# Business Unit Strategies 7

WILLIS, KASSANDRA 2161TS

## Chapter Outline

7-1 Porter's Generic Strategies
- 7-1a Low-Cost (Cost Leadership) Strategy
- 7-1b Focus–Low-Cost Strategy
- 7-1c Differentiation Strategy (No Focus)
- 7-1d Focus-Differentiation Strategy
- 7-1e Low-Cost–Differentiation Strategy
- 7-1f Focus–Low-Cost/Differentiation Strategy
- 7-1g Multiple Strategies

7-2 Miles and Snow's Strategy Framework
7-3 Business Size, Strategy, and Performance
7-4 Assessing Strategies
7-5 Global Concerns
7-6 Summary
Key Terms
Review Questions and Exercises
Practice Quiz
Notes
Reading 7-1

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After a firm's top managers have settled on a corporate-level strategy, their focus then shifts to how the firm's business or businesses should compete. Whereas the corporate strategy concerns the basic thrust of the firm—*where* top managers would like to lead the firm—the business or competitive strategy addresses the competitive aspect—*who* the business should serve, *what* needs should be satisfied, and *how* a business should develop core competencies and be positioned to satisfy customers' needs.

Another way of addressing the task of formulating a business strategy is to consider whether a business should concentrate its efforts on *exploiting* current opportunities, *exploring* new ones, or attempting to balance the two. Exploitation generates returns in the short term; exploration can create forms of sustainable competitive advantage for the long term. The business strategy developed for an organization seeks, among other things, to resolve this challenge.[1]

**Business Unit**
An organizational entity with its own unique mission, set of competitors, and industry.

**Generic Strategies**
Broad competitive Strategies that can be adopted by business units to guide their organizations.

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

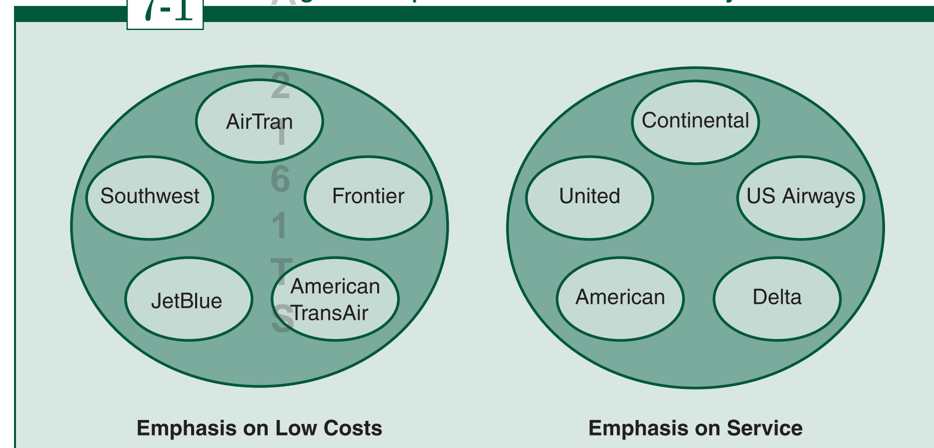
A **business unit** is an organizational entity with its own mission, set of competitors, and industry. A single firm that operates within only one industry is also considered a business unit. Strategic managers craft competitive strategies for each business unit to attain and sustain competitive advantage, a state whereby its successful strategies cannot be easily duplicated by competitors.[2] In most industries, different competitive approaches can be successful, depending on the business unit's resources

Each business competes with a unique competitive strategy. In the interest of simplicity, however, it is useful to categorize different strategies into a limited number of generic strategies based on their similarities. **Generic strategies** emphasize the commonalities among different business strategies, not their differences. Businesses adopting the same generic strategy comprise what is commonly referred to as a **strategic group**.[3] In the airline industry, for example, one strategic group may comprise carriers such as Southwest Airlines and AirTran that offer low fares and no frills on a limited number of domestic routes, thereby maintaining their low-cost structures (see Figure 7-1). A second strategic group may comprise many traditional carriers such as Continental, United, and American that serve both domestic and international routes and offer extra services such as meals and movies on extended flights.

Because industry definitions and strategy assessments are not always clear, identifying strategic groups within an industry is often difficult. Even when the industry definition is clear, an industry's business units may be categorized into

WILLIS KASSANDRA 2161TS

FIGURE 7-1 Strategic Groups in the Airline Industry



any number of strategic groups depending on the level of specificity desired. One or two competitors may also seem to be functioning between groups and thus be difficult to classify. For these reasons, the concept of strategic groups can be used as a means of understanding and illustrating competition within an industry, but the limitations of the approach should always be considered.

The challenging task of formulating and implementing a generic strategy is based on both internal and external factors. Because generic strategies by nature are overly simplistic, selecting generic approach is only the first step in formulating a business strategy.[4] It is also necessary to fine-tune the strategy and accentuate the organization's unique set of resource strengths.[5] Two generic strategy frameworks—one developed by Porter and another by Miles and Snow—can serve as good starting points for developing business strategies.

## 7-1 Porter's Generic Strategies

Michael Porter developed the most commonly cited generic strategy framework.[6] According to Porter's typology, a business unit must address two basic competitive concerns. First, managers must determine whether the business unit should focus its efforts on an identifiable subset of the industry in which it operates or seek to serve the entire market as a whole. For example, specialty clothing stores in shopping malls adopt the focus concept and concentrate their efforts on limited product lines primarily intended for a small market niche. In contrast, most chain grocery stores seek to serve the mass market—or at least most of it—by selecting an array of products and services that appeal to the general public as a whole. The smaller the business, the more desirable a focus strategy tends to be, although this is not always the case.

Second, managers must determine whether the business unit should compete primarily by minimizing its costs relative to those of its competitors (i.e., a low-cost strategy) or by seeking to offer unique or unusual products and services (i.e., a differentiation strategy). Porter views these two alternatives as mutually exclusive because differentiation efforts tend to erode a low-cost structure by raising production, promotional, and other expenses. In fact, Porter labeled business units attempting to emphasize both cost leadership and differentiation simultaneously as "stuck in the middle."[7] This is not necessarily the case, however, and the low-cost–differentiation strategy is a viable alternative for some businesses. Combining the two strategies is difficult, but businesses able to do so can perform exceptionally well.

Depending on the way strategic managers in a business unit address the first (i.e., focus or not) and second (low-cost, differentiation, or low-cost–differentiation) questions, six configurations are possible. A seventh approach—multiple strategies—involves the simultaneous deployment of more than one of the six configurations (see Table 7-1). The low-cost and differentiation strategies with and without focus comprise those in Porter's original framework.

### 7-1a Low-Cost (Cost Leadership) Strategy

Businesses that compete with a **low-cost strategy** produce basic, no-frills products and services for a mass market of price-sensitive customers. Because they attempt to satisfy most or all of the market, these businesses tend to be large and established. Low-cost businesses often succeed by building market share through low prices, although some charge prices comparable to rivals and enjoy a greater margin. Because customers generally are willing to pay only low to average prices

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**TABLE 7-1 Generic Strategies Based on Porter's Typology**

| Emphasis on Entire Market or Niche | Emphasis on Low Costs | Emphasis on Differentiation | Emphasis on Low Costs and Differentiation | Emphasis on Various Factors Depending on Market |
|---|---|---|---|---|
| **Entire Market** | Low-Cost Strategy | Differentiation Strategy | Low-Cost–Differentiation Strategy | Multiple Strategies |
| **Niche** | Focus–Low-Cost Strategy | Focus-Differentiation Strategy | Focus–Low-Cost/Differentiation Strategy | |

for "basic" products or services, it is essential that businesses using this strategy keep their overall costs as low as possible. Efficiency is a key to such businesses, as has been demonstrated by mega-retailer Wal-Mart in recent years.

Low-cost businesses tend to emphasize a low initial investment and low operating costs. Such organizations tend to purchase from suppliers who offer the lowest prices within a basic quality standard. Research and development efforts are directed at improving operational efficiency, and attempts are made to enhance logistical and distribution efficiencies. Such businesses often but not always deemphasize the development of new and improved products or services that might raise costs, and advertising and promotional expenditures will be minimized (see Strategy at Work 7-1).

## STRATEGY AT WORK 7-1

### The Low-Cost Strategy at Kola Real

Coca-Cola and PepsiCo enjoy substantial profit margins on their soft drinks in Mexico's $15 billion market, where the two have waged intense battles for market share during the past decade. Although Coke usually came out on top, the two collectively controlled sales and distribution in almost all of the country's major markets. In 2003, Coke had more than 70 percent of Mexican sales, and Pepsi had 21 percent. Consumers in Mexico drink more Coke per capita than those in any other nation.

In the early 2000s, however, both well-known colas have been challenged by an unlikely upstart from Peru known as Kola Real (pronounced "ray-'al"). Launched in Mexico in 2001, Kola Real captured 4 percent of the Mexican market in its first two years.

Bottled by the Ananos family from Peru, Kola Real lacks all of the frills and endorsements associated with Coke and Pepsi. The strategy is simple: Eliminate all possible costs and offer large sizes at low prices. Whereas Coke and Pepsi spend nearly 20 percent of revenues on concentrates, the Ananos family makes its own. Whereas Coke and Pepsi spend millions on promotion and manage their own fleets of attractive trucks, the Ananos family hires third parties for deliveries—even individuals with dented pickup trucks—and relies primarily on word-of-mouth advertising.

Central to Kola Real's success is the fact that the majority of Mexican cola drinkers are relatively poor and consider price to be a major factor in their purchase decisions. In Brazil, so-called B-brands (i.e., low-cost generic or store brands) now account for almost one-third of the country's cola sales. Fearing this could happen in Mexico, Coke and Pepsi have fought back with price cuts of their own, although they will not be able to challenge Kola Real's low-cost position on a large-scale basis.

