Organizational Strategy & Performance

2

Chapter Outline:

2-1
The Strategic Managment Process

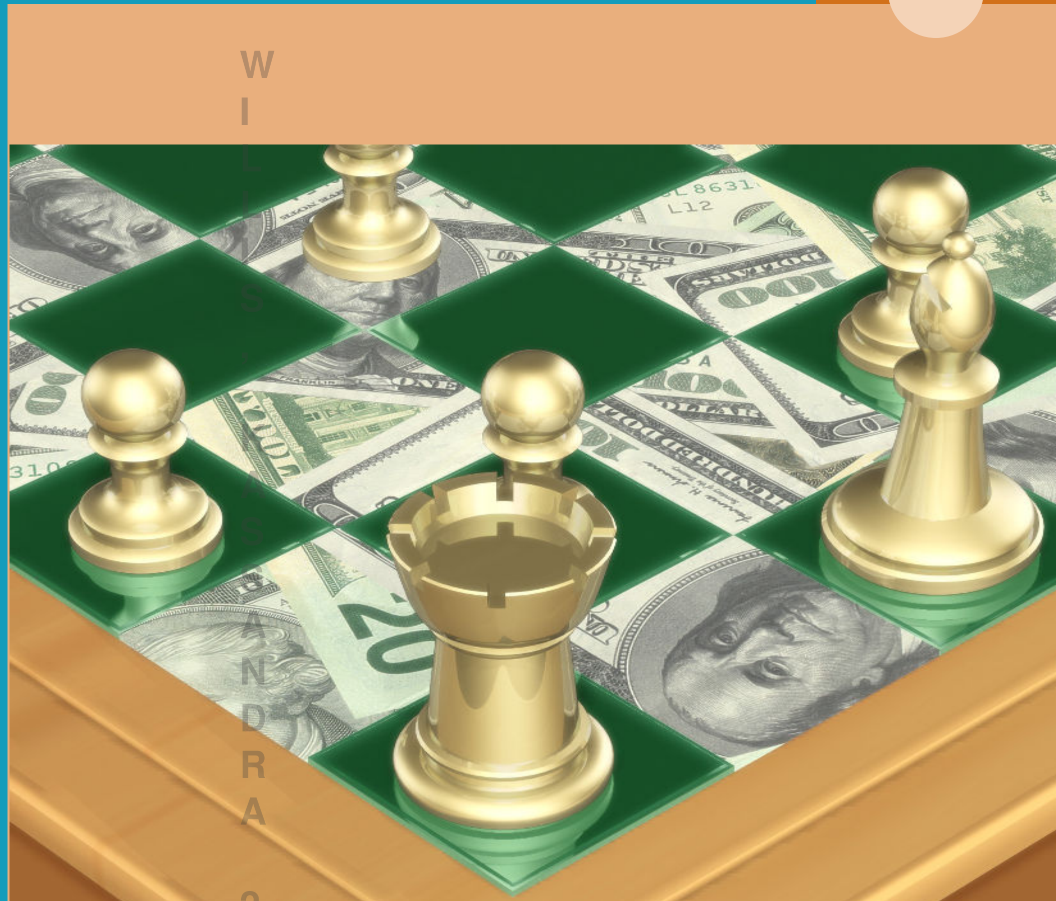
2-2
Theories of Strategy

2-3
Strategy at the Corporate Level

2-4
Strategy at the Business Level

2-5
Strategy at the Functional Level

Summary
Review Questions
Glossary
Endnotes



Key Terms

business-level strategy
business unit
competitive advantage
contingency theory
core competencies
corporate profile
corporate restructuring
corporate-level strategy
differentiation strategy
distinctive competence
divestment
downsizing
external growth
first-mover advantages
focus
functional strategies
generic strategies
growth strategy
industrial organization (IO)
industry
intended strategy
internal growth
liquidation
low-cost strategy
low-cost–differentiation
realized strategy
related diversification
retrenchment strategy
stability strategy
strategic alliances
strategic group
strategic mgmt. process
strategy
synergy
turnaround

Organizations are most likely to succeed when their activities are integrated toward a common purpose. But this does not occur automatically; it requires substantial forethought and planning. In other words, it requires a strategy. This chapter discusses the strategic planning process, as well as strategic alternatives available for each organization. Although the concepts presented herein have been developed with profit-seeking firms in mind, they can be equally applicable to public and private not-for-profit organizations that must compete in some way with other organizations or agencies.

The concept of an organizational strategy encapsulates the notion of planning for success. Specifically, a **strategy** refers to top management's plans to develop and sustain competitive advantage so that the organization's mission is fulfilled. A strategy provides direction for the organization and can be identified by examining a pattern of decisions made by an organization's top managers. It is most likely to be effective when it is compatible with the organization's structure and culture, concepts that will be developed later in the text. Although strategy is discussed before structure and culture, all three dimensions are tightly intertwined.

strategy
top management's plans to attain outcomes consistent with the organization's mission and goals

A successful strategy is marked by four key distinctions. First, it does not simply emerge, but rather is developed after top managers systematically evaluate both the organization's resources and external factors that can affect performance. Second, it is long-term and future-oriented—usually several years to a decade or longer—but built on knowledge about the past and present. Third, it is distinctively opportunistic, always seeking to take advantage of favorable situations that occur outside the organization. Finally, strategic thinking involves choices. "Win-win" strategic decisions are often possible, but most involve some degree of trade-off between alternatives, at least in the short run.

2-1 The Strategic Management Process

Ideally, a strategy is developed as part of a conscious activity led by an organization's top managers. The **strategic management process** also includes top management's analysis of the environment in which the organization operates prior to formulating a strategy, as well as the plan for implementation and control of the strategy. This process can be summarized in six steps:[1]

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

1. *External Analysis:* Analyze the opportunities and threats or constraints that exist in the organization's external environment.

2. *Internal Analysis:* Analyze the organization's strengths and weaknesses in its internal environment.

3. *Mission and Direction:* Reassess the organization's mission and its goals in light of the external and internal analyses.

4. *Strategy Formulation:* Formulate strategies that build and sustain competitive advantage by matching the organization's strengths and weaknesses with the environment's opportunities and threats. Consider the fit between the strategy and other organizational dimensions, such as the structure and the prevailing culture.

5. *Strategy Implementation:* Implement the strategies that have been developed. Make adjustments to the organizational structure, if feasible and relevant.

6. *Strategic Control:* Evaluate organizational effectiveness and engage in strategic control activities when the strategies are not producing the desired outcomes.

