 vs FY2014

| Key data<br>EUR million unless otherwise indicated | FY 2015 | FY 2014 | % Change |
|---|---|---|---|
| **Income statement summary** | | | |
| Revenue | 3 139 | 2 799 | 12% |
| Gross profit | 1 336 | 1 293 | 3% |
| Direct operating costs | (1 063) | (1 049) | 1% |
| Non-operating and other | (16) | (7) | 129% |
| Metal Processing EBITDA | 336 | 239 | 41% |
| Mining EBITDA | (41) | 44[2] | (193%) |
| Other & Eliminations EBITDA | (38) | (46) | (17%) |
| **EBITDA**[1] | **256** | **2 37**[2] | **8%** |
| EBITDA margin | 8% | 8% | 0% |
| Underlying adjustments | (3) | 39[2] | (101%) |
| Depreciation, depletion and amortisation | (251) | (257) | (2%) |
| Impairment loss/Impairment reversal | (564) | (255) | 121% |
| Net finance expense | (115) | (108) | 6% |
| Income tax benefit | 245 | 57 | 330% |
| Profit/(loss) for the period | (432) | (287) | 51% |
| Basic EPS (EUR) | (1.32) | (1.22) | 8% |

| | | | |
|---|---|---|---|
| CapEx | 419 | 294 | 43% |
| **Cash flow** | | | |
| Cash flow from operating activities before working change | 235 | 243 | (3%) |
| Working capital and other changes | (242) | 68 | (456%) |
| **Net debt exclusive of zinc prepay** | | | |
| Net debt, end of period | 761 | 438 | 74% |
| Net debt to EBITDA ratio[4] | 3.0 | 1.6[3] | – |
| Gearing[5] | 54% | 31% | – |
| **Net debt inclusive of zinc prepay** | | | |
| Net debt, end of period[6] | 896 | 438 | 105% |
| Net debt to EBITDA ratio[7] | 3.5 | 1.6[3] | – |
| Gearing[8] | 58% | 31% | – |

1 All references to EBITDA in the Annual Report 2015 are Underlying EBITDA. Underlying measures exclude exceptional items related to restructuring measures, M&A-related transaction expenses, impairment of assets, material income or expenses arising from embedded derivatives recognised under IAS 39 and other items arising from events or transactions clearly distinct from the ordinary activities of Nyrstar.

2 2014 Mining and Group EBITDA excludes non-cash gain of EUR 43 million achieved on the settlement of the Silver Stream at Campo Morado with Silver Wheaton. The gain was shown as part of underlying adjustments.

3 Based on actual EBITDA of EUR 280 million.

4 Net Debt to EBITDA ratio is calculated as Net Debt at the end of the period divided by last 12 months EBITDA.

5 Gearing is calculated as net debt to net debt plus equity at end of period.

6 Calculated as non-current and current loans and borrowings plus non-current other financial liabilities less cash and cash equivalents at end of period.

7 Calculated as non-current and current loans and borrowings plus non-current other financial liabilities less cash and cash equivalents at end of period divided by last 12 months EBITDA.

8 Calculated as non-current and current loans and borrowings plus non-current other financial liabilities to net debt plus non-current other financial liabilities plus total equity at end of period.

Source: *Nyrstar Annual Report 2015*, https://www.nyrstar.be/~/media/Files/N/Nyrstar-IR/shareholder-meetings/english/2016/10-annual-report-en-.pdf, p. 43.

this strategy, management determined the following strategic priorities:

- strengthen and maintain a more conservative balance sheet
- streamline the asset base with a focus on smelting operations
- redevelop the Port Pirie metal recovery and refining facility to maximise the value from concentrates and residues
- improve performance of the mining segment
- selectively invest in the existing smelter network to allow the processing of higher margin feeds
- optimise the feed book of raw materials
- improve end product mix and integration with key end users.[39]

However, in the second half of 2015 an asset assessment of the Mining segment confirmed that the scale of the Mining segment relative to the Metal Processing segment's requirement for concentrate was not material enough to justify the levels of capital allocation to the mines (see Figures 5 and 6).[40] It was determined that some of the Nyrstar mining operations had strong potential but the segment as a whole was expected to underperform without an injection of significant additional capital.[41] Nyrstar was capital constrained given the changed focus on its Metals Processing growth projects as well as the high sustaining 'standstill' capital for its existing smelters.[42] The board determined that a divestment process be initiated for some or all of Nyrstar's

**Table 2 Key financial metrics for mining segment FY2015 vs FY2014**

| Operations review: mining<br>Mining<br>EUR million unless otherwise indicated | FY 2015 | FY 2014 | % Change |
|---|---|---|---|
| Treatment charges | (78) | (84) | (7%) |
| Payable metal contribution | 347 | 373 | (7%) |
| By-products | 90 | 165 | (45%) |
| Other | (29) | (26) | 12% |
| **Gross profit** | **330** | **429** | **(23%)** |
| Employee expenses | (141) | (149) | (5%) |
| Energy expenses | (44) | (51) | (14%) |
| Other expenses | (170) | (170) | 0% |
| **Direct operating costs**[1] | **(355)** | **(370)** | **4%** |
| Non-operating and other | (16) | (15)[2] | 7% |
| **EBITDA** | **(41)** | **44**[2] | **(193%)** |
| Sustaining CapEx | 34 | 45 | (24%) |
| Exploration and development CapEx | 48 | 48 | 0% |
| Growth CapEx | 10 | 15 | (33%) |
| **Mining CapEx** | **92** | **108** | **(15%)** |

1 In 2015 Nyrstar changed its internal allocation of certain operating costs to its operating segments. This changed the composition of the allocation of the direct operating costs between the segments. The related 2014 information was restated to provide comparable information for the period. The change did not impact the previously reported Underlying EBITDA by the segments.

2 2014 Mining EBITDA excludes non-cash gain of EUR 43 million achieved on the settlement of the silver stream at Campo Morado with Silver Wheaton. The gain was shown as part of underlying adjustments.

Source: *Nyrstar Annual Report 2015*, https://www.nyrstar.be/~/media/Files/N/Nyrstar-IR/shareholder-meetings/english/2016/10-annual-report-en-.pdf, p. 49.

mining assets. At the time, BMO Capital Markets and Lazard were engaged as financial advisers to pursue a sale of all or the majority of the Mining segment assets.[43] This divestment process was launched on 7 January 2016.[44]

## ACQUISITION OF NYRSTAR: RESTRUCTURING DEAL

In late 2018/early 2019, as a consequence of challenging market conditions and a high degree of financial leverage, Nyrstar was facing growing solvency and liquidity risks. Since the listing of Nyrstar on the Euronext Brussels, Nyrstar group had recognised total impairments of approximately EUR 1.65 billion, mainly due to the carrying values of the mining assets, including the zinc streaming agreement with Talvivaara. These impairments caused significant deterioration in capital structure and financial risks on Nyrstar's balance sheet. This and the deterioration in macro-economic conditions meant that Nyrstar experienced material deterioration in revenues and cash flows. The company also had to deal with the refinancing of the maturity of a EUR 340 million bond in September 2019. These internal and external factors created short-term liquidity challenges and, in the absence of any balance sheet restructuring and capital structure review, Nyrstar would have faced becoming insolvent.[45] Nyrstar's board of directors subsequently announced a capital structure review, among other actions, to address the liquidity risks. Through this process there were few to no options available to Nyrstar other than a restructuring transaction where Nyrstar's debt providers would have to sustain material reductions in the face value of the debt. At the time one of Nyrstar's shareholders, Trafigura Group Pte Ltd, a privately owned market leader in the global commodities and energy trading industry, entered

**Figure 5** **Mining segment asset strategic review**

| Mine | Location | Competitiveness Zn S1,700/t | Competitiveness Zn $2,000/t | Resource potential | Product attractiveness | Capex Requirements | Core to Nyrstar | Comments |
|---|---|---|---|---|---|---|---|---|
| Campo Morado | Mexico | Weak | Marginal | Marginal | Marginal | Marginal | Weak | • Indefinite care and maintenance<br>• Ongoing cash cost at EUR 5 million per year post recent cost-saving measures<br>• Non-core to Nyrstar and divestment process underway |
| Myra Falls | Canada | Weak | Marginal | Strong | Strong | Weak | Weak | • Production suspended in May 2015<br>• Turnaround investment works have been suspended<br>• Ongoing cash cost at EUR 15–20 million per year post recent cost-saving measures<br>• Non-core to Nyrstar and divestment process underway |
| Contonga | Peru | Marginal | Strong | Strong | Marginal | Marginal | Weak | • Operations are ongoing<br>• High exploration and development potential<br>• Non-core to Nyrstar and divestment process underway |

Strong Marginal Weak

Source: Nyrstar, 2015, *Balance Sheet Strengthening Measures, Investor presentation*, 9 November, https://www.nyrstar.be/~/media/Files/N/Nyrstar-IR/results-reports-and-presentations/english/2015/balance-sheet-strengthening-presentation-final.pdf, p. 9.

into lock-up agreements and a restructuring deal with Nyrstar's bondholders, convertible note holders and bank lenders. On 31 July 2019, after successful completion of the restructuring, Trafigura became the majority owner of the operating assets of Nyrstar.[46]

## Questions

1. Compare the advantages and disadvantages of backward vertical integration. In the Nyrstar case, what were the key limitations and issues of this strategy?
2. Describe and critique the Nyrstar strategy as announced during 2015, using strategy frameworks. Explain your reasons.
3. What was Nyrstar's core competence? Did this support or hinder the vertical integration strategy?
4. In mature industries like zinc, what other corporate strategic actions other than vertical integration could organisations take to increase shareholder value? Discuss other value creation approaches.
5. In late 2010 Nyrstar made an all-cash takeover offer for the outstanding shares of Farallon Mining, valuing the equity at CN$409 million. As a result of this transaction, Nyrstar would fully own the Campo Morado asset in Mexico. The purported benefits to Nyrstar were an increase in upstream integration with low-cost mine operation, enhancement of its growth platform in the Americas, with substantial exploration potential and accretive to near-term earnings and cash flow. However, the mine never operated and was under indefinite care and maintenance. Discuss the key strategic and financial risks with international approaches to diversification.
6. The eventual acquisition of Nyrstar by Trafigura Group Pte Ltd averted the certain financial collapse of the Nyrstar group. The poorly crafted and failed vertical integration strategy was a major cause of Nyrstar's resulting poor financial position and solvency issues. Based on this case study and your analysis of Nyrstar's strategy, what were the key risk management failings with Nyrstar's growth ambitions and strategy?

**Figure 6** **Mining segment asset strategic review**

| Mine | Location | Competitiveness Zn S1,700/t | Competitiveness Zn $2,000/t | Resource potential | Product attractiveness | Capex Requirements | Core to Nyrstar | Comments |
|---|---|---|---|---|---|---|---|---|
| El Mochito | Honduras | Strong | Marginal | Marginal | Strong | Strong | Weak | • Remains operational<br>• Provides option value to Nyrstar but requires capital expenditure<br>• Underutilised milling capacity<br>• Continuing to review cost and capex savings, while disposal options are progressed |
| El Toqui | Chile | Weak | Marginal | Marginal | Marginal | Marginal | Weak | • Remains operational<br>• Has recently seen an increase in mining production<br>• Underutilised milling capacity<br>• Provides option value to Nyrstar but requires capital expenditure<br>• Continuing to review cost and capex savings while disposal options are progressed |

Strong Marginal Weak

Source: Nyrstar, 2015, *Balance Sheet Strengthening Measures, Investor presentation*, 9 November, https://www.nyrstar.be/~/media/Files/N/Nyrstar-IR/results-reports-and-presentations/english/2015/balance-sheet-strengthening-presentation-final.pdf, p. 9.

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# CASE 4

## Pfizer

JANUARY 2017

*'When Ian Read, an accountant and company lifer, took over as Pfizer's chief executive in December 2010, the drug firm was facing the impending patent expiration of Lipitor, the best-selling drug ever made, and the utter failure of one of the most lavishly funded research laboratories on the planet to develop much of anything. The stock was suffering, and Read's predecessor–Jeffrey Kindler, a bearlike lawyer hired from McDonald's–had just spent $68 billion to buy rival drug maker Wyeth in a Hail Mary strategy shift. Now Read had to make it work.'*[1]

### COMPANY AND INDUSTRY BACKGROUND

Pfizer was established in 1849 in Brooklyn, New York, by cousins Charles Pfizer and Charles Erhart with a loan of $2,500 from Pfizer's father.[2] Today, 167 years later, Pfizer Inc. has international revenues of $49 billion, which makes it the second-largest pharmaceutical manufacturer in the world.[3] Despite Pfizer's success, the company has faced many challenges over the last few decades. The pharmaceutical industry is heavily influenced by legal, political, and technological forces, and all indications are that the industry will continue to experience dramatic changes.

Since the passing of the Food and Drug Act in 1906, the Food and Drug Administration (FDA) has had regulatory authority over drugs in the United States. The scope of its initial authority was limited and in 1938 President Roosevelt signed the Food, Drug and Cosmetic Act (FD&C) into law, which significantly expanded federal oversight of drug manufacturing and marketing.[4] In addition to granting the FDA authority to mandate pre-market review of drugs, the FD&C also allowed the FDA to regulate drug labelling and advertising. Then, in 1992, Congress passed the Prescription Drug User Fee Act, which enables the FDA to collect fees from drug manufacturers to aid in funding the pre-market review process for new drug approvals.[5] The effect of these reforms was significant increases in the time and cost for drug manufacturers to bring new drugs to market.

In 2006, a study estimated the cost of bringing a new drug to market was between $802 million and $2 billion, depending on the type of drug being developed and the number of drugs being developed simultaneously.[6] The study found that approximately 60% of the total cost of drugs was related to pre-market clinical trials required by the FDA. As inflation, increased regulation, and other factors have affected the pharmaceutical industry, a 2012 study indicated that the cost per drug for the largest manufacturers has increased to over $5.5 billion.[7] For Pfizer, the total Research & Development (R&D) cost for each drug that received FDA approval was $7.7 billion between 1997 and 2011.[8] The steep rise in development costs has forced many large drug manufacturers – including Pfizer – to cut R&D budgets in an attempt to control rising costs.[9]

The reduction in R&D funding in reaction to expanding costs has led to stifled innovation and revealed a crisis looming ahead for many large drug manufacturers in the industry. Not only have many drug companies' blockbuster drugs gone off patent in recent years, but the reductions in R&D spending have resulted in drug pipelines that have failed to produce anything of significant value.[10] The number of new drugs approved by the FDA per billion dollars of R&D expenditures has halved every nine years since 1950.[11] The rapid increase in the cost of drug development and the reduction in the approval frequency of blockbuster-level drugs has led many industry experts to largely consider the current, fully integrated business model of large pharmaceutical companies to be unsustainable.[12]

### BUSINESS AND STRATEGIES

Like most large pharmaceutical manufacturers, Pfizer pursues a 'blockbuster' business model that is heavily reliant on its R&D pipeline to consistently develop and launch high volume drugs – drugs with expected annual revenues of $1 billion or greater.[13] In 2012, Pfizer began restructuring its operations into a new commercial operating model. Pfizer divested its infant nutrition business for $11.9 billion and spun-off its animal health unit, Zoetis. Additionally, Pfizer restructured its operations into two primary business segments: Innovative Products and Established Products. Pfizer's Innovative Products business is further divided into the Global Innovative Pharma (GIP) and Global Vaccines, Oncology and Consumer Healthcare (VOC) businesses.[14] Ian Read commented regarding the restructuring: 'This represents the next steps in Pfizer's journey to further revitalise our innovative core. Our new commercial model will provide each business with an enhanced ability to respond to market dynamics, greater visibility and focus, and distinctive capabilities.'[15] Figure 1 contains some useful financial comparisons between Pfizer's Innovative Products and its Established Products.

## Innovative products business

*Global Innovative Pharma (GIP) Business*. This business focuses on developing, registering and commercialising novel, value-creating medicines that improve patients' lives. Therapeutic areas include inflammation, cardiovascular/metabolic, neuroscience and pain, rare diseases and women's/men's health and include leading brands, such as Xeljanz®, Eliquis® and Lyrica®. GIP has a robust pipeline of medicines in inflammation, cardiovascular/metabolic disease, pain and rare diseases.[16]

*Global Vaccines, Oncology and Consumer Healthcare Business*. This segment consists of three businesses with the following key elements: (1) poised for high, organic growth; (2) distinct specialisation and operating models in science, talent and market approach; and (3) structured to ideally position Pfizer to be a market leader on a global basis.[17] Consumer products include Advil®, Centrum®, Robitussin®, Nexium® and ChapStick®.

## Established Products business

*Global Established Pharma (GEP) Business*. This area consists of three primary product segments: (1) Peri-LOE products which are losing or approaching a losing position in market exclusivity; (2) legacy established products in developed markets that have lost market exclusivity and those with growth opportunities; and (3) emerging market products with growth opportunities such as organic initiatives, partnerships, product enhancements, sterile injectables and biosimilars.[18] Examples of established products include Celebrex®, EpiPen®, Zoloft® and Lypitor®.

## Pricing strategy

Pfizer's and other large drug companies' revenue growth has been largely dependent on raising the price of older drugs, particularly those nearing patent expirations. Approximately

**Figure 1** **Pfizer business segment comparisons**

**Business Segment Financials Innovative vs Established Segments**

| | 2015 | | 2014 | | 2013 | |
|---|---|---|---|---|---|---|
| | Innovative | Established | Innovative | Established | Innovative | Established |
| Revenues | $26 758 | $21 587 | $24 005 | $25 149 | $23 602 | $27 619 |
| Cost of Sales | 3 650 | 4 486 | 3 848 | 4 570 | 3 675 | 4 732 |
| % of revenue | 13.60% | 20.80% | 16.00% | 18.20% | 15.60% | 17.10% |
| Selling, informational and administrative expenses | 6 807 | 3 572 | 6 162 | 3 903 | 5 520 | 4 714 |
| R&D Expenses | 3 030 | 758 | 2 549 | 657 | 2 154 | 737 |
| Amortisation of intangible assets | 94 | 36 | 69 | 85 | 58 | 100 |
| Restructuring charges and certain acquisition-related costs | – | – | – | – | 6 | – |
| Other (income)/ deductions – net | (1.087) | (150) | (1.096) | (265) | (576) | (216) |
| Income from continuing operations before provision for taxes on income | $14 264 | $12 885 | $12 472 | $16 199 | $12 765 | $17 552 |

Source: 2015 Pfizer Annual Report.

34% of Pfizer's revenue growth over the past three years has come from increasing prices on existing drugs.[19] Over this period, Pfizer has increased the price of Viagra by 57%, of Lyrica by 51% and of Premarin by 41%. A 2013 study by the AARP found that the price of Lipitor rose by 9.3% in the year preceding patent expiration, and by 17.5% in 2011, the year of expiration.[20] Pfizer is not alone in these practices. AbbVie and Bristol-Myers Squibb have both been reported as generating a very significant amount of their revenue growth from price increases. Drug pricing scandals and increased media and societal attention on drug pricing in general makes Pfizer's reliance on pricing strategy to drive top-line revenue growth unsustainable. This is evident in the drug industry's flat net pricing in 2015.[21]

## Growth strategy

Pfizer has become one of the largest pharmaceutical companies in the world primarily as a result of aggressive mergers and acquisitions (M&A). Pfizer's acquisitions have been focused on two main strategies: expanding its capabilities and acquiring brands with strong revenues. Many of Pfizer's acquisitions have provided new capabilities for the organisation, such as biologics with the acquisition of Warner-Lambert in 2000 and biosimilar drugs with the acquisition of Hospira in 2015. Additionally, Pfizer acquired the rights to the best-selling drug Lipitor in its 2000 acquisition of Warner-Lambert and the rights to Celebrex and Bextra in its 2003 acquisition of Pharmacia Corporation. From Pfizer's press releases and company history, a brief timeline of Pfizer's major acquisitions (and divestitures) is outlined below:[22]

- 2000: Pfizer acquires Warner-Lambert for $90 billion for their biologics and consumer products portfolio, along with the rights to Lipitor.
- 2003: Pfizer acquires Pharmacia Corporation for $60 billion and acquires the rights to Celebrex, Bextra, Detrol and Xalatan.
- 2005: Pfizer acquires Vicuron Pharmaceuticals for $1.9 billion for their antibiotic research and development.
- 2006: Pfizer sells its consumer products division to Johnson & Johnson for $16.6 billion.
- 2007: Pfizer acquires Coley Pharmaceutical for $164 million for their portfolio of biotechnology, cancer and vaccine drugs.
- 2009: Pfizer acquires Wyeth for $68 billion for their portfolio of biotech drugs.
- 2010: Pfizer acquires King Pharmaceuticals for $3.6 billion and acquires the rights to EpiPen.
- 2015: Pfizer Acquires Hospira for $16 billion for their biosimilar and injectable drugs portfolio, as well as infusion technologies.[23]
- 2016: Pfizer acquires Anacor Pharmaceuticals for $5.1 billion for their topical anti-inflammatory drugs and acquires the rights to Crisaborole.[24]
- 2016: Pfizer acquires Medivation for $14 billion for its prostate cancer drug Xtandi.[25]

Pfizer has attempted unsuccessfully to acquire a foreign drug company and relocate its headquarters overseas. CEO Ian Read has said numerous times that the company faces a competitive disadvantage with foreign rivals that have significantly lower tax bills.[26] These sorts of deals are called corporate inversions – transactions undergone by a US company that moves its tax residence to a foreign country in order to reduce US taxes.[27] In 2014, Pfizer attempted a merger with rival AstraZeneca, which faced fierce opposition from lawmakers on either side. In the end, Pfizer walked away from the $118 billion deal after rejection by AstraZeneca's board.[28]

In 2016 Pfizer entered into an agreement to merge with Allergan. The $160 billion deal would have created the largest pharmaceutical company in the world and would have allowed Pfizer to relocate its headquarters to Allergan's home country of Ireland in order to take advantage of their lower corporate tax rate.[29] However, on April 4, 2016, the US Department of Treasury took measures to limit corporate inversions.[30] Previously, a company realised tax benefits for inversions only when the foreign company would contribute 20% or greater of the combined company's assets. The new ruling disregards the last three years of US acquisitions by the foreign entity when determining the foreign company's relative size under the combined entity. The new rule was the predominant factor that caused Pfizer to pay $150 million to walk away the Allergan deal.[31] Pfizer would not have realised the full tax benefit of the inversion because Allergan's relative size would have fallen below the 20% threshold under the new tax rules.

## Innovation strategy

Pfizer has a long history of investing in R&D for the development of blockbuster drugs. However, many industry experts believe the age of blockbuster drugs has come to an end and that new blockbusters will be rare.[32] They argue that the opportunities for revolutionary drugs have been mostly exploited, with very few areas of medicine in which breakthrough drugs can have a huge impact. In light of industry trends, Pfizer has shifted its strategy of maintaining an industry-leading drug pipeline from in-house development to being more reliant on strategic partnerships and mergers and acquisitions.

To support its interest in strategic partnerships, in 2004 Pfizer founded Pfizer Venture Investments (PVI). Its goal is to identify and invest in strategic areas and businesses at the leading edge of healthcare science and technologies. PVI started with a $50 million annual budget and was Pfizer's way of staying ahead of industry trends and investing in companies which are developing compounds and technologies that will enhance Pfizer's drug pipeline and help drive the future of the pharmaceutical industry.[33] In January 2016, Pfizer announced that it would be expanding its investment strategy to include investments in early-stage scientific innovations in immuno-oncology, gene therapy and other cutting-edge fields. Pfizer invested nearly $46 million in four companies in these fields: BioAtla, NextCure Inc., Cortexyme Inc. and 4D Molecular Therapists, Inc. Pfizer's strategic partnership with these and other firms provides a world-class resource in start-up organisations to accelerate the pace of scientific innovation and to help develop their pipeline of drugs.[34]

## INSIDE PFIZER

### Management team

#### CEO, Ian C. Read

Ian C. Read was elected CEO of Pfizer in December of 2010 and Chairman of the Board in 2011, taking over from Jeffrey Kindler. Read has spent his entire career at Pfizer, starting as an operational auditor. Read's B.S. in chemical engineering and accounting experience set the groundwork for a successful career in pharmaceuticals. Some of his previous roles included CFO of Pfizer Mexico, Country Manager of Pfizer Brazil, President of Pfizer's International Pharmaceuticals Group, Executive Vice President of Europe and Corporate Vice President. Read also serves on the boards of Pharmaceutical Research Manufacturers of America (PhRMA), which represents the leading innovative biopharmaceutical research companies.[35]

#### Executive VP Strategy Portfolio and Commercial Operations, Laurie J. Olso

Laurie Oslo oversees long-term strategy, execution of commercial objectives and advises portfolio functions for R&D investment strategies. She started working for Pfizer in 1987 in Marketing Research. As an economics graduate from the State University of New York at Stony Brook and with a MBA from Hofstra University, her experiences span across domestic and global leadership positions in marketing, commercial development, strategy, analytics corporate responsibility and operations. Her most recent role was Senior Vice President of Portfolio Management and Analytics, and within that role she was part of the task force that 'redesigned Pfizer's R&D organization to strengthen its pipeline and improve efficiency.'[36]

#### Executive VP Chief Development Officer, Rod MacKenzie, PhD

Rod MacKenzie received his PhD from Imperial College, London, after getting his chemistry degree from the University of Glasgow. As the co-inventor of Darifenacin, which was sold in 2003 due to regulatory issues, MacKenzie held various positions within Pfizer before assuming his current position.[37] His role oversees 'the development and advancement of Pfizer's pipeline of medicines in several therapeutic areas.' He serves on the Portfolio Strategy and Investment Committee and sits on the Board of Directors for ViiV Healthcare.[38]

#### Executive VP Business Operations and CFO, Frank D'Amelio

Frank D'Amelio joined the company in September 2007 and oversees finance, business development and business operations. He has been ranked as a top CFO for various years by Institutional Investor magazine. He has led the organisation in many mergers, spin-offs and sales, such as: Pfizer and Wyeth merger, sale of their nutrition business and the spin-off of Zoetis. His experience comes from his many leadership roles at Alcatel-Lucent, including Senior Executive Vice President of Integration and Chief Administrative Officer, and his experience as COO of Lucent Technologies. Frank earned his MBA in Finance from St. John's University and his bachelor's degree in Accounting from St. Peter's College. Representing Pfizer, he currently serves on the Board of Directors for many organisations. They include, Humana, Inc., Zoetis, Inc., the Independent College Fund of New Jersey and the Gillen-Brewer School. [39]

### Major shareholders

Pfizer is a publicly traded company with approximately 6.2 billion shares outstanding at December 31, 2015.[40] According to Yahoo Finance, among Pfizer's primary shareholders are institutional investment companies Vanguard Group, Inc., BlackRock Institutional Trust Company and JPMorgan Chase & Co., who own 6.32%, 4.95% and 1.89% of total outstanding shares, respectively. Additionally, Pfizer's only major non-institutional shareholders are all executive-level leadership within the organisation.

### Human resources

Human resource efforts are led by Charles H. Hill III, who has been the Executive Vice President of Worldwide Human Resources since December 2010. Prior to that assignment, Hill was Senior Vice President of Human Resources for the Worldwide Biopharmaceuticals Businesses from 2008 through December 2010. On December 31, 2015, Pfizer employed approximately 97,900 employees across the globe.[41]

In 2007, Pfizer Global Manufacturing, a global manufacturing site in the U.K., was recognised for their Explorer training program. The Explorer program was a year long and covered team dynamics that included purpose, leadership, motivation, meetings and the environment, among other topics. For each of the four training segments, there were pre-workshop activities, two-day workshops, post-workshop assignments and a follow-up workshop.[42]

Pfizer also uses traditional techniques to develop their personnel. Employees are expected to collaborate with their direct leaders to create individual development plans. They have also implemented a tool called Mentor Match. It is designed to allow employees to volunteer as a mentor or search for mentors with certain characteristics. Managers are encouraged to give frequent and in-depth performance appraisals in lieu of the standard annual review process. Pfizer also uses short- and medium-term job rotations or projects to help further the development of their employees.[43]

## Organisational culture

Upon taking charge of Pfizer in 2010, Read soon discovered that many of the processes in place at Pfizer were broken. The process for FDA drug applications was so bad that the FDA sometimes refused to even review submitted applications. Read demanded answers, and the only answer he received was that everyone knew the application didn't meet the required quality standards, but nobody was willing to speak out about it. Read's response was to hand every employee a gold coin with the words 'Straight Talk' on one side and 'OWNIT!' on the other side. It was Read's way of empowering his employees to speak up to their boss when they believe they are wrong, but above all, to create accountability.[44] Since then, OWNIT! has become ingrained in Pfizer's culture.[45]

## Mission, purpose and values[46]

Pfizer's mission is: 'To be the premier, innovative biopharmaceutical company.'

Pfizer's purpose is: 'Innovate to bring therapies to patients that significantly improve their lives.'

Pfizer's core values are: 'Customer focus; Community; Respect for people; Performance; Collaboration; Leadership; Integrity; Quality; Innovation.'

## Operations and supply chain

Each of the Innovative Products and Established Products businesses is led by a single manager responsible for both commercial productivity and research and development activities that meet proof-of-concept requirements. The Innovative Products Business is tasked with development and commercialisation of new medicines and vaccines. The Established Products Business focuses on branded generic medicines and legacy brands that have lost or will lose market exclusivity in the short term. Both businesses have geographic footprints that span developed and emerging markets.[47]

Pfizer has a truly global supply chain network with 64 internal manufacturing facilities, over 200 supply chain partners and 134 logistics centers in 2015. Pfizer claims to have over 850 major product groups. Due to the high demands for traceability, Pfizer employs a serialisation program across its supply chain. Pfizer also uses their Highly Orchestrated Supply Network (HoSuN) to connect inventory, transportation, logistics and its associated security, compliance, environmental health and safety and other functions into a truly integrated system. They also use HoSuN for business continuity risk assessment and resolution.[48]

Manufacturing pharmaceuticals can be extremely complex. For example, the vaccine known as Prevenar 13 was produced for the one-billionth-time in 2015. According to Pfizer, manufacturing Prevenar 13 includes the participation of 1700 employees, 678 quality tests, 400 different raw materials and 580 steps in manufacturing, over 2 years.[49]

Pfizer earned 56% of its 2015 revenue from operations outside the United States, which represented $27.1 billion. Japan is the second largest market, behind the United States.[50]

## Marketing and distribution

Pfizer promotes its products within the global biopharmaceutical business to healthcare providers and patients. Pfizer's marketing organisation is responsible for educating a wealth of stakeholders regarding product approved uses, benefits and risks. Pfizer employs a direct-to-consumer advertising campaign in the US; this provides similar information and suggests that interested customers have discussions with their doctor. Pfizer's 'Global Consumer Healthcare business uses its own sales and marketing organisations to promote its products and occasionally uses distributors in smaller markets.' Television, digital, print and in-store media are all used to advertise to consumers.[51]

In the US, all products must be approved by the FDA prior to any marketing campaigns. The FDA oversight includes 'regulations that govern the testing, manufacturing, safety, efficacy, labeling and storage of our products, record keeping, advertising, and promotion.'[52] There are also several federal and state laws that were enacted to prevent fraud and abuse, including false claim and anti-kickback laws. Pfizer encounters 'similar regulatory and legislative issues in most other countries.'[53]

Pfizer has been criticised in the past regarding some of its foreign marketing practices. In August 2012, the US Securities and Exchange Commission fined Pfizer $45 million dollars for violating the US Foreign Corrupt Practices Act. In order to secure regulatory approval, sales and increased prescriptions, several subsidiaries of Pfizer had been bribing foreign officials. The bribes had been concealed under marketing and promotion expenses in the accounting records. Pfizer reported the violations voluntarily in 2004 and subsequently implemented anti-corruption training.[54]

From a distribution perspective, prescription pharmaceutical products primarily are sold primarily to wholesalers. In 2015, the 'top three biopharmaceutical wholesalers accounted for approximately 34% of our total revenues (and 74% of total US revenues).'[55] Pfizer also does some direct shipments to retailers, hospitals, pharmacies and clinics. For its vaccines, Pfizer 'primarily sell[s] directly to individual provider offices, the Centers for Disease Control and Prevention and wholesalers.'[56]

## Financial condition

Over the past five years, Pfizer's revenues have been steadily decreasing, reducing net income to a five-year low of $6.96 billion. A decrease in revenue from continuing operations is the primary cause of the decrease in revenues. The spin-off of Zoetis had a compounding effect on both the decrease in revenues and cost of sales post 2013. Current assets were steady over the past three years; however, there was a recent dip in short-term investments. Goodwill is increasing, reflecting the premiums paid for acquisitions in recent years. Pfizer's short-term borrowing has increased almost twofold in the past five years. Overall, Pfizer's balance sheet has been fairly steady the past two years, but Pfizer's total liabilities are slightly higher and its total equity slightly lower in 2015 compared to 2014. Both of these years are lower compared to pre-Zoetis spin-off levels.[57] Figures 2 and 3 contain detailed Pfizer financial information.

# COMPETITIVE LANDSCAPE

## Major competitors

The pharmaceutical industry invests heavily in research and clinical trials and relies on obtaining FDA approval and patent protection for its products to ensure prolonged profits while the next 'miracle' drug is under research. There are high payoffs when a drug is successfully brought to market; but there also great costs, in the form of massive time and monetary investments for failures, if it is not. Among Pfizer's largest competitors are Merck, Novartis, Bristol-Myers and Johnson & Johnson.[58]

**Figure 2** **Pfizer Income Statements**

| Consolidated Statements of Income – USD ($) Shares in Millions, $ in Millions | 2015 | 2014 | 2013 | 2012 | 2011 |
|---|---|---|---|---|---|
| Income Statement [Abstract] | | | | | |
| Revenues | $ 48 851 | $ 49 605 | $ 51 584 | $ 58 986 | $ 65 259 |
| Costs and expenses: | | | | | |
| Cost of sales | 9 648 | 9 577 | 9 586 | 11 334 | 14 076 |
| Selling, informational and administrative expenses | 14 809 | 14 097 | 14 355 | 16 616 | 18 832 |
| Research and development expenses | 7 690 | 8 393 | 6 678 | 7 870 | 9 074 |
| Amortization of intangible assets | 3 728 | 4 039 | 4 599 | 5 175 | 5 544 |
| Restructuring charges and certain acquisition-related costs | 1 152 | 250 | 1 182 | 1 880 | 2 930 |
| Other (income)/deductions – net | 2 860 | 1 009 | (532) | 4 031 | 2 499 |
| Income from continuing operations before provision for taxes on income | 8 965 | 12 240 | 15 716 | 12 080 | 12 304 |
| Provision for taxes on income | 1 990 | 3 120 | 4 306 | 2 562 | 3 909 |
| Income from continuing operations | 6 975 | 9 119 | 11 410 | 9 518 | 8 395 |
| Discontinued operations: | | | | | |
| Income from discontinued operations – net of tax | 17 | (6) | 308 | 297 | 350 |
| Gain/(loss) on disposal of discontinued operations – net of tax | (6) | 55 | 10 354 | 4 783 | 1 304 |
| Discontinued operations – net of tax | 11 | 48 | 10 662 | 5 080 | 1 654 |
| Net income before allocation to noncontrolling interests | 6 986 | 9 168 | 22 072 | 14 598 | 10 049 |
| Less: Net income attributable to noncontrolling interests | 26 | 32 | 69 | 28 | 40 |
| Net income attributable to Pfizer Inc. | $ 6 960 | $9 135 | $ 22 003 | $ 14 570 | $ 10 009 |

Source: Pfizer Annual Reports.

**Figure 3** **Pfizer Balance Sheets**

| Consolidated Balance Sheets – USD ($) $ in Millions | 2015 | 2014 | 2013 | 2012 | 2011 |
|---|---|---|---|---|---|
| Assets | | | | | |
| Cash and cash equivalents | $ 3 641 | $ 3 343 | $ 2 183 | $ 10 081 | $ 3 182 |
| Short-term investments | 19 649 | 32 779 | 30 225 | 22 318 | 23 270 |
| Trade accounts receivable, less allowance for doubtful accounts | 8 176 | 8 401 | 9 357 | 10 675 | 13 058 |
| Inventories | 7 513 | 5 663 | 6 166 | 6 076 | 6 610 |
| Current tax assets | 2 662 | 2 566 | 4 624 | 6 170 | 9 380 |
| Other current assets | 2 163 | 2 843 | 3 613 | 3 567 | 5 317 |
| Assets of discontinued operations and other assets held for sale | – | – | 76 | 5 944 | – |
| Total current assets | 43 804 | 55 595 | 56 244 | 64 831 | 60 817 |
| Long-term investments | 15 999 | 17 518 | 16 406 | 14 149 | 9 814 |
| Property, plant and equipment, less accumulated depreciation | 13 766 | 11 762 | 12 397 | 13 213 | 15 921 |
| Identifiable intangible assets, less accumulated amortization | 40 356 | 35 166 | 39 385 | 45 146 | 51 184 |
| Goodwill | 48 242 | 42 069 | 42 519 | 43 661 | 44 569 |
| Noncurrent deferred tax assets and other noncurrent tax assets | 1 794 | 1 944 | 1 554 | 1 565 | 5 697 |
| Other noncurrent assets | 3 499 | 3 513 | 3 596 | 3 233 | – |
| Total assets | $167 460 | $167 566 | $172 101 | $185 798 | $188 002 |
| Liabilities and Equity | | | | | |
| Short-term borrowings, including current portion of long-term debt | $10 160 | $5 141 | $6 027 | $6 424 | $4 016 |
| Trade accounts payable | 3 620 | 3 210 | 3 234 | 2 921 | 3 678 |
| Dividends payable | 1 852 | 1 711 | 1 663 | 1 733 | 1 796 |
| Income taxes payable | 418 | 531 | 678 | 979 | 1 009 |
| Accrued compensation and related items | 2 359 | 1 841 | 1 792 | 1 875 | 2 120 |
| Other current liabilities | 10 990 | 9 153 | 9 951 | 13 812 | 15 066 |
| Liabilities of discontinued operations | – | – | 21 | 1 442 | 1 224 |
| Total current liabilities | 29 399 | 21 587 | 23 366 | 29 186 | 28 909 |
| Long-term debt | 28 818 | 31 541 | 30 462 | 31 036 | 34 926 |
| Pension benefit obligations, net | 6 310 | 7 885 | 4 635 | 7 782 | 6 355 |
| Postretirement benefit obligations, net | 1 809 | 2 379 | 2 668 | 3 491 | 3 344 |
| Noncurrent deferred tax liabilities | 26 877 | 23 317 | 25 590 | 21 193 | 18 861 |
| Other taxes payable | 3 992 | 4 353 | 3 993 | 6 581 | 6 886 |
| Other noncurrent liabilities | 5 257 | 4 883 | 4 767 | 4 851 | 6 100 |
| Total liabilities | 102 463 | 95 944 | 95 481 | 104 120 | 105 381 |

| Consolidated Balance Sheets – USD ($) $ in Millions | 2015 | 2014 | 2013 | 2012 | 2011 |
|---|---|---|---|---|---|
| Commitments and contingencies | | | | | |
| Preferred stock, no par value, at stated value | $ 26 | $ 29 | $ 33 | $ 39 | $ 45 |
| Common stock | 459 | 455 | 453 | 448 | 445 |
| Additional paid-in capital | 81 016 | 78 977 | 77 283 | 72 608 | 71 423 |
| Employee benefit trusts | – | – | – | – | (3) |
| Treasury stock, shares at cost | (79 252) | (73 021) | (67 923) | (40 122) | (31 801) |
| Retained earnings | 71 993 | 72 176 | 69 732 | 54 240 | 46 210 |
| Accumulated other comprehensive loss | (9 522) | (7 316) | (3 271) | (5 953) | (4 129) |
| Total Pfizer Inc. shareholders' equity | 64 720 | 71 301 | 76 307 | 81 260 | 82 190 |
| Equity attributable to noncontrolling interests | 278 | 321 | 313 | 418 | 431 |
| Total equity | 64 998 | 71 622 | 76 620 | 81 678 | 82.621 |
| Total liabilities and equity | $ 167 460 | $167 566 | $ 172 101 | $ 185 798 | $188 002 |

Source: Pfizer Annual Reports.

Figure 4 contains some comparative financial ratios for these competitors.

### Merck & Co. (MRK)

Merck & Co. was founded in 1891 and had $39.5B in 2015 revenues, making it one of the largest pharmaceuticals companies in the world today. The cholesterol-lowering drug branded Zetia, which is Merck's 2nd largest revenue generator, is a direct competitor to Pfizer's drug Lipitor (patent expired in 2011). Zetia is selling at a rate of nearly $3 billion a year, whereas Lipitor is generating $1.86B.[59]

Major Acquisitions[60]:

1993: Merck acquired Medco Containment Services, Inc. ($6B)
2009: Schering-Plough merged with Merck & Co. ($41B merger)
2014: Merck acquired Cubist Pharmaceuticals ($8.4B)

### Novartis AG (NVS)

Founded in 1996 in Switzerland, Novartis AG is the pharmaceutical industry's world leader in sales, generating $50.4B in 2015 revenues. Novartis has several oncology products in the pipeline that will directly compete with Pfizer pharmaceuticals. Currently its best sellers are prescription treatments for cancer, multiple sclerosis and macular degeneration.[61]

Major Acquisitions[62]:

1999: Formed by merger with Ciba-Geigy and Sandoz Laboratories
2005: Acquired Hexal and Eon Labs ($8.29B)
2006: Acquired Chiron Corp. ($5.1B)
2010: Acquired Alcon ($39.3B)
2012: Acquired Fougera Pharmaceuticals ($1.5B)

### Bristol-Myers Squibb (BMY)

Bristol-Myers Squibb was founded in New York in 1887 and had $18.8B in 2015 revenues. They produce the market-leading antipsychotic drug, Abilify, which is widely used for treating schizophrenia. Bristol-Myers Squibb, like the majority of pharmaceuticals companies, derives the bulk of its profits from a limited number of expensive specialty drugs or much wider market spread of cheaper drugs.[63]

Major Acquisitions[64]:

2009: Acquired Medarex
2010: Acquired ZymoGenetics
2015: Acquired Flexus Biosciences ($1.25B) and Cardioxyl ($2B)
2016: Acquired Padlock Therapeutics ($600M) & Cormorant Pharmaceuticals ($520M)

### Johnson & Johnson (JNJ).

Founded in 1886, Johnson & Johnson is an American multinational medical devices, pharmaceutical (40% by revenues) and consumer packaged goods manufacturer. Besides over-the-counter products for self-treatment and at-home medication, Johnson & Johnson produces high-priced specialty

**Figure 4** **Comparative Financial Ratios**

| | Pfizer | Merck | Novartis | Bristol-Myers Squibb | Johnson & Johnson |
|---|---|---|---|---|---|
| Research over Revenue % | 15.74 | 16.97 | 17.73 | 35.79 | 12.91 |
| Revenue INR Mil | 48 851 | 39 498 | 50 387 | 16 560 | 70 074 |
| Gross Margin % | 80.3 | 62.2 | 65.5 | 76.4 | 69.3 |
| Operating Income INR Mil | 11 824 | 6 928 | 8 977 | 1 890 | 18 065 |
| Operating Margin % | 24.2 | 17.5 | 17.8 | 11.4 | 25.8 |
| Net Income INR Mil | 6 960 | 4 442 | 17 783 | 1 565 | 15 409 |
| Earnings Per Share INR | 1.11 | 1.56 | 7.29 | 0.93 | 5.48 |
| Dividends INR | 1.12 | 1.81 | 2.67 | 1.49 | 2.95 |
| Payout Ratio % * | 82.7 | 48.4 | 77.7 | 139.6 | 55.6 |
| Shares Mil | 6 257 | 2 841 | 2 403 | 1 679 | 2 813 |
| Book Value Per Share * INR | 10.82 | 16.39 | 32.31 | 9.08 | 25.86 |
| Operating Cash Flow INR Mil | 14 512 | 12 421 | 11 897 | 1 832 | 19 279 |
| Cap Spending INR Mil | −1 496 | −1 283 | −3 505 | −820 | −3 463 |
| Free Cash Flow INR Mil | 13 016 | 11 138 | 8 392 | 1 012 | 15 816 |
| Free Cash Flow Per Share * INR | 2.22 | 1.65 | 3.97 | 0.64 | 5.3 |
| Working Capital INR Mil | 14 405 | 10 561 | -863 | 2 398 | 32 463 |
| Tax Rate % | 22.2 | 17.44 | 13.6 | 21.47 | 19.73 |
| Net Margin % | 14.25 | 11.25 | 35.29 | 9.45 | 21.99 |
| Asset Turnover (Average) | 0.29 | 0.39 | 0.39 | 0.51 | 0.53 |
| Return on Assets % | 4.13 | 4.44 | 13.84 | 4.78 | 11.65 |
| Financial Leverage (Average) | 2.59 | 2.28 | 1.71 | 2.23 | 1.88 |
| Return on Equity % | 10.24 | 9.52 | 24.06 | 10.75 | 21.87 |
| Return on Invested Capital % | 7.11 | 6.74 | 19.28 | 7.83 | 17.55 |
| Interest Coverage | 8.48 | 9.04 | 13.16 | 12.29 | 35.78 |

Source: Morningstar.com

drugs used in the treatment of autoimmune diseases, prostate cancer and HIV/AIDS.[65]

Major Acquisitions:[66]

2006: Acquired consumer healthcare business of Pfizer ($16.6B)

2013: Acquired Aragon Pharma ($1B)

2014: Alios BioPharma, Inc ($1.75B).

## EXTERNAL ENVIRONMENT

The pharmaceutical industry is heavily influenced by legal, political and technological forces. Societal views on issues such as drug pricing and tax evasion have created demand for increased government regulation.

### Regulation

In the US, pharmaceutical companies are under the regulation granted to the Food and Drug Administration. The FDA has primarily provided oversight over pharmaceutical product quality through two actions: reviewing drug applications and inspecting factories for compliance with good manufacturing practices. In an effort to reduce recognised shortcomings, such as high levels of product recalls, shortages of critical drugs and limited inspection efforts, the FDA created an

Office of Pharmaceutical Quality (OPQ) in January 2015. The OPQ was created to enhance oversight of drug quality for all pharmaceuticals.[67] Its mission is to assure supply of quality drugs to the American market, use enhanced science and risk-based methods, leverage quantitative and expert assessments for product oversight, encourage development and adoption of new technologies, and 'provide seamless integration of review inspection, surveillance, policy, and research across the product life cycle.'[68]

FDA oversight impacts several areas of the value chain. For example, the FDA increased the importance of audit trails of information in manufacturing when 21 CFR part 11 came into effect. The update requires anyone designing, manufacturing, or testing pharmaceuticals to follow the guidelines. This encouraged manufacturers to keep better electronic records to include timestamps, validation and signatures. 21 CFR part 11 was built unto the National Drug Code (NDC), which was passed in 2007. The NDC required manufacturers to use a serialised code on the product to improve traceability throughout the supply chain post-manufacturer.[69]

### Affordable Care Act

In 2014, the Internal Revenue Service issued final regulations for the Branded Prescription Drug Fee (BPD), an annual non-tax deductible fee imposed on branded prescription drug manufacturers, which was included in the Patient Protection and Affordable Care Act (ACA). The new legislation requires government-funded drug programs to report yearly prescription drug sales data to the Department of Treasury. The reporting programs include: Medicare, Medicaid, TRICARE and the Department of Veterans Affairs. The branded prescription drug fee is allocated to manufacturers based on their relative percentage of total reported prescription drug sales.[70] The total 2014 BPD fee, according to the IRS fee schedule, was $3 billion – Pfizer's portion was approximately $220 million, which was paid in 2015.[71]

The ACA also amended the Public Health Service (PHS) Act to expedite FDA approval of biosimilars – drugs that are generic versions of FDA-approved biologic products. A manufacturer must show clinical evidence that a new product is 'highly similar' in effectiveness to an FDA-approved reference biologic. Once the FDA receives the trial data for a biosimilar, the ACA allows the FDA to pursue a fast-track approval process. Prior to 2010, no biosimilar products had been approved by the FDA.[72] As of August 2016, three biosimilar products had been approved.[73]

### Drug pricing concerns

Public outrage over increasing drug prices came to a head recently, with many scandals receiving national headline attention. One such incident occurred when Turing Pharmaceuticals raised the price of Daraprim – a drug used predominantly by AIDS patients and pregnant women – from $13.50 to $750 per pill, over a 5000% increase.[74] Another such incident involved Mylan, the company that manufacturers the injector EpiPen, which contains a drug used to treat life-threatening allergy attacks (a drug Pfizer manufacturers). Mylan increased the price of EpiPen from $265 to over $600 in less than three years.[75] Many believe the increase was in response to a settlement agreement in 2012 under which Mylan agreed to allow a generic competitor to enter the market in 2015.

The rising cost of healthcare in the United States is a growing concern among voters and societal pressures are seeing health care reform and regulation on drug prices reaching political platforms and ballots across the country. Political lobbyists on both sides are spending millions of dollars to influence the outcome of such initiatives. One such initiative, Proposition 61 in California, would limit the amount that state agencies pay for prescription drugs to that of the US Department of Veterans Affairs, which normally receives a 20 to 25% discount on its prescription drug prices. Pfizer donated more than $9.4 million to political action groups in opposition to Prop 61 and in total pharmaceutical companies contributed $109 million (Merck & Co. $9.4 million and Johnson & Johnson $9.3 million).[76]

## LOOKING FORWARD

Ian Read has been at Pfizer's helm for the past six years. With the patent expiration for Lipitor behind him, the best-selling drug in history is no longer contributing as much to Pfizer's bottom line. Is the firm still capable of delivering a sustainable pipeline of profitable drugs, or are major changes to strategy and operations necessary? And is Pfizer's opportunity for significant inversions over with the failed takeover attempts of both AstraZeneca and Allergan? To add to these issues, drug pricing scandals and healthcare reform have created an environment of active political reform. How can Pfizer navigate the upcoming challenges that growing societal discontent with 'big pharma' and the rising cost of healthcare present? Do these threats also provide opportunities? How can Pfizer best be positioned for growth and profitability in this challenging business environment?

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# CASE 5

## Atlassian

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**CASE LINK: This case applies concepts from Chapters 2, 3, 4, 5 and 13.**

Atlassian, an Australian team collaboration software company launched in 2002, specialises in productivity and collaboration tools for businesses. Its software assists teams in organising, discussing and completing shared work. The company, with 10 million active monthly users, has over 180 000 clients using its software products, including Citigroup, eBay, Coca-Cola, Visa, Procter & Gamble, BMW, Facebook, NASA and Netflix.[1]

Atlassian was formed on a A$10 000 credit card by entrepreneurs Scott Farquhar and Mike Cannon-Brookes. Their belief was that if you made a great piece of software, priced it right, and made it available to anyone to download from the internet, customers would come. Incredibly, Atlassian was built without a sales force, working on Farquhar and Cannon-Brookes' premise that if customers liked their product they would tell friends and associates. Atlassian was very quickly a success, with A$1 million in revenues in its first year, growing to A$14.9 million in 2005–06 when Cannon-Brookes and Farquhar were named entrepreneurs of the year by accounting giant Ernst & Young.[2] Revenue has continued to climb, reaching A$319.5 million in 2015, a 49 per cent increase on 2014 revenue.[3]

### THE INDUSTRY

Analysts at Gartner estimated global spending for infotech (including hardware, software, services and telecommunications) at US$3.8 trillion[4] for 2015. Within this massive revenue pool the industry is being continually reshaped. Rapid change is an industry hallmark, with customers continually demanding better service, lower prices, higher quality and more depth of inventory. Rapid change and customer demands have led to disruption in software and services delivery and business models. Legacy tech companies can no longer rely on one-dimensional value strategies. Improving margins and finding new revenue streams are critical for success. Many legacy tech companies are re-examining the structure of their businesses to seek better financial performance. Their profit margins and market share are under siege from aggressive competitors and disruptive, well-funded start-ups.


Mike Cannon-Brookes and Scott Farquhar

Source: Alamy Stock Photo/Trevor Collens

Legacy companies such as IBM, Symantec, Hewlett-Packard and eBay are looking for new business models that allow them to be more flexible and responsive to market demands and changes.[5] They are splitting into more nimble structures that enable them to compete with start-ups and aggressive new players. Separation can provide better revenue growth through the businesses' distinct strategies, targeted investments and innovation.

In the tech industry, in almost all situations, widening revenue streams is the only viable option for long-term survival. Shareholders are quickly losing patience with companies that look inward towards margin improvements. Most legacy companies are facing shrinking markets for their legacy products. Without some top-line improvement through organic innovation or acquisition, they are in the precarious position of being just a few earnings disappointments away from alienating shareholders and shedding market capitalisation.

For tech companies, the future will depend not as much on cost cutting as it will on outpacing competitors in rapidly evolving high-growth areas such as cloud computing, cybersecurity, data analytics, everything-as-a-service (XaaS) and digital content.[6] Companies with the highest growth potential are leaders in the so-called XaaS sector, which includes computing platforms, applications and infrastructure, delivered remotely.

According to Paul Sallomi, US and global technology sector leader at Deloitte, in the rising digital economy there are three certainties:

1 The pace of technological change will not slow down.
2 Standing still is not an option; barriers to entry will continue to fall. We are seeing the rapid rise of privately funded

companies whose market capitalisation would exceed US $1 billion if they were to go public.

3 Continued innovation will remain an essential component across all industries.[7]

## THE ATLASSIAN ADVANTAGE

In 2015, Atlassian, with its 'no sales force' philosophy, spent 21 per cent of revenue on selling its products. Similar software businesses do not come close to this ratio. Sales and marketing costs for Atlassian and competitors in 2015 are listed in Table 1.[8] Atlassian's business revolves around recurring subscription fees rather than software sales; therefore, it is not driven by a sales culture that's incentivised to close deals by the last day of the reporting cycle.

So how is this 'no sales force' model successful? Twenty years ago, the distribution model (how you get products to market) and the promotion strategies (how you sell a product) were two of the most important parts of sales success. Distribution and promotion are two of the 4Ps of marketing, part of the marketing mix still taught today. Atlassian is changing the way we think about distribution (see Figure 1) and promotion. It spends a greater percentage of revenue on building great products and then lets the market or customer do the selling for it. Its products are available online and are downloaded from its website. 'Through this word-of-mouth marketing, we have been able to build our brand with relatively low sales and marketing costs', the company said in its 2015 prospectus.[9] 'This strategy has allowed us to build a substantial customer base and community of users who use our products and act as advocates for our brand and solutions, often within their own corporate organisations.'

Atlassian is an example of the connected model[10] at work (see Figure 2). To remain competitive, vendors must connect customers to the products and buying experience they want – the customer *experience* is integral to the product.

Atlassian explains, 'Traditional enterprise software distribution models, with their focus on quota-driven sales representatives and reliance on large deals, are not well suited to reach, influence or meet the needs of teams, who are increasingly driving technology purchasing decisions'.[11] Atlassian's consumer-style approach to sales means that its products are all available online and free to trial. It declines to make exceptions to the contracting terms or price.

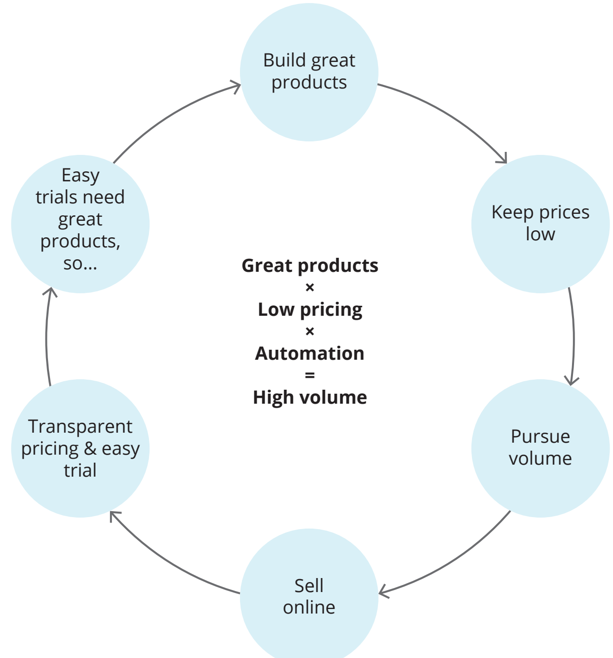
Atlassian understands its market and has built a community of users/advocates. The customer's experience of Atlassian is flawless through every stage of their purchasing journey – exploration (through networks, on the web, in communities), evaluation (advisers, free trials), engagement (easy to contract) and, importantly, in experience (life after the sale).[13] Atlassian has a deep understanding of what it is to be a customer-driven sales organisation.