*Source: Adapted from D. Luhnow and C. Terhune, "A Low-Budget Cola Shakes Up Markets South of the Border,"* Wall Street Journal, *27 October 2003, A1, A18.*

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

Low-cost leaders depend on unique capabilities not available to others in the industry such as access to scarce raw materials, large market share, or a high degree of capitalization.[8] Manufacturers that employ a low-cost strategy, however, are vulnerable to intense price competition that drives down profit margins and limits their ability to improve outputs, to augment their products with superior services, or to spend more on advertising and promotion.[9] The prospect of being caught in price wars keeps many manufacturers from adopting the low-cost strategy, although it can affect other businesses as well. Other low-cost leaders have bought their suppliers to control quality and distribution. Price cutting in the airline industry led to the demise of several upstarts even before the events of 9/11, and made it even more difficult to raise fares shortly thereafter.[10]

Success with the low-cost strategy can be short lived, however. Low-cost airline AirTran, for example, boasted a 2003 profit of $101 million while Delta squabbled with its pilots throughout the year in an effort to reduce costs. Delta dominates Atlanta where AirTran also has a hub, but has had difficulty cutting costs. In 2004, however, Delta finally made headway and began cutting many of its fares, some by as much as 50 percent. By 2005, AirTran, along with other low-cost airlines, began to feel the squeeze as major airlines such as Delta became more price competitive.[11]

Imitation by competitors can also be a concern when the basis for low-cost leadership is not proprietary and can be easily duplicated. Lego discovered this fact when Canadian upstart Mega Blocks began to steal market share by making colorful blocks that not only look like Legos, but also snap into them and sell for a lower price. Lego responded by launching the Quatro line of oversized blocks aimed at the preschool market and carrying lower prices than traditional Lego playsets.[12]

Low-cost businesses are also particularly vulnerable to technological obsolescence. Manufacturers that emphasize technological stability and do not respond to new product and market opportunities may eventually find that their products have become obsolete.

## 7-1b Focus–Low-Cost Strategy

The **focus–low-cost strategy** emphasizes low overall costs while serving a narrow segment of the market, producing no-frills products or services for price-sensitive customers in a market niche. Ideally, the small business unit that adopts the focus–low-cost strategy competes only in distinct market niches where it enjoys a cost advantage relative to large, low-cost competitors.

The focus concept is clear in theory, but often confusing in practice. In general, a business rejects a focus approach when it attempts to serve *most* of the market. In practice, however, virtually every business focuses its efforts, at least to some extent. Because *most* is a subjective term, scholars sometimes disagree on whether a particular business should be classified as focus or not.

**Focus–Low-Cost Strategy:**
A generic business unit strategy in which a smaller business keeps overall costs low while producing no-frills products or services for a market niche with elastic demand.

WILLIAM KASSANDRA 2161TS

Aldi is a clear example of a business that pursues a focus–low-cost strategy. Aldi is an international retailer that offers a limited assortment of groceries and related items at the lowest possible prices. Functional operations are tightly coordinated around a single strategic objective: low costs. Efforts are targeted to consumers with low to moderate incomes.

Aldi minimizes costs a number of ways. Most products are private label, allowing Aldi to negotiate rock-bottom prices from its suppliers. Stores are modest in size, much smaller than that of a typical chain grocer. Aldi only stocks common food and related products, maximizing inventory turnover. The retailer does not accept credit cards, eliminating the 2 to 4 percent fee typically charged by banks to process the transaction. Customers bag their own groceries and must either bring their own bags or purchase them from Aldi for a nominal charge. Aldi also takes an innovative approach to the use of its shopping carts. Customers insert a quarter to unlock a cart from the interlocked row of carts located outside the store entrance. The quarter is returned with the cart when it is locked back into the group. As a result, no employee time is required to collect stray carts unless a customer is willing to forego the quarter by not returning the cart!

Adding a focus orientation to cost leadership can enable a firm to avoid direct competition with a mass-market cost leader. In this manner, grocer Save-A-Lot has found a way to compete successfully against Wal-Mart Supercenters. Its prices are competitive with those at Wal-Mart, but Save-A-Lot pursues locations in urban areas that Wal-Mart rejected. Save-A-Lot also generates profits by opening small, inexpensive stores catering to U.S. households earning less than $35,000 a year. Save-A-Lot stocks mostly its own brand of high-turnover goods to minimize costs and eschews cost-inducing pharmacies, bakeries, and baggers.[13]

Like low-cost businesses, those adopting the focus–low-cost strategy are vulnerable to intense price competition that periodically occurs in markets with no-frills outputs. For instance, several years ago, Laker Airways successfully used the focus–low-cost strategy by providing the first no-frills, low-priced trans-Atlantic passenger service. The major airlines responded by dropping prices, eventually driving Laker out of business. The large competitors, because of their greater financial resources, were able to weather the short-term financial losses and survive the shakeout.[14] Southwest Airlines, in contrast, adopted a similar strategy and has been able to perform well despite competitive pressure from its large rivals.

To deter price competition, businesses employing the focus–low-cost strategy must continuously search for new ways to trim costs. The Irish no-frills air carrier Ryanair has surpassed Southwest in this regard. Passengers are required to pay for all food, drinks, and newspapers. Employees pay for their own training and uniforms. The airline even incorporates a strict no-refund policy, even if the airline cancels a flight. Even with an average ticket price of about $50, Ryanair faces constant pressure from its large rivals. In 2004, Ireland's state carrier Aer Lingus added routes and lowered prices in an attempt to model itself after Ryanair.[15]

Founded in 2003, Hungary's low-cost airline Wizz Air specializes in transporting Hungarians, Poles, and other Eastern Europeans to Britain and Ireland where many seek and find better paying jobs. CEO Jozsef Varadi sees buses—not other airlines—as their primary competition. Sparked by recent expansion of the European Union, Wizz Air makes economic sense for its customer base when considering fares and travel time.[16]

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Like low-cost businesses that do not adopt a focus approach, focus–low-cost businesses are particularly vulnerable to technological obsolescence. Businesses that value technological stability and do not respond to new product and market opportunities may eventually find that their products have become obsolete and are no longer desired by customers.

## 7-1c Differentiation Strategy (No Focus)

Businesses that utilize the **differentiation strategy** produce and market to the entire industry products or services that can be readily distinguished from those of their competitors. Because they attempt to satisfy most or all of the market, these businesses tend to be large and established. Differentiated businesses often attempt to create new product and market opportunities and have access to the latest scientific breakthroughs because technology and flexibility are key factors if firms are to initiate or keep pace with new developments in their industries.

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

The potential for differentiation is to some extent a function of its physical characteristics. Tangibly speaking, it is easier to differentiate an automobile than bottled water. However, intangible differentiation can extend beyond the physical characteristics of a product or service to encompass everything associated with the value perceived by customers. Because such businesses' customers *perceive* significant differences in their products or services, they are willing to pay average to high prices for them.

Of the prospective bases for differentiation, the most obvious is features of the product (or the mix of products) offered, including the objective and subjective differences in product attributes. Lexus automobiles, for example, have been differentiated on product features and are well known for their attention to detail, quality, and luxury feel. United and other airlines have attempted to differentiate their businesses by offering in-flight satellite telephone and e-mail services.[17] Continental even differentiated itself by emphasizing animal cargo.[18]

Speed can also be a key differentiator. For example, according to a 2004 survey by Mintel International Group, 64 percent of Americans said that they selected a restaurant based on the amount of time they had to eat. Speed has been an essential part of the Starbucks competitive strategy, but became a key concern when service slowed after breakfast sandwiches were added to the product line in the mid-2000s. Adding these food items broadened the appeal of Starbucks, but slowed service in a segment of the market where seconds count. In contrast, competitor Caribou Coffee can make a small coffee-of-the-day in only six seconds.[19]

Timing can also be a key factor, because first movers are more able to establish themselves in the market than those who come later, as was seen for a number of years with Domino's widespread introduction of pizza delivery.[20] Factors such as partnerships with other firms, locations, and a reputation for service quality can also be important (see Strategy at Work 7-2).

When customers are relatively price insensitive, a business may select a differentiation strategy and emphasize quality throughout its functional areas. Marketing materials may be printed on high-quality paper. The purchasing department emphasizes the quality and appropriateness of supplies and raw materials over their per unit costs. The research and development department emphasizes new product development (as opposed to cost-cutting measures).

Differentiated businesses are vulnerable to low-cost competitors offering similar products at lower prices, especially when the basis for differentiation is not well defined or it is not valued by customers. For example, a grocer may emphasize fast checkout, operating on the assumption that customers are willing to pay

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**STRATEGY AT WORK 7-2**

**The Differentiation Strategy in Residential Real Estate**

Implementing a differentiation strategy can be difficult in a highly regulated industry in which competitors are forced to follow rules and even work together. Residential real estate is an example of such an industry. In most cases, a real estate agent who lists a home for a seller must work with agents from other firms who represent prospective buyers. Buyers and sellers are interested in working only with agents who can negotiate successfully with other agents to complete the transaction. When one also considers the myriad of federal, state, and local regulations concerning property disclosure, confidentiality, and the like, one can easily see why it is difficult for an agent or real estate firm to differentiate service.

Differentiation in such an industry is possible, however. Boyd Williams Real Estate Company (www.boydwilliams.com) operates in the southeastern Mississippi community of Meridian, a city of about forty thousand people. To distinguish himself from his rivals, Boyd brings his mobile office to clients' homes, offices, hotel lobbies, and even restaurants over lunch break. He is always equipped with a laptop computer, portable printer, cell phone, and digital camera. Prospective buyers can view full-color pictures of virtually every home in the market from the mobile office. This approach seeks to provide maximum efficiency and convenience to the buyer.

Interestingly, commissions available to Boyd Williams are the same as those available to other agents who do not offer the same amenities. Clearly, Williams seeks to finance his additional investment in the mobile office by allowing consumers to move through the buying process more efficiently—saving him time as well—and by increasing his volume.

*Source: Adapted from Boyd Williams Real Estate Company home page, accessed March 29, 2002, www.boydwilliams.com.*

WILLIS, KASSANDRA 2161TS

a few cents more for additional cashiers and checkout lanes. If customers tend to be more concerned with product assortments and prices than with waiting times, they may shop at other stores instead.

Instituting a change in competitive strategy can be a difficult process, especially when the nature of the change involves a heightened emphasis on differentiation. For example, in 2002, Volkswagen entered the luxury market with the Phaeton, complete with doors trimmed in Italian leather, brushed chrome and chestnut, and a price tag of $70,000. Consumers found it difficult to associate Volkswagen with such refinement and the company sold only about three thousand Phaetons that year. Interestingly, upscale carmakers including such notables as BMW and Jaguar began to produce smaller, less expensive "luxury" cars, a move that received a greater welcome from consumers.[21]

### 7-1d Focus-Differentiation Strategy

**Focus-Differentiation Strategy**
A generic business unit strategy in which a smaller business produces highly differentiated products or services for the specialized needs of a market niche.

Firms utilizing the **focus-differentiation strategy** produce highly differentiated products or services for the specialized needs of a market niche. At first glance, the focus-differentiation strategy may appear to be a less attractive strategy than the no-focus differentiation strategy, because the former consciously limits the set of customers it seeks to target. However, unique market segments often require distinct approaches. For example, The Limited operates retail outlets to address multiple demographic segments simultaneously. Men are served by its Structure stores, women by its Lane Bryant stores, and children by its Limited Too stores. The Limited even targets trendy consumers with Express stores. U.S. chain Torrid features fifty-two stores and specializes in plus-size clothing for young, fashion-conscious women, a niche nonfocused retailers have not filled effectively.[22] In some cases, however, large business units are simply not interested in serving smaller, highly defined niches.