Although this process is simple and straightforward, complexities in the environment complicate the process, especially between the time a strategy is formulated and the time it is actually implemented. Henry Mintzberg introduced two terms to help clarify the shift that often occurs during this period. An **intended strategy** reflects what management originally planned and may be realized just as it was proposed , but the intended strategy and the **realized strategy**, what management actually implements usually differ.[2] Hence, the original strategy may be realized with desirable or undesirable results, or it may be modified as changes in the firm or the environment become known.

intended strategy
the original strategy top management plans and intends to implement

realized strategy
the strategy top management actually implements

The gap between the intended and realized strategies usually results from unforeseen environmental or organizational events, better information that was not available when the strategy was formulated, an improvement in top management's ability to assess its environment, or strategic responses from competitors. As such, this gap can be minimized if top managers assimilate and process information about the organization's environment more effectively. It is not uncommon for such a gap to exist, creating the need for constant strategic action if a firm is to stay on course. Instead of resisting modest strategic changes when new information is discovered, managers should search for new information and be willing to make such changes when necessary.

A thorough discussion of each step of the strategic management process is beyond the scope of this text. However, many of the concepts presented in the text relate to one or more of these phases. The remainder of this chapter is concerned primarily with the theories that influence the process and the content of corporate and competitive strategies available to organizations.

WILLIS, KASSANDRA 2161TS

2-2 Theories of Strategy

The strategic management process has been influenced by a number of theories and perspectives, three of which are summarized in the table 2-1 and discussed below.

TABLE 2-1 Theoretical Perspectives on Firm Performance

Theoretical Perspective	Primary Influence on Organizational Performance	How Perspective Fits Into the Strategic Management Process
Industrial organization (IO) theory	Structure of the industry	Step 1: External Analysis
Resource-based theory	Firm's unique combination of strategic resources	Step 2: Internal Analysis

WILLIS, KASSANDRA 2161TS

Industrial organization (IO) economics, a branch of microeconomics, emphasizes the *influence of the industry environment* upon the organization. IO emphasizes that an organization must adapt to influences exerted by its **industry**— the collection of competitors that offer similar products or services—to survive and prosper. Following this logic, organizational performance is primarily determined by the structure of the industry in which it competes. Industries with "favorable structures" offer the greatest opportunity for high organizational performance.

industrial organization (IO)
a view based in microecomonic theory that states that a firm's profitability is most closely associated with industry structure

industry
a group of competitors that produces similar products or services

IO logic can be seen in Michael Porter's frequently cited "five forces" model, discussed in greater detail in the following chapter. Porter's model identifies five structural elements that influence industry profitability: Existing rivalry, threat of substitutes, threat of new entrants, bargaining power of buyers, and bargaining power of suppliers.[3] These factors collectively determine the potential for profits in a particular industry. It assumes that organizations are likely to perform well when they operate in industries with attractive structures.

The concept of adaptation is central to the IO perspective. In essence, an organization's performance and ultimate survival depend on its ability to adapt to external forces rather than attempt to influence or control them. Strategies, resources, and competencies are assumed to be fairly similar among competitors within a given industry. If one organization deviates from the industry norm and implements a new, successful strategy, others will rapidly mimic the higher-performing organization by purchasing the resources, competencies, or management talent that have made the leading firm so profitable. Hence, strategic managers should seek to understand the nature of the industry and formulate strategies that feed off the industry's characteristics.[4]

resource-based theory
a view that states that a firm's performance is tied to the resources it acquires and utilizes.

In contrast to the IO perspective, **resource-based theory** views performance primarily as a function of an organization's ability to acquire and utilize its resources.[5] Although environmental opportunities and threats are important, an

organization's unique resources comprise the key variables that allow it to develop a **distinctive competence**, distinguishing itself from its rivals, and creating competitive advantage. "Resources" include all of a firm's tangible and intangible assets, such as capital, equipment, employees, knowledge, and information.[6] In many respects, an organization's resources define its capabilities, as an organization with strong research and development may also possess the capability to develop successful new products. Ultimately, this can create value and lead to greater performance.

distinctive competence
unique resources, skills, and capabilities that enable an organization to distinguish itself from its competitors and create a competitive advantage

All resources are not equally valuable. If resources are to be used for *sustainable* competitive advantage—a organization's ability to enjoy strategic benefits and outperform the industry norm over an extended period of time—those resources must be valuable, rare (i.e., not easily obtained by rivals), not easily imitated, and without strategically relevant substitutes.[7] In other words, the most desirable resources on ones that utilized by an organization in a way that competitors cannot easily match. Valuable resources contribute significantly to the organization's effectiveness and efficiency, rare resources are possessed by only a few competitors, and imperfectly imitable resources cannot be fully duplicated by rivals.

Contingency theory emphasizes the interaction between the organization and its environment. Within this perspective, the *fit* between organization and environment is the central concern. In other words, a strategy is most likely to be successful when it is consistent with the organization's mission, its competitive environment, and its resources. In effect, contingency theory represents a *middle ground* perspective that views organizational performance as the joint outcome of environmental forces and the firm's strategic actions. On the one hand, firms can become proactive by choosing to operate in environments where opportunities and threats match the firms' strengths and weaknesses.[8] On the other hand, should the industry environment change in a way that is unfavorable to the firm, its top managers should consider leaving that industry and reallocating its resources to other, more favorable industries.

contingency theory
a perspective that suggests that the most profitable firms are likely to be the ones that develop the best fit with their environments

Contingency theory is applied when a strategy is formulated. Strategic managers consider internal resources in light of external opportunities and threats and develop strategies that reflect a fit between the two. Hence, an effective strategy is not merely a "good idea," but one that capitalizes on the particular resources controlled by an organization and the environment in which it operates. In other words, an effective strategy "fits" the organization.

As has been demonstrated, each of these three perspectives has merit and has been incorporated into the strategic management process. The industrial organization view is prominent within the industry analysis phase, resource-based theory applies directly to the internal analysis phase, and contingency theory is seen in the strategy formulation phase. Hence, multiple perspectives are critical to a holistic understanding of an organization's strategy and its relationship with performance.[9]

WILLIS, KASSANDRA 2161TS

2-3 Strategy at the Corporate Level

The complex notion of organizational strategy can be examined from three perspectives: firm (also called corporate), business (also called competitive), and functional. The **corporate strategy** reflects the broad strategic approach top management formulates for the organization. The **business-level strategy** outlines the competitive pattern for a **business unit,** an organizational entity with its own mission, set of competitors, and industry. Top managers craft competitive strategies for each business (unit) to attain and sustain **competitive advantage**, a state whereby its successful strategies cannot be easily duplicated by its competitors.[10] **Functional strategies** are created at each functional level (i.e., marketing, finance, production, etc.) to support the business and corporate strategies.