**Table 1** Sales and marketing costs as a percentage of sales

| Company | Annual sales (mil.) | S&M costs (mil.) | S&M as % of sales |
|---|---|---|---|
| Atlassian | $319.5 | $68 | 21 |
| Salesforce | $537 | $276 | 51 |
| Workday | $787.9 | $315.8 | 40 |
| ServiceNow | $682.6 | $341.1 | 50 |
| NetSuite | $556.3 | $291 | 52 |
| Box | $216.4 | $207.7 | 96 |
| Zendesk | $127 | $77.9 | 61 |
| HubSpot | $115.9 | $77.8 | 68 |
| New Relic | $110.4 | $89.2 | 81 |

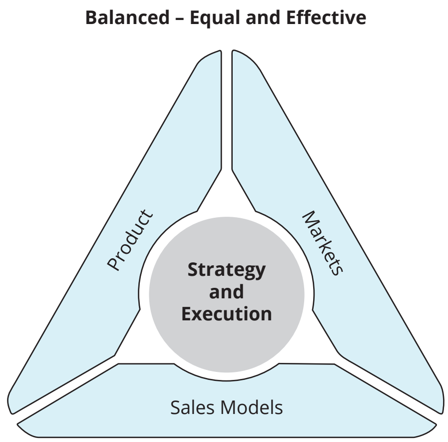
Source: FactSet, 2016, http://factset.com

**Figure 1** Atlassian distribution model




Source: Atlassian, 2015, *Atlassian Prospectus*, 105, https://www.sec.gov/Archives/edgar/data/1650372/000104746915008450/a2226437zf-1.htm

**Figure 2** Atlassian distribution model




Source: D. Finkeldey, 2015, *Living Proof: Atlassian – No sales people (everyone is a salesperson)*, Gartner.

## A HAPPY WORKPLACE

Atlassian also differs from other tech companies in that it is driven by an inspiring set of values (see Table 2) and focuses heavily on staff wellbeing. The company donates 1 per cent of profit, product, equity and employee time to charity, helping thousands of children in developing countries receive an education.[14]

For two years in a row (in 2014 and again in 2015)Atlassian topped *BRW*'s Best Places to Work list.[15] All new hires receive a 'celebration before you start' gift card to splurge on something for themselves, or celebrate with friends and family before their new job commences. The company also offers Atlassians initiatives such as five days' paid volunteer leave annually to participate in a cause of their choice, paid parental leave schemes, a buddy system to introduce new employees, and an additional three days' annual leave on top of the standard 20 for staff who have served for three years or more.[16] After five years Atlassians receive an all expenses-paid holiday. The company also offers Atlassians daily perks including free snacks, subsidised lunches, fitness classes, free beverages during the day and subsidised public transportation.[17]

Technology is used as a way to break down staff barriers. Atlassian's internal communication channel, Confluence (also an Atlassian product), serves as a collaboration platform. Through these systems, staff members can give their colleagues 'Kudos' for a job well done, without the approval of management. Kudos requests are submitted to HR, which arranges the recommended gift and a handwritten Kudos card. Eleven per cent of Atlassian staff members are awarded Kudos in an average week.[18] The company also has quarterly innovation events, called ShipIt, to reinforce its values and create time for people to step outside their day-to-day mindset and think creatively. See https://www.atlassian.com/company/shipit.

**Table 2** Summary of Atlassian company values

| | |
|---|---|
| **Open company, no bullshit** | Openness is root level for us and sharing is a first principle. |
| **Build with heart and balance** | Measure twice, cut once. Passion and urgency infuse everything we do, alongside the wisdom to consider options fully and with care. |
| **Don't #@!% the customer** | Customers are our lifeblood. Considering the customer perspective – collectively, not just a handful – comes first. |
| **Play, as a team** | We spend a huge amount of our time at work. Strive to put what's right for the team first – whether in a meeting room or on a football pitch. |
| **Be the change you seek** | Have the courage and resourcefulness to spark change. Continuous improvement is a shared responsibility; action is an independent one. |

Source: Adapted from Atlassian, 2016, Company values, https://www.atlassian.com/company/values

## ATLASSIAN'S EXPANSION

Prior to 2015, Atlassian relied entirely on profits to fund expansion – a rare feat in today's tech market. Most tech start-ups raise hundreds of millions of dollars from venture capitalists before they make profits or float on the stock market. In December 2015, Atlassian floated on the US market and reached A$8 billion (US$5.85 billion), with its shares soaring by 32 per cent, in opening trade.[19] This valuation made Atlassian, at the time, bigger than companies such as Medibank Private (A$5.9 billion), Fortescue Metals (A$5.7 billion) and the Bank of Queensland (A$5 billion). The US float placed Farquhar and Cannon-Brookes in the ranks of the 20 wealthiest Australians and was the biggest-ever float from an Australian company on US markets.[20]

Atlassian has grown slowly and deliberately, striking a careful balance between considered strategy and adapting to changes as they happen. Since 2010, Farquhar and Cannon-Brookes have tipped millions from their own pockets into local start-ups. They contribute to seed funds StartMate and Blackbird Ventures, as well as incubator Pollenizer. In a recent interview, Farquhar said, 'We look at a whole bunch of younger people who are running smaller businesses and say, "How can we help them – what is the help that we would have liked when we started Atlassian?". I haven't set financial targets; hopefully it's successful and you make money, but I think you have to be willing to lose, investing in start-ups'.[21]

Atlassian spent US$247.6 million on research and development from fiscal year 2013 to fiscal year 2015.[22] The company builds the products it needs and buys the products it can. Atlassian has acquired Stepka's Authentisoft, tools like Crucible, Fisheye and Clover, and instant messenger HipChat. The company's 2015 prospectus lists its growth strategy as 'adding customers, developing new products, expanding in existing customers and pursuing selective acquisitions'.[23] Drivers of growth include: 'protect and promote our culture', 'continue to refine our unique business model', 'increase product value' and 'grow the Atlassian marketplace and partner ecosystem'.[24]

## WHERE TO FROM HERE?

There is a contrary relationship between the strategies of private owner-run companies and public companies. When companies start up they often think long term, but when they go public there are shareholder demands to consider, so they begin focusing on the short term and quarterly reporting cycles. In addition, as companies grow they increase their management staff numbers. These managers are often on short- to medium-term contracts, with profit- and revenue-driven key performance indicators.

As Atlassian continues to grow, a major challenge will be innovating at scale. Small, flexible start-ups are generally the disruptors to the bigger, more established tech companies. Farquhar and Cannon-Brookes have changing roles. They now need to manage managers who manage managers who manage people. The strategies they used in a company of 100 people may not be the strategies they can use in a public company of 3000 people. Atlassian is in the big company category. How can it continue to innovate as it grows into a company in excess of 3000 staff, or is this no longer a strategy it should follow? Are Farquhar and Cannon-Brookes going to be able to do long-term thinking and long-term investing as a public company? Can Atlassian continue to use the 'no sales force' philosophy in such a competitive market? When does this cease to become a competitive advantage?

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# CASE 6

## The Sunshine Coast UNESCO Biosphere Reserve and Smart City: a new governance opportunity in a post-pandemic world?

FRANCIS HARTNETT

CASE LINK: This case applies concepts from Chapters 2, 9 and 10.

The Glass House Mountains in the Sunshine Coast Hinterland

Source: Alamy Stock Photo/Ingo Oeland

### A NEW ROLE FOR STRATEGIC LEADERSHIP AND ENTREPRENEURSHIP WHERE ETHICS, STAKEHOLDER INTERESTS AND VALUE CREATION MERGE

The Covid-19 pandemic shone a light on the vulnerabilities of our social, economic and ecological systems and institutions. It is a moment of pause and opportunity to consider governance and business strategy built on a new set of ethical and commercial considerations that fosters a more resilient and sustainable economy and world. The pandemic poses a dual challenge, which the private sector and other key stakeholders play a significant role in addressing, alongside the other urgent, and related, crisis of our time: the need to prioritise sustainability and the protection of the planet for future generations. A healthy community and wellbeing is a social prerogative; however, a healthy community is not solely human – it is its habitat, the soil, water and air. Yet the centrality and efficacy of government authority in meeting these challenges is no longer necessarily a given. Public confidence during the pandemic, from the UK to the USA, has been shaken, for instance, by confusion amid mixed messaging from political leaders and public health experts. Regions, states and businesses have initiated their own responses and Covid-19 policies to compensate for this. Indeed, employers are the most trusted institutions over government and media during this crisis, according to the 2020 Edelman Trust Barometer Report.[1]

Business and industry groups increasingly demonstrate a conscience and agency to act for the greater good. For instance, the United Nations (UN) Global Compact Leaders Summit brings together 12 000 companies towards innovative strategic entrepreneurialism that complements sustainability challenges on a local level. The Australian Climate Roundtable brings together business, industry, farming and environmental leaders who are independently acknowledging and acting on the findings of the UN's Intergovernmental Panel on Climate Change and the need to align practices towards the Paris Agreement goals of net-zero $CO_2$ emissions by 2050.[2] The fragility and health of the global biodiversity and marine life that underpin the world's food security, pharmaceutical supply chains and more are at stake. The future of banking and finance, urban mobility, the decarbonisation of heavy industries, and aviation and tourism increasingly align with objectives for a more sustainable and inclusive world for all.

This is reflected in the key talking points of the World Economic Forum's virtual Sustainable Development Impact Summit, held in 2020, which focused on more sustainable and 'shortened' supply chains using blockchain technology to increase efficiency; green finances that direct money away from polluting projects and towards those with a positive impact on communities; and social innovation supported by technology and creating equitable, accessible and inclusive social outcomes that define notions of 'smart cities'.[3]

This prerogative is encapsulated in the UN's 17 Sustainable Development Goals (SDGs), which focus on addressing global challenges, including climate change and environmental degradation.[4] Given the ongoing pandemic, a 'new normal' may be achieved through innovative disruptions over the decade ahead, defined by meeting the hoped-for Agenda 2030, the year by which it is hoped the SDGs will be met. This case study considers the role of the United Nations Educational, Scientific and Cultural Organization (UNESCO) Man and Biosphere Programme (MAB) of Biosphere Reserves (BR) (see Figure 1), using the Sunshine Coast Council's (SCC) nomination to focus on the development of new governance mechanisms and BR as a vehicle well positioned for advancing and achieving the SDGs as well as serving the interests of business and commercial vitality. For businesses to achieve strategic competitiveness in a BR at this time will require a particular focus on the general environment, what new relationships between stakeholders might be required, and ethical considerations, not as a separate matter of corporate social responsibility, but reflected in capabilities that contribute to forming potential competitive advantage.

The conceptual BR model is built around a core protected area with a defined buffer zone and transition area, where people live and work, using the natural resources of the area in a sustainable manner.[5]

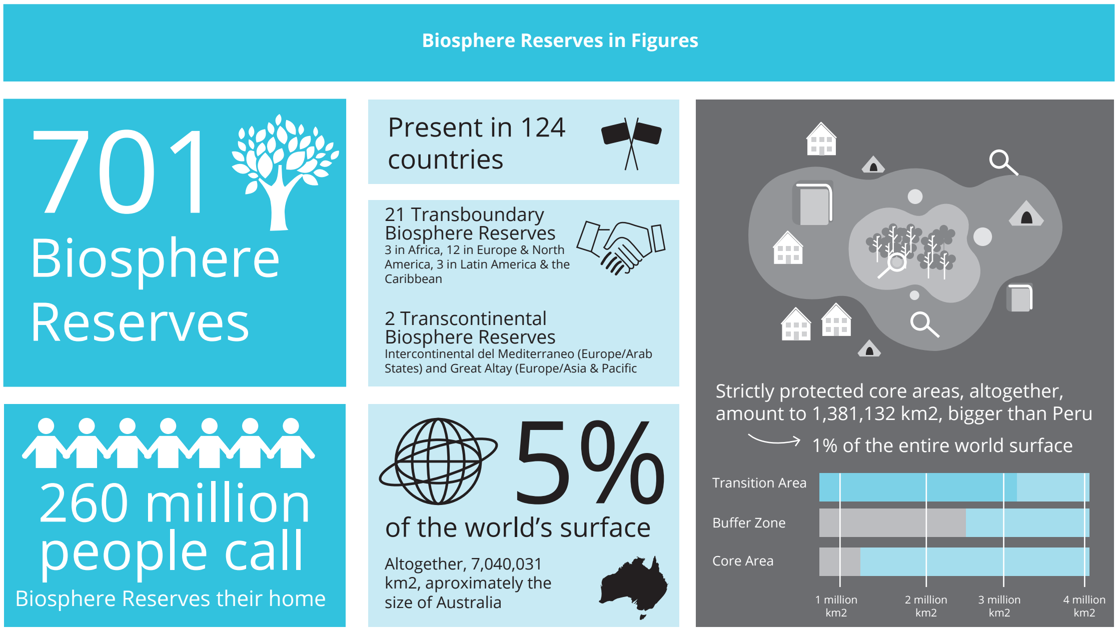
## UNESCO BIOSPHERE RESERVES – A MODEL FOR SUSTAINABILITY AND VALUE CREATION?

Initiated by UNESCO in the 1970s, Biosphere Reserves include terrestrial, marine and coastal ecosystems with the aim of reconciling conservation of biodiversity with its sustainable use. The SCC expects its region (located in south-east Queensland) to be recognised as a Biosphere Reserve and the latest member of the UNESCO MAB program in 2022. Biosphere Reserves are intended to serve as 'learning places for sustainable development' and experimental sites for testing interdisciplinary approaches to understanding and managing changes and interactions between social, economic and ecological systems. This includes goals of conflict prevention and protection of biodiversity. The UN estimates there are more than 2500 conflicts over fossil fuels, water, food and land currently occurring worldwide.[6] The 2020 *Global Assessment Report on Biodiversity and Ecosystem Services* found that 40 per cent of the world's plant species are now at risk of extinction.[7] Unsurprisingly, the need to address management of, and stakeholder involvement in, sustainable development is considered to be more urgent than ever before.

The Covid-19 pandemic has reshaped assumptions as to leadership and governance, especially in addressing socioeconomic and climatic challenges.[8] Biosphere Reserves are designed to be areas providing local solutions to global challenges and present a particularly relevant opportunity in addressing these issues. It is understood that Biosphere Reserves should serve sustainability *and* be of benefit to the economy,[9] yet the SCC faces a governance challenge that has been historically problematic for Biosphere Reserves in how best to achieve this. A procedure to determine best practice in BR management that creates value and utility for the resident population and businesses is (as of writing) still to be formulated. What 'success' and value look like naturally varies between the stakeholders involved, who range from UNESCO, national, state and local government to the business and local Indigenous community, among others. Albeit, the SCC acknowledges an alignment between performance measures 'for the biosphere and the United Nations Sustainable Development Goals could be beneficial'.[10]

The concept of ecological accounting is based on ecological measures and values, in addition to the familiar economic ones, to assist managers with performance appraisal, control, decision making and reporting for an organisation or region.[11]

**Figure 1** **UNESCO Man and Biosphere Programme of Biosphere Reserves**




Source: United Nations, Figures of the world network of biosphere reserves, https://en.unesco.org/sites/default/files/info_global_eng1.png.

It has previously been considered as a solution in reconciling sustainability and development and defining best practice in governance in general and adaptable to Biosphere Reserve management. However, more recently, the Covid-19 pandemic has shown it is unsatisfactory in addressing the importance of political-economy issues that link the economy, society and political interests, and which have broader governance implications in meeting the needs of the general population and competing stakeholder interests, especially those of the business community once condemned as 'part of the problem'.[12] The economic costs of the pandemic have fuelled the argument that the cure cannot be worse than the disease, yet the social and human costs bring into question this measure in terms of public health and, given its unequally distributed impacts across communities, by what values we want to govern. By economic measure alone the benefit-cost ratio for pandemic prevention, according to the World Bank's Development Report of 2014, is roughly 11:1. Essentially, if countries developed and implemented systems for early and effective prevention that met specified international standards, such as those of the SDGs, annual expenses would be moderate, and serve as an investment costing 10 times less than the expected annual cost of inaction.[13] As noted, the leadership role business is taking up in governance is unprecedented, as is its willingness to be 'part of the solution'. Important questions are: is there a new governance role for business in providing local solutions to global problems? And how does this impact upon strategy and controls in response to the currently fast-shifting external environment?

The general inadequacy of Biosphere Reserve management and performance evaluation to date is laid bare in the MAB International Co-Ordinating Council having last recorded only six of 621 Biosphere Reserves met with designation criteria (that cover the requirements for correct zoning, protection of biodiversity, integration of people and nature for sustainable development through participatory dialogue, knowledge sharing, poverty reduction, human wellbeing improvements, respect for cultural values and adaptation to climate change), which complement and contribute to the implementation of the SDGs.[14] Key issues are identified in that local communities and the private sector, which are the key natural resource-dependent entities and simultaneously pose the main source of ecological threat, have not been included sufficiently in Biosphere Reserve planning and management; similarly, ecological concerns should direct best practice, and governance needs to be equally concerned with commercial viability, from monetisation through to systems of certifiable branding.[15] In this way, the UNESCO designation holds utility in promoting the region and the related BR branding can serve business level strategy with production and marketing opportunities that differentiate both the destination and the businesses operating there as unique. However, trust in the authority, credibility and authenticity represented in branding the Biosphere Reserve is one underpinned by meeting global challenges through compliance to Biosphere Reserve criteria and each local community's commitment towards that. This might prompt new considerations as to business level strategy and how collective action and alliances can generate sustainable strategic advantages.

## SIGNIFICANCE OF THE PROBLEM IN AN URBAN CENTURY AND POTENTIAL OF THE SMART CITY

Sustainability and climate change issues are identified as a direct causal factor in triggering the Covid-19 pandemic, stemming from 'zoonotic spillover' and the resource-driven needs and demands of growing populations and the global economy. This frames the relevance of Biosphere Reserves, governance and management in general, and 'getting it right' with worldwide implications for global health, security and economies. In 1950, five years after the founding of the UN, the world's population was 2.6 billion. It is now over 7 billion with substantial growth increases of, on average, 81 million people each year. It is expected to reach 9.8 billion in 2050, two-thirds of which will reside in cities, and indeed some 80 per cent of Western populations already do.[16] This is due to successful health developments from reduced early mortality and surviving to reproductive age, increased fertility rates, wealth, globalisation and migration. Yet the success of political economic systems to date is now seen as untenable given existential threats from climate change, biodiversity, food and water security, inequality and conflict, among others, and which these successes directly exacerbate. It has been a period characterised with more intensive and unsustainable farming, greater exploitation of wildlife, surging travel and global warming.[17]

Zoonotic diseases are directly linked to this environmental change and human behaviour of which Covid-19 is not unique. Other recent examples include Ebola, SARS (severe acute respiratory syndrome), bird flu and the Zika virus. The disruption of pristine forests driven by logging, mining, road building through remote places, rapid urbanisation and population growth is bringing people into closer contact with animal species they may never have been near before and presents a hidden cost of human economic development. Quite simply, landscape changes are causing animals to lose habitats, which means species become crowded together and into greater contact with humans as do the pathogens they carry, most of which are unknown, yet to be discovered and present an ongoing future risk to planetary health. The next pandemic is an inevitability.[18] Disease ecologists link the risk of human and ecosystem health with the erosion of biodiversity causing the proliferation of species (often bats and rodents) most likely to transmit new diseases to us. The increase in wealth of emergent economies and fast-growing urban populations around the world has seen nutritional demands for protein in the form of 'wet markets' selling wild animals, including wolves, salamanders, crocodiles, scorpions, rats, squirrels, foxes, civets and turtles, and this has only multiplied this risk.[19]

While the SDGs seek to address these issues, they involve a political process also characterised by paradox wherein the more globalised the world becomes, the more localised is the responsibility to meet challenges. This is where smart cities can play a central role in realisation of an 'urban century', so called because the 21st century has seen more people living in cities than rural areas, and because of the importance of cities in sustainable global development. Cities are responsible for 70 per cent of global greenhouse gas emissions and, at the same time, 90 per cent of urban areas are situated on coastlines,[20] like the Sunshine Coast, and this exposes the majority of the world's population to the impacts of climate change. Smart city capabilities are increasingly enhanced through the Internet of Things where physical objects and places are embedded with sensors, software and other technologies for the purpose of connecting and exchanging data with other devices and systems over the internet. The data is used to manage assets and services, which increases efficiency and improves the operations and functionality of a city, mitigating the impacts of traffic congestion, carbon dioxide and greenhouse gas emissions, through to issues of parking and waste disposal. Similarly, the use of 'smart contracts' based on blockchain technology is an emerging characteristic of smart city governance that allows for transparency and is increasingly used to combat lack of accountability and corruption. 5G internet speeds, which enable driverless vehicle technologies and more, will further revolutionise urban spaces and sustainable development practices.

Natural habitat areas grow ever closer to cities as urban areas expand by an anticipated 2.4 billion people in the coming decades, a rate equivalent to building a new London every seven weeks. Forty per cent of strictly protected areas (nature reserves and other areas set aside to protect biodiversity) are anticipated to be within 50 km of a city by 2030.[21] The inevitable integration of natural habitat within cities heightens the need for smarter urban planning, the efficient and sustainable use of energy and other resources and the importance of local governments in national planning towards biodiversity goals; the UN has articulated such goals in what is known as the Aichi Targets.[22] It is sobering to note that as of 2020, the international community failed to meet any of the 20 Aichi biodiversity targets agreed to in Japan in 2010, which were designed to slow the loss of the natural world through tackling pollution to protecting coral reefs.[23]

In turn, it is of little surprise that, to date, smart cities associated with Biosphere Reserves (which the SCC identifies as), despite claims of sustainability, have in large part ignored their urban ecosystems.[24] Broader dissatisfaction with, and adaptation of, previous governance models and hopes for smart cities driving an urban century, wherein smart city ideals seek to realise achieving Agenda 2030 goals is an emergent policy priority.[25] UNESCO's Lima Action Plan sought to address these priorities in relation to Biosphere Reserves in promoting management mechanisms with a 'focus on a multi-stakeholder approach, with a particular emphasis on the involvement of local communities in management' and the importance of 'highly innovative and participative governance systems'.[26] Yet it remains opaque in prescription and its relevance is limited in consideration of the opportunities and challenges of Biosphere Reserves, particularly those defined by a smart city. Management and performance evaluation of a Biosphere Reserve might draw upon numerous related UN (and other) initiatives, from the noted SDGs to the Aichi Targets, and including, for instance, the Bio-Trade Facilitation Programme for Biodiversity Products and Services, the New Deal for Nature and the Global Compact on Corporate Sustainability and Cities Programme, to the European Union's COP-CITIES Scaling up Smart and Sustainable Cities Programme. The question is how to formulate a model for the SCC not solely defined by Biosphere Reserves, but as one defined and equipped with smart city capabilities.

## CAN THE EU'S MODEL BE THE SOLUTION? 'S3' AND BRIDGING ECOLOGICAL AND COMMERCIAL INTERESTS

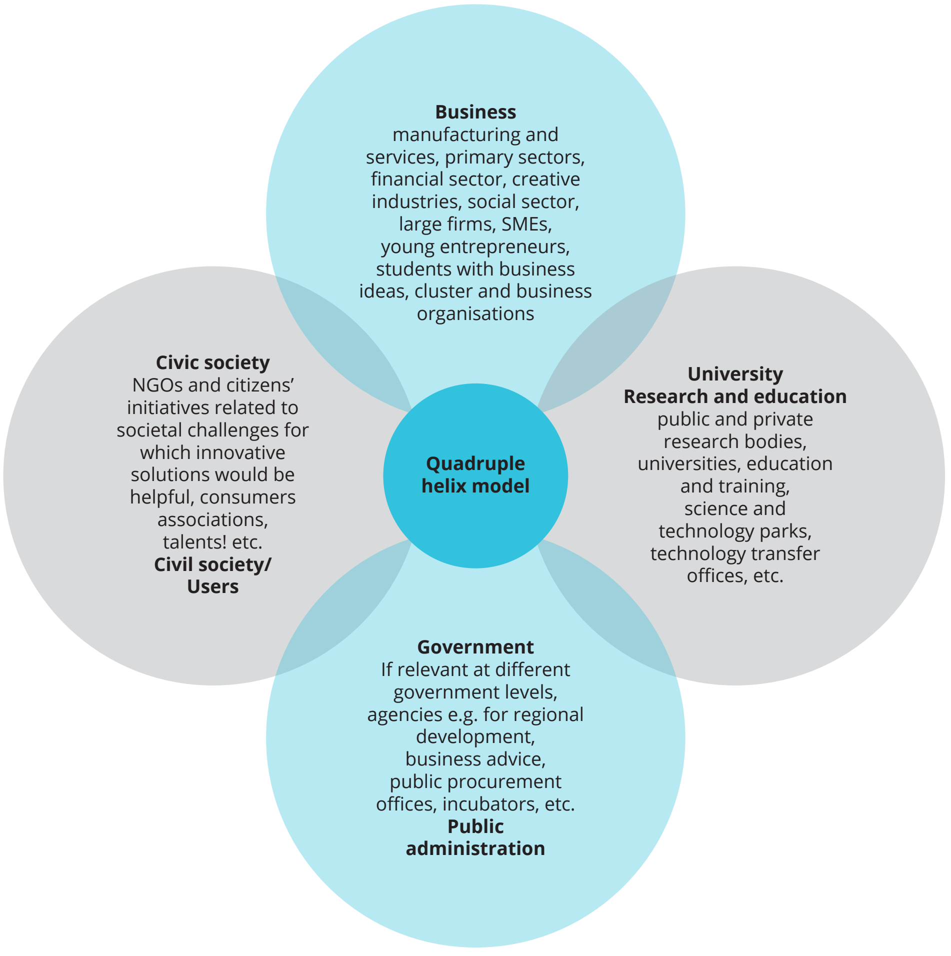
There is a general acknowledgement among researchers and policymakers that traditional methods for governing, value creation and management are insufficient, and a new form of paradigm is necessary.[27] Policy gaps, wherein the smart city champions for both ecological and commercial interests, suffer a notable lag. This is reflected in part when considering the UN conference on cities and human settlements: 'Habitat', which focuses on the impact of urbanisation and the need to secure political commitment for sustainable urban development, has met only once every 20 years.[28] The European Commission is now looking towards scalable digital transformations of cities and their communities that are smart, sustainable (climate-neutral) and resilient (especially in a post-pandemic context), balancing and defined by growth and local economies. It is acknowledged that, to date, scaling of smart city solutions remains limited in terms of both benefits enjoyed and stakeholder participation.[29]

One logical progression would be to merge SCC's smart city and sustainability credentials and the commercial viability of its Biosphere Reserves and develop performance measurements that are self-reinforcing and defined with goals to this end. As noted, the SCC states its vision is to become Australia's most sustainable region. This requires a new approach to not only Biosphere Reserve management but to local government too, and evaluating and monitoring performance accordingly. Incorporating SDG targets with smart city governance facilitated by technological innovations can prove a suitable vehicle towards identifying evaluation criteria and monitoring performance that best resonates with, and holds meaning for, community stakeholders in governance of their Biosphere Reserve.

The EU has developed a governance initiative to meet the challenge of an emergent Chinese economy in a form it has referred to as a 'smart specialisation strategy', or S3, to explore how stakeholder interactions enhance the ways in which companies deliver products and services in order to achieve sustainable competitiveness in the marketplace.[30] Smart specialisation approaches combine industrial, educational and innovation policies of a country or region towards identification of a limited number of priority areas for knowledge-based investments, focusing on their strengths and comparative advantages.[31] This merges a quadruple or 'multi-helix' collaborative governance model (see Figure 2) made up of business, universities, government and civic society as the four key representative stakeholders and so accommodates governance across multiple centres of authority and influence, sometimes both competing and cooperative, as a means towards adaptation to change. This model holds significant potential for both human-environment management and commercial innovation. It diverges from previous ecological conservation management models by acknowledging human settlement and economic activity as a reality and part of an ecosystem, and so accommodates entrepreneurial innovation to enhance the fit between ecosystem dynamics and governance systems, as well as self-interest, to drive better community engagement. The SCC could similarly integrate an adapted smart specialisation strategy and stakeholder model in governance of its Biosphere Reserve and to formulate effective evaluation and monitoring of its biosphere management performance.

Covid-19 may induce a lasting shift beyond the pandemic in terms of what we value and attitudes towards 'business

**Figure 2** **Quadruple helix model**



as usual' – a global energy transition may have permanently seen fossil fuel demand decline from having peaked in 2019, for example.[33] The interconnectedness of social, economic and ecological systems highlights the scale of systemic risks inherent in the global economy and vulnerabilities of supply chains, economies, health systems and political institutions. The SDGs and Agenda 2030 have lent urgency to achieving sustainability through local agency and business innovation, which is key to both recovery and the creation of resilient societies and economies. Former concepts of corporate social responsibility and squaring off the interests of shareholders while placating stakeholders is no longer sufficient in gauging risk assessment of financial, environmental and social concerns and realising strategic advantage.

Biosphere Reserves represent an opportunity to innovate, raise awareness and mitigate eroded regional identity and economies in the face of globalisation and adapt to practices beyond exploitation of ecosystems stretched beyond capacity. Similar to the rebuilding of the international political order, governance and economy post-World War II, the Covid-19 pandemic might provide enough impetus to shift values and, together with converging advances in technology, help redefine what a recovery should look like and what actual costs to factor into consideration, from decarbonisation through to finding meaning in work amid increasing automation. Smart cities such as the SCC can leverage governance through their technology capabilities and amplify the benefits of their Biosphere Reserve. Environmental, social and governance (ESG) funds already outperform traditional funds.[34] So, too, the Biosphere Reserve holds commercial potential and represents opportunity for the resident business community.

## Questions

1. What is the strategic leadership role and stakeholder dynamic for business towards Biosphere Reserves and Agenda 2030?
2. Does the EU's smart specialisation strategies (S3), with their inclusion of civic society as a key stakeholder, represent an opportunity for business leaders to contribute to shaping the general environment?
3. What commercial value might be generated from a Biosphere Reserve? Together with smart city capabilities, does it present business and government with a sustainable business model and a way to future-proof supply chains, investment and growth? What role has the Covid-19 pandemic played?
4. What implications are there for strategic planning, structure and controls in light of Covid-19, and considerations of the broader community and other non-industry stakeholders?
5. Does collaborative governance (such as S3) represent a critical strategic alliance key to dealing with booming cities, which raises the stakes for biodiversity, global health for populations and the need for smart urban planning? What are the opportunities and challenges for business?

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# CASE 7

## CrossFit at the crossroads

**CASE LINK: This case applies concepts from Chapters 1, 2, 3, 4, 5 and 12.**

*'I'm not trying to grow a business . . . I'm doing the right things for the right people for the right reasons'*

– Greg Glassman, Owner of CrossFit, Inc.[1]

It's a pleasant July morning in Carson, California, in 2016 as Greg Glassman, the founder of CrossFit, Inc. makes his way across the Stubhub Center turf and sits down on one of the black Rogue plyoboxes that line the back perimeter of the stadium. He gazes out past the ongoing rows of boxes, connected rigs and zigzag sprint course to see the sun starting to rise over the grandstand canopy. Just 15 hours earlier those grandstands were filled with thousands of passionate screaming fans cheering on the final contestants of the 2016 Reebok CrossFit Games. A slight grin appears across his face as he lets out a faint but subtle chuckle to himself, almost as if he can't believe that he has built the fitness industry's fastest-growing brand.

The tenth consecutive CrossFit Games, the largest CrossFit sporting event in the world, was now over and Glassman started to reflect back on how quickly his creation has risen in just a few decades. In 1995, he was a personal trainer looking for a place to train his loyal clientele after being kicked out of yet another commercial gym because management did not approve of his unorthodox training methods, and now, he is a multi-millionaire who owns one of the largest brands in the fitness industry. That unorthodox training method, well, it is now one of the most popular fitness workouts in the world and is arguably becoming one of the fastest growing sports of all time. Everything has happened so fast, he thought to himself while watching the cleanup crew start to tear down the event setup, we barely even have a concrete business plan, he jokes but deep down inside he knows that it is true. CrossFit has evolved so rapidly that Glassman and his relatively small but fiercely loyal employees have been forced to make important company decisions on the go. Evident by CrossFit's unprecedented growth, those decisions have more often than not been correct, but with little time to reflect on the company's aim and future, how could he be fully confident in the direction his company was heading and what does the future hold for a fitness company operating in an ever-changing, potentially fad-like industry?

As Glassman got up to leave the stadium to catch the quick flight back to Silicon Valley in the company jet, he decided he was going to disrupt his normal routine and take a few days off to think. His plan is to use this time to genuinely reflect on where his company has come and how the business has reached elite status as one of the largest fitness brands in the world. What can CrossFit, Inc. do to improve, what new trends can it capitalise on, where is the future of the company and sport going, and how can it avoid that dark irrelevant fate where so many fitness startup companies eventually end up?

### HISTORY OF CROSSFIT

#### Greg Glassman

Greg Glassman, born on 22 July 1956 to a rocket scientist father and a stay-at-home mother, was raised in the Los Angeles, CA, suburb of Woodland Hills. Around the age of one, Glassman was diagnosed with polio, a disease that affects the nerves in a person's spine and affects muscle movement. Growing up though, Glassman did not let this disease define who he was as he turned to sports such as gymnastics, cycling and weightlifting to counteract his inability to participate in contact sports. His aptitude on the pull-up bar along with having powerful upper body strength led him to excel at the rings in gymnastics, but a freak injury on a routine dismount in high school left him with a permanent limp and unable to compete. Glassman subsequently turned to coaching, a decision that would eventually define who he is and create a legacy most people only dream of.

Glassman refers to himself as a 'rabid libertarian',[2] a term defined as 'an advocate of the doctrine of free-will'.[3] In high school, Glassman habitually read and studied the theories of Milton Friedman, an American economist who wrote such books as *Capitalism and Freedom* and the introduction to the 50th anniversary edition of F.A. Hayek's *The Road to Serfdom*. It's here where Glassman's management theories would form the basis of his future business model, or lack thereof. At age 18, Glassman took a job as a gymnastics coach at the YWCA in Pasadena, CA. Little did he know at the time, this being his first real coaching gig, that it would eventually be his calling in life. He attended college but never graduated, stating 'I went to a half dozen institutions, but I was just there for the girls'.[4]

This case was written by Andrew Callaghan and Dr Charles B. Shrader of Iowa State University, July 2016. It is intended to be used as a basis for classroom discussion rather than as a demonstration of either effective or ineffective management of a situation. The case reflects the views of the authors and not the exact thoughts and opinions of CrossFit, Inc. management. Part of the information in this case is derived from the authors' personal experiences with the case company. Some of the opening and closing managerial situations included in the case are fictional and are for illustrative purposes only.

His passion was fitness training and throughout the late 1970s and '80s he worked as a personal trainer. His commitment, knowledge and extremely brash personality attracted people to enlist his services in the Silicon Valley area, but it was also his unique and unconventional methods towards fitness that allowed him to lure in not only the computer tech leaders and local service workers but also celebrities and professional athletes alike.

Results are what ultimately define success and Glassman knew how to attain them, but his methods were unusual and his workouts were seen as in your face and bordering on intimidating. So intimidating to the average gym goer in fact that he had been kicked out of seven or more commercial gyms as a result. Glassman's attitude towards fitness can be described as confident and assertive with firm beliefs, but that confidence can also be interpreted as defiant and arrogant. In a *60 Minutes* episode, when asked if he doesn't like to be told what to do, Glassman responded with a chuckle and said 'Oh, I don't mind being told what to do . . . I just won't do it'.[5] But that is who Greg Glassman is and that defiance is why he now owns 100 per cent of the fastest-growing fitness program and emerging sport in the world, CrossFit.

### The beginning

In the late 1980s and early '90s, Glassman tinkered with his workouts and found success with his clients by combining High Intensity Training (HIT) with heavy fundamental movements and sprints. His workouts were loud, intense and demanding but also successful and his client base started to expand. In 1995, after being asked to leave what would be his last commercial gym, Glassman decided to open his own training facility in Santa Cruz, CA. CrossFit (at the time Cross-Fit) was born. Glassman had a goal in mind: to establish a fitness program that would not only motivate participants to exercise but also to constantly work towards achieving a high level of fitness.[6] At the time, Glassman was still training clients solo, but after he started to become overbooked he soon realised that he could train multiple people together and still provide a safe environment as well as the required attention to each participant to be effective. With that he would also be able to increase his profits by charging a reduced rate to each member but add more members to each session.[7] Glassman found that his clients enjoyed the idea of group fitness, and after he was hired to train the Santa Cruz Police Department, the idea of 'The CrossFit Community' was formed.

In 2000, CrossFit, Inc. was legally established by Glassman and his (now ex) wife Lauren. When prompted by his oft-travelling clients to build a website and post workouts of the day (WOD), so that they could train on the road, Crossfit.com was created. In 2002, the first CrossFit affiliate was started in Seattle, WA (CrossFit North) by former Navy Seal Dave Werner and partners Robb Wolf and Nick Nibler. In the same year, the *CrossFit Journal* was published in which Glassman wrote three seminal articles explaining CrossFit's principles and theories, titled 'What is Fitness?', 'Foundations' and 'The Garage Gym'.

## CROSSFIT PHILOSOPHY

### What is fitness? (According to CrossFit, Inc.)

One of CrossFit's first newsletter articles[8] set out to explain the company philosophy by questioning previously proposed definitions of what it meant to be truly fit. The article challenged the notions of Merriam-Webster, *Outside Magazine* ('Fittest Man on Earth'), and the industry-leading National Strength and Conditioning Association (NSCA), by concluding that their definitions were either too broad or too narrow. The CrossFit article concluded that previous attempts to define fitness were inadequate. Glassman, however, defined fitness through a meaningful and measurable way as 'increased work capacity across broad time and modal domains',[9] where broad time means 'length of duration of effort' and modal domains 'variety of activity'.[10] In the 'What is Fitness?' article, Glassman defines three standards/models that they use for evaluating and guiding fitness. Together they outline CrossFit's view of fitness as 1) ten general physical skills widely defined by physiologists, 2) performance of athletic tasks, and 3) energy systems that drive all human action (Figure 1). CrossFit's aim is not to specialise in one certain task of fitness but to be a 'jack of all trades'. The article states, 'Our specialty is not specializing. Combat, survival, many sports and life reward this kind of fitness, and on average punish the specialist'.

### Foundations

The 'Foundations' article presented CrossFit's approach to generalised comprehensive fitness and away from the traditional workouts of isolation movements and extended aerobic sessions that the majority of the population participates in.[11] CrossFit works with 'compound (functional) movements and shorter high intensity cardiovascular sessions' because it believes that the two theories combined are 'radically more effective at eliciting nearly any desired fitness result' than any other form of fitness. The CrossFit workout can be universal as the movements and weights can be scaled to fit any participant, or 'athlete', as CrossFit's members are called. Outsiders are often amazed that CrossFit athletes range from professional athletes and military special ops to the elderly and disabled and everyone in-between. In the *60 Minutes* episode, when Glassman was asked if he would have a 75-year-old doing deadlifts his answer is simply, 'Uh huh, yeah, to say no is to say that if you drop your pen on the ground, you're not going to pick it up. It's a deadlift, it's picking something up off the ground. It does not require a physician's "Ok". If your physician doesn't think you should deadlift, you need to get a new doctor'.

**Figure 1** CrossFit's 3 standard principles

1) 10 recognized General Physical Skills:
   - If your goal is optimum physical competence, then all general physical skills must be considered:
   1) **Cardiovascular endurance/Respiratory endurance** – The ability of body systems to gather, process, and deliver oxygen
   2) **Stamina** – The ability of body systems to process, deliver, store, and utilize energy
   3) **Strength** – The ability of a muscular unit or combination of muscular units to apply force
   4) **Flexibility** – The ability to maximize the range of motion at a given joint
   5) **Power** – The ability of a muscular unit or combination of muscular units to apply maximum force in minimum time
   6) **Speed** – The ability to minimize the time cycle of a repeated movement
   7) **Coordination** – The ability to combine several distinct movement patterns into a singular distinct movement
   8) **Agility** – The ability to minimize transition time from one movement pattern to another
   9) **Balance** – The ability to control the placement of the body's center of gravity in relation to its support base
   10) **Accuracy** – The ability to control movement in a given direction or at a given intensity
2) The essence of this view is that fitness is about performing well at any and every task imaginable. Picture a hopper loaded with an infinite number of physical challenges where no selective mechanism is operative, and being asked to perform feats randomly drawn from the hopper. This model suggests that your fitness can be measured by your capacity to perform well at these tasks in relation to other individuals.

   The implication here is that fitness requires an ability to perform well at all tasks, even unfamiliar tasks, tasks combined in infinitely varying combinations. In practice this encourages the athlete to disinvest in any set notions of sets, rest periods, reps, exercises, order of exercises, routines, periodization, etc. Nature frequently provides largely unforeseeable challenges; train for that by striving to keep the training stimulus broad and constantly varied.
3) Three metabolic pathways that provide the energy for all human action
   1) Phosphagen Pathway – Dominates the highest powered activities (10 seconds or less)
   2) Glycolytic Pathway – Dominates moderate powered activities (up to several minutes)
   3) Oxidative Pathway – Dominates low-powered activities (excess of several minutes)

Total Fitness = The fitness that CrossFit promotes and develops requires competency and training in each of these three pathways or engines.

Source: Glassman, Greg. 'What is Fitness?' *The CrossFit Journal* (October 2002): 1–4. Web.

## The garage gym

Glassman also strongly believed that the equipment in a typical gym was useless. In simple terms he believed a gym should resemble a barn or garage. It should be open and uncluttered, and the equipment should require the use of muscle in the most natural fitness sense. CrossFit boxes were basic and austere. Modern gyms had fancy weight machines focused on isolation work. CrossFit, on the other hand, tried to develop overall fitness and conditioning as a philosophy. The whole thing was oriented towards a natural and more primitive approach to basic conditioning.

Glassman is such a firm believer in his methodology that he strongly believes that between diet and exercise, CrossFit can even be a solution to chronic diseases. The Centers for Disease Control and Prevention (CDC) has identified lack of exercise, poor nutrition, tobacco use and high alcohol intake as health risks that contribute towards many of the illnesses and early deaths related to chronic diseases. Glassman advocates that CrossFit targets two of those four conditions which are normally prescribed with prescription drugs (high blood pressure) or steroids (low muscle mass), 'the problem is being inactive and poor nutrition. It's a lifestyle issue'.[12]

The *CrossFit Journal*, or newsletter, became an important means for the company to disseminate Glassman's philosophy. Newsletters were published on a monthly basis and included articles dealing with box operations, fitness training and lifestyle. For example, the August 2014 *CrossFit Journal* contained a story about how affiliate owners compensate coaches and trainers. The story offered ideas on how to go beyond simple financial incentives to motivate coaches and trainers. Motivational ideas included: equal pay for both affiliate owners and trainers, enhanced education and certification programs for trainers, specialty programs for members, and building long-term relationships with trainers. Examples and success stories from CrossFit centres in California, New England and New Zealand were shared. The goal of the newsletter was to offer affiliate owners and trainers alike ideas on how to make each box more capable in terms of enhancing fitness and changing lives.[13]

## Workout methodology and structure

CrossFit workouts are based on constantly varied functional movements (real-life movements) that incorporate a mix of aspects from gymnastics, weightlifting and cardio, all while being performed at relatively high intensity (Figure 2). The workouts are typically performed in a gym, or 'garage gym' because of the rough appearance and similarities to at-home stripped-down style gyms, that the CrossFit community refers to as a 'box' and which includes an array of weights, racks, boxes, bands and balls but is void of commercial style machines (Figure 3). The workouts are roughly 60 minutes in length and typically include four phases: Warm-up/Stretch, Skill Development Segment (SDS), WOD, and an Individual or Group Stretch (Figure 4). The SDS focuses on Olympic type lifts or calisthenics (bodyweight movements), and the WOD generally contain a combination of all movements performed in high-intensity bouts that can last anywhere from 4 to 24 minutes depending on that day's goals. The workouts are designed to arouse an athlete's competitive nature not only within themselves but also with the other competitors. Times and repetitions are recorded on either large whiteboards or computer systems, which then rank the athlete's performances.

**Figure 2** List of CrossFit exercises

| Weightlifting | Gymnastics | Cardio/ Calisthenics |
|---|---|---|
| Deadlifts | Bar Muscle Up | Air Squats |
| Front & Back Squats | Rings Muscle Up | Box Jumps |
| Power Clean | Dips | Jump Rope |
| Hang Clean | Strict Pull Up | Rowing |
| Sumo Deadlift High Pull | Kipping Pull Up | Wall Ball |
| Snatch | | Sprints |
| Overhead Squat | | Jogging |
| Push Jerk | | Jumping Jacks |
| Push Press | | Sit Ups |
| Shoulder Press | | Push Ups |
| Thruster | | |
| Tire Flip | | |

**Figure 3** List of equipment

| Weightlifting | Gymnastics | Cardio/ Calisthenics |
|---|---|---|
| Squat Racks/Rig System | Pull-up Stations/ Rigs | Medicine Balls |
| Bumper Plates | Rings | Bands |
| Barbells | Ropes | PVC Pipes |
| Dumbbells | Hand Chalk | Ab Mats |
| Kettlebells | | Rowers |
| Sand bags | | Boxes |
| Dip Belts | | Hurdles |
| Steel Plates | | Jump Ropes |
| Large Tires | | Foam Rollers |
| Push Sleds | | |

**Figure 4** Daily workout example

Metcon (Time)
5 Rounds for time
3 Power Cleans 165/115 (male/female)
6 Box Jumps 30"/24" (male/female)
9 Toes 2 Bar
*8-min time cap

*Rest 3 minutes then*

Metcon (Time)
10,9,8,7,6,5,4,3,2,1
Shoulder to Overhead 135/95
Pull-ups
*13-minute time cap

*Rest 4 minutes then*

Metcon (Time)
3,6,9,12,15
Deadlifts 225/155
Burpees
*12-minute time cap
*ADD UP TOTAL TIME & RECORD

The CrossFit philosophy that workouts should be repeatable and measurable is the basis for self-improvement. The 'Benchmark Workouts' were originally given girls' names so that the athletes could easily identify the unified workout, and have grown to include Hero WOD in honour of fallen military, law enforcement and firefighters (Figure 5). The intent of the Benchmark Workouts is for athletes to perform them

**Figure 5** **'Girl' WODs**

| | | | |
|---|---|---|---|
| 'Amanda' | 'Diane' | 'Jackie' | 'Nicole' |
| 9-7-5 | Deadlift 225 lbs | 1000 metre row | Run 400 metres |
| Muscle Up | Handstand push-ups | Thruster 45 lbs (50 reps) | Max rep Pull-ups |
| Squat Snatch (135/95) | 21-15-9 reps, for time | Pull-ups (30 reps) | As many rounds as possible in 20 min |
| 'Angie' | 'Elizabeth' | 'Karen' | 'Cindy' |
| 100 Pull-ups | Clean 135 lbs | Wall-ball 150 shots | 5 Pull-ups |
| 100 Push-ups | Ring Dips | (men 20#-10' – women 14#-9') | 10 Push-ups |
| 100 Sit-ups | 21-15-9 reps, for time | For time | 15 Squats |
| 100 Squats | | | As many rounds as possible in 20 min |
| 'Annie' | 'Eva' | 'Kelly' | 'Helen' |
| Double-unders | Run 800 metres | Run 400 metres | 400 metre run |
| Sit-ups | 2 pood KB swing, 30 reps | 30 box jump, 24 inch box | 1.5 pood Kettlebell swing × 21 |
| 50-40-30-20 and 10 rep rounds; for time | 30 pull-ups | 30 Wall ball shots, 20 pound ball | Pull-ups 12 reps |
| | | | 3 rounds for time |
| 'Barbara' | 'Fran' | 'Linda' | 'Nancy' |
| 20 Pull-ups | 21-15-9 reps, for time | Deadlift 1 1/2 BW | 400 metre run |
| 30 Push-ups | Thruster 95 lbs | Bench BW | Overhead squat 95 lbs × 15 |
| 40 Sit-ups | Pull-ups | Clean 3/4 BW | 5 rounds for time |
| 50 Squats | | 10/9/8/7/6/5/4/3/2/1 rep | 5 rounds for time |
| 'Chelsea' | 'Grace' | 'Lynne' | |
| 5 Pull-ups | Clean and Jerk 135 lbs | Bodyweight bench press | |
| 10 Push-ups | 30 reps for time | Pull-ups | |
| 15 Squats | | 5 rounds for max reps | |
| Each min on the min for 30 min | | | |
| 'Christine' | 'Isabel' | 'Mary' | |
| 3 rounds for time | Snatch 135 lbs | 5 Handstand push-ups | |
| 500 m row | 30 reps for time | 10 1-legged squats | |
| 12 Body Weight Dead Lift | | 15 Pull-ups | |
| 21 Box Jumps | | As many rounds as possible in 20 min | |

**Figure 5 (cont.) 'HERO' WODs**

| JT | Michael | Badger | Nate |
|---|---|---|---|
| 21-15-9 reps, for time | 3 rounds for time | 3 rounds for time | As many rounds as possible in 20 min |
| Handstand push-ups | Run 800 metres | 95 pound Squat clean, 30 reps | 22 Muscle-ups |
| Ring dips | 50 Back Ext | 30 Pull-ups | 4 Handstand Push-ups |
| Push-ups | 50 Sit-ups | Run 800 metres | 8 2-Pood Kettlebell swings |
| **Daniel** | **Murph** | **Josh** | **Jason** |
| 50 Pull-ups | For Time | For time | 100 Squats |
| 400 metre run | 1 mile Run | 95 pound Overhead squat, 21 reps | 5 Muscle-ups |
| 95 pound Thruster, 21 reps | 100 Pull-ups | 42 Pull-ups | 75 Squats |
| 800 metre run | 200 Push-ups | 95 pound Overhead squat, 15 reps | 10 Muscle-ups |
| 95 pound Thruster, 21 reps | 300 Squats | 30 Pull-ups | 50 Squats |
| 400 metre run | 1 mile Run | 95 pound Overhead squat, 9 reps | 15 Muscle-ups 25 Squats |
| 50 Pull-ups | | 18 Pull-ups | 20 Muscle-ups |

*For a Complete List log onto https://crossfitiota.com/bench-marks/hero-wods/

periodically, say a few times per year, and compare scores to track their overall fitness progress. Glassman presented his theory in the September 2003 *CrossFit Journal* article in which he introduced the 'girls': 'only by repeating workouts can we confidently measure our progress'.[14]

## The CrossFit diet

Greg Glassman's regular response when asked about what CrossFit can do for a person is that it can deliver you to your 'genetic potential.' It is not just the workout that CrossFitters are encouraged to practise.[15] They are also urged to follow one of a few specific diets that, based on personal goals, will provide CrossFit members with increased energy, optimised health and will reduce the risk of chronic diseases. The seemingly most widely used diet is the paleo diet which is based on everyday, modern-type foods that 'mimic the food groups of human's pre-agricultural, hunter-gatherer ancestors'.[16] In Glassman's *World Class Fitness in 100 Words*[17] statement, he provides some CrossFit diet advice: 'eat meat and vegetables, nuts and seeds, some fruit, little starch and no sugar. Keep intake to levels that will support exercise but not body fat'. The paleo diet generally fits these criteria as its directions suggest people consume high protein, lower carbs, high fibre and moderate fat intake (Figure 6). While a few of CrossFit's top athletes have confessed to not following a strict diet to a 'T'[18], it's made quite obvious that following one of the suggested diet options while participating in CrossFit is recommended and will positively affect the athlete no matter if they are beginners or top-flight competitors.

Some CrossFit diet followers have become celebrities and authors in their own right. A good example is Christmas Abbott, author of the *Badass Body Diet*.[19]
This diet combines healthy eating guidelines with high-intensity workout plans for individual body types. Following this plan, athletes at all levels can set personal goals for developing toned cores and reducing body fat. Ms Abbott also has infused an element of fun into each workout, noting that people tend to stay with a workout plan longer if the workout is enjoyable.

## BUSINESS

CrossFit, Inc. is 100 per cent privately owned by Greg Glassman – an ownership situation that totally fits his style. In 2012, CrossFit began business as a 50/50 partnership between Glassman and his ex-wife. At that time, because of a contentious situation, Glassman's ex-wife's share was almost sold to Anthos Capital, an investment organisation looking to invest in one of America's fastest-growing brands. At the 11th hour though, Glassman was able to secure a matching loan through Summit Partners (Boston) for $16 093 000 and put a

**Figure 6** **Paleo diet foods**

| Do's: | | | | | |
|---|---|---|---|---|---|
| **Meats** | **Seafood** | **Veggies** | **Oils/Fats** | **Nuts** | **Fruits** |
| Poultry | Shrimp | Asparagus | Coconut Oil | Almonds | Apples |
| Pork | Lobster | Avocado | Olive Oil | Cashews | Berries |
| Pork Chops | Clams | Brussel Sprouts | Macadamia Oil | Hazelnuts | Peaches |
| Steak | Salmon | Carrots | Avocado Oil | Pecans | Plums |
| Veal | Tuna | Spinach | Grass-fed Butter | Sunflower Seeds | Mangos |
| Bacon | Shark | Celery | | | Grapes |
| Ground Beef | Tilapia | Broccoli | | | Lemons |
| Venison | Trout | Peppers | | | Limes |
| Buffalo | Walleye | Cabbage | | | Oranges |
| Bison | Crab | Zucchini | | | Bananas |
| Jerky | Scallops | | | | |
| | Oyster | | | | |
| **Don't's:** | | | | | |
| **Dairy** | **Grains** | **Legumes** | **Snacks** | | |
| Cheese | Cereal | Beans | Pretzels | | |
| Non-fat Creamer | Pasta | Peas | Chips | | |
| Butter | Bread | Peanuts | Cookies | | |
| Milk | English Muffin | Peanut Butter | Pastries | | |
| Yogurt/Pudding | Sandwiches | Tofu | Hot Dogs | | |
| | Crackers | Mesquite | Fries | | |
| | Oatmeal | Miso | Artificial Sweeteners | | |
| | Corn | Soybeans | Pop/Soda | | |
| | Pancakes | | Fruit Juices | | |
| | Hash Browns | | Energy Drinks | | |
| | Beer | | | | |

*These are an option list/not exact. Please see source for more information.

Source: http://ultimatepaleoguide.com/paleo-diet-food-list/

halt to the potential sale.[20] With Glassman in full control, he could operate the company autonomously, without input from outside corporate investors.

CrossFit, Inc. does not have to answer to shareholders or a board of directors. The headquarters, which handles the business operations, is located in Washington, DC, and the Media Office, the lifeblood of CrossFit's day-to-day technology operations, is based out of Silicon Valley. CrossFit's model resembles its owner's libertarian beliefs, as the growth of the company has come directly from its affiliation program that permits individuals to own and operate their own box while using the CrossFit name and allows them to run their business with independence and autonomy.

## Affiliation

CrossFit-affiliated boxes started in 2002 with the CrossFit North opening and have spread like wildfire throughout the world. To open a box, essentially all one has to do is fill out an application, pay $3000 per year, attend a two-day seminar detailing the business and the workout methodology, and pass a test to become a Level 1 instructor ($1000). When confronted about the seemingly easy nature of this process, CrossFit's fearless leader's response was:

> *Amazing huh?... Here's how it used to be: all you had to do was have the money. . . and you don't even have to take a test. That's where every other chain came from, someone just launched 'em.*[21]

CrossFit box owners have the freedom to manage their box in their best interests so that they can cater to the local demographic. To Glassman, his main concern is not about what hours the affiliate owners are operating, the location in which they choose to open their business or the music that is played; his only concern is that they follow CrossFit's physiology and methodology.[22] Each affiliate is locked into their original annual fee in case the fee is ever raised. In fact, there are affiliates, who got in early, that still pay only $500 per year.

CrossFit, Inc. created CrossFit RRG (Risk Retention Group), which is a captive stock insurance company that allows American affiliates to purchase specific CrossFit general liability and professional liability policies designed to cover the unusual risks boxes are susceptible to.[23] CF-RRG is a form of self-insurance where the affiliate owners purchase stock and become shareholders (one-time fee of $1000). Box owners who buy into the group are involved in the underwriting, risk management, claims administration and financial committees.[24] Boxes earning less than $125 000 per year pay a yearly premium of $1185 with boxes that earn greater than $125 000 per year paying an extra $8.70 per $1000 of gross revenue earned. Affiliations are urged to purchase insurance from CF-RRG rather than an outside vendor because CrossFit endures unique circumstances that most liability policies may not thoroughly cover. Owning this specialised policy, box owners are eliminating the possibility of omissions and will have the most comprehensive coverage available. International CrossFit boxes are insured through somewhat similar companies such as the CrossFit International Insurance Programme, which is run through Lloyd's of London and covers box owners in the UK.[25]

## GROWTH

Glassman admits that when he started CrossFit he did not have a business plan, that his goal was simply 'being committed not to screw it up', and that he has stuck by that plan ever since.[26] The numbers, though, would suggest otherwise. In 2016, a little over a decade and a half since CrossFit, Inc. was formed, Glassman's corporation has become one of the fastest-growing fitness companies of all time. With roughly 13 000 gyms in 142 different countries, CrossFit, Inc. rakes in close to $100 million and the CrossFit brand's estimated ecosystem is approximately in the $4 billion range (2016).[27] The scary part? The company is still growing. 'I don't know how you compete against me' said Glassman in an interview with CNBC.

CrossFit, Inc. brings in most of its profits from two main sources: 1) affiliates and 2) CrossFit Training Certification courses. But even with CrossFit's rapidly growing business it is hard to look anywhere else but at the core concepts that have brought it to this point: technology and having a loyal group dynamic culture that has adopted CrossFit as more than a workout but a way of life. CrossFit is a technology company. It started with Glassman posting workouts, journal articles and an easy-to-use blog onto http://www.crossfit.com. Since then, the company's success has followed the growth of the internet. One 10-minute browsing session on its website and you can find CrossFit's mission, workout methodology, limitless instructional videos, workouts of the day, nutritional ideas, gym locations, and much, much more, all for FREE. Yes, for *free*! When asked about the financial implications of giving away free content and how that makes sense in today's capitalistic economy, Glassman replied 'it didn't until we did it, the more video we give away, the more money we make'.[28] The *all exposure is good exposure* philosophy has assembled one of the largest viral communities in the world and when combined with their devout and enthusiastic allegiance towards the brand, largely explains why CrossFit, Inc. has been able to grow at the record-breaking pace it has.

