5 The Organization

Chapter Outline

Whereas previous chapters discussed the external analysis phase of the strategic management process, this chapter begins to consider internal factors. This shift from the industry level to the organizational level reflects a change in focus from similarities, or factors that tend to affect all of an industry's organizations in a like manner, to differences, or issues specific to a particular firm in an industry. This shift also relates to theoretical perspectives discussed in Chapter 1, marking a movement from an industrial organization (IO) perspective to a resource-based view of the firm.

Crafting a strategy for an organization whose purpose and resources are not well understood by its members is a difficult task, however. This chapter discusses the role that an organization's unique mission and resources, as well as social responsibility and ethics, play in the strategic management process.

5-1 Organizational Direction: Mission, Goals, and Objectives

Mission
The reason for an organization's existence. The mission statement is a broadly defined but enduring statement of purpose that identifies the scope of an organization's operations and its offerings to the various stakeholders.

Goals
Desired general ends toward which efforts are directed.

Objectives
Specific, verifiable, and often quantified versions of a goal.

Several terms are commonly used to delineate the direction of the organization. The **mission** is the reason for the firm's existence and is the broadest of these terms. The organization's **goals** represent the desired general ends toward which efforts are directed. **Objectives** are specific and often quantified versions of goals. Unlike goals, objectives are verifiable and specific, and are developed so that management can measure performance. Without verifiability and specificity, objectives will not provide a clear direction for strategy.

For example, the mission of an Internet Service Provider (ISP) might be "to provide high-quality, reliable Internet access to the southeastern United States at a profit." Management may establish a goal "to expand the size of the firm through acquisition of small ISPs." From this goal, specific objectives may be derived, such as "to increase access numbers by 20 percent each year for the next five years." As another example, management's goal may be "to be known as the innovative leader in the industry." On the basis of this goal, one of the specific objectives may be "to have 30 percent of sales each year come from new products developed during the preceding three years."

5-1a Global Influences on Mission

An organization's mission may be closely intertwined with international operations in several ways. A firm may need inputs from abroad or sell a large percentage of its products to global customers. Consider, for example, that virtually all of Japan's industries would grind to a halt if imports of raw materials from other nations ceased, because Japan is a small island nation and its natural resources are quite limited.

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

Organizational mission and international involvement are also connected through the economic concept of **comparative advantage**, the idea that certain products may be produced more cheaply or at a higher quality in particular countries due to advantages in labor costs or technology. Chinese manufacturers, for example, have enjoyed some of the lowest global labor rates for unskilled or semiskilled production in recent years. As skills rise in the rapidly emerging nation, some companies have succeeded in extending this comparative advantage to technical skill areas as well. The annual salary for successful engineers in China rose to around $15,000 in 2007, a level well below their comparably skilled counterparts in other parts of the world.[1]

Global involvement may also provide advantages to the firm not directly related to costs. For political reasons, a firm often needs to establish operations in other countries, especially if a substantial proportion of sales is derived abroad. Doing so can also provide managers with a critical understanding of local markets. For example, Ford operates plants in western Europe, where manufacturing has helped Ford's engineers design windshield wipers for cars engaged in high-speed driving on the German autobahns.[2]

Source: Ablestock.com

5-1b Goals and Stakeholders

At first glance, establishing a mission, goals, and objectives for a firm appears to be fairly simple; however, because stakeholders have different perspectives on the purpose of the firm, this task can become quite complex. **Stakeholders** are individuals or groups who are affected by or can influence an organization's operations. Firm stakeholders include such groups as shareholders, members of the board of directors, managers, employees, suppliers, creditors, and customers (see Table 5-1). As owners, shareholders traditionally represent the dominant group of stakeholders. Top managers, too, should be concerned not only with the shareholders' primary objective of profits, but also with those of other stakeholders.[3] Ideally, the mission, goals, and objectives should emphasize goals of the shareholders, and balance the pressures from other stakeholders.[4]

Stakeholders
Individuals or groups who are affected by or can influence an organization's operations.

It is not difficult to see how stakeholder goals can conflict with one another. For example, shareholders are generally interested in maximum profitability, whereas creditors are more concerned with long-term survival so that their loans will be repaid. Meanwhile, customers desire the lowest possible prices, even if offering them would result in losses for the firm. Hence, top management faces the difficult task of attempting to reconcile these differences while pursuing its own set of goals, which typically includes quality of work life and career advancement.

TABLE 5-1 Suggested Goals of Stakeholders

Stakeholders	Goals
Customers	The company should provide high-quality products and services at the most reasonable prices possible.
General public	The company should provide goods and services with minimum environmental costs, increase employment opportunities, and contribute to social and charitable causes.
Suppliers	The company should establish long-term relationships with suppliers and purchase from them at prices that allow the suppliers to remain profitable.
Employees	The company should provide good working conditions, equitable compensation, and opportunities for advancement.
Creditors	The company should maintain a healthy financial posture and a policy of on-time payment of debt.
Shareholders	The company should produce a higher-than-average return on equity.
Board of directors	Current directors should be retained and shielded from a legal liability.
Managers	The company should allow managers to benefit financially from the growth and success of the company.

This balancing act is evident when one considers the clash that can occur when top management goals are pitted against those of the board of directors. Although both groups are primarily accountable to the owners of the corporation, top management is responsible for generating financial returns and the board of directors is charged with oversight of the firm's management. Some have argued, however, that this traditional *shareholder-driven* perspective is too narrow, and that financial returns are actually maximized when a *customer-driven* perspective is adopted, a view that is consistent with the marketing concept.[5] Consumer advocate and 2000 U.S. presidential candidate Ralph Nader has argued for more than thirty years that large corporations must be more responsive to customers' needs.[6]

Firms create value for various parties, including employees through wages and salaries, shareholders through profits, customers through value derived from goods and services, and even governments through taxes. Firms that seek to maximize the value delivered to any single stakeholder at the expense of those of other groups can jeopardize their long-term survival and profitability.[7] For example, a firm that emphasizes the financial interests of shareholders over the monetary needs of employees can alienate employees, threatening shareholder returns in the long run. Likewise, establishing long-term relationships with suppliers may restrict the firm's ability to remain flexible and offer innovative products to customers. Top management is charged with the task of resolving opposing stakeholder demands, recognizing that the firm must be managed to balance the demands of various stakeholder groups for the long-term benefit of the corporation as a whole.[8]

5-2 Social Responsibility

An organization's direction is governed in part by its value system. An organization's values can be seen through its stance on service to society, as well as its support for high ethical standards among its managers. These factors are discussed in this section.

Social Responsibility
The expectation that business firms should serve both society and the financial interests of shareholders.

Social responsibility refers to the expectation that business firms should serve both society and the financial interests of the shareholders. A firm's stance on social responsibility can be a critical factor in making strategic decisions. If social responsibility is not considered, decisions may be aimed only at profit or other narrow objectives without concern for balancing social objectives that the firm might embody. The degree to which social responsibility is relevant in strategic decision making is widely debated, however.

From an economic perspective, businesses have always been expected to provide employment for individuals and meet consumer needs within legal constraints. Today, however, society also expects firms to help preserve the environment, to sell safe products, to treat their employees equitably, and to be truthful with their customers.[9] In some cases, firms are even expected to provide training to unemployed workers, contribute to education and the arts, and help revitalize urban areas. Firms such as Home Depot, Coca-Cola, UPS, and Johnson & Johnson recently earned high marks for social responsibility, whereas Bridgestone and Philip Morris were at the bottom of the list.[10] Figure 5-1 illustrates the approach to social responsibility at Johnson & Johnson, a firm whose corporate reputation ranked number one in 2002 and 2003 in the Harris Interactive survey.[11]

Many economists, including such notables as Adam Smith and Milton Friedman, have argued that social responsibility should not be part of management's

FIGURE 5-1 Johnson & Johnson Credo

Our Credo

We believe our first responsibility is to the doctors, nurses, and patients,
to mothers and fathers and all others who use our products and services.
In meeting their needs everything we do must be of high quality.
We must constantly strive to reduce our costs
in order to maintain reasonable prices.
Customers' orders must be serviced promptly and accurately.
Our suppliers and distributors must have an opportunity
to make a fair profit.

We are responsible to our employees,
the men and women who work with us throughout the world.
Everyone must be considered as an individual.
We must respect their dignity and recognize their merit.
They must have a sense of security in their jobs,
Compensation must be fair and adequate,
and working conditions clean, orderly, and safe.
We must be mindful of ways to help our employees fulfill
their family responsibilities.

Employees must feel free to make suggestions and complaints.
There must be equal opportunity for employment, development,
and advancement for those qualified.
We must provide competent management,
and their actions must be just and ethical.

We are responsible to the communities in which we live and work
and to the world community as well.
We must be good citizens—support good works and charities
and bear our fair share of taxes.
We must encourage civic improvements and better health
and education.
We must maintain in good order
the property we are privileged to use,
protecting the environment and natural resources.

Our final responsibility is to our stockholders.
Business must make a sound profit.
We must experiment with new ideas.
Research must be carried on, innovative programs developed and
mistakes paid for.
New equipment must be purchased, new facilities provided
and new products launched.
Reserves must be created to provide for adverse times.
When we operate according to these principles,
the stockholders should realize a fair return.

Johnson & Johnson

Source: *Reprinted by permission of Johnson & Johnson*

decision-making process. Friedman has maintained that business functions best when it concentrates on maximizing returns by producing goods and services within society's legal restrictions. According to Friedman, corporations should be concerned only with the legal pursuit of profit, while shareholders are free to pursue other worthy goals as they individually see fit. Even if one accepts Friedman's argument, firms should act in a socially responsible manner for two primary reasons.

First, acting responsibly can reduce the likelihood of more costly government regulation. Historically, regulations over business operations often were enacted because certain firms refused to act responsibly. Had some organizations not damaged the environment, sold unsafe products, or engaged in discrimination or misleading advertising, legislation in these areas would not have been necessary. Government regulation is always possible when companies operate in a manner contrary to society's interests, even if doing so is clearly within the legal jurisdiction of the firm.

Source: Ablestock.com

Second, stakeholders affected by a firm's social responsibility stance—most notably customers—are also those who must choose whether to transact business with the firm. Prospective customers have become more interested in learning about a company's social and philanthropic activities before making purchase decisions. Those who believe a firm is not socially responsible may take their business elsewhere. The social responsibility debate aside, many executives—especially those in large firms—have concluded that their organizations must at the minimum *appear* to be socially responsible or face the wrath of angry consumers. As such, they are greatly concerned about both the actual behavior of the firm and how it is perceived. Evidence suggests that consumers want the firms that produce the products and services they buy not only to support public initiatives, but also to uphold the same values in terms of the day-to-day decisions of running the company.[12] By definition, a firm that is socially responsible is one that is able to generate both profits and societal benefits; but exactly what is good for society is not always clear.[13] For example, society's demands for high employment and the production of desired goods and services must be balanced against the pollution and industrial wastes that may be generated by manufacturing operations. The decisions made to balance these concerns, however, can be quite difficult to make (see Strategy at Work 5-1).

Source: Ablestock.com

Social responsibility is a prominent issue in some industries. Pharmaceutical manufacturers, for example, spend billions of dollars to develop drugs for treating a wide range of ailments. The costs of the drugs, however, can determine the extent to which patients will benefit from them. In the United Kingdom, government officials called on physicians to stop prescribing various drugs for Alzheimer's disease, acknowledging their benefits but arguing that they do not justify the cost.[14] The same

STRATEGY AT WORK 5-1

GMAbility: Social Responsibility in Action

The public emphasis that General Motors places on social responsibility is quite noteworthy. The company's "GMAbility" initiative (www.gm.com/company/gmability) highlights a number of GM activities. For example, according to its 2001 sustainability report, GM has taken action to reduce emissions and water and energy consumption, while increasing its community support and number of partnerships. GM is also active in a variety of recycling, education, hazardous waste collection, and pollution prevention programs.

GM has partnered with The Nature Conservancy, an international environmental organization. GM spends $1 million annually to assist in the preservation of land and water systems in North America, Latin America, the Caribbean, and the Asia/Pacific region.

GM also participates in a variety of philanthropic activities, such as violence reduction programs in schools, Special Olympics, and community development. For example, GM partnered with Sun Microsystems and EDS to contribute more than $211 million in computer-aided design, manufacturing, and engineering (CAD/CAM/CAE) software, hardware, and training to Virginia Tech.

Sources: R. Alsop, "Perils of Corporate Philanthropy," Wall Street Journal, *16 January 2002, B1, B4; General Motors, www.gm.com/company/gmability, accessed March 14, 2002.*

realities can be true for medical procedures, especially in emerging economies. The pay-as-you-go system for medical treatment in China ultimately can deny costly life-saving treatment for the majority of its citizens who lack health insurance.[15]

In some instances, society's expectations of an organization may increase as the firm grows. For example, various constituencies have charged Wal-Mart with socially irresponsible behavior in recent years. Critics allege that the mega-retailer often competes unfairly, does not always follow fair hiring and promotion practices, and even contributes to local economic problems by abandoning strip-mall locations when larger stores are constructed. In 2004, CEO Lee Scott signaled a more assertive approach to countering such claims. As Scott put it, "When we're wrong, we change, so our detractors don't have a foothold in attacking us. Where we are right, we will fight and take each issue to the wall."[16]

A broader notion of social responsibility, **sustainable strategic management (SSM)**, has received increased attention in recent years. SSM refers to the strategies and related activities that promote superior performance from *both* market and environmental perspectives. Hence, an ideal strategy should seek market sustainability by meeting buyer demands and environmental sustainability by proactively managing finite resources. Organizations able to meet this challenge are more likely to perform well and benefit society over the long term.

Sustainable Strategic Management (SSM)
Strategies and related activities that promote superior performance from both market and environmental perspectives.

5-3 Managerial Ethics

Although social responsibility and managerial ethics are often grouped together in the popular business press, the terms are not synonymous. Whereas social responsibility considers the firm's ability to address issues beyond the financial concerns of the shareholders, **managerial ethics** refers to an individual's responsibility to make business decisions that are legal, honest, moral, and fair. Strategic decisions should not require managers or other employees to perform activities inconsistent with their ethical convictions concerning the role that they may be expected to play in firm activities (see Strategy at Work 5-2). The ethics test in Figure 5-2 provides an assessment of employees' ethics.

Managerial Ethics
An individual's responsibility to make business decisions that are legal, honest, moral, and fair.

STRATEGY AT WORK 5-2

Good Neighbor or Good Business?

After creating considerable destruction in the Caribbean, Hurricane Ivan hammered the Gulf Coast of the United States in September 2004. Because meteorologists had forecast the magnitude of the storm several days prior, many Americans soon to be affected turned to rivals Lowe's and Home Depot for plywood to board up their homes, for power generators, and for other supplies. Both retailers stepped into high gear to meet consumer needs.

Neither chain raised prices amidst the storm preparation and most stores made valiant attempts to remain open as long as possible. In one respect, Home Depot and Lowe's went the extra mile to assist customers in a crisis. In reality, however, remaining open extra hours was simply good business and helped to minimize local inventories that could be damaged if the stores were devastated by the storm.

Indeed, the two rivals were well aware of possible long-term effects that could stem from their ability to help customers prepare for the storm. As Home Depot's eastern division president, Tom Taylor, put it, "They'll remember who got them stuff. They'll remember who stayed open. The better job we can do during a hurricane, [the more] we can gain market share [after the storm]."

Could the Lowe's and Home Depot actions be described as good neighbor or good business? The answer is probably both.

Sources: D. Morse, "Competing in a Crisis," Wall Street Journal, *16 September 2004, B4, B5.*

FIGURE 5-2 Employee Ethics Test

Indicate the degree to which you agree or disagree with each statement.

Strongly Disagree -0- -1- -2- -3- Strongly Agree

	-0-	-1-	-2-	-3-
1. Employees should not expect to inform on their peers for wrongdoings.	☐	☐	☐	☐
2. There are times when a manager must overlook contract and safety violations in order to get on with the job.	☐	☐	☐	☐
3. It is not always possible to keep accurate expense account records; therefore, it is sometimes necessary to give approximate figures.	☐	☐	☐	☐
4. There are times when it is necessary to withhold embarrassing information from one's superior.	☐	☐	☐	☐
5. We should do what our managers suggest, though we may have doubts about it being the right thing to do.	☐	☐	☐	☐
6. It is sometimes necessary to conduct personal business on company time.	☐	☐	☐	☐
7. Sometimes it is good psychology to set goals somewhat above normal if it will help to obtain a greater effort from the sales force.	☐	☐	☐	☐
8. I would quote a "hopeful" shipping date in order to get an order.	☐	☐	☐	☐
9. It is proper to use the company 800 line for personal calls as long as it's not in company use.	☐	☐	☐	☐
10. Management must be goal oriented; therefore, the end justifies the means.	☐	☐	☐	☐
11. If it takes heavy entertainment and twisting a bit of company policy to win a large contract, I would authorize it.	☐	☐	☐	☐
12. Exceptions to company policy and procedures are a way of life.	☐	☐	☐	☐
13. Inventory controls should be designed to report "underages" rather than "overages" in goods received.	☐	☐	☐	☐
14. Occasional use of the company's copier for personal or community activities is acceptable.	☐	☐	☐	☐
15. Taking home company property (pens, tape, paper, etc.) for personal use is an accepted fringe benefit.	☐	☐	☐	☐

If your score is:

0	Prepare for canonization ceremony
1–5	Bishop material
6–10	High ethical values
11–15	Good ethical values
16–25	Average ethical values
26–35	Need moral development
36–44	Slipping fast
45	Leave valuables with warden

The line between social responsibility and managerial ethics can be difficult to draw, as what may be considered by some to be socially irresponsible firm behavior may be a direct result of unethical managerial decision making. Nonetheless, while the debate over social responsibility continues, few would argue that managers should not behave ethically. When executives shun clear ethical principles, corporate scandal or even demise can follow (see Strategy at Work 5-3).

What is morally right or wrong continues to be a topic of debate, especially when firms operate across borders where ethical standards can vary considerably.