There are two steps involved in developing the corporate strategy. The first step is to assess the markets or industries in which the firm operates. At the corporate level, top management defines the **corporate profile** by identifying the specific industry(s) in which the organization will operate. Three basic profiles are possible: operate in a single industry, operate in multiple related industries, or operate in multiple, unrelated industries.

An organization that operates in a single industry can benefit from the specialized knowledge that it develops from concentrating its efforts on one business area. This knowledge can help the firm improve product or service quality and become more efficient in its operations. McDonald's, for instance, constantly changes its product line, while maintaining a low per-unit cost of operations by concentrating exclusively on fast food. Wal-Mart benefits from expertise derived from concentration in the retailing industry. Although involved in other businesses as well, Anheuser Busch limits its scope of operations primarily to brewing, from which it derives more than 80 percent of its revenues and profits.[11] Firms operating in a single industry are more susceptible to sharp downturns in business cycles, however.

An organization may operate in multiple related industries to reduce the uncertainty and risk associated with operating in a single industry. An organization may diversify by developing a new line of business, or an organization with large, successful businesses may acquire smaller competitors with complementary product or service lines, a process known as **related diversification**. In some instances, however, a smaller firm may acquire a larger one, as was the case when Kmart acquired Sears in 2004. Size, of course, can be defined in a number of ways, including total revenues, number of employees or locations, or the physical size of facilities.

The key to successful related diversification is the development of **synergy** among the related business units. Synergy occurs when the two previously separate organizations join to generate higher effectiveness and efficiency than would have

corporate-level strategy
the broad strategy that top managment formulates for the overall organization

business-level stragegy
a strategy formulated for a business unit that identifies how it will compete with other businesses within its industry

business unit
an organizational entity with its own unique mission, set of competitors, and industry

competitive advantage
a state whereby a business unit's successful strategies cannot be easily duplicated by its competitors

functional strategies
strategies created at functional levels (e.g., marketing, finance, production, etc.) to support the business and corporate strategies

corporate profile
identification of the industry(ies) in which a firm operates

related diversification
a process whereby an organization acquires one or more businesses not related to its core domain

synergy
when the combination of two organizations results in higher efficiency and effectiveness that would otherwise be achieved by the two organizations separately

WILLIS, KASSANDRA 2161TS

been generated by them separately. When there are similarities in product or service lines, relationships in the distribution channels, or complementary managerial or technical expertise across business units, synergy is most likely to result.

An organization may choose to operate in unrelated industries because its managers wish to reduce risk by spreading resources across several markets, thereby pursuing **unrelated diversification** by acquiring businesses not related to its core domain. Unlike related diversification, unrelated diversification is not about synergy. Unrelated diversification is pursued primarily to reduce risks that are associated with the organization that operates in only one area of business. Unrelated diversification, however, can make it more difficult for managers to stay abreast of market and technological changes in the various industries. In addition, they may unknowingly shift attention away from the organization's primary business in favor of less critical ones.

unrelated diversification
process whereby an organization acquires businesses unrelated to its core domain

The second step involved in developing the corporate strategy is associated with the extent to which an organization seeks to increase its size. Simply stated, an organization may attempt to increase its size significantly, remain about the same size, or become smaller. These three possibilities are seen in three corporate strategies—growth, stability, and retrenchment (i.e., become smaller)—each of which is discussed in greater detail.

2-3a Growth Strategies

The **growth strategy** seeks to significantly increase a organization's revenues or market share. Growth may be attained in a variety of ways. **Internal growth** is accomplished when a firm increases revenues, production capacity, and its workforce, and can occur by growing a business or creating new ones. **External growth** is accomplished when an organization merges with or acquires another firm. Mergers are generally undertaken to share or transfer resources and/or improve competitiveness by combining resources.

growth strategy
corporate-level strategy designed to increase profits, sales, and/or market share

internal growth
growth strategy in which a firm expands by internally increasing its size and sales rather than by acquiring other companies

external growth
growth strategy whereby a firm acquires other companies

The attractiveness of merging with or acquiring another organization may seem intuitively obvious: Two organizations join forces into a single one that possesses all the strengths of the individual firms. The key to successful mergers and acquisitions is often found in the ability to develop synergy. Some companies like G.E. are well known for their ability to acquire other companies and integrate them effectively. Opportunities for synergy are not always easy to identify, however. It is not uncommon for an organization to acquire a business and later discard it when the anticipated synergy is not attained.

When two organizations combine through a merger or acquisition to form a "new" organization, blending two distinct cultures can be difficult amidst the rumors of layoffs and restructuring that often accompany the transaction.[12] This is especially true when organizations across borders are involved. Although carmakers Chrysler

WILLIS KASSANDRA 2161TS

and Daimler Benz merged to form DaimlerChrysler in 1998, complete cooperation between members from the two original organizations has been slow to develop. During the first few years of the merger, Mercedes executives closely guarded their technology from Chrysler for fear of eroding the Mercedes mystique. In 2003, the two divisions began to cooperate more closely when it began building the Crossfire, a Chrysler design with Mercedes components.[13]

One alternative to pursuing a merger or acquisition is to form a close relationship with another organization without becoming part of the same firm. **Strategic alliances**—often called partnerships—occur when two or more firms agree to share the costs, risks, and benefits associated with pursuing existing or new business opportunities. Strategic alliances can be temporary, disbanding after the project is finished, or they can involve multiple projects over an extended period of time.[14] A strategic alliance can be particularly attractive when a project may be so large that it would strain a single company's resources or require complex technology that no single firm possesses. Hence, firms with complementary technologies may combine forces, or one firm may contribute its technological expertise while another contributes its managerial or other abilities.[15] American carmakers General Motors and Ford have established strategic alliances with small manufacturers in emerging economies such as China and Russia. GM and Ford provide technological expertise to the alliance, whereas the producer in the host country provides access and distribution to the local market.

strategic alliances
corporate-level growth strategy in which two or more firms agree to share the costs, risks, and benefits associated with pursuing existing or new business opportunities. Strategic alliances are often referred to as partnerships

Strategic alliances have two major advantages over mergers and acquisitions. First, they minimize increases in bureaucratic, developmental, and coordination costs. Second, each company can share in the benefits of the alliance without bearing all the costs and risks itself. A key disadvantage of a strategic alliance, however, is that one partner in the alliance may offer less value to the project than other partners but may gain a disproportionate amount of critical know-how from the cooperation with its more progressive partners. In addition, the participating organizations may hesitate to share complete information and expertise with each other.