### The community

CrossFit is much more than just a fitness regimen – it has evolved into a distinctive community within itself where its followers are amazingly loyal and dedicated. For many, CrossFit has become a way of life. CrossFit affiliates have been extraordinarily successful in creating an atmosphere where its members feel a sense of belonging which motivates them to come back day after day and push themselves harder, whether that's to beat the person next to them or just to improve from their previous scores. The CrossFit community members have taken a leading role in marketing the CrossFit brand. They have created an almost obsessive-like adoration for CrossFit to the point where they actively promote the sport through any outlet possible. It has prompted outsiders to joke that 'the first rule of CrossFit is that you never stop talking about CrossFit', parodying a line from the Brad Pitt movie, *Fight Club*.[29] Whether box members are viewed as loyal, fanatic, annoying or crazy one thing for certain is that their dedication to spreading the brand, whether intentionally or unintentionally, has been an exceptionally lucrative model for CrossFit, Inc.

Glassman insists that he has not recruited one person to CrossFit. To him CrossFit has an open door policy and anyone who wants to join is welcomed to do so.[30] Through tremendous leadership and coaching, CrossFit has been able to provide an atmosphere where its members seek to live their lives in a state of optimal health and fitness in a time where health and fitness are becoming less of a priority.[31] The members work out together multiple times per week often creating a team-like bond. This type of interaction, uniting by a common goal or interest, is similar to the family-like atmosphere most sports or military teams have. The CrossFit Community is also able to attract members through their group volunteer and charitable.

American sociologist Ray Oldenburg introduced the idea of a 'Third Place' for healthy human existence.[32] He believed that humans must live in a balance of three realms: 1) Home/Family Life, 2) Work Life – where people spend most of their time, and 3) a Third Place – inclusively sociable places. Third Places are described as 'anchors' of community life and facilitate and foster broader, more creative social interaction. One of the main characteristics of Third Places is that they act as a 'leveller', which means they place no importance on an individual's status in society and allow for a sense of commonality between members. They are highly accessible places, where friendships develop that fill the human need for 'intimacy and affiliation'. In what used to be the traditional Third Place, church, studies have shown that the new generation of millennials have been leaving the religious life behind,[33] thus creating a void in many people's lives. The CrossFit Community, through its affiliates, has been able to provide that Third Place for many of its members. The box offers its athletes a place where they can build those social relationships and have a sense of 'place'. In turn, its members adopt the CrossFit lifestyle as one of their main identities and that becomes a part of who they are. This could explain why they 'always talk about CrossFit' or post CrossFit-related content to social media outlets. CrossFit, in a (smaller) sense, is as much a part of many of its members' lives as their families, therefore creating that automatic impulse to constantly want to talk or interact with each other about their CrossFit lives, the same as they would about their children or significant others.

In a 2014 CrossFit demographic study, the data did illustrate that the millennial generation had the highest level of participants but not by as much as many would think. They only comprised 40 per cent of participants while the 35–44 age group consisted of 20 per cent with the under 18s covering 18 per cent.[34] Along with the age demographic, the study found that CrossFit is evenly split 50/50 between female and male participants, thus attesting to the fact that the CrossFit workout is feasible at any age for both males and females.

## Technology and social media

The shift towards social media outlets becoming a primary form of contact in today's society has vastly affected the field of communication, marketing work and advertising. Gone are the days where the majority of adults actually dial someone's number and speak to them over the phone as social media has increased the ability and frequency in which people can 'check up' on one another in a much less personal way. In a 2014 social media study, it was found that 52 per cent of online adults now use at least two forms of social media sites and the numbers showed that usage by young adults (18–29 years old) on Instagram was around 53 per cent.[35] The CrossFit Community is no stranger to this as the basis of their growth can be attributed to increased action on the internet and social media sites from its members.

When CrossFit, Inc. launched its first blog system, which allowed box owners to communicate not only with headquarters, the media team and other affiliates at the click of a mouse, but also with their own clientele, it created an easy medium where information could be shared at a faster pace and to a larger audience. Just because Glassman himself has not recruited anyone over social media does not mean his loyal followers have not. The internet communication concept has spread to more common and interactive uses of social media (YouTube, Facebook, Twitter, Instagram, etc.) now within specific box communities as a way to mass market their new and exciting fitness program with outsiders. Since the mid-2000s box owners and community members have hit the social media world running and are no strangers to posting pictures, videos or workout statuses from their experiences or the CrossFit world. Social media is an incredibly accessible and cost- effective way to reach a wide audience in little time, and the more community members post, the more CrossFit's ecosystem grows. It's a multiplier effect that spreads the CrossFit brand like wildfire. A 2012 study on internet usage found that 23 per cent of US internet users under the age of 35 said they would buy a brand because of a friend's social endorsement, such as a 'like' on Facebook.[36] This is a growing trend in the capitalistic technological world we live in, and for businesses looking to grow it is almost a must that they use social media as a marketing outlet.

Although many of the CrossFit customers who actively post personal information on social media understand the logic or intent of spreading 'the word' about CrossFit, often they are also engaging in a form of self-promotion. As adults, people start to have fewer tangible goals they can point to and share as a source of pride. Their high school accolades have lost social value and their current work accomplishments usually do not translate well to social media. CrossFit fills that void and allows members to take pride in their accomplishments, whether it is losing weight, hitting a new personal record, or even simply proving that they have gotten off the couch and are participating in an intense workout.[37] A 2014 sociological study[38] on 'trophies of surplus enjoyment' (photos, merchandise, trinkets, etc.) found that people hunt for trophies at events they attend not just for their fandom and remembrance but also as envy-inducing commodities they can share on social media so that others can acknowledge them through 'likes,' 'favourites' and 'retweets'. This is often what CrossFit community members are doing when posting photos and videos to social media. The pictures or videos of them participating in CrossFit act as 'acquired trophies' so that others can socially recognise their efforts and potentially elevate their 'status' in the viewer's eyes.

The CrossFit Community's indulgence in social media, evidenced by the rapid success of CrossFit as a sport and a brand, further proves that their presence in the technological and social media world has been a surefire benefit. The CrossFit Community as a whole understands the value of social media, and whether their intentions are of a conscious or an unconscious nature, they use this medium to pique the interest of outsiders about as well as anybody.

### The CrossFit Games

From the very first journal article introducing CrossFit on a larger scale, Greg Glassman has challenged the idea of who is the 'fittest on earth'. The CrossFit philosophy of defining fitness through meaningful and measurable ways opened up a door for competition to exist. Enter, the CrossFit Games, which have been held annually since 2007 and continue to grow at record numbers each year. The games are a physically and mentally demanding competition held over a few days where competitors are blind to the certain events until right before they participate. At the end, the overall winners are awarded the title 'Fittest on Earth'.

The first games in 2007, held on CrossFit Games Director Dave Castro's parents' land in California, consisted of first-come participation with the winner receiving a $500 prize. The games' popularity grew as the company grew and in 2011 the CrossFit Games hit a banner year as CrossFit, Inc. signed Reebok to a 10-year title sponsorship as well as having the games broadcast through ESPN3 (online).[39] With the rising number of participants yearly, CrossFit adopted an online qualification format that included three stages. Stage 1, known as 'The Open', occurs in March when contestants submit weekly scores online from recently released competition workouts from crossfit.com. The scores are validated through affiliates, or video is uploaded proving participants' score times. The top qualifiers from predetermined regions participate in Stage 2, regional events, held throughout the world in order to qualify for Stage 3, the CrossFit Games. In 2011, online participation totaled 26 000 submissions and has grown exponentially as 2016 online submissions totalled 308 000 people, a CrossFit Games record.[40]

With Reebok and ESPN on board, the CrossFit Games are now considered a top-flight fitness competition and are broadcast worldwide live on ESPN. The winners in 2016 received $275 000 and the total prize pool, paid from the Reebok contract, was $2 200 000 and will rise annually throughout the length of the contract (Figure 7). Even though the CrossFit Games are not a large profit source for CrossFit, Inc. the magnitude of what the games bring to the company is immeasurable. The exposure of the competition alone is one of the driving forces in making CrossFit the number one fitness enterprise on the planet and looking at the yearly increase in participants, prize money and attendance, the games' momentum does not appear to be slowing down.

## INDUSTRY COMPETITION

At the beginning of 2016 there were numerous fitness centres competing in a growing national and global market. Primary activities for this industry included operating health clubs, gyms, aerobic and exercise centres, and other fitness-related facilities. The industry was fragmented, with many companies growing and combining across regional and product lines. Demand for fitness and recreation centres continued to increase, thereby causing the number of people employed in the industry to increase. By 2015 there were almost 33 000 fitness centres in the United States. The industry employed approximately 568 000 people that same year.[41] In 2016, the overall industry had grown to $27.1 billion in revenue and $2.8 billion in profits. Membership fees were the single largest revenue component and member retention was the key to a centre's profitability. Fitness centres competed on brand recognition, customer service, price and services offered.[42]

Even though competition was great, industry entry barriers were considered to be low. It was possible to lease equipment and buildings, and both equipment and buildings had long life spans. Many start-ups were able to use second-hand or previously used equipment. Wages were low. There were not many regulations other than zoning and building permit processes at the local level. Access to capital for start-ups was readily available in most instances. The only real entry barrier was the brand loyalty and recognition built up by established gyms and fitness centres. Fitness centre memberships were on the rise. However, in the future, it was expected that entry barriers would rise due to the possibility that corporate wellness programs would create strong demand for large-scale memberships, thereby creating barriers for newer companies.[43]

Yet even with all this activity in the business of fitness, there was evidence that additional growth was possible. A 2016 study of nine countries by Censuswide, a global consultancy, found that the average person spent only 0.7 per cent of their life exercising – or stated differently, out of an average person's 25 915 days on earth, they tended to spend only 180 days exercising.[44] However, the number of adults aged 20 to 64 spending leisure times exercising and on sports was increasing. Plus, the number

**Figure 7** The CrossFit games history data

| Participant Data | | |
|---|---|---|
| Year | # of Participants | |
| 2007 | 60 (no open) | Games |
| 2008 | 300 (cap – no open) | Games |
| 2009 | 146 (post regionals) | Games |
| 2010 | 86 (post regionals) | Games |
| 2011 | 26 000+ | Open |
| 2012 | 69 240 | Open |
| 2013 | 138 000+ | Open |
| 2014 | 209 000+ | Open |
| 2015 | 273 000+ | Open |
| 2016 | 308 000+ | Open |

| Participant Data (Open) | | | |
|---|---|---|---|
| Year | Winner | Total Prize Purse | Sponsor |
| 2007 | $500 | $1 000 | |
| 2008 | $1 500 | $3 000 | |
| 2009 | $5 000 | $10 000 | |
| 2010 | $25 000 | $50 000 | Progenex |
| 2011 | $250 000 | $1 000 000 | Reebok |
| 2012 | $250 000 | ? | Reebok |
| 2013 | $275 000 | ? | Reebok |
| 2014 | $275 000 | $1 750 000 | Reebok |
| 2015 | $275 000 | $2 000 000 | Reebok |
| 2016 | $275 000 | $2 200 000 | Reebok |
| 2017 | ? | $2 400 000 | Reebok |
| 2018 | ? | $2 600 000 | Reebok |
| 2019 | ? | $2 800 000 | Reebok |
| 2020 | ? | $3 000 000 | Reebok |

*Spaces with '?' mean we were unable to find accurate numbers.
Sources: http://www.everylastrep.com/fitness-for-beginners/look-crossfit-games-history
http://games.crossfit.com/content/history

of employers viewing exercise as an important component of employee health was also on the rise. Therefore, in the minds of many, these findings established the need for an increased emphasis on global fitness. The view of industry experts was that there was plenty of room for growth for both large companies and niche players (see Figure 8 for possible fitness niches). The industry was expected to grow, in terms of industry value added (IVA, a measure of the industry's contribution to the economy overall) by approximately 3 per cent from 2016 to 2021.[45]

CrossFit competed in this industry with a unique value proposition that was more a philosophy of fitness than a business model. It appealed strongly to the largest market segment – consumers aged 34 years and younger.[46] Still, other companies thrived in the industry as well. Among the industry leaders were

**Figure 8** **Top 20 worldwide fitness trends for 2017**

1. Wearable technology
2. Body weight training
3. High-intensity interval training
4. Educated, certified and experienced fitness professionals
5. Strength training
6. Group training
7. Exercise is medicine
8. Yoga
9. Personal training
10. Exercise and weight loss
11. Fitness programs for older adults
12. Functional fitness
13. Outdoor activities
14. Group personal training
15. Wellness coaching
16. Worksite health promotion
17. Smartphone exercise apps
18. Outcomes measurements
19. Circuit training
20. Flexibility and mobility rollers

Source: Worldwide Survey of Fitness Trends for 2017 by Walter R. Thompson, PhD., ACSM's Health & Fitness Journal, November/December 2016

Anytime Fitness, Arcadia Fitness, Gold's Gym, GoodLife Fitness, LA Fitness, Planet Fitness, 24 Hour Fitness and Zumba. LA Fitness and Planet Fitness were publicly traded companies, while most other competitors were private or closely held organisations. Each company sought large-scale expansion while at the same time targeting particular segments for growth.

### Anytime Fitness

As the name implies, Anytime Fitness operates fitness centres that are open for workouts 24 hours a day, 365 days a year. Anytime Fitness, with more than 3 million members, was one of the fastest-growing and most progressive fitness businesses in the world. It received notoriety as one of *Entrepreneur Magazine*'s top 10 fastest-growing franchises across all industries in 2015. From its first centre in 2002, it grew into all 50 US states and 20 countries, with 38 wholly owned and approximately 3000 franchised centres worldwide in 2016. For example, it opened a fitness centre in Rome in 2016. The co-founder, Chuck Runyon, used private equity and franchising to finance the company's rapid growth. Also to facilitate growth, in 2016 it moved into a new building and expanded to 300 employees at its headquarters in Woodbury, Minnesota. Runyon expected to continue growing the company at a rate of approximately 400 franchisees annually towards of goal of 4500 centres by 2020. Starting a franchise cost between $100 000 and $500 000 plus a $30–37 500 franchise fee. Anytime required franchise owners to pay a $549 monthly royalty. In 2017, the parent company of Anytime Fitness, Self Esteem Brands, was diversifying into salons and other fitness-related businesses.[47]

### Arcadia and GoodLife

With more than 365 operating fitness centres, GoodLife Fitness was the largest fitness company in Canada. Members could join for around $50 a month and specific classes were available for an additional fee. TRX suspension training classes were the most popular, starting at $199 for six weeks. These classes kept members involved through a progressive training structure, with each new class building upon what members learned in previous classes. Many GoodLife centres were oriented towards women's fitness. GoodLife provided individual trainers as well as individualised workout sessions for class members in order to mesh with member work schedules. Another Canadian fitness company, Arcadia, specialised in fitness programs for women taught by women that emphasised the use of gravity and body weight as resistance. Arcadia and GoodLife occupied some of the same competitive space in a growing market. The Canadian fitness industry generated over $2 billion in revenue and was growing at an annual rate of over 2 per cent. Approximately five million Canadian citizens were members of fitness clubs in 2012.[48]

### LA Fitness

This company began in 1984 in Covina, in Southern California. Its mission is to provide lifelong good health benefits to an increasingly diverse membership base. The business model was to tailor each individual fitness centre to the specific needs of the community into which the company expanded. LA Fitness viewed its competence as being able to understand and meet the distinctive needs of the metropolitan communities in which it operated. It offered workouts and programs to people of all ages and fitness levels. The company strove to be family-friendly. Growth goals for LA Fitness centred on the idea of making fitness more available to larger segments of the community. It offered access to free weights, weight machines and cardio to members.[49]

### Planet Fitness

Planet Fitness was also a large and fast-growing competitor in this industry. In 2015, it maintained over 1100 spacious and clean facilities (most of these were franchises) in 47 states with a large selection of Planet Fitness-branded equipment. Its slogan is: 'We're not a gym. We're Planet Fitness.' Typical centres were 1860 square metres filled with purple and yellow cardio and weight-training equipment of all types. Memberships were inexpensive relative to other centres and Planet Fitness offered unlimited fitness instruction to all members. Its goal was to appeal to a broad market by creating a welcoming and non-intimidating, 'judgment-free', fitness environment for anyone.

Company revenue for 2015 was $1.5 billion and it had aggressive plans that included growing equipment sales, expanding franchise royalties, driving revenue growth and growing into a broad range of markets. Planet Fitness planned to increase the number of stores in the United States to over 4000 and to grow into Canada in the near future.[50]

### Gold's Gym

Gold's Gym considered itself the original fitness company. Founded by Joe Gold in Venice, California, in 1965, it gained notoriety in the documentary movie *Pumping Iron* starring two young weight-lifting sensations Arnold Schwarzenegger and Lou Ferrigno. Gold's had over three million members in 22 countries and 38 states in 2016. It offered weight-training primarily, but also cycling, martial arts, muscle endurance, yoga and Zumba. However, it was strength training that set Gold's apart from other centres. The company claimed to be able to enhance the strength of members, with the additional claim that with physical strength came strength to excel at other aspects of life. Gold's Gym was privately held.[51]

### 24 Hour Fitness

24 Hour Fitness competed in a market space similar to Anytime Fitness and Planet Fitness. 24 Hour operated 400 centres for four million members in 17 states. The company had run successfully for over 30 years, offering convenience to its members. It had accessible, affordable, convenient places for people of all fitness levels and abilities. Its business model was oriented towards allowing each individual to seek out his or her own fitness goals and pursue them on their own terms.[52]

### Zumba

Zumba began operations in 2001. By 2016 it had grown to almost 200 000 centres or locations worldwide. The basic idea of Zumba fitness was to burn calories through dance-related aerobic routines. Zumba centres or classes were found in churches, hospitals, schools and universities. Almost any room large enough with a good sound system would suffice as a Zumba centre. The company also aggressively sold Zumba workouts on CD. The main goal was to provide a non-threatening atmosphere where participants could dance and have fun. Zumba tended to appeal to mothers because it enabled them to work out at home. Company executives also claimed that people tended to stay with Zumba longer than other competitors because it was fun. Zumba sold itself as being 'fitnesstainment'.[53]

## CRITICISM

The growth of CrossFit is undeniable and the future of the company and sport is still as bright as ever, but CrossFit, like most fitness industry start-ups, is facing a certain degree of criticism and scepticism. Throughout the first decade and a half, CrossFit has faced an array of naysayers who criticise CrossFit's methods, techniques, safety measures and legitimacy. The following are a few of the most common criticisms.

### Cult

One of the most widely mentioned criticisms of the CrossFit industry is that it is a 'cult'. Doubters of CrossFit feel that the family-oriented atmosphere that CrossFit revolves around resembles that of a cult-like following. Typical arguments insist that CrossFit brainwashes its members with their workout effectiveness, paying large membership fees (generally around $100/month), to being led by a 'leader' who dictates how they should act, to being elitists who only socialise with other CrossFit members.

### Injury/Safety

Outsiders have often claimed that the CrossFit workout can be unsafe for its participants. The intensity and competitive nature can lead to too much heavy lifting and improper form all the way through the rep sets opening up opportunities for injury. The most commonly mentioned injury/disease used against CrossFit is rhabdomyolysis. Shortened in the CrossFit world to 'rhabdo', this is caused by the death of muscle fibres and the release of their contents into the bloodstream.[54] Rhabdo results from overexertion, which leads to the body's muscles breaking down and potentially causing kidney failure. Although it can be deadly, it is usually a treatable disease.

### Legitimacy

Many proponents of CrossFit argue that the workout methods do not produce realistic results – that the libertarian methods of allowing box owners to create their own workouts within an entire methodology opens up the risk for unqualified coaches to piece together workouts that are not safe and do not translate into results.[55] High Intensity Interval Training (HIIT) is widely considered one of the best forms of exercise to burn fat, and CrossFit is no stranger to utilising this method. But many feel CrossFit fails at this in its mix of intensity versus volume. Some contend that CrossFit uses HIIT as a fitness test and not necessarily for the best results. For example, a widely used HIIT method is TABATA (named for Japanese scientist Dr Izumi Tabata), which uses eight rounds of one exercise (bike, sprints, etc.) that includes 20 seconds of all-out work and 10 seconds of rest. CrossFit has a workout called 'TABATA THIS' in which athletes complete rows, air squats, pull-ups, push-ups and sit-ups . . . for 40 intervals! Critics say that this far exceeds the accepted mix and exposes participants to a decrease in intensity because of the large volume as well as a breakdown in technique, which can lead to both less effective and more dangerous results.[56]

### Saturating the market

While most of CrossFit's criticism comes from outside the community, there are affiliate owners who have concerns regarding the rapid pace at which CrossFit has grown. One box owner who has seen the rise of CrossFit through increased usage of social media pointed out that 'growth doesn't equate to quality'. He wonders if the rapid growth is just inflating a trend or if CrossFit will become a permanent fitness fixture.[57]

While many business owners are reluctant to respond to public criticism for fear that it will damage their reputation, CrossFit, Inc. and its legion of followers are the exact opposite. CrossFit has a team of employees who patrol the internet looking to defend the brand with an iron fist against anyone and everyone who tries to deface it. Glassman has an entire team of lawyers dedicated only to defending the brand name as well as its trademark from people around the world who attempt to use the CrossFit name without paying for it. When asked why, Glassman explains, 'if you don't defend it, you won't have a brand for long. We are in shark-infested waters and I've got shark-repellent attorneys'.[58]

## WHAT NEXT?

After a few days of relaxation, reflection and thought, Glassman came to the confirmation that he was content as to where CrossFit was, both the brand and the workout. He understood that he is one of the fortunate ones to break through the 'fad' stage in the fitness industry and is truly on the verge of creating not just a revolutionary workout but an entirely new sport, and he did it his way. With that thought though, he knows that there are future decisions that must be made to allow the brand to continue to grow and some of those decisions could conflict with CrossFit's current culture, values and philosophies.

Sticking to CrossFit's roots as a technology leveraging fitness company, he thought about the future, how it can continue to stay on the cutting edge of technology and what avenues would be beneficial to continue to grow the CrossFit brand. Now that CrossFit, Inc. is in a place of financial stability, he also kicked around the idea of starting to get involved in large outside advertising to increase the brand's recognition and reach, such as stadium naming rights and national television advertising. Would the opportunity to increase his brand awareness through mainstream advertising, a path that CrossFit typically has not followed, help or hurt the loyalty aspect of his devout followers, and what would the impact be at the local affiliate network?

The sport of CrossFit is undoubtedly growing. The Reebok CrossFit Games are increasing each year in participants, attendance and revenue. His firm belief that CrossFit athletes are the 'fittest on earth' due to their well-rounded abilities is something that he would adamantly defend anywhere. With the Rio 2016 Olympic games approaching, he cannot help but dream about CrossFit being an event in future Olympics. The exposure of CrossFit at the largest stage of worldwide competition has the capability to solidify CrossFit as a major sporting event, not to mention the potential financial impact. The ability for CrossFit's dedicated athletes to have the opportunity to compete for their countries would be incredible, Glassman thought. But, for this ever to happen, he knows that drastic changes would have to take place. First off, in addition to the International Olympic Committee (IOC), an international governing body would be needed to oversee the sport,[59] undoubtedly limiting his power as CrossFit's sole decision maker. Policies and regulations would be altered and CrossFit staples such as the random nature of events that the CrossFit Games are known for, among others, would most likely change. Is this something that he, personally, is willing to do to grow the sport? Can the sport of CrossFit survive and grow on its own? What would the impact be at the national and local levels with the radical changes that would likely occur?

Glassman's thoughts then reverted to CrossFit, Inc.'s affiliate business model and how current trends could impact the company's growth. How could they address some of the

**Figure 9** **Eight things you probably didn't know about Crossfit**

1. **You don't have to be young or in great shape to try CrossFit** (CrossFit is for beginners, experienced athletes, the fit, and the un-fit)
2. **CrossFit works out your mind as well as your body** (a common reason for gym cancellation has to do with mindset of the member – CrossFit defeats this by training the mind to work through soreness and fatigue)
3. **CrossFit has a strong connection to law enforcement and military officials** (CrossFit is popular with police and military specialized teams across the country)
4. **CrossFit commemorated a set of workouts to fallen soldiers** (common in boxes around the world – these workouts are named in honor of fallen soldiers who were CrossFit followers)
5. **CrossFit gyms have exclusive owners** (in order to open up your own CrossFit 'box' you need more than cash – you will need to write an essay, complete an application, pay a yearly fee, and complete instructor training courses; this enhances the quality of gyms across the board)
6. **CrossFit offers a 'Kids' program** (parents can bring their kids to a growing number of the gyms)
7. **CrossFit has a Paleo Diet kitchen on premises** (for member convenience – works like a subscription service at many of the boxes)
8. **CrossFit is 60% female** (there are about 6 million CrossFit women members)

Source: http://www.interesticle.com/fitness-and-health/8-things-you-probably-didnt-know-about-crossfit criticism surrounding CrossFit and how would potential remedies impact the company financially? For example, should CrossFit, Inc. mandate continuing education for coaches and should it charge for this or go in the opposite direction and invest in its coaches, in an attempt to increase the competency at each affiliate? Lastly, his attention turned to how he should handle the issue of large corporate CrossFit gyms, such as Boston's Reebok CrossFit Back Bay, who operate full-service, state-of-the-art boxes.[60] Since the beginning, the 'Garage Gym', a stripped-down, rather unsightly facility with only the essential equipment needed for a hard-core workout, has been the standard. Allowing corporate companies to open 'globo-gym' type facilities with full-service amenities such as locker rooms and all hours' access could change the landscape of CrossFit affiliations as they currently exist. Even if these facilities stay true to CrossFit's roots (equipment, loud music, etc.), what would the effects be on the local affiliates' ability to survive? Would there be a 'Walmart-Effect'[61] and if so, should it increase the corporate-sized gyms' yearly fee to offset the loss of small affiliates? Would this be detrimental to the CrossFit philosophy or would it further legitimise CrossFit as a high-end fitness option?

**Figure 10** CrossFit, Inc. growth contributors

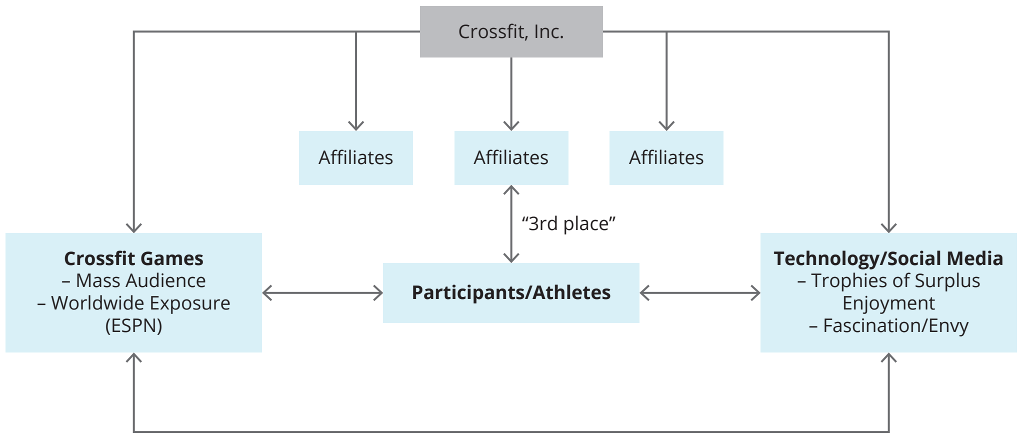
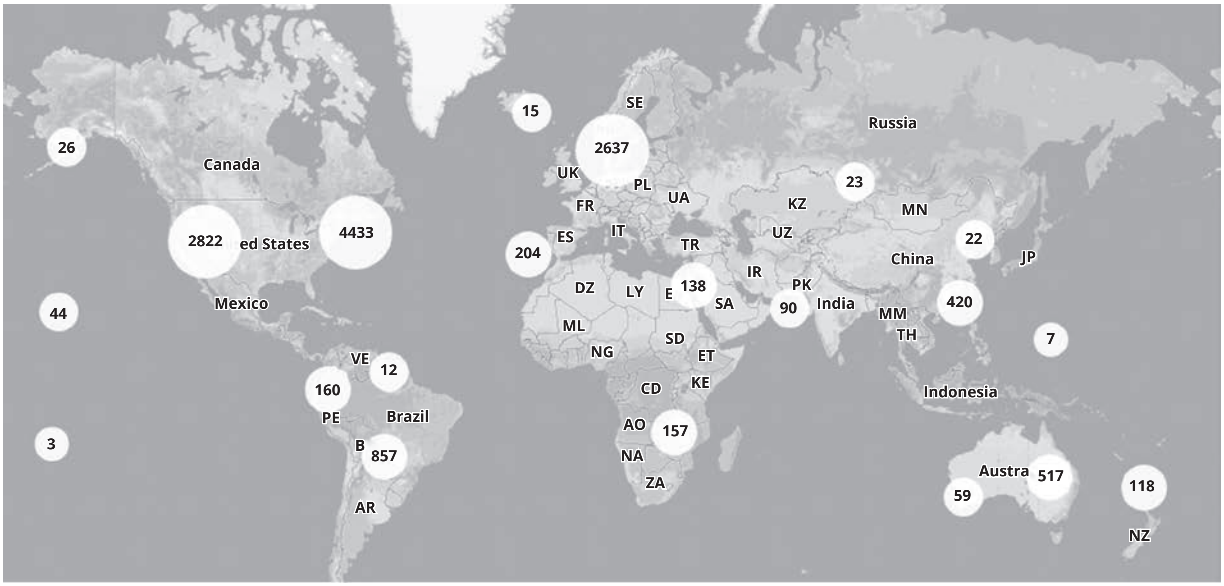



**Figure 11** Worldwide CrossFit box locations map




Source: https://map.crossfit.com/

As Glassman sat at his desk wondering how these opportunities and potential changes would affect the CrossFit world, he leaned back in his chair and scanned the room looking at all of the pictures, posters and plaques hanging on his wall. Each one represented something different but all of them contributed to the growth of CrossFit in their own way. Then he noticed one in particular. It was a small 8 × 10 frame, somewhat lost among the other flashy pieces, but it carried more meaning than anything up there. It was a photo of him and the officers from the Santa Cruz Police Department, the original CrossFit group. He realises that changes are inevitable, but the photo reminds him that CrossFit grew from the dedication, commitment and loyalty of its community. Moving forward he would like his decisions to remain true to those roots and his libertarian approach, because that is the essence of his success.

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# CASE 8

## The movie exhibition industry: 2018 and beyond

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**CASE LINK: This case applies concepts from Chapters 2, 3, 4 and 5.**

The scene: On a cold, dark, nearly deserted location a solitary figure, the last of his kind, stands sentinel. In this remote place, little has changed while elsewhere the world is transforming. The philosophical question: Are the systems, structures and heroes of the past still relevant or are they obsolete? The action: An epic battle, which (spoiler alert!) not all will survive. Is this the plot to *The Last Jedi*, 2017's most successful motion picture? Certainly, but the situation is also analogous to that facing movie exhibitors – movie theatres – in 2018. A timeline of the industry matches the plot twists of even the most gripping sci-fi fantasy adventure (Figure 1). Consider the facts:

- As shown in Figure 2, 2017's $11.1 billion in domestic box office receipts[1] was near historical highs, but down 2.5 per cent from 2016's record-setting year. Domestic box office revenue records were set in five of the prior 10 years, but declined in the other five.
- At first glance, the 1.236 billion tickets sold domestically is impressive. However, attendance declined nearly 6 per cent from 2016 and the long-term trend in attendance is negative; each year fewer people go to the movies. 2017's attendance is the lowest since 1992 and is down 21 per cent from the most recent peak in 2002.
- The trend in per capita admissions is negative. In 2017, the average number of films seen per person was 3.7; in 2006, it was 4.7.[2] Both are well down from 1946's peak 4 billion tickets sold when the typical person attended 28 movies a year.
- In recent years ticket price increases have exceeded inflation, indicating some recent pricing power. At $8.97, the average ticket price has risen 30 per cent since 2007 (Figure 3). Recent price increases, however, occur at the same time as attendance has declined, raising concerns that prices now exceed the value provided to a greater number of potential viewers.
- The demographic trends in exhibitors' core domestic market are changing. Studios target an audience of 12–24 year olds. While this demographic group will increase 15 per cent by 2035, the fastest-growing segment of the population is those 60 and older. This population segment will grow 36 per cent by 2035. Unfortunately, at 2.5 visits per year, this audience currently attends the movies the least (Figure 4).
- Movies are more widely available than ever, creating new substitutes for where, when and how they are viewed.
- The industry's major initiative to lower costs and draw audiences fizzled out: investments of $2.6 billion since 2005 in digital projection (Figure 5) have not reduced costs or yielded parity compared with home theatres. Audience interest in 3D movies, available with digitisation, appears limited. 3D ticket sales peaked in 2010 at 17 per cent of tickets and have declined steadily to just 11 per cent in 2017 (Figures 2 and 6).
- Exhibitors have little control over their largest cost: rental fees for motion pictures. Costs are high due to a small number of suppliers with high bargaining power due to highly differentiated content (Figures 7, 10 and 12).
- The industry is increasingly bifurcated between two markets, domestic (clear signs of maturity such as a declining number of screens domestically, increasing threat of substitution, difficulty innovating and signs of consolidation) and international (growth, rapidly expanding theatre counts, rising attendance and increasing revenues) (Figures 1, 8 and 9).

Much like the Jedi in the *Star Wars* saga, movie exhibitors are engaged in an epic struggle. Exhibitors, much like the Jedi, have held a seemingly unquestionable place within society. Exhibitors have long held a position as ***the*** local face of the entertainment industry in communities. Are movie theatres still relevant? Will they survive? Might movie theatres go the way of the Jedi and cease to exist? Might your local movie theatre be *The Last Exhibitor*?

### THE MOTION PICTURE VALUE CHAIN

The structure of the motion picture value chain has changed little since the 1920s. It consists of three stages: studio production, distribution and exhibition – the theatres that show the films.

This case is intended solely for the purpose of classroom discussion. It is not intended to be used for any kind of endorsement, source of data, or depiction of effective or ineffective management. All opinions expressed, and all errors and omissions, are entirely those of the author.

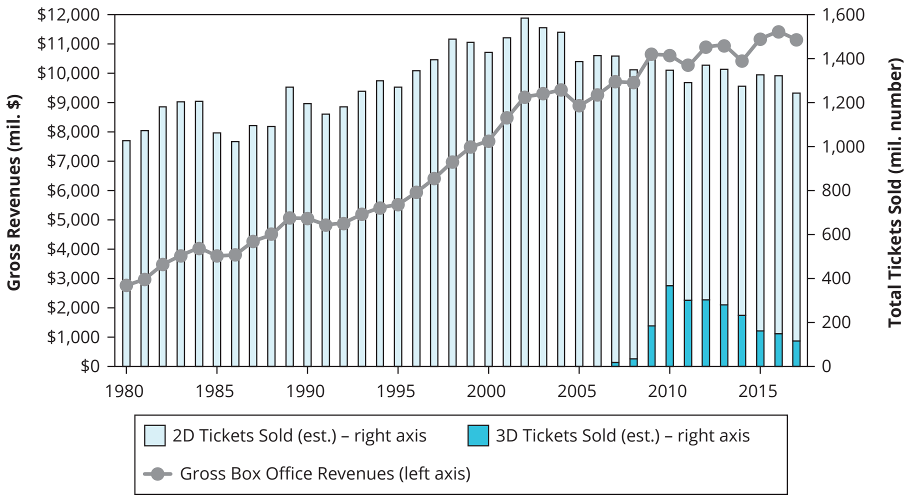
**Figure 1** Top 25 motion pictures based on 2017 domestic box office

| | | | | | | | Domestic | | International | | | Global | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Movie | 2016 Dom. Gross | Dom. Rank | Studio | Genre | MPAA Rating | Prod. Budget (mil.) | Domestic Box Office to Budget Ratio | % Opening Weekend | Gross (mil.) | Rank | Intl. Box Office to Budget Ratio | Gross (mil.) | Rank | % Gross Outside US | Global Box Office to Budget Ratio |
| Star Wars: The Last Jedi | $620 | 1 | BV | S-F Fan | PG-13 | $200 | 3.6 | 35% | $524 | 9 | 2.6 | $1,334 | 1 | 74% | 2.6 |
| Beauty and the Beast (2017) | $504 | 2 | BV | Fan | PG | $160 | 7.9 | 35% | $760 | 3 | 4.7 | $1,264 | 2 | 60% | 4.7 |
| Wonder Woman | $413 | 3 | WB | Act/Adv | PG-13 | $149 | 5.5 | 25% | $406 | 13 | 2.7 | $821 | 9 | 49% | 2.7 |
| Jumanji: Welcome to the Jungle | $405 | 4 | Sony | Act | PG-13 | $90 | 10.7 | 14% | $557 | 6 | 6.2 | $962 | 5 | 58% | 6.2 |
| Guardians of the Galaxy Vol. 2 | $390 | 5 | BV | Act/Adv | PG-13 | $200 | 4.3 | 38% | $474 | 11 | 2.4 | $864 | 7 | 55% | 2.4 |
| Spider-Man: Homecoming | $334 | 6 | Sony | Act/Adv | PG-13 | $175 | 5.0 | 35% | $546 | 7 | 3.1 | $880 | 6 | 62% | 3.1 |
| It | $327 | 7 | WB (NL) | Horr | R | $35 | 20.0 | 38% | $373 | 16 | 10.7 | $700 | 12 | 53% | 10.7 |
| Thor: Ragnarok | $315 | 8 | BV | Act/Adv | PG-13 | $180 | 4.7 | 39% | $539 | 8 | 3.0 | $854 | 8 | 63% | 3.0 |
| Despicable Me 3 | $265 | 9 | Univ. | Anim | PG | $80 | 12.9 | 37% | $770 | 2 | 9.6 | $1,035 | 4 | 74% | 9.6 |
| Justice League | $229 | 10 | WB | Act/Adv | PG-13 | $165 | 4.0 | 41% | $429 | 12 | 2.6 | $658 | 13 | 65% | 2.6 |
| Logan | $226 | 11 | Fox | Act/Adv | R | $97 | 6.4 | 39% | $393 | 15 | 4.0 | $619 | 14 | 63% | 4.0 |
| The Fate of the Furious | $226 | 12 | Univ. | Act | PG-13 | $250 | 4.9 | 44% | $1,010 | 1 | 4.0 | $1,236 | 3 | 82% | 4.0 |
| Coco | $210 | 13 | BV | Anim | PG | $100 | 8.1 | 24% | $597 | 5 | 6.0 | $807 | 10 | 74% | 6.0 |
| Dunkirk | $188 | 14 | WB | War | PG-13 | $100 | 5.3 | 27% | $337 | 19 | 3.4 | $527 | 18 | 64% | 3.4 |
| Get Out | $176 | 15 | Univ. | Horr | R | $5 | 56.7 | 19% | $79 | 25 | 17.6 | $255 | 25 | 31% | 17.6 |
| The LEGO Batman Movie | $176 | 16 | WB | Anim | PG | $80 | 3.9 | 30% | $136 | 24 | 1.7 | $312 | 22 | 44% | 1.7 |
| The Boss Baby | $175 | 17 | Fox | Anim | PG | $75 | 7.0 | 29% | $353 | 17 | 4.7 | $528 | 17 | 67% | 4.7 |

| | | | | | | | Domestic | | International | | | Global | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Movie | 2016 Dom. Gross | Dom. Rank | Studio | Genre | MPAA Rating | Prod. Budget (mil.) | Domestic Box Office to Budget Ratio | % Opening Weekend | Gross (mil.) | Rank | Intl. Box Office to Budget Ratio | Gross (mil.) | Rank | % Gross Outside US | Global Box Office to Budget Ratio |
| The Greatest Showman | $174 | 18 | Fox | Mus | PG | $84 | 5.2 | 8% | $259 | 20 | 3.1 | $433 | 20 | 60% | 3.1 |
| Pirates of the Caribbean: Dead Men Tell No Tales | $173 | 19 | BV | Adv | PG-13 | $230 | 3.5 | 45% | $622 | 4 | 2.7 | $795 | 11 | 78% | 2.7 |
| Kong: Skull Island | $168 | 20 | WB | Act/Adv | PG-13 | $185 | 3.1 | 36% | $399 | 14 | 2.2 | $567 | 16 | 70% | 2.2 |
| Cars 3 | $153 | 21 | BV | Anim | G | $100 | 3.8 | 35% | $231 | 21 | 2.3 | $384 | 21 | 60% | 2.3 |
| War for the Planet of the Apes | $147 | 22 | Fox | S-F Act | PG-13 | $150 | 3.3 | 38% | $344 | 18 | 2.3 | $491 | 19 | 70% | 2.3 |
| Split | $138 | 23 | Univ. | Horr Thrl | PG-13 | $9 | 30.9 | 29% | $140 | 23 | 15.6 | $278 | 24 | 50% | 15.6 |
| Wonder | $132 | 24 | LG | Drama | PG | $70 | 4.3 | 21% | $168 | 22 | 2.4 | $301 | 23 | 56% | 2.4 |
| Transformers: The Last Knight | $130 | 25 | Para | Sci-Fi Act | PG-13 | $217 | 2.8 | 34% | $475 | 10 | 2.2 | $605 | 15 | 79% | 2.2 |
| Total for Top 25 | $6,394 | | | | | $3,186 | | | $10,921 | | | $15,509 | | | |
| Average for Top 25 | $256 | | | | | $127 | 9.1 | 32% | $437 | | 4.9 | $700 | | 62% | 4.9 |

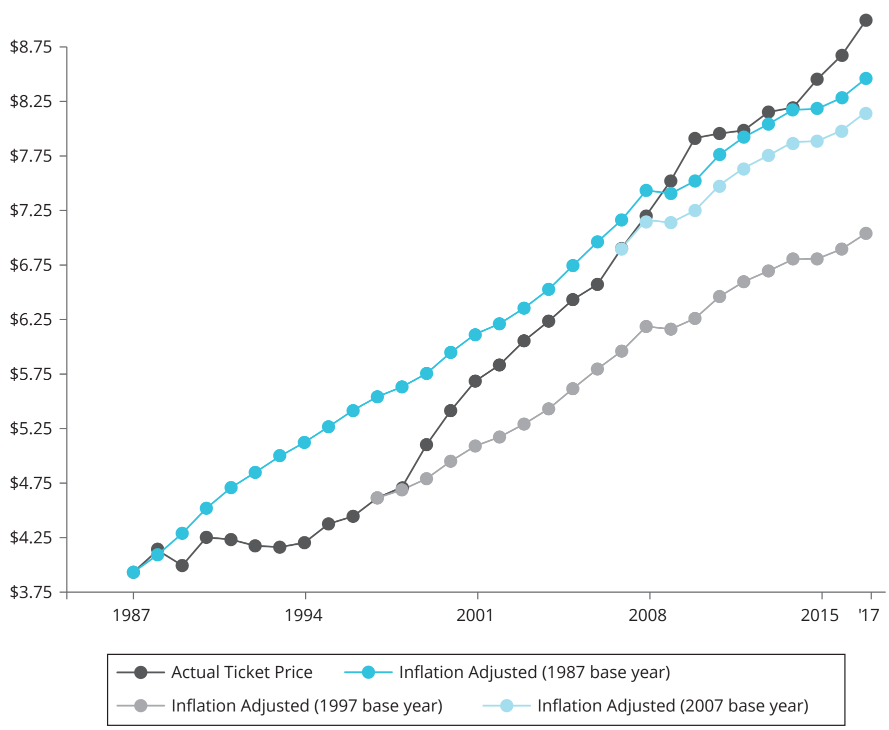
Notes: Data from Boxofficemojo.com, MPAA, other sources and author estimates and calculations.
2017 Gross is total domestic gross for all films originally released in 2017. Domestic, international, and total gross encompasses entire theatrical release.
Studios: BV = Disney/Buena Vista/Pixar, Fox = 20th Century Fox, LG = Lionsgate, NL = New Line, Para = Paramount, Sony = Sony, Univ = Universal, WB = Warner Bros.,
Genres as follows: Act = Action, Adv = Adventure, Anim = Animation, Com = Comedy, Drama = Drama, Fant = Fantasy, Horr = Horror, Musc—Musical, S-F = Science Fiction
Some production budgets estimated.
Domestic = US and Canada; International = Outside US and Canada; Global = all locations
B:P Ratio = Total box office (domestic, international, and global) to Production Budget.
% O.W. = percentage of total domestic box office from the opening weekend.
Internal rank and global rank are based on international and global gross among the domestic top 25 motion pictures only.

**Figure 2** Domestic box office receipts and ticket sales, 1980–2017




Data Source: Boxofficemojo.com, MPAA Theatrical Statistics & Theatrical and Home Entertainment Market Environment (THEME) Reports, and author estimates. Some years of 3D ticket volume estimated based on reported 3D revenues with ticket prices estimated as 30% premium over 2D.

**Figure 3** Ticket prices versus inflation, 1987–2017




Notes: Inflation adjustments based on CPI values reported by Minneapolis Federal Reserve Bank, URL: https://www.minneapolisfed.org/community/financial-and-economic-education/cpi-calculator-information/consumer-price-index-and-inflation-rates-1913

**Figure 4** US demographic and admission trends

| | 2017 Admissions | | | 2018 Population | | Est. 2035 Population | | Change 2017–2035 | | Expected Impact of Change | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Age Segment | % of Tickets Purchased (2017) | Admissions Per Capita (2017) | % of Frequent Movie Goers[1] | # (mil.) | % | # (mil.) | % | # (mil.) | % | # Increase per Existing Screen (based on 40,246 screens) | New Annual Admissions per Screen (based on 2017 per capita rate) | Additional Admissions per Screen per Weekend | % of New Admissions |
| 2 to 11 yrs | 10% | 2.9 | 8% | 44.7 | 14% | 50.0 | 13% | 5.3 | 12% | 131.6 | 381.8 | 7.3 | 9% |
| 12 to 17 yrs | 11% | 4.9 | 13% | 26.6 | 8% | 30.6 | 8% | 4.0 | 15% | 99.5 | 487.7 | 9.4 | 11% |
| 18 to 24 yrs | 12% | 4.7 | 12% | 30.5 | 9% | 35.7 | 9% | 5.2 | 17% | 130.2 | 612.0 | 11.8 | 14% |
| 25 to 39 yrs | 26% | 4.4 | 26% | 67.9 | 21% | 73.3 | 19% | 5.5 | 8% | 136.5 | 600.8 | 11.6 | 14% |
| 40 to 49 yrs | 13% | 3.6 | 15% | 41.3 | 13% | 48.7 | 13% | 7.3 | 18% | 182.2 | 655.8 | 12.6 | 15% |
| 50 to 59 yrs | 12% | 3.0 | 13% | 43.3 | 13% | 43.8 | 12% | 0.5 | 1% | 12.3 | 36.8 | 0.7 | 1% |
| 60 yrs+ | 16% | 2.5 | 14% | 71.7 | 22% | 97.3 | 26% | 25.6 | 36% | 637.1 | 1,592.7 | 30.6 | 36% |
| | 100% | US Avg. in 2017 = 3.7 | 100% | 326.0 | 100% | 379.5 | 100% | 53.5 | 15% | 1,329.4 | 4,467.6 | 84.0 | 14% |

Notes: Source: Data: US Census (2014), https://www.census.gov/population/projections/data/national/2014/summarytables.html, author estimates, and MPAA Theatrical Statistics & Theatrical and Home Entertainment Market Environment (THEME) Reports.

[1]Frequent moviegoer defined by MPAA as one who attends the cinema at least once per month

[2]Based on 2017 40,246 screens, actual # (not in mil.).

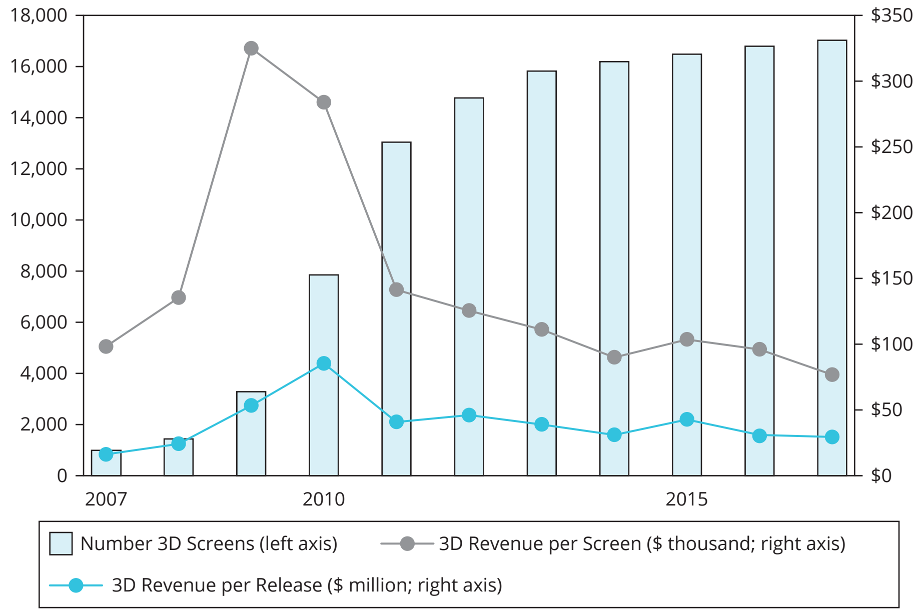
[3]Based on 2017 per capita admission rates by age group.

**Figure 5** US theatre screens 2000–17

| | | | Analogue Screens | | | Digital Screens – Non-3D | | | | Digital Screens – 3D | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Year | Total Screens | Change from Prior Year | # | Change from Prior Year | As % of Total Screens | # | Change from Prior Year | As % of Total Screens | Est. Digital Invest. ($ mil.) | # | Change from Prior Year | As % of Total Screens | As % of Digital Screens | Est. 3D Invest. ($ mil.) | Total Digital Investment ($ mil.) |
| 2000 | 37,396 | | 37,396 | | 100.0% | | | | | | | | | | |
| 2001 | 36,764 | –1.7% | 36,764 | –1.7% | 100.0% | | | | | | | | | | |
| 2002 | 35,280 | –4.0% | 35,280 | –4.0% | 100.0% | | | | | | | | | | |
| 2003 | 36,146 | 2.5% | 36,146 | 2.5% | 100.0% | | | | | | | | | | |
| 2004 | 36,594 | 1.2% | 36,594 | 1.2% | 100.0% | | | | | | | | | | |
| 2005 | 38,852 | 6.2% | 38,862 | 6.2% | 100.0% | 200 | | 0.5% | $10 | | | | | | $10 |
| 2006 | 38,415 | –1.1% | 36,412 | –6.3% | 94.8% | 2,003 | 901.5% | 5.2% | $90 | | | | | | $90 |
| 2007 | 38,974 | 1.5% | 34,342 | –5.7% | 88.1% | 3,646 | 82.0% | 9.4% | $82 | 986 | | 2.5% | 21.3% | $74 | $156 |
| 2008 | 38,843 | –0.3% | 33,319 | –3.0% | 85.8% | 4,088 | 12.1% | 10.5% | $22 | 1,427 | 44.7% | 3.7% | 25.9% | $33 | $55 |
| 2009 | 39,233 | 1.0% | 31,815 | –4.5% | 81.1% | 4,149 | 1.5% | 10.6% | $3 | 3,269 | 129.1% | 8.3% | 44.1% | $138 | $141 |
| 2010 | 39,547 | 0.8% | 23,773 | –25.3% | 60.1% | 7,937 | 91.3% | 20.1% | $189 | 7,837 | 139.7% | 19.8% | 49.7% | $343 | $532 |
| 2011 | 39,641 | 0.2% | 14,020 | –41.0% | 35.4% | 12,620 | 59.0% | 31.8% | $234 | 13,001 | 65.9% | 32.8% | 50.7% | $387 | $621 |
| 2012 | 42,803 | 8.0% | 6,426 | –54.2% | 15.0% | 21,643 | 71.5% | 50.6% | $451 | 14,734 | 13.3% | 34.4% | 40.5% | $130 | $581 |
| 2013 | 42,184 | –1.4% | 2,990 | –53.5% | 7.1% | 24,042 | 11.1% | 57.0% | $120 | 15,782 | 7.1% | 37.4% | 39.6% | $79 | $199 |
| 2014 | 43,265 | 2.6% | 1,747 | –41.6% | 4.0% | 25,372 | 5.5% | 58.6% | $67 | 16,146 | 2.3% | 37.3% | 38.9% | $27 | $94 |
| 2015 | 43,661 | 0.9% | 1,109 | –36.5% | 2.5% | 26,111 | 2.9% | 59.8% | $37 | 16,441 | 1.8% | 37.7% | 38.6% | $22 | $59 |
| 2016 | 43,531 | –0.3% | 872 | –21.4% | 2.0% | 25,914 | –0.8% | 59.5% | $0 | 16,745 | 1.8% | 38.5% | 39.3% | $23 | $23 |
| 2017 | 43,036 | –1.1% | 0 | –100.0% | 0.0% | 26,238 | 1.3% | 61.0% | $16 | 16.978 | 1.4% | 39.5% | 39.3% | $17 | **$34** |
| | | | | | | | | | **$1,322** | | | | | **$1,273** | **$2,595** |

Notes: Based on author estimates and MPAA Theatrical Statistics & Theatrical and Home Entertainment Market Environment (THEME) Report on # screens. Estimated investments (cumulative) based on estimated cost of digital screen ($50,000 per installation) and digital 3D ($75,000 per installation).

**Figure 6** **Domestic 3D – screens, revenues and releases**




Notes: Data from MPAA Theatrical Statistics & Theatrical and Home Entertainment Market Environment (THEME) Reports, NATO (National Association of Theater Owners), boxofficemojo, and author estimates.

## Studio production

The studios produce the industry's life force: motion picture content. Studios are highly concentrated with the top six responsible for a minority of films, but the majority of domestic[3] film revenues (see Figure 7). Even within the top studios, concentration is increasing due to fewer films with larger budgets and global appeal. In 2017, the top six studios produced 101 major motion pictures (14 per cent of films). Yet these films constitute 83 per cent of all domestic box office receipts, up from 71 per cent for the top six in 2000. Studios collectively released 738 films in 2017, an average of 14 per week. The maths for exhibitors is this: two are by Hollywood's major studios. Show those films or the audience will not attend. The combination of high studio concentration and highly differentiated content gives the studios considerable negotiating and pricing power over exhibitors.

The financial risk for studios is significant as production costs are considerable (Figure 1). Studios invested $3 billion for what became 2017's highest grossing 25 films ($127 million per film; range: $5 million to $250 million). Risks continue to increase as production budgets have skyrocketed. In 1980, the production budget for the highest grossing films averaged just $11 million. In the 1990s, films turned to special effects and costs reached $102 million (up 827 per cent). Today, special effects alone can top $100 million for a major production. These investments, however, are no guarantee for success; a proven formula remains elusive. Many 'sure things' flop at the box office while others surprise.

Large hauls at the box office are a poor indication of wise production decisions; profitability is the ratio of box office receipts to production cost. While Hollywood has long made assessing profitability nearly impossible, at a box office, gross to production cost ratio of 2.0 a film has generally covered its costs. *The Last Jedi*'s $1.3 billion global box office covered its estimated $200 million cost of production 2.6 times (a success), but not a smash. Meanwhile a largely unknown horror film, *Get Out*, produced for just $5 million, was an enormous critical and financial success. By the end of its theatrical run, the picture had grossed $176 million domestically, yielding a 56.7 ratio of box office receipts to production cost. The level of investments and risk results in studios putting return on their investment ahead of all other parties, including exhibitors.