STRATEGY AT WORK 5-3

Ethical Concerns and the Corporate Scandals of 2001 and 2002

The period from mid-2001 to mid-2002 witnessed an unprecedented number of ethical allegations and corporate misdoings that jolted Americans' confidence in corporate America. In August 2002, *Forbes* published "The Corporate Scandal Sheet" in an effort to keep track of the dearth of ethical violations and allegations rampant at that time. The *Wall Street Journal* also followed in January 2003 with an extensive chronicle of events for 2002. In November 2001, Enron, once one of the world's largest electricity and natural gas traders, admitted overstating its earnings by $567 million between 1997 and 2001 and filed for Chapter 11 bankruptcy protection the following month. In another case, the astute craft and décor authority Martha Stewart sold a large number of her ImClone Systems shares one day before the company released damaging news about an experimental cancer drug, raising the specter of insider information and thus resulting in a conviction.

Although the deluge of news surrounding such scandals began to slowly subside in late 2002, public fervor concerning a perceived lack of corporate accountability and widespread corporate legerdemain has not. This fervor has been sparked further by press reports of executive prosecutions associated with these scandals several years later. U.S. governmental agencies have responded with new policies and procedures designed to foster a more complete disclosure of corporate financial doings and make it more difficult for executives to mislead investors about the performance of their firms. These actions notwithstanding, however, it is clear that a key part of the solution to this problem lies in a willingness of managers at all levels to commit to a sense of fair play and uphold ethical standards at a personal level.

Sources: R. Alsop, "Corporate Scandals Hit Home," Wall Street Journal, *19 February 2004, B1, B2; P. Patsuris, "The Corporate Scandal Sheet,"* Forbes,*www.forbes.com/2002/07/25/accountingtracker.html, accessed August 26, 2002; L. S. Egodigwe, J. C. Long, and N. Warfield, "A Year of Scandals and Sorrow,"* Wall Street Journal Interactive Edition, *2 January 2003; P. Behr, "Ailing Enron Files for Chapter 11 Bankruptcy Protection,"* Washington Post, *3 December 2001, A7; C. Gasparino and S. Craig, "Merrill Worker Casts Doubt on Stewart's Stop-Loss Pact,"* Wall Street Journal Interactive Edition, *24 June 2002.*

In the United States, for example, bribes to government officials to secure favorable treatment would be considered unethical. In other countries—especially those with developing economies—small "cash tips" are an accepted means of transacting business and may even be considered an integral part of an underpaid government official's compensation.

Ethics is a key consideration, especially at top management levels. Selecting the right individual to serve as CEO can be a perilous task, especially when a leader departs abruptly. Although evaluating a person's professional qualifications is still important, personal characteristics are gaining prominence. Consider that Boeing's CEO Harry Stonecipher was dismissed in March 2005 after directors became aware of explicit e-mails to a female employee with whom he was having an affair. Events such as these have prompted directors to search for personal behavior that might disqualify them as leaders, including sexual harassment, drinking problems, or failing to file income taxes properly.[17]

Wal-Mart's Thomas Coughlin ended his twenty-seven-year stint with the firm in 2005. Originally appointed as director of loss prevention in 1978, Coughlin was promoted to director of human resources in 1983 and president of the Wal-Mart Stores division in 1999. In 2003, Coughlin was elected to Wal-Mart's board. He retired as an executive in January 2005 due to health reasons, but was forced to resign from the board two months later when a pattern of expense account abuses was uncovered. The investigation that uncovered the abuses began when

Coughlin asked a firm lieutenant to approve $2,000 in expense payments without providing any receipts.[18]

Ethical decisions are not always resolved easily and can even be observed differently at different times. In 1991, for example, the U.S. Food and Drug Administration (FDA) banned silicone breast implants in most instances, a decision that fueled the demise of many of its original marketers who lost billions of dollars in lawsuits alleging product flaws, breast cancer, and other serious health concerns. Dow Corning lost $3.2 billion in settlements and remained in bankruptcy protection from 1995 to 2004. Since that time, however, several major studies found no link between silicone implants and major diseases. In 2006, the FDA reapproved the sale of silicone implants. Hence, what was originally termed as "unethical" behavior by Dow Corning is once again being touted as an acceptable product.[19]

Utilitarian View of Ethics
Perspective suggesting that anticipated outcomes and consequences should be the only considerations when evaluating an ethical dilemma.

What constitutes ethical behavior can be viewed in a number of ways, six of which are discussed here. The **utilitarian view of ethics** suggests that anticipated outcomes and consequences should be the only considerations when evaluating an ethical dilemma. The primary shortcoming associated with this approach, however, is that a decision may have multiple consequences, some of which may be positive, others negative, and still others undetermined. For example, a decision to layoff 10 percent of an organization's workforce will harm those who lose their jobs but may help shareholders by increasing the projected returns on their investments. The long-term effect of the layoff could be positive if the organization emerges as a more competitive entity or negative if employee morale suffers and productivity declines. Hence, the utilitarian view is not always easy to apply. Research suggests that the utilitarian view is the most commonly applied perspective in organizations.[20] Note, however, that these views of ethical decision making are not always mutually exclusive. Managers often employ a combination of ethical perspectives when making decisions.

Self-Interest View of Ethics
Perspective suggesting the benefits of the decision maker should be the primary consideration when weighing a decision.

The **self-interest view of ethics** suggests that benefits of the decision maker(s) should be the primary considerations. This view assumes that society will likely benefit when its individual members make decisions that are in their own best interest. As Smith and Friedman argued, firms that attempt to maximize their returns within the legal regulations of society behave ethically. This perspective limits ethical concerns to the consideration of short-term financial benefits for the organization.

Self-interest can be viewed from either a narrow, short-run perspective or a broader, long-term perspective, however. It can be argued that one who always self-promotes short-term interests at the expense of others will suffer greater loss in the long term. For example, firms whose managers construct loopholes in their product or service warranties to promote short-term profits can ultimately alienate their customers. Hence, ethical behavior has long-term profit considerations.

Rights View of Ethics
Perspective that evaluates organizational decisions on the extent to which they protect individual rights.

The **rights view of ethics** evaluates organizational decisions to the extent to which they protect basic individual rights, such as a customer's right to privacy and an employee's right to a safe work environment. The key shortcoming of this approach, however, is that it is possible to protect individual rights at the expense of group progress or productivity.

Justice View of Ethics
Perspective suggesting that all decisions will be made in accordance with preestablished rules or guidelines.

The **justice view of ethics** suggests that all decisions will be made in accordance with preestablished rules or guidelines. Employee salaries may be administered by developing a formula that computes salary based on level of experience, amount of training, years of experience, and previous job evaluations. The key shortcoming associated with the justice view is that it requires decision makers to develop rules and procedures for every possible anticipated outcome—an arduous task indeed.

The **integrative social contracts view of ethics** suggests that decisions should be based on existing norms of behavior, including cultural, community, or industry factors. Although this perspective emphasizes the situational influences on a particular decision, it deemphasizes the need for clear standards of right and wrong devoid of the situation.[21]

Integrative Social Contracts View of Ethics

Perspective suggesting that decisions should be based on existing norms of behavior, including cultural, community, or industry factors.

The **religious view of ethics** is based on personal or religious convictions. In the United States, the Judeo-Christian heritage forms a distinct notion of ethics, whereas Islam, Hinduism, and other religions comprise the majority viewpoint in distant nations. From the Christian perspective, for example, individuals should behave in ways that benefit others, treating other people as one would wish to be treated.[22] In one respect, the religious perspective counters the integrative social contracts view because it emphasizes clear principles of right or wrong with limited regard to situational variables. Needless to say, however, the religious view would result in markedly different ethical perspectives across cultures with different prominent religious traditions.

Religious View of Ethics

Perspective that evaluates organizational decisions on the basis of personal or religious convictions.

Some activities associated with strategic analysis may be questionable from an ethical standpoint. Few would argue that obtaining competitive information from one's own customers or purchasing and breaking down a competitor's products would be unethical. However, some companies have been known to extensively interview managers with key competitors for executive positions that do not exist.

Other examples illustrate the complexities of ethical issues faced by firms. In 2000, Philip Morris introduced the Merit brand of cigarettes designed to reduce the risk of fire when left unattended. The manufacturer claimed that the ultrathin paper used to wrap the tobacco burns more slowly and would cause fewer fires. Shortly after introduction, however, a company scientist reported that the cigarettes actually increase the risk of fire. Philip Morris fired the scientist in 2002 and continued to market the cigarette, although the fire-reduction claim was avoided. The U.S. Department of Justice launched a lawsuit against Philip Morris in 2004 alleging that the action was part of a broader attempt to conceal the negative effects of cigarette smoke from the public.[23]

In 2003, the Recording Industry Association of America launched several hundred lawsuits at teenagers and college students in an effort to emphasize the notion that swapping copyrighted music files via the Internet is against the law. Critics charged that "suing kids" is both bad business and unethical; industry executives argued that the law is clear and that widespread violations are taking a serious toll on its member firms.[24]

Ethics in advertising is also a key concern. Kraft, the largest food company in the United States, spends about $90 million annually advertising directly to children. In 2004 and 2005, however, the company announced plans not to direct advertisements for products such as Oreos and Lunchables to children under twelve years. When explaining the firm's decision, executives referenced the link between such products and obesity in children.[25]

Some firms and individuals indiscriminately use bulk e-mails to "spam" the public by e-mailing unwanted direct response advertisements of pornography sites, mortgage and investment services, and the like. Studies suggest that spam costs U.S. corporations billions of dollars each year due to loss

Management Focus on **Ethics**

A Memory Device for Making Ethical Decisions

Most people believe it is important that ethics take on a conscious, deliberate role in business decision making. The issue of ethics boils down to asking yourself, "What price am I willing to pay for this decision, and can I live with that price?" This process can be helped by using the word *ethics* as a mnemonic device.

E = EXPERIENCE. The values we carry with us into adulthood, and into business, are those that were modeled to us, usually by a parent, teacher, or other significant adult. How people behave and the decisions they make speak much louder and are more convincing than what they say.

T = TRAINING. Training means training yourself to keep the question of ethics fresh in your mind deliberately.

H = HINDSIGHT. Success leaves clues that we need to tap into in order to help us make that tough decision. What if the problem you face was the problem of the person you admire most in life? What would this person do?

I = INTUITION. What does your gut tell you is the right thing to do? Some call it conscience or insight. How do you know when you've gone against your gut feeling? You experience guilt, shame, remorse, or perhaps a restless night. Now the decision is what to do about it?

C = COMPANY. How will your decision affect the company, coworkers, customers, and your family? No matter the size of your decision, it affects other people in your life.

S = SELF-ESTEEM. The greatest ethical decision is one that builds self-esteem through the accomplishment of goals based on how these goals positively impact those around you.

Sources: Adapted from F. Bucaro, "Ethical Considerations in Business," Manage, *August/September 2000, 14; A. Gaudine and L. Thorne, "Emotion and Ethical Decision Making in Organizations,"* Journal of Business Ethics, *1 May 2001, 175–187.*

of worker productivity, consumption of bandwidth and other technological resources, and the use of technical support time. Although this largely illegal practice is deplored by most industry groups and Internet users, enforcement is a complicated legal endeavor.[26] Strategic managers are challenged to know where to draw the line concerning such practices.

Why do some organizations portray a pattern of unethical business practices? Anand and Ashforth identified six common rationalization tactics to explain this behavior.[27] First, individuals *deny responsibility*, rationalizing that they have no other choice but to participate in unethical behavior. One employee may contend that the practice is directly associated with another's responsibility.

Second, individuals *deny injury*, suggesting that the unethical behavior did not really hurt anyone. This perspective defines behavior only as unethical if directly injured parties can be clearly identified and then hesitates to acknowledge the injury.

Third, individuals *deny rights of the victims*, rationalizing that "they deserve what they got anyway." This perspective rationalizes unethical behavior when competitors or other related parties are alleged to be involved at least at the same level of corruption.

Fourth, individuals *engage in social weighting* by making carefully controlled comparisons. One way this is done is by character assassination of those suggesting that a particular pattern of behavior is unethical. If those condemning us are corrupt—the argument goes—then how can credence be given to their arguments? Another way this is done is by selectively comparing the unethical action to others whose actions are purported to be even more unethical. For example, falsifying an expense account for meals not eaten on a business trip is not considered a major offense when compared to someone who falsifies expenses for an entire business trip that never occurred.

Fifth, individuals can *appeal to higher values* by suggesting that justification of the unethical behavior is due to a higher order value. In this sense, one might argue that it is necessary to accept some degree of lower level unethical behavior in pursuit to ethical responsibility at a higher level. For example, a sales rep who is brought in to help resolve a dispute between a customer and another sales rep may deny the legitimate claims of the customer, rationalizing that loyalty among sales representatives is a higher order value.

Finally, individuals may *invoke the metaphor of the ledger*, arguing that they have the right to engage in certain unethical practices because of other good things they have done. For example, a manager on a business trip may justify padding a travel expense account because she has already done "more than her share" of traveling in recent months.

Improving the ethical stance of an organization is not easy, however. Treviño and Brown identify five commonly held myths concerning ethics in organizations.[28] These myths and accompanying realities are summarized in Table 5-2. In concert, they argue that ethical decision making is a complex process that extends beyond removing the bad apples from the organization and establishing formal ethics codes. It begins with proactive behavior on the part of top executives that infuses ethics into the fabric of the organization.

5-4 The Agency Problem

Ideally, top management should attempt to maximize the return to shareholders on their investment while simultaneously satisfying the interests of other stakeholders. For as long as absentee owners (i.e., the shareholders)

TABLE 5-2 Myths and Realities of Organizational Ethics

Myth	Reality
1. Ethical decision making is easy.	Ethical decision making is a complex process.
2. Unethical behavior can be traced to a limited number of bad apples in an organization.	Unethical behavior can be a systemic part of the organization's culture.
3. Ethics can be managed by developing formal ethics codes and programs.	Formal codes and programs are helpful, but ethical expectations must be part of the culture and fabric of the organization.
4. Ethical leadership is really about leader morality and honesty.	Leader morality and honesty is a good start, but the leader must also infuse ethics into the organization and hold others accountable.
5. Business leaders are less ethical today than they used to be.	Ethical concern in organizations has always been a pervasive issue.

Source: Based on L. K. Treviño and M. E. Brown, "Managing to Be Ethical: Debunking Five Business Ethics Myths," Academy of Management Executive *18(2) (2004): 69–81.*

Source: Ablestock.com

have been hiring professionals to manage their companies, however, questions have been raised concerning the degree of emphasis these managers actually place on maximizing financial returns.[29] Of course, managers emphasizing their own goals over those of the shareholders would raise serious ethical questions.

This concern has become more prominent in recent years as shares of publicly traded firms are more widely dispersed, making it harder for shareholders to exert control over a firm. For this reason, it is not uncommon to see successful, small, privately held firms seeking to stay small so the owner can remain personally in charge of the major business decisions.

Agency Problem
A situation in which a firm's top managers (i.e., the "agents" of the firm's owners) do not act in the best interests of the shareholders.

The **agency problem** refers to a situation in which a firm's managers—the so-called agents of the owners—fail to act in the best interests of the shareholders. The extent to which the problem adversely affects most firms is widely debated, and factors associated with the problem can vary from country to country.[30] Indeed, some argue that management primarily serves its own interests, whereas others contend that managers share the same interests as the shareholders. These two perspectives are briefly discussed in sections 5-4a and 5-4b.

5-4a Management Serves Its Own Interests

According to one perspective, top managers tend to pursue strategies that ultimately increase their own salaries and other rewards. In particular, top executives are likely to grow their firms because increases in rewards usually accompany increases in organizational size and its greater responsibilities, even if growth is not the optimal strategy for the firm. This perspective is based on the tendency for management salaries to increase as the organization grows.[31]

Excessive CEO compensation has been widely criticized in recent years.[32] Although what is considered excessive varies among stakeholders, many CEOs have come under fire for their annual compensation. According to a number of surveys, most managers believe CEOs earn too much. During the 1980s, CEO compensation rose by 212 percent, compared to only 54 percent for factory workers, 73 percent for engineers, and 95 percent for teachers. After a brief decline in the early 1990s, CEO salaries began to climb once again.

In addition to salary, CEOs typically receive stock options and bonuses, revenues from profit-sharing plans, retirement benefits, and interest-free loans. As a result, CEOs in America's 350 largest publicly held corporations average more than $3 million annually in salary and bonuses, a figure that has declined only once in the past ten years. Recently, however, corporate boards have taken a closer look at CEO pay to ensure a tighter link between company performance and total compensation.

Hewlett-Packard's former CEO, Carly Fiorina, was one of the highest paid chief executives in the world, with a compensation package valued at nearly $90 million when she joined the company in 2000. The intriguing element of the package, however, was a grant for the equivalent of 580,000 restricted HP shares over three years, a block of stock worth $66.1 million when Fiorina's tenure began. When HP fired her in 2005, Fiorina received cash, stock, and pension benefits worth about $40 million, prompting protests from union officials and shareholders alike.[33]

Limiting CEO pay is not easy. Whole Foods Market attempted to restrict the pay of its CEO in the 1980s to eight times that of the average worker, a multiple that crept upward and was raised to nineteen times in 2006 to keep the firm from losing key leaders to competitors.[34] Hence, it is not surprising that political interest in regulating or limiting CEO pay is a hot topic. In 2007, some U.S. lawmakers supported legislation allowing shareholders to veto any CEO pay packages. A number of academics, mutual-fund trustees, institutional investors, union leaders, and politicians have taken a stand on this issue.[35] CEO pay can become a complex issue when a firm is going through a financial crisis and demanding sacrifices from the rank and file. Gerard Arpey, chairman and CEO of American Airlines (AMR), accepted stock options as part of his compensation, but turned down promotion raises in 2004.[36] In addition, many firms have discovered difficulties when attempting to reclaim pay from executives even in the case of malfeasance.[37]

CEOs in the United States earn on average far more than their counterparts in other countries; however, U.S. firms have become more likely than their global counterparts to employ non-Americans as CEOs. Interestingly, a number of studies have demonstrated that CEO salary is more closely tied to company size than to performance. Recently, however, firms have begun to tie compensation more closely to corporate performance. Most firms appear willing to continue to pay large sums to chief executives, provided the corporation performs at a comparable level. Surveys of CEO compensation practices continue to uncover special arrangements and considerable bonuses.