2-3b Stability Strategy

Although growth is intuitively appealing, it is not always the most effective strategy. The **stability strategy** seeks to keep the organization at roughly the same size. Growth may occur naturally but is typically limited to the level of industry growth. Stability enables the organization to focus its efforts on enhancing current activities, while avoiding costs associated with internal or external growth. An organization may adopt a stability strategy in leaner times and shift to a growth strategy when economic conditions improve. Stability can also be an effective strategy for a high performing organization, but it is not necessarily a risk-averse strategy.

stability strategy
corporate-level strategy intended to maintain a firm's present size and current lines of business

WILLIS, KASSANDRA 2161TS

Stability may be pursued instead of growth under at least four sets of circumstances:

1. Industry growth is slow or non-existent. In this situation, one firm's growth must come at the expense of a rival. This can be particularly costly, especially when attacking an industry leader.[16]

2. Costs associated with growth do not exceed its benefits. During the "cola wars" of the 1980s, PepsiCo and Coca-Cola spent millions to lure consumers to their cola brands, only to realize that the costs associated with securing this market share severely reduce profits.

3. Growth may place great constraints on quality and customer service, especially in small organizations known for their personal service and attention to detail.

4. Large, dominant organizations may not wish to risk prosecution for monopolistic practices associated with growth. American firms, for example, may be prohibited from acquiring competitors if regulators believe their combined market shares will threaten competitiveness. Even internal growth can be problematic at times, as was the case in the late 1990s through 2001 with Microsoft's costly defense against federal charges that the company unfairly dictated terms in the software industry.

2-3c Retrenchment Strategies

Growth strategies and the stability strategy are generally adopted by healthy organizations. But when performance is disappointing, a **retrenchment strategy** may be appropriate. Retrenchment takes one or a combination of three forms: turnaround, divestment, or liquidation. A retrenchment strategy is often accompanied by a reorganization process known as corporate restructuring. **Corporate restructuring** includes such actions as realigning divisions in the firm, reducing the amount of cash under the discretion of senior executives, and acquiring or divesting business units.[17] Restructuring is not limited to organizations that perform poorly over an extended period of time. Even well-known, leading companies progress through product and economic cycles that require them to restructure on occasion. Fast-food giant McDonald's, for example, posted a fourth quarter 2002 loss of $344 million, its first in 37 years. The firm responded with a restructuring plan that included opening fewer new stores, greater product and marketing emphasis on existing outlets, and a number of store closings in 2003 in the United States and Japan, its two largest markets.[18]

A **turnaround** seeks to transform the organization into a leaner, more effective firm and can include such actions as eliminating unprofitable outputs, reducing the size of the workforce, cutting costs of distribution, and reassessing product lines

retrenchment strategy
corporate-level strategy designed to reduce the size of the firm

corporate restructuring
corporate strategic approach that includes such actions as realigning divisions in the firm, reducing the amount of cash under the discretion of senior executives, and acquiring or divesting business units

turnaround
corporate-level retrenchment strategy intended to transform the firm into a leaner and more effective business by reducing costs and rethinking the firm's product lines and target markets

WILLIS, KASSANDRA 2161TS

and customer groups.[19] Turnarounds are often accompanied by **downsizing**, the elimination of one or more hierarchical levels in an organization. Turnarounds are often preceded by changes in the external environment. In general, a turnaround is usually not as drastic a move as corporate restructuring, but the two terms are often used interchangeably in the business press.

downsizing
a means of organizational restructuring that eliminates one or more hierarchical levels from the organization and pushes decision making downward in the organization

Turnarounds involving layoffs are generally more difficult to implement than one might think. When layoffs are required, organizations must address their effects on both departing employees and those who remain with the organization, the "survivors." Employees may be given opportunities to voluntarily leave—generally with an incentive—to make the process as congenial as possible. The problem with this approach, however, is that those departing are often the top performers who are most marketable, leaving the organization with a less competitive workforce. When layoffs are simply announced, less competitive workers can be eliminated more easily, but morale is likely to suffer more.[20]

Effective strategic planning at the corporate level requires strong teamowork and communication.

When layoffs are necessary, however, several actions may palliate some of the negative effects. Top managers should communicate honestly and effectively with all employees, explain why the layoff is necessary and clarify how terminated employees were selected. Everyone, including the survivors, should be made aware of how departing employees will be supported. Employees should also be encouraged to take advantage of outplacement or other services available to them, and special efforts should be made to ensure that such programs are administered in a clear and consistent manner.[21] Although these measures will not eliminate all the harsh feelings associated with layoffs, they can help keep the process under control and minimize any negative repercussions.

Divestment—selling one or more business units—may be necessary when an industry in which an organization competes is in decline, or when a business

divestment
a corporate-level retrenchment strategy in which a firm sells one or more of its business units

WILLIS, KASANDRA 2161TS

unit drains resources from more profitable units, is not performing well, or is not producing the desired synergy. In a well-publicized spin-off, PepsiCo divested its KFC, Taco Bell, and Pizza Hut business units into a new company, Tricon Global Restaurants, Inc., in 1997 in order to refocus PepsiCo's efforts on its beverage and snack food divisions. Tricon's name was officially changed to Yum Brands in 2002 and has since acquired several other restaurant chains.

Liquidation involves the sale of all the organization's assets and is the strategy of last resort. Liquidation results in a termination of the business and involves a divestment of *all* the firm's business units and should be adopted only under extreme conditions. Shareholders and creditors experience financial losses, employees eventually lose their jobs, suppliers lose a customer, and the community suffers an increase in unemployment and a decrease in tax revenues. Hence, liquidation should be pursued only when other forms of retrenchment are not viable.

liquidation
a retrenchment strategy of last resort whereby a firm terminates one or more of its business units by selling their assets

2-4 Strategy at the Business Level

The corporate strategy does not address all of the strategic questions that an organization must face. Whereas the corporate strategy concerns the basic thrust of the firm—*where* top managers would like to lead the firm—the business strategy addresses the competitive aspect— *who* the business should serve, *what* needs should be satisfied, and *how* a business should develop core competencies and be positioned to satisfy customer needs.

Although each business strategy is unique, the concepts of business strategy can be more easily presented by considering a limited number of **generic strategies** based on their similarities. Businesses adopting the same generic strategy comprise what is commonly referred to as a **strategic group**.[22] Because industry definitions and strategy assessments are not always clear, identifying strategic groups within an industry can be difficult. Hence, the concept of strategic groups can be used as a means of understanding and illustrating competition within an industry, but the limitations of the approach should always be considered.

generic strategies
strategies that can be adopted by business units to guide their organizations

strategic group
a select group of direct competitors who have similar strategic profiles

Effective business strategies take into account likely responses from competitors - just like a game of chess.