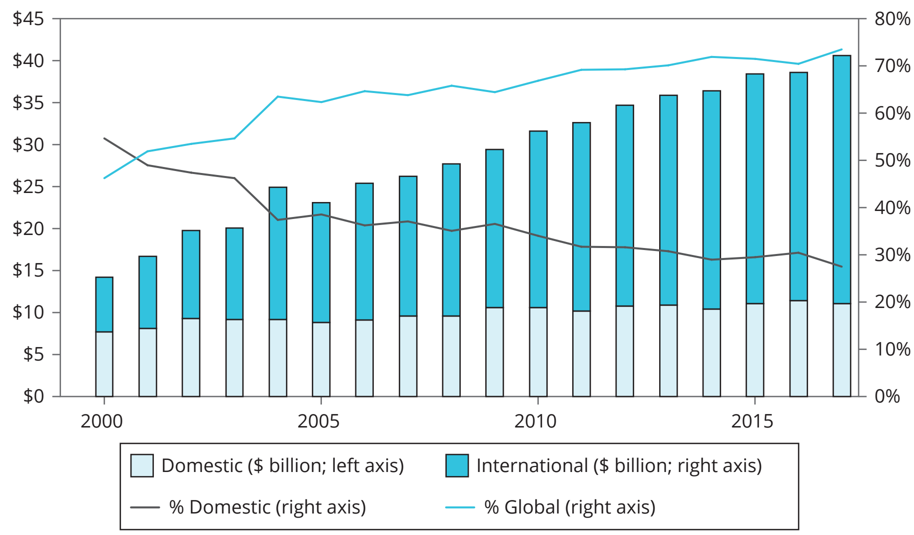
Studios focus on 12–24 year olds, consistently the largest audience for movies. At just 17 per cent of the US population, this group purchases 23 per cent of all tickets (per capital attendance of 4.8 movies per year). More narrowly, 10 per cent of the population are 'frequent' moviegoers, those who attend more than one movie per month, and are responsible for half of all ticket sales. Thirty-five per cent of these frequent moviegoers are 12–24 year olds.[4] Studios target this audience

**Figure 7** Top six studios/distributors 2017

| | 2000 | | | | 2017 | | | | % Change 2000–2017 | |
|---|---|---|---|---|---|---|---|---|---|---|
| Studio / Distributor | Rank | $ Share | Total Gross | # Films | Rank | $ Share | Total Gross | # Films | Total Gross | # Films |
| Buena Vista | 1 | 15.5% | $1,176 | 21 | 1 | 21.8% | $2,410 | 8 | 105% | –62% |
| Universal | 2 | 14.1% | $1,069 | 13 | 3 | 13.8% | $1,529 | 14 | 111% | 8% |
| Warner Bros. | 3 | 11.9% | $905 | 22 | 2 | 18.4% | $2,035 | 20 | 125% | –9% |
| Paramount | 4 | 10.4% | $791 | 12 | | | | | | |
| Dreamworks SKG | 5 | 10.3% | $777 | 10 | | | | | | |
| 20th Century Fox | 6 | 9.5% | $723 | 13 | 4 | 12.0% | $1,326 | 14 | 24% | 8% |
| Sony / Columbia | | | | | 5 | 9.6% | $1,060 | 26 | 55% | –10% |
| Lionsgate | | | | | 6 | 8.0% | $885 | 19 | 2574% | 6% |
| Total for top 6 | | | $5,441 | 91 | | | $9,245 | 101 | 70% | 11% |
| Top 6 as % of industry | | | 71.0% | 19.0% | | | 83.4% | 13.7% | 17% | |
| All other studios | | | $2,220 | 387 | | | $1,846 | 637 | –17% | 65% |
| All other studios as % of industry | | | 29.0% | 81.0% | | | 16.6% | 86.3% | | |
| Industry Total | | | $7,661 | 478 | | | $11,091 | 738 | 45% | 54% |

Source: MPAA Theatrical Statistics & Theatrical and Home Entertainment Market Environment (THEME) Reports, boxofficemojo.com, and author estimates.

**Figure 8** Domestic versus International box office receipts 2000–2017



with PG and PG-13 fare including 20 of 2017's top 25 releases. However, more demographic trends are more favourable in other segments (Figure 4). While the US population will increase 15 per cent by 2035, this core audience will grow 16 per cent, just 229 people per current theatre screen or 21 additional attendees per screen on the typical weekend. The largest growth – in both percentage and number of individuals – is among 60+ year olds. This market currently has the lowest admissions per capita, just 2.5 annually, but represents a potentially lucrative market increasing by 25.6 million, up 36 per cent. At current per capita attendance levels, the increased population in this segment adds more than 30 potential viewers per screen per weekend. Attracting this audience is largely outside of the control of the exhibitors, dependent instead on whether the studios produce films attractive to them.

Domestic exhibitors were once the sole distribution channel for films. This has changed dramatically. Within the top 25 domestic films, 62 per cent of all box office revenue was from outside the domestic market. Over 73 per cent of total global box office revenues are derived outside of the domestic market (Figure 8). Studios view this as their primary opportunity for growth, as both ticket sales and dollar volume are rising rapidly. From 2000 to 2017, domestic receipts grew at a compounded annual rate of under 3 per cent while international grew at nearly 9 per cent. Based on attendance, both India's 2.02 billion and China's 1.26 billion admissions in 2015 exceeded that of the US. Unlike the domestic market, attendance in these markets is increasing each year. The studios are also changing their perspective on ticket prices in large population markets. In India, for example, attendees pay an average of just \$0.78. In China, it is \$5.10.[5]

This has led studios to internationalise their content. While horror films like *Get Out* and dramas like *Wonder* require smaller production budgets than science fiction, action and adventure films, they are riskier in international markets. The subtle nuances of a drama are easily lost across cultures and the appeal of horror films is culturally dependent. Animated films targeting children, such as *Coco* and *Cars 3,* and action-packed franchise films with known characters, little dialogue, made in 3D and laden with special effects, such as *The Fate of the Furious*, have the greatest potential for cross-cultural appeal. Yet, these films carry two risks: lack of appeal to the 60+ demographic segment in the US and larger budgets. Action-packed franchise films target the 12–24-year-old segment of the population, but are the least desirable domestically among the fastest-growing segment of the domestic market, those 60+. Costs are also higher, increasing the risk if a movie bombs. Among the top 10 highest internationally grossing US studio-produced films in 2017, the average production budget was \$158 million – one quarter higher than the average for the top 25 – and only two animated films, *Despicable Me 3* and *Jumanji: Welcome to the Jungle*, had production under \$100 million.

As studios shift their focus to the international market, they are increasingly less dependent on the domestic market, further increasing their bargaining power over exhibitors. The internationalisation of the motion picture industry is starkly different for studios and exhibitors: studios are seeking to increase revenues through product licensing, DVD and digital sales, and international expansion; domestic exhibitors remain wholly reliant on charging an unchanging core market of viewers to see movies.

## Distribution

Distributors are the intermediaries between the studios and exhibitors. Distribution entails all steps following a film's artistic completion, including marketing, logistics and administration. Distributors negotiate a percentage of box office receipts for distribution services or purchase rights to films and profit directly from box office receipts. Distributors select and market films to exhibitors' booking agents, handle collections, audit reported attendance and perform other administrative tasks. There are over 300 distributors, but the majority of work is done by a few majors, commonly a division of a studio. The production of 2017's *It*, an adaptation of Stephen King's book, was led by New Line Cinema with four other production companies credited. Warner Brothers released and distributed the film, both domestically and across international markets.

Until 2005, the distribution of motion pictures entailed the physical shipment of large reels of 35 mm film, a process largely unchanged since the 1940s. Each theatre would receive a shipment of heavy physical canisters containing a 'release print' of a film. These prints cost \$20 000–\$30 000 upfront for each film plus \$1000–\$1500 for each print. Print costs for a modern major picture opening on 3500 screens come to \$3.50–\$5.25 million. These costs were borne by the distributors, but paid for by movie attendees. Sequentially releasing a film across markets reduced costs. It would premier domestically and then phase across individual foreign markets as the transportation of the physical film allowed.

Beginning in 2006, distributors and studios encouraged exhibitors to transition to digital projection technology. Digital projection uses high-powered 4K LCD projectors to cast the movie onto a specialised screen. Distribution of encrypted files, to deter piracy, is via download from satellite, internet or reusable hard drive. This near instantaneous distribution allows a picture's release across multiple global markets. Additionally, digital projection allows for consistently high-quality images, as there is no physical wear to the film, and enables the exhibition of 'alternative content', including sports, concerts, performance, and other events created and distributed outside of the motion picture studio value chain. This re-projecting of the domestic industry replaced film projection with digital.

At the end of 2017, virtually 100 per cent of commercial US screens utilised digital projection, up from just 5 per cent in 2006 (Figure 5). Each digital projection system serves a single screen and costs $50 000 to $75 000 including the projector, computers and hardware, and a specialised screen. This equates to a capital cumulative investment of approximately $2.6 billion in the US alone. Virtual print fees, rebates from distributors on each film distributed digitally, partially funded the conversion. These fees, as much as 17 per cent of rental costs, expired in 2013. Despite the cost savings of digital distribution, film rental rates, which include the cost of distribution, have averaged 50–55 per cent of box office revenue for several decades. This suggests that the studios, not the exhibitors, benefit from the reduced cost of distribution.

### Exhibition

Exhibitors – the local movie theatre – provide a location where audiences can view a motion picture. The basic business model of exhibitors – using movies as the draw and selling concessions to make a profit – has changed little since the time of touring motion picture shows that would set up in town halls and churches. As attending movies became popular, permanent theatres were constructed. Studios soon recognised the potential profit in exhibition and vertically integrated, gaining control over the films shown and capturing downstream profits. This practice ended in 1948 with the Supreme Court's ruling against the studios in *United States v. Paramount Pictures*. Studios were forced to divest theatres, leaving the two to negotiate film access and rental fees. Single theatre and single screen organisations' exhibitors fared poorly as studios retained the upper hand in setting rental rates. Exhibitors sought to increase bargaining power and economies by consolidating, multiplying the bargaining power of individual theatres by the number of screens managed. This reached its zenith in the 1980s with the mass rollout of the multiplex concept. Maximising bargaining power based on multiple screens while minimising labour and facility costs, exhibitors constructed large entertainment complexes, sometimes with dozens of screens. Most of the original local single screen theatres closed, unable to compete on cost or viewing experience.

Today, the 10 largest exhibitor 'circuits' operate 32 per cent of theatres, controlling a disproportionate 54 per cent of screens (Figure 9). In many industries, this high concentration of industry outlets would provide the organisations with significant buying power. Larger circuits benefit from some power as larger circuits can negotiate slightly better prices on some concession supplies and access revenues from national advertisers. However, movie content is highly differentiated; theatres are not. An exhibitor trying to drive too hard a bargain may miss showing a film on opening weekend. Thus, the true power rests with the studios and distributors.

At the top of the circuits are the four largest all national chains: AMC, Regal and Cinemark serving the US, and Cineplex serving Canada. These chains operate large multiplexes, averaging 12 screens per location. These organisations operate under one third of all US and Canadian theatre locations, but 54 per cent of screens. The next tier of circuits consists of regional operators (Marcus, Harkins, Southern, B&B, National Amusements and Malco). The regional operators control another 4.7 per cent of theatres and 7.5 per cent of screens. The remaining circuits, 63 per cent of all theatres operating 38 per cent of screens, range from smaller chains operating several miniplexes consisting of 2–7 screens down to single-theatre, single-screen locations.

## THE BUSINESS OF EXHIBITION

Exhibitors have three revenue sources: box office receipts, concessions and advertising (see Figures 10 and 12). They have low discretion: their ability to influence revenues and expenses is limited. Exhibitor operating margins average a slim 10 per cent; net income may fluctuate wildly based on the tax benefits of prior losses.

### Box office revenues

Ticket sales constitute almost two-thirds of exhibition business revenues. The return, however, is quite small due to the power of the studios. Among the largest exhibitors, film rental fees average 54 per cent of box office receipts. These costs are typically higher for smaller circuits. The bases for rental rates are: the size of the circuit and both the duration and seat commitment. While attendees may gripe about the average ticket price of $8.97, most do not realise that $4.85 (55 per cent) goes to the studio. The exhibitor may not break even unless concessions are purchased.

The portion of box office revenues retained by the theatre increases each week. On opening weekend, an exhibitor may pay the distributor 80–90 per cent of the box office gross in rental fees, retaining only 10–20 per cent. In subsequent weeks, the exhibitor's portion increases to as much as 80–90 per cent. For truly event films, studios have considerable power and can capture a higher percentage of the box office. For *The Last Jedi*, the standard exhibition contract stipulated a rental rate of about 65 per cent of the ticket price and required exhibitors to show the film on their largest screens for four weeks, or the rate increased to 70 per cent.[6]

While non-opening weekends offer exhibitors larger margins, the studios focus on attracting audiences on opening weekend with well-funded publicity campaigns. Focusing on getting audiences to the theatre on the opening weekend results in lower marketing expenses for each film, keeps the film pipeline flowing with releases, and avoids competition between films for a common audience (e.g. two R-rated comedies opening the same weekend). Among 2017's top 10 releases, an

**Figure 9** **Leading domestic circuits 2017**

| | | US & Canada | | | | | Non-US & Canada | | | Global | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Circuit & Headquarters Location | US Theater Brands (Locations) | # Theaters | % of US Theaters | # Screens | % of US Screens | Avg. Screens per Theater | # Theaters | # Screens | % of Non-US Screens | # Theaters | Screens | % Global Screens |
| AMC Theaters* Kansas City, KS | AMC & Carmike (national) | 656 | 12.2% | 8,218 | 20.4% | 12.5 | 862 | 7,087 | 4.3% | 1,802 | 15,380 | 9.0% |
| Regal Entertainment Group** Knoxville, TN | Regal, United Artists & Edwards (national) | 566 | 10.5% | 7,379 | 18.3% | 13.0 | 3 | 23 | 0.0% | 561 | 7,402 | 4.3% |
| Cinemark*** Plano, TX | Cinemark & Century (national) | 339 | 6.3% | 4,561 | 11.3% | 13.5 | 194 | 1,398 | 0.8% | 533 | 5,959 | 3.5% |
| Cineplex Entertainment Toronto, ON Canada | Cineplex Cinemas, VIP, Galaxy & Silver City (Canada) | 165 | 3.1% | 1,683 | 4.2% | 10.2 | 0 | 0 | 0.0% | 165 | 1,683 | 1.0% |
| Marcus Theaters Milwaukee, WI | Marcus (WI, IL, IA, MN, MO, NE, ND & OH) | 68 | 1.3% | 885 | 2.2% | 13.0 | 0 | 0 | 0.0% | 68 | 885 | 0.5% |
| Harkins Theaters Scottsdale, AZ | Harkins (AZ, CA, CO, OK, & TX) | 33 | 0.6% | 501 | 1.2% | 15.2 | 0 | 0 | 0.0% | 33 | 501 | 0.3% |
| Southern Theaters New Orleans, LA | The Grand Theaters, AmStar Cinemas & Movie Tavern (LA, MS, NC, TX & FL) | 44 | 0.8% | 499 | 1.2% | 11.3 | 0 | 0 | 0.0% | 44 | 499 | 0.3% |

| | | US & Canada | | | | | Non-US & Canada | | | Global | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Circuit & Headquarters Location | US Theater Brands (Locations) | # Theaters | % of US Theaters | # Screens | % of US Screens | Avg. Screens per Theater | # Theaters | # Screens | % of Non-US Screens | # Theaters | Screens | % Global Screens |
| National Amusements Norwood, MA | Showcase, Cinema de Lux, Multiplex, SuperLux and UCI (MA, NY, RI, CT, NJ & OH) | 29 | 0.5% | 392 | 1.0% | 13.5 | 40 | 558 | 0.3% | 69 | 950 | 0.6% |
| B&B Theaters Liberty, MO | B&B Theaters (MO, KS, OK, FL, TX, AR & MS) | 47 | 0.9% | 377 | 0.9% | 8.0 | 0 | 0 | 0.0% | 47 | 377 | 0.2% |
| Malco Theaters Inc. Memphis, TN | Malco & local names (TN, MS, AR, LA, MO, KY) | 34 | 0.6% | 353 | 0.9% | 10.4 | 0 | 0 | 0.0% | 34 | 353 | 0.2% |
| Total for top four | | 1,726 | 32.0% | 21,841 | 54.3% | 12.7 | 1,059 | 8,508 | 5.1% | 3,061 | 30,424 | 17.7% |
| Total for # 5–10 | | 255 | 4.7% | 3,007 | 7.5% | 11.8 | 40 | 558 | 0.3% | 295 | 3,565 | 2.1% |
| Total for top 10 | | 1,981 | 36.7% | 24,848 | 61.7% | 12.5 | 1,099 | 9,066 | 5.4% | 3,356 | 33,989 | 19.8% |
| All others | | 3,417 | 63.3% | 15,398 | 38.3% | 4.5 | | 157,291 | 94.6% | | 137,766 | 80.2% |
| Industry total | | 5,398 | 100.0% | 40,246 | 100.0% | 7.5 | | 166,357 | 100.0% | | 171,755 | 100.0% |

Notes: # Domestic (US & Canadian) theaters and screens based on 2017 NATO data & 2017 MPAA 2017 Theatrical statistics; 171,755 global screens is per MPAA Theatrical and Home Entertainment Market Environment (THEME) Report, author estimates for international theaters and screens for some organisations.

*Under AMC: Odeon (Europe (UK, Spain, Italy & Germany: 242 theaters /2,243 screens), Nordic (Scandinavia 68/473). Same common parent control of: Hoyts (Australia: 52/424), Wanda (China: 447/3,947).

**Guam, Saipan & American Samoa.

***Brazil (81 theaters / 608 screens), Colombia (35/193), Argentina (21/184), Central America (includes Honduras, El Salvador, Nicaragua, Costa Rica, Panama, and Guatemala, 16/120), Chile (18/126), Peru (13/93), Ecuador (7/45), Bolivia (1/13), Paraguay (1/10), and Curacao (1/6).

average of 32 per cent of total domestic revenues were on the opening weekend. Two 2017 films, *The Fate of the Furious* and *Pirates of the Caribbean: Dead Men Tell No Tales*, received more than 40 per cent of their total domestic box office revenue in the opening weekend. While these films draw audiences, they are less lucrative than films staying in the theatre for multiple weeks. Exhibitors can actually keep more of the box office receipts from films such as *The Greatest Showman*, with just 9 per cent of total revenue in the opening weekend, and *Jumanji: Welcome to the Jungle* and *Get Out*, which each had less than 20 per cent of revenues on the opening weekend.

Such films are, however, the exception. A weak opening weekend typically results in a short run in theatres as attendance declines when studio-funded marketing campaigns shift towards the next film. In industry terminology, the 'multiple' (the percentage coming after opening weekend) has been declining steadily, falling 25 per cent since 2002.[7] This limits an exhibitor's potential to save on film rental costs by skipping opening weekend. A theatre will typically lose attendees as audiences seek another theatre if one does not show a film on opening weekend.

**Figure 10** **Typical revenue and expenses per screen at an eight-screen theatre**

| REVENUES | Annual | % | Avg. Weekend |
|---|---|---|---|
| Box Office Revenue | $275,477 | 63% | $5,298 |
| Concessions | $146,491 | 33% | $2,817 |
| Advertising | $18,426 | 4% | $354 |
| Total Revenues ($13.34 per admission) | $440,394 | 100% | $8,469 |
| EXPENSES | | | |
| **Fixed** | | | |
| Facility | $66,059 | 15% | $1,270 |
| Labor | $39,635 | 9% | $762 |
| Utilities | $48,443 | 11% | $932 |
| Other SG&A | $79,271 | 18% | $1,524 |
| Total Fixed Costs | $233,409 | 53% | $4,489 |
| **Variable** | | | |
| Film Rental | $148,758 | 54% | $2,861 |
| Concession Supplies | $20,509 | 14% | $394 |
| Total Variable Costs | $169,266 | 36% | $3,255 |
| **Total Expenses** | $402,675 | 89% | $7,744 |
| OPERATING INCOME | $37,719 | 8.6% | $725 |

Notes:
Box Office Revenue: 1,236,000,000 attendees in 2017 / 40,246 screens = 30,711 attendees annually per screen X $8.97 per ticket = $275,477 annual box office revenue per screen. Data reported in Figures 2 and 9.
Concessions Revenue: 30,711 attendees annually per screen X $4.77/admission (avg. concessions sales per admission from Exhibit 12 (AMC, Regal & Cinemark) = $146,491
Advertising Revenue: $750 million in 2017 (Figure 11) / 1,236,000,000 attendees in 2017 = $0.60 / admission X 30,711 attendees annually per screen = $18,426 annually.
Fixed Expenses: Author estimates based on analysis of select large exhibitor SEC filings, MPAA and NATO data; scaled to a single screen within an eight-theater multiplex; values may deviate from industry average and any individual organisation.
Variable Expenses: Film rental: 54% of Box Office Admission Revenue based on average for AMC, Regal & Cinemark in the domestic market.
Concession Supplies: 14% Percentage of Concession Revenue
Average weekend calculated as Annual / 52

## Concessions

A frequent moviegoer lament is high concession prices. At an average of $4.77 per admission, concessions constitute one-third of exhibitor revenues. Direct costs of under 15 per cent make concessions the primary source of exhibitor profit. Three factors drive concession profits: attendance, pricing and material costs. The most important is attendance: more attendees yields more concession sales. Sales influence price. The $5.00 and $9.00 price points for the large soft drink and popcorn are not accidental, but the result of considerable market research and profit maximisation calculations. The inputs are largely commodities. Volume purchases reduce costs. Large circuits negotiate better prices on everything from popcorn and soft drinks to cups and napkins.

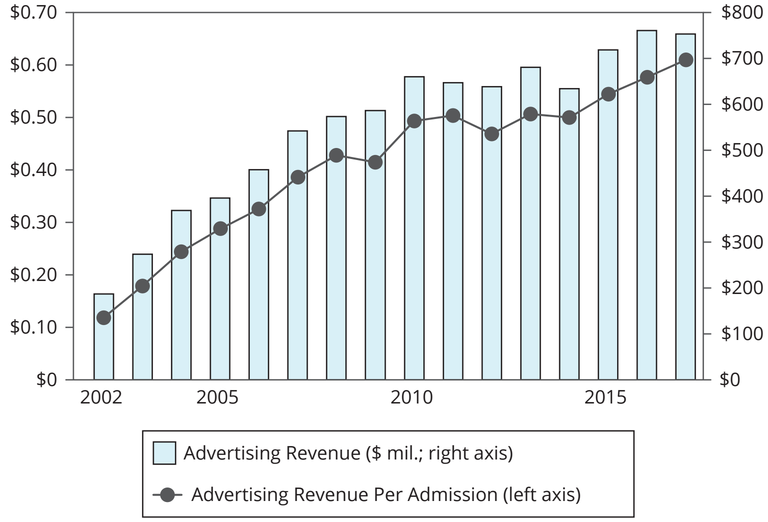
Once consisting of only boxed candy, popcorn and soft drinks purchased at the counter in the lobby, concessions now include a variety of food, drink and location options. Concession options such as hamburgers, salads, hot appetisers and alcoholic beverage sales increase average concession sales per patron. They must, however, be considered in conjunction with higher costs for kitchen facilities, labour and food ingredients. A $15 burger has a lower gross margin percentage than a $9 tub of popcorn due to higher food costs, but may not make the same profit in dollars. Patrons may skip one $5 soft drink for several rounds of $8 beer, wine or bar sales.

Exhibitors have placed increased attention on concessions due to dual appeal: audiences are attracted to the new experience of dining at the theatre while exhibitors benefit from the sale of higher dollar concessions. Exhibitors are aggressively pursuing this revenue stream through a variety of means including enhanced counter service, in-lobby and in-theatre ordering, and waiter service. The profitability of these approaches requires careful evaluation to ensure profitability is increased.

## Advertising

The low margins derived from ticket sales cause exhibitors to focus on other sources of revenue. The highest margin, and therefore the most attractive, is advertising, including pre-show and lobby advertising and previews. Advertising revenues have increased from $186 million in 2002 to $751 million in 2017 (Figure 11).[8] More importantly, the time devoted to ads in each showing has increased. The number of previews has also increased from just three or four, ten years ago to six or seven, currently. This includes the two typically provided to the studio as part of the film rental agreement.[9] Though advertising constitutes just 5 per cent of exhibitor revenues, it is highly profitable and growing. Instead of paying for short films' to show prior to the feature, exhibitors show ads, which they are paid to show. Advertising revenues for exhibitors averaged $18 652 per screen in 2017, $0.61 per admission, up 15 per cent in just five years.[10] Yet audiences express dislike for advertising at the theatre and, if dissatisfaction increases, may opt to view movies at home. Balancing the lucrative revenues from ads with audience tolerance is an ongoing struggle for exhibitors.

**Figure 11** **Exhibitor advertising revenue (total and per admission)**




Sources: Author calculations based on data from Cinema Advertising Council, 2017, MPAA Theatrical Statistics & Theatrical and Home Entertainment Market Environment (THEME) Report, boxofficemojo.com

## THE MAJOR EXHIBITOR CIRCUITS

Four exhibitor 'circuits' dominate the domestic market, collectively controlling 34 per cent of domestic theatres but a disproportionate 55 per cent of screens. The four circuits serve different geographic areas and operate with different business-level strategies (see Figure 9).[11] AMC is the largest domestic exhibitor with 8218 screens in 656 theatres. Domestically, the circuit uses the AMC and Loews chains to concentrate on urban areas near large population centres, such as those in California, Florida and Texas with megaplex theatres averaging 12.5 screens. By offering 3-D, IMAX and other premium viewing experiences, AMC's ticket prices are consistently near the top of the market. Concession sales per attendee are also the highest among the majors at $5.06 per patron (see Figure 12).

AMC's operations became much more diverse in 2016 when it acquired the former #4 domestic circuit, Carmike Theaters. Carmike focused on small to midsized markets, targeting populations of less than 100 000 that have few alternative entertainment options. They served this market with no-frills locations averaging 10 screens per theatre. At $1 below the industry average, the ticket price reflects the low cost. Concession sales per patron were the lowest in the industry. Carmike's locations have been rebranded as AMC and AMC Classic locations. The acquisition of Carmike made AMC the largest domestic theatre chain with control over 20 per cent of domestic screens. Combining the companies was expected to reduce costs by $35 million annually.[12]

Dalian Wanda Group, a Chinese conglomerate with commercial real estate and cultural holdings, acquired AMC in 2012 for a reported $2.6 billion.[13] To many observers, the acquisition signalled the start of an expected wave of consolidation and globalisation in the movie exhibition industry. At the time of the acquisition, Wanda operated some 150 theatres in China as well as significant studio production facilities. The acquisition resulted in Wanda becoming both the single largest and the most geographically diverse exhibitor globally. Since the acquisition of AMC, Wanda has continued its acquisition approach to expansion by purchasing the European Odeon circuit and Australia's Hoyts. In 2017, Wanda/AMC announced the acquisition of Nordic, another European-based circuit with operations in Scandinavia. Once finalised, Wanda/AMC will be the world's largest theatre circuit with more than 15 000 screens across more than 1800 theatres. The scale and reach of the company is unprecedented: one company controlling nearly 10 per cent of global screens across all of the major viewing markets. This scale could result in greater leverage negotiating rental rates.

Unlike AMC, Regal, the second largest domestic chain, operates nearly exclusively in the US with its namesake Regal as well as United Artists and Edwards Theaters. The organisation operates 7379 screens across 566 theatres. Regal focuses on midsize markets using multi- and megaplexes with 13 screens per location, with an average ticket price of $10.20 and average concession sales of $4.72 per admission. Cinemark, the #3 domestic circuit by size, operates 339 domestic locations with 4559 screens under the Cinemark and Century brands. Cinemark serves smaller markets, operating as the sole theatre in 90 per cent of its markets. Its average ticket price is $7.78. Cinemark was the first domestic circuit to expand beyond the domestic market and currently operates 1398 screens in 194 theatre across 15 Central and South American countries. Canadian-based Cineplex Entertainment is the fourth largest domestic.[14] The result of several mergers and acquisitions, the circuit operates 165 theatres with 1683 screens across Canada.

Major circuits compete based on geographic locations, not direct competition. The differentiators operate in higher cost locations near shopping and restaurants, within or in front of the mall. The cost leaders position theatres in less trafficked locations with lower rent such as in a strip mall or behind the shopping mall. Beyond location, there are more differences within each exhibitor's offerings than across circuits. The industry has a history of new offerings, including air conditioning, digital projection and stadium seating among many others, being tested by a circuit in individual theatres, then being implemented in all of their theatres or within a select set. Once introduced, competitors quickly adopt innovations as well as each one trying to lure customers to the theatre and, to a lesser extent, away from competing theatres within a market. The result is that most theatres are indistinguishable from one another: a ticket booth, a lobby, snack bar and multiple theatres each containing a projector, screen, sound system and rows of seats. The same movies – produced, developed and released by one of the major studios – shown with nearly the same start times. Audiences pay, within a dollar or two within a local market, nearly the same price for admission in the low price versus differentiated theatre.

Despite the apparent homogeneity and cooptation, these innovations keep the movie exhibition industry relevant. What keeps customers returning to the theatre? What attracts the audience?

## ATTRACTING THE AUDIENCE

A CBS News poll indicates the movie theatre is currently the *least* likely place for a viewer to watch a movie, well behind television and computer screens.[15] It is therefore important for exhibitors to understand why people choose to watch a movie in the theatre as opposed to engaging one of a myriad of other viewing options. Traditionally, the draw of the theatre may have been far more important than what film was showing.

**Figure 12** **Select 2017 AMC, Cinemark and Regal Financials**

| | AMC* | Cinemark** | Regal*** |
|---|---|---|---|
| **Theater and Attendance Information** | | | |
| Screens (US only) | 8,224 | 4,559 | 7,322 |
| Theaters (US only) | 649 | 339 | 560 |
| Screens per Theater (US only) | 12.7 | 13.4 | 13.1 |
| Total US Attendance (in thousands) | 240,974 | 174,400 | 196,900 |
| Avg. Ticket Price | $9.67 | $7.78 | $10.20 |
| Avg. Concessions | $5.06 | $4.53 | $4.72 |
| Avg. Ad Revenue per admittance | $0.72 | $0.43 | $1.14 |
| Avg. Revenue per admittance | $15.45 | $12.74 | $16.06 |
| Avg. Attendance per screen | 29,301 | 38,254 | 26,892 |
| Avg. Admission revenue per screen | $283,344 | $297,616 | $274,294 |
| **Income Statement ($ mil.)** | | | |
| Revenues | | | |
| Admissions | $2,330.90 | $1,356.90 | $2,008.10 |
| Concessions | $1,220.10 | $790.10 | $930.20 |
| Other Income | $172.50 | $75.10 | $224.70 |
| **Total Revenues** | $3,723.50 | $2,222.10 | $3,163.00 |
| Admissions as % of Revenues | 62.60% | 61.06% | 63.49% |
| Concessions as % of Revenues | 32.77% | 35.56% | 29.41% |
| Other as % of Revenues | 4.63% | 3.38% | 7.10% |
| Expenses | | | |
| Film rental and advertising | $1,224.70 | $756.40 | $1,067.80 |
| Concessions | $176.60 | $112.80 | $123.80 |
| Building, wages, utilities & other operating costs | $2,285.50 | $1,030.70 | $1,699.70 |
| **Total Cost of Operation** | $3,686.80 | $1,899.90 | $2,891.30 |
| **Operating Income** | $36.70 | $322.20 | $271.70 |
| Operating Income per admission | $0.15 | $1.85 | $1.38 |
| Operating Income as % total revenue | 0.99% | 14.50% | 8.59% |
| Film rental and advertising as % of admission revenues | 52.54% | 55.74% | 53.17% |
| Concessions costs as % of concession revenues | 14.47% | 14.28% | 13.31% |
| Buildings, wages, utilities & other costs as % of Total Revenues | 61.38% | 46.38% | 53.74% |
| **Net Income ($ in mil.)** | ($530.70) | $197.50 | $112.30 |
| Net profit margin | −14.25% | 8.89% | 3.55% |
| Net profit per admission*** | ($2.20) | $1.13 | $0.81 |

Notes:
Data source: SEC filings & author estimates.
* AMCs financial performance is for US operating segment only. Net income includes $230.3 in corporate borrowing and $187.9 in losses of non-consolidated entities.
** Cinemark's Theater and Attendance Information and operating data is for domestic operations only. Operating income, total cost of operations, and net income estimated based on consolidated operations.
*** Cinemark's Net income per admission calculated using global admissions and consolidated income.

Moviegoers describe attending the theatre as an experience, with the appeal owing to:[16]

- watching the giant theatre screen
- hearing a theatrical sound system
- the opportunity to be out of the house
- not having to wait to see a particular movie
- the theatre as a location option for a date.

The ability of theatres to provide experiences beyond what audiences can achieve at home is diminishing. Of the reasons why people go to the movies, the place aspects (i.e. the theatre as a place to be out of house and as a place for a date) seem the most immune to substitution. While 'third spaces', places outside of the home where people can gather, meet, talk and linger, have become more common, theatres offer a unique opportunity for people to simultaneously be together while not talking. Few teenagers want a movie and popcorn with their date at home with mum and dad.

The overall 'experience' offered by theatres falls short for many. Marketing research organisation, Mintel, reports the reasons for *not* attending the theatre more frequently are largely the result of the declining experience. This is due to the overall cost, at-home viewing options, interruptions such as mobile phones in the theatre, rude patrons, the overall hassle and ads prior to the show.[17] The *Wall Street Journal* reported on the movie-going experience quite negatively, noting interruptions ranging from the intrusion of soundtracks in adjacent theatres to mobile phones, out-of-order ticket kiosks and a seemingly endless parade of preshow ads.[18]

The time allocated to pre-show ads has even inspired criticism by industry insiders. Toby Emmerich, New Line Cinema's head of production, faced a not-so-common choice: to attend opening night in a theatre or in a private screening room at actor Jim Carrey's home. Because he generally enjoys the experience of watching a film among a large audience, he chose the theatre. However, after sitting through 15 minutes of ads, he lamented to his wife that perhaps they should have attended the private screening after all.[19]

## The home viewing substitution

Rapid improvements and cost reductions in home viewing technology and the widespread availability of timely and inexpensive content are making home viewing a viable substitute to theatre exhibition. The unique value proposition offered by movie theatres' large screens, the audio quality of a theatrical sound system and avoiding the long wait for viewing the movie are fading.

### Home viewing substitution: screen and sound

Televisions have historically been small, expensive appliances with poor sound quality, faring poorly in comparison to the big screen and sound system offered by the local theatre. This has changed dramatically as televisions have become larger, offer better picture and sound quality, and are cheaper. The average television is increasingly a large, high definition model coupled with an inexpensive yet impressive audio system. Compared to home equipment options of the past, even modest in-home technology increasingly represents a viable visual substitute to the big screen at the theatre.

In 1997, the average TV set was a 23". This increased to 32" in 2010 and to 39" in 2014.[20] In 2018, the purchase of sets 55" and larger was common. Sharp, a leading TV manufacturer, predicts the *average* screen will exceed 60" in the very near future.[21] The increase in size has been possible due to increases in resolution, owing to a US Federal Communications Commission mandate that all broadcasters convert to digital broadcasting by 2009. This led to a transition from the then-standard 480 horizontal lines of resolution to the high definition (HD) standard with 1080 lines of resolution.[22] As of 2017, more than 83 per cent of US households had at least one HD television, most 32" or larger, allowing for very high-quality visual images.

HD televisions have been available since 2000, but initially were cost prohibitive. Wholesale prices for televisions fell 65 per cent from the late 1990s to 2007[23] as manufacturing economies from the production of LCD screens emerged. In 2005, the average 32" HDTV set retailed for $1566. By 2009, five years following mass adoption, the average price declined by 76 per cent to $511. By 2016, the 10-year mark, the average price had fallen 84 per cent to under $250.

Bundled home theatre systems include 65" 3D capable TV, surround sound audio and Blu-ray player offering a movie experience that rivals many theatres, all for under $1000. According to Mike Gabriel, Sharp's head of marketing and communications, the high-tech home theatre that once seemed just the privilege of the wealthy has now become a staple among most average American homes.[24] Overall, home TVs are becoming larger and offer high-quality images that reduce the differentiated appeal of the 'giant' screen offered by exhibitors.

If the size and resolution of today's home television screens are a problem for exhibitors, the next generation may be catastrophic, and the next-next generation apocalyptic. The next wave of televisions – 'Ultra' HD (UHD) or 4K – is shifting from early adopters to mainstream purchasers. A 4K set has four times the resolution of a 1080 set. Despite an average sale price of $1250 in 2018, sales of UHD TVs are the fastest growing category and constitute the majority of sets larger than 60".

Of course, electronics companies are already working on the next-next thing: 8K televisions.[25] The higher resolution will be most noticeable in very large TV sets, those 85" and up. To appreciate the differences in picture quality, especially at large screen size, it is helpful to think in terms of image size, such as from a digital camera. Each frame in a standard 1080 broadcast is equivalent to a 2-megapixel image. Like a digital photo, there are limits on enlargement before the eye can identify individual pixels. This can become noticeable in 50” 1080 TVs when viewed closely. A 4K TV has 4000 horizontal lines, comparable to an 8-megapixel image. In the next-next generation of televisions, 8K, each frame is the equivalent of a 32-megapixel image.[26] This allows for viewing on very large screens, those above 120”, without any noticeable pixillation. The first commercially available 8K television (native 8K content is not yet available) is a 98” set by LG. The initial price? $55 000.[27] Potential purchasers should keep in mind that TV set prices drop dramatically. If 8K follows the price trend of LCD TV, look for that 98” LG 8K set to be well below $5000 in just a few years.

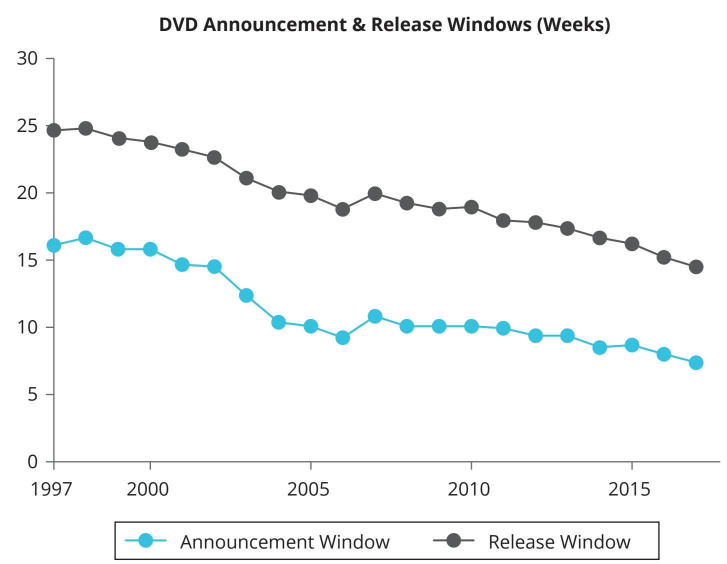
How large and how high a resolution a television must be to substitute for a theatre screen is subjective. For many, a laptop screen is sufficient; for others, only the true wall-size screen offered by the local exhibitor will do. What is clear, the unique value provided by home television and sound systems is rapidly eroding the unique value proposition offered by exhibitors. The most common projection standard in theatres, the one exhibitors just invested $2.6 billion in during the conversion to digital, is 4K. The history of technology updates to compete on visual quality is as old as the exhibition business itself. To maintain an advantage in the visual experience provided at the theatre, exhibitors must consider the next generation of 8K and 16K projectors or lose the visual quality advantage to home viewing.

### Home viewing substitution: content and timing

Even the best home theatre offers little value without content. Unfortunately, for exhibitors, home content is flourishing and goes well beyond movies. Consumer spending on home entertainment content, including disk purchases, digital downloads and streaming subscriptions, totalled $47.8 billion in 2017.[28] All companies serving this market – studios, exhibitors, rental and on-demand companies, networks and streaming organisations – are fighting to keep and grow their revenue stream.

Studios maximise profits by releasing motion pictures in a series of ‘windows’ under which the sooner a motion picture is viewed following the theatrical release the costlier it is to see it. It begins with theatrical release, generating $4.85 per admission for the studio. The next window is consumer purchase of the motion picture: DVD or digital sales. Studios receive $12 to $15 per copy purchased. The purchaser is increasingly, to the detriment of exhibitors, a consumer who opted not to see the movie in a theatre.[29] Studios once relied on DVD sales to fuel profits, but physical DVD sales declined from $13.7 billion in 2006 to $5.5 billion in 2016 (decline of 60 per cent).[30] Digital sales are on the rise, but 2016’s $2 billion total sales suggests consumers are opting to stream or subscribe instead of purchasing movies. Sales revenues in 2016 were only half of what they were at their peak.[31] To spur sales and capitalise on marketing expenditures from the theatrical release, studios have reduced the time between theatrical release and DVD availability. The window to DVD release declined from 23.7 weeks in 2000 to 14.4 weeks in 2017. Movies are available for purchase, as digital files or as DVDs, approximately one week sooner every two years (see Figure 13).

**Figure 13** **DVD announcement and release windows (in weeks)**




Data source: National Association of Theater Owners (NATO) press releases on Average video release window and Average video announcement. URL: http://www.natoonline.org/data/windows/

Digital video on demand (VOD) is the first in a series of rental options. VOD provided by cable companies, iTunes, Amazon and others exceeded $2 billion in 2017. VOD generates approximately $3.50 for the studio per purchase.[32] Releasing a motion picture shortly after it exits theatre; while it is still in the theatre; even at the time of theatrical opening – 'simultaneous release' – are all options. While premium VOD would have a negative impact on exhibitors, its potential revenue for studios – as much as $59.99 per purchase – is attractive. Exhibitors have previously banded together against premium VOD by threatening to boycott films by studios. Some studios, notably Disney, appear committed to the current theatrical release model.[33]

Physical rental, once the only rental option, is in rapid decline. Studios net approximately $1.25 per DVD sold to a physical rental company.[34] The dominant physical rental was store-based organisations, such as Blockbuster Video, but is now a kiosk-based model, dominated by RedBox. From 2015 to 2016, the physical rental market declined by 19 per cent to $2.5 billion.[35] RedBox, the industry leader, reported a same-location rental decline of 4.9 per cent in 2015 despite rentals costing as little as $1.25 per night.[36]

Streaming is the fastest-growing portion of the rental market and among the most cost-effective for viewers. Streaming includes Netflix, Amazon Prime Video, Hulu, HBONow and others. Licence rates to streaming services vary considerably based on the popularity of the movie; some estimates put the average studio net below $0.50 per viewing, among the least profitable channels for the studio.[37] The growth of streaming sufficiently cannibalised DVD and digital sales to the point that studios imposed a 28-day delay from DVD sales to the availability of streaming. Exhibitors voiced strong encouragement when several studios expressed a desire for a 56-day delay to increase DVD sales. Both Netflix and Amazon offer SD as well as HD formats and are beginning to offer content in the 4K format. The most distant from the theatrical release, and providing the least revenue to studios, is a showing on a subscription movie channel (e.g. HBO, Showtime and Cinemax), a subscription cable television channel (e.g. TNT, FX and AMC) or a major over-air broadcast network (e.g. ABC, CBS, NBC and Fox).

Beyond the growth in opportunities to see motion pictures outside of their theatres, exhibitors face reduced attendance due to interest in non-film content. Movies are no longer the sole draw for audiences. Content beyond movies increasingly is a substitute to exhibitors. Motion pictures have been *the* outlet for Hollywood's best talent. This changed in 1999 with the premier of HBO's *The Sopranos*. The series ran for six years, winning multiple awards, including those for writing, acting and directing. The series cemented a shift in artistic attention to the small screen. Many writers had a realisation: unlike a movie, which requires characters and story to evolve over 120 minutes, in a television format they could evolve over several seasons, each consisting of 10, 20, even 30 or more hours on screen. Other series emerged including *Mad Men* and *Breaking Bad*. The production of *The Walking Dead* and *House of Cards* had roots in the success of *The Sopranos*.

The time viewing streaming content is time not spent at the theatre. The average American spends 2.8 hours daily watching television.[38] Scaled differently, the time typically spent at the theatre each *year* is equal to about *two days* of television viewing. For exhibitors, the time someone spends binge watching the last season of a show or just hanging out to 'Netflix and chill' presents a lost revenue opportunity.

Overall, the availability of quality content and the visual and audio experience available in the home are rapidly converging, some would argue, surpassing offerings available at the theatre. Paul Dergarabedian, president of Hollywood.com's box-office division, labels it a 'cultural shift' in how people view entertainment.[39] People are more interested in content than ever before. Unfortunately, for movie exhibitors, there is more competition than ever in both the content worth viewing and ways to do so.

## RECENT EXHIBITOR INITIATIVES

With attending a movie costing nearly $20 a person including admission, a drink and a snack versus the alternative of the sunk cost of an existing Netflix subscription, how can exhibitors compete? In what areas should exhibitors be making their investments to continue to offer a unique theatre-going experience? Exhibitors have historically been innovators. Exhibitors were among the first commercial adopters of air conditioning, which perhaps drew in as many customers as a refuge from summer heat as for entertainment. Advances in projection systems, screens and sound systems all improved the experience. Other innovations increase experience quality while also lowering costs. The ubiquitous stadium-style seating was once an experience differentiator, but was equally beneficial as it reduced the space needed per seat. This reduced the size and cost of facilities. Exhibitors continue to pursue a number of strategic initiatives aimed at increasing attendance, increasing the viewer's willingness to pay, and lowering costs.

At no time in the movie exhibition industry's existence have the stakes seemed so high. Attendance is declining. The wait needed to see a movie outside of the theatre has never been shorter. Content other than motion pictures is increasingly popular. Impressive screens and sound systems are common in homes. Mobile phones, ads and sticky floors mar the overall experience at the theatre. What will it take to bring audiences back to the theatre?

Market researcher, Mintel, reports that 80 to 90 per cent of theatre goers would pay a premium of $1 to $2 each for a wide range of options to make the experience either decrease the negatives of the current theatre-going experience or to make it more luxurious.[40] Improved video and sound quality, improvements to seating (including luxurious materials such as leather, sofa-style seating, footrests, along with more legroom), the ability to choose and reserve a seat location in advance, immersive viewing experiences such as 4D, higher end food and drink options, the ability to order from your seat in the theatre, and adult-only screens are among those desired. Exhibitors and their suppliers are developing, testing and rolling out a range of options addressing these. Some are for individual screens, others for all screens within a theatre complex. Theatres will invest in those strategic initiatives to draw audiences and produce revenue in excess of costs.

## Projection innovations

The conversion to digital projection and rollout of 3D are not the end of projection innovations. Some directors are opting to increase image quality through the number of frames per second (fps) of film from the long established standard of 24 to 48 and higher. Screeners of Ang Lee's *Billy Lynn's Long Halftime Walk* shown with 4K 3D laser projection at 120 frames per second used described the visual experience in terms like 'impeccably bright' and 'stunning detail and clarity'.[41] Commercially, the film fared poorly in wide release, due in part to a lack of theatres equipped with the required projection equipment. Thus, there exists something of a catch-22: some attendees will pay a premium for enhanced visual quality, but it requires both exhibitors and film producers to commit to making the investments needed. To date, few of either have.

Most large circuits offer some form of extra-large screens.[42] Traditionally located only in specially constructed dome-shaped theatres in science museums, the original IMAX format utilised film that was 10 times the size of that used in standard 35 mm projectors. IMAX now operates more than 600 screens. These circuit-based IMAX digital screens are far smaller than the original IMAX screens, but can be much larger than the typical theatre screen. Located within Regal and AMC theatre complexes, the screens are often independent, and booked and operated by IMAX. Action films, usually in 3D, are a staple. To capture more of this differentiated revenue, several circuits have begun creating their own super-size screens and formats. IMAX is typically a $3 to $7 premium per ticket. Revenues for IMAX Corporation grew approximately 30 per cent from 2013 to 2017.[43]

Audio systems are being improved. In the 1980s, theatres impressed viewers with 7.1 sound systems – two rear channels (left and right), two channels mid screen, two near the screen, one under the screen and a subwoofer channel for bass. Such systems have long been available for homes. To keep theatre sound as a differentiator, Dolby® Laboratories has created Atmos™, a full surround system with up to 64 individual channels for speakers in a theatre, including multiple ceiling speakers that can truly immerse the audience in sound.[44] While exhibitors may benefit, Dolby has licensed a home version that emulates the experience in home theatres.

## Alternative content/event cinema

Exhibitors' transition to digital projection served as an enabling technology for alternative content, also called event cinema, a broad term encompassing virtually any content that is not a motion picture. This includes live concerts and theatre, standup comedy, sporting events, television series premieres and finales, even virtual art gallery tours. Event cinema is the fastest-growing segment at the box office, increasing from $112 million worldwide in 2010[45] to $277 million in 2014, and expected to reach $1 billion – about 5 per cent of the box office – by 2019.[46] Ticket prices average $12.33 per event. Event cinema content can be singular events, such as recent concerts, or series attracting repeat visits, such as *Metropolitan Opera Live* shown in 2000 venues in 70 countries across six continents.[47] The 2017–18 season featured 10 live events on Saturday afternoons with encore rebroadcasts on Wednesdays.

Distribution is performed by entities such as Digital Cinema Distribution Coalition (DCDC), a consortium of major circuits that owns and operates its own satellite network for distribution. A number of organisations have emerged to provide content such as Fathom Events, which distributes a variety of music, sports, television and other alternative content. Fathom's clients include more than 875 theatres. Fathom Events has sold more than 18 million tickets.[48] Having an intermediary for a distributor is essential for exhibitors as the cost of pursuing and licensing content is prohibitive for individual exhibitors. The cross-exhibitor cooperation also affords marketing opportunities not economically available to an individual exhibitor.

Alternative content is a supplement to motion picture content. It is best during off-peak movie attendance times such as Monday to Thursday when as little as 5 per cent of theatre seats are occupied.[49] Bud Mayo, former CEO of the Digiplex Digital Cinema Destinations theatre chain prior to an acquisition by Carmike, described the approach: 'What happens with those [alternative content] performances is that single events will out-gross certainly the lowest-grossing movie playing that theatre that day. The relationship has averaged more than 10 times the lowest-grossing movie for the entire day.'[50] In marginal dollar terms, alternative content can be a boon on otherwise slow nights. A Wednesday showing of Broadway's *West Side Story* at a Digitech theatre had an average ticket price of $12.50 and grossed $2425. In comparison, screens showing films that night grossed just $56 to $73 each. The alternative content also brought in nearly 200 additional customers who may purchase concessions.[51]

The success of events rests heavily on having a built-in fan base or the ability to market individual events. Dan Diamond, VP of Fathom Events, reports that its most successful event came as a surprise: the 25 November 2013 showing of *Dr Who: The Day of the Doctor* in celebration of the 50th anniversary of *Dr Who*, the popular BBC series. The box office gross was the largest on a per-screen basis for the day, raking in over $17 000 per location.[52] The challenge for exhibitors, accustomed to studio marketing campaigns promoting each week's box office release, is the development of capabilities in marketing single-night events to niche audiences at low cost.

## Luxury theatres

Several chains and new entrants are trying to lure attendees with the promise of a luxury experience. Established players like AMC and Regal are reseating screens and entire theatres with premium seats. Smaller theatre chain iPic, with 17 locations across the US, offers perhaps the most luxurious theatre available outside of a private screening room, complete with reclining leather chairs, pillows and blankets. Lobbies resemble stylish high-end hotels and feature a cocktail lounge and full in-theatre restaurant service. Complete with a membership program, the theatres operate more like social clubs than traditional theatres. Ticket purchases, $16–$27 per seat without food, are made not at a ticket booth but rather with a concierge.[53]

Another chain, Cinépolis, is a subsidiary of Mexican theatre company Cinépoli. Cinépolis began with one location in San Diego in 2011 and has since expanded to 20 locations through development and acquisition.[54] Offerings differ by location, ranging from standard theatres with leather rocking seats to full service at-your-seat dining with bar service. Tickets for luxury screens average nearly $20. The company offers something for everyone: some showings are restricted to those 21 and older while other theatres feature Cinépolis Junior with a children's in-theatre playground available for use for 20 minutes before a movie starts.[55]

## Immersion experiences: 4D and beyond

The first wave of immersive experiences was 3D technology. Ten years ago, 3D was to be the next great projection technology and revenue producer, but its appeal has waned. 3D's share of domestic ticket sales peaked in 2010 at 7 per cent of tickets and has since been in a steady decline to 11 per cent of tickets sold in 2017. It remains a draw in international markets.

The second wave of immersive experiences draws the viewer further into the action by combining 3D, off-screen special effects, and motion seating synchronised to the on-screen action into a '4D' experience.[56] Some theatres add additional immersive elements by introducing scents into the theatre, using off-screen light effects, and even water sprayers to bring the action of the movie off the screen and into the theatre. An encounter with a dinosaur on a dark and stormy night is seen on the screen, heard through the sound system and felt through a shaking seat. The encounter is even more real when water sprays and strobe lights flash. The whole experience can become a drink-spilling experience. Liability waivers, minimum age requirements and cautions are all standard. Wary of repeating the less-than-expected results of 3D, 4D is being touted as occupying a niche within the broader theatre experience. The 4D experience typically comes at a surcharge of $8–$12 over standard tickets.

The third wave of immersion will merge movies with video games. Exhibitors, producers and equipment companies are working on interaction elements ranging from simple interactions such as shooting on-screen targets with lasers to more complex bullet screens where you can text your thoughts about scenes and the movie and they are projected onto the screen in real time.[57] All are seeking to provide a more immersive and interactive experience than passive sitting and movie watching. Some industry observers anticipate that immersion technologies will include feedback systems and story forks where the actions and choices of the audience lead to plot twists and different story outcomes with each viewing. Eventually, the line between what constitutes a movie versus a video game may blur.

## Concession initiatives

Expanding beyond the standard concession stand offers exhibitors opportunities to capture new revenue streams. Three main formats for concessions have emerged.

### Expanded in-lobby

Many theatres have expanded the concession counter beyond candy, popcorn and soft drinks. This expanded in-lobby dining causes many theatre lobbies to resemble mall food courts. In- and off-lobby restaurants operated or licensed by the exhibitor allow for pre-theatre dining. Taking a page from restaurants where a primary profit centre is often the bar, some theatres now configure the lobby around a bar, with expanded and upscale fare, beer and alcohol service.

### In-theatre dining

Many theatres have adopted in-theatre dining with orders placed from one's seat in the theatre and delivered by waiters. Chunky's Cinema and Pub, with four New England locations, locates theatre in lower-cost underutilised former retail locations. The format combines burger, salad and sandwich options with beverages, including beer. The format is flat theatre with banquet-style tables. The seating is unique: Lincoln Town Car seats on castors that allow for easy cleaning. Alamo Drafthouse Cinemas takes a similar approach using a stadium-seating configuration. A single bar-style table in front of each row of seats serves as a table for customer's orders. In comparison to traditional theatres, these formats see significant increases in food and beverage sales.

### Upscale within-theatre dining

Several circuits are targeting the high end of the dining market, focusing on the experience of the theatre with luxurious settings and upscale food. In addition to its standard theatres, AMC has developed Dine-In Theaters with two theatre configurations. Its Fork & Screen theatres are much like the Alamo Drafthouse Cinema with enhanced stadium theatre seats and in-theatre wait service on an expanded menu. Its Cinema Suite theatres make the experience more intimate. Customers, 21 and older, purchase tickets for specific seats in smaller theatres equipped with reclining lounge chairs, complete with footrests, and order at their seat using a computerised system.

## Advertising initiatives

Exhibitors are keen to expand highly profitable advertising, but do so in ways that do not diminish the theatre experience. On- and off-screen advertisements generate revenue. Off-screen advertising such as promotional videos, lobby events and sponsored concession promotions are 9 per cent of revenues. The majority, 91 per cent, comes from on-screen ads for upcoming releases, companies and products that play before the feature presentation.

Both exhibitors and advertisers seek ways to make on-screen ads more palatable to audiences. Many ads are in 3D with production quality rivalling a studio release. Theatres are also incorporating innovative technologies such as crowd gaming into ads where the movement or sound of the audience controls on-screen actions. In 2015, audiences in 100 Screenvision-equipped theatres selected the driving experience and virtually drove an XC90 as part of Volvo's re-launch of the vehicle. Attendees selected the scene, steered the car and controlled the vehicle's speed by waving.[58] The equipment required? A wireless video camera above the screen, a Web-enabled laptop containing the game linked to the developer's website and inexpensive motion-sensing technology all linked to the theatre's digital projector.

Advertisers are keen on increasing the engagement of movie audiences to increase the return on ads.[59] From on-screen QR codes to Bluetooth devices that drop advertiser websites directly into the browser on attendees' phones, interactive is the next step in theatre advertising. Making ads enjoyable and useful rather than loathed may create an opportunity to increase this small but high-margin component of exhibitor revenues. Given all of these advertising initiatives, exhibitors may eventually draw from the pages of free software: the ability to pay a premium for an ad-free experience.

## Seating

Movie theatres are among the minority of entertainment venues selling tickets without a commitment to the purchaser's viewing experience. Sports and concertgoers, for example, always know where they will be sitting in relation to a performance. Movie theatres have long been the province of a first-come, first-select seating model. However, all of the major exhibition chains have incorporated elements of reserved seating – purchasing a ticket tied to a specific seat during a specific showing – into their theatres. These take a variety of forms, ranging from theatres consisting entirely of reserved seat screens, to specific screens consisting exclusively of reserved seats, to screens with mixed open and reserved options. For the exhibitor, reserved seating requires a reservation and seat selection system and the ability to enforce seating and reconcile disputes, but comes with additional revenues. Reserved seating is frequently a service surcharge, not part of the ticket price, of $1 to $3 per seat. Reserved seating is currently one aspect of luxury formats with prices in the $15 range – about double the industry average – but moving into economy theatres too.

## Dynamic pricing

The technology needed for reserved seating is a gateway to dynamic pricing systems. Matinee, youth and senior discounts are the primary pricing tiers. Most non-movie events have multiple pricing levels based on seating, show time and weekday versus weekend. Movie theatres have limited flexibility due to the contract restrictions. 'Dynamic pricing', which incorporates demand into pricing models, is the next generation of ticket pricing.[60] The simplest models involve surcharges for big-budget blockbuster films in their first few days of release. Odeon & UCI, two European chains purchased by AMC, already price using this approach.[61]

A more advanced approach is to adjust prices for each movie, day of the week, show time and even seat location based on demand tracked in real-time.[62] This could mean radical changes, including lower ticket prices for off time and poorly attended movies and increased prices for prime seats at peak times and opening weekend. For the theatre, dynamic pricing offers the opportunity to fill otherwise unsold seats and to move showings between screens based on demand. Australian chain Cineplex offers dynamic pricing, but studios are cautious. Disney, for example, has set and required payment of a minimum average ticket price for some films.[63] For customers, dynamic pricing offers the opportunity to reduce the cost of attending the theatre. Do you not want to spend more than $5 to see a particular movie? Apps are on their way to find locations and show times matching your criteria.