Firms can focus their efforts in several ways. Popular retailer Cabela's has even successfully targeted its efforts to men who hate to shop! The Cabela's in Michigan draws an estimated 6 million visitors to its retail store each year, mixing its outdoorsman-oriented merchandise with an aquarium, indoor waterfall stocked with trout, and realistic nature scenes. As a result, Cabela's has secured a customer base largely ignored by other retailers.[23]

In general, high prices are acceptable to certain customers who need product performance, prestige, safety, or security, especially when only one or a few businesses cater to their needs. As such, focus differentiation is most appropriate when market demand is inelastic, because high-cost products are often required to support the specialized efforts to serve a limited market niche. As a result, cost reduction efforts, while always desirable, are not emphasized.[24]

## 7-1e Low-Cost–Differentiation Strategy

Debate is widespread among scholars and practitioners as to the feasibility of pursuing low-cost and differentiation strategies simultaneously. Porter suggests that implementing a **low-cost–differentiation strategy** is not advisable and leaves a business stuck in the middle, because actions designed to support one strategy could actually work against the other. Simply stated, differentiating a product generally costs a considerable amount of money, which would erode a firm's cost leadership basis. In addition, a number of cost-cutting measures may be directly related to quality and other bases of differentiation. Following this logic, a business should choose *either* a low-cost *or* a differentiation strategy, but not both.[25]

**Low-Cost–Differentiation Strategy**
A generic business unit strategy in which a larger business unit maintains low costs while producing distinct products or services industry-wide for a large market with a relatively inelastic demand.

Others contend that the two approaches are not necessarily mutually exclusive.[26] For example, some businesses begin with a differentiation strategy and integrate low costs as they grow, developing economies of scale along the way. Others seek forms of differentiation that also provide cost advantages, such as enhancing and enlarging the filter on a cigarette, which reduces the amount of costly tobacco required to manufacture the product.

Perhaps the best example of a business that has successfully combined the two approaches is McDonald's. The fast-food giant was originally known for consistency from store to store, friendly service, and cleanliness. These bases for differentiation catapulted McDonald's to market share leader, allowing the firm to negotiate for beef, potatoes, and other key materials at the lowest possible cost. This unique combination of resources and strategic attributes has placed McDonald's in an enviable position as undisputed industry leader, although it is facing increased competitive pressure from differentiated competitors emphasizing Mexican, "fresh and healthy," or other distinct product lines.[27]

A more recent example of the combination strategy is the relatively young airline JetBlue Airways, launched in 2000 to provide economical air service among a limited number of cities. JetBlue distinguished itself by providing new planes, satellite television on board, and leather seating. JetBlue also minimized costs by such measures as squeezing more seats into its planes, selling most of its tickets on the Internet to avoid commissions, shortening ground delays, and serving snacks instead of meals. Hence, JetBlue's differentiation efforts increased its load factor (i.e., the average percentage of filled seats), also reducing its per-passenger flight costs.[28]

Changes in the U.S. mobile home industry in the 2000s also illustrate a link between low cost and differentiation. Traditionally, mobile homes have been positioned as a low-cost, affordable housing option to low-income consumers. In 2004, about 22 million Americans, or 8 percent of the U.S. population, live in manufactured housing. Sales approached almost 400,000 units per year in the late 1990s.

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By 2003, however, sales had declined to about 131,000 units, a year in which about 100,000 units were repossessed from previous customers. Manufacturers such as Clayton Homes responded by targeting customers with moderate incomes, offering homes with upscale features, such as Mohn faucets, porcelain sinks, a wood-burning fireplace, and even a high-definition television set.[29]

Revenue declines within an industry may cause some of its differentiated businesses to cut costs to remain competitive. In the years following the events of 9/11, for example, British Air embarked on an aggressive cost-cutting campaign, ordering replacement jets devoid of the customary special features, trimming the total number of jets in its fleet, cutting fees to travel agents, eliminating 13,000 jobs, and even limiting menu choices for customers. Ticket prices were also reduced so that the airline could become more competitive with low-fare carriers. As a result, British Air has integrated an emphasis on low costs into its traditional differentiation emphasis.[30] Indeed, the low-cost–differentiation strategy is possible to attain and can be quite effective. Porter's point is well taken, however, because implementing the combination strategy is generally more difficult than implementing either the low-cost or the differentiation strategy alone. This strategy begins with an organizational commitment to quality products or services, thereby differentiating itself from its competitors. Because customers may be drawn to high quality, demand may rise, resulting in a larger market share and providing economies of scale that permit lower per unit costs in purchasing, manufacturing, financing, research and development, and marketing (see Strategy at Work 7-3).

A business can pursue low costs and differentiation simultaneously through six primary means: commitment to quality, differentiation on low price, process innovations, product innovations, value innovations, and structural innovations (see Table 7-2). First, commitment to quality throughout the business organization not only improves outputs but also reduces costs involved in scrap, warranty,

STRATEGY AT WORK 7-3

### Competitive Strategy in the Fast-Food Industry

Although fast food in the United States has long been considered an economical lunch or dinner option, restaurants over the years have attempted to differentiate their products and create brand loyalty among consumers, with varying degrees of success. An advent of the 1990s was the notion of the "value menu" or "99 cents menu," whereby restaurants offered a limited number of its sandwich and other items at special prices for cost-conscious consumers. Initially, this move was seen as a necessary means of serving consumers during down economic times. The concept stuck, however, and many analysts believe it is here to stay.

While offering some sandwiches at or near the one-dollar price point, many restaurants also offer—and heavily promote—highly differentiated products in the two- to three-dollar range. Managers hope that many consumers will be lured in for the special prices, only to "move up" to the higher priced items when it is time to order. McDonald's, Burger King, and Wendy's all follow this approach to some degree on a national level. In 2002, Hardee's even introduced the "six dollar burger," a sandwich designed to compete with those offered in the six-dollar range at sitdown restaurants such as Applebee's, but for only $3.95 at Hardee's.

A new breed of fast-food restaurants is avoiding the value menu concept, however. High-end sandwich chains such as Panera Bread Company and Corner Bakery Café are sticking to a highly differentiated approach, emphasizing fresh bread and ingredients to an increasingly health-conscious market. The various strategies implemented by different, successful fast-food players demonstrate the number of viable market niches available in the industry.

*Source: Adapted from S. Leung, "Fast-Food Chains Vie to Carve Out Empire in Pricey Sandwiches,"* Wall Street Journal, *5 February 2002, A1, A10.*

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**TABLE 7-2 Means of Pursuing Low Costs and Differentiation Simultaneously**

1. Commitment to quality
2. Differentiation on low price
3. Process innovations
4. Product innovations
5. Value innovations
6. Structural innovations

and service after the sale. **Quality** refers to the features and characteristics of a product or service that enable it to satisfy stated or implied needs.[31] Hence, a high-quality product or service conforms to a predetermined set of specifications and satisfies the needs of its users. In this sense, quality is based on *perceptions* and is a measure of customer satisfaction with a product over its lifetime, relative to customer satisfaction with competitors' product offerings.[32]

**Quality**
The features and characteristics of a product or service that allow it to satisfy stated or implied needs.

Building quality into a product does not necessarily increase total costs, because the costs of rework, scrap, and servicing the product after the sale may be reduced; and the business benefits from increased customer satisfaction and repeat sales, which can improve economies of scale. The emphasis in the 1990s on quality improvement programs sought to improve product and service quality and increase customer satisfaction by implementing a holistic commitment to quality, as seen through the eyes of the customer. Studies suggest that when properly implemented, an emphasis on quality can improve customer satisfaction while lowering costs.[33]

Second, a lower than average price may be viewed as a basis for differentiating one's products or services. However, low prices should be distinguished from low costs. Whereas *price* refers to the transaction between the firm and its customers, *cost* refers to the expenses incurred in the production of a good or service. Firms with low production costs do not always translate these low costs into low prices. Anheuser Busch, for example, maintains one of the lowest per unit production costs in the beer industry but does not offer its beers at a low price. However, many firms that achieve low-cost positions also lower their prices because their competitors may not be able to afford to match their price level. These firms are combining low costs with a differentiation based on price.

Third, **process innovations** increase the efficiency of operations and distribution. Although these improvements are normally thought of as lowering costs, they can also enhance product or service differentiation. For example, the recent emphasis on eliminating processes that do not add value to the end product has not only cut costs for many businesses, but also increased production and delivery speed, a key form of differentiation.

**Process Innovations**
A business unit's activities that increase the efficiency of operations and distribution.

Fourth, **product innovations** are typically presumed to enhance differentiation but can also lower costs. For instance, over the years, Philip Morris developed a filter cigarette and, later, cigarettes with low tar and nicotine levels. These innovations not only differentiated its products, but also allowed the company to use less tobacco per cigarette to produce a higher quality product at a dramatic reduction in per unit costs.[34]

**Product Innovations**
A business unit's activities that enhance the differentiation of its products or services.

Fifth, firms may engage in **value innovations**, modifying products, services, and activities in order to maximize the value delivered to customers.[35] Such firms seek to provide maximum value by differentiating products and services only to the extent that any associated cost hikes can be justified by increases in overall

**Value Innovations**
Modifying products, services, and activities in order to maximize the value delivered to customers.

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**Structural Innovations**
Modifying the structure of the organization and/or the business model to improve competitiveness.

**Business Web**
A system of internetworked, fluid, specialized businesses that come together to create value for customers.

value *and* by pursing cost reductions that result in minimal if any reductions in value. By focusing on value instead of low cost or differentiation, a firm can offer the overall combination of cost minimization and differentiation in an industry.

Finally, the importance of **structural innovations**, modifying the structure of the organization or the business model to improve competitiveness, has been highlighted in recent years. Recent approaches to structural innovation include the virtual corporation, outsourcing, and the Japanese kieretsu. The notion of **business webs,** or systems of internetworked, fluid, specialized businesses that come together to create value for customers, has gained prominence among strategic thinkers. Within the business web model, organizations do not focus solely on their own activities, but consciously develop partnerships with other businesses, each focusing on its own core competence to better achieve its mission.[36]

### 7-1f Focus–Low-Cost/Differentiation Strategy

**Focus–Low-Cost/ Differentiation Strategy**
A generic strategy in which a smaller business produces highly differentiated products or services for the specialized needs of a select group of customers while keeping its costs low.