WILLIS, KASSANDRA 2161TS

The challenging task of formulating and implementing a generic strategy for each business unit is based on a number of factors. Selecting the generic approach is only the first step in formulating a business strategy.[23] It is also necessary to fine-tune the strategy and accentuate the organization's unique set of resource strengths.[24] Two generic strategy frameworks—one by Porter and one by Miles and Snow—serve as good starting points for developing business strategies.

2-4a Porter's Generic Strategies

Michael Porter developed the most commonly cited generic strategy framework.[25] According to Porter's typology, a business unit must address two basic competitive concerns. First, managers must determine whether the business unit should **focus** its efforts on an identifiable subset of the industry in which it operates or seek to serve the entire market as a whole. For example, many specialty clothing stores in shopping malls adopt the focus concept and concentrate their efforts on limited product lines primarily intended for a small market niche. In contrast, most chain grocery stores seek to serve the "mass market"—or at least most of it—by selecting an array of products and services that appeal to the general public as a whole. Second, managers must determine whether the business unit should compete primarily by minimizing its costs relative to those of its competitors or by seeking to differentiate itself by offering unique and/or unusual products and services.

focus
the concentration of strategic efforts on an identifiable subset of the industry in which it operates, as opposed to the entire market as a whole

According to Porter, these two alternatives are mutually exclusive because differentiation efforts tend to erode a low-cost structure by raising production, promotional, and other expenses. Depending on the way strategic managers in a business unit address the first (i.e., focus or not) and second (low-cost, differentiation, or low-cost–differentiation) questions, six configurations are possible, as summarized below:

TABLE 2.2 Theoretical Perspectives on Firm Performance Configurations

	Emphasis on Costs	Emphasis on Costs & Uniqueness	Emphasis on Uniqueness
Concentration on a single subset of the market	Focus: Low-cost strategy	Focus: Low-cost-differentiation strategy	Focus: Differentiation strategy
Attempt to serve the market as a whole	Low-cost strategy	Low-cost-differentiation strategy	Differentiation strategy

Businesses that compete with a **low-cost strategy** minimize costs by producing basic, no-frills products and services. Low-cost businesses often succeed by building market share through low prices, although some may charge prices comparable to rivals and enjoy a greater margin. Because customers are usually not willing to pay high or even average prices for basic products or services, it is essential that businesses using this strategy keep their overall costs as low as

low cost strategy
a generic business unit strategy in which a larger business produces, at the lowest cost possible, no-frills products and services industry-wide for a large market with a relatively elastic demand

WILLIS KASSANDRA 2164TS

possible. Efficiency is a key to such businesses, as has been demonstrated by mega-retailer Wal-Mart in recent years.

Low-cost businesses typically emphasize a low initial investment and low operating costs. They tend to purchase from suppliers who offer the lowest prices within a basic quality standard to minimize production expenditures. Most research and development efforts are directed at improving operational efficiency, and attempts are made to enhance logistical and distribution efficiencies. Such businesses tend to de-emphasize the development of new and improved products or services that might raise costs.

A cost leader may be more likely than other businesses to outsource a number of its production activities if costs are reduced as a result, even if modest amounts of control over quality are lost as a result. In addition, the most efficient means of distribution is sought, even if it is not the fastest or easiest to manage. Successful low-cost businesses do not emphasize cost minimization to the degree that quality and service decline excessively, an approach that can result in the production of "cheap" goods and services that nobody is willing to purchase.

Businesses that employ the **differentiation strategy** emphasize uniqueness, producing and marketing products or services that can be readily distinguished from those of their competitors. Differentiated businesses seek new product and market opportunities by leveraging advances in technology. Successful differentiation is typically linked to an organization's **core competencies**, its key capabilities and collective learning skills that are fundamental to its strategy, performance, and long-term performance. Ideally, core competencies should provide access to a wide array of markets, contribute directly to the goods and services being produced, and be difficult to imitate.

The potential for differentiation is to some extent a function of a product's physical characteristics. Tangibly speaking, it is easier to differentiate an automobile than bottled water. However, intangible differentiation can extend beyond the physical characteristics of a product or service to encompass everything associated with the value perceived by customers. As such, there are a number of prospective bases for differentiation, most notably product features (or the mix of products offered), including the objective and subjective differences in product attributes. Lexus automobiles, for example, have been differentiated on product features and are well known for their attention to detail, quality, and luxury feel. United and other airlines have attempted to differentiate their businesses by offering in-flight satellite telephone and e-mail services.[26]

Caution should be exercised when considering the combination of low cost and differentiation strategies. As aforementioned, Porter contends a **low-cost–differentiation strategy** is not advisable and leaves a business "stuck in the middle" because differentiating a product generally drives up costs, eroding a

differentiation strategy
a generic business unit strategy in which a business produces and markets to the entire industry products or services that can be readily distinguished from those of its competitors.

core competencies
an organization's key capabilities and collective learning skills that are fundamental to its strategy, performance, and long-term profitability

low-cost differentiation strategy
a generic business unit strategy in which a business unit maintains low costs while producing distinct products or services industry-wide

WILLIS, KASSANDRA 2161735

Best Practices

Delivering Value at Aldi

Aldi is an international retailer that offers a limited assortment of groceries and related items at the lowest possible prices. Aldi provides an excellent example of an organization whose functional operations are tightly coordinated around a single strategic objective, low costs.

Aldi minimizes costs a number of ways. Most products are private label, allowing Aldi to negotiate rock-bottom prices from its suppliers. Stores are modest in size, much smaller than that of a typical chain grocer. Aldi only stocks common food and related products, maximizing inventory turnover. The retailer does not accept credit cards, eliminating the 2-4 percent fee typically charged by banks to process the transaction. Customers bag their own groceries and must either bring their own bags or purchase them from Aldi at a nominal charge.

Aldi also takes an innovate approach to the use of its shopping carts. Customers insert a quarter to unlock a cart from the interlocked row of carts located outside the store entrance. The quarter is returned with the cart is locked back into the group. As a result, no employee time is required to collect stray carts unless a customer is willing to forego the quarter by not returning the cart!

Aldi has grown to more than 5,000 stores in Europe, the United States, and Australia. Peruse the company web site at www.aldi.com for more information on the retailer and its strategic approach. Which competitive strategy is Aldi implementing? How do Aldi's activities work together to support the strategy?