## Beyond content

Many smaller exhibitors are seeking increased profitability beyond movies by reimagining their theatres as multi-entertainment venues. By adding activities such as game rooms, bowling, even laser tag and at-table trivia, a theatre becomes a one-stop location for family-friendly entertainment. Frank Theaters, for example, combines movies, bowling and games for the whole family with dining in its locations, making it possible to spend an entertaining evening at the theatre without ever seeing a movie.

## IS YOURS THE LAST THEATRE?

The existence of the Jedi approached folklore status in 2017's *The Last Jedi*. Many have heard of them, but sightings are rare. Might the local movie theatre soon be as rare as the Jedi? While theatres experiment with a variety of initiatives to draw viewers, the clock is ticking. Prior initiatives, most recently 3D, have failed to live up to their potential as a durable and enduring way to attract audiences.

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# CASE 9

## Pacific Drilling: The preferred offshore driller

**CASE LINK: This case applies concepts from Chapters 6, 9 and 13.**

From June 2014 to January 2015, the market price of oil fell from US$115[1] per barrel down to $49 per barrel.[2] As oil prices went down, so did the appetite of energy companies for offshore exploration. Further compounding the problems was the oversupply of rigs, due to drillers having overbuilt during the boom times. As of March 2015, there was no near-term recovery in sight for oil prices, which had major implications for Pacific Drilling, a growing offshore drilling company based in Texas.

Founded in 2006, Pacific Drilling owned and operated a fleet of eight high-specification drillships operating in ultra-deepwater drilling environments in depths up to 3.7 km and offered the most advanced drilling technology available. As of 2015, the company had nearly 1600 employees and had generated more than $1 billion in annual revenue (see Figures 1, 2 and 3).

With growing competition from rivals – both emerging and more established companies – Pacific Drilling sought to expand its customer base. However, the close relationships that it had cultivated with its existing partners (which

**Figure 1** Pacific Drilling income statements, 2012–2014

| | Years Ended 31 December | | |
|---|---|---|---|
| (in thousands, except per share amounts) | 2014 | 2013 | 2012 |
| **Revenues** | | | |
| Contract drilling | $ 1 085 794 | $ 745 574 | $ 638 050 |
| **Cost and expenses** | | | |
| Contract drilling | (459 617) | (337 277) | (331 495) |
| General and administrative | (57 662) | (48 614) | (45 386) |
| Depreciation | (199 337) | (149 465) | (127 698) |
| | (716 616) | (535 356) | (504 579) |
| Loss of hire insurance recovery | – | – | 23 671 |
| **Operating income** | 369 178 | 210 218 | 157 142 |
| **Other income (expense)** | | | |
| Costs on interest rate swap termination | – | (38 184) | – |
| Interest expense | (130 130) | (94 027) | (104 685) |
| Total interest expense | (130 130) | (132 211) | (104 685) |
| Costs on extinguishment of debt | – | (28 428) | – |
| Other income (expense) | (5 171) | (1 554) | 3 245 |
| **Income before income taxes** | 233 877 | 48 025 | 55 702 |
| Income tax expense | (45 620) | (22 523) | (21 713) |
| **Net income** | $ 188 257 | $ 25 502 | $ 33 989 |
| **Earnings / common share, basic** | $ 0.87 | $ 0.12 | $ 0.16 |
| **Weighted average number of common shares, basic** | 217 223 | 216 964 | 216 901 |
| **Earnings / common share, diluted** | $ 0.87 | $ 0.12 | $ 0.16 |
| **Weighted average number of common shares, diluted** | 217 376 | 217 421 | 216 903 |

Source: Company documents.

**Figure 2** **Pacific Drilling balance sheets, 2013–2014**

| (in thousands, except par value) | 2014 | 2013 |
|---|---|---|
| Cash and cash equivalents | $ 167 794 | $ 204 123 |
| Accounts receivable | 231 027 | 206 078 |
| Materials and supplies | 95 660 | 65 709 |
| Deferred financing costs, current | 14 665 | 14 857 |
| Deferred costs, current | 25 199 | 48 202 |
| Prepaid expenses and other current assets | 17 056 | 13 889 |
| Total current assets | 551 401 | 552 858 |
| Property and equipment, net | 5 431 823 | 4 512 154 |
| Deferred financing costs, current | 45 978 | 53 300 |
| Other assets | 48 099 | 45 728 |
| Total assets | 6 077 301 | 5 164 040 |
| Liabilities and shareholders' equity | | |
| Accounts payable | $ 40 577 | $ 54 235 |
| Accrued expenses | 45 963 | 66 026 |
| Long-term debt, current | 369 000 | 7 500 |
| Accrued interest | 24 534 | 21 984 |
| Derivative liabilities, current | 8 648 | 4 984 |
| Deferred revenue, current | 84 104 | $ 96 658 |
| Total current liabilities | 572 826 | 251 387 |
| Long-term debt, net of current maturities | 2 781 242 | 2 423 337 |
| Deferred revenue, current | 108 812 | 88 465 |
| Other long-term liabilities | 35 549 | 927 |
| Total long-term liabilities | 2 925 603 | 2 512 729 |
| Common shares, $0.01 par value per share, 5,000,000 shares authorised, 232,770 and 224,100 shares issued, and 215,784 and 217,035 shares outstanding as of 31 December 2015 and 31 December 2013, respectively | 2 175 | 2 170 |
| Additional paid-in capital | 2 369 432 | 2 358 858 |
| Treasury shares, at cost | (8 240) | – |
| Accumulated other comprehensive loss | (20 205) | (8 557) |
| Retained earnings | 235 710 | 47 453 |
| Total shareholders' equity | 2 578 872 | 2 399 924 |
| Total liabilities and shareholders' equity | 6 077 301 | 5 164 040 |

Source: Company documents.

**Figure 3** **Pacific Drilling cash flow statements, 2012–2014**

| (in thousands) | 2014 | 2013 | 2012 |
|---|---|---|---|
| **Cash flow from operating activities:** | | | |
| Net income | $ 188 257 | $ 25 502 | $ 33 989 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation expense | 199 337 | 149 465 | 127 698 |
| Amortization of deferred revenue | (109 208) | (72 515) | (95 750) |
| Amortization of deferred costs | 51 173 | 39 479 | 70 660 |
| Amortization of deferred financing costs | 10 416 | 10 106 | 13 926 |
| Amortization of debt discount | 817 | 445 | – |
| Write-off of unamortized deferred financing costs | – | 27 644 | – |
| Costs on interest rate swap termination | – | 38 184 | – |
| Deferred income taxes | 18 661 | (3 119) | (3 766) |
| Share-based compensation expense | 10 484 | 9 315 | 5 318 |
| Changes in operating assets and liabilities: | | | |
| Accounts receivable | (24 949) | (53 779) | (89 721) |
| Materials and supplies | (29 951) | (16 083) | (6 640) |
| Prepaid expenses and other assets | (56 493) | (30 840) | (61 548) |
| Accounts payable and accrued expenses | 20 865 | 12 301 | 33 865 |
| Deferred revenue | 117 001 | 94 482 | 156 967 |
| Net cash provided by operating activities | 396 410 | 230 587 | 184 998 |
| **Cash flow from investing activities:** | | | |
| Capital expenditures | (1 136 205) | (876 142) | (449 951) |
| Decrease in restricted cash | – | 172 184 | 204 784 |
| Net cash used in investing activities | (1 136 205) | (703 958) | (245 167) |
| **Cash flow from financing activities:** | | | |
| Proceeds from shares issued under share-based compensation plan | 95 | – | – |
| Proceeds from long-term debt | 760 000 | 1 656 250 | 797 415 |
| Payments on long-term debt | (41 833) | (1 480 000) | (218 750) |
| Payments for costs on interest rate swap termination | – | (41 993) | – |
| Payments for financing costs | (7 569) | (62 684) | (19 853) |
| Purchases of treasury shares | (7 227) | – | – |
| Net cash provided by financing activities | 703 466 | 71 573 | 558 812 |
| Increase (decrease) in cash and cash equivalents | (36 329) | (401 798) | 498 643 |
| Cash and cash equivalents, beginning of period | 204 123 | 605 921 | 107 278 |
| Cash and cash equivalents, end of period | $ 167 794 | $ 204 123 | $ 605 921 |

Source: Company documents.

had helped its early stage growth) raised concerns that the driller had become too closely linked to them (in terms of culture, processes and technology) to effectively translate its efficiency gains to new producer partners.

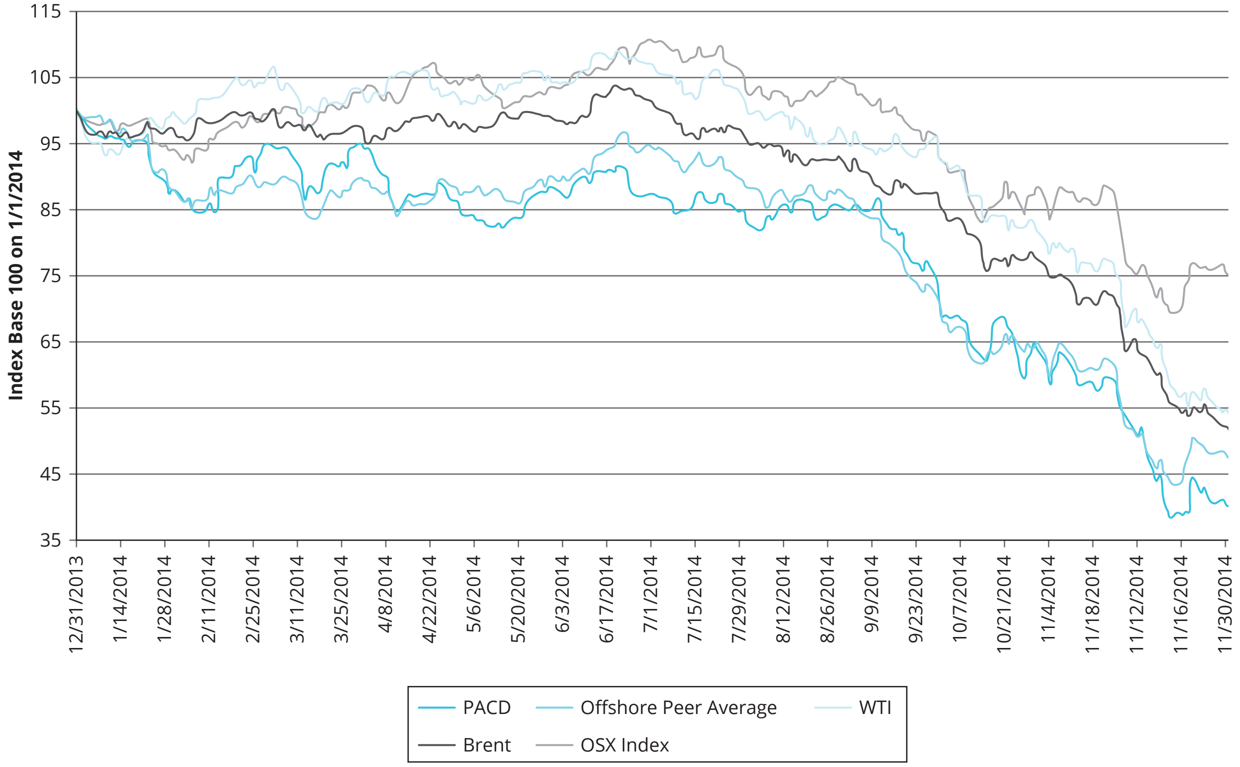
The company's chief executive officer (CEO), Christian J. Beckett, and his team received a range of opinions about what the company should do to weather the storm and emerge stronger. Investors also felt the pain from the company's stock price sliding from $11 per share in 2014 to less than $4 per share, as did the stock price of all offshore drillers during that time (see Figure 4). As he considered the available options, Beckett faced another critical crossroad. The company had survived tough times before – in the early stages of the company's development, the team had successfully manoeuvred through the 2008 global financial crisis as the credit markets collapsed. But as Beckett admitted, the current challenge was unique in many ways, and Pacific Drilling was a different company from earlier. However, it remained to be answered to what extent Beckett and his team could rely on what they had successfully done in the past, and to what extent they would need to adapt.

## THE OFFSHORE DRILLING INDUSTRY

The offshore oil industry involved the exploration and production of oil and gas from underwater wells, often in locations off continental coasts but sometimes in inland seas and lakes. Offshore sites held greater promise than onshore sites for oil producers to develop their oil reserves, and achieve higher production rates, especially in less explored deepwater sites. For instance, in recent years, the greatest increases of any offshore drilling region had been the demand for ultra-deepwater rigs in the Golden Triangle of Oil, which consisted of the Gulf of Mexico and the waters off the coasts of South America and West Africa (see Figure 5). Over the past decade, deepwater discoveries had far outpaced those in shallow water.[3]

Developing a well usually involves two main players: the oil producer and the driller that physically drills the well in accordance with the producer's specifications. A small number of oil companies owned a few offshore rigs and conducted drilling in-house. Most companies, however, outsourced the work to drilling contractors. Some producers, known as independent producers, focused solely on the upstream, or

**Figure 4** **High correlation between offshore drillers' stocks and oil price, December 2013 to 2014**




Note: PACD = Pacific Drilling; WTI = West Texas Intermediate; OSX = Oil Service Sector Index

Source: Organization of the Petroleum Exporting Countries; Yahoo finance; and company analysis.

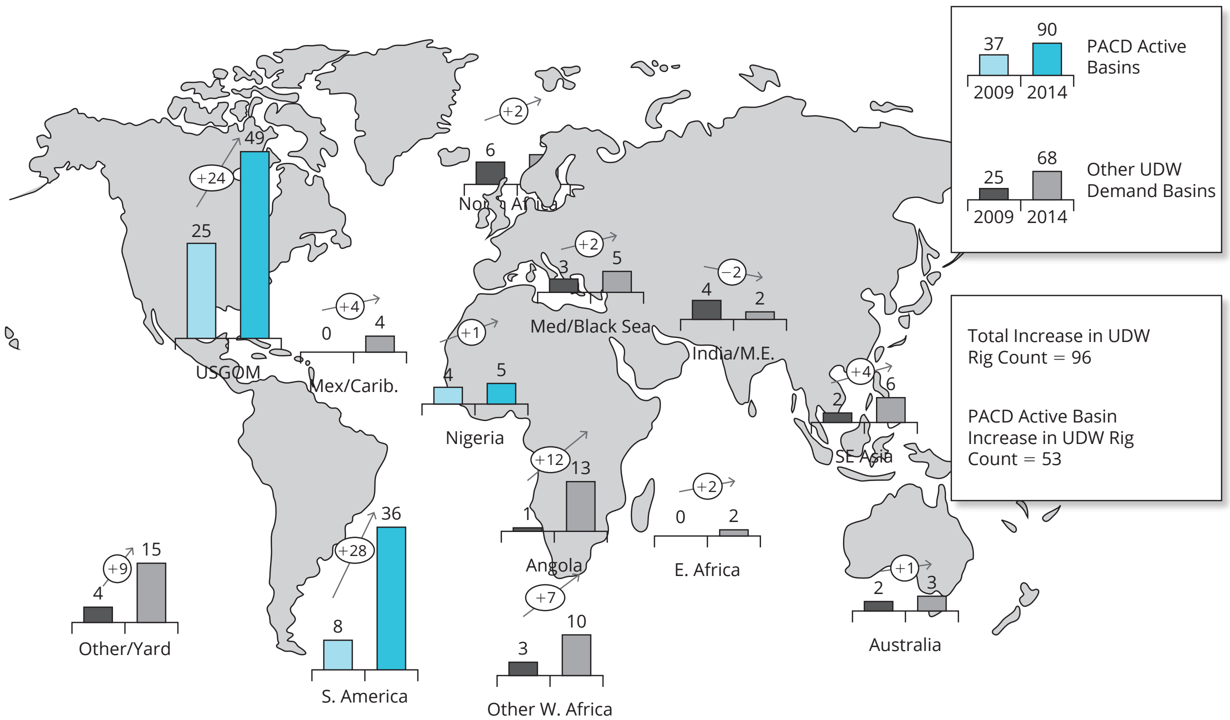
early stage, activities of exploration and production (e.g. Anadarko). Others were integrated multinational corporations (e.g. BP, ExxonMobil, Chevron and Shell) and state-owned companies (e.g. Brazil's Petrobras and Saudi Arabia's Aramco) that also performed downstream or later-stage activities, such as refining and marketing of the extracted oil and gas.

Oil exploration began with geological and seismological research on a potential well. Next was the purchase or lease of the promising ocean terrain, almost always from governments. Once sufficient due diligence was completed and the rights to explore the site were secured, producers typically contracted with drillers to drill exploratory wells. If the results were encouraging, drilling began on development wells in the area for eventual oil extraction. How quickly drilling, and then extraction, could be accomplished depended on the supporting infrastructure (e.g. pipelines connecting to processing facilities) around the drilling site, weather conditions and geological characteristics. Another factor was productivity, which was a function of the drilling technology used and the working experience of the producer-drilling teams.

Offshore drilling typically used three types of rigs: jack-ups, semi-submersibles and drillships. *Jack-ups* were used in shallow water (up to approximately 0.12 km of water), and their operating deck was supported by multiple legs that extended down to the ocean floor. *Semi-submersibles* (semis) could operate in water depths of up to 3 km. They floated on submerged pontoons with an operating deck that was well above the water's surface. *Drillships* could operate in water depths of up to 3.6 km. They looked like large, ocean-going freighters with a drilling derrick mounted in the centre of the ship. They offered greater mobility and deck space than semis and were therefore often preferred in remote locations. Their larger size also allowed them to provide greater operational efficiency through enhancements such as dual derricks[4] and additional drilling equipment.

Drillers competed to lease their rigs to producers. The drillers were usually paid based on day rates,[5] which varied widely across rig types. Deepwater oil reserves were much more difficult to tap and required more advanced equipment and expertise than some other locations. As a result, day rates for semis and drillships could be three to five times higher than jack-up rates.

**Figure 5** **The Golden Triangle of Oil that drove ultra-deepwater (UDW) demand growth 2009–2014**




Note: PACD = Pacific Drilling; USGOM = U.S. Gulf of Mexico; Mex. = Mexico; Carib. = the Caribbean; Med = the Mediterranean; M.E. = Middle East

Source: 'Ultra-Deepwater Demand Growth', ODS-Petrodata, Inc., accessed April 12, 2015; Company analysis.

Day rates also varied in relation to market conditions and could be further differentiated by the quality and efficiency of the drilling rigs and services, which were often the result of technological and processing innovations that could ultimately provide lower total drilling costs for the producer (see Figure 6). Day rates were usually locked in through negotiated contracts, with the duration of the contracts and the lead time decided on prior to the start of the contract. However, day rates also fluctuated with market conditions.

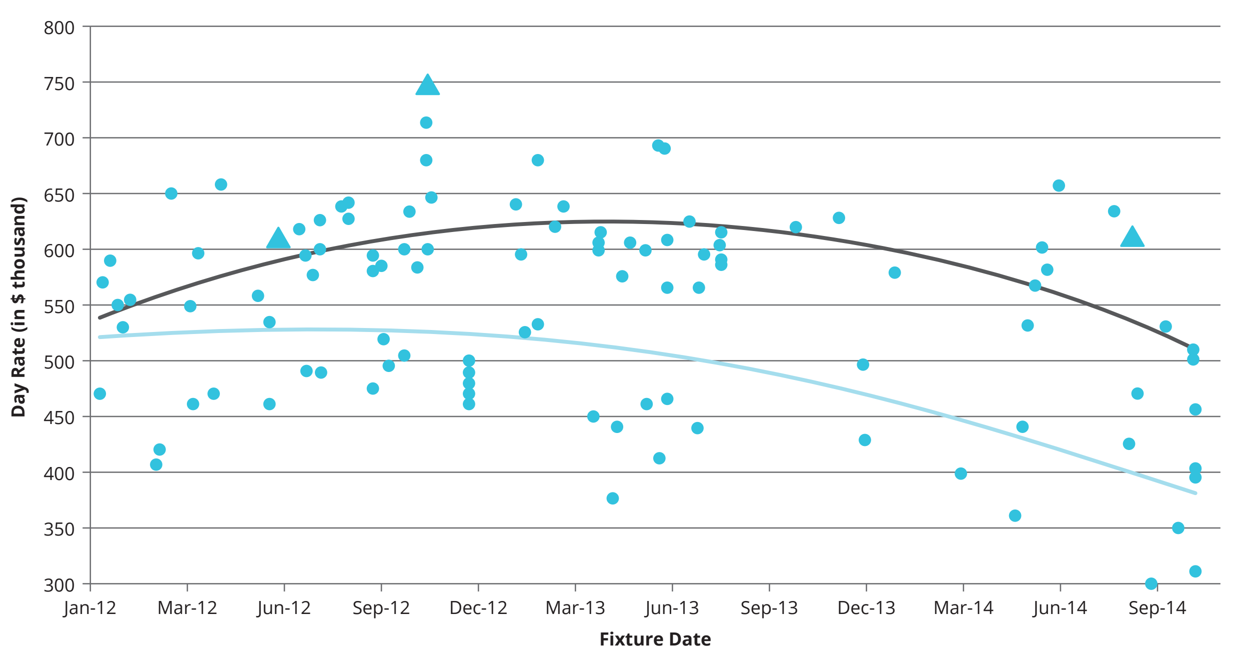
Many factors could affect a producer's choice of driller. For example, national oil companies often held public tenders and chose drillers based on the rig's suitability and the day rate. International oil companies had been known to be much more reliant on existing relationships.[6] Because relocating rigs was costly and time-consuming,[7] producers seeking to develop wells in a certain region were more likely to contract a driller that already had the required type of rig ready in the area. In certain geographic locations, government regulation and local content criteria could be barriers to entry, thereby playing a significant role in the selection of a drilling contractor.

Rigs that were not leased out were usually 'stacked' (i.e. idle), or taken out of service, by the driller to minimise operating costs. A 'hot-stacked' rig remained fully crewed, standing by, ready for work if a contract could be obtained, and the downtime was used for maintenance and repairs; a 'warm-stacked' rig retained some of the crew and underwent a reduced level of maintenance and repairs; and a 'cold-stacked' rig was completely vacated and its doors welded shut.[8]

The offshore drilling industry rose and fell with oil prices (see Figure 4). The early 1970s witnessed a spike in oil prices due to actions by the Organization of the Petroleum Exporting Countries (OPEC) that increased the supply of offshore rigs as drillers rushed to meet the increase in drilling demand. The industry later suffered an overcapacity of rigs when prices came back down during the mid-1970s.[9] Such cycles continued with the oil price spike in 1979, its collapse in early 1986 and its recovery in 1987. Oil prices remained depressed during the 1990s until 1998, due to the economic slowdown in Asia, then started climbing in the early 2000s, which pushed utilisation rates, and thereby day rates, to historical highs. The financial crisis that started in 2008 caused utilisation rates and day rates to decline sharply again, as oil prices fell below $40 per barrel from their peak of $140 per barrel a year earlier.[10]

Players in the offshore drilling industry included both diversified drillers (e.g., Transocean, Seadrill, Ensco, Noble, Diamond, Rowan, and Atwood) and niche drillers

**Figure 6** **Day rate trends for floating rigs by rig quality (2012–2014)**




Note: Analysis uses publicly available data; includes rigs with water depth capability greater than 1.5 km and contract day rate revenue from mutual contracts greater than one year.

Source: 'Trends for Floating Rigs by Rig Type', ODS-Petrodata, Inc., accessed 12 April 2015; Company analysis.

(e.g., Ocean Rig). Larger, diversified drillers had fleets that included rigs of various types and typically had a broader geographic presence (see Figure 7).

## CHRIS BECKETT: CEO AND THE FIRST EMPLOYEE

With the initial purchase of a drillship under construction, Pacific Drilling was founded in 2006 as a subsidiary of Tanker Pacific, one of the largest tanker fleet owners in the world. After ordering a second rig in 2007, the company transferred its rigs to a joint venture with 50–50 ownership with Transocean. In 2008, Pacific Drilling expanded its activities beyond the joint venture to include four ultra-deepwater drillships, which had been constructed in South Korea at Samsung Heavy Industries, one of the three largest shipyards in the world. At the same time, Beckett was approached by Idan Ofer, an Israeli tycoon and the principal of Tanker Pacific. Ofer asked Beckett to be the company's first employee and to lead the development of Pacific Drilling as CEO. Beckett, a 2002 MBA graduate from Rice University in Texas, had previously been the head of corporate planning at Transocean, a strategy consultant at McKinsey, and the US land seismic manager at Schlumberger.

As the CEO of a start-up, Beckett challenged the industry's conventional wisdom:

> Back to 2004 and 2005, the industry was coming out of the downturn. . . . There was a belief in most of the established drillers that they would sit on what they had, and they would own the market. They would have a strong market position. There was an absolutely strong belief that nobody from outside could enter the industry. No clients would take the risk to work with a new driller without any proven record. Also, no lenders would take the risk to build several-hundred-million-dollar assets with a new player.

Despite huge challenges and personal risks, Beckett believed that the offshore drilling industry was changing and provided great opportunity for a start-up such as Pacific Drilling, which focused on premier technology and ultra-deepwater drilling. In particular, he noted:

> When we started Pacific Drilling, it was with the view that the assets that were being designed, built, and delivered into the market around 2005 and 2006 onwards were, for the first time in the industry, explicitly supposed to outcompete those of the previous generation by being more efficient: by reducing the time to drill a well. A lot of the incumbents missed that as a fundamental change, and they believed that if they didn't build rigs then nobody would build rigs and that they could continue with the technology that they had and control the market. What happens in most industries is that somebody comes in from the outside and delivers the technology to the market place and supersedes them by using disruptive technology.

In November 2014, Beckett won the Ernst & Young (EY) Entrepreneur of the Year National Award in the Energy, Cleantech and Natural Resources category for his leadership in growing the start-up company into a highly respected niche player in the offshore drilling market. 'Chris Beckett is the definition of a high-growth entrepreneur', said Mike Kacsmar, EY Entrepreneur of the Year Americas program director. 'He's grown a world-class team based on that entrepreneurial spirit, and he encouraged his employees to make an impact by identifying novel approaches and seeing those ideas through to implementation.'[11]

## ORGANISATION STRATEGY

Beckett strongly believed that the new generation of rigs would be fundamentally more efficient than the existing generation. Over time, the previous generation would become obsolete. Therefore, his vision of Pacific Drilling was that of a preferred, high-specification, floating-rig drilling contractor. The strategy was to use its consistent fleet of ultra-deepwater drillships, which were built by the top-of-the-class shipyard Samsung Heavy Industries, outfitted with the newest drilling packages by National Oilwell Varco, and managed by a highly experienced team to provide differentiated drilling services for its customers. This focus gave Pacific Drilling a strong competitive advantage over companies such as Transocean, which was more diversified and less focused (see Figures 8 and 9). Beckett explained his vision of the company:

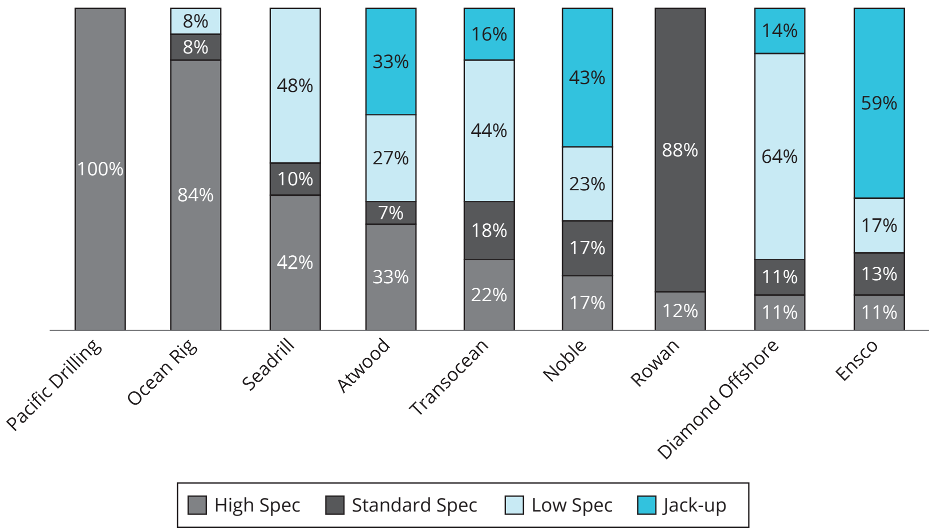
> The benefit that we had and that we foresaw for Pacific Drilling was to be focused on one asset class and not allow ourselves to be dragged into other asset classes. We could therefore optimize our maintenance systems, procurement, operating programs, and safety programs to deliver the best results with this one asset class.

**Figure 7** **Profiles of Pacific Drilling's competitors**

| | |
|---|---|
| Transocean | Transocean operated the largest fleet in the offshore drilling industry with 85 rigs (15 jack-ups, 39 semi-submersibles and 31 drillships) with an average age of 17 years. The company's market capitalisation was approximately $6.8 billion, which was the second largest in the industry. It had an operational presence in the waters of the United States, Norway, the United Kingdom, West Africa, Brazil, South-East Asia, and Australia. Over the past five years, the company had delivered operating margins of about 22 per cent, which was below the industry average. The company's strategy was to upgrade its fleet and divest its non-core assets. |
| Seadrill | Seadrill operated 57 rigs (25 jack-ups, 15 semi-submersibles and 17 drillships) with an average age of 3.4 years. It was one of the youngest fleets in the industry. The company's market capitalisation was $5.9 billion. Over the past five years, the company had also had the second-highest operating margins in the industry at about 40 per cent. It had an operational presence in the waters of the United States, Mexico, Norway, Brazil, West Africa, the Middle East and Asia Pacific. Its strategy was to maintain its technology advantage by continuing to invest heavily in fleet renewal and growth. |
| Ensco | Ensco operated 74 rigs (46 jack-ups, 18 semi-submersibles, and 10 drillships) with an average age of 19.6 years. The company's market capitalisation of $7.1 billion was the largest in the industry, and it generated average operating margins of 40 per cent over the previous five years. It had an operational presence in the waters of the United States, Brazil, the Mediterranean, the Middle East, Africa, Europe and Asia Pacific. Its strategy was to update its fleet, invest in employee training and maintain its diverse geographic presence. |
| Noble | Noble operated 39 rigs (19 jack-ups, 11 semi-submersibles and nine drillships) with an average age of 15.8 years, which made it the second-oldest fleet in the industry. The company's market capitalisation was $4.4 billion. It had a diverse operational presence with rigs operating in the waters of the United States, Brazil, Mexico, the United Kingdom, the Middle East, Africa and Australia. The company performed just below the industry average, delivering operating margins of around 27 per cent over the previous five years. Its strategy was to update its fleet, invest in employee training and maintain its diverse geographic presence. |
| Diamond | Diamond operated 41 rigs (six jack-ups, 30 semi-submersibles and five drillships) with an average age of 30.4 years, which made it the oldest fleet in the industry. The company's market capitalisation was $5.3 billion. Over the previous five years, the company delivered operating margins of about 31 per cent, which was in line with the industry average. The company had a very low level of debt relative to its size and in comparison to its peers. At the same time, its older rigs enabled the company to be very competitive on rig pricing. The company strategy was to maintain its attractive pricing and its financial strength. |
| Rowan | Rowan operated 34 rigs (30 jack-ups and four drillships) with an average age of 16.4 years. The company's market capitalisation was $2.9 billion. It operated rigs in the waters of the United States, Saudi Arabia, the United Kingdom, Norway and Malaysia. The company generated average operating margins of about 23 per cent over the previous five years. The company's strategy focus was to maintain its diverse geographic presence, be more cost-effective and execute better. |
| Atwood | Atwood operated 14 rigs (five jack-ups, five semi-submersibles and four drillships) with an average age of 9.6 years. The company's market capitalisation was $1.9 billion. It had an international presence, with rigs in the waters of the United States, Australia, Equatorial Guinea and Thailand. The company achieved the highest operating margins in the industry over the previous five years at about 44 per cent. Its strategy was to continue growing while maintaining its operational efficiency. |
| Ocean Rig | Ocean Rig operated 13 rigs and focused on drilling in deeper waters (two semi-submersibles and 11 drillships) with an average age of 3.3 years. The company's market capitalisation was $1.2 billion. It had a rig presence in the waters of Brazil, Angola, Norway and Ireland. Its operating margins were at the industry average of approximately 30 per cent. The company's strategic focus was to grow its fleet of high-specification drilling rigs and to broaden its geographic reach. |

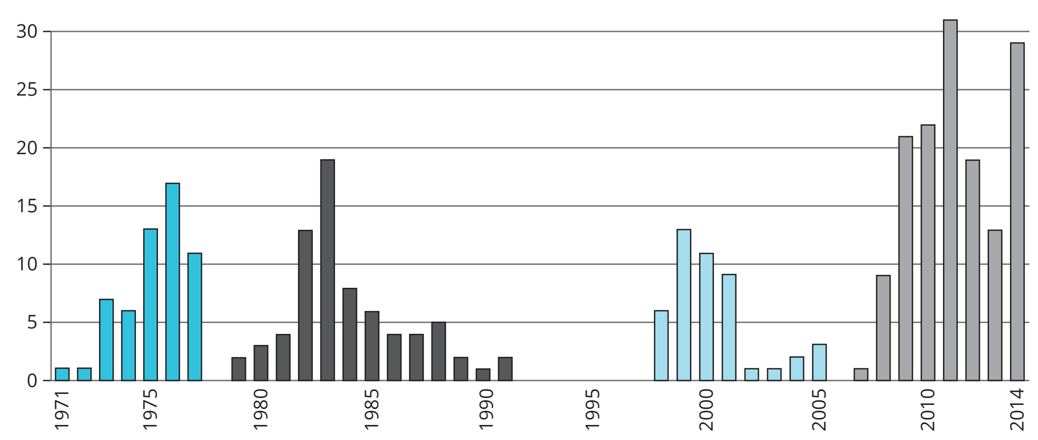
Source: 'Oil Drillers', ODS-Petrodata, accessed 12 April 2015; Yahoo finance; company analysis.

**Figure 8** Fleet composition by rig capability and type




Source: Company documents; 'Fleet Composition by Rig Capability', ODS-Petrodata, Inc., accessed 12 April 2015.

**Figure 9** Number of floating rigs in global fleet by delivery year (1971–2014)




Source: Company documents; 'Floating Rigs by Delivery Year', ODS-Petrodata, Inc., accessed 12 April 2015.

In 2008, Beckett and his team prepared a thorough technical and safety-drilling manual, but the industry did not seem ready for what Pacific Drilling was offering. One potential client that Beckett pursued requested that the company rework its manual and prepare a new proposal. Saddled with debt and yet to book its first customer, Pacific Drilling considered the prospect of a compromise by revising the manual to align with the standard industry practices. However, Beckett and his team knew that the compromise would mean losing what they believed to be the company's key differentiator. So they instead held firm and asked the customer to reconsider.

That potential client was Chevron, the first and ultimately most supportive customer throughout Pacific Drilling's growth, eventually contracting more than half of the company's drillships.

As Chevron officials later admitted, the original manual that had been proposed was among the best they had ever seen. Beckett reflected on that challenging but rewarding situation:

> So we were able to build a relationship with Chevron based on relationships we had in previous companies. They knew the people they were dealing with, and they could get comfortable that those people would be committed to delivering the product and service quality. They could look at who the financial backers were and where we were building rigs, and all the associated pieces came to a comfort factor that we would do what we planned to do.

The collaboration with Chevron also yielded access to a technological innovation: dual-gradient drilling (DGD), a process that enabled an oil company to access reservoirs that had previously been considered 'undrillable.' Unlike conventional drilling that used only one drilling fluid, DGD employed two different fluids in the wellbore – one in the drilling riser, with below-average density, and the other below the wellhead, with above-average density. Using DGD allowed the driller to overcome narrow pore pressure fracture gradient margins and to drill larger and deeper holes using fewer casing strings. It also helped the driller to better manage downhole pressure as the drill bit moved through various types of geologies such as sand, shale and tar (see Figure 10).

DGD was technologically proven in the late 1990s; however, it had not yet been deployed on a commercial rig. While Chevron expected DGD to reduce the total cost to drill a well, the company had not yet worked with a drilling contractor to fully implement the technology. Pacific Drilling management was aware of the potential for DGD and embraced the possibilities to work with Chevron on developing processes and procedures. It took about six months before Chevron was comfortable that Pacific Drilling was the right partner to commercialise DGD, leading to Pacific Drilling's first drilling contract.

Pacific Drilling's close relationship with Chevron was among the few relative constants in an often volatile and unpredictable market. Chevron had contracted four drillships with Pacific Drilling to date for operations in the Gulf of Mexico and Nigeria. The justification was simple: Pacific Drilling rigs were equipped with the capabilities that Chevron desired, and collaboration among the companies' employees, both onshore and offshore, had become seamless.

After Chevron had signed the first contract, opportunities from other producers emerged for Pacific Drilling. Chevron's willingness to repeatedly work with the new company was an endorsement of the substantial value that Pacific Drilling could deliver to its customers. With a more established reputation, Pacific Drilling was able to broaden its customer base to include Total (one drillship in Nigeria) and Petrobras (one drillship in Brazil). By the end of 2014, the company had signed \$2.7 billion in contracts (see Figure 11).

Working with Chevron to implement DGD also helped Pacific Drilling improve and refine its operating and management systems. Implementation of DGD technology demanded that Pacific Drilling work closely with Chevron on the development of operating procedures and employee training. At the time, Pacific Drilling operated two drillships that were DGD-capable (i.e. the Pacific Santa Ana and Pacific Sharav). Frédéric Jacquemin, the director of the DGD program at Pacific Drilling at the time, noted that 'with DGD, integrating a new technology is not only about equipment but it is also about defining new processes and training people'.

Although the full deployment of DGD technology was still a work in progress, Pacific Drilling's close collaboration with Chevron led to a corporate emphasis on process innovations and technological leadership. Pacific Drilling continued to invest in technological innovation in an effort to keep its fleet as up-to-date as possible. For example, its newest rigs were equipped with automated drilling systems that reduced the number of personnel on the drilling floor, substantially improving drilling speed while also reducing safety risks. The company also equipped its rigs with a higher than usual amount of drilling mud storage and processing capability, which allowed the rig to move more quickly through the drilling process and also to be more self-sufficient: a particular advantage in remote operating locations, where the cost of support vessels was high.

Pacific Drilling implemented SAP software on all of its drillships to better monitor daily rig operations and respond in real time to unforeseen problems. Traditionally, workers on a rig monitored their tasks using pen and paper and provided hard-copy reports to their supervisors. The SAP software helped to continually update information across functions during the drilling process, improving operational efficiency. The company reduced the amount of downtime (non-operating time due to malfunctions) and ultimately improved safety, both of which increased profitability and benefit to customers.

Pacific Drilling developed its own company management system using the highest standards (see Figure 12). The company

**Figure 10** **Dual-gradient drilling**

### The Problem: Deep Water Challenges

Conventional drilling methods have potential challenges:

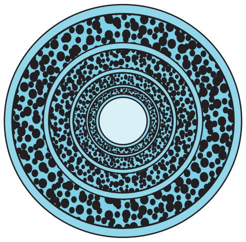
- Well control / lost circulation
- Challenging cement jobs
- Mechanical challenges with tight tolerance tools
- Restrictive completions

The industry is drilling even more difficult wells. We now routinely drill nearly 'un-drillable' wells:

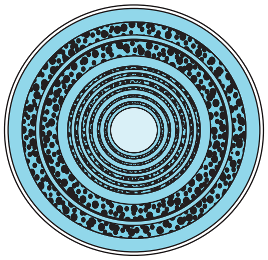
- More than 9000-metre well depth
- More than 1800-metre water depth

New floating rigs capable of drilling to 12 000-metre well depth enable the industry to attempt even more deep water projects.

Conventional Casing Program

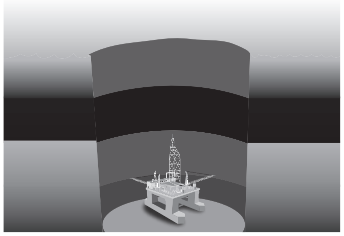


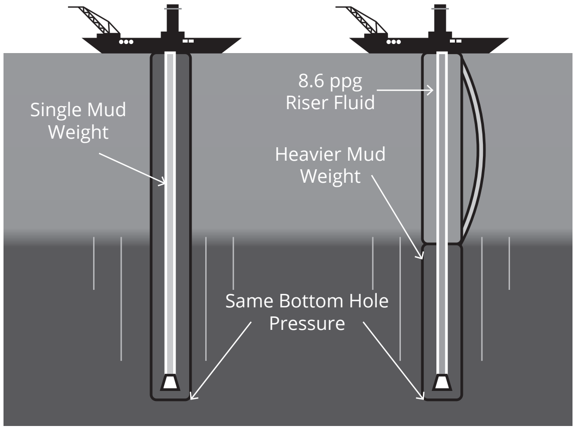
Deepwater Casing Program



### The Solution: Dual Gradient Drilling

With DGD, we literally replace the mud in the drilling riser with a seawater-density fluid and use a denser mud below the mudline to achieve the same bottom hole pressure.






Note: DGD 5 dual gradient drilling; ppg 5 pore pressure gradient
Source: Chevron, Dale Straub Presentation at the International Association of Drilling Contractors' Dual Gradient Drilling seminar, Madrid, Spain (7 April 2014).

had the advantage of being able to implement this system from the beginning, whereas most of its peers had to adapt management systems to their legacy corporate practices. The company also emphasised consistency in its processes and procedures. For example, the company went through an exhaustive exercise to develop a standardised framework for making operations and maintenance decisions related to a key piece of equipment on its rigs. When Pacific Drilling showed the framework to its clients, it was told that no other driller had made this type of effort to better manage the equipment.

**Figure 11** **Pacific Drilling growth profile**

| | First Quarter of 2011 | Fourth Quarter of 2014 |
|---|---|---|
| Number of rigs | 4 | 8 |
| Number of operating rigs | 0 | 6 |
| Number of drilling contracts | 2 | 6 |
| Contract backlog (in $ billions) | $1.5 | $2.7 |
| Number of employees | Approximately 500 | Approximately 1,600 |
| Market capitalization (in $ billions) | $2.1 | $1.0 |

Source: Company documents.

## ORGANISATIONAL CULTURE AND STRUCTURE

Pacific Drilling had set clearly defined values that provided a framework for corporate decision-making and employee behaviour. The company's core principles were cleverly embodied using the mnemonic of its name PACIFIC (see Figure 13).

To build the company's legitimacy and credibility, Beckett recruited highly experienced experts with proven track records from a variety of professional backgrounds. In doing so, he aimed to find the best solutions and processes for the start-up company. Beckett also knew that in this industry, talent and connections were key. To attract star employees, he offered promotions from their current positions, as well as the opportunity of a lifetime – helping to build a new company. Beckett also promised less organisational hierarchy, and he kept his word by creating a leaner, flatter company.

Pacific Drilling's organisational structure provided advantages through shorter communications paths, ease of collaboration and efficient decision-making (see Figure 14). For example, the marketing of rigs was traditionally done by a dedicated marketing team, which then handed over the contract to the operations department to run the rigs. However, the company encouraged its marketing and operations teams to work together with the client from the first stage of negotiation until the end of the drilling campaign, which resulted in greater consistency between what the marketing team promised and what was actually done, increasing the company's credibility and building stronger relationships with the client.

Beckett also recognised that the company needed a culture of entrepreneurship and accountability.[12] Employees were empowered to make suggestions and take ownership of processes and projects. Pacific Drilling focused on hiring employees who fit with the company's culture. Every potential employee was interviewed by three established employees. Through this process, the company selected recruits who were dedicated to performing above the average and who had enthusiasm for building a unique company. These qualities were reflected in a commitment the company made to its employees: 'Pacific Drilling is committed to be the employer of choice in the offshore drilling industry and provide the tools and resources to enable its people to deliver consistently exceptional performance'.

Given the inherently dangerous nature of the industry, Beckett and his management team consciously strived to develop a culture of safety, even at the expense of stopping drilling operations. The company implemented the Stop Work Obligation, which dictated that it was the responsibility and duty of any individual to stop any work that the employee felt had an unacceptable level of risk or other concern. This directive went beyond the traditional Stop Work Authority that was an industry practice and gave employees the right to stop work but didn't require them to do so.

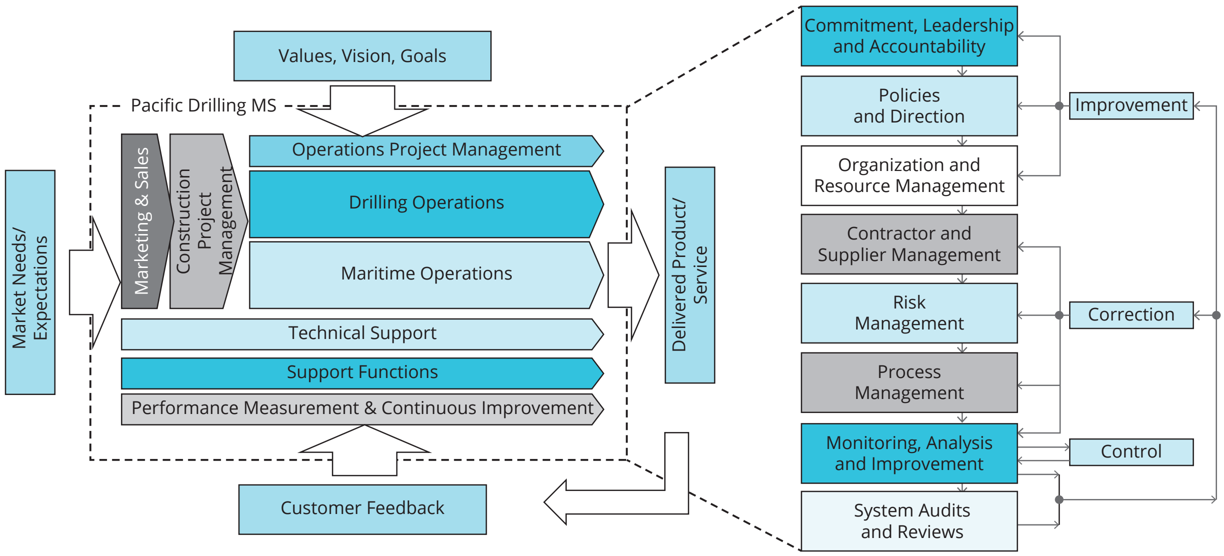
In an industry where producers valued drillers' reputation for safety, Pacific Drilling had achieved multiple years without any lost-time incidents on several rigs. Its safety performance had been recognised with an 'A' rating on the Chevron Contractor Health, Environment, and Safety Management program in the Gulf of Mexico and in Nigeria. Pacific Drilling was also the first drilling contractor to certify its safety and environmental management systems with the Center for Offshore Safety (see Figure 15).

## CHALLENGES

### Growth and customer base challenges

Beckett and his team had planned to expand the company's fleet from the current eight drillships to 12. The need to contract out these ships pushed the company to broaden its customer base beyond relying on Chevron. In this industry, producers had usually been more likely to contract drillers

**Figure 12** Pacific Drilling management system (MS)




Source: Company documents.

**Figure 13** Pacific Drilling company values

| | |
|---|---|
| **P**roactive: | Continually refining its approach to anticipate stakeholder needs |
| **A**ccountable: | Taking responsibility for actions and performance as individuals and as a company |
| **C**ustomer oriented: | Striving to exceed customer expectations |
| **I**ntegrity: | Acting honestly and fairly in all they do |
| **F**inancially responsible: | Maximising long-term value creation for shareholders |
| **I**nnovative: | Seeking creative solutions in every aspect of its business |
| **C**ommunity focused: | Ensuring a sustainable and positive impact on the communities where they work |

Source: Company documents.

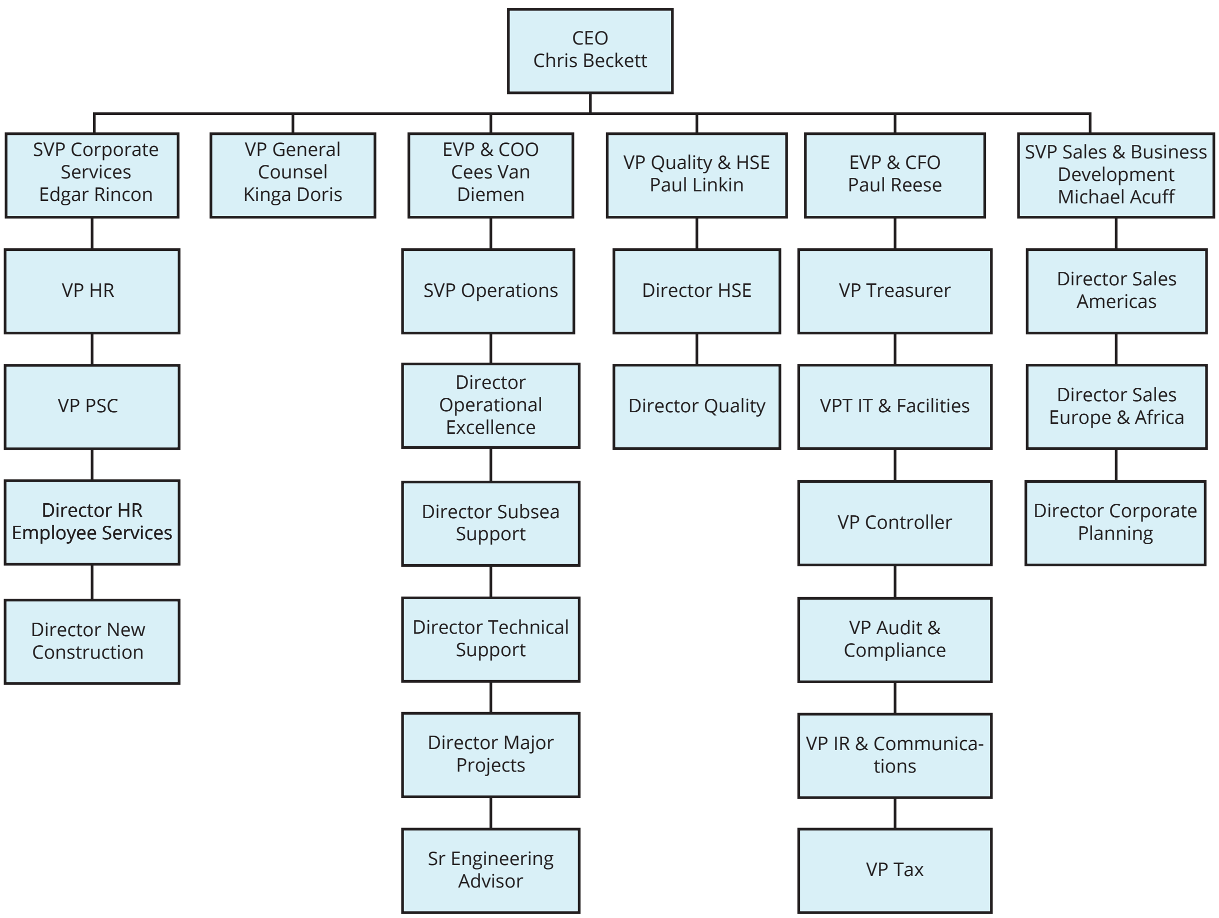
with whom they had worked before, in part because of the efficiency gained from a prior working relationship.

As Pacific Drilling sought to broaden its customer base, there was some concern that the company was tied too closely to Chevron. The technology, processes and culture that Pacific Drilling had developed were significantly influenced by the company's close collaboration with Chevron. There was a concern that efficiency would be lost, even if only temporarily, when changing to a different drilling partnership. Evidence had shown that a given producer demonstrated productivity gains in a partnership with one driller, resulting from having acquired 'relationship-specific' capabilities over the time that the two companies had worked together. However, these gains often did not translate to the same level of productivity gains in partnerships with new drillers,[13] which seemed to explain Chevron's preference to continue to contract Pacific Drilling. Chevron's support was fundamental in Pacific Drilling's success as a new entrant, but its ability to grow as a more mature company was likely to be constrained by that very same factor.

## Technology challenges

The technology advantage that Pacific Drilling had over competitors for deepwater drillships was also being

**Figure 14** **Pacific Drilling organisational chart after reorganisation in February 2015**




Note: CEO = chief executive officer; SVP = senior vice-president; VP = vice-president; EVP = executive vice-president; COO = chief operating officer; HSE = health, safety and environment; CFO = chief financial officer; HR = human resources; PSC = procurement and supply chain; IT = information technology; IR = investor relations; Sr = senior.

Source: Company documents.

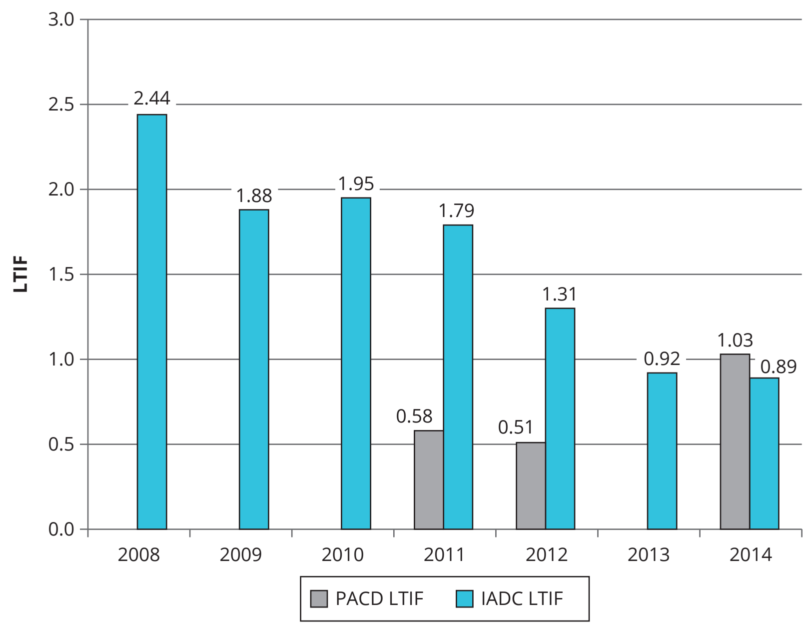
challenged as other drillers upgraded their floater fleets. Competitors' rigs scheduled for delivery in 2016 and 2017 would have incremental technological advantages over Pacific Drilling's first rig.

## Market challenges

The price of oil had been tumbling since mid-2014, while North American shale oil production had grown rapidly and global energy demand had been weakening. For offshore drillers, existing contracts that had been nearing completion had been less likely to be extended. For available rigs, competition among drillers became intense as day rates were pushed down.

Over the previous decade, the number of offshore rigs worldwide had increased from approximately 670 to 950. Although the offshore floating rig count increased from approximately 200 to 350 from 2004 to late 2014, average utilisation rates also increased over the same time period, from around 77 per cent to 86 per cent. Historically, newer rigs competed down in their day rates, causing older rigs to be stacked, either permanently or until the market recovered. Recently, though, the industry seemed to have undergone a fundamental shift. Once demand began collapsing in 2014, there was an overcapacity of deepwater rigs, and drillers struggled to find new contracts for their available rigs. The

**Figure 15** **Pacific Drilling's safety performance as of the end of 2014**




Notes:
Lost Time Incidents Frequency (LTIF) is the number of lost-time incidents per million work hours.

- International Association of Drilling Contractors (IADC) data include all land and water regions up to and including 2012.
- IADC data only include water regions where Pacific Drilling (PACD) was working in 2013 and 2014 (i.e., the United States, Africa, and South America).
- IADC data for 2014 is up to the third quarter year-to-date information only.

Key 2014 safety achievements:

- Pacific Bora achieved 3.75 years without an LTI and 1.75 years without a recordable incident.
- Pacific Scirocco achieved 3.5 years without an LTI and 1.5 years without a recordable incident.
- Pacific Khamsin achieved 1 year without an LTI and almost 1 year without a recordable incident.
- Pacific Sharav had zero LTIs since commencing contract.
- "A" rating on the Chevron Contractor Health, Environment, and Safety (HES) Management (CHESM) program in both deepwater and the Nigerian business units.

Source: Company documents.

current industry downturn and significant rig oversupply led to deepwater drillships and semis being cold-stacked for the first time in history (see Figure 16).