Business units that adopt a **focus–low-cost/differentiation strategy** produce highly differentiated products or services for the specialized needs of a select group of customers while keeping their costs low. Businesses utilizing this strategy share all the characteristics of the previous strategies. The focus–low-cost/differentiation strategy is difficult to implement because the niche orientation limits prospects for economies of scale and opportunities for structural innovations. Many small, independent restaurants such as those specializing in ethnic or international cuisine adopt this approach, constantly seeking a balance of cost reductions and uniqueness targeted at a specific group of consumers. For example, many university towns have small eateries that emphasize a unique specialty—such as Garibaldi's barbeque pizza in Memphis, Tennessee—while also minimizing costs to remain affordable to the price-conscious college student.

### 7-1g Multiple Strategies

**Multiple Strategies**
A strategic alternative for a larger business unit in which the organization simultaneously employs more than one of the generic business strategies.

In some cases, business units utilize **multiple strategies**, or more than one of the six strategies identified in sections 7-1a through 7-1f, simultaneously. Unlike the *combination* low-cost–differentiations strategy, multiple strategies involve the *simultaneous* execution of two or more different generic strategies, each tailored to the needs of a distinct market or class of customer. For this reason, large businesses are more likely than small ones to adopt this approach. Hotels, for example, utilize multiple strategies when they offer basic rooms to most guests but reserve suites on the top floor for others.

A multiple strategy approach can be difficult to implement and confusing to customers. Many airlines utilize multiple strategies when they offer both highly differentiated (and high-priced) service via first-class seating and economical, limited-frills service in coach. To distinguish between these two classes of customers, airlines typically provide separate customer service counters, different boarding times and procedures, and better food for their first-class passengers. While this approach is not optimal in theory, it enables airlines to satisfy the needs of more than one traveling segment without flying additional aircraft.

## 7-2 Miles and Snow's Strategy Framework

A second commonly used framework introduced by Miles and Snow considers four strategic types: prospectors, defenders, analyzers, and reactors.[37] Miles and Snow's typology is an alternative to Porter's approach to generic strategy.

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*Prospectors* perceive a dynamic, uncertain environment and maintain flexibility to combat environmental change. Prospectors introduce new products and services, and design the industry. Thus, prospectors tend to possess a loose structure, a low division of labor, and low formalization and centralization. While a prospector identifies and exploits new product and market opportunities, it accepts the risk associated with new ideas. For example, Amazon.com's initial launch of its Web bookstore was a major risk, one that resulted in much greater success for the company than with literally hundreds of other Internet start-ups in the late 1990s.

Prospectors typically seek **first-mover advantages** derived from being first to market. First-mover advantages can be strong, as demonstrated by products widely known by their original brand names, such as Kleenex and Chap Stick. Being first, however, can be a risky proposition, and research has shown that competitors may be able to catch up quickly and effectively.[38] As a result, prospectors must develop expertise in innovation and evaluate risk scenarios effectively.

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

Prospectors are typically focused on corporate entrepreneurship, or **intrapreneurship**. Whereas entrepreneurship focuses on the development of new business ventures as a means of launching an organization, intrapreneurship involves the creation of new business ventures within an existing firm. Established firms seeking to foster a culture that encourages the type of innovative activity often seen in upstarts must provide time, resources, and rewards to employees who develop new venture opportunities for the organization.

**Intrapreneurship**
The creation of new business ventures within an existing firm.

It can be argued that all businesses should be prospectors, at least to some extent. For example, Kraft revenues from traditional and "new and improved" versions of its Ritz, Kool-Aid, Maxwell House, Jell-O, and other brand products began to slip in the early 2000s. Kraft fired its CEO, Betsy Holden, in late 2003 in an effort to place a greater emphasis on new products instead of more conservative brand extensions.[39]

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

*Analyzers* stress stability and flexibility, and attempt to capitalize on the best of the prospector and defender strategy types. Tight control is exerted over existing operations with loose control for new undertakings. The strength of the analyzer is the ability to respond to prospectors (or imitate them) while maintaining efficiency in operations. An analyzer may follow a prospector's successful lead, modify the product or service offered by the prospector, and market it more effectively. In effect, an analyzer is seeking a "second-mover" advantage.[40]

Copying successful competitors can be a successful strategy when both organizations share the resources needed to effectively implement similar programs. After sales slumped in 2000 at Taco Bell, president Emil Brolick acknowledged plans to model the restaurant after Wendy's, noting Wendy's ability to gain market share without slashing prices. In 2001, Taco Bell began appealing to a more mature market with additional pricey items and fewer promotions. Although the product lines are substantially different, Brolick hopes that a similar approach for Taco Bell can produce similar results.[41]

*Reactors* lack consistency in strategic choice and perform poorly. The reactor organization lacks an appropriate set of response mechanisms with which to confront environmental change. The reactor strategic type also lacks strength.

In some respects, Porter's typology and Miles and Snow's typology are similar. For example, Miles and Snow's prospector business is likely to emphasize

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## Case Analysis 7-1

### Step 10: What Is the Current Business-Level Strategy?

One needs to examine each major business unit (if there is more than one) and identify which generic strategy best describes the strategy of each business unit. Both strategy typologies (e.g., Porter, Miles and Snow) should be applied, but additional support should also be provided. Each business has its own unique strategy based on its own combination of resources. Hence, it is also important to discuss how the organization's business-level strategy differs from others in the industry that might share the same generic strategy. What makes the organization unique? This phase of the strategy management process is critical and often neglected.

The notion of business-level strategy cannot be understood independent of industry definition because an organization's business-level strategy is expressed in terms *relative* to others in the industry. For example, the competitive strategy for retailing giant Wal-Mart might be considered that of differentiation or low-cost–differentiation strategy if the industry is defined "discount retailers," whereas it might be considered as low cost if the industry is defined more broadly as "department stores."

differentiation, whereas the defender business typically emphasizes low costs. These tendencies notwithstanding, fundamental differences exist between the typologies. Porter's approach is based on economic principles associated with the cost-differentiation dichotomy, whereas the Miles and Snow approach describes the philosophical approach of the business to its environment (see Case Analysis 7-1).

## 7-3 Business Size, Strategy, and Performance

Researchers examining the relationship between a business unit's size and its performance, relative to those of its competitors, have interesting observations. Midsize business units often perform poorly in comparison with small or large competitors, because they typically do not possess the advantages associated with being flexible like their small rivals or possessing substantial resources like their large rivals.[42] Specifically, small businesses enjoy flexibility in meeting specific market demands and a potentially quicker reaction to environmental changes. Because of their lower investments, they may be able to make strategic moves and pursue more limited revenue opportunities that would be unprofitable for midsize or large businesses. Likewise, large businesses can translate their economies of scale into lower costs per unit and may be better able to bargain with their suppliers or customers, or to win industry price wars.

Because midsize business units tend to lack the advantages of either small or large rivals, many choose to become larger or smaller to capitalize on advantages of their competitors. Specifically, they may seek to expand their operations (i.e., increase their size) to take advantage of scale economies, or they may retrench (i.e., decrease their size) to avail themselves of the advantages possessed by small companies. Either option can be difficult and may not even be feasible, depending on various competitive and industry forces.[43] It is not suggested that all midsize businesses perform poorly and should aggressively attempt to increase or decrease size. Nonetheless, strategic managers should understand the relationships between

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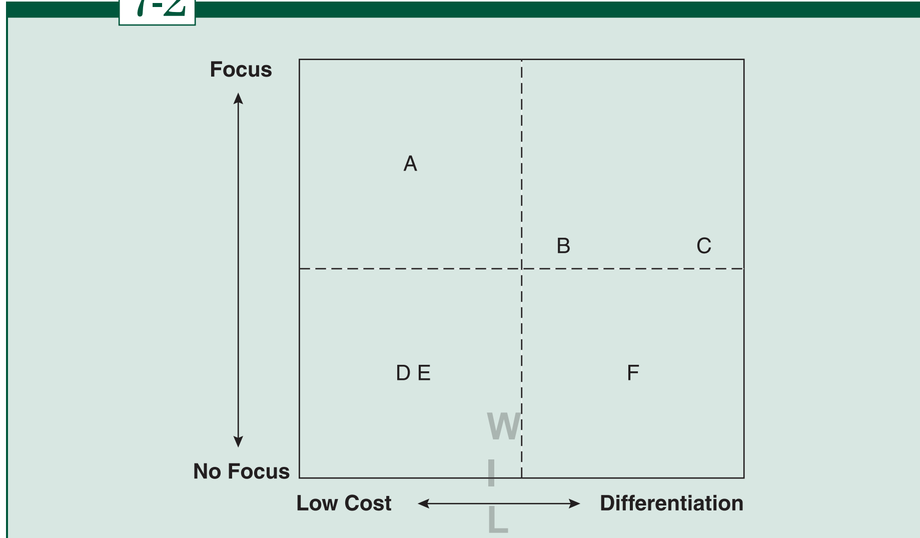
FIGURE 7-2 Porter's Generic Strategy Matrix




size and performance and consider them when evaluating the specific needs of their business units.

## 7-4 Assessing Strategies

Although the distinctions between such strategies as cost leadership and differentiation or prospectors and differentiators are readily made in theory, they are not always easy to assign in practice. Considering Porter's typology, cost leadership and differentiation may be viewed as opposite extremes on a continuum. Likewise, focus and no focus can also be seen as opposite extremes. Figure 7-2 illustrates this approach with a hypothetical industry containing six rivals. Company A is the only focus–low-cost competitor. Companies B and C—generally seen as part of the same strategic group—are slightly less focused than A; both B and C are more differentiated than A, but C is more differentiated than B. Companies D and E—clearly members of the same strategic group—employ low-cost (no-focus) strategies, whereas company E follows a differentiation (no-focus) approach. Viewing generic strategies as a matter of degree enables analysts to illustrate relatively minor distinctions between businesses employing the same generic strategy. This approach can also be applied to the Miles and Snow typology, with prospectors and defenders anchoring ends of a continuum and analyzers in the middle.[44]

Categorizing businesses in such a matrix is not easy and can be somewhat subjective. Consider Wal-Mart as an example. Traditionally, the retailer has eschewed a focus approach in favor of a one-size-fits-all approach geared at selling to most consumers. Although this approach was successful for a while, sales growth in the United States began to decline in the early 2000s. In 2006, the retailer began modifying its product mixes in many of its U.S. stores to target six groups: African Americans, the affluent, empty-nesters, Hispanics, suburbanites, and rural residents.[45] On the one hand, this move reflects an attempt by Wal-Mart to concentrate its efforts on specific markets, an approach consistent with Porter's focus strategy. On the other hand, the six groups identified together comprise the majority of the U.S. population, suggesting that Wal-Mart's competitive strategy does not qualify as a focus strategy, but as a no-focus strategy with some degree of tailoring each store to the needs of its clientele. Although it might not be appropriate to reclassify

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## Case Analysis 7-2

### Step 11: What Business-Level Strategies Are Presently Being Employed by Competitors?

To analyze all the competitive options available to a business, one needs to understand the strategic approach of competitors. Because obtaining detailed information about all competitors is often difficult, a focus on the primary competitors utilizing at least one of the business strategy typologies is appropriate. The key here is to understand how different competitors in the industry utilize various strategic means to serve customers and pursue profitability. It is helpful to identify how the companies are similar and different in their strategic approaches. This insight can help strategic managers predict how competitors might respond to a change in strategy.