Pay practices in Internet businesses have also changed. Many Internet-based companies have increasingly adopted short-term incentives and bonus plans that are tied to more traditional business performance metrics, such as increased revenue or nearing profitability.

Executives may also pursue **diversification**, the process of increasing the size of their firms by acquiring other companies that may be related to the firm's core business. Diversification not only increases a firm's size but may also improve its survivability by spreading operational risks among its various business units. Diversification pursued only to spread risk, however, is generally not in the best interest of shareholders, who always have the option of reducing their financial risks by diversifying their own financial portfolios.[38] This perspective does not necessarily suggest that top management is unconcerned with the firm's profitability or market value; rather, top managers may emphasize business performance only to the extent that it discourages shareholder revolts and hostile takeovers.

Diversification
The process of acquiring companies to increase a firm's size.

The extent to which this perspective is accurate can create an advantage for relatively small, entrepreneurial organizations whose owners actively manage the firm. For this reason, such firms may be able to compete aggressively and successfully with their larger, more established competitors.

5-4b Management and Stockholders Share the Same Interests

Because managers' livelihoods are directly related to the success of the firm, one can argue that managers generally share the same interests as the stockholders. This perspective is supported at least in part by several empirical studies. One study, for example, found that firm profit—not size—is the primary determinant of top management rewards.[39] Another points to a significant relationship between common stock earnings and top executives' salaries.[40] Hence, according to these studies, management rewards rise with firm performance, a relationship that encourages managers to be most concerned with company performance.

One of the most common suggestions for aligning the goals of top management and those of shareholders is to award shares of stock or stock options to top management, transforming professional managers into shareholders. Stock option plans and high salaries may bring the interests of top management and stockholders closer together.[41] Top executives seek to protect their salaries and option plans and can do so only by delivering higher business performance. Indeed, research has suggested that as managerial stock ownership rises, the interests of managers and shareholders begin to converge to some extent.[42] This view has gained support from others, but for different reasons.[43] Many suggest that managerial jobs contain structural imperatives that force managers to attempt to enhance profits.[44] In addition, when managers are major shareholders, they may become entrenched and risk averse, adopting conservative strategies that are beneficial to themselves but not necessarily to their shareholders.

Employee Stock Ownership Plan (ESOP)
A formal program that transfers shares of stock to a company's employees.

In sum, the debate over whether top managers are primarily concerned with their firms' returns or their own interests continues. Most scholars and practitioners believe both perspectives have merit, and pursue compensation models designed to bring the two sides together, such as those that emphasize stock options and profit sharing for managers instead of fixed pay levels. Many companies have adopted **employee stock ownership plans (ESOPs)** to distribute shares of the company's stock to managers and other employees over a period of time.

5-5 Corporate Governance and Goals of Boards of Directors

Corporate Governance
The board of directors, institutional investors, and blockholders who monitor firm strategies to ensure managerial responsiveness.

Corporate governance refers to the board of directors, institutional investors (e.g., pension and retirement funds, mutual funds, banks, insurance companies, among other money managers), and large shareholders known as *blockholders* who monitor firm strategies to ensure effective management. Boards of directors and institutional investors—representatives of pension and retirement funds, mutual funds, and financial institutions—are generally the most influential in the governance systems. Boards of directors represent the shareholders and are legally authorized to monitor firm activities, as well as the selection, evaluation, and compensation of top managers. Because institutional investors own more than half of all shares of publicly traded firms, they tend to wield substantial influence. Blockholders tend to hold less than 20 percent of the shares, so their influence is proportionally less than that of institutional investors.[45]

Boards often include both inside (i.e., firm executives) and outside directors. Insiders bring company-specific knowledge to the board, whereas outsiders bring independence and an external perspective. Over the past several decades, the composition of the typical board has shifted from one controlled by insiders to one controlled by outsiders. This increase in outside influence often allows board members to oversee managerial decisions more effectively.[46] Furthermore, when additional outsiders are added to insider-dominated boards, CEO dismissal is more likely when corporate performance declines,[47] and outsiders are more likely to pressure for corporate restructuring.[48]

In the 1990s, the number of corporate board members with memberships in other boards began to increase dramatically. With outside directors of the largest 500 firms in the United States commanding an average of $151,000 in cash and equity in 2005, companies often became concerned about both potential conflicts of interest and the amount of time each individual can spend with the affairs of each company. As a result, many companies have begun to limit the number of board memberships their own board members may hold. Approximately two-thirds of corporate board members at the largest 1,500 U.S. companies do not hold seats on other boards. In addition, some firms are reconsidering board member compensation. In 2006, for example, Coke unveiled a plan that pays its board members only if the company hits earnings targets. The plan, however, does pay new members $175,000 as a signing bonus.[49]

This change has been underscored by the Sarbanes-Oxley Act of 2002, which requires that firms include more independent directors on their boards and make new disclosures on internal controls, ethics codes, and the composition of their audit committees on annual reports. Analysts have noted positive changes among boards as a result of this legislation in terms of both independence and expertise.[50] Evidence also suggests that many CEOs have become more reluctant to sit on boards of publicly held companies. Increased liability on the part of board members and recent policy changes that often restrict the number of outside boards on which a CEO may serve have also contributed to this change.[51]

Even with new disclosure regulations, it can be difficult to determine precisely what top executives earn at public companies. In 2004, for example, Regions Financial, Ryland Group, and Home Depot each reimbursed their top executives more than $3 million for personal taxes levied on executive perks. Details of such payments are not always readily available in corporate filings.[52]

Boards of directors consist of officials elected by the shareholders and are responsible for monitoring activities in the organization, evaluating top management's strategic proposals, and establishing the broad strategic direction for the firm, although few boards tend to be aggressive in this regard. As such, boards are responsible for selecting and replacing the chief executive officer, establishing the CEO's compensation package, advising top management on strategic issues, and monitoring managerial and company performance as representatives of the shareholders. Critics charge, however, that board members do not always fulfill their legal roles.[53] One reason is board members are nominated by the CEO, who expects them to support his or her strategic initiatives. The generous compensation they often receive is also a key issue.[54]

When boards are controlled by insiders, a rubber stamp mentality can develop, whereby directors do not aggressively challenge executive decisions as they should. This is particularly true when the CEO also serves as chair of the board, a phenomenon known as **CEO duality**.[55] Although research shows mixed results concerning the desirability of CEO duality,[56] insider board members may be less willing to exert control when the CEO is also the chair of the board, because present rewards and future career prospects within the firm are largely determined by the CEO. In the absence of CEO duality, however, insiders may be more likely to contribute to board control, often in subtle and indirect ways so as not to document any opposition to the decisions of the CEO. For example, the insiders may ostensibly present both sides of various issues, while carefully framing the alternatives in favor of one that may be in opposition to the wishes of the CEO.

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

STRATEGY AT WORK 5-4

The Growing Responsiveness of Boards

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

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

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

In some instances, boards of directors, pressured by institutional investors, have forced the turnover of top executives. In one prominent example, GM's market share declined from 44 percent to 33 percent between 1981 and 1992. In 1992, the California Public Employees Retirement System, a significant shareholder, pressured the eleven outside board members (a majority of the fifteen-member board) to reassert strategic control over the firm. As a result, the shareholder forced a complete overhaul of senior GM executives, the first since 1920. GM generated profits of $2.6 billion, $7.6 billion, and $9.7 billion in 1993, 1994, and 1995, respectively.

Sources: N. Dunne, "Adding a Little Muscle in the Boardroom," Financial Times, *10 October 2003, I; W. Royal, "Impeach the Board,"* Industry Week, *16 November 1998, 47–50; C. Torres, "Firms' Restructuring Often Hurt Foreign Buyers,"* Wall Street Journal Interactive Edition, *13 May 1996; M. L. Weidenbaum, "The Evolving Corporate Board,"* Society, *March–April 1995, 9–16.*

Pressure on directors to acknowledge shareholder concerns has increased over the past two decades. The major source of pressure in recent years has come from institutional investors, owners of large chunks of most publicly traded companies by way of retirement or mutual funds. By virtue of the size of their investments, they wield considerable power and are more willing to use it than ever before (see Strategy at Work 5-4).

Some board members have played effective stewardship roles. Many directors promote strongly the best interests of their firm's shareholders and various other stakeholder groups as well. Research indicates, for instance, that board members are often invaluable sources of environmental and competitive information.[57] By conscientiously carrying out their duties, directors can ensure that management remains focused on company performance.[58]

A number of recommendations have been made on how to promote an effective governance system. For example, it has been suggested that outside directors be the only ones to evaluate the performance of top managers against the established mission and goals, that all outside board members meet alone at least once annually, and that boards of directors establish appropriate qualifications for board membership and communicate these qualifications to shareholders. For institutional shareholders, it is recommended that institutions and other shareholders act as owners and not just investors,[59] that they not interfere with day-to-day managerial decisions, that they evaluate the performance of the board of directors regularly,[60] and that they recognize that the prosperity of the firm benefits all shareholders.

5-6 Takeovers

When shareholders conclude that the top managers of a firm with ineffective board members are mismanaging the firm, institutional investors, blockholders, and other shareholders may sell their shares, depressing the market price of the company's stock.[61] Depressed prices often lead to a **takeover**, a purchase of a controlling quantity of a firm's shares by an individual, a group of investors, or another organization. Takeovers may be attempted by outsiders or insiders, and may be friendly or unfriendly. A friendly takeover is one in which both the buyer and seller desire the transaction. In contrast, an unfriendly takeover is one in which the target firm resists the sale, whereby one or more individuals purchase enough shares in the target firm to either force a change in top management or to manage the firm themselves. Interestingly, groups that seek to initiate unfriendly takeovers often include current or former firm executives.

Takeover

The purchase of a controlling quantity of shares in a firm by an individual, a group of investors, or another organization. Takeovers may be friendly or unfriendly.

In many cases, sudden takeover attempts rely heavily on borrowed funds to finance the acquisition, a process referred to as a **leveraged buyout (LBO)**. LBOs strap the company with heavy debt and often lead to a partial divestment of some of the firm's subsidiaries of product divisions to lighten the burden.[62]

Leveraged Buyout (LBO)

A takeover in which the acquiring party borrows funds to purchase a firm.

Corporate takeovers have been both defended and criticized. On the positive side, takeovers provide a system of checks and balances often required to initiate changes in ineffective management. Proponents argue that the threat of LBOs can pressure managers to operate their firms more efficiently.[63]

Takeovers have been criticized from several perspectives. The need to pay back large loans can cause management to pursue activities that are expedient in the short run but not best for the firm in the long run. In addition, the extra debt required to finance an LBO tends to increase the likelihood of bankruptcy for a troubled firm.[64]

5-7 Summary

An organization's mission outlines the reason for its existence. A clear purpose provides managers with a sense of direction and can guide all of the organization's activities. Goals represent the desired general ends toward which organizational efforts are directed. However, managers, shareholders, and board members do not always share the same goals. Top management must attempt to reconcile and satisfy the interests of each of the stakeholder groups while pursuing its own goals. Inherent in the notion of mission and goals is the organization's position on social responsibility and the ethical standards it expects its managers to uphold.

Takeovers and leveraged buyouts have emerged as mechanisms for resolving some of the goal conflicts that occur among various stakeholder groups. The usefulness of these mechanisms continues to be widely debated, however.

Key Terms

agency problem
CEO duality
comparative advantage
corporate governance
diversification
employee stock ownership plan (ESOP)
goals
integrative social contracts view of ethics
justice view of ethics
leveraged buyout
managerial ethics
mission
objectives
religious view of ethics
rights view of ethics
self-interest view of ethics
social responsibility
stakeholders
sustainable strategic management
takeover
utilitarian view of ethics

Review Questions and Exercises

1. What is and should be the relationship between an organization's mission and its strategy?

2. What is the difference between social responsibility and managerial ethics?

3. Select a company that has published a mission statement on its Web site. Evaluate its mission statement along each of the following criteria.

- **a.** Is the mission statement comprehensive? Is it concise?
- **b.** Does the mission statement delineate, in broad terms, what products or services the firm is to offer?
- **c.** Is the mission statement consistent with the company's actual activities and competitive prospects?

4. Why do stakeholders in the same organization often have different goals? Would it not be best if they shared the same goals? Explain.

5. What are the key advantages and disadvantages of leveraged buyouts?

Practice Quiz

True or False

1. Goals are specific and often quantified versions of objectives.

2. If a firm is able to consistently earn above-average profits, then it is effectively balancing the goals of its stakeholders.

3. The agency problem refers to the balancing act a firm must exhibit when attempting to satisfy the myriad of governmental agencies.

4. A firm's managers may pursue diversification even if performance is likely to suffer because diversification can reduce the risk of firm failure.

5. A common suggestion for aligning the goals of top management and those of shareholders is to award shares of stock or stock options to top management.

6. Most boards of directors include both inside and outside directors.

Multiple Choice

7. The reason for the firm's existence is known as

A. the vision.
B. organizational goals.
C. organizational objectives.
D. none of the above

8. The idea that certain products may be produced more cheaply or at a higher quality in particular countries due to advantages in labor costs or technology is known as

A. comparative advantage.
B. competitive advantage.
C. strategic advantage.
D. national advantage.

9. Which of the following is not an example of a stakeholder?

A. customers

B. suppliers

C. employees

D. none of the above

10. An individual's responsibility to make business decisions that are legal, honest, moral, and fair is known as

A. social responsibility.

B. the social imperative.

C. managerial ethics.

D. all of the above

11. The board of directors is responsible for

A. selecting the CEO.

B. determining the CEO's compensation package.

C. overseeing the firm's strategies.

D. all of the above

12. Leveraged buyouts can

A. strap the company with a large amount of debt.

B. serve as a system of checks and balances.

C. lead to the sale of company assets.

D. all of the above

Notes

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READING 5-1

Insight from *strategy+business*

This chapter's strategy+business reading highlights the fact that progressive firms can meet social challenges while securing profits. South African power company Eskom anticipated the end to apartheid and has facilitated social change in the country by providing electricity to sections of the country dominated by a poor, predominantly black population.

The Company that Anticipated History

By Ann Graham

Driving along the old two-lane road from the Republic of South Africa's political capital, Pretoria, to its commercial hub, Johannesburg, a visitor sees two strikingly different nations.

The first South Africa looks like an emerging economy in hypergrowth. Hundreds of acres of rolling hillsides are rapidly giving way to new four-lane highways, office parks, shopping centers, and housing developments of modest and McMansion-style homes. Parking lots in Johannesburg suburbs are jammed with BMWs, Mercedes-Benzes, and Range Rovers. A supermarket called Woolworth's resembles the American haute-healthy food emporium Whole Foods; an apparel store, Kozi Kids, looks like the Gap. Bars and restaurants cater to young, university-educated, upwardly mobile professional blacks—a category that didn't exist 15 years ago. It emerged after the 1994 national election, which brought Nelson Mandela and the African National Congress (ANC), the country's oldest black rights organization, to power.

The second South Africa consists of a predominantly black population mired in poverty. Next door to many of the new malls and mansions are sprawling shantytowns of rusting metal shacks. Men and women in tattered clothes walk from them daily through tall grasses down to the urban roads. On their heads, some balance baskets filled with fruits and vegetables or trinkets they will try to sell to travelers. Day laborers jam themselves into ramshackle minivan taxis that take them to pickup points for construction or farm work. If they're not lucky enough to land those jobs, these itinerant workers might end up in a crowded shopping center parking lot, directing cars to open spaces and hoping to receive a small tip for their service.

South Africa's president, Thabo Mbeki, calls these two South Africas the "first" and "second" economies. They are a legacy of apartheid, the system of racial segregation that governed South Africa from 1946 to 1994, effectively excluding nonwhites (who make up 79 percent of South Africa's 47 million people) from the nation's economy and politics. Even with GDP growth averaging 3 percent since 1994, and more blacks rising out of poverty to enter the first economy, whites' per capita income of 82,000 rand (US$11,000) is still more than five times that of blacks, and black unemployment remains a problem. Officially, unemployment nationwide stands at about 27 percent. Unofficially, the rate is anywhere from 40 to 75 percent among blacks.

Access to electricity is always an important first step up the economic ladder. In South Africa, Eskom Holdings Ltd. provides that first step. A government-owned corporation headquartered in the Johannesburg suburb of Sandton, Eskom generates 95 percent of the country's electricity. Many organizations debate whether their business has social responsibilities, but Eskom's core business is itself a social responsibility. Without electricity, educating children is difficult; families must heat their homes with coal or wood, a major cause of respiratory diseases; and new businesses and employment opportunities can't grow. Eskom receives 80 percent of its revenues from industrial customers, but the company also has a self-imposed mission: to deliver electricity to all individuals, especially those who, in every sense, have lived without power.

Eskom adopted this mandate not in the wake of apartheid's fall, but in the mid-1980s, when it was legally prohibited from providing electricity to black communities. The company's early embrace of "electricity for all" (as the policy is called) allowed the company to play a leadership role early on in the social transformation of South Africa. Not only did the company rethink the value of serving black customers and remake its work force to bring blacks into positions of responsibility—both in defiance of the laws then in place—but it thus positioned itself as one of the very few African companies that could make a play for international expansion. (South African Breweries, now SABMiller, is another.)

Ahead of Change

"One cannot manage change," wrote noted management author Peter Drucker. "One can only be ahead of it." That maxim could be Eskom's motto. By preparing in advance for the end of apartheid, risking its own executives' lives in the process, the company established a pivotal role for itself in the South African economy, and arguably in its culture as well. Eskom's story is the sort often recounted under the banner of corporate social responsibility, but the company's efforts were not primarily motivated by the desire for a good reputation. They had much more to do with resilience and growth as an enterprise.

Eskom's leaders take the position that because no business can perform to its full potential in a society that is failing, companies must be involved in the societal health of their country. "It's not only that society needs strong and sustainable businesses. Businesses need sustainable societies in which to operate," says Wendy Poulton, Eskom's general manager of corporate sustainability. "Our view is if you don't recognize this as a business, you're going to be out of business."