WILLIS, KASSANDRA 2161TS

firm's cost leadership basis."[27] In addition, a number of cost-cutting measures may be directly related to quality and/or other bases of differentiation. Following this logic, a business should choose *either* low-cost *or* differentiation, but not both.[28]

However, this is not necessarily the case, and the low-cost–differentiation strategy is a viable alternative for some businesses, although combining the two strategies can be difficult.[29] For example, some businesses begin with a differentiation strategy and integrate low costs as they grow, developing economies of scale along the way. Others seek forms of differentiation that also provide cost advantages, such as enhancing and enlarging the filter on a cigarette, which reduces the amount of costly tobacco required to manufacture the product, while also differentiating it from those of its competitors.

Fast-food giant McDonald's has combined low costs and differentiation effectively. The company was originally known for consistency from store to store, friendly service, and cleanliness. These bases for differentiation catapulted McDonald's to market share leader, allowing the firm to negotiate for beef, potatoes, and other key materials at the lowest possible cost. This unique combination of resources and strategic attributes has placed McDonald's in an enviable position as undisputed industry leader, although competition in this industry is intense.[30]

Changes in the mobile home industry in the United States also illustrates a link between low cost and differentiation. Traditionally, mobile homes have been positioned as a low-cost, affordable housing option to low income consumers. Indeed, about 22 million Americans, or 8 percent of the U.S. population, lived in manufactured housing in 2004. Sales approached almost 400,000 units per year

in the late 1990s. However, they declined to about 131,000 units by 2003, a year in which about 100,000 units were repossessed from previous customers. Today, manufactured housing does not always represent a low-cost housing option. Manufacturers such as Clayton Homes responded to the hike in repossessions by targeting potential customers with higher incomes and offering homes with upscale features, such as Mohn faucets, porcelain sinks, a wood-burning fireplace, and even a high-definition television set.[31]

2-4b Miles and Snow's Generic Strategies

A second commonly used framework for categorizing business-level strategies was developed by Miles and Snow and considers four strategic types: prospectors, defenders, analyzers, and reactors.[32] *Prospectors* perceive a dynamic, uncertain environment and maintain flexibility to combat environmental change. Prospectors introduce new products and new services, and design the industry. As such, prospectors tend to possess a loose structure, a low division of labor, and low formalization and centralization. Prospectors typically seek **first-mover advantages** derived from being first to market. First-mover advantages can be strong, as demonstrated by products widely known by their original brand names, such as Kleenex and Chap Stick. Being first, however, is not always beneficial, and research has shown that competitors may be able to catch up quickly and effectively.[33] As a result, prospectors must develop expertise in innovation and evaluate risk scenarios effectively.

first-mover advantages
benefits derived from being the first organization to offer a new or modified product or service.

Defenders are almost the opposite of prospectors. They perceive the environment to be stable and certain, seeking stability and control in their operations to achieve maximum efficiency. Defenders incorporate an extensive division of labor, high formalization, and high centralization. The defender usually concentrates on only one segment of the market and stresses efficiency throughout the organization.

Analyzers stress stability and flexibility, attempting to capitalize on the best of the prospector and defender strategy types. Tight control is exerted over existing operations with loose control for new undertakings. The strength of the analyzer is the ability to respond to prospectors (or imitate them) while maintaining greater efficiencies in operations. An analyzer may follow a prospector's successful lead, modify the product or service offered by the prospector, and market it more effectively. In effect, an analyzer is seeking a "second mover" advantage, waiting to see which prospector moves are successful and then following suit as needed.[34]

Copying successful competitors can be a successful strategy when both organizations share the resources needed to effectively implement similar programs. After sales slumped in 2000 at Taco Bell, president Emil Brolick acknowledged its plans to model the restaurant after Wendy's, noting the rival's ability to gain market share without slashing prices. In 2001, Taco Bell began appealing to a more

WILLIS KASSANDRA 2161TS

Career Point

Personality & Strategy

Does your personality fit better with one competitive strategy than with another? Perhaps it does. Consider Miles & Snow's generic strategy typology as an example. What kind of managers would be best suited for a prospector organization? Recall that the prospector seeks competitive advantage by being first with new products, services, or markets. By their nature, prospectors embrace the notion of risk. If you enjoy the fast pace of change, like new opportunities, are creative, and are not stressed by uncertainties associated with change, then a prospector organization might be an excellent fit.

Perhaps you are more analytical, less outgoing, and work well with numbers. Defender organizations seek competitive advantage by serving an established segment of the market very well. Defenders often do so by emphasizing efficiency of operations and cost controls.

Analyzers seek competitive advantage by balancing desires for innovation and cost controls. Analytical skills may also be highly important to professionals working in analyzer organizations. Flexibility is also a key attribute of analyzers.

In most instances, reactor organizations would not be attractive to any individuals. Regardless of strategy, most healthy organizations seek a balance of personality types, at least to some extent. However, people make an organization function and can contribute more when they can relate to or identify with the strategy it is pursuing. Perhaps you should consider how your personality type fits with the organization's strategy when you consider your next career move.

WILLIS, KASSANDRA 2161TS

mature market with additional pricey items and fewer promotions. Although the product lines are substantially different, this approach has proven beneficial for Taco Bell.[35]

Reactors represent the fourth strategic type, lacking consistency in strategic choice and performing poorly. The reactor organization lacks an appropriate set of response mechanisms with which to confront environmental change. There is no strength in the reactor strategic type, and reactor organizations are generally encouraged to restructure and select one of the other three strategic approaches.Porter's typology and Miles and Snow's typology represent different approaches to business strategies in organization, but share some similarities. For example, Miles and Snow's prospector business is likely to emphasize differentiation, whereas the defender business typically emphasizes low costs. Miles and Snow's analyzer type also appears to resemble the low-cost-differentiation combination within Porter's framework. These tendencies notwithstanding, fundamental differences exist between the typologies. Porter's approach is based on economic principles associated with the cost-differentiation dichotomy, whereas the Miles and Snow approach describes the philosophical approach of the business to its environment.

2-5 Strategy at the Functional Level

Strategic consistency throughout the organization can enhance prospects for success. After corporate- and business-level strategies have been developed, strategies should be formulated at the business unit's functional levels, such as those of marketing, finance, production, purchasing, human resources, and information systems. Functional strategies should support the implementation of the corporate- and business-level strategies. In doing so, each functional area should integrate its activities with those of the other functional departments because a change in one department can affect both the manner in which other departments operate and the overall performance of the business unit.