WILLIS, KASSANDRA 2161TS

Wal-Mart strategy as a focus approach because of this strategic shift, a modest move toward the focus end of the continuum may be warranted.

In addition, formulating an effective competitive strategy is almost impossible without a clear understanding of the primary competitors and their strategies. Specifically, it is important to comprehend how rivals compete, what they are attempting to accomplish (i.e., their goals), what assumptions they hold concerning the industry, and what their unique strengths and weaknesses are relative to others in the industry. Developing this understanding not only helps top managers formulate strategies to position a business in the industry, but can also help them forecast any competitive responses that rivals might make if a major strategic change is implemented (see Case Analysis 7-2).

Many strategic moves are not instituted by businesses when they anticipate a competitor's activities, but in response to moves that have already been implemented. For example, by 2003, online hospitality sites Hotels.com and Expedia.com had teamed up with franchise hotels with unused capacity to fill extra rooms at discounted rates. As a result, consumers were able to secure high-quality accommodations at substantial savings. The hotel chains associated with these franchised units earn substantial profits from their reservation services and therefore began to restrict franchisees from offering rates at Web sites lower than those offered by the hotel chain's site. As one executive put it, "If we are not careful, these wholesalers will become…so big and powerful that we will have to work with them . . . And you will have to pay a premium to be on their shelves."[46]

Taking advantage of a competitor's misfortune is not always easy, however. In 2000, Bridgestone's Firestone unit was forced to recall 6.5 million tires linked to fatal accidents on Ford Explorers in a widely publicized challenge to its credibility. Goodyear, however, was unable to meet the sudden increase in demand for its tires and responded by raising prices. Although sales stabilized at Bridgestone in the early 2000s at a market share about 2 percent lower than before the recall, Goodyear's market share had declined back to its pre-recall levels by 2003. Hence, Goodyear was unable to respond effectively to Bridgestone's woes.[47]

# 7-5 Global Concerns

Identifying the competitive strategy of a business operating in global markets can be a complex task. Unfortunately, no simple formula exists for developing and implementing successful business strategies across national borders. A popular approach to this challenge is to think globally, but act locally. Following this logic,

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a business organization would emphasize the synergy created by serving multiple markets globally, but formulate a distinct competitive strategy for each specific market that is tailored to its unique situation. Others argue that consistency across global markets is critical, citing examples such as Coca-Cola, whose emphasis on quality, brand recognition, and a small world theme has been successful in a number of global markets. These two approaches represent distinct perspectives on what it takes to be successful in foreign markets. Consider several examples.

Coca-Cola's global approach to marketing the popular soft drink has been relatively consistent across borders. Some product differences exist, however, due to availability and cost factors. In Mexico, for example, Coke contains readily available cane sugar. In the United States, where customers are not believed to perceive a major difference in sweeteners, Coke changed to high-fructose corn syrup, a less expensive alternative.[48]

Compared to Coca-Cola, Yum Brands takes a more localized approach with its KFC business unit. KFC emphasizes chicken in its host country—the United States—but added fish sandwiches to menus at its Malaysian outlets in early 2006. According to KFC Holdings (Malaysia) executive director and chief operating officer To Chun Wah, "As much as our customers love our chicken products, they also want a greater variety of meat products at KFC. Our market surveys show that our customers want more than just tasty, high quality and affordable chicken but are also constantly on the lookout for new and interesting things to eat." This move reflects a clear plan to localize business strategies along the lines of taste. Outlets in Malaysia are not required to carry the fish sandwich, however. Fish sandwiches had already proven to be successful in other Asian markets, such as Beijing, Shanghai, and Taipei.[49]

Yum Brands took localization another step further in 2004 when it launched East Dawning, a bright, clean fast-food restaurant in Shanghai. East Dawning operates like Yum's KFC restaurants except that its menu and décor are Chinese. Menu offerings include Chinese favorites such as noodles, rice, soy milk, fried dough, and plum juice. Yum hopes to turn East Dawning into China's largest fast-food restaurant one day. Yum is also considering launching an Indian fast-food restaurant in India.[50]

Consider Swedish home furnishings designer Ikea. Responding to frugality in the local market, Ikea sells many of its products in China at prices well below those in other parts of the world. The Beijing store, opened in 2006, is its second largest store in the world, behind Ikea's Stockholm store, and draws an estimated three times as many visitors as its other outlets. Ikea has experienced success selling to the growing middle class in China, but at prices that would be considered bargains elsewhere in the world.[51]

There is wisdom in both global strategy perspectives—localizing and maintaining consistency across borders—although the most effective approach will depend on the mission, goals, and characteristics of the organization. In practice, businesses rarely operate at one extreme or the other. Hence, these alternative approaches can be viewed as opposite ends of a continuum. Regardless of choice, there are costs and trade-offs associated with every position along the continuum.

Tailoring a business strategy to meet the unique demands of a different market can be especially challenging because it requires that top managers understand the similarities and differences between the markets from both industry and cultural perspectives. For example, since the 1970s, Japanese automobile manufacturers have sought to blend a distinctively Japanese approach to building cars with a sensitivity to North American and European values. Honda, the first

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Japanese manufacturer to operate a facility in the United States, has been most aggressive in this regard. In 2000, Mitsubishi was aggressively redesigning the Montero Sport to make it a "global vehicle" that could sell effectively in world markets. In 2001, however, the car maker dropped its one-size-fits-all approach and began to emphasize design factors unique to the critical U.S. market.[52]

Given the intense competition in most markets in the developed world, strategic managers must remain abreast of opportunities that may exist in emerging economies. India, for example, has enjoyed considerable growth in recent years. Some firms have outsourced jobs in technical areas to India where trained workers are available at considerably lower wages. Economic liberalization in the country has invited additional foreign investment into the country. India's Tata Motors helped overcome the country's reputation for poor production quality by exporting an estimated twenty thousand CityRovers to the United Kingdom in 2004.[53]

India, however, has received only a small fraction of the level of foreign investment made in China, which boasts the world's largest population and has been tabbed as a world economic leader within the next few decades. China's entrance into the World Trade Organization, declining import tariffs, and increasing consumer incomes suggest a bright future for the nation. At present, China remains a mix of the traditional lifestyle based in socialism and its own form of a neo-Western economic development. Nowhere is this friction seen best than on the roads of the capital, Beijing, where crowds of bicycles attempt to negotiate traffic with buses and a rapidly increasing number of personal automobiles. U.S.-style traffic reports have even become pervasive in a country where the world's largest automakers are fighting for a stake in what many experts believe will be a consumer automobile growth phase of mammoth proportions.[54]

When a Western firm seeks to conduct business with one of its Chinese counterparts, managers from both firms must recognize the cultural differences between the two nations. Recently, a number of consulting and management development organizations in both China and the West have been busy training managers to become aware of such differences and take action to minimize misunderstandings that can arise from them. For example, Chinese managers are more likely than Americans to smoke during meetings and less likely to answer e-mail from international partners. In the United States, it is more common to emphasize subordinate contributions to solving problems, whereas Chinese managers are more likely to respect the judgment of their superiors without subordinate involvement.[55]

Western manufacturers such as Eastman Kodak, Proctor & Gamble, Group Danone of France, and Siemens AG of Germany have already established a strong presence in China. A number of Western restaurants and retailers have also begun to expand aggressively into China, including U.S.-based McDonald's, Popeye's Chicken, and Wal-Mart. As the CEO of Yum, owner of KFC, Pizza Hut, and Taco Bell, put it, "China is an absolute gold mine for us."[56] French-based Carrefour is the largest foreign retailer in China with ninety hypermarkets in about two dozen cities. Product mixes in the Chinese stores tend to be similar to those in the domestic market, with adjustments made for local preferences. For a number of firms, the only attractive prospects for growth lie in emerging economies such as China, Brazil, and Mexico.[57]

## 7-6 Summary

At the business level, top managers determine how the organization is to compete effectively. According to Porter's framework, managers must decide whether to focus on a segment of the market—a strategy often appropriate for small businesses—and whether to emphasize low costs or differentiation.

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Each approach has its own set of advantages and challenges. Business units may also seek to combine the low-cost and differentiation strategies, although this approach can be difficult to implement effectively.

According to Miles and Snow's framework, managers may select a prospector, an analyzer, a defender, or a reactor strategy. Each of the first three approaches can serve as an effective approach, whereas the reactor strategy is a suboptimal choice.

Top managers should also consider the roles of business size, the strategies of rivals, and opportunities in emerging markets when seeking to develop business strategies.

## *Key Terms*

business unit
business webs
differentiation strategy
first-mover advantages
focus-differentiation strategy
focus–low-cost/differentiation strategy
focus–low-cost strategy
generic strategies
intrapreneurship
low-cost–differentiation strategy
low-cost strategy
multiple strategies
process innovations
product innovations
quality
strategic group
structural innovations
value innovations

## *Review Questions and Exercises*

1. What is the difference between a corporate strategy and a business strategy?
2. Identify the generic business strategy configurations available to strategic managers, according to Porter's typology.
3. Is it possible for a business to differentiate its outputs and lower its costs simultaneously? Explain.
4. Identify the generic business strategy configurations available to strategic managers, according to Miles and Snow's typology.
5. How are the business strategy typologies by Porter and those by Miles and Snow similar? How are they different?
6. Why might one expect the performance level of mid-size business units to be lower than the performance level of either small or large business units?

## *Practice Quiz*

### *True or False*

1. The focus-differentiation strategy emphasizes low overall costs while serving a narrow segment of the market.
2. Businesses that utilize the focus strategy produce and market to the entire industry products or services that can be readily distinguished from those of their competitors.
3. The combination strategy can also be referred to as multiple strategies.
4. There is no advantage to the reactor strategic type.
5. The generic strategy typologies developed by Porter and by Miles and Snow possess both similarities and differences.
6. Midsize businesses tend to be outperformed by their smaller and larger counterparts.