Since the inception of "electricity for all," Eskom has electrified an average of 300,000 additional homes annually. In 2006, Eskom reported delivering electricity to 3.3 million homes, compared to only 120,000 during the last years of apartheid. To be sure, this electrification rate lags behind those of other emerging economies, such as India and China, but it means that 66 percent of the South African public has electricity, which is up from 30 percent a decade ago. This rate is more than four times the percentage in the rest of sub-Saharan Africa. With wholly owned electric power operations in 20 sub-Saharan countries and partnerships in 10 others, Eskom is also trying to be an economic engine for all of Africa—intending to bring electricity to more than a billion people, many of whom still live by candles and kerosene lamps. Currently, Eskom is among the largest utilities in the world, ranking 11th in generation capacity and seventh in sales, according to its 2005 annual report. Electricity sales reached R36.6 billion (US$4.61 billion), with pretax profits of R4.6 million (US$579,710) in the 2005–06 fiscal year.

Throughout its history, Eskom has had to manage the complex relationship among South Africa's government, financial, and industrial sectors. The utility traces its origins to private entrepreneurs at the beginning of the 20th century who won the first concessions to transmit electricity to the newly discovered gold deposits of the Witwaterstrand, the mountain range in northeastern South Africa that now houses the richest gold mines on earth. In 1910, when the Union of South Africa was formed, the Transvaal provincial government, representing the heart of the mining region, declared that supplying electricity was too important a public service to leave in private hands. In 1923, when apartheid was still a relatively informal policy in the country, the Electricity Supply Commission, abbreviated to *Escom* (the spelling was later changed), was created to absorb and run South Africa's electricity assets, with no profit requirement.

Escom was one of the first parastatals—South Africa's state corporations. Together with Iscor, which produces iron and steel; Sasol, which refines liquid fuels and other products from coal; and Foskor, which mines phosphate, Escom provided the infrastructure and raw materials to grow South Africa's economy. The parastatals also provided critical support to the government's increasingly separatist regime. After 1948, when apartheid became national policy, the government and therefore Escom effectively wrote off most black townships, arguing that their inhabitants would one day return to the so-called homelands. This homeland policy, or "grand apartheid," inhibited investment in township infrastructure, schools, and other basic services. However, the demand for electricity increased among the white population—enough to drive Escom to expand its generating capacity dramatically in the 1960s and early '70s.

When the utility made plans to erect five coal-fired power stations, Dr. Ian McRae, then the head of power station operations, saw a large problem ahead: a shortage of white workers with the skills needed to staff those plants. "We realized we had all these new power stations coming on and we didn't have the people to operate them," recalls Dr. McRae.

His solution was to begin training blacks to fill these positions, even though most were illiterate and apartheid outlawed them from being anything more than unskilled laborers. At the time, the laws reserved certain jobs for whites, and white trade unions jealously guarded those rules. (Black trade unions were illegal until 1979.) Breaking the law, though, wasn't what most concerned Dr. McRae; rather, he worried whether Escom's employees would support such radical measures. So he set up meetings at each power station with trade union representatives, plant managers, and black laborers to discuss the idea of blacks' doing jobs traditionally performed by whites. Reassured that there would be minimal resistance, Dr. McRae started introducing blacks into the ranks in the new position of "operating assistant" and providing them with the training to develop their technical skills. He removed the existing educational barriers so that nonwhite operators could move into the position of shift supervisor. "I got people to agree that a good operator, with some experience, could move up," says Dr. McRae.

By the late 1970s, worldwide condemnation of apartheid had left South Africa isolated, and its economy was stagnating. Demand for power plummeted, and it soon became clear that the power stations Escom had committed to build were no longer needed. After the company jacked up prices to offset the costs of construction and operational misfires, it found itself in financial difficulty.

That's when the government stepped in. In May 1983, a commission appointed by the Minerals and Energy Ministry and led by mining executive W.J. de Villiers found fault with Escom's management of forecasting, governance, accounting, and investment. Amid the commission's inquiry, a scandal broke concerning a company accountant who had defrauded Escom of nearly $4 million; he was convicted and the finance chief was forced to resign. Escom was now a national embarrassment. The De Villiers Commission replaced its existing hierarchy with a new two-tier governance structure. An Electricity Council, appointed by and reporting to the government, represented the stakeholders, including consumers and unions, and set policy. Below that was the management board, which ran the company. For the first time, Escom would be accountable for profits and losses.

In 1984, the De Villiers Commission nominated Dr. McRae to be Escom's chief executive. For chairman of the new management board, South African President P.W. Botha chose Dr. John B. Maree. The two men, temperamentally quite different, took on financial and cultural reforms together. Dr. McRae was the consummate company man. Soft-spoken and professorial in demeanor, he had started at Escom as an artisan's apprentice in 1947. He was well-liked and respected inside the company and in the industry. Dr. Maree, a turnaround specialist, was renowned for his shrewd political instincts and his blunt management style. A former divisional chair at Barlows Ltd., one of the country's oldest and largest conglomerates, Dr. Maree came to Escom following a three-year stint as the chief executive of Armscor, South Africa's defense parastatal.

Drs. McRae and Maree began by looking inward. Using Dr. McRae's signature "walkabouts," a technique he had developed years earlier to make sure he never lost touch with his employees, they met with small groups of senior and middle managers in regional offices, power stations, and distribution and service departments. Morale was low. Consumer criticism had hurt, and Escom-bashing in the press made it worse.

At the head office, the two assembled Escom's best and brightest managers and strategic thinkers into a senior management council they called the "Top 30." A few outsiders were also invited, including Reuel J. Khoza, a management consultant recognized for his entrepreneurial acumen and commitment to social change. (In 1997, he would become Eskom's first black chairman.) Escom's leaders defined their most pressing task as fixing the fiscal mess and turning Escom into one of the world's top utilities. "John and I knew our performance had to be first class, or the government would take over," remembers Dr. McRae. "I had seen all over Africa how disastrous such political interference could be. We had to keep the government out of the engine room."

Electricity for All

Downsizing was a critical step—and a move unheard of at Escom. Over the years, Escom had developed a reputation as an undemanding workplace. People joked that Escom stood for "easy, slow, comfortable." Dr. Maree pushed through instant work-force reductions from 66,000 to 60,000. By 1995 the head count was 39,000. (Today it's just under 30,000.) A name change from *Escom* to *Eskom* symbolically cemented the shift and distanced the company from its former identity as the government's supply commission.

While Dr. Maree drove the company to higher performance, Dr. McRae started to champion the vision of "electricity for all"—a response to the change he believed was inevitable. "South Africa was facing political transition, either through armed struggle or political negotiation," he wrote in his memoir, *The Test of Leadership* (EE Publishers, 2006). "When (not if) the ANC came into power, Eskom needed to be performing to the satisfaction of everyone in our country and that included making electricity available to all, not just one third of the population."

Dr. McRae proposed that Eskom begin offering electricity directly to households in the townships.

Other executives agreed, but saw his plan as too risky, politically and financially. They weren't convinced blacks really wanted electricity; the few who could afford it complained of poor service and exorbitant bills. Furthermore, there was no commercial logic for growing a customer base of poor households, especially because at the time it was still illegal for Eskom to do so.

"To me the threat of not getting people electricity was greater," recalls Dr. McRae. "In these urban townships, there was no commercial or industrial infrastructure. What really worried me wasn't the lack of electricity; it was poverty."

Before pressing for further support within the company, he decided to see for himself if there was market demand. At great personal risk, he went to townships, where few whites had ever ventured, to ask residents directly whether they wanted electricity, and if they would pay for Eskom's service. With the help of the then-banned ANC, he met at night with people in churches and in their homes. On one visit to Soweto, Dr. McRae learned why the bills were so high: Meters were locked in cubicles on the sidewalks and were not read regularly. "When I went to those meetings, I got a clear signal that they did want electricity if the price was reasonable and they could get decent service," he says.

To buttress his argument, he pointed to the *favelas* of Rio de Janeiro. In these squatter cities, which are similar to South Africa's shantytowns, the residents were eager to buy electricity when delivery was reliable. Dr. McRae won the support of Eskom's board, and in 1989, he launched a drive to bring affordable, safe electricity to the townships.

To achieve that goal, the utility had to devise a completely new way to collect payment. There was no postal service, and most residents had no fixed address and did not hold regular jobs. Eskom came up with a revolutionary prepayment system that is still in use; an inhome metering system that changed the dynamics of the black political struggle—withholding payment was a frequent form of protest—and forever altered the business model of Eskom. The in-home system used fare cards purchased at the post office; customers inserted them into the meter to activate the electricity flow. Four lights in the meter box allowed residents to monitor how much electricity they had left. The system also helped residents and the company avoid a mishap that both hated: service disconnections for nonpayment. Township activists continued to play an advocacy role; for example, they pressed for the replacement of unreliable meters. Meanwhile, as Dr. McRae recalls, new stories of township entrepreneurialism emerged. A man who had baked his family's bread over an open fire invested in two electric ovens, which he used to start a successful bakery business that grew to have seven employees. A skilled welder launched a business with two other men making fencing, security bars for windows, and small steel chairs. Successes like these were the clearest vindication of Eskom's prescience.

Equalizing Opportunity

As the company worked to desegregate power delivery, its leaders attacked segregation inside Eskom. Dr. Maree recalls becoming committed to the idea when the company opened its Matimba power station, near the Botswana border, in 1987. "I'll never forget one man who came up to me and said, 'Dr. Maree, electricity has no color. Eskom should not have color.' That really hit me." To be a top-performing utility, he and Dr. McRae declared, Eskom had to fast-track development of the staff from all races. They also argued that Eskom would better serve black customers if black workers at Eskom held positions of authority.

Integration was painful, especially for middle managers. "I remember sending young engineers, one black and one white, to the power stations," says Dr. Steve Lennon, who was then a middle manager and is now Eskom's managing director of resources and strategy. "They were expected to work together, but they weren't allowed to sleep in the same place. I had a fight with one station manager, and ended up transferring a black scientist to another project because of the segregation." At the same time, it was Eskom's social progressiveness and its growing reputation for technical excellence that attracted highly skilled individuals like Dr. Lennon in the first place.

And it also attracted those few black students who had beaten the odds to become engineers. When Ehud Matya graduated from engineering school in 1986, he committed to a four-year stint with Eskom. He had been the first black at his school to win an Eskomsponsored scholarship, and Eskom had gone out on a limb to award it to him. Assigned to a team piloting a software system at Duvha Power Plant, the largest in the world, he broke the managerial color barrier. Yet lavatories and lunchrooms were still closed to him. Before the year was over, he left Eskom for a job at South African Breweries. "The race issues were more challenging than I had expected," he says.

Dr. Maree concedes that desegregating Eskom was painful for everyone, as well as time-consuming. "It took us two years to get all our regulations changed, because apartheid was still the law." To pave the way for blacks to assume executive positions, including seats on the Electricity Council, Dr. Maree worked his political connections right up to President Botha. At a meeting with the president in 1987, he says, "We agreed Eskom should take a step very few others had taken."

By the end of 1987, conditions had improved enough that Mr. Matya, for one, felt comfortable returning to Eskom. His post this time was chief of logistics at a distribution unit in Bloemfontein, a conservative Afrikaaner stronghold. "I took the job with the clear intent of being part of the transformation process," he says. Then, after the ANC assumed power in 1994, Mr. Matya became the first black manager at Duvha, where he'd once been forbidden to use the toilets. He is currently Eskom's managing director for generation and sits on the executive management committee.

Eskom's willingness to integrate its work force as far back as the 1970s paid an enormous dividend in building the company's capacity for leadership. "I joined the company in 1993, when the country's transformational initiatives were in their infancy," says Thulani S. Gcabashe, Eskom's current chief executive officer, who started as an electrification manager in Natal. "Eskom saw its chance to get an early start—make our own mistakes and learn from them. So by the time the rest of society was ready to start putting out guidelines, we were the ones being consulted. If you look at the Employment Equity Act of 1998, it is very much based on what we started doing in the 1990s." Even today, Eskom is one of the few South African corporations to consistently meet or exceed the requirements of the first post-apartheid government's 1995 Reconstruction and Development Program, which included targets for promoting affirmative action and bringing water and electricity to poor communities. In 1993, 60 percent of all Eskom employees were black, and 5 percent of the managerial, supervisory, and professional staff were black. By the time Dr. Maree retired in 1997, more than 50 percent of the managerial and technical professionals were black. The next chairman and CEO, respectively, Mr. Khoza and Mr. Gcabashe, aimed by 2000 to fill half of all supervisory personnel and top managerial positions with nonwhites. "In the end, we achieved this goal a year ahead," says Mr. Gcabashe. "We also said 1.75 million homes will have electricity by the year 2000, and we beat that goal a year ahead, too." Eskom's nonwhite supervisory and managerial goal for 2010 is 65 percent.

Eskom's top executive team is made up almost exclusively of blacks, as is its board of directors. (Dr. Lennon is the only white member of the executive management committee.) Eskom appointed its first black chairman of the board, Mr. Khoza, in 1997. (He stepped down in 2005. His successor is Valli Moosa, a former minister of the environment.) Mr. Gcabashe is Eskom's first black CEO. (He is scheduled to retire at the end of 2007.) By contrast, as of March 2006, Sasol—South Africa's state-owned synthetic fuel and chemical company—had appointed only its second black executive director in 12 years.

As the South African government formalizes and expands its regulations on training and promoting nonwhite managers, companies scramble to formulate their compliance strategies. But Eskom has already met the government requirements, and is now concentrating on recruitment and development strategies, to fill its pipeline of managerial and technical talent in a market where such talent is in short supply.

"We start to recruit young men and women in high school and support them through university. Then we bring them into the business in a two-year training program," says Mr. Gcabashe. The Eskom Foundation, a social investment nonprofit founded by Mr. Khoza and Allen J. Morgan, a former CEO who succeeded Dr. McRae, funds health, education, and small business programs for disadvantaged South Africans. The foundation provides scholarships to promising students and helps schools develop teaching resources in math and science. Eskom is also promoting a first generation of women in management. In 1993, about 8 percent of Eskom professionals were women. Now the number is 30 percent, which includes the only female power station manager in the world, and a senior transmission manager responsible for ensuring the stability of the national grid.

Ubuntu Management

When Mr. Khoza succeeded Dr. Maree, he brought along his own visions for Eskom. As the company's first black chairman, accountable to South Africa's first black government, Mr. Khoza felt his mandate was to complete the integration of Eskom while ensuring it continued to perform at a high level.

To meet this management challenge, he applied an African humanist philosophy known as *ubuntu*. Translated from Zulu as "I am because you are, you are because we are," ubuntu is based on the idea that human beings derive their primary identity from the communities where they live and work, and that these communities must therefore demonstrate respect for people in large and small ways. Mr. Khoza says the ubuntu ethic helped him recognize that white executives held most of the skills and knowledge needed to manage the company. "I could not behave like a bull in a china shop and decree that there will be black managers tomorrow," he says. "I strove to understand the business, not just the business as it technically performs, but the people who deliver and how to motivate them to deliver."

Selling that view inside and outside Eskom was critical to Mr. Khoza's success, and he was tested almost immediately. When he arrived, Eskom's longtime head of finance, who was white, was considering a lucrative job offer. It would have been politically expedient to replace him with a black executive, but Mr. Khoza worked hard to persuade the man to stay at Eskom. "If he had left, the entire finance and treasury department would have followed him and I would have been left with a void," says Mr. Khoza. He saw an opportunity to turn the executive into a valuable ally. What won the employee over, says Mr. Khoza, "was not giving him a counteroffer in terms of money, but selling him on a philosophy."

In his book *The Power of Governance: Enhancing the Performance of State-Owned Enterprises* (coauthored with Mohamed Adam; Pan Macmillan, 2005), Mr. Khoza explains Eskom's credo since 1994: "At the heart of the transformation process was a continued commitment by Eskom and the South African government to superlative performance. This encompasses economic, financial, and operational excellence, social and environmental responsibility, and good governance." It also encompassed a new, almost obsessively detailed dedication to tracking results, in a company that had once "lost" $4 million. The 400-page 2005 annual report lists virtually everything the company achieved or did not achieve, down to the attendance records of directors at board meetings. Although some consider the report overkill, Eskom's executives and managers continually scrutinize the data to develop strategy and improve performance. For example, the company's Human Resources Sustainability Index (HRSI), described by the company as a "measure of Eskom's ongoing ability to achieve its human resources objectives," covers 26 indicators of employee health and wellness, competence, satisfaction, and race and gender equity. "One needs to institutionalize putting race, gender, and performance into a productive context," says Mpho Letlape, Eskom's managing director for human resources.

Eskom has also been a national leader in the fight against HIV/AIDS. In 1987, it launched South Africa's first workplace programs, shining a light on the then-taboo disease with education and treatment programs. It continues to add programs on AIDS awareness and prevention. "Last year, 95 of our colleagues passed away from HIV/AIDS-related diseases. That is a lot of people, but it would have been far worse if we had not started acting when we did," says Mr. Gcabashe.

Eskom sustains its social leadership without sacrificing financial performance. The company has consistently earned a profit since recovering from near-bankruptcy in 1984. It has also earned investment-grade credit ratings from Standard & Poor's, Moody's, and Fitch—a claim few state-owned utilities in developing countries can make.

Confronting the Future

Despite its many accomplishments, Eskom still faces significant challenges. Several major power outages in the Western Cape and local rolling blackouts and tension over rising electricity prices hit Eskom all at once in early 2006. Consumers grew angry, and Eskom became a campaign issue during the local government elections in March. To the country's leading business newspaper, *Business Day,* the year 2006 was Eskom's "horror year. In 12 short months, the electric utility that could do no wrong suddenly became a problem child."

Eskom has addressed the problems. The national rolling blackouts that media predicted never materialized, and the Koeberg nuclear power plant, a primary supplier for the Western Cape, is now back online. Eskom has negotiated a multiyear price agreement with the regulatory agency that keeps electricity prices in line with inflation. In July 2006, the government announced a long-range energy plan for the country, which includes a five-year, R97 billion ($12.2 billion) program—the largest in 20 years—to expand and upgrade Eskom's capacity. Two-thirds of the money will go to generation, including new coal technology, hydro, and gas options; the rest will go to distribution, transmission, new business, and renewable energy. Eskom is working with Plug Power, an American fuel cell manufacturer, and IST Holdings, a South African power industry equipment distributor and longtime Eskom supplier, on a pilot project to make fuel cells affordable. "I had a guy at one American utility tell me that unless I had 100 years of proven field experience, he didn't want to talk to me. A utility needs to be conservative, but Eskom pushes for innovation more than most," says Mark Sperry, chief marketing officer of Plug Power.