Unfortunately, managers in each functional area often do not understand the interrelationships among the functions. For example, marketers who do not understand production may promise customers product features that the production department cannot readily or economically integrate into the product's design. In contrast, production managers who do not understand marketing may insist on production changes that result in relatively minor cost changes but fail to satisfy customer needs. In a similar vein, it is not worthwhile to launch a new advertising campaign emphasizing product quality while the production department is undergoing a massive effort to cut costs. For this reason, managers in all functional areas need to understand how the areas should integrate, and they should work together to formulate functional strategies that "fit" and support the business- and corporate-level strategies.

Functional strategies are formulated after the corporate and business strategies have already been established. However, examining the capabilities of the functional areas is still necessary when various corporate and business strategic options are being considered. For example, an airline considering expansion through additional international routes should consider factors such as the need for additional personnel and the organization's ability to finance additional airplanes *before* settling on the expansion plan as the preferred strategic option.

WILLIS, KASSANDRA 2161IS

Summary

Strategies are developed to integrate an organization's activities behind a common purpose. The process of strategic management is influenced by a number of perspectives, including industrial organization economics, resource based theory, and contingency theory. The strategic management process includes external and internal analysis and the examination of mission and goals, as well as the formulation, and implementation of strategies at three levels within the organization. Each of the three perspectives plays a distinct role in the strategic management process.

At the broad firm level, managers must identify the markets in which the organization will compete. In addition, they can attempt to increase the size of the organization through internal or external growth, seek to maintain stability, or pursue a reduction in size through retrenchment. At the business level, top managers formulate strategies to enable the business unit to compete effectively. Generic strategy frameworks can be used to illustrate the strategic approaches available. Porter's framework of business strategies includes low costs, differentiation, and focus. Miles and Snow's framework includes prospectors, defenders, analyzers, and reactors. Functional strategies are also developed for each business unit to support the business and firm level strategies.

Review Questions & Exercises

1. What are the advantages and disadvantages of internal growth as opposed to growth through mergers and acquisitions?
2. Why would an organization adopt a stability strategy? Is a stability strategy a suboptimal approach for organizations over the long term?
3. Can low-cost and differentiation strategies be combined effectively? Why or why not?
4. How do strategies at the functional level integrate with those at the firm and business levels?

WILLIS, KASSANDRA 21617S

Glossary

- **Business-Level Strategy:** A strategy formulated for a business unit that identifies how it will compete with other businesses within its industry.
- **Business Unit:** An organizational entity with its own unique mission, set of competitors, and industry.
- **Competitive Advantage:** A state whereby a business unit's successful strategies cannot be easily duplicated by its competitors.
- **Contingency Theory:** A perspective that suggests that the most profitable firms are likely to be the ones that develop the best fit with their environment.
- **Core Competencies:** An organization's key capabilities and collective learning skills that are fundamental to its strategy, performance, and long-term profitability.
- **Corporate Profile:** Identification of the industry(ies) in which a firm operates.
- **Corporate Restructuring:** A corporate strategic approach that includes such actions as realigning divisions in the firm, reducing the amount of cash under the discretion of senior executives, and acquiring or divesting business units.
- **Corporate-Level Strategy:** The broad strategy that top management formulates for the overall organization.
- **Differentiation Strategy:** A generic business unit strategy in which a business produces and markets to the entire industry products or services that can be readily distinguished from those of its competitors.

- **Distinctive Competence:** Unique resources, skills, and capabilities that enable an organization to distinguish itself from its competitors and create competitive advantage.

- **Divestment:** A corporate-level retrenchment strategy in which a firm sells one or more of its business units.

- **Downsizing:** A means of organizational restructuring that eliminates one or more hierarchical levels from the organization and pushes decision-making downward in the organization.

- **External Growth:** A growth strategy whereby a firm acquires other companies.

- **First-Mover Advantages:** Benefits derived from being the first organization to offer a new or modified product or service.

- **Focus:** The concentration of strategic efforts on an identifiable subset of the industry in which it operates, as opposed to the entire market as a whole.

- **Functional Strategies:** Strategies created at functional levels (e.g., marketing, finance, production, etc.) to support the business and corporate strategies.

- **Generic Strategies:** Strategies that can be adopted by business units to guide their organizations.

- **Growth Strategy:** A corporate-level strategy designed to increase profits, sales, and/or market share.

- **Industrial Organization (IO):** A view based in microeconomic theory which states that firm profitability is most closely associated with industry structure.

- **Industry:** A group of competitors that produces similar products or services.

- **Intended strategy:** The original strategy top management plans and intends to implement.

- **Internal Growth:** A growth strategy in which a firm expands by internally increasing its size and sales rather than by acquiring other companies.

- **Liquidation:** A retrenchment strategy whereby a firm terminates one or more of its business units by selling their assets.

- **Low-Cost Strategy:** A generic business unit strategy in which a larger business produces, at the lowest cost possible, no-frills products and services industry-wide for a large market with a relatively elastic demand.

- **Low-Cost–Differentiation Strategy** A generic business unit strategy in which a business unit maintains low costs while producing distinct products or services industry-wide.

- **Related Diversification:** A process whereby an organization acquires one or more businesses not

WILLIS, KASSANDRA 216175

related to its core domain.

- **Realized Strategy:** The strategy top management actually implements.

- **Retrenchment Strategy:** A corporate-level strategy designed to reduce the size of the firm.

- **Stability Strategy:** A corporate-level strategy intended to maintain a firm's present size and current lines of business.

- **Strategic Alliances:** A corporate-level growth strategy in which two or more firms agree to share the costs, risks, and benefits associated with pursuing existing or new business opportunities. Strategic alliances are often referred to as partnerships.

- **Strategic Group:** A select group of direct competitors who have similar strategic profiles.

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

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

- **Synergy:** When the combination of two organizations results in higher efficiency and effectiveness that would otherwise be achieved by the two organizations separately.

- **Turnaround:** A corporate-level retrenchment strategy intended to transform the firm into a leaner and more effective business by reducing costs and rethinking the firm's product lines and target markets.

- **Unrelated Diversification:** A process whereby an organization acquires businesses unrelated to its core domain.