### *Multiple Choice*

7. Businesses adopting the same generic strategy are referred to as
   - **A.** low-cost businesses.
   - **B.** differentiated businesses.
   - **C.** a strategic group.
   - **D.** none of the above
8. A no-frills product targeted at the market at large is consistent with the
   - **A.** low-cost strategy.
   - **B.** differentiation strategy.
   - **C.** focus strategy.
   - **D.** none of the above

WILLIS KASSANDRA 2161TS

**9.** Which of the following is not a key advantage of the low-cost–differentiation strategy?

**A.** It enables the business to compete from a cost leadership position.

**B.** It is easier to implement than either the low-cost or the differentiation strategy.

**C.** It allows the business to distinguish its products from the competition.

**D.** It offers the prospects of high profitability.

**10.** Modifying the structure of the organization and/or the business model to improve competitiveness is consistent with

**A.** the low-cost strategy.

**B.** the focus strategy.

**C.** the differentiation strategy.

**D.** none of the above

**11.** Analyzers

**A.** seek first-mover advantages.

**B.** control a distinct segment of the market.

**C.** display some of the characteristics of both prospectors and defenders.

**D.** none of the above

**12.** Emerging markets are often more attractive than developed ones because

**A.** competition is not as intense.

**B.** consumer incomes in emerging markets are not a concern.

**C.** the infrastructure in emerging markets is already developed.

**D.** none of the above

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WILLIS, KASSANDRA 2161TS

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READING 7-1

# Insight from *strategy+business*

*Leadership and innovation may be appealing concepts, but they are not always crucial to strategic success. This chapter's strategy+business reading refers to the alternative approach as imitation and notes that doing so reduces risk and can increase efficiency. As Carr puts it, "Innovation has its place…but it's not every place."*

## Mastering Imitation

***For every thousand flowers that bloom, a million weeds surface. Best to cultivate from the greats.***

**By Nicholas G. Carr**

Management thinking has for some time been dominated by two big themes: leadership and innovation. It's not hard to see why. Both are important yet amorphous subjects. As resistant to definition as they are essential to business success, they offer unbounded opportunities for exposition and exploration to researcher, philosopher, and charlatan alike.

They have something else in common, too. It's come to be assumed that leadership and innovation are universally good qualities to which all should aspire. Through high-minded training programs, reward systems, and communication efforts, companies today routinely seek to democratize innovativeness and leadership—to drive them into every nook and cranny of their organization. In one way, this phenomenon seems yet another manifestation of the peculiarly American assumption that what's good small doses must be great in large quantities. In another way, it appears to spring out of the shift from a manufacturing to a service economy, with the attendant weakening of traditional management hierarchies.

But is the phenomenon as salutary as it first appears? Is it really in the best interest of companies to try to turn all their employees into leaders, all their units into hotbeds of creativity? I'm not convinced. The cult of leadership seems especially, even insidiously, dangerous. Too often, it ends up promoting an insipid textbook form of leadership, a "five keys to success" pantomime. At worst, it breeds a particularly insufferable kind of despot—the boss who, like David Brent in the BBC series *The Office*, feels compelled to flourish his entirely imaginary "leadership qualities" in front of his beleaguered staff. The result, inevitably, is organizational cynicism.

The cult of innovation seems healthy on the face of it. In a free market, after all, innovation underpins competitive advantage, which in turn undergirds profitability. Being indistinguishable from everyone else means operating with a microthin profit margin, if not outright losses. So why not try to innovate everywhere—to let, as Chairman Mao famously put it, a thousand flowers bloom?

Here's why not: For every thousand flowers, you get a million weeds. Innovation is by its very nature wasteful. It demands experimentation, speculative investment, and failure, all of which entail high costs anti risks. Indeed, it is innovations intrinsic uncertainty that gives it its value. High risks and costs form the barriers to competition that give successful innovators their edge. If innovation were a sure thing, everyone would do it equally well, and its strategic value would be neutralized. It would become just another cost of doing business.

But the high costs and risks also make discretion and prudence paramount. The most successful companies know when to take a chance on innovation, but they also know when to take the less glamorous but far safer route of imitation. Although imitation is often viewed as innovation's homely sibling, it's every bit as central to business success. Indeed, it's what makes innovation economically feasible.

### Deliberate but Dicey

So the critical first question for any would-be innovator should not be *How?* but *Where?* Deciding where to innovate—and where not to—is fundamentally a strategic exercise, requiring a clear understanding of a company's existing and potential sources of competitive advantage.

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If corporate innovation involves a deliberate but dicey attempt to create a new product or practice with commercial value, then the target should be one in which a company has an opportunity to establish a *meaningful* and *defensible* point of differentiation from its competitors. A meaningful point of differentiation is one that, to paraphrase Michael Porter, translates into either lower-cost operations or higher-value products, the two linchpins of outstanding profitability. A defensible point of differentiation is one that is resistant to rapid competitive replication. Defensible doesn't mean permanent; competition eventually erases all differences. What's important is to be able to sustain the differentiation long enough at least to offset the up-front costs and risks of innovation.

The proper focus of innovation will vary greatly from company to company, but at a high level successful businesses can be divided into two camps: process innovators and product innovators. Process innovators distinguish themselves by being more efficient in how they work; they produce fairly standardized products at a lower cost than competitors do, enabling them to earn relatively high profits at prevailing market prices (or drive competitors out of business through ruthless discounting). Process innovators tend to be the largest of all companies, dominating big, mature markets. Product innovators, on the other hand, make their mark by offering customers particularly attractive goods or services—those that offer superior functionality, more fashionable designs, or simply more enticing brand names or packaging. Their supranormal profitability, as an economist would put it, derives from the premium prices they can charge. Product innovators tend to pioneer new markets or to hold lucrative niches in older industries.

In the personal computer market, Dell stands as a classic process innovator. Its products are nothing special—they're essentially commodities that meet the prevailing needs of most buyers. But through the relentless fine-tuning of its supply, assembly, and distribution operations, Dell has gained a wide cost advantage over its rivals that has made it the fastest-growing, most profitable company in its industry—by far. Apple, on the other hand, is the model of an effective product innovator. It has carved out a profitable niche in a cutthroat business by offering distinctive and stylish products that a sizable set of buyers are willing to pay more for.

What's especially noteworthy about Dell and Apple is the discipline they bring to innovation. They innovate where creativity will buttress their core advantages, and they imitate elsewhere. You could argue, in fact, that to be a successful product innovator you need to be an adept process imitator, and to be a winning process innovator you need to be a good product imitator.

Dell, for instance, is skilled at quickly copying products and product features, which has enabled it to apply its superior process skills to a series of new markets, from servers to storage drives to switches. In some cases, it simply contracts with existing suppliers to provide it with commodity products to push through its distribution system. In challenging Hewlett-Packard in the lucrative market for printers, Dell is buying its products from Lexmark and rebranding them as its own. It thus avoids high research and development expenditures, further reinforcing its cost advantage.

As for Apple, its resurgence since the late 1990s has been as attributable to emulating processes as to churning out breakthrough products like the iMac and iBook. Soon after Steve Jobs returned as CEO in 1996, for example, he hired an operations ace, IBM and Compaq veteran Timothy Cook, to retool the company's rusty supply chain. By copying the best practices pioneered by companies like Dell, Mr. Cook dramatically reduced Apple's in-channel inventory, and the savings in working capital provided an immediate boost to profitability. On the distribution end, Apple has successfully copied efficient direct-to-customer channels such as online sales and dedicated stores.

Compare Dell's and Apple's highly disciplined innovation efforts to Gateway's shoot-anything-that-approach. Gateway started as a process innovator, becoming, with Dell, a pioneer of direct distribution, but it also tried to be a product differentiator, maintaining relatively high-cost manufacturing plants, investing more than Dell in R&D, and launching expensive brand-advertising campaigns. It innovated aggressively on the retailing end as well, pioneering the exclusive stores that Apple would later (and more successfully) copy. It even tried to be a service innovator, pursuing a highly publicized "beyond the box" strategy involving the provision of various consulting services to small businesses. By trying to innovate everywhere, Gateway failed to build a strong competitive advantage anywhere. It was unable to distinguish its products enough to escape the industry price wars, and its operating costs remained much higher than Dell's. Today, it is struggling to survive.

For purposes of illustration, I've drawn clear lines between products and processes and between innovation and imitation. In practice, those lines are usually

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blurred. A new industrial chemical, for example, will often arise as much through process advances in the manufacturing plant as through product breakthroughs in the research and development lab.

Even the most amazing new products will often incorporate ideas and components filched from others. In creating the iPod, its latest hit, Apple borrowed the major components from outside suppliers—the basic circuitry from PortalPlayer, the tiny hard drive from Toshiba, the battery from Sony, the digital-to-analog converter from Wolfson. It concentrated its innovation in its core strengths of engineering, design, marketing, partnering, and, most important of all, the integration of hardware and software. It's hard to think of another company that has the skill and business model required to tie together a handheld music player (iPod), an elegant PC application for playing and organizing music files (iTunes), and an online store filled with songs from all the major recording studios (iTunes Music Store).

The lesson is clear: Innovate passionately in those places where you can separate yourself from the competition. Where differentiation promises to be elusive or fleeting, be a cold-blooded imitator.

## Creativity Kills Competence

Beyond the dubious economics, one of the biggest problems with unconstrained innovation is that it can end up devaluing competence. It says to employees, It's not enough to do your job extremely well: You're only truly valuable if you "think outside the box" or "push the envelope" or—pick your cliché. That can lead to distorted measurement and reward systems, misdirected activity, and ultimately the disenfranchisement of a company's best workers.

A few years ago, a firm I'm familiar with got the innovation religion, and suffered mightily as a result. After nearly a decade of strong growth, the company's sales had gone soft and its margins had narrowed. It realized, correctly, that it required an infusion of new thinking. But rather than concentrate its efforts in the two areas that might have made a real difference to its business—new product development and branding—it took an unfocused, more-is-more approach. It democratized innovation by putting it at the heart of its annual incentive-compensation program. To earn a decent bonus, each employee had to demonstrate some form of creativity in his or her work, and each business unit had to provide examples and measures of its innovativeness.

The company's intentions were noble, but the program backfired. Dozens of piecemeal innovation initiatives were launched; even the IT help desk and the reception staff strove to reinvent their functions. The management and measurement of all these efforts required a cumbersome new bureaucracy and a small mountain of paperwork. Little thought was given to the actual business impact of the individual programs—creativity had become a good in its own right. Not surprisingly, employees and managers let their attention drift away from their day jobs, which suddenly seemed like secondary concerns, and the company's core business suffered.

The effect of the effort on individual employees was particularly distressing. The least talented workers actually embraced the program with the greatest fervor; it provided them with a respite from what they saw as the drudgery of their regular work. They became fonts of new and largely useless ideas, meticulously documenting their every passing fancy. The most competent employees, in contrast, treated the whole project as a silly game. They went through the motions, all the while complaining to one another about the emptiness of the exercise. Believing the company was rewarding smart talk over real accomplishment, they were slowly drained of their morale and motivation, and many of them ended up heading for the exit. Creativity had trumped competence, and performance took a hit.