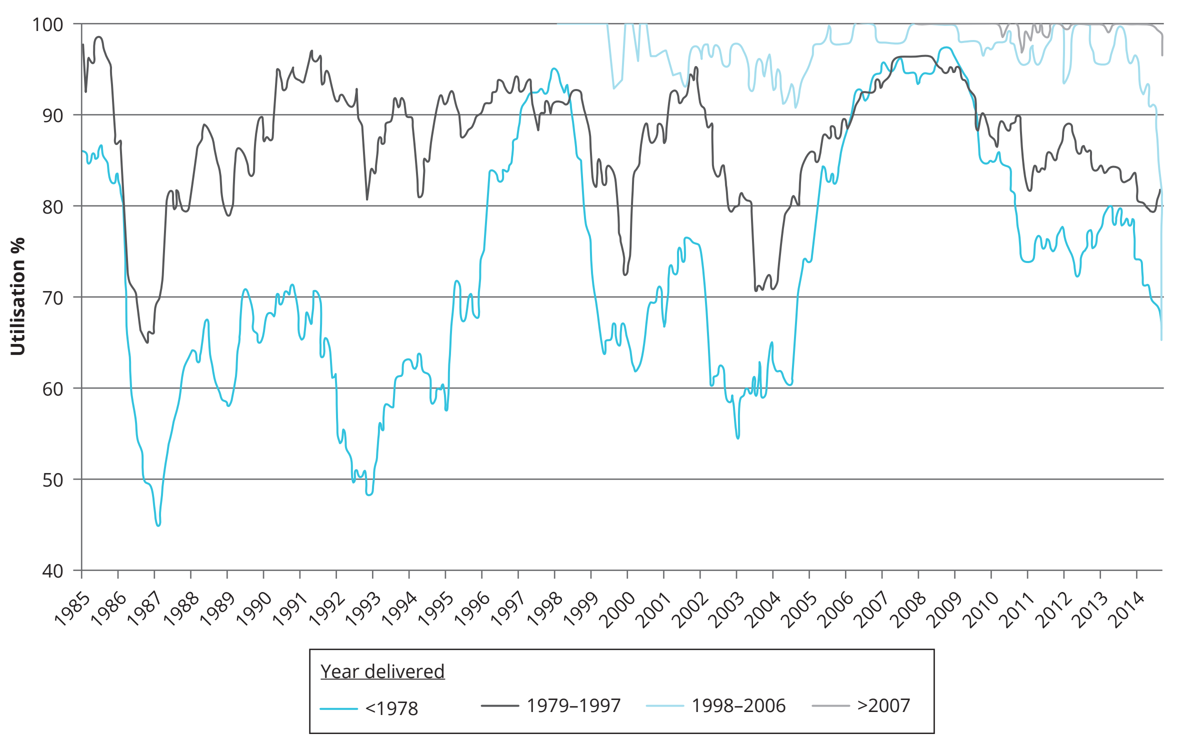
Pacific Drilling's immediate issue was to secure a contract on two of its drillships, Pacific Meltem and Pacific Mistral, that had been sitting idle. Because modern drillships had rarely been cold-stacked, keeping the crew on board was costly. The company was also concerned about two additional drillships: Pacific Khamsin, which would come off contract in late 2015, and Pacific Zonda, scheduled for delivery from the shipyard in late 2015.

## Strategic choices

Pacific Drilling had come to a critical juncture, and important decisions had to be made. As a more mature company, Pacific Drilling had been confronting a different competitive landscape. During the past year, very few new contracts had been awarded in the industry. Some of the company's peers were willing to bid significantly below market rates to win the few new jobs available. Looking forward, Pacific Drilling had a significant number of high-specification floating rigs available to be contracted. Although there had been weak demand for very high-specification rigs, there had also been relatively limited supply, which supported the company's contracting prospects.

Overcoming challenges had been nothing new for Beckett. Yet, with the challenging market environment and other constraints, Beckett made the following statement in a letter to employees: 'Despite the weakening market, we expect further growth in 2015, but we must continue to execute well on our growth plans and secure new contracts to deliver on this expectation'.

**Figure 16** **Floating rig utilisation after 1985 by build cycle**




Source: Company documents.

## NOTES

1. All currency amounts are in US$ unless otherwise specified.
2. Brad Plumer, 'Why Oil Prices Keep Falling—And Throwing the World into Turmoil,' Vox Media Inc., updated January 23, 2015, accessed April 12, 2015, www.vox.com/2014/12/16/7401705/oil-prices-falling.
3. Deutsche Bank Markets Research, 'What Is New? Key Stats & Event to Watch,' *Oilfield Services Chronicle*, June 23, 2014.
4. A derrick is a pyramid-shaped structure above the rig floor where the crown block, monkey board, and racking board are supported. Dual derricks have two drilling units on one hull.
5. Drillers usually charge oil producers on a daily work rate, which varies depending on the location, the type of rig, and the market conditions. For example, by March 2015, Pacific Drilling's average day rate was $558,000 and Diamond Offshore's rate was $450,000.
6. Ramon Casadesus-Masanell, Kenneth Corts, and Joseph McElroy, *The Offshore Drilling Industry in 2011* (Boston, MA: Harvard Business School, 2011). Available from Ivey Publishing, product no. 711543.
7. According to Casadesus-Masanell, Corts, and McElroy, moving a jack-up rig from the Gulf of Mexico to the North Sea took about a month, and mobilisation alone cost between $2 million and $5 million, exclusive of day rates.
8. As a cost-reduction step, a cold-stacked rig is often stored in a harbour, shipyard, or designated offshore area because its contracting prospects look bleak. It will be out of service for extended periods of time and may not be actively marketed.
9. Robert B. Barsky and Lutz Kilian, 'Oil and the Macroeconomy Since the 1970s,' *Journal of Economic Perspectives* 18, no. 4 (Fall, 2004): 115–134.
10. Casadesus-Masanell, Corts, and McElroy, op. cit.
11. Ernst & Young Global Limited, 'Chris Beckett, CEO of Pacific Drilling, Named EY Entrepreneur of the Year™ 2014 National Energy, Cleantech and Natural Resources Award Winner,' November 15, 2014, accessed April 12, 2015, www.ey.com/US/en/Newsroom/News-releases/News-EY-US-EOY-2014-Chris-Beckett-Pacific-Drilling-National-Energy-AwardWinner.
12. Based on information from the company's Media and Public Relations department.
13. Ryan Kellogg, 'Learning by Drilling: Interfirm Learning and Relationship Persistence in the Texas Oilpatch,' *Quarterly Journal of Economics* 126 (2011): 1961–2004.

# CASE 10

## The trivago way – growing without growing up?

**CASE LINK: This case applies concepts from Chapters 8, 11, 12 and 13.**

**HHL Leipzig Graduate School of Management** is a university-level institution and ranks among the leading international business schools. The goal of the oldest business school in German-speaking Europe is to educate effective, responsible and entrepreneurially minded leaders. HHL stands out for its excellent teaching, its clear research focus, its effective knowledge transfer into practice as well as its outstanding student services. According to the *Financial Times*, HHL ranks first in Germany and fifth globally for its entrepreneurship focus within the MSc and EMBA programs. HHL is accredited by AACSB International. http://www.hhl.de

*On the night of 16 December 2016, Rolf Schrömgens, trivago's CEO and managing director, gazed over the New York City skyline. Only a few hours previously, he and his co-founders had rung the stock market opening bell at NASDAQ and, thereby, realised the largest IPO of a German company in NASDAQ history.*

*A feeling of disbelief washed over him as he considered the incredible journey the team had taken. What had started only a decade earlier as a small, online-travel community had become the world's leading hotel meta-search engine. Each month, it linked 120 million travellers with 1.3 million hotels in 190 countries. In 2013, trivago had signed a USD 632 million deal in which travel giant Expedia acquired 61.6 per cent of trivago's shares. Since then, the organisation had continued to grow rapidly. Only two weeks prior to the IPO, trivago had released its figures for yet another record year. From 2015 to 2016, its revenue had again increased by more than 50 per cent to EUR 754 million. Moreover, in 2016, the organisation hired employee number 1200 and the fast-paced recruitment continued.*

*Now, in the silence of his hotel room, Rolf's mind turned to the question that had often preoccupied him in recent months: Would trivago be able to remain the entrepreneurial, driven company he had built and loved?*

*He thought back to the days prior to trivago's emergence. He and his co-founders had worked for large corporations that were focused on high efficiency but functioned on the basis of bureaucratic processes and rigid routines. As such, these corporations were not open to change or innovation, and Rolf and his associates felt they were not desirable places to work. Consequently, the goal of not 'becoming corporate' became a core premise for building trivago. The task had been easy when trivago was still a small start-up, but its rapid growth made preserving the company's entrepreneurial capacity an increasingly challenging task.*

### Business model

In 2016, trivago's field of business could be described as hotel-related online marketing and distribution. The organisation provided a two-sided, online meta-search platform that connected travellers seeking hotel accommodation with more than 200 booking sites and 1.3 million hotels. With 1.4 billion visits and 487 million qualified referrals[1] in 2016, trivago was the largest hotel meta-search platform in the world. What differentiated trivago's business model from that of online travel agents (OTAs) was its value proposition as an independent information provider. trivago did not sell hotel rooms. Instead, it organised large amounts of hotel-related information from multiple sources to offer the optimal basis for making a booking decision. Thus, trivago helped users convert their initial interest into a clear, specific booking intention, thereby fulfilling their personal needs.

Given the large number of hotels, even in smaller cities, finding the right place to stay could be time consuming and frustrating for travellers, who generally faced an overload of information. trivago supported accommodation seekers in this regard by providing real-time transparency regarding a large set of hotels, room availability and prices (Figure 1). Moreover, it reduced the number of booking sites a user had to visit before booking. All of trivago's services were free for the traveller.

OTAs faced the challenge of winning customers. A duopoly of industry giants – Expedia, Inc. (e.g. Expedia.com, TripAdvisor, eLong, Hotels.com) and The Priceline Group (e.g. Priceline.com, Booking.com, Agoda, Kayak) with

This case was written by Sabina Pielken, Philipp Veit, and Professor Dr Stephan Stubner, HHL Leipzig Graduate School of Management. Sabina Pielken and Philipp Veit contributed equally to this project and should be considered co-first authors.

The case is intended to be used as the basis for class discussion rather than to illustrate either the effective or ineffective handling of a management situation. Information used in this case was compiled from public sources and through primary data collection. The latter was made possible through the generous co-operation of trivago NV.

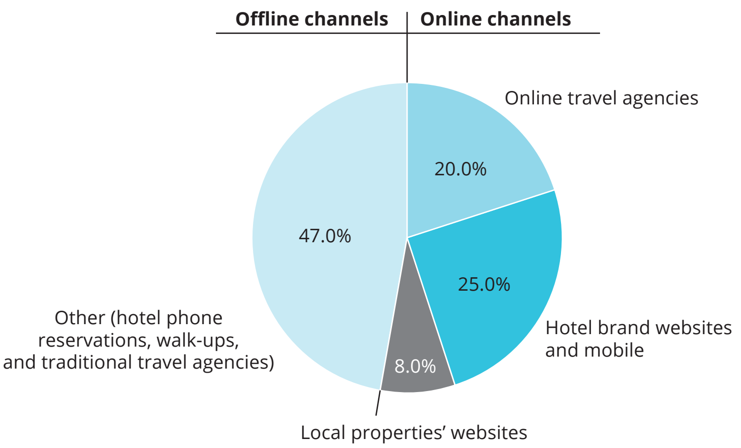
**Figure 1** **Traveller value added**


Travellers entered their desired location, room choice, date of stay and individual preferences, such as hotel rating, family friendliness and customer ranking. They then received a filtered and synthesised list of hotels from multiple sources ranked by price, popularity or distance to city centre. trivago further enriched this information through, for example, a distilled, easy-to-use rating review. After a hotel was selected, the accommodation seeker received an overview of all available booking providers and their corresponding prices. As such, trivago offered a one-stop method for researching hotels and initiating bookings.

Source: trivago earnings call, Q1 2017.

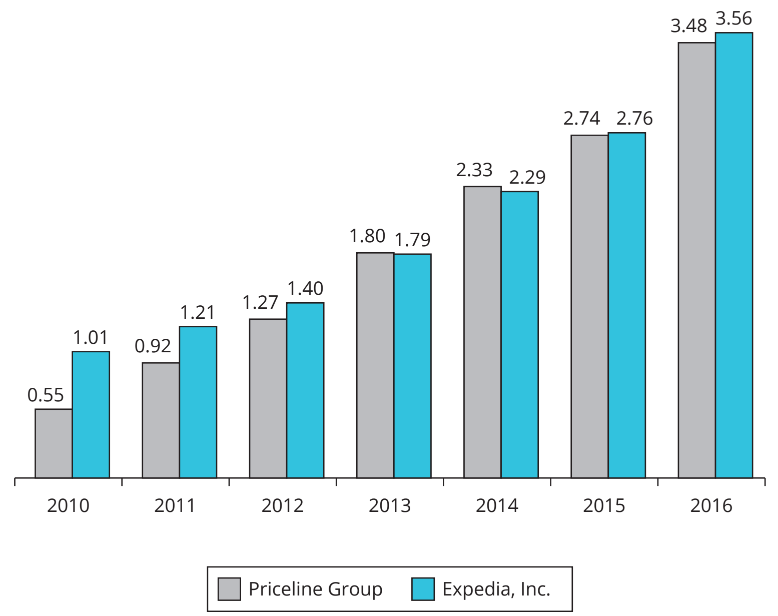
their various sub-sites – dominated online distribution. For example, 75 per cent of US online hotel bookings went through Expedia, Inc. in 2014, while 60 per cent of online bookings of European hotels in 2015 went through The Priceline Group. The OTAs competed for direct bookings with each other, offline booking providers and the hotel brands themselves (Figure 2). OTAs typically worked with hotels using a commission-based model and they received commissions of 15 to 30 per cent of the room price. As the same hotel could be booked through various travel agents and platforms, OTAs invested heavily in marketing in order to be the premier access point for room distribution (Figure 3). trivago added value to OTAs by offering them direct customer access, as well as a performance-based measurable marketing

**Figure 2** **Booking channels – market shares (2015)**




Source: Authors' illustration based on Skift (2016).

**Figure 3** **Advertisement spending – the Priceline Group versus Expedia, Inc. (USDbn)**




Note: Expedia, Inc. online advertisement spending estimated based on The Priceline Group's average online advertisement share multiplied by Expedia's total marketing expenditure.

Source: Online advertisement data for The Priceline Group as displayed by Statista (2017).

and distribution channel (Figure 4). trivago monetised its business using a cost-per-click (CPC) bidding platform (Figure 5) and a flat fee for managing premium features on hotel profiles.

## Meta-search competition

trivago faced head-on competition in its own competitive environment. By 2016, hotel meta-search had become the starting point for 30 to 50 per cent of hotel-related online searches and the area was still growing rapidly. Therefore, organisations invested heavily in building brand recognition to capture market share. trivago and its major meta-search competitors, Kayak and TripAdvisor, engaged in a constant and fierce fight to serve as the 'front gate' for the customer. One key driver of competition in these two-sided platform markets was found in cross-site network effects. In other

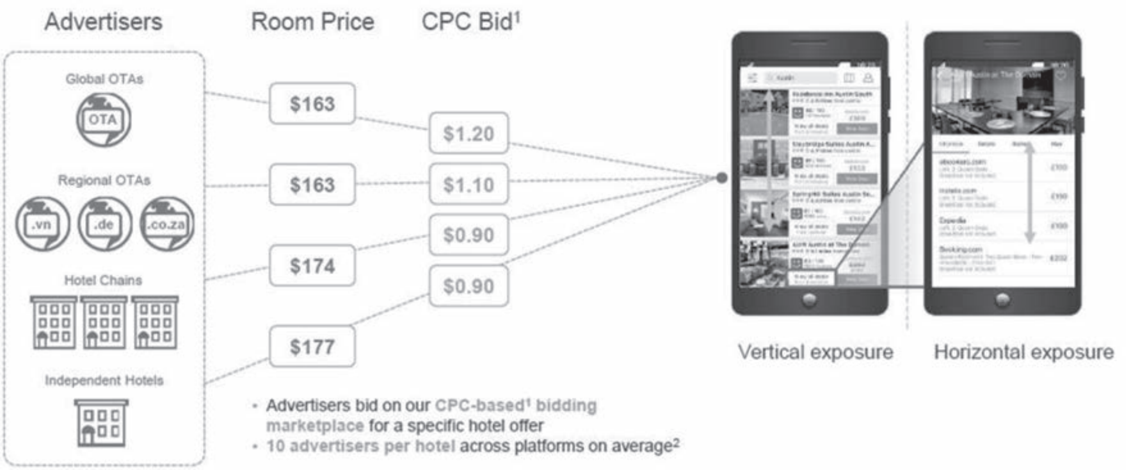
**Figure 4** **ROAS comparison, trivago versus online travel agent (OTA) (example)**

A hotel in Berlin launched a marketing campaign on trivago that referred customers directly to the hotel's own booking engine. The following results were achieved, which can be compared to those of a traditional OTA-based business.

| Trivago | | Online Travel Agent (OTA) | |
|---|---|---|---|
| **Marketing budget** | EUR 1,000/month | **Average OTA commission** | 25% on net room price |
| **Clicks** | 1,891 | **Average net room price** | EUR 120/night |
| **Bookings** | 71 | **OTA commission** | EUR 30/night |
| **Room nights** | 133 | **Room nights** | 133 |
| **Channel revenue** | EUR 15,960 | **Channel revenue** | EUR 15,960 |
| **ROAS** | (EUR 15,960/EUR 1,000) = **1596%** | **ROAS** | EUR 15,960/(EUR 30*133) = **400%** |

Source: Case authors based on hebsdigital (2013).

**Figure 5** **Overview of monetisation – CPC bidding**




CPC bidding relies on a real-time auction mechanism that allows hotels or online travel agents (OTAs) to define a maximum pay-per-click price for a visitor referral to their site. While the best price for a room will always be listed at the top, the highest bid receives a higher page ranking for a selected hotel and, therefore, better visibility. Actual CPCs are determined by the competitive forces reflected in the willingness of OTAs or hotels to match a given bid based on a pre-defined budget and maximum bidding price. OTAs and hotels can choose to let trivago automatically manage their bids to increase convenience and usability. This is particularly useful for smaller hotels. For trivago, the bidding model generates highly stable cash flows – if a bidder drops out, sales are still guaranteed through another auction participant.

Source: trivago earnings call, Q1 2017.

words, the value generated for travellers increased with the number of hotels listed on a platform, as they therefore had more freedom of choice. On the other hand, an active presence on trivago became more attractive for hotels and OTAs, as more travellers could be reached. This influenced the share of marketing budgets committed to trivago. Consequently, for trivago and its competitors, the number of users was highly significant, as higher numbers resulted in increasing returns to scale and enhanced profitability given the sites' highly scalable infrastructure.

Thus, trivago developed in a fast-paced, competitive environment where it wanted to play the leading role. Rolf stated: 'In two, three, or four years, one company in the market will dominate the top of the funnel. We want to be that player.'

## STARTING UP: 2004–2009

### The initial idea

In early 2004, Rolf provided the initial spark to what would become one of Germany's biggest start-up success stories of the early twenty-first century. He called Peter Vinnemeier and Stephan Stubner. These close friends had studied together and worked together as co-founders of ciao.com, a review-based evaluation platform for products and services from mobile phones to hotels. The three met for breakfast at Tresznjewski, a restaurant in the cultural heart of Munich. At that breakfast, Rolf pitched his business idea to his friends: creating a 'digital Wikipedia for travel' in the form of a web-based, focused community for sharing travel experiences. The website would be monetised through a CPM[2] payment model for affiliate marketing banners, which could be placed next to the focal content ranging from personal travel guides and tips to travelogues, evaluations and pictures. The idea was met with immediate approval, as Peter and Stephan were both strong believers in the power of user-generated content, a belief based on their experiences at ciao.com.

Rolf's proposal came during the golden era of online marketing. Advertisers were willing to pay a three-digit price per thousand advertising impressions (CPM) and many young organisations were entering the online-marketing field in order to take advantage of the high returns. Driven by their entrepreneurial spirit, Rolf, Peter and Stephan soon started working on the initial idea in a single-room office under a garage in Düsseldorf. Given their limited resources, they focused on bootstrapping their endeavour to build a great product that would enable them to at least pay the bills.

In June 2005, trivago GmbH was founded and the first beta version of trivago went live in Germany.

### Team and working model in the early years

In early 2006, Stephan left trivago and Malte Siewert, also a former fellow student, joined the organisation as a co-founder. Moreover, a first business-angel funding round was completed, which also provided trivago with valuable contacts and expertise. Later that year, Rolf as CMO, Peter as CTO and Malte as CFO started looking for employees to support them in their respective functions. Employees were usually hired as interns and were offered a permanent position after successfully completing an internship. By early 2007, the first interns had been permanently hired. At this early stage, everyone was still doing a bit of everything and the employees supported one another wherever possible.

Within a short period of time, the small trivago team managed to develop a passionate and dedicated working mode, which was highly result oriented and performance driven. All work pursued at trivago had to directly and measurably affect the business. The founders made important decisions together and although they did not always agree, each of them was committed to accepting the majority vote. In addition, decisions were based on analytics rather than on emotions. In order to pursue a project and allocate resources accordingly, the founders had to be convinced of sufficient 'short-term' return potential. At the same time, early employees welcomed the positive relationships among each other and with the founders, who were always accessible and open to new ideas. The founders' unrestricted accessibility was underpinned by the fact that the door to their office was almost always open. Even though the founders expected their employees to work independently on their tasks and to equip themselves with the knowledge they needed, employees were encouraged to directly approach them whenever they needed support or assistance. The founders favoured informal and constructive direct peer-to-peer communication not only among themselves but also with and among their employees. As one of the first employees stated:

> What made trivago special from the first day was the feeling of family. The founders wanted us to reach our objectives, but they also wanted us to enjoy working for trivago and being part of the team.

## Finding product–market fit

Success did not come easily. By the end of 2006, advertisers' satisfaction with their advertisements' performance on trivago's site was decreasing, as the advertisements generated too few direct bookings. The devil was in the details. For example, advertised hotels were often unrelated to the content on trivago's site. As advertisers were unable to find a solution, trivago developed a software algorithm to match hotel advertisements with site content. Moreover, as the different advertisements often featured the same hotels at different prices, trivago created a database that bundled the advertisements together, which allowed it to display different prices for the same product without showing double entries. This marked the birth of trivago's price-comparison feature. In addition to hotel advertisements, trivago experimented with a variety of other products (e.g. flights, holiday packages) and tried to license its software algorithm to generate additional revenue. Moreover, the company began to expand internationally. It was present in the United Kingdom, Spain, France, Sweden, Poland and Italy by the end of 2007.

The year 2008 was a groundbreaking one for trivago. An additional funding round, which aimed at supporting trivago's growth and internationalisation, was completed. The funds backing trivago contributed additional industry expertise and network contacts. Nevertheless, trivago's revenue was declining, and the founders felt a need to reconsider their ambitions and search for ways of securing the company's liquidity. Despite the availability of funding, the founders insisted that the business needed to quickly pay for itself. In other words, subsisting on venture capital was not an option. Therefore, during a 'legendary management offsite' meeting in 2008, Malte, Peter and Rolf pondered the company's future. Rolf described the situation:

> We had not yet understood that people were visiting our site for the price comparison, not because we were the 'travel wiki' we aimed to be. That was when we realized we were doing too many things at the same time . . . software licensing, flights . . . We realized that if we continued like that, trivago would never amount to anything.

On the basis of the organisation's strengths, the founders decided to limit their business operations to meta-search and price comparisons for hotels only. To manifest this focus, they formulated trivago's mission statement: 'to be the traveler's first and independent source of information for finding the ideal hotel at the lowest rate.' This mission statement was to guide all future business decisions. Three months later, trivago relaunched the entire website. Notably, by the end of 2008, the company had extended its market presence to Russia, Greece and the Netherlands, and it had 19 employees. At the time, more than 2.5 million visitors per month were searching 225 000 hotels around the globe.

In conjunction with the mission statement's introduction, the founders intensively discussed brand-building opportunities. One important reason for doing so was to become more independent of Google and its dominant search-market position by increasing the ratio of branded traffic. The founders knew that trivago could only be travellers' primary and independent source of information if travellers considered trivago before any other source. For this purpose, trivago needed to be a recognised brand. At the time, TV spots were the medium of choice for reaching a broad audience. Convinced of the value of TV advertising, trivago invested half of the capital it had previously collected from investors. The plan worked and trivago's advertising spots struck a chord with the German TV audience. The TV spots were a key driver of trivago's success, as reflected in the year-on-year revenue growth rate of nearly 400 per cent from 2009 to 2010.

## GROWING WITHOUT GROWING UP?: 2010–2016

### Growth numbers and office locations

In 2010, trivago took its TV presence international and aired TV campaigns in five European countries. That year, the meta-search engine could compare hotel prices from more than 100 websites. Every second person in Germany and Spain recognised the trivago brand. In fact, Spain became trivago's strongest market in 2011. Moreover, in 2011, trivago launched TV advertisements in the United States and Brazil.

The company's internationalisation, marketing activities and increasing product complexity fuelled the need for more staff. With 46 employees in 2010, trivago had already more than doubled its workforce from 2008 and, in 2011, the company welcomed employee number 100. The growing number of employees forced trivago to frequently change office locations, as capacity limits were quickly reached. Hence, in December 2011, after having changed office locations twice since its foundation, trivago moved for the third time. Its new office was located at 'Bennigsen-Platz' in Düsseldorf. In terms of interior design, trivago favoured open-space offices. The meeting rooms were individually designed and furnished, and often named after employees' hometowns. Relaxation areas, table-soccer games and a climbing wall were introduced for recreation purposes, while complimentary drinks and healthy snacks were made available in trivago's shared office kitchens. In addition, gym classes were provided free of charge.

In 2012, 315 employees already called trivago their working home. External growth also remained strong and, by the end of 2012, trivago was present in 33 markets, 13 more than at the beginning of 2010. At that time, the period of significant organisational growth was topped off with Expedia, Inc. announcing that it would buy a 61.6 per cent strategic stake in trivago, making the company the first German start-up worth more than one billion dollars. The Expedia deal did not affect trivago's appetite for growth. In the ensuing years, trivago expanded into 22 new countries across Europe, South America, Africa and Asia, adding 150 new partner websites and hotel chains to its price-comparison network. The increase in the number of hotels listed in its database from 700 000 in 2013 to more than 1 million in 2016 led to an increase in brokered hotel rooms to 1.4 billion. Even though trivago strongly insisted on a one-office policy, it opened up two innovation centres, one in Leipzig, Germany, and the other in Palma de Mallorca, Spain, in 2013. However, management insisted that new offices should only be opened if regulatory or entrepreneurial (e.g. innovations apart from the core product) interests justified it. Moreover, the new offices were kept as small as possible, as the Düsseldorf office was to always be 'home' to at least 90 per cent of trivago's employees. By 2014, trivago had become the world's leading hotel meta-search company. The trivago growth engine was further fuelled by the skyrocketing employee numbers, which rose from 571 in 2013 to more than 1200 in 2016.

The increasing number of employees soon started to challenge the 'Bennigsen-Platz' office's capacity. New office space was continuously added by spreading employees across multiple floors and, later, to surrounding buildings. During this time, however, the top management team was alarmed by the increasing physical distance among employees. The founders feared that it could lead to communication challenges, social detachment and empire building, which could negatively affect day-to-day cooperation, trust building and information exchange. Slower working and learning processes were the dreaded, potential consequences. Therefore, in early 2016, trivago announced that it had commissioned the construction of a trivago campus in Düsseldorf, where all employees would be reunited in 2018.

### Workforce characteristics

Members of trivago's workforce shared many characteristics from the beginning. For example, most of the employees were young, and they came from diverse cultural and educational backgrounds. The hiring of international talents was seen as particularly advantageous. As one employee outlined:

> We always looked to recruit talented people from around the world who are still in the early stages of their careers and reflective. We need pragmatic people with an agile mindset and a willingness to continue learning.

The fact that these employees were willing to leave their home countries and move to Düsseldorf implied that they were adventurous, willing to take risks and able to adapt to a new environment. Moreover, as many new employees were new to Düsseldorf without social contacts outside the organisation, employees often quickly developed friendships, which contributed to trivago's team spirit. These features were all greatly appreciated in the entrepreneurial environment of trivago. In contrast, more experienced employees who had been socialised in corporations were often seen as difficult to integrate, as they were frequently already shaped by organisational cultures that promoted rigidity, less openness to new ideas and strong career aspirations.

Despite trivago's established practice of hiring young professionals who did not have extensive experience with other companies and the fact that the company generally wanted to promote internally, hiring some experienced personnel was unavoidable from a skills perspective. Certain external hires were seen as vital, as trivago's size required increasingly advanced management and leadership capabilities. Moreover, these professionals were expected to be able to bring in new managerial impulses for professionalising the organisation without making trivago 'corporate' in its working style. In 2015, the top management team was expanded beyond the group of founders. Andrej Lehnert and Johannes Thomas were promoted from within trivago to become managing directors. Both had been with trivago since 2011. Moreover, Axel Hefer left the German online furniture retailer Home 24 AG, where he had served as COO and CFO, to join trivago in 2016. Like the three founders, Axel had studied at HHL Leipzig Graduate School of Management. Initially, Axel led the Country Development department, but he was soon promoted to the top management team.

By the end of 2016, the top management team's competencies were distributed as follows: Axel was CFO and the managing director for finance, legal and international; Andrej was the managing director for marketing and business intelligence; Johannes was the managing director for advertiser relations, business operations and strategy; Malte was the managing director for trivago's marketplace-related business; Peter was the managing director for technology; and Rolf was CEO, and responsible for products, people and culture.

## Organisational structure

In 2010, departments and teams began to evolve on an as-needed basis. While departments were expected to function with a high degree of freedom, an increasingly specialised range of tasks required more cross-team coordination. Compared to the early years in which each employee covered a broad range of issues, job profiles became particularised and, therefore, changed significantly. Hierarchies and clearer responsibilities began to emerge within each department and team. In terms of leadership structure, the chain at trivago was basically as follows: managing directors were responsible for department leads, department leads were responsible for their team leads, and team leads were responsible for their team members. Moreover, a basic matrix structure evolved in which country-development teams were supported by functional teams active in, for example, marketing, technology, finance and human resources (HR).

However, the founders were wary of formal management and control structures, which they felt could limit subsidiarity and compromise decision speed across the organisation. They feared that increasingly specialised tasks could lead to silo-based thinking, and that evolving hierarchical structures could give rise to status asymmetries in which individuals perceived discrimination in the supply of information and the degree of decision autonomy depending on their hierarchical status. To counter the emergence of such asymmetries, the founders tried to nurture an 'absence of ego' mentality. They believed that such a mentality was vital for the success of a knowledge-driven business in which the accessibility and flow of information and data formed the basis of competitiveness. One step towards an 'absence of ego' mentality was the founders' official announcement that trivago would remain a company without job titles. As one employee explained:

> At trivago, it is important to respect others' knowledge and inspiration, not their titles. Decision processes should not be slowed down because an individual feels a need to get approval from various levels. Instead, the individual should be empowered to make his or her own decisions and work independently.

The official statement from top management seemed necessary, as employees had started to create titles on their own. One employee described this period: 'It was a bit weird . . . We had interns calling themselves "Senior Vice-President", while their team leads did not have titles themselves,' The employees' reaction to the abolishment of titles took the form of a series of questions: 'If we do not have titles, how do I emphasise the expectations linked to my position?', 'How am I supposed to lead?' and 'How am I supposed to be led?'

To strike a balance between the title-free environment and the clear role expectations, a self-developed categorisation pattern called 'Responsibility Scope' was introduced in the early 2010s. This scope was expressed in a three-stage system: developers, executors and supporters. Supporters were expected to be temporary, topic-specific project leaders whose work was guided by daily or multiple meetings during the week. Executors were to take on managerial responsibility for their own divisions, and their work focused on goals and their attainment. trivago considered the role expectations for supporters and executors as similarly to be found in other companies, while it viewed the developer role as more unique. Developers were expected to act as entrepreneurs within the company, resulting in small and fast 'organisations-within-the-organisation with the aim of keeping trivago adaptable. Rolf explained:

> Developers are expected to be independent players inside the organization who think of the company as their own. They are granted entrepreneurial freedom, they are motivated, and they are led by inspiration and only sporadic meetings. Developers need to be self-reflective to such a point that they abandon their position if it is no longer meaningful to the company.

## Company values and purpose

After surpassing 150 employees in 2012, trivago's management started to sense growing anonymity. It became increasingly difficult to remember everyone's name and personal communication became more complex. This development alarmed the founders, as it could dilute the highly cherished start-up spirit. In 2013, therefore, the company hired a dedicated employee to take over the function of 'Strategy & Organization', which had formerly been handled by Rolf. The department's purpose was to ensure that trivago would not be driven by bureaucracy or politics. The newcomer's first task was to create a formalised description of the values inherent in trivago's culture. For this purpose, in-depth interviews were conducted with trivago employees, especially those hired in the early days. Furthermore, employees were asked to participate in a company survey and describe what trivago meant to them. The survey and interview results were aggregated and then discussed in an open meeting with interested developers. This enabled the identification and formulation of six core values: trust, authenticity, entrepreneurial passion, power of proof, unwavering focus and fanatic learning (Figure 6). Employees who had been with trivago since the early days did not view these values as something new. Instead, the core-value list was a written representation of what had been always felt and lived at trivago. To stress the overall importance of trivago's values and foster their internalisation, they were prominently communicated both within and outside the organisation. In addition to displaying the values on office walls and on the website, the values were discussed with all employees holding leadership responsibility, as trivago believed that living the values was only possible if these employees served as role models in this regard.

In 2016, trivago introduced its purpose statement: 'empower to get more out of life'. This message was designed to emphasise the feeling that each trivago employee and the company as a whole should strive for and to clarify the company's purpose. When reflecting on the purpose statement, Rolf stated:

> We put a lot of thought into the development of that statement. In essence, 'empower' means creating a basis from which an individual can be successful – a basis from which he or she can get more out of life. 'To get more out of life' represents personal learning and growth. It is an individualistic, non-competitive approach that focuses on continuous personal development. This purpose also represents the founding team's motivation for establishing trivago – freedom and personal development.

## Management style and planning

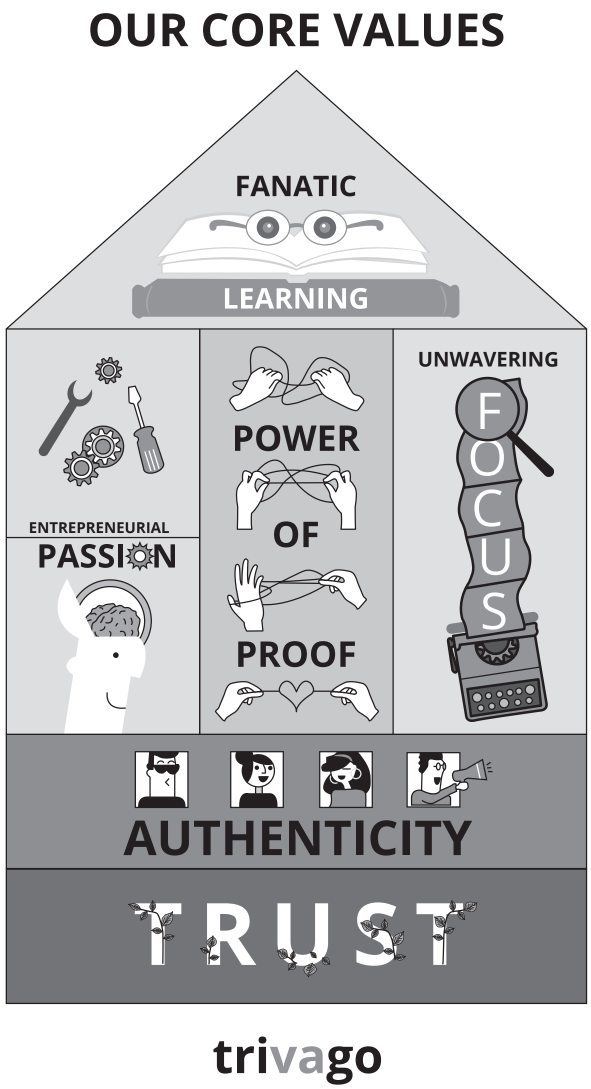
Instead of resting on their laurels after the Expedia deal in March 2013, the founders were still driven to continually improve trivago as a product and as a company. Every employee would soon know their mantra: 'never great, never wise, never done'. Expedia had contractually agreed to a hands-off approach, which was an important requirement for the founders. Therefore, trivago continued to operate independently and its founders remained in place.

Trivago continued to finance its expansion solely through its own profits, such that it operated on a break-even basis. As in the early trivago days, decisions regarding investments in new initiatives and growth were based on an analytical trial-and-error principle: initiatives needed to be analytically sound and the potential for short-term revenue had to be visible. Initiatives were then run through a test phase to obtain proof-of-concept data. Therefore, decisions were data-driven whenever possible. If initiatives did not work out as planned, their initiators could either make justifiable improvements or stop the projects. Employees, regardless of their position, were expected to constantly challenge whether a task or activity made sense. Whenever certain tasks or activities were proven to add no value, employees were expected to either adapt or terminate them. In this context, failure was always seen as an opportunity to learn. As one developer stated: 'You need to be willing to pay for knowledge.'

In 2015, to emphasise trivago's 'absence of ego' mentality and to decrease the perceived distance between employees and the managing team, the managing directors moved out of their shared office and spread their work stations across the open-space office areas, where they could mingle with their respective teams. The former management office room, named 'Leipzig' in honour of the place where the founders first met, was then used for weekly management meetings.

In 2015, trivago also introduced a yearly Management Workshop and a Strategy Summit. During the Management Workshop, managing directors developed the company's

**Figure 6** Trivago's core values




- Trust: We want to build an environment in which mutual trust can develop that gives employees the confidence to discuss matters openly and act freely.
- Authenticity: We aim to be authentic and appreciate constructive and straight feedback.
- Entrepreneurial passion: We believe that entrepreneurial passion drives us forward to continuously try out new and improved ways of thinking and doing.
- Power of proof: We believe that data, used correctly, can lead to empirical, proof-based decisionmaking across the organization.
- Focus: We focus our energy on our mission of being the traveler's first and independent source of information for finding the ideal hotel at the lowest rate. This mission drives where we spend our time and focus. We believe that multiple small, incremental improvements toward this goal add up to long-term success.
- Learning: We never stand still and choose to remain open minded and inquisitive. We try new ideas and continue to challenge received wisdom.

Source: Image – trivago (2017), text – trivago IPO prospectus (2016).

overall strategic priorities for the upcoming year. Those priorities were then presented and discussed in a subsequent Strategy Summit attended by the developers. Generally, these strategic priorities were expected to support trivago's mission as formulated in 2008 and to be compatible with trivago's core values. Moreover, based on a critical review of the previous year, they included ideas for adjustments necessary to achieve the mission. Finally, strategic priorities were to be viewed as guiding lights rather than fixed goals. Eventually, the tasks related to these strategic priorities were not delegated from top down. Instead, the teams developed their own missions and strategic priorities based on the overall strategic guiding lights, trivago's mission statement and trivago's values. As Rolf stated: 'At trivago, we emphasize the need to convince, not command, people. Therefore, we do not enforce strategic initiatives from the top down.' This need to convince instead of command was also reflected in how meetings were conducted. Employees were granted freedom to only attend meetings if they individually perceived them as value-adding.

## Systems and processes

### Recruiting

The need to increase the number of employees amplified the recruitment efforts required from each department. In order to let each department concentrate on its core tasks, an HR department was established in early 2010. HR began to introduce a centralised recruiting process that same year. Ideas for systematising job advertisements and the application process were developed by HR in 2011, and a system was introduced in the following year. In 2014, a joint 'Talents and Organisation' (TO) team, the result of the consolidation of HR and the 'Strategy & Organisation' department, was established to focus recruiting, developing and retaining talent, as well as the best ways of sharing the trivago identity in a rapid-growth environment. The department was also charged with anticipating needed changes in trivago's organisational design and introducing value-conforming measures. The aim was to ensure that the growing organisation would still function and that it would not 'become corporate.' In the year of its formation, TO introduced a structured, week-long, onboarding process. On their first day, new employees ran through an extensive process aimed at ensuring that everyone understood the trivago values and why they were vital for the organisation. The new employees also familiarised themselves with the challenges of different departments through practical case studies designed to help them understand the various roles and responsibilities. One of the managing directors took the time to welcome each new group of employees and to personally explain what trivago represented. TO also introduced a structured offboarding process aiming at understanding why employees left the company and where improvements could be made.

In 2014, more than 260 people were hired, while the number of applications exceeded 45 000. While trivago had no rigid recruitment criteria, cultural fit with the company was key, especially as the need for experienced staff with specialised functional expertise increased with continuing professionalisation. As one developer stated:

> If you are someone who needs clear direction – for this problem I go to 'A' and for another problem I go to 'B,' you will not be happy here. Here at trivago, you always need to find new approaches and figure out who can help you yourself. Also, we do not have a hierarchy of communication – you can approach anyone who might be of help.

Therefore, the right traits, which were labelled as 'trivago skills' (e.g. intrinsic motivation, positivity, trust in others) and 'universal skills' (e.g. taking ownership, welcoming of change, determination) were viewed as crucial for trivago employees.

### Performance evaluations, rewards and employee development

Given the continued growth in employee numbers and departments, trivago introduced additional measures to reduce the risk of status asymmetries and strengthen the entrepreneurial core. In 2012, HR introduced a customised 360-degree feedback tool. Initially an Excel document, the tool developed over the years into a professional in-house peer-evaluation software that was constantly adapted. As of 2014, the 'trivago 360' reflected the six trivago values and the universal skills, which served as the basis for evaluations of employees' individual job performance (Figure 7). Twice each year, every employee had to be provided with feedback by the person to whom he or she reported. The content of that feedback was based on input from the employee's direct peers. The aim in this regard was to enable a fair, unbiased feedback process and to reduce employees' dependence on the people to whom they reported. Instead of appearing as superiors, employees with leadership responsibility were encouraged to function as mentors. Prior to the introduction of the 'trivago 360' tool, no mandatory, standardised feedback mode existed. If an employee received feedback, it usually solely reflected the evaluation of the person responsible for him or her.

Trivago established and openly communicated its philosophy of trust-based working hours and vacation days. The company's employees had neither a fixed number of working hours nor any limitations on the number of vacation days. This philosophy was mainly attributable to the founders' conviction that how much someone worked was not an appropriate measure of performance. As long as results were achieved on time and with the expected level of quality, the amount of time invested in a certain task did not matter.

To keep employees motivated and aligned, trivago further professionalised its incentives in 2015. One step was the introduction of a structured 'Salary Review Process,' which was intended to align compensation levels and remove differences among departments. The process itself was linked to the trivago values via the 360-degree feedback tool. The aim was to incentivise value-conforming behaviour in order to foster the living of the trivago spirit and to move authority over compensation into the hands of the group. Furthermore, two types of ad-hoc bonuses were introduced in 2016. Executives with direct leadership responsibility could grant an instant bonus to reward exceptional efforts

**Figure 7** **360-degree feedback criteria**

**Trivago – value contribution and trivago skills**

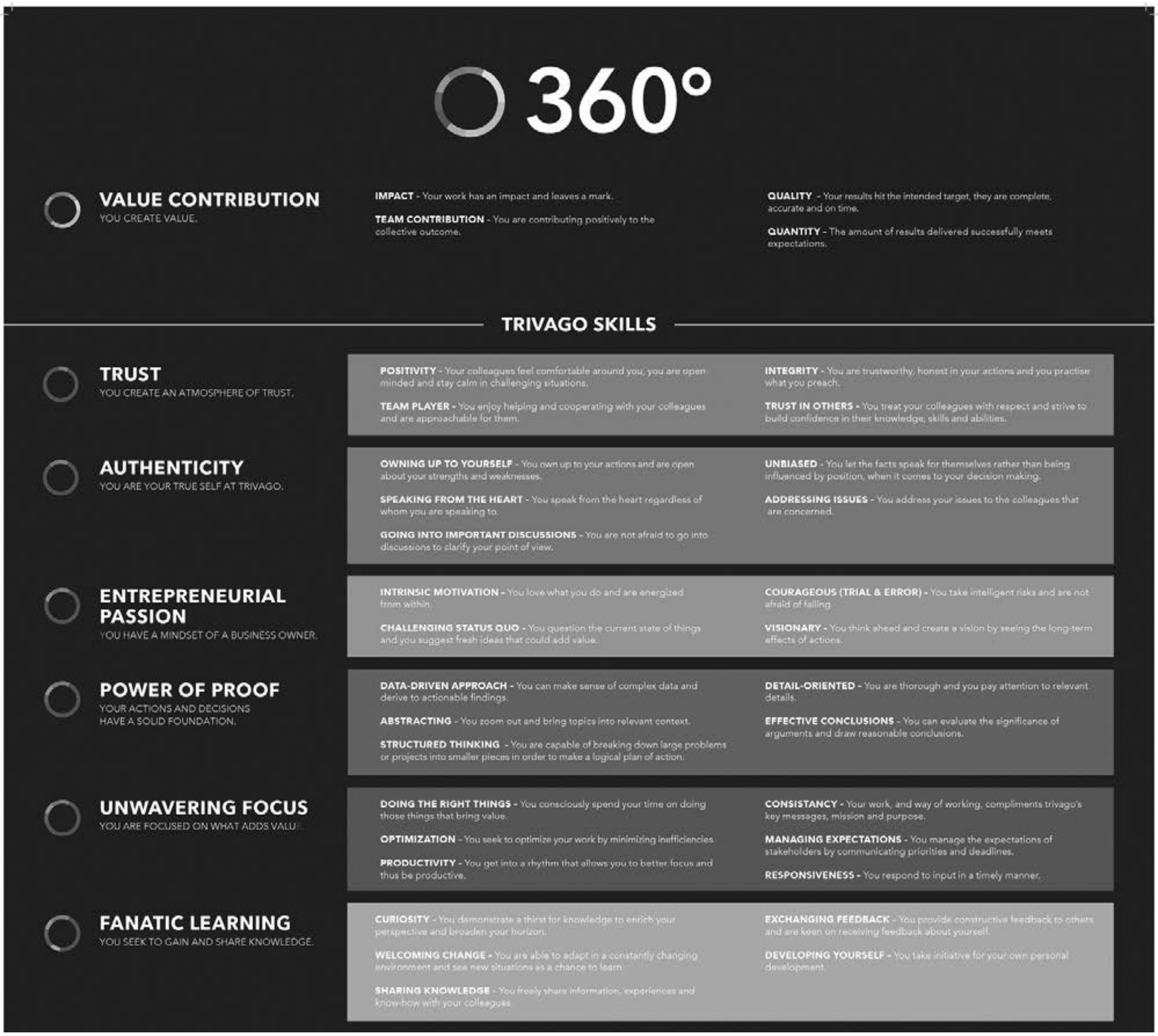
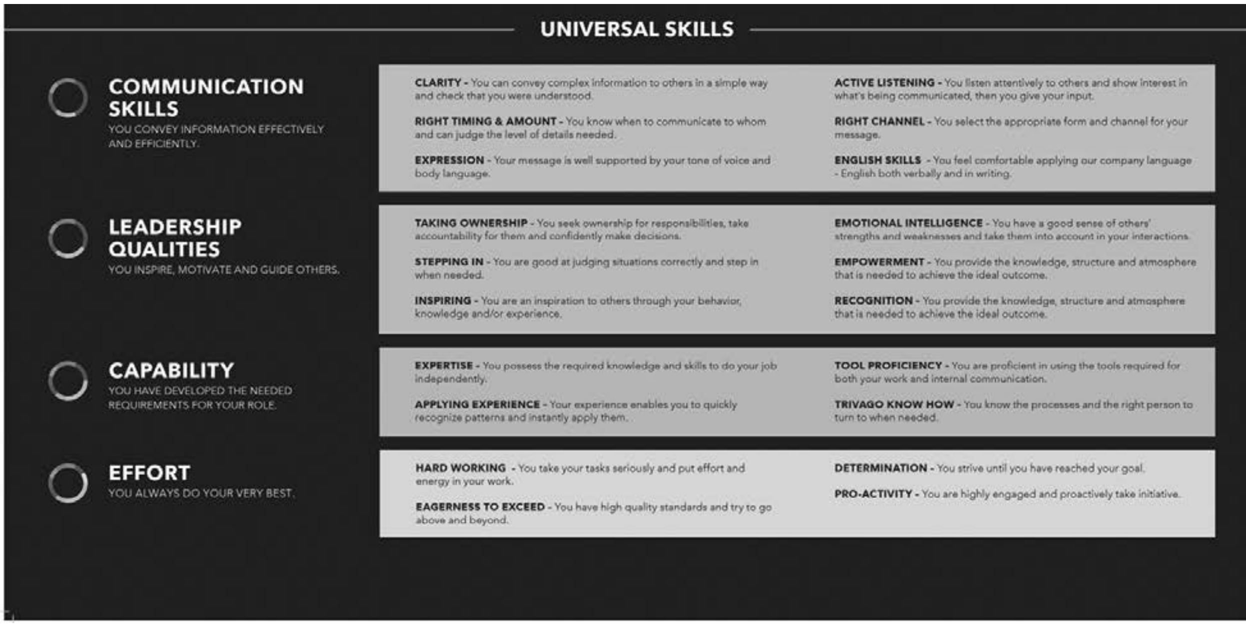


**Figure 7** 360-degree feedback criteria (*continued*)

**Trivago – universal skills**




Source: trivago (2017); the original trivago 360-degree feedback poster has been graphically adapted for the sake of readability.

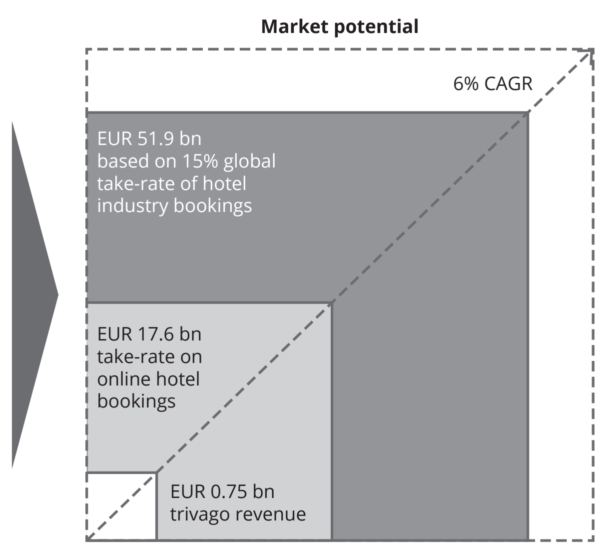
**Figure 8** Online hotel market – KPIs, size and potential

**$415 bn** Large global hotel bookings market

**33%** Low online penetration

**10.8%** High online hotel bookings growth

**56%** Highly fragmented market




Source: trivago earnings call, Q1 2017.

that went well beyond expectations. Such rewards were designed to support employees' intrinsic motivations and replace variable salary components, which were seen as extrinsic motivators. Extrinsic motivators, in turn, were not viewed as appropriate tools for motivating people in the long term. Moreover, each employee received a monthly bonus allowance with which to reward co-workers. As Rolf explained:

> I believe that the era of managing systems based on extrinsically motivating people is over. The idea that people do not want to work is outdated. In a knowledge-worker environment, you cannot really control people anyway. Therefore, the only viable option is to make sure people are intrinsically motivated to achieve something.

In 2015, TO introduced a management-development training program in response to trivago's preference for internal promotion. With an average employee age of around 28 and the company rapidly growing, many executives with leadership responsibility had to quickly adapt to their new responsibilities. Although trivago viewed personal development as a 'pull responsibility' (e.g. it would pay for self-selected seminars if the need was reasonably justified), the company offered its own 'trivago Academy', which covered a variety of topics chosen to inspire employees and broaden their thinking. As one developer accentuated: 'You can find the knowledge you need somewhere in the company, but we expect you to equip yourself with what you need!

### Communication

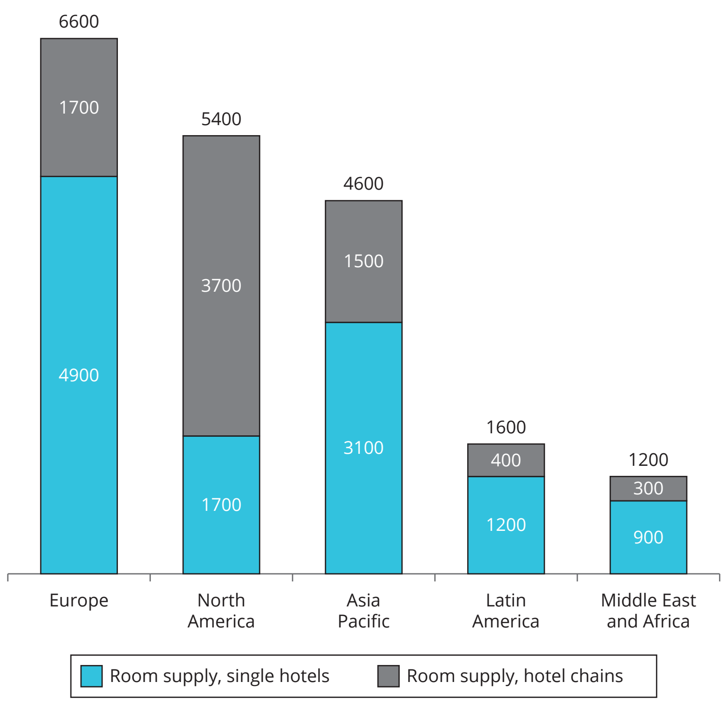
The increasing specialisation and rising headcount affected decision speed. One developer responsible for multiple country teams discussed this issue:

> One of the greatest issues I am fighting against is the fact that we are getting slow in all departments. That seems to come naturally with size . . . We can decide to do something, but when I ask about it later, nothing has happened because people are waiting for a meeting or someone is on vacation. Now there are too many people involved, which was never an issue in the past.

Similarly, communication flows started to slow. One department lead described this problem:

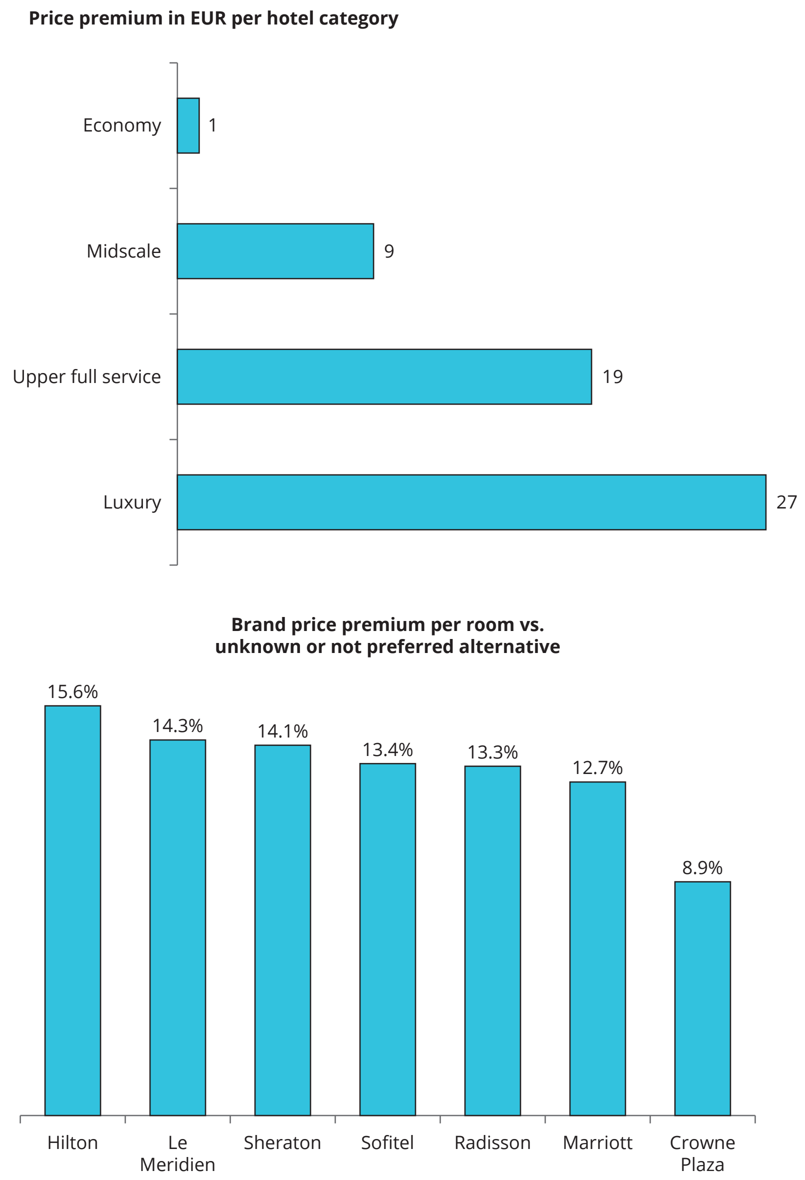
> In the old days, I knew who was doing what and could just walk over there if I needed something . . . Today I sometimes do not even know where to go! This is why we need to continuously strive to also professionalize the way we keep our culture alive.

**Figure 9** **Hotel market fragmentation – hotel chains versus single hotel room supply, 2014 ('000)**




Source: Adapted from ESSEC, Graf (2016) based on STR Global (2014).

**Figure 10** **Price premium, branded hotels, 2015**




Source: Hotel News Now based on BDRC Continental (2015).

To keep direct communication flowing and avoid information silos, trivago implemented a set of communication and coordination tools. One was known as 'trivago talk', a kind of internal social-media application. It was introduced to allow for the sharing of company information and easier identification of peers. The tool was centred around work-related topics, such as announcements of new team members, discussions of technical issues and invitations to joint leisure activities, such as soccer training. 'trivago knowledge', a company wiki, was developed to consolidate information on all departments, teams, and current and past projects and initiatives. 'Slack', an instant messaging tool for teams, was introduced in 2015 to ensure day-to-day communication and increase communication efficiency. Finally, 'trivago task' was introduced to allow for jobs to be assigned to service functions, such as requests for new mail accounts.