WILLIS, KASSANDRA 21161TS

(Endnotes)

1. Based on P. Wright, M. Kroll, and J. A. Parnell, Strategic Management:Concepts (Upper Saddle River, NJ: Prentice Hall, 1998).
2. H. Mintzberg, "Opening Up the Definition of Strategy," in J. B. Quinn, H. Mintzberg, and R. M. James, eds., The Strategy Process (Englewood Cliffs, NJ: Prentice Hall, 1988), pp. 14–15.
3. M. E. Porter, "The Contributions of Industrial Organization to Strategic Management," Academy of Management Review 6 (1981): 609–620.
4. J. S. Bain, Industrial Organization (New York: Wiley, 1968); F. M. Scherer and D. Ross, Industrial Market Structure and Economic Performance (Boston: Houghton-Mifflin, 1990).
5. It has been argued that the resource-based perspective does not qualify as an academic theory. For details on this exchange, see R.L. Priem and J.E. Butler, "Is the Resource-Based 'View' a Useful Perspective for Strategic Management Research," Academy of Management Review 26 (2001): 22-40; J.B. Barney, "Is the Resource-Based 'View' a Useful Perspective for Strategic Management Research? Yes," Academy of Management Review 26 (2001): 41-56.
6. J. B. Barney, "Looking Inside for Competitive Advantage," Academy of Management Executive 19 (1995): 49–61.
7. S. L. Berman, J. Down, and C. W. L. Hill, "Tacit Knowledge as a Source of Competitive Advantage in the National Basketball Association," Academy of Management Journal 45 (2002): 13–32.
8. E. J. Zajac, M. S. Kraatz, R. K. F. Bresser, "Modeling the Dynamics of Strategic Fit: A Normative Approach to Strategic Change," Strategic Management Journal 21 (2000): 429–453.
9. C. A. Lengnick-Hall and J. A. Wolff, "Similarities and Contradictions in the Core Logic of Three Strategy Research Streams," Strategic Management Journal 20 (1999): 1109–1132; O. E. Williamson, "Strategy Research: Governance and Competence Perspectives," Strategic Management Journal 20 (1999): 1109-1132; O. E. Williamson, "Strategy Research: Governance and Competence Perspectives," Strategic Management Journal 20 (1999): 1087–1108.
10. I. M. Cockburn, R. M. Henderson, S. Stern, "Untangling the Origins of Competitive Advantage," Strategic Management Journal 21 (2000): 1123–1145.
11. P. Wright, M. Kroll, and J. A. Parnell, Strategic Management:Concepts (Upper Saddle River, NJ: Prentice Hall, 1998).
12. M. A. Hitt, J. S. Harrison, and R. D. Ireland, Mergers and Acquisitions: A Guide to Creating Value for Stakeholders (New York: Oxford University Press, 2001).
13. N.E. Boudette, "At DaimlerChrysler, a New Push To Make Its Units Work Together," Wall Street Journal, 12 March 2003, pp. A1,A15.
14. J. J. Reuer, M. Zollo, and H. Singh, "Post-Formation Dynamics in Strategic Alliances," Strategic Management Journal 23 (2002): 135–152.
15. T. E. Stuart, "Interorganizational Alliances and the Performance of Firms: A Study of Growth and Innovation Rates in a High-Technology Industry," Strategic Management Journal 21 (2000): 791–811.
16. K. G. Smith, W. J. Ferrier, C. M. Grimm, "King of the Hill: Dethroning the Industry Leader," Academy of Management Executive 15, no. 2 (2001): 59–70.
17. J. F. Weston, "Restructuring and Its Implications for Business Economics," Business Economics, January 1998, pp. 41-46..
18. R. Gibson, "McDonald's Posts a Super-Size Loss, Lowers Growth Goals," Dow Jones Newswires, 23 January 2003.
19. See M. Garry, "A&P Strikes Back," Progressive Grocer, February 1994, pp. 32–38.
20. M. Murray, "Waiting for the Ax to Fall," Wall Street Journal, 13 March 2001, pp. B1, B10.
21. Purchasing, "Some Specifics on How to Handle Layoffs," 16 December 1999, http://www.manufacturing.net/pur/index.asp?layout =article&articleId=CA148401&stt=001&text=some+specifics+on+how+to+handle+layoffs.
22. T. D. Ferguson, D. L. Deephouse, and W. L. Ferguson, "Do Strategic Groups Differ in Reputation?" Strategic Management Journal

WILLIS, KASSANDRA 2161TS

21 (2000): 1195–1214.

23. R. S. Kaplan and D. P. Norton, “Having Trouble with Your Strategy? Then Map It,” Harvard Business Review 78, no. 5 (2000): 167–176.
24. C. Campbell-Hunt, “What Have We Learned about Generic Competitive Strategy? A Meta-Analysis,” Strategic Management Journal 21 (2000): 127–154.
25. M. E. Porter, Competitive Strategy (New York: Free Press, 1980).
26. S. Carey, “United to Install In-Flight E-Mail By End of Year,” Wall Street Journal, 17 June 2003, pp. D1,D2; S. McCartney, “New In-Flight E-Mail Falls Short,” Wall Street Journal, 31 March 2004, pp. D1,D3.
27. M. E. Porter, Competitive Strategy (New York: Free Press, 1980), p. 41.
28. M. E. Porter, Competitive Strategy (Boston: Free Press, 1980).
29. J. A. Parnell, “New Evidence in the Generic Strategy and Business Performance Debate: A Research Note,” British Journal of Management 8 (1997):175–181; J. A. Parnell, “Reframing the Combination Strategy Debate: Defining Different Forms of Combination,” Journal of Applied Management Studies 9, no. 1 (2000): 33–54; C. W. L. Hill, “Differentiation Versus Low Cost or Differentiation and Low Cost: A Contingency Framework,” Academy of Management Review 13 (1988): 401–412.
30. R. Papiernik, “McDonald’s Shows It Can Market Well with Numbers, Knack for Good Timing,” Nation’s Restaurant News, 1 May 2000, p. 15-16; J. F. Love, McDonald’s: Behind the Arches (New York: Bantam Press, 1995).
31. J.R. Hagerty, “Mobile-Home Industry Tries to Haul Itself out of Big Slump,” Wall Street Journal, 30 March 2004, pp. A1,A12.
32. R. E. Miles and C. C. Snow, Organizational Strategy, Structure, and Process (New York: West, 1978); M. Forte, J. J. Hoffman, B. T. Lamont, and E. N. Brockmann, “Organizational Form and Environment: An Analysis of Between-Form and Within-Form Responses to Environmental Change,” Strategic Management Journal 21 (2000): 753–773.
33. J. A. Matthews, “Competitive Advantages of the Latecomer Firm: A Resource-Based Account of Industrial Catch-Up Strategies,” Asia Pacific Journal of Management 19 (2002): 467–488.
34. H. C. Hoppe and U. Lehmann-Grube, “Second-Mover Advantages in Dynamic Quality Competition,” Journal of Economics & Management Strategy 10 (2001): 419–434.
35. J. Ordonez, “Taco Bell Chief Has New Tactic: Be Like Wendy’s,” Wall Street Journal, 23 February 2001, pp. B1, B4.

WILLIS, KASSANDRA 21617TS