Innovation has its place—a very, very important place but it's not everyplace. Creativity should not be allowed to shoulder competence to the verges. Acts of innovation may determine what companies do, but it's competence that determines how well they do it. Let a half-dozen flowers bloom, and keep the weeds in check.

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**Nicholas G. Carr** (ncarr@mac.com) a contributing editor to *strategy+business* and a former executive editor of *Harvard Business Review,* is the author of *Does IT Matter? Information Technology and the Corrosion of Competitive Advantage* (Harvard Business School Press, 2004).

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# Functional Strategies

8

## Chapter Outline


8-1 Marketing
  8-1a Pricing Strategies
  8-1b Promotion Strategies
  8-1c Product/Service Strategies
  8-1d Place (Distribution) Strategies
8-2 Finance
8-3 Production
  8-3a Quality Considerations
  8-3b Research and Development
8-4 Purchasing
8-5 Human Resources
  8-5a Human Capital and Knowledge Management
  8-5b Knowledge and Competitive Advantage
8-6 Information Systems Management
8-7 Summary
Key Terms
Review Questions and Exercises
Practice Quiz
Notes
Reading 8-1


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Corporate-level and business-level strategies can only be successful if they are supported by strategies at the business unit's functional levels, such as marketing, finance, production, purchasing, human resources, and information systems. Each functional area should integrate its activities with those of the other functional departments because a change in one department can affect both the manner in which other departments operate and the overall performance of the business unit. Indeed, the extent to which all of the business unit's **functional strategies** integrate can determine the effectiveness of the unit's business-level and firm-level strategies.

**Functional Strategies**
The strategies pursued by each functional area of a business unit, such as marketing, finance, or production.

Although functional strategies are formulated after the corporate and business strategies have already been established, it is a good idea to consider the capabilities of functional areas while debating higher level strategies. For example, an airline considering expansion through additional international routes should consider factors such as the need for additional personnel and the organization's

WILLIS, KASSANDRA 2161TS

**TABLE 8-1 Integrating Business and Functional Strategies**

| Strategy | Low-Cost | Differentiation | Low-Cost–Differentiation |
|---|---|---|---|
| **Marketing** | Emphasize low-cost distribution and low-cost advertising and promotion. | Emphasize differentiated distribution and advertising and promotion on a large scale. | Emphasize differentiated distribution and advertising and promotion on a large scale at the lowest cost possible. |
| **Finance** | Lower financial costs by borrowing when credit costs are low and issuing stock when the market is strong. | Emphasize obtaining resources and funding output improvements or innovations, even when financial costs may be high. | Emphasize obtaining resources and funding output improvements or innovations at the lowest possible cost. |
| **Production** | Emphasize operation efficiencies through learning, economies of scale, and capital-labor substitution possibilities. | Emphasize quality in operations even when the cost of doing so is high. | Emphasize quality in operations when the cost of doing so is relatively low. |
| **Purchasing** | Purchase at low costs through quantity discounts. Operate storage and warehouse facilities and control inventory efficiently. | Purchase high-quality inputs, even if they cost more. Conduct storage, warehouse, and inventory activities with extensive care, even if costs are higher. | Purchase high-quality inputs, but only if costs are low. Conduct storage, warehouse, and inventory activities with care, but only if costs are relatively low. |
| **Research and Development (R&D)** | Emphasize process R&D aimed at lowering costs of operation and distribution. | Emphasize product/service R&D aimed at enhancing the outputs of the business. | Emphasize both product/service R&D and process R&D. |
| **Human Resource Management** | Emphasize reward systems that encourage cost reductions. | Emphasize reward systems that encourage innovation. | Emphasize reward systems that encourage cost reductions and innovation. |
| **Information Systems** | Emphasize timely and pertinent information on costs of operations. | Emphasize timely and pertinent information on the ongoing processes that yield unique products/services. | Emphasize both timely and pertinent information on costs of operations and innovation processes that are meant to yield unique products/services. |

*Source:* Adapted from P. Wright, M. Kroll, and J. A. Parnell, *Strategic Management: Concepts* (Upper Saddle River, NJ: Prentice Hall, 1998).

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ability to finance additional airplanes *before* settling on the expansion plan as the preferred strategic option.

Unfortunately, managers in each functional area may not fully appreciate the interrelationships among the functions. Marketers who do not understand production may promise customers product features that the production department cannot readily or economically integrate into the product's design. Production managers who do not understand marketing may insist on production changes that result in relatively minor cost changes but fail to satisfy customer needs. For this reason, managers in all functional areas should understand how the areas integrate, and they should work together to formulate functional strategies that fit together and support the corporate- and business-level strategies.

This chapter examines functional strategies in the areas of marketing, finance, production, purchasing, human resources, and information systems. Although the relationships among functional strategies are not always clear, Table 8-1 summarizes the way functional strategies typically integrate with the business strategy using as an example the modified version of Porter's typology discussed in Chapter 7.

This chapter is organized along functions. In practice, however, many of the issues discussed herein are *cross-functional* and therefore concern more than one functional area. Production warranties, for example, are a key concern for both the production and marketing departments. These issues are discussed in the functional section where they seem to fit the best.

## 8-1 Marketing

The competitive strategy and the marketing functional strategy are tightly intertwined. Traditionally, marketing has been dissected into four dimensions or four Ps: price, promotion, product/service, and place (i.e., channels of distribution). The particular generic strategy adopted by the business unit influences how these various dimensions are planned and executed. The emphasis on marketing—most notably the notion of customer orientation—continues to gain prominence and places a high level of importance on marketing strategies that support the firm and business strategies.[1] From a competitive standpoint, marketing is arguably the most critical of the functional strategies and should be considered early in the development of the business strategy.

### 8-1a Pricing Strategies

Business units that compete with the low-cost generic strategy produce basic, relatively undifferentiated outputs and often offer low prices. Wal-Mart, for example, is known for its highly effective high-volume, low-cost strategy. Even Internet powerhouse Amazon.com has sought to follow the Wal-Mart model, cutting prices when possible in an effort to gain economies of scale (discussed in greater detail in section 8-3) through high volume.[2]

Motel 6 also incorporates such a strategy, offering clean and comfortable, low-priced rooms. Founded more than forty years ago, Motel 6 minimizes costs by offering few services, such as restaurants or conference rooms. Its simple brand name, Motel 6, even conveys the impression of economy services. Consistent with its no-frills outputs, each Motel 6 offers rooms at daily rates at or below other nearby chain motels. Promotional efforts—primarily radio spots with limited

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television and billboards—are relatively limited and attempt to convey to the traveling public that Motel 6 offers satisfactory economy lodging.[3]

Businesses that use the generic strategy of low-cost differentiation must market quality products and services that are distinguishable from the outputs of their competitors.[4] For example, Hampton Inn offers larger rooms with better quality furnishings than Motel 6, along with amenities such as a free breakfast buffet, swimming pool, and conference rooms. The brand name Hampton Inn is intended to convey the impression of quality and value. Average to slightly above average prices are charged for Hampton Inn rooms, depending on the competitive situation, and promotional efforts connote a differentiated quality image.

Businesses emphasizing low prices, however, often find it difficult to raise prices if it becomes necessary. Fast-food restaurants with "dollar menus" in the United States experienced declines in sales when they attempted to wean consumers from such values in the early 2000s. Automakers relied heavily on rebates to sell cars during this time—an average of over $3,000 for Chevrolets—and have experienced similar difficulties.[5]

Business units that combine the focus strategy with the differentiation or low-cost–differentiation generic strategy tend to emphasize other factors in their marketing strategies. These businesses offer unique, high-quality products and services to meet the specialized needs of a relatively small market. Most bed-and-breakfast establishments offer a limited number of rooms to discriminating travelers who seek accommodations with a local, home-oriented flavor.

Pricing strategies can involve more than simply a price point relative to the competition. Health clubs, for example, typically promote memberships by the month and offer discounts for commitments of one or two years. Research suggests that many consumers would actually save money if they chose to pay on a per-visit basis or make a higher monthly payment without a long-term commitment because they never actually use the facilities as much as they project when they join. By offering unlimited usage for a period of time, health clubs are *perceived* to be more price competitive by consumers who may or may not attain their fitness goals.[6]

## 8-1b Promotion Strategies

Firms operating in certain industries have been banned from advertising in the United States, although many of these regulations have been lifted. Medical professionals, attorneys, and pharmaceutical companies are now permitted to advertise their products and services, provided they meet specific requirements. Advertising can often backfire, however, if consumers perceive that expenses associated with the promotion may drive up already steep fees, as could be the case for attorney services or prescription medicines.[7]

From a marketing perspective, the Internet presently offers opportunities for integration among various media. In the early 2000s, Proctor & Gamble began sponsoring news stories on topics such as health care, parenting, and nutrition, ending each ninety-second segment with a referral to its Web site via the television station's site. For example, a story on diaper rash might conclude with a referral to the Pampers page.[8]

The Internet enables many businesses to target potential customers in an efficient manner. For this reason, Internet-based and traditional businesses have begun to use the Net as a significant part of their promotional campaigns. Following an initial boom in Internet advertising in the late 1990s, interest

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in Web advertising waned for several years. By the mid-2000s, however, the advent of broadband and new advertising formats, including more sophisticated animation, sparked a resurgence. Search-related advertisements—those which appear alongside search results at popular search sites—remain quite popular.[9]

### 8-1c Product/Service Strategies

Product decisions are a key part of the marketing mix and can be quite interesting. Consider the following examples. Honda, Nissan, and other carmakers began adding safety features in many of their 2004 models to provide SUV drivers, who place a high value on safety, with alternatives in smaller vehicles.[10] In 2003, restaurants such as McDonald's and Starbucks began installing Wi-Fi (i.e., wireless fidelity high-speed Internet access) in some of their restaurants to provide online access for customers with laptops. In some instances, one hour of access is available as an add-on to a value meal.[11] In the early 2000s, PepsiCo controlled three of the top five soft drinks in the United States. Market shares of two of the three—Pepsi and Mountain Dew—declined, however, while Diet Pepsi increased during this time. Although Diet Pepsi remained third in revenues behind its two siblings, PepsiCo announced in early 2005 that Diet Pepsi would replace Pepsi as its new flagship, a major shift in its marketing efforts.[12] Since the introduction of Coke Zero in 2005, Coca-Cola has also shifted much of its attention away from its flagship—Coca-Cola Classic—to its low-calorie alternative.[13]

Product design is also critical to all firms, regardless of the strategies they employ. Although design was traditionally associated with appearance, the concept also includes such features as designing a product for easy manufacturability so that fewer parts have to be purchased or improving the product's ability to perform its purpose.[14] Effective design now addresses aesthetics as well as other consumer concerns, including such factors as how a product works, how it feels in the hand, how easy it is to assemble and fix, and even what its prospects are for recycling. Gaining a competitive advantage through superior product design involves all functional areas. A well-designed product is attractive and easy to build, market, use, and maintain; it is also driven by simplicity.