Given its awareness of the potential for silo thinking, inertia and stereotyping in daily work routines, and its desire to strengthen the sense of community and transparent

**Figure 11** **Hotel room distribution – background information.**

Demand for hotel rooms is often seasonal and price elastic. In most regions, guests stay an average of two nights. As a result, hoteliers face short sales cycles and intense pressure to distribute rooms. Effective room distribution is crucial, as stable occupancy rates have a significant leverage effect on profitability due to a high share of fixed costs for personnel and maintenance. In addition, distribution channels for hotel rooms consist of several disintegrated legacy technology platforms, such as pre-internet central reservations systems (CRS), global distribution systems (GDS), telephone booking systems and other offline sales platforms. Online channels consist of online travel agents (OTAs), the hotels' own booking engines and meta-search sites. In general, channels differ in terms of technical complexity, margins and average booking terms (e.g. last-minute versus well in advance), but can all contribute significant revenue? Therefore, hotels face pressure to simultaneously manage multiple channels using distinct IT systems.

Source: Case authors.

communication, trivago organised four events for the entire company on a yearly basis: a Christmas party (introduced in 2007), a trivago Update Meeting in the spring (introduced in 2008), a company trip (introduced in 2010) and a summer party (introduced in 2015). The Update Meeting began with the managing directors presenting the organisation's strategic priorities for the year and ended with a party. The trivago trip was a four-day trip designed as a cross-departmental bonding tool. The trip focused on fun activities that were oriented towards connecting people across departments. Each team was also encouraged to regularly organise its own events, such as bowling or team dinners. For this purpose, an event budget of EUR 30 per team member was available monthly. Twice each year, this monthly budget was used for events at which participating members of all teams were mixed randomly.

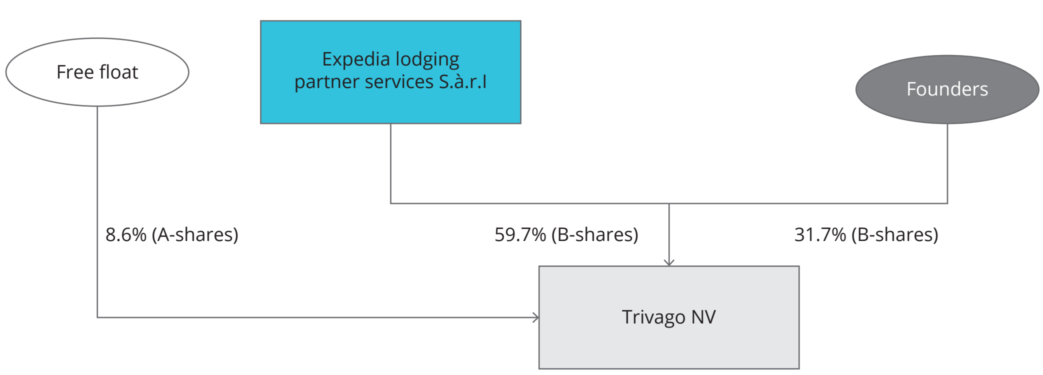
In 2014, TO introduced a yearly company-wide survey that asked each staff member to identify company strengths and areas in need of improvement. The TO team was in continuous dialogue with all departments in order to be close to the needs of employees and anticipate changing company needs. As one HR consultant outlined: 'It is part of my job to have my ears to the ground, as our employees know what needs to be done.' Many TO projects resulted from trivago's bottom-up approach to employee involvement and communication. As one TO team member stated:

> We constantly need to ask ourselves and others whether a standardized tool or process is really the best way to solve a certain issue. When implementing projects, we must convince people, which requires continuous communication and explanations.

Whenever possible, new tools and suggestions for processes were tested in one or two departments. This was seen as

**Figure 12** **Planned post-IPO shareholder structure, 2016 – trivago NV**

Ownership interests, trivago




Share classes

A-shares = Economic interests

B-shares = Voting interests

Source: trivago IPO prospectus (2016).

**Figure 13 Supervisory board members**

The following people were members of trivago's Supervisory Board as of January 2017.

| Name | Age |
|---|---|
| *Supervisory Board members* | |
| Mieke S. De Schepper | 41 |
| Peter M. Kern | 49 |
| Dara Khosrowshahi | 47 |
| Frédéric Mazzella | 40 |
| Mark D. Okerstrom | 43 |
| Niklas Östberg | 36 |
| David Schneider | 34 |

Pursuant to the Amended and Restated Shareholders' Agreement, Mrs. De Schepper, Mr. Kern, Mr. Khosrowshahi, and Mr. Okerstrom were selected to serve as Supervisory Board members by Expedia. Mr. Mazzella, Mr. Östberg, and Mr. Schneider were selected to serve as Supervisory Board members by the founders.

Source: Table – trivago company website (2017), text – based on trivago IPO prospectus (2016).

important, as TO would only proceed with a company-wide rollout if the testing department fully backed the project and was willing to publicly support it based on the perceived benefits. Even then, TO typically produced tools that could still be declined by individual departments and teams. One developer said: 'If I do not see the value in something that has been proposed, I just do not do it. Nobody has ever tried to argue with me about it.'

Another opportunity for feedback and discussion initiated in 2015 and coordinated by TO were 'trivago Fridays'. These events were regular Q&A panels that were dedicated to particular company topics. Prior to each panel, all employees could hand in and vote for questions to be discussed at the panel. At least one managing director took part in each trivago Friday and was available for questions.

The focus on establishing outlets for information exchange not only aimed to strengthen informal and socially grounded relationships, but also to allow for direct communication and feedback across the entire organisation, independent of responsibilities and role expectations.

## TRIVAGO'S IPO: NOT THE END BUT THE BEGINNING

Towards the end of 2016, trivago announced its plan to go public and to do so quickly. When addressing potential investors, Rolf stated: 'You will be investing in a company with an amazing culture with so much focus on learning that, regardless of what happens in the future, we will always be able to adapt.' In this vein, trivago's CFO clarified the company's growth ambitions.

> In our business, there is a trade-off between growth and profitability. However, from our perspective, it would not be a good idea to aggressively improve profitability while sacrificing growth. This is because our growth, as such, is more than a revenue figure.

On 16 December 2016, Rolf, Peter, Malte and Axel rang the NASDAQ stock market opening bell. The room was filled with trivago employees, all of whom represented the group effort that had made trivago's success possible. At trivago, the IPO was seen not as the end but as the beginning of a new chapter in trivago's path to continued growth. For additional information see Figures 8–14.

> When Rolf's mind again turned to the many people who made trivago the organisation it had become, he felt a sense of renewed energy. He stopped pondering and focused on the challenge ahead – the need to 'stay entrepreneurial' and avoid 'becoming corporate' in order to secure future growth and success.

**Figure 14 Shareholders' agreement – background information**

*'The Amended and Restated Shareholders' Agreement contains certain provisions that could result in the departure of certain of our senior management. If the Founders, collectively, hold less than 15% of our outstanding Class A shares and Class B shares (calculated as if all securities convertible, exercisable or exchangeable for Class A shares or Class B shares had been converted, exercised or exchanged), they lose certain contractual rights to nominate members of our management board. In such case, our supervisory board may also request from the Founders, the resignation of members of the supervisory board who have been nominated by the Founders. In addition, the general meeting of shareholders, which is controlled by Expedia, has broad discretion to remove members of our management board with and without cause, irrespective of the Founders' holdings. If the general meeting of shareholders has reasonable cause, as defined in the Amended and Restated Shareholders' Agreement, for such removal, Expedia has the unilateral right, subject to certain exceptions, to purchase all of such members' shares.'*

Source: Trivago IPO prospectus (2016).

## NOTES

1. Qualified referral: a unique visitor who clicks on at least one referral to a booking page. For example, if a single visitor clicks on multiple hotel offers in trivago's search results in a given day, they count as multiple referrals, but as only one qualified referral.
2. CPM: cost-per-mille ad-impressions. In banner marketing, one view equals one impression.

# CASE 11

## The Volkswagen emissions scandal

CASE LINK: This case applies concepts from Chapters 1, 10 and 12.

In October 2015, Mathias Müller became CEO of Volkswagen (VW), the 78-year-old economic jewel of Germany. His predecessor, Martin Winterkorn, who had led VW for eight years, had resigned suddenly in the midst of one of the biggest scandals to ever hit VW and the auto industry. In September, VW had admitted to United States regulators that it had deliberately installed 'defeat devices' in many of its diesel cars, which enabled the cars to cheat on federal and state emissions tests, making them able to pass the tests and hit ambitious mileage and performance targets while actually emitting up to 40 times more hazardous gases into the atmosphere than legally allowed. The discovery had prompted the US Environmental Protection Agency (EPA) to halt final certification of VW's 2016 diesel models, and VW itself had halted sales of its 2015 models. As fallout from the defeat devices developed, VW posted its first quarterly loss in more than 15 years, and its stock plummeted. Winterkorn and several other top executives were replaced, and VW abandoned its goal of becoming the world's largest automaker. In addition to significant financial implications, VW was rapidly losing its prized reputation as a trustworthy company capable of outstanding engineering feats.

### VOLKSWAGEN BACKGROUND: THE POWER OF GERMAN ENGINEERING[1]

In 1937, VW was founded in Germany under the Nazi regime by the labour unions with the help of Ferdinand Porsche, the inventor of the Beetle (the people's car). Tasked with making a car that was affordable for all consumers, VW's flagship car, the compact and iconic Beetle, first rolled off the manufacturing floor in 1945, and by 1949, half of all passenger cars produced in West Germany were built by VW. The company began exporting cars in the late 1940s, and by 1955, the company had sold over one million Beetles worldwide. The Beetle would eventually surpass Ford's Model T as the highest-selling model ever built, reaching sales of more than 15 million by 1972. When sales of the Beetle began to decline in the late 1970s, VW branched into other models, including the Passat, Jetta, Golf and Polo. The VW brand eventually folded into a broader public holding company, Volkswagen AG, which by 2014 owned 12 subsidiaries, including VW passenger cars, Audi, Porsche and Bentley.

By 2014 (Figure 1), VW was one of the biggest organisations in the world. It had factories in 31 countries, employed almost 600 000 people worldwide, and sold its cars around the world. In 2014, it sold 10.2 million vehicles, a 5 per cent growth over 2013, and reached its goal of taking over the title of 'world's largest auto manufacturer' from Toyota. Sales revenue in 2014 was EUR202 billion, with an operating profit of EUR12 billion (Figure 2).[2]

The shareholders of Volkswagen AG were largely made up of descendants of Porsche (50% ownership), but VW also had significant ownership from the German state of Lower Saxony (20% ownership) and Qatar's sovereign wealth fund (17% ownership), as well as independent shareholders who made up 10 per cent ownership.[3] Per German corporate law, Volkswagen AG had a 20-member supervisory board responsible for corporate governance, rather than a board of directors. As required by law, 50 per cent of the seats were allocated to VW's labour force (union representatives and employees that are elected representatives of the union), leaving the other 10 seats to be divvied up among the shareholders. As of 2015, only one of these seats was held by an outsider (Annika Falkengren, the CEO of a Swedish bank); the other nine were as follows: five to members of the Porsche and Piëch (relatives of the Porsche) families, two to Lower Saxony and two to Qatar.[4]

At a time when Europe was continuing to recover from the global financial crisis, VW was one of the most significant engines in the German economy. In May 2015, it was listed by *Forbes* as the largest public company in Germany by revenue, surpassing its nearest competitor, Daimler, by almost US$100 billion.[5] It was also one of Germany's largest employers.[6] Wolfsburg, Germany, the town in Lower Saxony where VW was headquartered, owed its existence to the company: it was created out of farmland to be the original site for manufacturing the VW Beetle. By the mid-2000s, the company owned the town's professional soccer team, its major hotels and even an automotive theme park that attracted millions of visitors per year.[7]

This public-sourced case was prepared by Luann J. Lynch, Almand R. Coleman Professor of Business Administration, Cameron Cutro (MBA '16), and Elizabeth Bird (MBA '16). It was written as a basis for class discussion rather than to illustrate effective or ineffective handling of an administrative situation. 

**Figure 1** **Timeline of events**

**2007**
Martin Winterkorn becomes CEO of VW and through his Strategy 2018 sets ambitious goals for vehicle sales.

**2008**
After cancelling deal with BlueTec technology, VW announces new clean diesel technology called Lean NOx Trap and designed to meet regulations.

**2009**
VW's Jetta wins Green Car of the Year award.

**2011**
In reaction to growing public concern, the EPA announces plans to further regulate US emissions by offering 'credits' to companies for using new technology, such as hybrid or electric cars, to improve the environmental effects of their fleets. Credits were not offered to diesel manufacturers.

**2013**
A non-profit group, the ICCT, notices that diesel technology in the United States appears to be cleaner – begins road testing of diesel vehicles.

**2014**
Researchers turn over the results of the study to the US EPA. The EPA opens investigation and questions VW about the findings. VW denies accusations of wrongdoing.

VW reaches its Strategy 2018 sales goal early, selling over 10 million vehicles and surpassing Toyota in sales volume, thereby becoming the world's largest automaker.

**2015**
The EPA and the state of California prepare for further testing and confirm that initial test findings are consistent.

**18 September 2015**
VW publicly admits that it had installed defeat devices on nearly 500,000 diesel vehicles across 14 models sold in the United States since 2009.

**23–25 September 2015**
Martin Winterkorn resigns as CEO, and Mathias Müller becomes new CEO.

Source: Created by author based on the order of events as portrayed in the case.

The company's stated values included 'customer focus, superior performance, creating value, renewability, respect, responsibility, and sustainability'.[8] These values were intended to guide decisions made by employees throughout the company and were accompanied by a 25-page Code of Conduct on which every employee was trained after joining VW. This Code of Conduct was written in 2009 and systematically rolled out to employees across the globe in 2010. It addressed topics such as management culture and collaboration, anticorruption and fair competition, and it was intended to be a 'guidepost that combines the essential basic principles of our activities and supports our employees in mastering the legal and ethical challenges in their daily work'.[9] In addition, all VW employees received compliance training; 185 000 were trained on compliance in 2014.[10]

Throughout its history, VW had been widely admired for its innovation in design and engineering. It was one of the first companies to introduce the three-way catalytic converter, prompting it to boast on its website that it was a 'pioneer of low-emission monitoring'.[11] The company experienced its first brush with US emissions standards in the 1970s, however, when the EPA caught it installing defeat devices that would allow it to cheat on newly enacted emissions standards. At the time, it paid a US$120 000 fine.[12]

VW had also been known for its quirky advertising highlighting its unique products and top-notch engineering. The company made advertising history with its 'Think Small' campaign in the United States in the 1950s, which encouraged Americans to consider smaller vehicles like the Beetle. In recent years, it stressed its virtue through advertisements proclaiming 'the power of German engineering', with commercials featuring engineers sprouting angel wings. At a time when most major US automakers were still struggling to recover from the global financial crisis and both Toyota and General Motors were reeling from major safety recalls, VW was perceived as reliable, successful and innovative. In his 2014 annual letter to shareholders, CEO Martin Winterkorn wrote: 'We stand for strength, reliability, and long-term success – even under less favorable conditions'.[13]

'The power of German engineering' was more than just a marketing tagline for VW; it was a motto, a way of doing business and a symbol of national pride. Germany had become a country that prided itself on its world-class engineering and precision manufacturing.[14] In part due to the country's engineering prowess, the automobile industry had become a powerhouse in Germany, and VW had become the leader in that industry. This dominance in manufacturing helped Germany weather the 2008 global financial crisis and kept unemployment low. Germany was able to boost employment and its economy largely through its ability to export products; automobiles made up a full one-fifth of this market. The strength of VW and

**Figure 2** Volkswagen Group key financials, pre-scandal

| | Vehicles Sold | Revenue (EUR millions) | Operating Profit (EUR millions) |
|---|---|---|---|
| 2007 | 6 191 618 | 108 897 | 6 151 |
| 2008 | 6 271 724 | 113 808 | 6 333 |
| 2009 | 6 309 743 | 105 187 | 1 855 |
| 2010 | 7 278 440 | 126 875 | 7 141 |
| 2011 | 8 361 294 | 159 337 | 11 271 |
| 2012 | 9 344 559 | 192 676 | 11 498 |
| 2013 | 9 728 250 | 197 007 | 11 671 |
| 2014 | 10 217 003 | 202 458 | 12 697 |

Data source: Volkswagen AG annual reports.

much of the German economy depended on the growth of its engineering exports, making German engineering more than just a point of national pride – it was an economic necessity.[15]

## VW LEADERSHIP AND STRATEGY 2018

Winterkorn, who took over as CEO in 2007, was focused on leading VW through its Strategy 2018, an ambitious plan to position the company as a global and environmental leader. The overarching goal of the strategy was to transform VW into the world's largest automaker. Said Winterkorn, 'Our pursuit of innovation and perfection and our responsible approach will help to make us the world's largest automaker by 2018 – both economically and ecologically'. Strategy 2018 had four primary goals: (1) to sell 10 million+ vehicles per year (thus making VW the world's largest automaker); (2) to become the world leader in customer satisfaction and quality; (3) to achieve an 8 per cent return on sales; and (4) to be the most attractive employer in the automotive industry.[16] Throughout Winterkorn's tenure, VW made steady progress on each of these goals.

Under the leadership of Winterkorn and his mentor, VW Chairman Ferdinand Piëch (a grandson of VW founder Porsche and himself VW CEO from 1993 until 2002), VW became a tightly controlled, highly centralised company. Its corporate culture was one of command-and-control, with leadership setting aggressive goals and senior executives involved in even relatively minor decisions.[17] The company gained a reputation for being hard-charging and brutally competitive, and former employees described an environment in which subordinates were fearful of ever admitting failure or contradicting their superiors.

Both Piëch and Winterkorn came from engineering backgrounds and kept a close eye on product development. Piëch, who recruited Winterkorn to Audi in 1981 and became his mentor for more than 25 years, would boast that he elicited superior performance by 'terrifying his engineers'.[18] It was well known that VW executives and engineers would be 'shaking in their boots prior to presentations before Piëch, knowing that if he was displeased, they might be fired instantly'.[19] By the time he became CEO in 2007, Winterkorn was considered 'a cold, distant figure . . . known for obsessive attention to detail'.[20] Unlike other contemporary auto industry CEOs who were experts in financial management and turnarounds, Winterkorn was considered a 'classic car guy'.[21] He was known for carrying a gauge with him at all times to measure flaws in vehicles as they came off the production line and for publicly disparaging subordinates. Said an industry analyst, 'He doesn't like bad news. Before anyone reports to him, they make sure they have good news'.[22]

Winterkorn was relentless in his pursuit of becoming the world's largest automaker. Speaking at the opening of VW's new factory in Chattanooga, Tennessee, in 2011, he promised that 'by 2018, we want to take our group to the very top of the global car industry.'[23] Although VW was growing, these promises were still considered ambitious, especially in the United States, a market that VW had previously neglected and where it held a reputation for selling expensive and undesirable cars.[24] In order to meet Winterkorn's goals, the US market would be a critical component to success. The company would need to sell 1 million vehicles (800 000 Volkswagens and 200 000 Audis) annually, tripling its 2007 sales.[25]

## ACHIEVING AMBITIOUS GOALS WHILE MEETING REGULATIONS[26]

In the mid-2000s, when Winterkorn began his tenure as CEO and announced VW's goal of becoming the world's largest automaker within the next decade, the auto industry in the

United States and around the world was facing significant engineering challenges. Persistently high prices at the gas pump and toughening mileage standards put pressure on automakers to design more fuel-efficient vehicles, while growing concerns about climate change spurred increasingly stringent emissions regulations. In order to drive sales, automakers needed to find ways to optimise fuel efficiency and emissions while still designing the high-performing vehicles that Americans had become accustomed to driving. The market for hybrid-electric cars, notably Toyota's Prius, was growing rapidly.[27]

Rather than compete with Toyota and other automakers in the hybrid market, VW had opted for a strategy of diesel, viewing it as a huge growth opportunity within the US car market and a viable eco-friendly alternative. While diesel made up almost half of new car sales in Europe, it held just 5 per cent of the US auto market in 2007,[28] and Winterkorn believed it was an opportune time to expand diesel sales in the United States. Diesel offered a cheaper, more powerful alternative to hybrid vehicles, promising high fuel efficiency without sacrificing powerful performance. But before it could market fuel-efficient diesel in the United States, VW had to overcome one major roadblock: diesel cars generated significantly more nitrogen oxide (NOx) than gasoline-powered engines, making it difficult for them to clear the stringent American emissions standards without sacrificing fuel efficiency or performance. In order to sell its cars in the US market, a critical part of the company's goal of becoming the world's largest car manufacturer, VW would have to engineer a way to strip its cars of these pollutants to meet US regulations (Figure 3).

In 2005, Wolfgang Bernhard, VW's head of brand, was in charge of designing the next-generation diesel engine for consumer cars that would provide both fuel efficiency and meet low US emission standards. Bernhard chose a strategy seen as controversial within the VW management team. Rather than develop an in-house solution, he instead adopted a competitor's technology, a Daimler invention called BlueTec. BlueTec used a substance called urea – essentially cat urine – to neutralise NOx. It required that VW install an extra pump and tank of urea in each vehicle, at a cost of EUR300 per vehicle. But just two years later, in 2007, boardroom battles within VW led to the appointment of Winterkorn as CEO, who promptly ousted Bernhard and cancelled the BlueTec deal. VW leadership stressed that BlueTec was too expensive, took up too much space in small cars, would hamper fuel efficiency, and that VW did not need to partner with an archrival to achieve its engineering goals.

VW engineers were suddenly on their own to find a way to meet stringent US emissions standards on diesel without

**Figure 3** **Background on US emissions regulations[1]**

The EPA both sets minimum standards for fuel efficiency for a company's fleet of vehicles and regulates emissions according to the Clean Air Act. The Clean Air Act, passed by the United States Congress in 1970, was designed to combat a number of air pollution problems threatening environmental safety and public health. As the country had grown more industrialised and urban, dense smog was visible in many of the nation's cities and prompted a public outcry for government action. The Clean Air Act required the EPA to 'establish national ambient air quality standards for certain common and widespread pollutants based on the latest science'.[2] One of the key provisions emphasised minimising pollution from motor vehicles, focusing on emissions of carbon monoxide, volatile organic compounds, and NOx. Emissions standards were gradually tightened over time.

The Clean Air Act requires that the EPA certify that all motor vehicles sold in the United States meet federal emissions standards. Without this certification, a vehicle cannot be sold in the United States. For decades, tests on new models to be released in the United States have been conducted at indoor laboratories as opposed to performing actual driving tests on the road. The tests use dynamometers – essentially car treadmills – which simulate driving and measure the exhaust emissions of a stationary car. The tests are conducted in laboratories rather than on the road to achieve cost efficiency and ensure standardisation of the test from vehicle to vehicle within a fleet.[3]

[1]Most of the information in this section is from the EPA's "Clean Air Act Overview," https://www.epa.gov/clean-air-act-overview; "Clean Air Act Text," https://www.epa.gov/clean-air-act-overview/clean-air-act-text; "Clean Air Act Requirements and History," https://www.epa.gov/clean-air-act-overview/clean-air-act-requirements-and-history; and "Progress Cleaning the Air and Improving People's Health," https://www.epa.gov/clean-air-act-overview/progress-cleaning-air-and-improving-peoples-health (all accessed Jan. 16, 2015); as well as http://www.bloomberg.com/news/articles/2015-10-21/how-could-volkswagen-s-top-engineers-not-have-known.

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[3]"EPA Should Do More Road Emissions Tests, Critics Say," *Automotive News*, September 29, 2015, http://www.autonews.com/article/20150929/OEM11/150929807/epa-should-do-more-road-emissions-tests-critics-say (accessed Jun. 20, 2016).

Source: Created by author.

sacrificing mileage or performance, and they needed to find it quickly. As it struggled to come up with a solution, the company was forced to delay for six months the release of the new diesel Jetta that was to be at the centre of its new marketing push.

Whatever solution was devised, software was likely to be at the centre of it. Modern cars contained approximately 100 million lines of software code that controlled everything from basic operations to media to safety. Software could also help a car control the amount of pollutants it emitted, by monitoring carbon monoxide and NOx emissions and then diverting pollutants to special systems that converted them into less harmful substances. Around the time that VW engineers were struggling to determine the right solution, auto industry–supplier Bosch gave VW diesel engine-management software for use during testing. This software could detect when a vehicle was in a testing environment and activated emissions-controlling devices. Bosch believed VW was only using this software during its internal testing, and sold the software to VW with the understanding that utilising the software in publicly sold vehicles was illegal.[29]

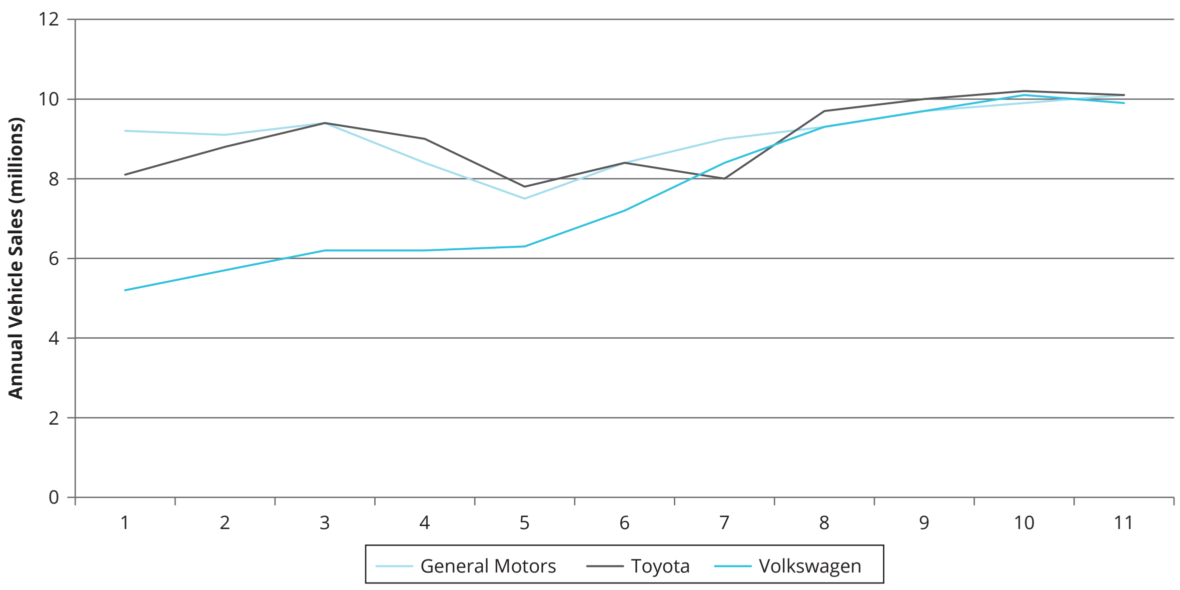
## CLEAN DIESEL SALES TAKE OFF

By 2008, it appeared that 'the power of German engineering' had once again pulled through. VW announced the rollout of a new clean diesel technology called the Lean NOx Trap, which it claimed had solved the problem of delivering high fuel efficiency while still meeting emissions standards. The new technology garnered considerable attention for VW. Its 2009 clean diesel Jetta TDI won the Green Car of the Year award, beating out hybrids and electric vehicles. It hosted a multiweek 'dieselution tour' to 'change any outdated perceptions about diesel technology' and prove its environmental virtue.[30] Some of its vehicles were reportedly getting almost 60 mpg, which was unheard of for a nonelectric or hybrid car. At a conference on diesel emissions the same year, a VW executive boasted that 'you don't have to sacrifice power to be environmentally conscious'.[31] Clean diesel became the centrepiece of VW's US marketing strategy, and sales took off. Diesel sales grew by 20 per cent in 2010, 26 per cent in 2011 and 25 per cent in 2012, though they began to taper off slightly in 2013 and 2014.[32] By 2014, VW's diesel cars accounted for 21 per cent of the company's US sales.[33]

In 2011, VW's goal of selling 1 million vehicles in the United States was beginning to look achievable. US domestic companies struggled under the weight of economic crises and bailouts, and Toyota and Honda had yet to fully recover from the impact on production of the 2011 Japanese earthquake. By 2012, VW claimed 3 per cent market share in the United States,[34] up from 2.5 per cent in 2011 and 2.2 per cent in 2010.[35] VW sales in the United States hit 440 000 in 2014, more than double 2009 sales.[36]

By 2014, VW was well on its way to achieving all four Strategy 2018 goals. Worldwide sales grew steadily at approximately 7.2

**Figure 4** **Worldwide annual car and light truck sales by manufacturer 2005–2015**




Data source: Created by author using data obtained from Bloomberg.

per cent CAGR from 2007, when Winterkorn took over, to 2014.[37] Most notably, the company reached its sales goal in 2014, selling more than 10 million vehicles and surpassing Toyota in sales volume, thereby becoming the world's largest automaker four years ahead of the deadline it had set for itself (Figure 4).[38]

Sales were particularly strong for VW vehicles in China, growing 10 per cent since 2013.[39] Yet sales in the United States were causing concern. US consumers' tastes had shifted towards midsized SUVs, an area in which VW had very few offerings. By 2014, VW held only 2.2 per cent market share in the United States,[40] and VW sales dipped down to just around 370 000, far short of the 800 000 projected and just barely above the company's 2011 numbers.

While VW invested in its US diesel strategy, EPA officials in the Obama administration announced in 2011 a plan to require automakers to increase fleet-wide fuel efficiency from an average of 35.5 mpg to 54.5 mpg by 2025, while also further reducing emissions. To help car manufacturers offset the business implications of these ambitious new standards, companies were able to earn credits for utilising groundbreaking technology that improved the environmental effects of their fleets, such as hybrids and electric cars. Credits could be used to lower the average fleet miles per gallon or emissions rating of the manufacturer that would otherwise be over the EPA limits. But credits were not offered to diesel manufacturers, as diesel technology was not viewed as the future of environmental car manufacturing. Automakers that had invested in diesel, such as VW and Mercedes-Benz, lobbied for diesel cars to be eligible to earn credits due to the technology's superior fuel efficiency. These organisations had made the decision to invest in diesel on the basis that it was environmentally conscious, but the EPA argued that diesel traditionally emitted much higher levels of NOx than gasoline-powered vehicles, and therefore would not allow diesel cars to earn the credits. This left VW with a fleet that did not meet the EPA's new standards, and unlike its competitors, the company had no credit-earning hybrid cars.

## SCANDAL UNFOLDS[41]

In 2013, a non-profit group called the International Council on Clean Transportation (ICCT) noticed something strange: diesel technologies appeared cleaner in the United States than in Europe. The ICCT hoped to identify what made diesel technologies superior in the United States in order to improve emissions in Europe. The traditional in-lab emissions tests had not provided any clues to the engineering differences, which were producing lower-emission vehicles in the United States, so the researchers proposed on-road (as opposed to in-lab) testing of diesel cars in order to better understand these differences. They partnered with West Virginia University's Center for Alternative Fuels, Engines, and Emissions and California environmental regulators to perform tests on several types of diesel vehicles, starting with a BMW X5, a VW Jetta and a VW Passat (all three selected by chance; they were models conveniently available to the researchers). The researchers compared in-lab and on-road emissions and mileage performance.

Almost immediately, the two VW vehicles stood out. They performed flawlessly in the lab, but once on the open road, their emissions were significantly higher, as shown in **Table 1**. What the researchers unexpectedly uncovered was that these differences were perhaps not the result of superior engineering, but rather the result of cars specifically designed to take advantage of testing environments.

In early 2014, the researchers turned over the surprising results of the study to the US EPA, which questioned VW about the findings. VW flatly denied any accusations of wrongdoing. The West Virginia University researcher who led the tests said VW 'tried to poke holes in our study and its methods, saying we didn't know what we were doing'.[42] The researchers eventually conducted an in-depth examination of VW's software, reviewing millions of lines of code for something to explain the strange discrepancy in emissions. They discovered an unusual set of instructions that was sent to emissions controls whenever the vehicle was only utilising two of its four wheels (as it would during in-lab testing). In essence, the vehicle recognised whether it was in a test lab or on the road. The defeat device limited emissions in the lab (therefore hindering performance), but once out on the road, emissions returned to levels far above federal regulations and performance did not suffer.

Armed with this information, EPA officials threatened to withhold certification of VW and Audi's 2016 diesel models,

**Table 1** **Emissions test results**

| | EPA Limit | 2015 Jetta In-Lab Testing | 2015 Jetta On-Road Testing |
|---|---|---|---|
| Emissions level (grams of NOx emitted per mile) | 0.07 | 0.07 | 2.45 (~35 × higher than legal limit) |

Data sources: Bloomberg Businessweek, http://www.bloomberg.com/news/articles/2015-10-21/how-could-volkswagen-s-top-engineers-not-have-known; EPA, https://www3.epa.gov/otaq/consumer/f99017.pdf.

**Figure 5** **US models with defeat device**

**Affected 2.0-litre diesel models:**

- Jetta (2009–2015)
- Jetta Sportwagen (2009–2014)
- Beetle (2012–2015)
- Beetle Convertible (2012–2015)
- Audi A3 (2010–2015)
- Golf (2010–2015)
- Golf Sportwagen (2015)
- Passat (2012–2015)

**Affected 3.0-litre diesel models:**

- Volkswagen Touareg (2014)
- Porsche Cayenne (2015)
- Audi A6 Quattro (2016)
- Audi A7 Quattro (2016)
- Audi A8 (2016)
- Audi A8L (2016)

Data source: EPA, 'Volkswagen Light Duty Diesel Vehicle Violations for Model Years 2009–2016', https://www.epa.gov/vw (accessed 28 February, 2016).

which forced VW's hand. On 18 September 2015 – one week after being named the world's 'most sustainable automaker'[43] – the company publicly admitted that it had installed defeat devices on nearly 500 000 diesel vehicles across 14 models sold in the United States since 2009, when the clean diesel technology launched (Figure 5). This number was later scaled up to 11 million vehicles worldwide. It was discovered that the vehicles were emitting up to 40 times the US legal limit of pollution into the atmosphere.[44]

VW officials apologised but vehemently denied widespread knowledge of the defeat devices within the company, blaming a few engineers for the error and claiming that senior management had no knowledge of wrongdoing. They claimed that the millions of lines of software code made it impossible for anyone to know every line, particularly upper management, meaning that engineers could have included the emissions-defeating protocol without management knowing.[45] Michael Horn, VW's CEO of American operations, testified before Congress in October 2015, stressing that the defeat devices were 'not a corporate decision' and were instead the work of 'a couple of software engineers'.[46] As members of Congress expressed disbelief that VW's senior leadership did not know about the devices, Horn admitted, 'I agree, that's very hard to believe'.[47]

Despite denying any wrongdoing, CEO Martin Winterkorn resigned five days after the scandal became public, stating that 'I am stunned that misconduct on such a scale was possible in the Volkswagen Group. As CEO I accept responsibility for the irregularities that have been found in the diesel engines . . . even though I am not aware of any wrongdoing on my part'. (See Figure 6 for Winterkorn's full statement.)

**Figure 6** **Post-scandal statement by Martin Winterkorn, 23 September 2015**

'I am shocked by the events of the past few days. Above all, I am stunned that misconduct on such a scale was possible in the Volkswagen Group.

As CEO I accept responsibility for the irregularities that have been found in diesel engines and have therefore requested the Supervisory Board to agree on terminating my function as CEO of the Volkswagen Group. I am doing this in the interests of the company even though I am not aware of any wrongdoing on my part.

Volkswagen needs a fresh start—also in terms of personnel. I am clearing the way for this fresh start with my resignation.

I have always been driven by my desire to serve this company, especially our customers and employees. Volkswagen has been, is, and will always be my life.

The process of clarification and transparency must continue. This is the only way to win back trust. I am convinced that the Volkswagen Group and its team will overcome this grave crisis.'

Source: 'Statement by Prof. Dr. Winterkorn', Volkswagen US Media Newsroom, 23 September 2015, http://media.vw.com/release/1070/ (accessed 20 June 2016).

## FALLOUT[48]

The fallout from the scandal was swift and far-reaching. Regulators across the United States and across the globe opened investigations. In the United States, the EPA stated that VW could face up to US$18 billion in fines – US$37 500 per car for each of the estimated 500 000 cars impacted.[49] The FBI opened a criminal probe, as did the attorneys general of all 50 states, and the Justice Department opened a civil lawsuit against the company over the deception. Outside of the United States, Germany and the European Union also opened criminal investigations, and German officials raided VW's headquarters days after the scandal came to light.[50]

The scandal had considerable immediate effects on VW's business. In the wake of VW's admission, the EPA withheld final certification on VW's 2016 diesel models, and VW voluntarily halted sales of its 2015 models still in inventory.

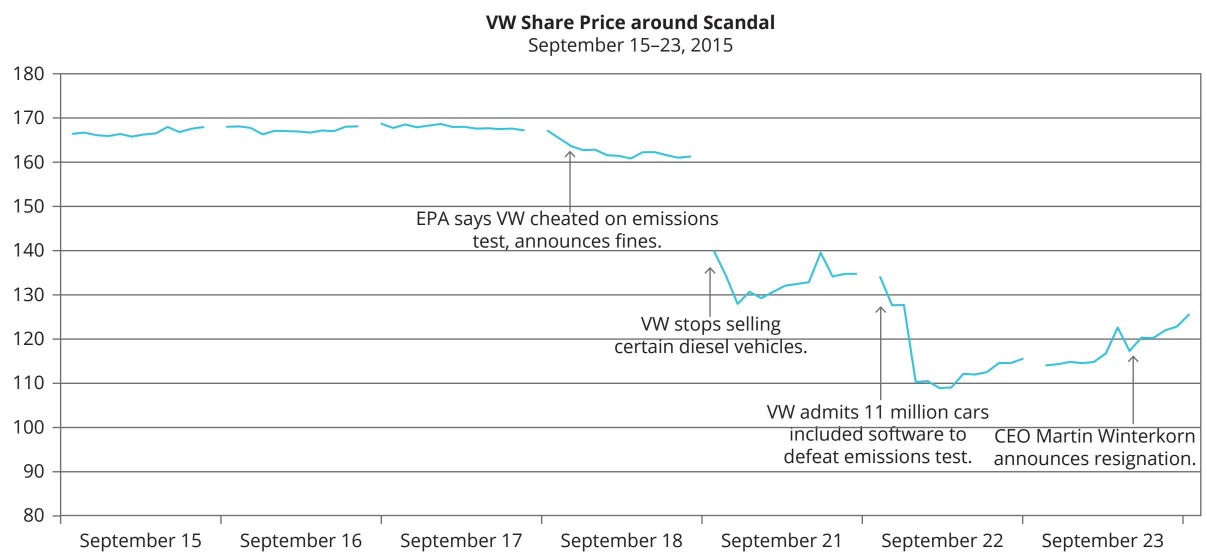
As diesel vehicles composed approximately 20 per cent of VW's US sales, this significantly affected VW's performance. In October, VW reported its first quarterly loss in 15 years. Furthermore, its market cap shrank by one-third in the month after the scandal went public (Figure 7), and the company quickly abandoned its goal of remaining the world's largest automaker.[51] In addition to Winterkorn's resignation, at least nine senior managers were quickly suspended or put on leave, and Matthias Müller, formerly the Porsche brand chief, was appointed VW's new CEO.

VW's American operations and dealers were severely hurt by the scandal they claimed to have known nothing about. VW America said in a statement to American customers, 'The recent TDI (Turbocharged Direct Injection) news is a disappointment to the entire VW of America family. We sincerely apologize, and we recognize this matter has jeopardized the strong relationship between our loyal owners and the brand'.[52] The scandal had a considerable effect on independent VW dealers, who were crippled by the sudden drop in sales. VW paid dealers up to USD1000 per car and wired cash to dealers to handle the crisis locally.[53] In November, American consumers who had purchased the vehicles that were affected received a goodwill package in the mail, which included USD1000 and 24-hour roadside assistance and did not require the consumer to release VW of any liability.

The German economy expected to see a substantial change as a result of VW's actions. The German auto industry, led by VW, accounted for 20 per cent of German exports and 3 per cent of German GDP. One in seven jobs were directly or indirectly linked to the industry, and the country was steeling itself for potential job losses.[54] The city of Wolfsburg, Germany, where VW was headquartered, issued an immediate budget and hiring freeze and halted all infrastructure projects in anticipation of substantially reduced corporate taxes coming from its hometown company.[55] 'While the German economy defied Greece, the euro crisis and the Chinese slowdown, it could now be facing the biggest downside risk in a long while,' Carsten Brzeski, chief economist at Germany's ING-DiBa bank, wrote. 'The irony of all of this is that the threat could now come from the inside, rather than from the outside'.[56]

In June 2016, VW agreed to a $14.7 billion settlement in the emissions scandal. The settlement was estimated to provide $10 billion to fund buybacks of vehicles from approximately 475 000 vehicle owners and an additional cash compensation of $2.7 billion was to assist in environmental clean-up and $2 billion to fund programs by the EPA and California that focused on cleaner vehicles. The company could still face additional civil penalties or charges in other countries, and the company and some of its executives could face criminal charges as well.[57]

**Figure 7** **VW share price around scandal 15–23 September 2015**




Data source: Created by author with stock price data from Bloomberg.
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# NOTES

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# CASE 12

## Otis in the global elevator industry

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**CASE LINK:** This case applies concepts from Chapters 2, 3, 4 and 5.

Otis is a dominant player in the global elevator industry. It is part of United Technologies (UTC), a diversified American organisation. UTC's revenue in 2014 was US$65 billion and there were around 200 000 employees spread across the globe. It has a number of well-known business areas including Sikorsky (Black Hawk helicopters), Chubb security, a range of aerospace products and Pratt & Whitney.[1]

The idea of a lift (elevator) has been around for 150 years. Old elevators had an operator (who may have been paid but often relied on tips) who stood or sat in the cabin all day using a handle to raise the cab up and down between floors. Stopping the cabin exactly in line with the level of the floor was considered quite an art.

United Technologies includes OTIS; UTC Climate, Controls & Security; Sikorsky; and Pratt & Whitney. Shown here is Sikorsky's Black Hawk helicopter.

Source: Alamy Stock Photo/© Michael Dunlea

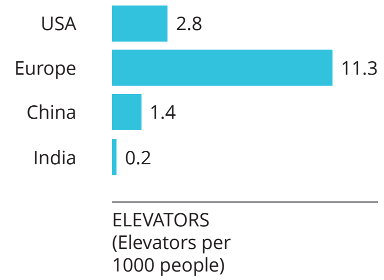
When a building is tall and you cannot always use stairs, you get into a large metal box, press a button, and after a short ride you emerge on another floor (How many floors is it before you use an elevator? What impact does culture have on this decision?). Demand is expanding as global population increases and urbanisation continues apace. In China, new cities evolve to incorporate huge growth and newer city populations can rapidly increase to many millions of people. In Africa and South America, change is slower but the message is the same: country people are moving to the city and live in high-rise apartments while working in high-rise offices. The world is becoming more vertical than ever before, hence elevator demand is strong. Figure 1 shows the current number of elevators per 1000 people, and although the current number of elevators per population is low in China and India, with urbanisation and large populations, demand is focused on Asia. Seven out of 10 new elevators are sold in the Mumbai (India), Seoul (South Korea) and Hong Kong triangle.

The elevator industry also benefits from the trend to an ageing population. As people get older they are less able to climb stairs, so domestic elevators and escalators become a welcome addition. As economies expand, incomes tend to rise and more developments can afford elevators. Also, due to anti-discrimination and equal-opportunity regulations, more and more multistorey buildings are required by law to include elevators.


100-year-old elevator.

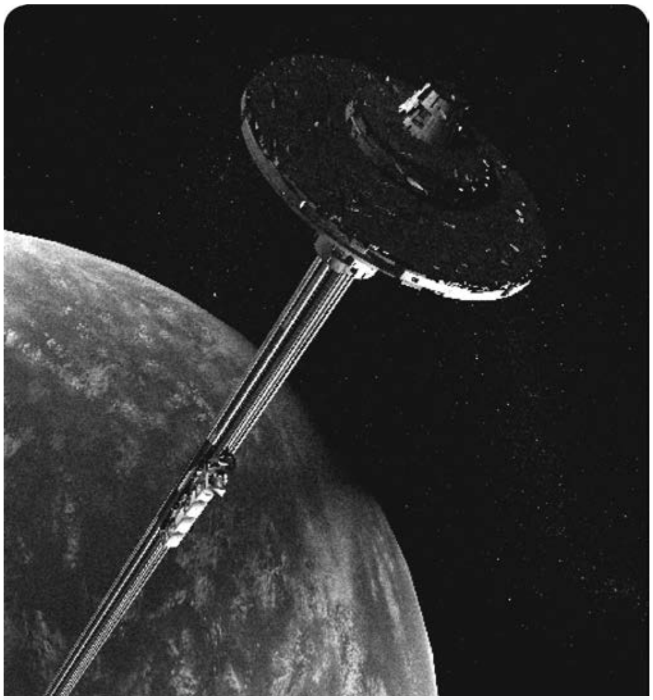
Source: Getty Images/Bettmann

**Figure 1** **Elevators per 1000 people**




Source: United Technologies, 2012, *UTC Annual Report 2012, 1.*

Another change that has affected the industry is the fast-paced technological revolution. Technology is capable of doing far more than ever before. Cars are 'thinking' now, with self-handling headlights and steering that avoids obstacles. Computers are becoming phones and phones are becoming computers. Books are now on tablets (e.g. a Kindle or an iPad). Email is everywhere – on your phone, on your computer or on your phablet (a phone so big it's a tablet too). Elevators can now talk, letting passengers know which floor they are coming to, and companies can monitor elevator performance remotely (even from another continent). What can we expect from elevators of the future? Black Line Ascension is a start-up company in Seattle



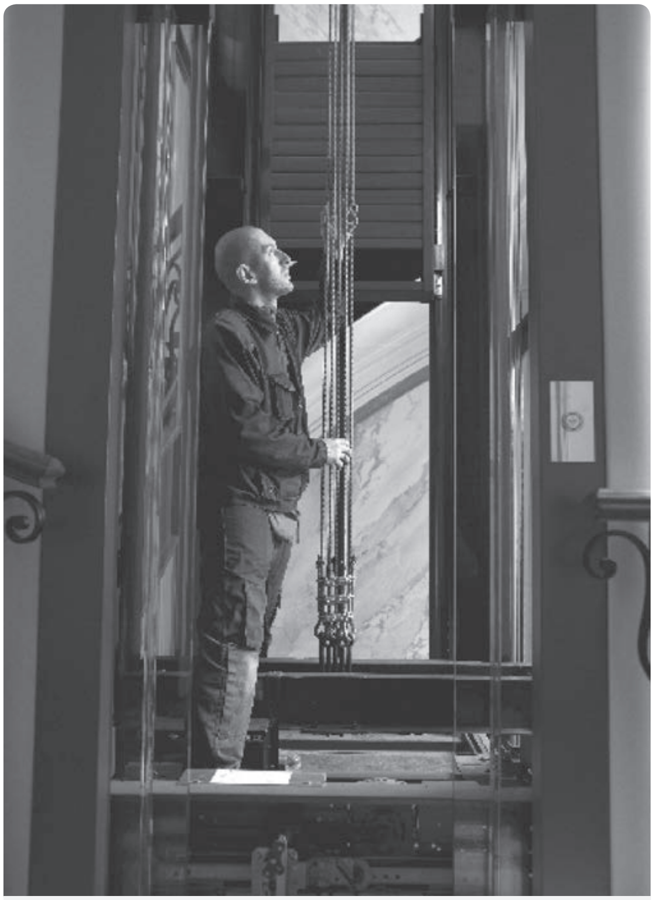
Elevators of the future?

Source: Science Photo Library/Christian Darkin

that conducts space elevator research. Some scientists believe that a space elevator could be a reality by 2050.

## THE INDUSTRY

The elevator industry works around two main activities. The first is the manufacture and sale of elevators which generate a margin of around 10 per cent. The second is maintenance. Elevators require regular maintenance as they have the potential for catastrophic accidents. In many countries, building regulations require annual safety checks. (Have you seen a safety certificate posted on or near an elevator?) Companies pay US$2000 to US$5000 per year for maintenance, and the margins in this business area are 25–35 per cent. The maintenance side of the business is very stable, while sales are subject to economic cycles. Around half the profits of elevator companies come from maintenance. This makes it difficult to enter the industry as you need trained and trusted technicians distributed globally in order to sell elevators on an international scale.



Up to half of the profits in elevator companies come from servicing and maintenance.

Source: Science Photo Library/Christian Darkin

While the biggest markets for new elevators are now Asian, European markets continue to be profitable, particularly for maintenance. There are four major players in this industry, all of which compete globally: Otis (USA), KONE (Finland), Schindler (Switzerland) and ThyssenKrupp (Germany).

KONE has been committed to understanding the needs of its customers for over a century, providing industry-leading elevators, escalators and automatic building doors, as well as innovative solutions for modernisation and maintenance.

The company's objective is to offer the best 'People Flow' experience by developing and delivering solutions that enable people to move smoothly, safely, comfortably and without waiting in buildings in an increasingly urbanised environment. In 2015, KONE had annual net sales of almost US$13 billion and had approximately 40 000 employees.[2]

ThyssenKrupp Corporation is a huge steelmaker with a long history and has 150 000 employees spread over more than 80 countries. It aims to develop solutions for 'sustainable progress'. In the fiscal year 2014/15, ThyssenKrupp generated sales of US$64 billion. Elevators are one of the four main groups in the corporation. The strong corporate backing and technical capabilities for the elevator division makes it a formidable competitor.[3]

Schindler was founded in 1874 in Lucerne, Switzerland. Today, the Schindler Group is one of the world's leading providers of elevators, escalators and moving walkways and is active in the areas of production, installation, maintenance and modernisation. It has operations in more than 100 countries and employs over 45 000 people. Around 59 per cent of employees work in the area of installation and maintenance, 8 per cent at production sites in the USA, Brazil, Europe, China and India, and 33 per cent in engineering, sales and administration. The company reported revenue of nearly US$13 billion for 2015. Schindler has been observing the trend of sales to the East and has now launched the largest investment program in its history. It is building five new factories simultaneously – two in China, two in India and one in Slovakia. The new plant in Shanghai is huge – the size of 40 football fields. The company is also investing in employee expertise in the areas of research and installation, maintenance and repair; all focused on elevators.[4]

The large revenue returns based on a 10 per cent margin for new elevators makes the industry a competitive market for new players. The big four may well be challenged by other players with growing revenue streams.

One such organisation is Mitsubishi Electric, which has been in the elevator business since 1935. It is an innovative company with over 117 000 employees. The scope of Mitsubishi Electric is evident in Table 1.

The industry has had trouble with price fixing. In 2007 the European antitrust authorities fined it over US$1 million for fixing the German and Benelux markets.[5]

## OTIS

Otis is the most well-known brand in the industry. Its elevators and escalators sell in more than 200 countries around the world. The size and scope of the company's business is reflected in Table 2.

The history of the company highlights its continued growth and also its innovation in the industry. Elisha Otis invented the safety elevator for his employer in 1852. He then went solo and sold three elevators in 1853 for US$300 each. Then sales slumped. No more were sold in 1853 or early 1854. He decided to promote his invention by showing it at the Crystal Palace Exhibition in New York City in May 1854. Sales shot up, and he sold seven in the remainder of 1854 and 15 in 1855, and from there the company was launched.

Otis soon went international and in February 1884, it established sales offices in London and Paris by purchasing the American Elevator Company. Some of the early sales provided elevators for the Eiffel Tower, London Underground Railroad, Glasgow Harbour Tunnel, the Kremlin, Balmoral Castle, Hungarian Royal Palace and offices and apartments throughout Europe. The Otis brothers took over in 1861 and the company was incorporated in 1867. Innovation continued and by 1901 Otis was able to produce elevators that could go above 90 metres, thereby enabling the skyscraper revolution.

In 1932, towards the end of the Great Depression, Otis started to highlight maintenance as a revenue stream. In 1948 it produced the 'automatic elevator' that did not need an operator, and in 1964 it merged with French organisation Ascenseurs. In 1976 Otis was taken over by UTC and operated as a wholly owned subsidiary, although little changed. It continued to innovate and internationalise, dominating the global elevator market. It now has remote access systems that enable the company to maintain elevators at distance, thereby receiving early indications of problems and making down-times far shorter. Otis' eService system allows elevator operators to track the performance of their equipment and log service requests from their computers.

At the beginning of the new millennium, Otis transformed the industry through the introduction of a flat, polyurethane-coated steel belt to lift the elevator car and provide traction, instead of the steel cables which had been used for more than a century. This new technology helped improve energy efficiency, made the ride smoother and eliminated the need for a machine room. It became the fastest-selling product in Otis' history![6] The next innovation in cable technology is carbon fibre, which should allow elevators to travel up to 1 kilometre in a single run, double what's currently possible with a steel cable. As lift cables get longer, the weight of cable can account for more than the car and its passengers. Carbon fibre is 90 per cent lighter than the equivalent steel cable, thereby reducing the load and enabling

**Table 1** Mitsubishi electric profile

| | |
|---|---|
| Energy and electric systems | Turbine generators, hydraulic turbine generators, nuclear power plant equipment, motors, transformers, power electronics equipment, circuit breakers, gas insulated switches, switch control devices, surveillance-system control and security systems, large display devices, electrical equipment for locomotives and rolling stock, elevators, escalators, building security systems, building management systems, particle beam treatment systems and others |
| Industrial automation systems | Programmable logic controllers, inverters, servomotors, human–machine interface, motors, hoists, magnetic switches, no-fuse circuit breakers, short-circuit breakers, transformers for electricity distribution, time and power meters, uninterruptible power supply, industrial fans, computerised numerical controllers, electrical-discharge machines, laser processing machines, industrial robots, clutches, automotive electrical equipment, car electronics and car mechatronics, car multimedia and others |
| Information and communication systems | Wireless and wired communications systems, surveillance cameras, satellite communications equipment, satellites, radar equipment, antennas, missile systems, fire control systems, broadcasting equipment, data transmission devices, network security systems, information systems equipment, systems integration and others |
| Electronic devices | Power modules, high-frequency devices, optical devices, LCD devices, microcomputers, system LSIs and others |
| Home appliances | LCD televisions, projection TVs, display monitors, projectors, Blu-ray disc recorders, room air conditioners, package air conditioners, air-to-water heat pump boilers, refrigerators, electric fans, ventilators, photovoltaic systems, hot water supply systems, LED lamps, fluorescent lamps, indoor lighting, compressors, chillers, dehumidifiers, air purifiers, showcases, cleaners, jar rice cookers, microwave ovens, IH cooking heaters and others |
| Others | Procurement, logistics, real estate, advertising, finance and other services |

Source: Mitsubishi Electric Corporation, 2016, Profile of the Mitsubishi Electric Group, http://www.mitsubishielectric.com/company/about/at-a-glance/index.html

**Table 2** Otis at a glance

| | |
|---|---|
| People | Approximately 65 000 employees, with 53 000 outside the USA |
| Revenue | US$13 billion in 2014, of which 83 per cent was generated outside the USA |
| Installed base | Approximately 2.5 million Otis elevators and escalators in operation worldwide |
| Service base | More than 1.8 million elevators and escalators serviced worldwide |
| Countries | Products offered in more than 200 countries and territories |
| Manufacturing | Major manufacturing facilities in the Americas, Europe and Asia |
| Engineering and test centres | Engineering facilities in the USA, Austria, Brazil, China, Czech Republic, France, Germany, India, Italy, Japan, South Korea and Spain<br>The company's two tallest elevator test towers are located in Shibayama, Japan (154 metres above ground, 27 metres below ground) and Bristol, CT, USA (117 metres above ground) |

Source: Otis, 2016, About Otis, http://www.otisworldwide.com/d1-about.html

**Table 3** **Sales/profit/profit margin in UTC group**

| (US$ in millions) | Net sales | | | Operating profits | | | Operating profit margin | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2014 US$ | 2013 US$ | 2012 US$ | 2014 US$ | 2013 US$ | 2012 US$ | 2014 % | 2013 % | 2012 % |
| Otis | 12 982 | 12 484 | 12 056 | 2 640 | 2 590 | 2 512 | 20.3 | 20.7 | 20.8 |
| UTC Climate, Controls & Security | 16 823 | 16 809 | 17 090 | 2 782 | 2 590 | 2 425 | 16.5 | 15.4 | 14.2 |
| Pratt & Whitney | 14 208 | 14 501 | 13 964 | 2 000 | 1 876 | 1 589 | 13.8 | 12.9 | 11.4 |
| UTC Aerospace Systems | 14 215 | 13 347 | 8 334 | 2 355 | 2 018 | 944 | 16.6 | 15.1 | 11.3 |
| Sikorsky | 7 451 | 6 253 | 6 791 | 219 | 594 | 712 | 2.9 | 9.5 | 10.5 |
| Consolidated (total after eliminations) | 65 100 | 62 626 | 57 708 | 9 769 | 9 209 | 7 684 | 15 | 14.7 | 13.3 |

Source: United Technologies, 2014, *UTC Annual Report 2014*, 18.

far taller continuous runs. Currently in tall skyscrapers, passengers are required to step out of the elevator at a transfer floor or 'sky lobby'. These transfer floors take up valuable floor space that can't be let.

Throughout the 2000s Otis has become a leader in energy-saving elevators and also has an elevator that switches to battery power when mains power fails. In 2005 Otis also introduced the regenerative drive. As the elevator descends, the regenerative drive uses that kinetic energy to generate electricity for the building's grid. The company produces and maintains elevators, walkways and other people-moving machines. Its main customer bases are architects and property developers, where it maintains close working relationships across such businesses on a global scale. Otis regards itself as ethical and employs what it believes are 'the most talented people in the world'.[7] Leadership is experienced and global in orientation.