A plaque near the entrance to Eskom's headquarters marks the place where a time capsule was buried to mark the company's 75th anniversary in 1998. The capsule will be opened in 2023, Eskom's centennial year. "May the contents highlighting past achievements be a source of inspiration to those achievers of the future," the plaque says. Most of Eskom's current leaders, black and white, were there on the day that capsule was buried, and like most South Africans, they have lived through the transformation of the country and the company.

"I was born in South Africa in 1959, so I'm a product of apartheid. I was designed a racist," says Dr. Lennon. "It is one of those things that South Africans who were born in the late '50s, who went through the public education system, and who are honest with themselves, spend a lot of time thinking about and regretting. But my time at Eskom, and in South Africa, during this transition has been an incredible life experience. What is so exciting is that, as an individual, you can do a lot to create positive change."

Because the lead time for building new power stations is 20 to 25 years, Eskom will always face difficulties in anticipating power capacity needs. And politics is always a complicating factor. No matter how successful Eskom is at keeping the government out of the engine room, it still must answer to those in charge —for good and ill. Debates over pricing and privatization are never settled.

In that light, Eskom's biggest asset is arguably the resilience its leaders, white *and* black, have cultivated throughout the company since the 1980s. That resilience, in turn, has allowed it to stay in front of public-sector trends and needs, a critical capability in a government-owned power utility. "The advantage of being ahead of the game, says Mr. Gcabashe, "is not that you can dictate the terms of legislation, but you can influence the thinking around issues based on the experience you already have."

But one doesn't have to be government-owned, or African, to find inspiration in Eskom's story. These days, every company's performance is in some way tied to the social and political environment in which it operates. If Eskom is a model for companies facing such enormous changes as global warming and soaring health-care costs, then the most effective approach is not risk management as usual. Eskom thrived by anticipating the course of history and stepping out in front of change, thereby building its capacity to lead. Its example suggests that any other company can do the same.

Resources

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Corporate-Level Strategies 6

Chapter Outline

Corporate-level Strategy
The strategy that top management formulates for the overall company (or should be operating).

Chapter 5 laid the foundation for addressing the strategic direction within the organization. Strategies exist at three levels in any organization: the corporate or firm level, the business unit or competitive level, and the functional level. This chapter focuses on the strategy at the broadest of these three levels, the **corporate-level strategy**, or the strategy top management formulates for the overall corporation. In general, corporate-level strategy concerns precede the competitive and tactical issues related to business and functional strategies.

6-1 The Corporate Profile

Corporate Profile
Identification of the industry(ies) in which a firm operates.

The first step in formulating an organization's strategy is to assess the markets or industries in which the firm operates. The **corporate profile** identifies one or more businesses and industries in which the firm operates. A firm may choose three basic profiles: (1) to operate in a single industry, (2) to operate in multiple related industries, and (3) to operate in multiple unrelated industries.

Most firms start as single-business companies, and many continue to thrive while remaining active primarily in one industry. By competing in only one industry, firms such as UPS, Exxon-Mobil, and Home Depot 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. Firms operating in a single industry are more susceptible to sharp downturns in business cycles, however. For this reason, most large firms eventually pursue diversification and compete in more than one industry. Diversification allows a firm to grow, (potentially) use its resources more effectively, and make use of surplus revenues.

Firms that diversify may choose to compete in related or unrelated industries. Related diversification involves expanding into similar businesses that may complement the original or primary business. Wal-Mart—which also operates Sam's Wholesale Club—benefits from expertise derived from concentration in multiple retailing industries. McDonald's—which owns Boston Market—also operates in related industries. In contrast, General Electric (GE) operates in a vast array of unrelated businesses ranging from television sets to aircraft engines to financial services.

Although diversification can reduce the uncertainty and risk associated with operating in a single industry, participating in numerous unrelated businesses may result in uncertainties associated with losing touch with the fundamentals of each business. As a result, many scholars and executives occupy the middle ground by arguing that aggregate uncertainty is minimized when a firm diversifies its holdings, but only into related industries.[1] Relatedness, however, is ultimately in the eyes of the beholder, and may be based on clear similarities such as product lines or customers or less obvious bases such as distribution channels or raw material similarities.

Unrelated diversification is driven by the desire to capitalize on profit opportunities in a given industry and involves the corporation in businesses that typically are dissimilar. Although such an approach may reduce risk for the firm, it also carries potential disadvantages. Because their interests are spread throughout unrelated business units, strategic managers may not stay abreast of market and technological changes that affect the businesses. In addition, they may unknowingly neglect the firm's primary, or core, business in favor of one or more other units. Avoiding these pitfalls is easier when a firm's business units are related.

The key to successful related diversification is the development of synergy among the related business units. **Synergy** occurs when the combination of two organizations results in higher effectiveness and efficiency than would otherwise be generated separately. Opportunities for synergy are not always easy to identify. Synergy may occur when similarities exist in product or service lines, relationships in the distribution channels, or complementary managerial or technical expertise across business units.

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

Synergy between business units does not always materialize as originally planned. For example, when Sports Illustrated campaigned in 2005 to merge its Web site with the AOL Web portal to create a massive sports site, AOL balked, suggesting that Sports Illustrated had too little to offer. Several years prior, parent company Time Warner might have encouraged the partnership between its two business units under the guise of "corporate synergy," but instead the Time Warner president, Jeffrey Bewkes, told the magazine to look elsewhere for a partner. Unlike his predecessors who preached synergy among Time Warner business units, Bewkes challenged the universality of the synergy concept and began selling off less profitable businesses.[2] In another example, when CVS acquired pharmacy-benefits manager Caremark Rx in 2007, the California Public Employees Retirement System (CALPERS) voted more than 2.1 million Caremark shares and more than 3.1 million CVS shares against the deal. CALPERS officials charged that poor synergy existed between the retailer and the benefits manager.[3]

Each of the three corporate profiles includes successful firms, as no single profile proves to be the best. After selection of the corporate profile, the next consideration is the corporate strategy.

6-2 Strategic Alternatives at the Corporate Level

The three basic strategic alternatives at the corporate level are growth, stability, and retrenchment. The available strategies are listed in Table 6-1.

6-3 Growth Strategies

The **growth strategy** seeks to significantly increase a firm's revenues or market share. Although many top executives believe that growth is always the single best strategy for a healthy firm, this is not the case. Rather, a firm should adopt a

TABLE 6-1 Corporate-Level Strategies

1. Growth strategies
    a. Internal growth
    b. External growth
        - Horizontal related integration
        - Horizontal related diversification
        - Conglomerate unrelated diversification
        - Vertical integration
        - Strategic alliances (partnerships)
2. Stability strategy
3. Retrenchment strategies
    a. Turnaround
    b. Divestment
    c. Liquidation

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

External Growth
A corporate-level growth strategy whereby a firm acquires other companies.

Merger
A corporate-level growth strategy in which a firm combines with another firm through an exchange of stock.

Acquisition
A form of a merger whereby one firm purchases another, often with a combination of cash and stock.

growth strategy only if growth is expected to result in an increase in firm value. This theme is revisited in section 6-4.

Growth may be attained primarily by two means. **Internal growth** is accomplished when a firm increases revenues, production capacity, and its workforce; it can occur by growing an existing business or creating new ones. In contrast, **external growth** is accomplished when two firms merge or one acquires the other. A **merger** occurs when two or more firms, usually of roughly similar sizes, combine into one through an exchange of stock. An **acquisition** is a form of a merger whereby one firm purchases another, often with a combination of cash and stock. Firms with large, successful businesses often acquire smaller competitors with different or complementary product or service lines. For example, Wendy's acquired the Mexican quick-casual chain Baja Fresh in 2001 and grew the chain to include almost two hundred eateries in the United States by 2003.[4] Classifying a merger as an acquisition is not always easy, however.

There are clear advantages to both internal and external growth. Internal growth enables a firm to maintain control over the enterprise by adding new products, facilities, or businesses incrementally. Internal growth enables the firm to preserve its corporate culture and image while expanding at a more controlled pace.

The attractiveness of external growth through mergers and acquisitions seems intuitively obvious: Two firms join forces and the combined organization possesses all the strengths of the individual firms. Indeed, when two firms possess complementary resources and cooperate in a friendly acquisition or merger, the results can be positive (see Strategy at Work 6-1).

External growth has its shortcomings, however. In an acquisition, the acquiring firm typically must pay a premium (i.e., an amount greater than the current share price) to obtain the firm, a process that leads to increased debt and legal fees. In addition, top managers in the acquired firm often depart the organization.

Another potential pitfall associated with mergers and acquisitions is that of blending two distinct cultures or ways of thinking, a process that can be

STRATEGY AT WORK 6-1

Sears and Kmart Join Forces

Kmart acquired Sears in November 2004 in an $11.5 billion deal that placed the newly combined firm—named Sears Holding Corporation—in the number three U.S. retailing position behind Wal-Mart and Home Dept. The move followed a decade of struggles by both century-old companies.

Going into the acquisition, Sears boasted more stores (2,000 versus 1,500) and employees (249,000 versus 144,000) than Kmart. From a financial perspective, Kmart was showing signs of turning around several years of dismal performance, generating $801 million in profit during the first nine months of 2004, while Sears had reported $61 million in losses. It was immediately confirmed that the total number of stores and employees would be reduced as the new firm restructures.

Those behind the deal are hoping for improved efficiencies, with each retailer adding a number of successful product lines from the other. Prior to the acquisition Sears was widely believed to be the stronger brand, bringing with it Craftsman tools, Diehard batteries, Kenmore appliances, and Lands' End apparel. Kmart's key brands included Martha Stewart, Jaclyn Smith, Joe Boxer, Route 66, and Sesame Street. Insiders expect some repositioning of the store brands, with Kmart becoming a slightly more upscale retailer and Sears moving in the opposite direction. The extent to which the two retail icons will enjoy renewed success as a team remains to be seen, however.

Source: A. Merrick and D. K. Berman, "Kmart to Buy Sears for $11.5 Billion," Wall Street Journal, *18 November 2004, A1, A8* difficult amidst the rumors or layoffs and restructuring that often accompany the deal.[5] This is especially the case across borders. For example, although carmakers Chrysler and Daimler Benz merged to form DaimlerChrysler in 1998, complete cooperation between members from the two original organizations was 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. The Crossfire—a Chrysler design with Mercedes components—was introduced in 2004 and represented the first joint vehicle. The synergy never seemed to materialize, however, and most of Chrysler was sold to a private investment group, Cerberus, for $7.4 billion in 2007. After other financial considerations were taken into account, Daimler actually paid Cerberus about $500 million to take the financially strapped carmaker it had paid $36 billion for nine years earlier.[6]

External growth can take many forms, five of which are discussed in sections 6-3a through 6-3e. Although these forms are not always mutually exclusive, it is appropriate to consider each example individually.

6-3a Horizontal Related Integration

A firm that acquires other companies in the same line of business is engaging in **horizontal related integration**. Doing so allows a firm operating in a single industry to grow rapidly without moving into other industries. Hence, the primary impetus for such a strategy is a desire for increased market share. Such growth can create scale economies for the firm, increase its negotiating leverage with suppliers, and enable the firm to promote its goods and services to a large audience more efficiently and effectively.

Horizontal Related Integration
A form of acquisition in which a firm expands by acquiring other companies in its same line of business.

6-3b Horizontal Related Diversification

A firm is engaging in **horizontal related diversification** when it acquires a business outside its present scope of operation, but with similar or related **core competencies**, the firm's key capabilities and collective learning skills that are fundamental to its strategy, performance, and long-term profitability. The purpose of horizontal related diversification is to create synergy by transferring and/or sharing the capabilities among the various business units. For example, in the 1990s and early 2000s, numerous banks consolidated to gain economies of scale.

Horizontal Related Diversification
A form of diversification in which a firm acquires a business outside its present scope of operation but with similar or related core competencies.

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. When a firm lacks one or more key core competencies and acquires a business unit that possesses them, these two firms may combine complementary core competencies. For example, when a traditional retailer with a quality reputation acquires an e-tailer with a strong Internet presence and Web savvy, the idea is to combine the two capabilities so that the newly created firm can enjoy the best of both competencies.

Core Competencies
The firm's key capabilities and collective learning skills that are fundamental to its strategy, performance, and long-term profitability.

6-3c Conglomerate (Unrelated) Diversification

When a corporation acquires a business in an unrelated industry to reduce cyclical fluctuations in cash flows or revenues, it is pursuing **conglomerate, or unrelated diversification**.[7] Whereas diversifying into related industries is pursued for strategic reasons, diversifying into unrelated industries is primarily financially driven.[8] Conglomerate diversification allows a firm to continue to grow even when its core business has matured. However, firm managers often lack the expertise required to manage a myriad of unrelated businesses.

Conglomerate (Unrelated) Diversification
A form of diversification in which a firm acquires a business to reduce cyclical fluctuations in cash flows or revenues.

6-3d Vertical Integration

Vertical Integration
A form of integration in which a firm expands by acquiring a company in the distribution channel.

Backward Integration
A firm's acquisition of its suppliers.

Forward Integration
A firm's acquisition of one or more of its buyers.

Vertical integration refers to merging various stages of activities in the distribution channel. Firms in some industries tend to be more vertically integrated than those in other industries, although variations can exist among similar firms. Full integration occurs when a firm performs all activities ranging from the procurement of raw materials to the production of final outputs, whereas firms that engage in some but not all of these activities are only partially integrated. When a firm acquires its suppliers (i.e., expands "upstream"), it is engaging in **backward integration**; when a firm acquires its buyers (i.e., expands "downstream"), it is engaging in **forward integration**.

Vertically integrated firms enjoy certain advantages. Vertical integration can reduce transportation costs, provide more opportunities to differentiate products because of the increased control over inputs, and provide access to distribution channels that would not otherwise be accessible to the firm. Transactions costs between suppliers and buyers may be reduced when the same firm owns both entities. Proprietary technology can be more easily secured when information is shared among businesses owned by the same parent firm. It is often possible to reduce costs by coordinating distribution activities among the business units. It is also easier to develop and maintain high quality when a single firm controls all the businesses associated with the production of a good or service.[9]

Vertical integration also has its disadvantages. It can reduce operational flexibility because the firm is heavily invested both upstream and downstream. Vertical integration can even raise production costs and reduce efficiency because of the lack of supplier competition. Overhead costs may increase as the need and ability to coordinate activities among business units increases. Because producers within a vertically integrated firm are committed to working with suppliers owned by the same firm, it will be forced to pay higher prices for its inputs if its suppliers are not technologically competitive.[10]

6-3e Strategic Alliances (Partnerships)

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

Strategic alliances—often called *partnerships*—occur when two or more firms agree to share the costs, risks, and benefits associated with pursuing new business opportunities. Such arrangements include joint ventures, franchise or license agreements, joint operations, joint long-term supplier agreements, marketing agreements, and consortiums. Strategic alliances can be temporary, disbanding after the project is finished, or can involve multiple projects over an extended time. The late 1990s and early 2000s witnessed a sharp increase in strategic alliances.[11]


Source: Comstock.com

Broadly speaking, strategic alliances are considered to be a form of growth, but the firm does not necessarily gain revenues because there is no exchange of resources. Although many strategic alliances may be undertaken for political, economic, or technological reasons, others may be pursued as an alternative to diversification. In this context, a firm may opt to work closely with other firms to pursue various business opportunities instead of attempting to purchase the firms outright. Another key reason is the generation of greater customer value through synergy.[12] A particular 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.[13]

There are many examples of partnerships, especially where technology and global access are key considerations. IBM and Apple Computer have exchanged technology in an attempt to develop more effective computer operating systems. GM, Ford, and Chrysler are jointly conducting research to enhance battery technology for electric cars. GM, Lockheed, Southern California Edison, and Pacific Gas & Electric have been working together to develop widely used electric vehicles and advanced mass transportation systems.[14]

Strategic alliances have two major advantages. First, they minimize increases in bureaucratic, developmental, and coordination costs when compared to mergers and acquisitions. Second, each company can share in the benefits of the alliance without bearing all the costs and risks itself. The major disadvantage of a strategic alliance 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.

Strategic alliances can be problematic if the partner firms do not agree explicitly on the contribution each will make to the alliance. In 2000, for example, Amazon.com and Toys "R" Us inked a ten-year deal to join forces, with Amazon agreeing to devote a portion of its Web site to Toys "R" Us products, and the toy retailer agreeing to stock certain items on the virtual shelves. Although the arrangement was touted as an example of how Internet retailers can work effectively with their traditional counterparts, the deal deteriorated several years later and ended up in court in 2006. Toys argued that Amazon broke its original commitment to use Toys as its sole provider of toys and related products, while Amazon contended that Toys did not maintain an appropriate selection of products.[15]

6-4 Stability Strategy

Although growth is intuitively appealing, it is not always the most effective strategy. The **stability strategy** *for a firm that has operations in multiple industries* maintains the current array of businesses for two reasons: First, stability enables the corporation to focus managerial efforts on enhancing existing business units, by fostering productivity and innovation. Second, the cost of adding new businesses may exceed the potential benefits. A corporation may adopt a stability strategy in leaner times and shift to a growth strategy when economic conditions improve. Stability can be an effective strategy for a high-performing firm, but it is not necessarily a risk-averse strategy.

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

For a single-industry firm, the stability strategy is one that maintains approximately the same operations without pursuing significant growth in revenues or in the size of the organization. Growth may occur naturally but is typically limited to the level of industry growth. Such a business may select stability instead of growth for four reasons.

First, *industry growth may be slow or nonexistent*. In this situation, one firm's growth must come at the expense of another firm. This can be particularly costly, especially when attacking an industry leader.[16]

Second, *the costs associated with growth do not always exceed the 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 dampened profits.