## THE DIGITAL ELEVATOR AGE

Otis has experimented with software solutions to passenger flow. Its Compass interface system allows users to select the floor they need before they step onto the elevator. The system


Digital advertising for elevators.

Source: Alamy Stock Photo/World History Archive

New magnetic elevators will travel sideways.

Source: MULTI by thyssenkrupp © thyssenkrupp evaluates current requests, selects the best elevator for that passenger and directs her or him to it, increasing the efficiency of the system by up to 20 to 40 per cent.

Digital technology is bringing a new element into the industry: the interactive TV screen. Advertisers are able to promote their products in elevators, making money for Otis and the building operators. Interactive TV screens can serve multiple purposes, including informing passengers of problems, providing advertising, offering entertainment or, in the rare case of a trapped passenger, videoconferencing with rescuers.[8]

## WHERE CAN THE INDUSTRY GO FROM HERE?

Tables 3, 4 and 5 show Otis' most recent sales results. Otis is still the major player in the elevator industry. Competition is not directly threatening but is nevertheless present, and all the major players are well set up.

ThyssenKrupp, for example, has trumped Otis in unveiling its latest technological advance, a cable-free, multi-car, multi-directional elevator run using magnetic technology similar to that used by maglev trains. This elevator system opens up the potential for elevator cabins to move horizontally as well as vertically. This in turn offers the potential for multiple cabins to operate in a single system, with cabins going up one shaft and down an adjacent shaft. ThyssenKrupp proposes that the maglev elevator requires smaller shafts that can increase a building's usable area by up to 25 per cent. With the addition of pressurised cabins, like an aeroplane, these new elevators will shoot up at incredible speeds.[9]

The industry is changing and new technology is being used to improve performance and profitability. Research and development may be outsourced to improve productivity and larger elevators are being manufactured. This is a profitable industry and annual revenue is strong and growing. Can Otis remain the leader of the pack? How? What are the major risks to Otis' dominance?

**Table 4 Globalisation: percentage of business conducted outside the USA**

| | 2014 | 2013 |
|---|---|---|
| Otis | 81% | 82% |

Source: United Technologies, 2014, *UTC Annual Report 2014*, 18.

**Table 5 Sales results, 2014**

| (US$ in millions) | 2014 US$ | 2013 US$ | 2012 US$ | Total increase (decrease) year-over-year | | | |
|---|---|---|---|---|---|---|---|
| | | | | 2014 compare w. 2013 | | 2013 compare w. 2012 | |
| Net sales | 12 982 | 12 484 | 12 056 | $498 | 4% | $428 | 4% |
| Cost of sales | 8 756 | 8 345 | 8 008 | 411 | 5% | 337 | 4% |
| Operating expenses and other | 1 586 | 1 549 | 1 536 | | | | |
| Operating profits | 2 640 | 2 590 | 2 512 | $50 | 2% | $78 | 3% |

Source: United Technologies, 2014, *UTC Annual Report 2014*, 19.

## NOTES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# CASE 13

## Dick Smith: the fall of an Aussie icon

GREG ZOOEFF

**CASE LINK:** This case applies concepts from Chapters 2, 3, 4, 5, 6, 7 and 11.


Source: FairfaxPhotos.com

### BACKGROUND

Dick Smith was founded in 1968 by Dick Smith and owned by him and his wife until 1982. Dick Smith Holdings Limited was the holding company of the Dick Smith Group (DSG) that consisted of 11 wholly owned subsidiaries. DSG operated consumer electronics retail stores and an online consumer electronics retail business throughout Australia and New Zealand. It operated from more than 390 locations and had at least 3000 employees. The majority of the network was branded as 'Dick Smith' stores, but also incorporated 'Move' bannered stores, 'Electronics Powered by Dick Smith' outlets in David Jones stores, and commercial and online businesses.[1]

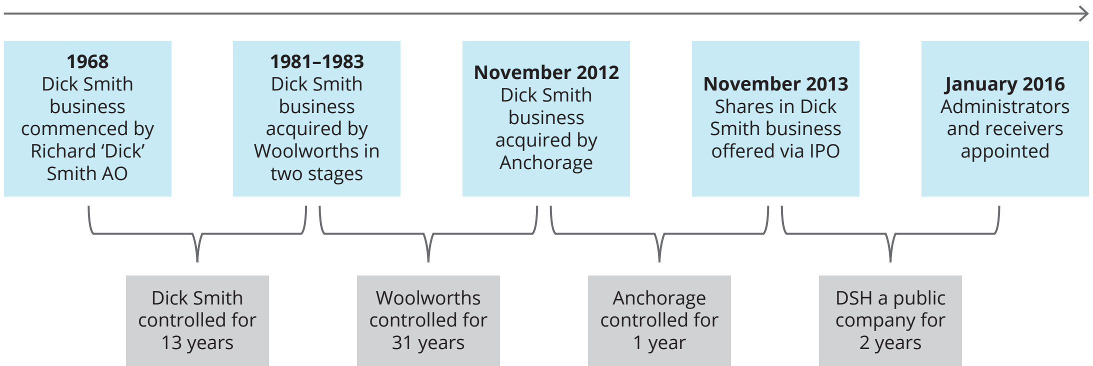
Woolworths Limited acquired Dick Smith Electronics in 1982 and then sold it to private equity (PE) company Anchorage Capital Partners (Anchorage) in 2012, which subsequently floated DSG on the Australian Securities Exchange (ASX) in December 2013. The Initial Public Offering (IPO) price was A$2.20 per share and raised A$345 million in equity.[2] Anchorage sold 80 per cent of its shareholding in December 2013 and the remaining 20 per cent was sold in September 2014.[3]

The timeline and control of DSG is represented in Figure 1.

In 2015, concerns emerged about trading performance, inventory management and buyer rebates and their collective impact on cash flow. The share price weakened dramatically (see Figure 2).

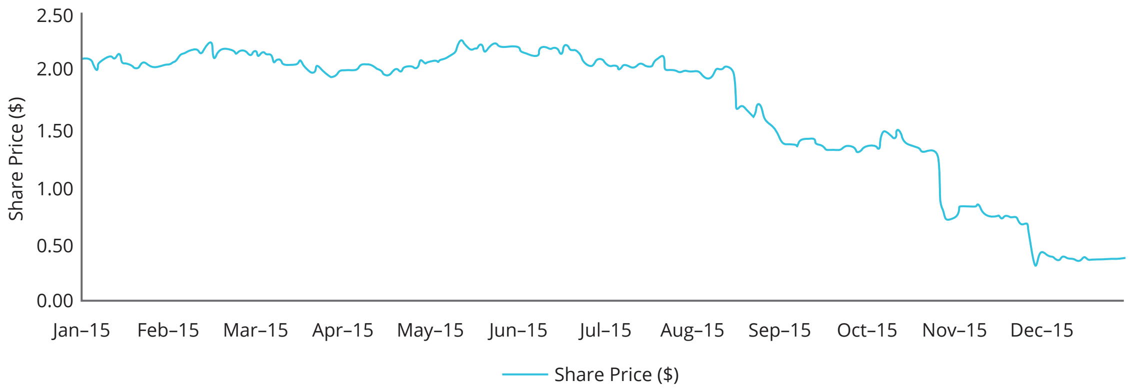
By December 2015, the share price had fallen 80 per cent. On 4 January 2016, DSG (and associated entities) was placed into voluntary administration by the board. Subsequently, a syndicate of lenders appointed Ferrier Hodgson as receivers and managers. The online operations and Dick Smith brand

**Figure 1** Timeline of ownership of Dick Smith




Source: McGrathNicol, 2016, *The Dick Smith Group, Report to creditors pursuant to Section 439A of the Corporations Act 2001*, 13 July, https://www.mcgrathnicol.com/app/uploads/DS-Australia-Report-to-Creditors-13-July-2016-updated-15-July-2016.pdf, p. 20.

**Figure 2** DSH share price performance




Source: McGrathNicol, 2016, *The Dick Smith Group, Report to creditors pursuant to Section 439A of the Corporations Act 2001*, 13 July, https://www.mcgrathnicol.com/app/uploads/DS-Australia-Report-to-Creditors-13-July-2016-updated-15-July-2016.pdf, p. 27.

were sold to Kogan.com in May 2016 and the remainder of the business was liquidated.[4]

## ACQUISITION BY ANCHORAGE CAPITAL

Under Woolworths, Dick Smith lacked vision and was losing market share. Woolworths made a restructuring provision of $300 million in the first half of FY2012, reflecting the diminished value of the Dick Smith business. Woolworths received consideration from Anchorage of $115 million, representing approximately 5 x FY2013 earnings before interest, tax, depreciation and amortisation (EBITDA).[5] As a comparison, the consumer discretionary industry in 2012 had a median enterprise value/EBITDA multiple of 7.6 times.[6] Woolworths struggled to find any other credible bidders, and therefore the divestment process lacked competitive tension to realise a higher acquisition price. The low price relative to this implied enterprise value was reflective of its little to no growth prospects at the time.[7] As a private equity ‘financial buyer’, Anchorage was motivated to seek the lowest possible price for Dick Smith as it had to implement a turnaround program and was bearing the implementation risk and risk of underperformance.

## TRANSFORMATION PROGRAM PRE-IPO

The transformation program undertaken by Anchorage was focused on material improvements in profitability before an exit by Anchorage. Figure 3 summarises pro forma EBITDA from FY2013 to FY2014 and includes the uplift from proposed transformation actions at the time. In the context of the IPO, the $48.4 million in EBITDA improvement was valued at $358 million (EBITDA multiple of 7.4 x) and a significant driver in IPO value.[8]

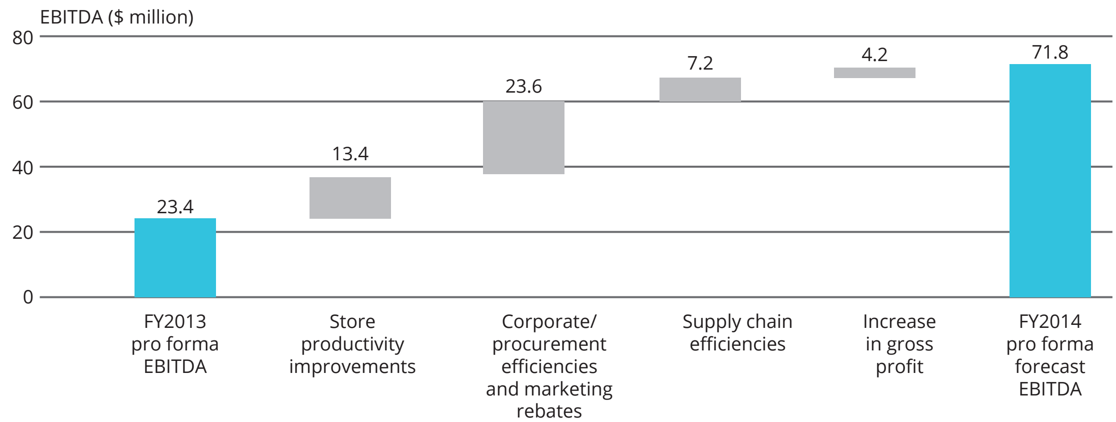
The largest part of its program was related to procurement, supplier relationships and marketing, which was forecast to deliver half of the EBITDA uplift. The renegotiation of supplier agreements, corporate agreements and buying business process changes, among others, in addition to productivity improvements, were aimed at improving its competitive positon.[9] Anchorage did reduce Dick Smith’s cost of doing business (CODB) percentage of sales and at the time of the IPO the CODB% was below 20 per cent, which was a marked reduction from the time Anchorage took control.[10] However, Dick Smith’s CODB% was still above its competitors and was highly dependent on leveraging sales growth to drive the CODB% down further.[11]

The marketing agreements were renegotiated and significant marketing activity was undertaken. The increase in marketing activity did coincide with an increase in pro forma sales, as these sales for FY2013 were higher than FY2014 by $53 million (see Figure 4).

Anchorage introduced an omni-channel strategy aimed at increasing exposure and distribution through online channels.[12] For a retailer, a digital strategy is paramount, but Anchorage’s initiative was not mature and only represented a small proportion of Dick Smith’s total revenue. While an important part of its growth platform, it was unclear what this strategy actually delivered in terms of value.

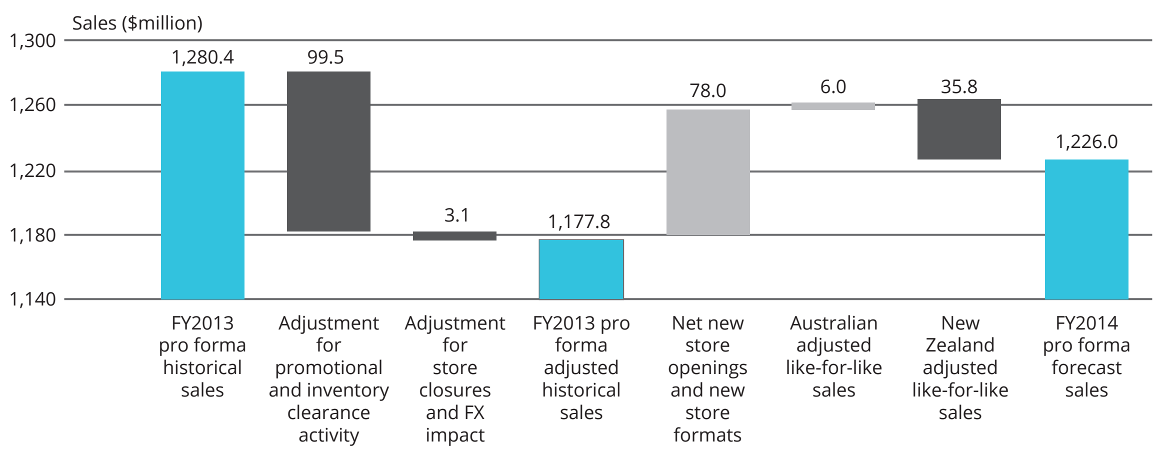
Under Anchorage’s ownership, it signed an exclusive agreement with David Jones to operate its consumer electronics division.[13] The objective was to increase sales through expanding its target segments; however, this strategy was questionable on the basis that David Jones was in a different market segment of clothing and apparel.

**Figure 3** **Pro forma FY2014 EBITDA**




Source: © Copyright 2020 ASX Corporate Governance Council, Dick Smith Holdings Ltd, 2013, *Dick Smith Holdings Limited Prospectus*, 21 November, https://www.asx.com.au/asxpdf/20131122/pdf/42l1lzy2s4jz05.pdf, p. 58.

**Figure 4** **Pro forma FY2013 to FY2014 sales reconciliation**




Source: © Copyright 2020 ASX Corporate Governance Council, Dick Smith Holdings Ltd, 2013, *Dick Smith Holdings Limited Prospectus*, 21 November, https://www.asx.com.au/asxpdf/20131122/pdf/42l1lzy2s4jz05.pdf, p. 56.

## INDUSTRY AND COMPETITIVE DYNAMICS IN THE CONSUMER ELECTRONICS SECTOR

In Australia and New Zealand, consumer electronics products retailing occurs through different platforms and brands. These include:

- specialty consumer electronics retailers (with physical stores and online channels), such as Dick Smith, JB Hi-Fi, Harvey Norman and other independent consumer electronics retailers
- department stores, such as Myer and David Jones
- stores, such as Big W, Kmart, Target and The Warehouse Group
- online pure-play retailers, such as Appliances Online, Amazon, eBay and Kogan.[14]

Dick Smith was one of the largest consumer electronics and appliance specialist retailers in Australia and New Zealand, with others including JB Hi-Fi and Harvey Norman (see Table 1). At the time, DSG had an estimated 10 to 11 per cent market share of the Australia and New Zealand consumer electronics sector. The DSG products were focused on the office and mobility segments as well as entertainment and

**Table 1 DSG primary competition**

| | Dick Smith | JB Hi-Fi | Harvey Norman |
|---|---|---|---|
| Core product focus | Office<br>Mobility<br>Entertainment | Entertainment<br>Office<br>CDs, DVDs, video games and other software<br>Appliances | Office<br>Entertainment<br>Appliances<br>Furniture and bedding |
| Australia and New Zealand store network | Total: 359<br>Australia: 298<br>New Zealand: 61 | Total: 177<br>Australia: 164<br>New Zealand: 13 | Total: 239<br>Australia: 206 (franchised)<br>New Zealand: 33 (owned) |
| Store banners | Dick Smith: 328<br>David Jones Electronics<br>Powered by Dick Smith: 30<br>Move: 1 | JB Hi-Fi: 168<br>JB Hi-Fi Home: 8<br>Clive Anthonys: 1 | Harvey Norman: 210<br>Domayne: 17<br>Joyce Mayne: 12 |
| Omni-channel platforms | Stores<br>Online transactional websites<br>Mobile transactional websites<br>Mobile transactional apps (full online product range)<br>Click-and-collect<br>In-store online portals | Stores<br>Online transactional websites<br>Mobile transactional websites<br>Mobile apps<br>Click-and-collect | Stores<br>Online transactional websites<br>Mobile transactional websites<br>Mobile photo apps<br>Click-and-collect |

Source: Dick Smith Holdings Ltd, 2013, *Dick Smith Holdings Limited Prospectus*, 21 November, https://www.asx.com.au/asxpdf/20131122/pdf/42l1lzy2s4jz05.pdf, p. 25.

accessories, and it had the largest electronic store network and several different banners to cover a larger demographic scope.[15]

## DSG INITIAL PUBLIC OFFERING

The DSG listing on the ASX was successful. Large investment houses and sophisticated investors bought into the growth story for DSG.[16] However, the IPO valuation was questionable. First, it was debatable that a comparable trading EBITDA or price earnings multiple was indeed correct for the strategic and financial context of DSG and was likely too high in pricing the IPO. DSG did not have an attractive historical performance of consistent free cash flow (FCF) growth and, despite what Anchorage promised by way of growth, it was not risk free. Second, while Anchorage did turn around Dick Smith, the IPO valuation was based on the premise of forecast EBITDA. These appeared optimistic and not commensurate with the risk profile of the organisation. The FCF risks were either downplayed or misunderstood by Anchorage. In this case, it was apparent the equities market mispriced the strategic and financial risk for DSG.

## DSG EXPANSION STRATEGY

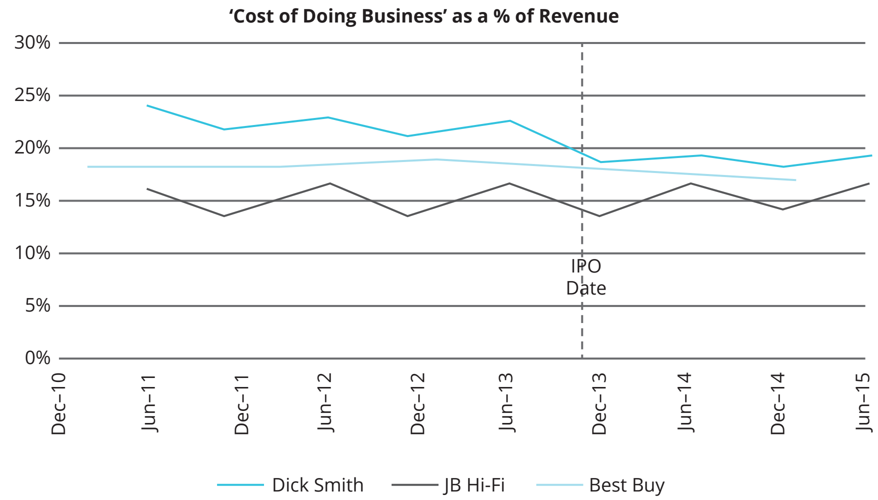
Post the IPO, DSG embarked on an expansion strategy. The DSG expansion strategy had five core pillars, namely:

1. new store expansion with the ambition to grow to 420–430 stores
2. new formats to target new segments of the market with MOVE and David Jones
3. private label growth
4. leveraging online platforms at physical locations
5. cost transformation.[17]

The Dick Smith-branded stores were core business and contributed 80 per cent of DSG revenue.[18] The external and internal factors that posed material risks to DSG's growth strategy were:

- DSG was at a competitive disadvantage, it operated in the highly competitive electronics retail market and only had a market share of approximately 10 per cent
- DSG had a high cost of doing business (see Figure 5)
- it suffered scale disadvantages to incumbents like Harvey Norman and JB Hi-Fi, which had larger financial capacity and offered greater product diversification at lower prices

**Figure 5** **Cost of doing business**




Source: Anchorage Capital Partners, 2016, *Senate Economics References Committee Inquiry in Relation to the Causes and Consequences of the Collapse of Listed Retailers in Australia, Anchorage Capital Partners Submission*, 18 March, https://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Dick_Smith/Submissions, p. 12.

- while it was growing its online business, it was not a significant contributor to DSG revenue
- the emergence of new digital players posed a threat
- DSG was highly dependent on the success of sales in the office products category that represented 42 per cent of sales in FY2015. This posed revenue sensitivity risks
- DSG was expanding stores at a time when its operating cash flow and FCF were declining from FY2014 to 31 December 2015.

While it was taking initiatives to grow the digital business, its 'bricks-and-mortar' expansion strategy was central to its growth ambitions. However, given the industry structure and its competitive position, this strategy was high risk. DSG was using the logic that a bigger 'profitable' store network would increase sales. While scale can deliver cost advantages, DSG had product mix and inventory issues. DSG had a well-known brand but it was debatable whether it had privileged assets that created any identifiable core competency; for example, its stores and distribution network did not possess any particular uniqueness compared with other electronics retailers such as JB Hi-Fi or Harvey Norman, which were larger and had greater product diversity and bargaining power with suppliers.

DSG was focused on increasing sales by selling to new target segments and better delivery distribution channels while leveraging digital capabilities to enhance its position. It also focused on actions of cost control that resulted in the CODB% declining by 21 bps to 18.7 per cent in FY2015 compared to FY2014.[19] However, it was unclear how DSG was going to sustain year-on-year CODB% improvements beyond this period.

## FINANCIAL PERFORMANCE OF DSG

The financial performance of the DSG company provides insights into the strategic and financial risks and failure of management to mitigate these. The following sections provide an analysis of the financial performance in the period immediately after the IPO and up to the period preceding financial collapse. The profit and loss, balance sheet and cash flow data are presented with accompanying analysis of key issues and risks.

### Profit and loss

The profit and loss (P/L) summary is highlighted in Table 2 and is based on audited results for the consolidated accounts. The key points and issues were:

1. DSG reported year-on-year revenue growth from FY2013 to FY2015 and steady gross margins. Revenue growth was due to new stores and increased sales growth in the commercial and online businesses. DSG generated around 40 per cent of its revenue from office products division in FY2015.
2. The commercial business segment contributed approximately 7 per cent of revenue in FY2015 (about $90 million).
3. The November 2012 acquisition by Anchorage resulted in a discount on acquisition of $146 million. The discount on

**Table 2** **Profit and loss summary FY2013 to FY2015**

| Summary profit and loss<br>$m | FY2013<br>10 mths | FY2014<br>Full year | FY2015<br>Full year |
|---|---|---|---|
| Revenue | 791.4 | 1 227.6 | 1 319.7 |
| Cost of sales | (607.0) | (919.6) | (992.8) |
| Gross profit | 184.4 | 308.0 | 326.8 |
| *Gross profit margin* | 23% | 25% | 25% |
| Other income | 146.9 | 1.2 | 1.0 |
| Marketing and sales costs | (104.7) | (130.5) | (112.9) |
| Occupancy and rental expenses | (46.4) | (79.3) | (93.3) |
| Administration costs | (35.7) | (45.2) | (57.3) |
| Finance costs | (2.3) | (2.9) | (4.1) |
| Other expenses | (3.5) | (22.7) | (6.8) |
| **Profit before income tax** | **138.7** | **28.7** | **53.4** |
| Income tax (expense)/benefit | 1.4 | (8.9) | (15.5) |
| **Net profit for the year** | **140.2** | **19.8** | **37.9** |
| FX and hedging, net of tax | 6.3 | (0.4) | (0.5) |
| **Total comprehensive income for the year** | **146.5** | **19.4** | **37.4** |

Source: McGrathNicol, 2016, *The Dick Smith Group, Report to Creditors Pursuant to Section 439A of the Corporations Act 2001*, 13 July, https://www.mcgrathnicol.com/app/uploads/DS-Australia-Report-to-Creditors-13-July-2016-updated-15-July-2016.pdf, p. 31.

acquisition is the difference between the fair value of net assets acquired and the consideration paid and was treated as other income in FY2013.

4. Rental expenses increased from $46 million in FY2013 to $93 million in FY2015 primarily due to the increase in the number of stores.[20]

## Balance sheet FY2013 to FY2015

The balance sheet summary is highlighted in Table 3 and was based on audited results for the consolidated accounts. The key points and issues were:

1. trade and other receivables increased, primarily due to increased rebates from suppliers as inventory was purchased
2. inventory increased each year, due to new store openings and to carry more private label products
3. plant and equipment increased each year due to the need for additional shop fit-outs as the store network expanded
4. trade and other payables increased from $153 million in FY2013 to over $220 million in FY2014 and FY2015 as DSG sought credit from suppliers to fund the additional inventory growth
5. borrowings increased, in part to contribute to the capital cost of establishing new stores
6. DSG held the majority of its assets in inventory and it steadily increased inventory holdings from FY2013 to FY2015
7. The significant increase in DSG's inventory increased the risk of balance sheet impairment.[21]

## Cash flow summary FY2013 to FY2015

The cash flow summary is highlighted in Table 4 and was based on audited results for the consolidated accounts. The key points and issues were:

1. cash flow from operating activities decreased each year from FY2013 to FY2015
2. DSG generated materially higher cash inflows from operating activities in FY2013 as a result of the July 2016 Report to Creditors; credit from suppliers to fund the additional inventory of the Dick Smith business by Anchorage
3. the net cash outflow from operating activities in FY2015 is partly attributable to payments to suppliers, connected to the inventory build-up on the balance sheet
4. cash outflows from investing activities decreased each year from FY2013 to FY2015
5. the payments for acquisition of the business totalling $103 million across FY2013 and FY2014 represent

**Table 3** **Balance sheet summary FY2013 to FY2015**

| Summary balance sheet | | | |
|---|---|---|---|
| $m | Jun-2013 | Jun-2014 | Jun-2015 |
| **Current assets** | | | |
| Cash and cash equivalents | 46.5 | 29.9 | 29.5 |
| Trade and other receivables | 10.4 | 46.7 | 53.3 |
| Inventories | 170.8 | 253.8 | 293.0 |
| Other current assets | 13.5 | 5.5 | 14.1 |
| Total current assets | 241.2 | 335.9 | 390.0 |
| **Non-current assets** | | | |
| Plant and equipment | 60.3 | 78.8 | 92.5 |
| Deferred tax assets | 42.9 | 36.5 | 26.0 |
| Total non-current assets | 103.1 | 115.3 | 118.5 |
| **Total assets** | **344.3** | **451.2** | **508.5** |
| **Current liabilities** | | | |
| Trade and other payables | (153.3) | (247.7) | (228.4) |
| Borrowings | – | – | (70.5) |
| Provisions | (16.1) | (13.6) | (13.3) |
| Other current liabilities | (2.9) | (5.5) | (4.3) |
| Total current liabilities | (172.3) | (266.8) | (316.5) |
| **Non-current liabilities** | | | |
| Provisions | (13.9) | (7.3) | (6.1) |
| Lease liabilities | (1.7) | (10.1) | (16.8) |
| Total non-current liabilities | (15.6) | (17.4) | (22.8) |
| **Total liabilities** | **(187.9)** | **(284.2)** | **(339.4)** |
| **Net assets** | **156.5** | **166.9** | **169.1** |
| **Equity** | | | |
| Issued capital | 10.0 | 346.1 | 346.1 |
| Reserves | 6.3 | (339.2) | (339.4) |
| Retained earnings | 140.2 | 160.0 | 162.4 |
| **Total equity** | **156.5** | **166.9** | **169.1** |

Source: McGrathNicol, 2016, *The Dick Smith Group, Report to Creditors Pursuant to Section 439A of the Corporations Act 2001*, 13 July, https://www.mcgrathnicol.com/app/uploads/DS-Australia-Report-to-Creditors-13-July-2016-updated-15-July-2016.pdf, p. 32.

the purchase price paid by Anchorage to Woolworths (the amount is calculated as the purchase price ($115 million) less cash acquired ($12 million))

6. payments for plant and equipment increased each year due to the store network expansion
7. the cash flow from financing activities was variable from FY2013 to FY2015 at DSG as capital structure changed
8. DSG total borrowings were at year end in FY2015 $71 million
9. DSG paid shareholder dividends in FY2015 totalling $36 million.[22]

**Table 4 Cash flow summary FY2013 to FY2015**

| Cash flow summary<br>$m | FY2013<br>10 mths | FY2014<br>Full year | FY2015<br>Full year |
|---|---|---|---|
| **Cash flows from operating activities** | | | |
| Receipts from customers | 890.4 | 1 316.4 | 1 446.0 |
| Payments to suppliers and employees | (772.4) | (1 261.1) | (1 430.9) |
| Interest and other costs of finance paid | (2.3) | (2.9) | (4.1) |
| Tax paid | 0.9 | (0.7) | (15.4) |
| Interest received | 1.1 | 0.5 | 0.4 |
| Net cash (used in/provided by operating activities) | 117.6 | 52.2 | (3.9) |
| **Cash flows from investing activities** | | | |
| Payments for plant and equipment | (2.5) | (30.5) | (31.6) |
| Proceeds on sale of plant and equipment | – | 0.5 | – |
| Payment for acquisition of business, net of cash acquired | (78.6) | (24.0) | – |
| Net cash used in investing activities | (81.1) | (54.0) | (31.6) |
| **Cash flows from financing activities** | | | |
| Proceeds from issue of shares | 10.0 | 343.6 | – |
| Payment in relation to corporate reorganisation | – | (358.6) | – |
| Proceeds (payments) from borrowings | – | 57.6 | 122.5 |
| Repayment of borrowings | – | (57.6) | (52.0) |
| Dividend paid | – | – | (35.5) |
| **Net cash provided by/(used in) financing activities** | **10.0** | **(15.0)** | **35.0** |
| **Net decrease in cash and cash equivalents** | **46.5** | **(16.8)** | **(0.5)** |
| FX | – | 0.2 | 0.1 |
| Cash and cash equivalents at the beginning of the year | – | 46.5 | 29.9 |
| **Cash and cash equivalents at the end of the year** | **46.5** | **29.9** | **29.5** |

Source: McGrathNicol, 2016, *The Dick Smith Group, Report to Creditors Pursuant to Section 439A of the Corporations Act 2001*, 13 July, https://www.mcgrathnicol.com/app/uploads/DS-Australia-Report-to-Creditors-13-July-2016-updated-15-July-2016.pdf, p. 34.

## FINANCIAL PERFORMANCE RISKS AND ISSUES

Several financial risks were evident in DSG before and at the time of the company being placed into voluntary administration. The following summarises the core issues and reasons for the financial collapse of DSG.

### Ineffective inventory management

The inventory carrying value increased as at 30 June 2013 from $170 million to $293 million as at 30 June 2015 due to new store expansions, declining DSG market share, decline in year-on-year store sales and purchasing decisions based on rebates instead of customer demand. From June 2013 there was an overall steady increase in inventory days. From mid-2015 the increase in aged inventory and inventory days resulted in pre-tax non-cash $60 million impairment. The clearance sale in the first half FY2016 had the effect of reducing sales of high margin products. This compounded the reduction in profitability because an unfavourable product mix was sold preferentially.[23]

### Purchasing decisions

The purchasing decisions at DSG were a significant issue. Decisions on the type and volume of stock were being based on supplier rebates rather than customer demand. The consequences of this led to an increase in inventory, slowing of inventory turnover and poor decisions on product mix which impacted on margins. In DSG's case, this practice of maximising rebates led to obsolete stock but also in part to the $60 million inventory impairment in November 2015. The extent of reliance on rebates was evident in FY2015, where $191 million in rebates (including marketing subsidies) produced an EBITDA of $72 million. Excluding the rebates the EBITDA was –$119 million, indicating that rebates were a significant part of the DSG business. While rebating is normal in retail, it appears that rebating within DSG was problematic.[24]

### Unfavourable product mix

The December 2015 clearance sale had unintended consequences in that DSG's inventory mix did not meet customer demand in the December trading period. The poor product mix was also attributed to restrictive credit requirements by suppliers with some demanding cash on delivery. Also DSG had reduced access to some quality products. The liquidity compression within DSG hindered it from stocking high margin and high demand products. This was a major contributor in the poor December 2015 sales performance.[25]

### Competitive pressure and declining performance

Net profit after tax (NPAT) and free cash flow (operating cash flow less CaPex) deteriorated from FY2013 to the end of 31 December 2015. NPAT declined from a high of $140.2 million in FY2013 to $19.8 million (FY2014), $37.9 million (FY2015) and –$116.7 million (six months ending 31 December 2015). This was a result of poor sales performance, particularly in the six months ending 31 December 2015, as a result of competitive pressure, poor operational performance and questionable stock purchasing decisions. Gross profit margins were maintained at 25 per cent in FY2014 and FY2015, but collapsed in the six-month period to 31 December 2015 to 8 per cent. The FCF performance was also problematic. In FY2013, FCF was $115.1 million, $21.7 million (FY2014), –$35.5 million (FY2015) and –$43 million (six months to 31 December 2015). This was a consistent year-on-year material decline and indicates that DSG core operations were materially deficient cash generators. DSG's earnings quality was dubious and problematic. From FY2013 through to FY2015 operating cash flow declined and in the six months to December 2015 was characterised by material variations in profit and cash flow due to suboptimal inventory management and ambitious store investment. The FCF had been declining since FY2013 and in FY2015 and first half FY2016 was negative for the entire period.[26]

### Declining liquidity

The net increase/(decrease) in cash and cash equivalents were $46.5 million (FY2013), –$16.8 million (FY2014) and –$0.5 million (FY2015). Ignoring the FY2013 operating cash flow result as DSG generated materially higher cash inflows from sale clearance activities undertaken by Anchorage, the operating cash flow declined from $52.2 million in FY2014 to –$3.9 million in FY2015 and then –$22 million for the six months ending December 2015. Borrowing also increased from FY2014 to FY2015 by $70.5 million and then to the six months ending December 2015 to $127.2 million, indicating deficient cash flow generation in the business (see Figure 6). These metrics indicate increasing liquidity pressure in the business due to various operational and strategic risks in the business. On 28 October 2015 at the Dick Smith Annual General Meeting (approximately two months before the DSG board placed DSG into administration) the chairman stated:

> Cash flow during the year was impacted by the decision to avail ourselves of beneficial inventory buying opportunities. This involved the Company buying inventory earlier in the year than normal to take advantage of favourable exchange rates and product prices and resulted in the payment of this inventory before the end of the year. Your Directors anticipate improved cash conversion in 2016, despite the challenging retail environment.
>
> Notwithstanding the cash flow impact, the Company's balance sheet remains strong.
>
> Your Directors are pleased to declare a 5 cent per share fully franked dividend, which was paid on 30 September 2015....[27]

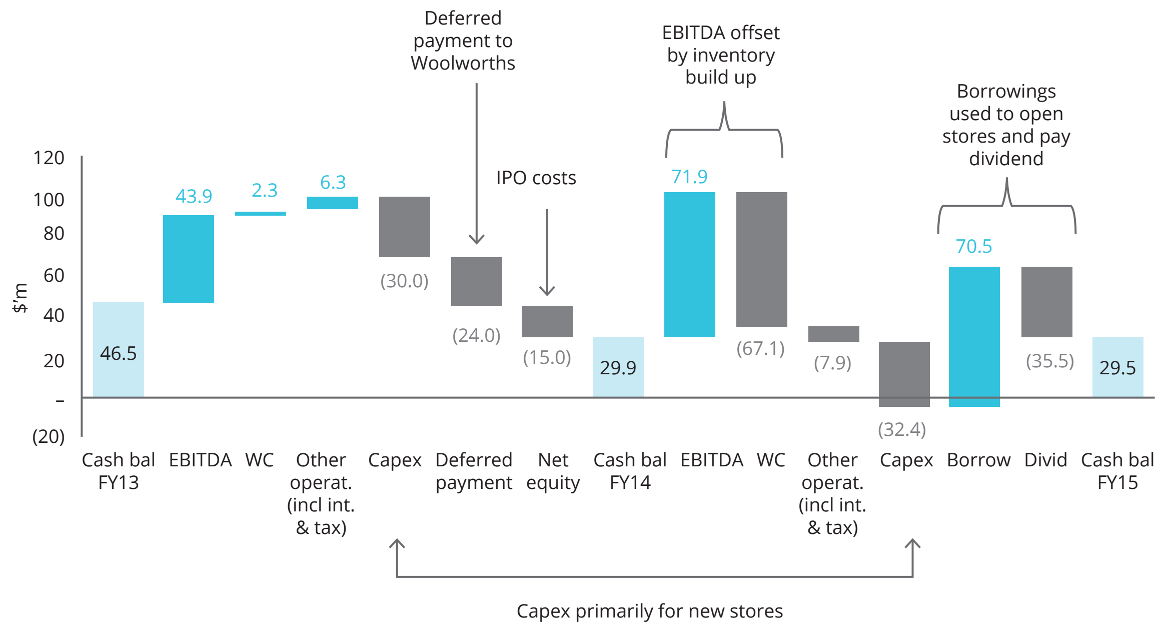
## STRATEGIC FACTORS AND OTHER ISSUES

The financial implications of the failure of DSG were likely caused by several interacting factors. The intended strategy and execution thereof, the role of corporate governance and the ownership of DSG pre-IPO are important factors that need to be considered in the failure of the business.

### Corporate governance

It is argued that a board's approach to strategy can be categorised according to two constructs: strategic control and financial control. The extent to which either construct is favoured depends on factors such as board power, environmental uncertainty and information asymmetry.[28]

**Figure 6 DSH cash movements since FY2013**




Source: McGrathNicol, 2016, *The Dick Smith Group, Report to Creditors Pursuant to Section 439A of the Corporations Act 2001*, 13 July, https://www.mcgrathnicol.com/app/uploads/DS-Australia-Report-to-Creditors-13-July-2016-updated-15-July-2016.pdf, p. 35.

The DSG board appeared to struggle with these strategic and financial control issues. DSG had as part of its remuneration processes short-term and long-term incentives. The growth strategy appeared to be mismatched with its long-term incentives because it was predominantly focused on sales revenue and not necessarily creation. While the DSG board had established a finance and risk audit committee and had a risk management framework, given the failure of the business it is questionable whether governance was effective.

## Physical store expansion strategy

As at the end of FY2015, DSG had 393 physical store locations and in the second half FY2015 it opened 14 stores (net of store closures). It was planning to open a further 15 to 20 stores in FY2016. Its ambition was to grow its store network to 420 to 430 stores by FY2017 and grow private labels among other growth actions.[29] DSG's revenue was highly dependent on its store revenue. Further expansion into an already highly competitive electronics market was fraught with risks. The expansion was funded by debt, but declining cash flow performance increased the financial risk and hence insolvency and default risk. While it was attempting to diversify its channels and increase sales through targeting other segments – for example, MOVE, David Jones in-stores and omni-channel strategy – these represented only a small proportion of its revenue-producing network and consequently was not effective in arresting the decline in performance.

## Anchorage Capital

It is arguable that Anchorage Capital set up DSG for successful long-term sustainable operation. As a financial buyer Anchorage did not have long-term ambitions for DSG and an exit was engineered through an IPO. Anchorage only had 20 per cent of DSG shares in escrow post the IPO and fully exited in September 2014.[30]

Anchorage and Woolworths agreed on a total consideration for the transaction of $115 million but $103 million was deferred consideration that was paid to Woolworths in FY2013 ($78.6 million) and FY2014 ($24 million). In the context of DSG cash flows, these payments represented material outflows at a time that DSG was gearing up for expansion and also increasing inventory. These transactions would have in part contributed to liquidity stress in the business as DSG turned to debt funding to acquire more inventories, fund capital expenditure and pay dividends.[31]

## CONCLUDING REMARKS

The failure of DSG was unlikely to have been caused by one factor. The performance of the DSG board to provide prudent and rigorous financial risk management oversight and the flawed expansion strategy were principal causes. However, the role of private equity firm Anchorage is also worthy of debate as its equity interest was short-term with a focus to maximise the value of its initial investment as quickly as possible. In this case, the mismatch of short-term financial engineering and strategy to create sustainable long-term shareholder value was an evident and problematic issue with adverse consequences for shareholders, debt providers and employees.

### Questions

1. Critically analyse the fatal flaws in the DSG strategy using the framework of strategic capabilities and competitive advantage in the post-IPO period. Did DSG possess any core competence or not? Provide views and supporting arguments.
2. Discuss whether a non-PE buyer (i.e. a strategic buyer rather than a pure financial buyer) that DSG may have had a more sustainable financial outcome and avoided financial collapse. Or was it doomed to fail regardless of corporate sponsor/owner? Provide views with supporting arguments.
3. DSG had arguably an experienced, qualified and well-credentialled board, was essentially compliant with ASX Corporate Governance principles and conventional governance regimes at the time, and had a coherent risk policy and framework. Why did the board still miss the growing financial and liquidity risk with the intended strategy? Provide plausible reasons and logic supporting your views.
4. Using industry structure models, discuss the core issue facing DSG.

## NOTES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# GLOSSARY

**above-average returns**
returns in excess of what an investor expects to earn from other investments with a similar amount of risk

**acquisition**
a strategy through which one organisation buys a controlling, or 100 per cent, interest in another organisation with the intent of making the acquired organisation a subsidiary business within its portfolio

**agency costs**
the sum of incentive costs, monitoring costs, enforcement costs and individual financial losses incurred by principals because governance mechanisms cannot guarantee total compliance by the agent

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

**average returns**
returns equal to those an investor expects to earn from other investments with a similar amount of risk

**balanced scorecard**
a framework that organisations can use to verify that they have established both strategic and financial controls to assess their performance

**board of directors**
a group of elected individuals whose primary responsibility is to act in the owners' interests by formally monitoring and controlling the organisation's executives

**business-level cooperative strategy**
used to help the organisation improve its performance in individual product markets

**business-level strategy**
an integrated and coordinated set of commitments and actions the organisation uses to gain a competitive advantage by exploiting core competencies in specific product markets

**business model**
describes what an organisation does to create, deliver and capture value for its stakeholders

**capability**
the capacity for a set of resources to perform a task or an activity in an integrative manner

**combination structure**
a structure drawing characteristics and mechanisms from both the worldwide geographic area structure and the worldwide product divisional structure

**competitive action**
a strategic or tactical action the organisation takes to build or defend its competitive advantages or improve its market position

**competitive behaviour**
the set of competitive actions and competitive responses the organisation takes to build or defend its competitive advantages and to improve its market position

**competitive dynamics**
refers to all competitive behaviours; that is, the total set of actions and responses taken by all organisations competing within a market

**competitive form**
a structure in which there is complete independence among the organisation's divisions

**competitive response**
a strategic or tactical action the organisation takes to counter the effects of a competitor's competitive action

**competitive rivalry**
the ongoing set of competitive actions and competitive responses occurring between competitors as they compete against each other for an advantageous market position

**competitor intelligence**
the set of data and information the organisation gathers to better understand and better anticipate competitors' objectives, strategies, assumptions and capabilities

**competitors**
organisations operating in the same market, offering similar products and targeting similar customers

**complementary strategic alliances**
business-level alliances in which organisations share some of their resources and capabilities in complementary ways to develop competitive advantages

**complementors**
companies or networks of companies that sell complementary goods or services that are compatible with the focal organisation's good or service

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

**cooperative strategy**
a strategy in which organisations work together to achieve a shared objective

**core competencies**
capabilities that serve as a source of competitive advantage for an organisation over its rivals

**corporate entrepreneurship**
the use or application of entrepreneurship within an established organisation

**corporate governance**
the set of mechanisms used to manage the relationship among stakeholders and to determine and control the strategic direction and performance of organisations

**corporate social responsibility (CSR)**
requires companies to consider the interests of all stakeholders, including investors, suppliers, consumers, employees and the community, in going about its business
**corporate-level cooperative strategy**
used by the organisation to help it diversify in terms of products offered or markets served, or both
**corporate-level core competencies**
complex sets of resources and capabilities that link different businesses, primarily through managerial and technological knowledge, experience and expertise
**corporate-level strategy**
specifies actions an organisation takes to gain a competitive advantage by selecting and managing a group of different businesses competing in different product markets
**cost leadership strategy**
an integrated set of actions taken to produce goods or services with features that are acceptable to customers at the lowest cost, relative to that of competitors
**costly-to-imitate capabilities**
capabilities that another organisation cannot easily develop
**cross-border strategic alliance**
an international cooperative strategy in which organisations with headquarters in different nations combine some of their resources and capabilities to create a competitive advantage
**demographic segment**
concerned with a population's size, age structure, geographic distribution, ethnic mix and income distribution
**differentiation strategy**
an integrated set of actions taken to produce goods or services (at an acceptable cost) that customers perceive as being different in ways that are important to them
**diversifying strategic alliance**
a corporate-level cooperative strategy in which organisations share some of their resources and capabilities to diversify into new product or market areas
**economic environment**
refers to the nature and direction of the economy in which an organisation competes or may compete
**economies of scale**
average cost (i.e. cost per unit of output) decreases as output volume increases
**economies of scope**
cost savings that the organisation creates by successfully sharing some of its resources and capabilities or transferring one (or more) corporate-level core competence that was developed in one of its businesses to another of its businesses
**entrepreneurial mindset**
the person who values uncertainty in the marketplace and seeks to continuously identify opportunities with the potential to lead to important innovations
**entrepreneurial opportunities**
conditions in which new goods or services can satisfy a need in the market
**entrepreneurs**
individuals, acting independently or as part of an organisation, who see an entrepreneurial opportunity and then take risks to develop an innovation to pursue it
**equity strategic alliance**
an alliance in which two or more organisations own different percentages of the company they have formed by combining some of their resources and capabilities to create a competitive advantage
**ethnocentric strategy**
strategy based on the belief that the people, customs and traditions of your own race or nationality are better than those of others. In business, this means hiring or promoting staff from the country of the headquarters, and standardising based on the HQ country's processes
**executive compensation**
a governance mechanism that seeks to align the interests of managers and owners through salaries, bonuses and long-term incentive compensation, such as stock awards and options
**executive management team**
composed of the key managers who are responsible for selecting and implementing the organisation's strategies
**external managerial labour market**
the collection of managerial career opportunities and the qualified people who are external to the organisation in which the opportunities exist
**fast-cycle markets**
markets in which the organisation's capabilities are not shielded from imitation and where imitation happens quickly and perhaps somewhat inexpensively
**financial controls**
largely objective criteria used to measure the organisation's performance against previously established quantitative standards
**financial economies**
cost savings realised through improved allocations of financial resources based on investments inside or outside the organisation
**first mover**
an organisation that takes an initial competitive action in order to build or defend its competitive advantages or to improve its market position
**focus strategy**
an integrated set of actions taken to produce goods or services that serve the needs of a particular competitive segment
**franchising**
a corporate-level cooperative strategy in which an organisation (the franchisor) uses a franchise as a contractual relationship to describe and control the sharing of its resources and capabilities with partners (the franchisees)
**functional structure**
consists of a chief executive officer and a limited corporate staff, with functional line managers in dominant

organisational areas, such as production, accounting, marketing, research and development, engineering and human resources

**general environment**
composed of dimensions in the broader society that influence an industry and the organisations within it

**global economy**
one in which goods, services, people, skills and ideas move freely across geographic borders

**global mindset**
the ability to study an internal environment in ways that are not dependent on the assumptions of a single country, culture or context

**global segment**
includes relevant new global markets, existing markets that are changing, important international political events and critical cultural and institutional characteristics of global markets

**global strategy**
an international strategy through which the organisation offers standardised products across country markets, with competitive strategy being dictated by the home office

**'glocalisation' strategy**
strategy based on the belief that products or services should be developed and distributed globally but is also adjusted to accommodate the user or consumer in a local market. Glocalisation is a combination of the words 'globalisation' and 'localisation'

**greenfield venture**
the establishment of a new wholly owned subsidiary

**heterogeneous management team**
composed of individuals with different cultural backgrounds, experience and education

**human capital**
refers to the knowledge and skills of an organisation's entire workforce

**hypercompetition**
a condition where competitors engage in intense rivalry, markets change quickly and often, and entry barriers are low

**imitation**
the adoption of an innovation by similar organisations

**industry**
a group of organisations producing products that are close substitutes

**industry environment**
the set of factors that directly influences an organisation and its competitive actions and competitive response: the threat of new entrants, the power of suppliers, the power of buyers, the threat of product substitutes and the intensity of rivalry among competitors

**innovation**
a new or improved product or process that differs from the previous product or process and that has been made available to potential users

**innovation process**
based on the need to commit resources and the consideration of the uncertainty of returns from innovative investments

**institutional owners**
financial institutions such as stock mutual funds and superannuation funds that control large-block shareholder positions

**intangible resources**
assets that generally are rooted deeply in the organisation's history and have accumulated over time

**integrated cost leadership/differentiation strategy**
involves engaging in primary value chain activities and support functions that allow an organisation to simultaneously pursue low cost and differentiation

**internal managerial labour market**
consists of an organisation's opportunities for managerial positions and the qualified employees within that organisation

**international diversification strategy**
a strategy through which an organisation expands the sales of its goods or services across the borders of global regions and countries into different geographic locations or markets

**international entrepreneurship**
a process in which organisations creatively discover and exploit opportunities that are outside their domestic markets in order to develop a competitive advantage

**international strategy**
a strategy through which the organisation sells its goods or services outside its domestic market

**invention**
the act of creating or developing a new product or process

**joint venture**
a strategic alliance in which two or more organisations create a legally independent company to share some of their resources and capabilities to develop a competitive advantage

**large-block shareholders**
typically own at least 5 per cent of a corporation's issued shares

**late mover**
an organisation that responds to a competitive action, but only after considerable time has elapsed after the first mover's action and the second mover's response

**managerial opportunism**
the seeking of self-interest with guile (i.e. cunning or deceit)

**market commonality**
concerned with the number of markets with which the organisation and a competitor are jointly involved and the degree of importance of the individual markets to each

**market for corporate control**
an external governance mechanism that becomes active when an organisation's internal controls fail

**market power**
exists when an organisation is able to sell its products above the existing competitive level or to reduce the costs of its primary and support activities below the competitive level, or both

**market segmentation**
a process used to cluster people with similar needs into individual and identifiable groups
**merger**
a strategy through which two organisations agree to integrate their operations on a relatively coequal basis
**mission**
specifies the business or businesses in which the organisation intends to compete and the customers it intends to serve
**multi-divisional (M-form) structure**
consists of operating divisions, each representing a separate business or profit centre in which the top corporate officer delegates responsibilities for day-to-day operations and business-unit strategy to division managers
**multi-domestic strategy**
an international strategy in which strategic and operating decisions are decentralised to the strategic business unit in each country so as to allow that unit to tailor products to the local market. See also polycentric strategy
**multi-market competition**
occurs when organisations compete against each other in several product or geographic markets
**multi-point competition**
exists when two or more diversified organisations simultaneously compete in the same product areas or geographic markets
**network cooperative strategy**
a cooperative strategy wherein several organisations agree to form multiple partnerships to achieve shared objectives
**non-equity strategic alliance**
an alliance in which two or more organisations develop a contractual relationship to share some of their unique resources and capabilities to create a competitive advantage
**non-substitutable capabilities**
capabilities that do not have strategic equivalents
**opportunity**
a condition in the general environment that, if exploited, helps a company achieve strategic competitiveness
**organisational controls**
guide the use of strategy, indicate how to compare actual results with expected results and suggest corrective actions to take when the difference between actual and expected results is unacceptable
**organisational culture**
refers to the complex set of ideologies, symbols and core values that are shared throughout the organisation and that influence how the organisation conducts business
**organisational structure**
specifies the organisation's formal reporting relationships, procedures, controls, and authority and decision-making processes
**outsourcing**
the purchase of a value-creating activity from an external supplier
**ownership concentration**
refers to both the number of large-block shareholders and the total percentage of shares they own
**physical environment segment**
refers to potential and actual changes in the physical environment and business practices that are intended to positively respond to and deal with those changes
**political/legal segment**
the arena in which organisations and interest groups compete for attention, resources and a voice in overseeing the body of laws and regulations guiding the interactions among nations
**polycentric strategy**
strategy based on the belief that the local people, customs and traditions are best suited to business in that country. This means hiring or promoting local staff, and adopting many local processes rather than a single standardised global approach
**product innovation**
a good or service that is new or significantly improved, including significant improvements in technical specifications, components and materials, software in the product, user friendliness or other functional characteristics
**profit pool**
entails the total profits earned in an industry at all points along the value chain
**quality**
exists when the organisation's goods or services meet or exceed customers' expectations
**rare capabilities**
capabilities that few, if any, competitors possess
**regiocentric strategy**
strategy based on the belief that the regional people, customs and traditions are best suited to business in that region. This means hiring or promoting staff from, or with knowledge of, that region, and adopting regional processes that apply across multiple countries in the region rather than a single standardised global approach or an individual country approach
**resource similarity**
the extent to which the organisation's tangible and intangible resources are comparable to a competitor's in terms of both type and amount
**resources**
inputs into an organisation's production process, such as capital equipment, the skills of individual employees, patents, finances and talented managers
**restructuring**
a strategy through which an organisation changes its set of businesses or its financial structure
**risk**
an investor's uncertainty about the economic gains or losses that will result from a particular investment
**second mover**
an organisation that responds to the first mover's competitive action, typically through imitation

**simple structure**
a structure in which the owner-manager makes all major decisions and monitors all activities while the staff serves as an extension of the manager's supervisory authority

**slow-cycle markets**
markets in which the organisation's competitive advantages are shielded from imitation for what are commonly long periods of time and where imitation is costly

**social capital**
involves relationships inside and outside the organisation that assist the organisation to accomplish tasks and create value for customers and shareholders

**sociocultural segment**
concerned with a society's attitudes and cultural values

**stakeholders**
the individuals and groups who can affect and are affected by the strategic outcomes achieved and who have enforceable claims on an organisation's performance

**standard-cycle markets**
markets in which the organisation's competitive advantages are moderately shielded from imitation and where imitation is moderately costly

**strategic action or strategic response**
a market-based move that involves a significant commitment of organisational resources and is difficult to implement and reverse

**strategic alliance**
a cooperative strategy in which organisations combine some of their resources and capabilities to create a competitive advantage

**strategic business unit (SBU) form**
consists of three levels: corporate headquarters, strategic business units (SBUs) and SBU divisions

**strategic competitiveness**
achieved when an organisation successfully formulates and implements a value-creating strategy

**strategic controls**
largely subjective criteria intended to verify that the organisation is using appropriate strategies for the conditions in the external environment and the company's competitive advantages

**strategic direction**
the image and character the organisation seeks to develop over time

**strategic entrepreneurship**
taking entrepreneurial actions using a strategic perspective

**strategic flexibility**
a set of capabilities used to respond to various demands and opportunities existing in a dynamic and uncertain competitive environment

**strategic group**
a set of organisations that emphasise similar strategic dimensions and use a similar strategy

**strategic leaders**
people located in different sections of the organisation using the strategic management process to assist the organisation reach its vision and mission

**strategic leadership**
the ability to anticipate, envision, maintain flexibility and empower others to create strategic change as necessary

**strategic management process**
the full set of commitments, decisions and actions required for an organisation to achieve strategic competitiveness and earn above-average returns

**strategy**
an integrated and coordinated set of commitments and actions designed to exploit core competencies and gain a competitive advantage

**support functions**
include the activities or tasks the organisation completes in order to support the work being done to produce, sell, distribute and service the products the organisation is producing

**synergistic strategic alliance**
a corporate-level cooperative strategy in which organisations share some of their resources and capabilities to create economies of scope

**synergy**
exists when the value created by business units working together exceeds the value that those same units create working independently

**tactical action or tactical response**
a market-based move that is taken to fine-tune a strategy; it involves fewer resources and is relatively easy to implement and reverse

**takeover**
a special type of acquisition strategy wherein the target organisation does not solicit the acquiring organisation's bid

**tangible resources**
assets that can be seen and quantified

**technological segment**
the organisations and activities involved with creating new knowledge and translating that knowledge into new outputs, products, processes and materials

**threat**
a condition in the general environment that may hinder a company's efforts to achieve strategic competitiveness

**total quality management (TQM)**
a managerial innovation that emphasises an organisation's total commitment to the customer and to continuous improvement of every process through the use of data-driven, problem-solving approaches based on empowerment of employee groups and teams

**transnational strategy**
an international strategy through which the organisation seeks to achieve both global efficiency and local responsiveness

**valuable capabilities**
allow the organisation to exploit opportunities or neutralise threats in its external environment

**value**
measured by a product's performance characteristics and by its attributes for which customers are willing to pay

**value chain activities**
activities or tasks the organisation completes in order to produce products and then sell, distribute and service those products in ways that create value for customers

**vertical integration**
exists when a company produces its own inputs (backward integration) or owns its own source of output distribution (forward integration)

**vision**
a picture of what the organisation wants to be and, in broad terms, what it wants to ultimately achieve

**worldwide geographic area structure**
emphasises national interests and facilitates the organisation's efforts to satisfy local or cultural differences

**worldwide product divisional structure**
decision-making authority is centralised in the worldwide division headquarters to coordinate and integrate decisions and actions among divisional business units

# NAME INDEX

# SUBJECT INDEX