Third, *growth may place great constraints on quality, marketing efforts, and customer service*. Growth for small firms can create a strategic challenge as managers attempt to retain the flexibility and entrepreneurial spirit that helped found the company while making the substantial capital outlays and commitments typically associated with larger firms. Strategic managers of such firms are understandably hesitant to adopt growth strategies, even when financial prospects look promising, if they believe that their uniqueness may be lost in the transition. After going public in 2002, U.S. airline upstart JetBlue surpassed the $1 billion mark in revenues in 2004 and announced plans to employ as many as thirty thousand workers to operate 275 planes by 2010. With increased hiring and contract commitments, however, JetBlue risks losing its ability to respond quickly to shifts in consumer demand patterns and environmental factors, an ability that helped shape the firm's early success. As evidenced in 2007, the fast-growing airline stranded hundreds of passengers when inexperienced and overwhelmed customer and crew services did not cancel and reschedule flights appropriately during a snowstorm, an error that cost the company $30 million in payments to customers alone and eventually led to the board's removal of founder David Neeleman.[17]

Even large, established firms can experience quality challenges when they grow rapidly, as has been the case when Toyota achieved 10 percent of the global automobile market in 2004 and began to push toward a goal of 15 percent.[18] Even when Toyota surpassed its sales goal of 150,000 vehicles from its Scion division in 2006, the carmaker decided to place a sales ceiling of 150,000 Scions annually to support the brand's "underground" and hard-to-get image.[19] McDonald's turnaround between 2003 and 2007 has been widely credited to CEO Jim Skinner's decision to eschew growth for a strategy built around improving existing locations through improvements in service, food taste, ambience, value, and marketing.[20]

Finally, *large, dominant firms 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.

It is interesting to note, however, that declines in demand do not necessarily require a stability strategy for each firm in an industry. To the contrary, business opportunities may be presented when markets shrink. For example, F^3 Fat Free Foods is a New York–based retailer of more than seven thousand food products, most of which are fat free. In the early 2000s, most analysts were proclaiming that the fat-free category was past its prime. The urban grocer was experiencing considerable success, however, due in part to the declining attention traditional grocers were paying to a hard-core segment of fat-conscious consumers.[21]

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

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.

6-5 Retrenchment Strategies

Growth and stability strategies are usually adopted when firms are performing well. When performance is disappointing, however, a **retrenchment strategy** may be appropriate. Retrenchment may take one or a combination of three forms: turnaround, divestment, or liquidation.

6-5a Turnaround

A **turnaround** seeks to transform the corporation into a leaner, more effective firm, and includes such actions as eliminating unprofitable outputs, pruning assets, reducing the size of the workforce, cutting costs of distribution, and reassessing the firm's product lines and customer groups.[22] Turnarounds are often preceded by changes in the macroenvironment, industry structure, or competitive behavior. Broadly speaking, a turnaround is not as drastic a move as restructuring, although the two can work together.

Consider, as an example, what may be the most famous turnaround in U.S. history. By the late 1970s, Chrysler was on the verge of bankruptcy. Its newly hired CEO, Lee Iacocca, implemented a dramatic turnaround strategy. Many employees were laid off, while those remaining agreed to forgo part of their salaries and benefits. Twenty plants were either closed or consolidated. Collectively, these actions lowered the firm's break-even point from an annual sales level in half to about 1.2 million vehicles. It is interesting to note that Iacocca also implemented a divestment strategy (another form of retrenchment) by selling Chrysler's marine outboard motor, defense, and air-conditioning divisions, as well as all of its automobile manufacturing plants located outside the United States. By 1982, Chrysler began to show a profit after having lost $3.5 billion in the preceding four years. Over the subsequent two decades, Chrysler embarked on various forms of growth and stability strategies, merged with Daimler Benz to form DaimlerChrysler, and was eventually sold to Cerberus in 2007.

Turnarounds often focus on a change of company leadership. When Greg Brenneman replaced Brad Blum as Burger King CEO in 2004, sales had declined to the point where the fast-food chain was on the verge of losing its number two position behind McDonald's to Wendy's. Brenneman moved quickly to improve morale and relationships with franchisees, who control about 90 percent of all restaurants. He also cut costs and increased sales with an assortment of new products. As a result, customer traffic increased by 7 percent in 2005, the first annual increase in eight years.[23]

When a turnaround involves layoffs, firms must be prepared to address their effects on both departing employees and survivors. Employees may be given opportunities to voluntarily leave—generally with an incentive—to make the process as congenial as possible. When this situation occurs, however, those departing are often the top performers who are most marketable, leaving the firm with a less competitive workforce. Of course, when layoffs are simply announced, morale is likely to suffer considerably. For this reason, turnarounds involving layoffs are often more difficult to implement than anticipated.[24]

When layoffs are necessary, however, several actions can help to palliate some of the negative effects. Specifically, top management is encouraged to communicate honestly and effectively with all employees, explaining why the downsizing is necessary and 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 partake of services available to them, and special efforts should be made to ensure that such programs are administered in a clear and consistent manner.[25] Although these measures will not eliminate all the harsh feelings associated with layoffs, they can help keep the process under control.

Some executives are widely recognized as "turnaround specialists" and may be brought in as temporary CEOs to lead the process and orchestrate such unpopular strategic moves as layoffs, budget cuts, and reorganizations. Robert "Steve" Miller, also a major player in the Chrysler turnaround, has served as CEO of Waste Management and the automobile parts supplier Federal-Mogul, as well as a consultant on turnaround issues to such companies as Aetna. According to Miller, the CEO in a company seeking turnaround should be honest with employees from the outset and seek their input. The CEO should also spend time with customers. As Miller put it, "Listen to your customers. [They] are usually more perceptive than you are about what you need to do with your company."[26]

Case Analysis 6-1

Step 9: What Is the Current Firm-Level Strategy?

What is the corporate profile? Is the organization attempting to grow, maintain its present size, or retrench? One need not be concerned with what the company *should be* doing at this point, but rather what *is presently being* implemented. It is important to provide sufficient detail to support the assessment of the strategy. It is also important not to assume that public references to growth in one specific division or line of business necessarily means that a firm is pursuing an *overall growth* strategy.

6-5b Divestment

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

If it is believed that one or more of the firm's business units may function more effectively as part of another firm, then a **divestment** strategy may be pursued. Divestment may be necessary when the industry is in decline, or when a business unit drains resources from more profitable units, is not performing well, or is not synergistic with other corporate holdings. 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. The spin-off was designed to refocus PepsiCo's efforts on its beverage and snack food divisions. Tricon's name was officially changed to Yum Brands in 2002. Yum added A&W All American Food and Long John Silver's to the portfolio shortly thereafter and has performed well.

6-5c Liquidation

Liquidation
A corporate-level retrenchment strategy in which a firm terminates one or more of its business units by the sale of their assets.

Liquidation is the strategy of last resort, and terminates the business unit by selling its assets. In effect, liquidation represents a divestment of *all* the firm's business units and should be adopted only under extreme conditions. Shareholders and creditors experience financial losses, some of the managers and employees lose their jobs, suppliers lose a customer, and the community suffers an increase in unemployment and a decrease in tax revenues. For this reason, liquidation should be pursued only when other forms of retrenchment are not viable (see Case Analysis 6-1).

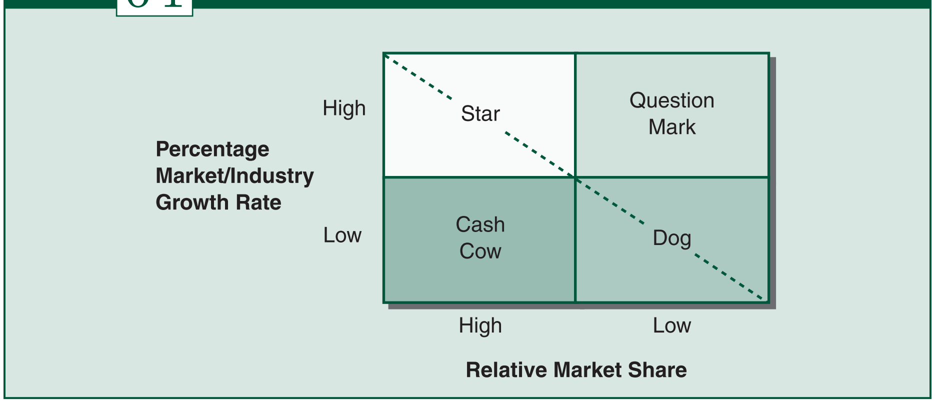
6-6 BCG Growth-Share Matrix

It is often difficult to coordinate the activities of multiple business units, particularly when they are minimally related or not related at all. Corporate portfolio frameworks have been developed to provide guidelines for strategists. Although firm-specific conditions may require exceptions to the guidelines, these frameworks can provide an excellent starting point to consider strategy in firms with multiple business units. The Boston Consulting Group (BCG) original framework is one of the most widely recognized.

BCG Growth-share Matrix
A corporate portfolio framework developed by the Boston Consulting Group (BCG) that categorizes a firm's business units by the market share that the firm holds and the growth rate of the firm's respective markets.

The **BCG growth-share matrix** was developed in 1967 by the Boston Consulting Group (BCG) and is illustrated by the matrix shown in Figure 6-1. The market's rate of growth is indicated on the vertical axis, and the firm's share of the market is indicated on the horizontal axis. A firm's business units can be plotted on the matrix with a circle whose size denotes the relative size of the business unit. The horizontal position of a business indicates its market share, and its vertical position depicts the growth rate of the market in which it competes. Managers and consultants can categorize each business unit as a star, question mark, cash cow, or dog, depending on each one's relative market share and the growth rate of its market.[27]

FIGURE 6-1 The Original BCG Framework

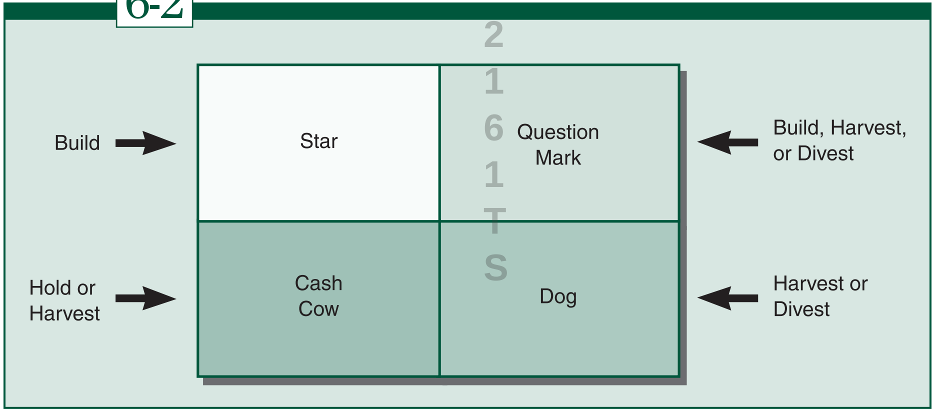


A *star* is a business unit that has a large share of a high-growth market, generally 10 percent or higher. Although stars are usually profitable, they often necessitate considerable cash to continue their growth and to fight off the numerous competitors that are attracted to fast growing markets. *Question marks* are business units with low shares of rapidly growing markets, and may be new businesses just entering the market. If they are able to grow and develop into market leaders, they evolve into stars; if not, they will likely be divested or liquidated.

A *cash cow* is a business unit that has a large share of a slow-growth market, generally less than 10 percent. Cash cows are normally highly profitable because they often dominate a market that does not attract a large number of new entrants. Because they are well established, they need not spend vast resources for advertising, product promotions, or consumer rebates. The firm may invest the excess cash generated in its stars and question marks. Lastly, *dogs* are business units that have small market shares in slow-growth (or even declining) industries. Dogs are generally marginal businesses that incur either losses or small profits, and are often liquidated.

Ideally, a well-balanced corporation should have mostly stars and cash cows, some question marks (because they can represent the future of the corporation), and few, if any, dogs. To attain this ideal, corporate-level managers have four options (see Figure 6-2). First, managers can *build* market share with stars and question marks. The key for question marks is to identify and support the promising ones

FIGURE 6-2 Alternative Strategies with Strategic Business Units



so that they can be transformed into stars. Building market share may involve significant price reductions, which may result in losses or marginal profitability in the short run.

Second, management can *hold* market share with cash cows, thereby generating more cash than building market share does. Hence, the cash contributed by the cash cows can be used to support stars and those question marks deemed most promising.

Third, management may *harvest*, or milk, as much short-term cash from a business as possible, usually while allowing its market share to decline. The cash gained from this strategy is also used to support stars and selected question marks. The businesses harvested usually include dogs, question marks that demonstrate little growth potential, and some weak cash cows.

Lastly, management may *divest* a business unit to provide cash to the corporation and stem the outflow of cash that would have been spent on the business in the future. As dogs and less promising question marks are divested, the cash provided is reallocated to stars and more promising question marks.

All things equal, healthy multibusiness unit firms should maintain a balance of business units that generate cash and those that require funds for growth. Broadly speaking, business units below the dotted line in Figure 6-1 are *revenue generators*, whereas business units above the dotted line are *revenue users*. The balance of businesses on both sides of the line can be a key factor in decisions to acquire new business units or divest old ones.

The BCG matrix heavily emphasizes the importance of market share leadership as a precursor to profitability. Some question marks are cultivated to become leaders as well, but less promising question marks and dogs are usually targeted either for harvesting or divestiture.

The BCG matrix provides managers with a systematic means of considering the relationships among business units in its portfolio. A number of limitations of this and similar frameworks have been identified, however. For example, the BCG matrix assumes that success is directly linked to high performance, a relationship that often—but not always—exists in a corporation. The model also assumes that strategic managers are free to make portfolio decisions, such as transferring capital from cash cows to question marks, without challenges from shareholders and others. Hence, although the BCG matrix serves as an excellent starting point and generates discussion on critical strategy issues, it should not be interpreted literally.

6-7 Global Corporate Strategy

Regardless of the corporate profile, a business may choose to be involved only in its domestic market, or it may compete abroad at one of three levels: international, multinational, or global. Effective operation at any of these levels often—but not always—necessitates economies of scale and a relatively high market share.[28]

Moving outside the domestic market, some companies choose to be involved on an *international* basis by operating in various countries but limiting their involvement to importing, exporting, licensing, or making strategic alliances. Exporting alone can significantly benefit even a small company. However, international joint ventures—a form of strategic alliance involving cooperative arrangements between businesses across borders—may be desirable even when resources for a direct investment are available.

Source: Ablestock.com

Global strategic alliances are common in the automobile manufacturing industry. In 2001, GM launched a $333 million joint venture with Russian firm

OAO Avtovaz. GM provides technological support to the struggling holdover from Soviet-era industry to engineer a stripped-down version of an SUV currently offered by the Avtovaz. By engaging in the joint venture, GM gained immediate access to the market but placed its reputation on the line by putting its "Chevy" name on a vehicle produced by a technologically weak automobile producer. In 2005, the venture's annual production had reached about 50,000 sedans and SUVs—the Viva and Niva respectively—sold under the Chevrolet brand. In 2006, however, venture profits declined and GM announced plans to build its own production facilities in Russia, an indication that the joint venture may be in trouble. [29]

Automotive joint ventures are also popular in Asia. By 2005, most major Chinese automakers had secured established global partners to assist in their expansion outside of China. Shanghai Automotive Industry Corporation (SAIC) has partnered with Volkswagen and General Motors, Dongfeng Motor with Nissan and Peugeot-Citroën, and Changan with Ford and Suzuki. When Toyota outsold Ford for the first time in July 2006, Ford launched an intensive review of its brands and began to explore global alliances even more.[30]

Firms with global objectives may decide to invest directly in facilities abroad. Due to the complexities associated with establishing operations across borders, however, strategic alliances may be particularly attractive to firms seeking to expand their global involvement. Companies often possess market, regulatory, and other knowledge about their domestic markets but may need to partner with companies abroad to gain access to this knowledge as it pertains to international markets. The international strategic alliances visible among automobile producers include production facilities owned jointly by General Motors and Toyota and by Ford and Mazda.

International strategic alliances provide particular advantages to a firm. They can provide entry into a global market, access to the partner's knowledge about the foreign market, and risk sharing with the partner firm. They can work effectively when partners can learn from each other, when neither partner is large enough to function alone, and when both partners share common strategic goals but are not in direct competition. Problems that arise from international joint ventures include disputes and lack of trust over proprietary knowledge, cultural differences between firms, and disputes over ways to share the costs and revenues associated with the partnership.

International Licensing

An arrangement whereby a foreign licensee purchases the rights to produce a company's products and/or use its technology in the licensee's country for a negotiated fee structure.

Other conservative options are also available to a firm seeking an international presence. Under an **international licensing** agreement, a foreign licensee purchases the rights to produce a company's products and use its technology in the licensee's country for a negotiated fee structure. This arrangement is common among pharmaceutical firms. Drug producers in one nation typically allow producers in other nations to produce and market their products abroad.[31]

International Franchising

A form of licensing in which a local franchisee pays a franchiser in another country for the right to use the franchiser's brand names, promotions, materials, and procedures.

International franchising is a long-term form of licensing in which a local franchisee pays a franchiser in another country for the right to use the franchiser's brand names, promotions, materials, and procedures.[32] Whereas licensing is predominantly pursued by manufacturers, franchising is more commonly utilized in service industries, such as fast-food restaurants.

Other companies are involved at the *multinational* level, where firms direct investments in other countries, and their subsidiaries operate independently of one another. Colgate-Palmolive has attained a large worldwide market share through its decentralized operations in foreign markets.

Finally, some firms are *globally* involved, with direct investments and interdependent subdivisions abroad. For example, some of Caterpillar's subsidiaries produce components in different countries, while other subsidiaries assemble these components, and still other units sell the finished products. As a result, Caterpillar has achieved a low-cost position by producing its own heavy components for its large global market. If its various subsidiaries operated independently and produced only for their individual regional markets, Caterpillar would be unable to realize these vast economies of scale.[33]

Expanding into global markets is not always easy. In 2003, for example, McDonald's announced plans to expand its cadre of 566 stores in China by approximately 100 stores annually. By that time, however, KFC had already grown to about 900 eateries in China with plans for an additional 200 units annually. McDonald's slower growth resulted from its struggle to build a network of local suppliers, many of whom are the same ones it utilizes in the United States, whereas KFC built a network of Chinese suppliers while aggressively adapting to local tastes in an effort to speed up its growth efforts. Starbuck's has about five hundred Chinese locations but has found it difficult to convert a nation of tea drinkers to specialty coffees.[34]

Some of the complexities associated with adopting a global perspective are illustrated by Kellogg's production dilemma. Some countries appreciate the vitamin fortification in Corn Flakes common in Kellogg's host country, the United States. Denmark, however, does not want vitamins added to cereal for fear that some might exceed recommended daily doses. Officials in the Netherlands do not believe vitamin D or folic acid is beneficial, but the Finns like more vitamin D to make up for sun deprivation. As a result, Kellogg plants in England and Germany have produced four different varieties of Corn Flakes since 1997 to meet the differences in demand throughout the European Union.[35]

Consider Wal-Mart. When the giant retailer first expanded outside of the United States in the early 1990s, the retailing giant made mistakes by presuming that its successful American model would succeed in disparate global markets. Golf clubs in Brazil and ice skates in Mexico were among the early casualties, and some German customers mistook the friendliness of its clerks for flirting. In the early and mid-2000s, Wal-Mart changed course, expanding by acquiring successful local retail chains, hiring locals to manage them, and learning the local tastes and culture. Wal-Mart's acquisitions of grocer Asda in the United Kingdom and retailer Cifra SA in Mexico have given the firm strong stakes in two nations without expanding its operations internally.[36] Wal-Mart has grown rapidly and enjoyed considerable success in developing markets such as Mexico where "shoppers care more about the cost of medicine and microwaves than the cultural incursions of a multinational corporation."[37]

Wal-Mart was never able to win over Germany's frugal and demanding customers from the country's strong, local discount retailers. After losing money for eight years, Wal-Mart sold its eighty-five stores to German rival Metro AG. Interestingly, the firm's largest global competitor, Carrefour, seemed to know better all along. Carrefour had operations in twenty-nine countries when Wal-Mart decided to leave Germany altogether in 2006, but the number two global retailer never had stores in Germany.[38]

Wal-Mart has faced other challenges in China where the retailer has sixty-six stores, mostly hypermarkets. Wal-Mart's global rival Carrefour has eighty stores, however, and China's top thirty domestic chain stores operate more than sixteen thousand outlets, making for a highly competitive market. Expansion outside of the most developed cities, such as Shanghai and Beijing, is a complex task indeed. China lacks a nationwide logistics network of trucks, highways, and warehouses to distribute products efficiently. Local tastes vary in a country with multiple languages and dialects and diverse climates. For example, one-half of Chinese grocery expenditures are on fresh and live produce, a necessity in a nation with few refrigerated trucks. The result is a highly fragmented market, with the top hundred retailers accounting for less than 10 percent of total retail sales. Wal-Mart is attempting to gain a national footprint by purchasing stores currently operated by Trust-Mart, a Chinese retailer known for small outlets emphasizing basic products at low prices. In 2006, Wal-Mart introduced a credit card in partnership with China's Bank of Communication, the first issued by a foreign company in a country where less than 5 percent of the population uses credit cards. As we can see, Wal-Mart will be challenged to develop its presence in China over the next decade.[39]

Firms change from domestic-oriented strategies to a global orientation for numerous reasons. Pursuing global markets can reduce per-unit production costs by increasing volume. A global strategy can extend the product life cycle of products whose domestic markets may be declining, as U.S. cigarette manufacturers did in the 1990s. Establishing facilities abroad can also help a firm benefit from cost differences associated with comparative advantage, which partially explains why athletic shoes tend to be produced most efficiently in parts of Asia where rubber is plentiful and labor is less costly. A global orientation can lessen risk because demand and competitive factors tend to vary among nations. Consider the following factors, however.

1. Are customer needs abroad similar to those in the firm's domestic market? If so, the firm may be able to develop economies of scale by producing a higher volume of the same goods or services for both markets.
2. Are differences in transportation and other costs abroad favorable and conducive to producing goods and services abroad? Are these differences favorable and conducive to exporting or importing goods from one country to another?
3. Are the firm's customers or partners already involved in global business? If so, the firm may need to become equally involved.
4. Will distributing goods and services abroad be difficult? If competitors already control distribution channels in another country, expansion into that country will be difficult.
5. Will government trade policies facilitate or hinder global expansion? For example, NAFTA facilitates trade among firms in the United States, Canada, and Mexico. Similar trading blocs, such as the European Economic Union (EEU), occur in other parts of the world.
6. Will managers in one country be able to learn from managers in other countries? If so, global expansion may improve efficiency and effectiveness, both abroad and in the host country.

Corporate growth is often pursued through expansion into emerging economies, those nations that have achieved enough development to warrant expansion but whose markets are not yet fully served. Although emerging economies such as China, South Africa, Mexico, and parts of eastern Europe are attractive in many respects, poor infrastructure (e.g., telecommunications, highways), cumbersome government regulations, and a poorly trained workforce can create great challenges for the firm considering expansion. The advantages and disadvantages of growth through global expansion should be considered carefully before pursuing expansion into an emerging market.

6-8 Summary

Two key sets of strategic decisions must be made at the corporate level. First, top executives must identify the corporate profile and determine whether the firm will operate in a single business, in more than one related business, or in more than one unrelated business. Benefits and shortcomings are associated with each profile option.

Second, strategic managers must select a corporate strategy from among three basic choices: growth, stability, or retrenchment. Additional alternatives associated with growth and retrenchment strategies must also be addressed. A firm may choose a form of corporate restructuring to support strategic attempts to revive its competitiveness and performance.

Portfolio frameworks such as the BCG matrix can assist corporate executives in managing the relationships among the firm's business units. In doing so, executives must determine the extent to which the firm will involve itself in business operations.

Global concerns represent a key consideration at the corporate strategy level. The three broad options range from conservative to aggressive, each with advantages and disadvantages, depending on the level of international involvement desired.

Key Terms

acquisition
backward integration
BCG growth-share matrix
conglomerate unrelated diversification
core competencies
corporate-level strategy
corporate profile
divestment
external growth
forward integration
growth strategy
horizontal related diversification
horizontal related integration
internal growth
international franchising
international licensing
liquidation
merger
retrenchment strategy
stability strategy
strategic alliances
synergy
turnaround
vertical integration

Review Questions and Exercises

1. What are the advantages and disadvantages of internal growth as opposed to growth through mergers and acquisitions?
2. Why would management adopt a stability strategy? Can stability strategies be viable over time? Why or why not?
3. When is a retrenchment strategy appropriate? What criteria can help determine what particular retrenchment strategy should be used?
4. How should the BCG matrix be applied? Are such portfolios always useful to corporate executives?
5. What are the advantages and disadvantages associated with corporations operating in centralized or decentralized fashions?
6. What factors should a firm's managers consider when determining the degree of international involvement appropriate for the organization?

Practice Quiz

True or False

1. Because firms operating in single industries are more susceptible to industry downturns, most firms eventually diversify into other industries.
2. The growth strategy is the most effective strategy for a healthy firm.
3. Synergy occurs when the combination of two organizations results in higher effectiveness and efficiency than would otherwise be generated by them separately.
4. Strategic alliances typically involve higher bureaucratic and developmental costs when compared to mergers and acquisitions.
5. Corporate restructuring involves the acquisition of business units unrelated to the firm's core business unit.
6. The BCG matrix provides managers with a systematic means of determining whether a growth, stability, or retrenchment strategy should be adopted.

Multiple Choice

7. Diversification allows a firm to
- **A.** concentrate its efforts on a single business.
- **B.** use its resources more effectively.
- **C.** create excess resources.
- **D.** all of the above

8. A firm seeking rapid growth should pursue
- **A.** internal growth.
- **B.** external growth.
- **C.** divestment of poor performing businesses.
- **D.** a restructuring strategy.

9. When a firm purchases both its suppliers and buyers, it is engaging in
- **A.** forward integration.
- **B.** backward integration.
- **C.** both forward and backward integration.
- **D.** none of the above

10. Which of the following is not a potential reason for selecting a stability strategy?
- **A.** The industry is not growing.
- **B.** Growth may place constraints on customer service.
- **C.** Costs associated with growth exceed its benefits.
- **D.** The stability inherently reduces risk.

11. Firms operating on an international basis limit their activities to
- **A.** importing and exporting.
- **B.** licensing.
- **C.** strategic alliances.
- **D.** all of the above

12. Which of the following is not an advantage of international joint ventures?
- **A.** Firms gain access to knowledge about a foreign market.
- **B.** Partners have the ability to eliminate risk associated with global expansion.
- **C.** Firms can learn from each other.
- **D.** Entry into the foreign market is secured.

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READING 6-1

Insight from *strategy+business*

Executives are constantly searching for ways to make their firms more innovative. This chapter's strategy+business reading suggests, however, that some firms are built for innovation and market development whereas others are best equipped for industry consolidation. It is important for strategic decision makers to recognize the capabilities the organization has—and does not have—when charting a course of action. Concepts discussed in the article relate to development and execution of both corporate and business strategies.

Colonizers and Consolidators: The Two Cultures of Corporate Strategy

By Costas Markides and Paul Geroski

Take this quick test: Which innovative company created online bookselling in the 1990s? If your answer is Amazon.com, you are wrong. The idea for online bookselling—and the first online bookstore—came from Charles Stack, an Ohio-based bookseller, in 1991. Computer Literacy, a successful retail chain, also registered an Internet domain name for a bookstore in 1991. Amazon did not enter the market until 1995.

Another quiz: Which innovator came up with the idea for online brokerage services? If you answered Charles Schwab or E-Trade, again you are wrong. Two Chicago brokerage firms—Howe Barnes Investments Inc. and Security APL Inc.—launched the first Internet-based stock trading service, a joint venture called the Net Investor, in January 1995. Schwab did not launch its Web-trading service until March 1996.

Both examples highlight a simple point: The individuals or companies that create radically new markets are not necessarily the ones that scale them into mass markets. Indeed, historical evidence shows that in the majority of cases, product and service pioneers are almost *never* the ones to conquer the markets they create. For at least 20 years, the Xerox Corporation has been derided for its inability to successfully commercialize scores of new products and technologies, including, notably, the now ubiquitous personal computer OS interface, developed at its PARC research center in Northern California. In reality, Xerox's failure is more the norm than the exception.

For those brought up to believe in the enduring value of "pioneering" and "first-mover advantage," such a statement may come as a surprise. However, recent work by many scholars, including William Boulding, a professor at Duke University's Fuqua School of Business, and Markus Christen, an assistant professor at INSEAD; former Booz Allen Hamilton executives Rhonda Germany, Raman Muralidharan, Charles F. Lucier, and Janet D. Torsilieri; Steven P. Schnaars, a professor of marketing at Baruch College's Zicklin School of Business; and Gerard J. Tellis, of the University of Southern California's Marshall School of Business, and Peter N. Colder, an associate professor at New York University's Stern School of Business—as well as our own research—has shown that the widely held belief that pioneers enjoy first-mover advantages and grow to market dominance is simply wrong.

Our research, which examined the early evolution of several new markets, provided a number of clues about how markets are created, how they evolve, and what their structural features and characteristics are in their early formative years. (See "Research Methodology," following page.) In industry after industry, we saw the same pattern unfold: Upon the creation of a new market, there's a mad entry rush by scores, sometimes hundreds, of players to colonize it. At some stage in the evolution of the market, a "dominant design" emerges, which standardizes the core product or service being produced, gives it its lasting identity, and defines the identity of the market it serves. Upon the emergence of this dominant design, a shakeout and consolidation takes place in the market: The overwhelming majority of early movers that choose the wrong design go out of business; a few prescient (or lucky) ones that bet on the winning design survive, and a handful of these grow to market dominance.

For example, more than 1,000 firms populated the U.S. automotive industry at one time or another between

Source: Reprinted with permission from *strategy+business,* the award-winning management quarterly published by Booz Allen Hamilton. http://www.strategy-business.com.

its creation in 1885 and the introduction of Ford's Model T in 1908; dozens of new carmakers entered and exited the industry each year during that period. Yet by the late 1950s, only seven auto manufacturers were left in the United States. Similarly, there were more than 274 competitors in the tire market in the early 1920s. Fifty years later, no more than 23 had survived. And from a peak of 89 competitors in the television-set industry in the 1950s, only a small number of U.S.-owned manufacturers existed at the end of the 1980s—and none after 1995.

Although the survivors in the consolidation wars are those that, by definition, selected the winning design, only a handful of these lucky or insightful victors will grow to dominate the new market. The eventual market leaders are the firms that proactively and strategically invest to grow the market and attract the average customer to it. These winners are scarcely ever the early entrants. Indeed, the early entrants—we call them colonizers—are almost never the successful consolidators. Most colonizers disappear, never to be heard from again.

The fact that firms that create new product and service markets are rarely the ones that scale them into mass markets carries serious implications for the modern corporation. Our research points to a simple reason for this phenomenon: The skills, mind-sets, and competencies needed for discovery and invention not only are *different* from those needed for commercialization; they *conflict* with the needed characteristics. This means that firms good at invention are unlikely to be good at commercialization, and vice versa.

Some firms are natural colonizers, able to explore new technologies quickly and effectively and to make the creative leap from a technological novelty to a product or service that meets customer needs. What these firms are good at is creating new market niches. Other firms are natural consolidators. They are able to organize a market, turning a clever idea into something that reliably and regularly meets the promise, can attract consumers, and can be manufactured and distributed efficiently to a mass market.

Very few firms are good at both sets of activities.

Colonizers' Commitments

What skills are needed for effective pioneering? To answer this question, we need to understand how new, disruptive markets are created, and by whom. Our historical analysis of 20 markets that were created in the last 100 years shows that the creation of new markets is consistently accompanied by the same four events:

- The haphazard (and at times accidental or lucky) development of a new technology
- A flood of companies entering the uncertain (and risky) market opened by the development of this new technology
- A slow initial uptake of the products and services associated with the new technology, followed by a huge explosion of customer interest when a dominant design is established
- The death of most of the early entrants (and their products) once a design emerges as dominant

The oft-told story of the development of the Internet provides a ready example. The technologies associated with its invention and growth, including the TCP/IP protocol, the HTML programming language, and the Mosaic browser, were developed randomly. No one involved with the technology in the early days had any idea of the scope or scale of the end product. No one had a master plan that linked the development of new client-server relations to the possibility of booking a hotel room by computer from a mobile phone. This apparently unplanned, unsystematic development of the underlying technology seems to have been largely a consequence of how the work was done, and by whom—mainly scientists and engineers in research institutes and universities that were under contract, at least at the start, to the U.S. Department of Defense.

When the "finished" Internet emerged from the convergence of the three "killer" platform technologies, numerous business possibilities presented themselves. They were poorly defined, but attractive enough to draw hordes of new entrants with a variety of different types of business models. This, in turn, triggered a signal that led to massive market expansion: By introducing new applications, these colonizers made using the Internet attractive for a vast number of new types of consumers and businesses. Internet connection rates, usage, and the revenues generated by various businesses on the Net grew vertiginously.

Yet, while the World Wide Web seemed like an overnight sensation, the fact is its takeoff took decades, its existence and evolution cannot be credited to any clear customer needs. Rather, engineers "playing" with new technologies propelled the new market onto an unsuspecting population.

Our research shows that a variation on this theme introduces all radically new markets. Such markets, we find over and over, are rarely created by demand or customer needs. Demand-driven innovations can, at best, develop and extend existing markets incrementally. These innovations usually come in the form of either product extensions or process innovations; valuable as they are, they do not create disruptive new markets. Evidence shows that disruptive new markets are actually created in a haphazard manner when a new technology gets *pushed* onto a market.

This kind of innovation process is called "supply push" by economists, and it has a peculiar property: Since innovation leads demand, inventors have to aim at a very imprecise target. Indeed, most new products are *experience goods*; customers are able to form clear preferences about them only by using them. This is very important, and it carries three major implications:

- Since the new product or service does not meet an immediate, well-articulated need, it is likely that a long period of time will pass before customers adopt it. Hence, one can expect adoption rates to be slow.
- Since there are no well-articulated needs, it is impossible to be sure of the right design of a new product or service built on the new technology. Hence, the market is likely to fill rapidly with a large supply of products and product variants, as entrepreneurs make guesses about customer wants and needs.
- Since customer preferences will evolve with experience, there is likely to be as much product development postinnovation as there is before the introduction of the new product. Hence, there are likely to be plenty of opportunities for a second mover to come into the market and win a position.

All this suggests that early markets are volatile and unpredictable places, characterized by high technological and customer uncertainty. New entrants come and go, experimentation is a way of life, and high turnover is the norm. Yet these markets are also characterized by two identifiable types of fluidity: fluidity in the number of and rate by which firms enter and leave the market; and fluidity in the number of products and product/feature variants created.

To survive in such an environment—as inhospitable as it maybe exciting—colonizers must have certain traits. They must be enthusiasts. They must have deep knowledge of the basic science and technology and should be interested in pushing it as far as they can. This means that colonizers are often serial risk takers. They are willing to bet on seriously speculative projects that result in new products well beyond the frontier of current knowledge about the relevant science and technology. Colonizers often assume that customers share their enthusiasm for science and technology, and value performance in the same way the inventors do.

Colonizers need to be flexible and adaptable so that they can respond to the developments of the new technology or of the new market. They need to be relatively open to outside influences and to have internal processes that facilitate the learning of technical information. On the other hand, they do not require marketing skills (they often need to cultivate the attentions of only a few lead risers), and they do not need production skills. Their organizations are not required to be very large or complex, so colonizers don't have to have organizational skills or the ability to build and monitor complex accounting, personnel, or service delivery systems. Typically, colonizers are quick-hit entrants; their competitive advantage arises from their ability to be flexible and agile and to hit their continually moving target accurately.

Effective Consolidators

Compare this set of skills with the competencies consolidators must have to grow niches into mass markets.

Consolidators need to win the dominant design battle and then unify the market whose potential they unleash. Typically, that means making heavy investments in exploiting scale economies, following learning curves, developing strong brands, and controlling the channels of distribution to the mass market.

Creating a dominant design and consolidating a market around it is a formidable task. To do it successfully, a firm needs to make serious investments in production, so it can consistently and efficiently produce a high-quality product. Furthermore, a consolidator needs to be able to sway consumers and create a marketplace consensus to support its proposed dominant design. That requires the consolidator to identify, reach out to, and overcome the risk aversion of the many potential customers who are unwilling to shoulder the hazards of choosing from among a developing market's multiple prototypes. Therefore, a consolidator must have the ability to build brands. Consolidators also must have the skills to create an organization that can distribute to the mass market and serve a large and continuously growing customer base.

For these and other reasons, consolidators are typically slow movers—and they ought to be. The investment in consolidating a market involves substantial sunk costs and should not be undertaken lightly. Consolidators are also risk averse. Having invested heavily in the growth of the market, they are unwilling to throw it all away by undertaking risky investments or projects that might cannibalize their installed customer base.

One can imagine the complexity of trying to set up structures, cultures, and processes that facilitate both colonization and consolidation. The incentives and investment horizons needed to do each activity well are fundamentally different and can rarely coexist. The attitudes toward risk are different. Even the mind-sets and behaviors needed for each activity are so different that coexistence is next to impossible. Perhaps this is why several researchers (e.g., Christopher Meyer and Rudy Ruggles of the now-closed Center for Business Innovation, and James Brian Quinn, emeritus professor of management at Dartmouth College's Amos Tuck School of Business) have advised established companies to "outsource" innovation.

The example of Lotus, now part of IBM, highlights how difficult it is to combine the two types of organizations. As Robert Sutton has reported in the *Harvard Business Review*, after Lotus's initial success with its "killer application" product, the spreadsheet program Lotus 1-2-3, the company brought in experienced professional managers to guide it forward. It soon discovered, however, that the structures and processes that the mature Lotus needed to function effectively were inhibiting innovation. In a now-famous experiment to demonstrate this, Lotus executives assembled the resumes of the first 40 people to join the company, changed their names, and put them into the applicant group. Not one was asked in for an interview; the professional managers who were running Lotus considered the "wacky" risk takers who had created the company too deviant from the current culture to warrant even a phone call.

Contemporary business is filled with examples that support the distinctions between colonization and consolidation skills. Apple Computer Inc. pioneered the home PC market, but was unable to scale it up. However, Apple's competencies may yet allow it to win as an online music and entertainment distribution company, expanding a niche that industry pioneer Real-Networks Inc. helped invent but has been unable to scale profitably. The Microsoft Corporation might appear to be both colonizer and consolidator; in fact, though, the company's expertise is in following and growing markets uncovered by others, whether in word-processing programs (Microsoft Word versus Word-Perfect), spreadsheets (Excel versus Lotus), operating systems (Windows versus Mac OS), or other products.

There are, of course, exceptions to this rule. 3M was successful in both discovering and commercializing the Post-it Note. But such cases are rare. If we are careful in examining how new markets are created and who the early pioneers really are, we soon see that the companies that scaled up the new markets are rarely the early entrants.

Where Dinosaurs Thrive

Consider most big, established companies in the economy. Given the skills, competencies, attitudes, and cultures they possess, it should come as no surprise to learn that their expertise is in consolidation. Established companies, by definition, have the financial resources, market power, reputation, brand-building skills, and facturing ability that consolidation of a market requires. The very firms that we have come to call bureaucracies or dinosaurs are often the ones perfectly positioned to take a niche market and scale it.

That's the good news for established firms. The bad news is that, as we have seen, such firms are not good at *creating* new markets. They often lack the curiosity and the internal incentives to apply new scientific knowledge to what seem like blue-sky projects. They also lack the entrepreneurial skills to succeed with disruptive innovations. Consolidators do not have the cultures or structures necessary to withstand the turbulent environments that characterize new markets. And they lack the attitudes and mind-sets that are required for pioneering.

The best evidence for this is the almost total vacuum during the past quarter-century of dramatic technological upheavals that began at large companies. As Richard Leifer et al. ask in the book *Radical Innovation*, "How many big companies pioneered the technologies and business models that now dominate e-commerce, personal computing, biotech, and wireless communications?" The answer, according to the authors, is none—which not only subverts the message of their own subtitle, *How Mature Companies Can Outsmart Upstarts*, but undermines the theories of many management gurus about how established firms can strategically innovate in their industries.

Prominent among these beliefs is that established companies can "learn" or "adopt" the skills and attitudes of pioneers in order to create new markets. Look, their advisors tell them: Don't you want to be like Body Shop or Cisco or Virgin? All you have to do is adopt *their* structures, cultures, and processes. Who says elephants can't dance? Just go on a diet and lose some of that excess weight, learn a few tricks, and off you go!

As we have argued in this article, this would not do the established firms much good. Attempting to incorporate the new skills into the existing organization almost always produces one of two outcomes: Either the existing culture and attitudes reject the new transplants, or the transplanted skills and attitudes take over and destroy the very things that have made the established firm a success (and that it still needs to be successful in its existing business).

This helps explain why most established firms, while they are happy to pay high lecture fees, are actually unwilling to implement the advice and ideas that academics and consultants have developed over the past few years to make industry giants more innovative. For example, Gary Hamel has proposed such ideas as making the strategy process democratic and "bringing Silicon Valley inside the organization." Similarly, Costas Markides, an author of this article, argued in 1997 and 1998 that corporations should import into their organizations those features of capitalism that promote innovation (such as decentralized allocation of resources, multiple sources of financing, and constant experimentation). This is all sensible stuff, and the ideas appear logical and creative. But how many established companies do you know that have adopted any of them? All this advice might be helpful in making a company more innovative in general, but it will not help established companies create radically new markets.

A similar point has also been made in a slightly different context by Christopher Meyer and Rudy Ruggles., too, once believed it was possible to teach established companies how to innovate with the same verve as pioneers, "codify[ing] their secrets into a replicable process that we can impose on our own organizations. But, they conceded last year in the *Harvard Business Review*, "Our attitude is shifting. We now warn companies, 'Don't try this at home.' Like many activities that involve talent and tacit learning, reconnaissance requires an inherent feel for the work and lots of practice. Not many companies can claim that inherent strength; nor can they devote much time to practicing, given that their day-to-day work is exploitation, not exploration.

This isn't to say that established firms have to give up completely on the possibility of creating new markets. Clayton M. Christensen has offered another, more viable option. Recognizing how difficult it is for colonization skills to coexist with consolidation skills, he and his colleagues, as well as Robert A. Burgelman and Leonard R. Sayles, in their 1986 book, *Inside Corporate Innovation: Strategy, Structure, and Managerial Skills*, have advocated the creation of separate units or divisions within established organizations where new, disruptive growth businesses can be nurtured.

Resorting to a separate organizational entity is certainly possible; IBM adopted this strategy when it moved into the PC business, and so did the Royal Bank of Scotland when it created a telephone insurance service in the U.K. But such a strategy is not without problems. Our own recent research on the topic has shown that creating a separate unit to protect the pioneers from the stifling bureaucracy of the established firm is neither necessary nor sufficient for success. Costs are incurred by the failure to exploit synergies between the two businesses. The "pioneer" unit is also left exposed to attacks from established companies in the industry. Attempts to solve these problems often end up in failure because the established parent begins to apply its own mind-sets and processes to the startup's business.

A third alternative for established firms that want to create radical new markets has been proposed by Michael L. Tushman, of the Harvard Business School, and Charles A. O'Reilly III, of the Stanford Graduate School of Business. They argue that pioneering and consolidation can coexist if the company is successful in creating an "ambidextrous" organizational infrastructure. Such an organization will have successfully put in place multiple, contradictory structures, processes, and cultures. E. Leclerc, the French supermarket chain, is an excellent example of a successful ambidextrous company. (See "Focus: The Ambidextrousness of E. Leclerc.")

Although the ambidextrous organization is an admirable model, examples are unfortunately few and far between. As Professors Tushman and O'Reilly themselves admit, only a small minority of farsighted firms can claim to be ambidextrous. Most firms that try to operate this way will fail.

Finding Feeders

The final option—and the one that most companies have ignored—is for established businesses to leave the challenges of market creation to startup firms and focus their own attention and resources on consolidation.

But to become successful consolidators, they must be ready to lump into a new market just when the dominant design is about to emerge and the market is ready to take off. For such perfect timing, established firms must create, sustain, and nurture a network of feeder firms—young entrepreneurial companies that are busy colonizing new niches. Through its business development function, the established company could serve as a venture capitalist to these feeder firms. Then, when it is time to consolidate the market, it could build a new mass-market business on the platform that these feeder firms have provided.

Such a specialization of labor already exists in creative industries—movies, book publishing, and the visual and performing arts. As Richard Caves notes in his book *Creative Industries: Contracts Between Art and Commerce*, firms in creative industries are either small-scale pickers that concentrate on the selection and development of new creative talent, or large-scale promoters that undertake the packaging and widespread distribution of established creative goods.

Messrs. Meyer and Ruggles say that a small but rapidly growing industry is emerging around firms that specialize in exploration in non-entertainment industries as well, allowing mature firms to outsource their exploration needs and focus on growing the ideas into mass markets. James Brian Quinn, too, points out that strategically outsourcing innovation is now an accepted practice in a number of industries, including pharmaceuticals, financial services, computers, telecommunications, and energy systems.

Such a "network" strategy has several advantages over the "grow it inside" strategy: It allows the firm to cover more technologies and more market niches; it enables the feeder firms to compete with one another while allowing the parent company to benchmark one against the other; it is easier to manage because it bypasses the problems of trying to manage two conflicting businesses simultaneously; and it has all the traditional benefits of outsourcing.

Indeed, one can credibly argue that the outsourcing model is in fact the one that has been adopted historically by large firms, albeit in an unplanned and haphazard way. For what are colonizers if not an external source of innovation? And aren't consolidators appropriators and scalers of others' innovations? In effect, we are arguing merely for adding a consciousness to what previously has been an unconscious, random process.

Therefore, the right way forward for established, mature firms is not to build their own new business inside and then consolidate when the time is right. Rather, they should maintain and manage a feeder system of colonizer businesses—very much what pharmaceutical companies are doing with biotech and what Unilever, for example, is doing with new consumer products. Then, when the time is right, they should move in for consolidation and scale up what their partners are doing.

We are aware that this cuts against the grain of much of the thinking of the last few years, which aimed to make established corporations more "entrepreneurial" by developing the cultures and structures of the younger startup firms. In our view, this is misplaced counsel. It's like advising a 70-year-old person how to train to win at the next Olympics—it simply won't happen!

By trying to be ambidextrous, established companies risk being "stuck in the middle." What they need to do is focus on the area where they have an advantage—and that is in consolidating good new ideas drawn from niche markets into new and valuable mass markets.

Focus: The Ambidextrousness of E. Leclerc

E. Leclerc, the French supermarket chain, gives us an example of the successes—and the challenges—of operating as an ambidextrous organization. E. Leclerc was founded in the late 1950s by Edouard Leclerc, who gave up a career as a Catholic priest to start a supermarket dedicated to offering branded products at low prices. The organization has grown to a chain of more than 500 hypermarkets. It is now expanding beyond France.

E. Leclerc is a master at balancing quite a few conflicting forces: It has achieved low cost and differentiation simultaneously; it is very decentralized in some value-chain activities and yet centralized in many others; it is broken up into many small autonomous units but still enjoys the benefits of size; it is structured as a federation of independent stores yet behaves as an integrated network; it encourages continuous experimentation with new products and concepts yet survives the inevitable losses without pain; its employees feel and act like "owners" of the organization yet own no stock; the whole organization behaves like one big family yet is a money-making machine.

How could it possibly achieve all these things simultaneously, and how does it manage such variety?

The answer has many angles. First, E. Leclerc is not a single company. The stores are owned and operated by different individuals who choose to trade under the E. Leclerc name. They are not franchisees in the conventional sense: They do not have to pay for the right to use the E. Leclerc name; in fact, they receive numerous benefits from their E. Leclerc association for which they do not have to pay anything. However, they have to abide by certain norms and regulations, including the primary rule that they will never be undersold by competitors. In addition, no individual—including members of the Leclerc family—is allowed to own more than two stores.

Each store is given total autonomy over its affairs. Each is free to decide what products to sell, what prices to charge, what promotions to run, and so on. In addition, each store can find its own suppliers and negotiate its own prices.

Such decentralization and autonomy encourage experimentation, and the structure achieves differentiation, but not at the expense of low cost. For example, each region has its own warehouse, which is owned by the member stores. On behalf of all its members, the warehouse orders and stores those products that do not need to be sold fresh. This achieves purchasing economies. In addition, a central purchasing department in Paris identifies potential suppliers and negotiates prices with them. Although individual stores do not have to use a centrally recommended supplier, this method also helps achieve purchasing economies. The use of the E. Leclerc name by all has advertising and promotional benefits and cuts costs. Finally, new E. Leclerc stores are always started by current E. Leclerc employees, who receive the financial backing and guarantees of current E. LecLerc store owners. The financial backing of a prominent local businessperson has benefits in dealing with the banks for startup capital.

Every owner is active in the management of the whole organization. All attend monthly regional meetings as well as frequent national meetings, where decisions are made and experiences exchanged.

Each store belongs to a region, and each region is "run" by a member for three years (on a voluntary basis). The regional president directs the affairs of the region and travels extensively to individual stores to offer advice, monitor plans, and transfer best practices. Furthermore, at the end of each year, each owner has to distribute 25 percent of the stores profits to its employees.

Owners also have the "duty" (not obligation) to act as a "godparent" to one of their employees. The selected employee is someone who has been identified as having high potential and who might be a future E. Leclerc owner. This individual receives continuous support and advice and, when the time comes, financial backing and moral support to start a store. If the new store fails, the "godparent" is financially responsible for liabilities.

How is so much variety managed? Information systems are used to monitor what is happening across the "federation." Frequent meetings also help owners exchange ideas and monitor progress. But the two primary mechanisms of control are (1) a common and deeply felt vision that sets the parameters within which each member store operates; and (2) a strong family culture in which everybody is treated with fairness and openness and all are equal. It is interesting that each store has its own unique culture (created primarily by the personality of the store owner), yet a common E. Leclerc culture still permeates the whole organization. This common culture sets the parameters, the norms, the shared values, and the constraints within which individuals behave. It is this shared culture that allows so much autonomy and freedom without the fear that somebody, somewhere, will do something nasty.

–C.M. and P.G.

Research Methodology

We examined the historical evolution of 20 newly created markets, from the moment they were formed until they grew to mass market. The 20 markets were television, personal computers, scientific instruments, the Internet, supercomputers, online groceries, cars, beer, Internet service provision, tires, semiconductors, baked beans, genetically modified foods, mobile phones, video recorders, satellite TV, stereo sound, typewriters, computer operating systems, and medical diagnostic imaging. We first examined what new technologies were developed that gave rise to the new products or services and how these technologies were discovered. We then studied how the new markets developed in their early years, how many companies entered and exited the market, and what kinds of product (or service) variants developed. Finally, we examined how the market developed once a dominant design emerged and what firms survived this event. Further details of this research can be found in *The Early Evolution of New Markets,* by Paul Geroski.

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Real-Time Case 23: Nike

Phil Knight and Bill Bowerman met at the University of Oregon in 1957. In 1962, they formed Blue Ribbon Sports to manufacture high-quality running shoes. In the following year, they began selling Tiger shoes—manufactured by Onitsuka Tiger in Japan—out of cars at track meets in the United States. The company became Nike in 1972, named for the Greek goddess of victory.

By 1979, the company had secured 50 percent of the U.S. running shoe market. Nike went public in 1980. The shoemaker expanded into other sports with Michael Jordan's "Air Jordan" in 1985 and the cross trainer in 1987. Nike signed Tiger Woods to a $40 million endorsement contract in 1995 and continued its prowess into most major sports. The company acquired competitor Converse in 2003 and currently competes with such shoemakers as Adidas and Reebok. Much of Nike's success may be attributed to its ability to sign major sports stars to endorse its products, most recently LeBron James for an estimated $90 million.

Today, Nike is the number-one shoemaker in the world and controls over 20 percent of the athletic shoe market in the United States. The company designs and markets shoes for basketball, baseball, golf, cheerleading, volleyball, and other sports—in addition to Cole Haan dress and casual shoes and a line of athletic apparel—in about 200 countries. Approximately half of the company's revenues come from outside of the United States. Chairman, CEO, and cofounder Phil Knight still owns controlling shares in the company.

In addition to distribution through an estimated 27,000 retail shoe and sporting goods stores in the United States and 30,000 abroad, Nike operates about 175 of its own Niketown stores, NikeGoddess shops for women, and factory outlet stores. The company also operates twenty-four distribution centers worldwide, although it dropped Sears as a retail outlet in 2005.

Nike has continued to expand its product offerings to a variety of sports-related categories, including apparel, clothing bags, two-way radios, and even heart monitors. Nike's late 1980s advertising slogan, "Just Do It," is still widely renowned as highly effective and memorable. Although Nike has been highly successful throughout Europe, the firm closed all of its Paris operations in 2004 because of difficulties with its French franchise operator.

Adidas acquired Reebok in 2006 and presents a formidable challenge to Nike's industry leadership position. Nike veteran Mark Parker succeeded Bill Perez as CEO in 2006.

Because most of its shoes are manufactured by contractors in low-wage companies, Nike has been a constant target of human rights activists citing poor wages and alleging child labor violations and substandard working conditions. Nike has taken steps to improve conditions, but critics continue to charge that more should be done.

Perspectives

- Gapper, J., "The big bucks that keep Nike in the big league," *Financial Times*, 4 November 2003, 19. The cost of big league endorsements notwithstanding, it is argued that Nike's success is attributable at least in part to its ability to secure such athletes as Michael Jordan and LeBron James.
- Holmes, S., and Bernstein, A., "The new Nike," *Business Week Online*, 20 September 2004. Nike has transitioned from a "fly by the seat of your pants" shoemaker in its early days to a more professionally managed firm.
- Kang, S., "Nike gets back to basics," *Wall Street Journal*, 2 April 2007, B1. In the past, Nike has flooded retailers with multiple variations of its "swoosh" products, complicating manufacturing efforts and confusing customers. It has moved to simplify its product lines and refocus efforts on the most popular products.

Case Challenges

- How critical are Nike's expensive endorsements to the company's success? Are the endorsements worth the money? Explain.
- To what extent, if any, is Nike liable for the actions of its manufacturing contractors with regard to employment issues and human rights violations?
- Could private-label athletic shoes pose a serious threat to Nike in the future?

- How might the Adidas acquisition of Reebok create strategic problems for Nike?

Internet Sites of Interest

- Corporate Web site: www.nike.com
- Web sites of key competitors: www.reebok.com, www.addidas.com
- Sporting Goods Manufacturers Association: www.sgma.com
- American Apparel & Footwear Association: www.americanapparel.org