Customer service is also a critical marketing concern. Developing and maintaining the quality of customer service can be more challenging than enhancing product quality, because the consumer perceives service value primarily at the time the service is rendered (or not rendered).[15] All functional areas must work together to provide the customer with product and service value.[16] For example, an online retailer must fulfill several customer needs. First, it must offer value to customers in their shopping. Carrying the products that customers desire at competitive prices means that the various functions must communicate with one another and cooperate closely. Next, it must make certain that its employees are able to respond to customer inquiries, either electronically or by telephone. This capability requires effective human resource management training as well as information systems management. The e-tailer must also ensure that it stocks sufficient quantities of the items that it promotes, a common problem for start-ups in the 1990s. This requires interaction among the purchasing, inventory, information systems, and marketing functions. Finally, the company must provide the clear, efficient, and secure means for

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**STRATEGY AT WORK 8-1**

### Importance of Customer Service in e-Commerce

In e-commerce, extraordinary customer service can lead to great increases in future sales through repeat visits and positive word of mouth. In addition, online shoppers expect to have prompt customer service throughout the buying experience. Research has found that as many as 40 percent of online buyers abruptly discontinue shopping at e-tailers because of unsatisfactory customer service.

Today, online shoppers are more sophisticated, with complex questions and expectations of real-time responses. Customers are beginning to expect instant service via a toll-free number, live text chat, or other such immediate response methods.

Major package carrier DHL offers customer service only by e-mail or telephone. Oliver Deschryver, chief technology officer at DHL Airways Inc., also added that text chat and collaborative browsing are definitely part of the strategy.

Nordstrom.com launched text-based chat that has the added feature of "watching," whereby online shoppers can actually view the exact colors of the fabrics while they are chatting with a customer service representative. Paul Onnen, the company's chief technology officer, hopes that this will enrich the customers' shopping experience.

Many companies are also using sophisticated software to improve online customer service. Averitt Express built a broad range of customer service applications using Domino Web Server Release 5 and Lotus Notes. Home Inc. combined customer relationship management (CRM) and e-commerce applications with Oracle Financials to integrate its online business.

As Christopher Little, vice president and general manager of GE Distribution Finance, puts it, "Our goal is complete customer fulfillment online, which means I want to keep my shop open to our customers 24 hours a day, seven days a week."

*Sources: R. Spiegel, "Study: Top Customer Service Drives E-Commerce Sales,"* E-Commerce Times, *1 December 1999; M. Zetlin, "E-Customer Service Gets Real,"* Computerworld *34(44) (2000): 56–57; L. Stevens, "Companies Go beyond CRM to Pamper Online Customers,"* Informationweek *808 (2000): 184–188; T. Sinioukov, "Financial Services' E-Commerce Outreach,"* Dealerscope *42(9) (2000): 28.*

WILLIS, KASSANDRA 2161TS

customers to complete the purchase process accurately and quickly, requiring the close cooperation of information systems and human resource management (see Strategy at Work 8-1).

*Source: Ablestock.com*

Product/service decisions are often difficult. Responding to market share gains by discounters such as Target, Federated Department Stores recently redesigned its stores to promote self-service, while reducing the number of sales clerks. The large retailer hopes that consumers will perceive the efficient layout as more convenient, while enabling Federated to cut costs.[17] At the same time, Saks, Macy's, and Federated have introduced upscale private label products in an attempt to lower prices while maintaining a quality image.[18]

The importance of service cannot be overemphasized. The Southwest Airlines frequent fliers appreciate that company's commitment to superior service in a friendly, professional, but sometimes comical environment.[19] Interestingly, surveys typically suggest that more than one-third of consumers choose businesses that charge high prices but provide excellent service over companies that offer low prices but mediocre service.[20]

Personal attention is an important way that some businesses provide superior service. Personal attention involves paying heed to details, addressing customers' concerns, answering technical questions, and providing service after the sale.[21] Such attention often plays an important psychological role as well because customers see how important quality is to the organization.[22]

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**STRATEGY AT WORK 8-2**

### The Importance of Distribution and Production Capacity in e-Commerce Success

Despite the early failures of many dot-com start-ups, some Internet companies continue to grow. These e-tailers understand that they are facing an unprecedented challenge—how to create an infrastructure that cost effectively meets the needs and complex demands of today's sophisticated customer. To respond, many are designing and implementing multichannel distribution models to enhance distribution and improve customer service.

Customers who shop on the Internet typically check their order several times before they receive it. This means that the distribution system should be able to confirm order receipt, notify the customer of shipping details, and provide immediate notice of any problems that may occur in the process.

For example, JCPenny.com reaps success in drawing record sales with an effective distribution system. Of course, JCPenny.com does not depend solely on e-commerce for its retail sales. Other clothing merchants that have followed suit include Gap.com, EddieBauer.com, and BananaRepublic.com. BarnesandNoble.com has also successfully integrated its product inventories and distribution channels. Shipping costs have been slashed, and customers now have more options for pickups, purchase, and returns.

Innovation has not been limited to e-tailers. For example, DaimlerChrysler created its own Internet applications, one of which is known as FastCar. This Internet-based development and production system enables development and production departments to collaborate in real time.

*Sources: L. Enos, "DaimlerChrysler Forms E-Business Subsidiary,"* E-Commerce Times, *9 October 2000; D. Christensen, "Delivering the Promise of 'E,'"* World Trade *13(12) (2000): 60–61; M. Mahoney, "And the Dot-Com Survivors Are . . ."* E-Commerce Times, *2 February 2001.*

## 8-1d Place (Distribution) Strategies

Low-cost businesses typically seek distribution channels that meet the basic needs of the target market while minimizing costs. In contrast, differentiated businesses often select the most appropriate means of distribution regardless of cost and may even use the means of distribution as a way of differentiating the business (see Strategy at Work 8-2). For example, cost leader Cici's distributes its pizza through low-priced buffets and customer pickup at the restaurant, whereas Domino's has used "free" delivery—the cost of which is built into the price—as an effective means of differentiation over the years (see Case Analysis 8-1).

*Source: Comstock.com*

## Case Analysis 8-1

### Step 12: What Is the Organization's Marketing Strategy?

Given the strong link between a business's competitive strategy and its marketing functional strategy, this step can require much research and depth. What marketing efforts are underway to support the current business-level strategy? Are these efforts successful? Why or why not? Provide examples of recent promotional or public relations campaigns that support your assessment.

An effective means of assessing the marketing strategy is to analyze each of the four Ps individually. Company Web sites and trade journals are excellent sources for the type of information that should be included in this section.

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## 8-2 Finance

The financial strategy addresses factors related to managing cash, raising capital, and making investments. Because few businesses internally generate the amount of cash necessary to grow, most resort to other means of securing financial resources. Different means of securing funds will likely be considered and prioritized depending on the corporate and business strategies selected.[23]

Source: Comstock.com

Low-cost businesses pursue financial strategies that are intended to minimize their financial costs. They place a great emphasis on keeping costs within the limits of the funds they are able to generate from operations. When borrowing becomes necessary, they usually try to do so when credit costs are relatively low, even if they must defer expansion plans.

In contrast, differentiated businesses are more likely to pursue financial strategies that fund initiatives such as quality improvements and product research and development (R&D) even when the cost of securing funds is relatively high. They may sell common stock, incur debt, or even seek venture capital regardless of the costs of doing so. The greatest strategic priorities are maintaining quality and enhancing differentiation, not minimizing the cost of funds.

One can assess a firm's financial strategy, as well as its performance, by examining its financial ratios and comparing them to those of key competitors or industry averages. Comparing current ratios to those in the past is also relevant. Table 8-2 lists key financial ratios that can help evaluate the financial position of the organization (see Case Analysis 8-2). However, strategic decisions should not be based on financial ratios alone. Although ratios can provide valuable insight, their usefulness is limited, because the accounting data on which they are based do not always provide a complete picture of the firm's financial position.

## 8-3 Production

Similar in some respects to the product dimension of the marketing strategy, the production or operations strategy outlines *how* a business generates its goods and services. Production/operations management (POM) is crucial to both manufacturing and service organizations.[24] In general, the production strategy difference between low-cost businesses and differentiated businesses is straightforward. Low-cost businesses develop production systems that minimize production costs, often by limiting customer options and product features. In contrast, differentiated businesses tend to develop systems that emphasize product and service quality and distinctiveness, even if production costs rise as a result.

Organizational size is also a key factor in production strategy decisions. Generally speaking, the range of production strategies at its disposal increases as an organization grows. Large business units can capitalize on factors that accompany their larger size. Each of these factors is associated with the **experience curve**, the reduction in per unit costs that occurs as an organization gains experience producing a product or service.[25]

**Experience Curve**
The reduction in per unit costs that occurs as an organization gains experience producing a product or service.

Interestingly, each time a company's output doubles, production costs decline by a specific percentage, depending on the industry. The greater the percentage, the greater the role size plays in performance. For instance, with a sales volume of 1 million units, per unit costs may be $200 in a particular industry. With a doubling of volume to 2 million units, per unit costs may decline by 20 percent. Another doubling of volume to 4 million units may lower per unit costs another 20 percent. The experience curve can be observed in a wide range of manufacturing and service industries, including automobiles, personal computers, and airlines. Although the

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**TABLE 8-2 Primer on Essential Financial Ratios**

| Ratio | Formula | What the Ratios Represent |
|---|---|---|
| **Liquidity Ratios** | | |
| *Current Ratio* | Current Assets / Current Liabilities | Indicates how much of the current liabilities the current assets can cover; ordinarily 2:1 or better is desirable. |
| *Quick Ratio or Acid Test or Liquidity Test* | Current Assets – Inventory / Current Liabilities | Indicates how rapidly a business can come up with cash on short notice. Not relevant for firms where inventory is almost immediately convertible to cash (e.g., McDonald's). |
| **Activity Ratios** | | |
| *Asset Turnover* | Total Revenues (i.e., Sales) / Total Assets during Period | Measures how efficiently the company's total assets are being used to generate sales. |
| *Inventory Turnover* | Cost of Goods Sold / Average Inventory for Period | Indicates how many times inventory of finished goods is sold per year. |
| *Sales-to-Working Capital* | Net Sales / Net Working Capital | Measures how efficiently net working capital (current assets – current liabilities) is used to generate sales. |
| **Leverage Ratios** | | |
| *Debt-to-Asset* | Total Debt / Total Assets | Indicates the percentage that borrowed funds are utilized to finance the assets of the firm. |
| *Debt-to-Equity* | Total Debt / Stockholders' Equity | Indicates the percentage of funds provided by creditors as compared with owners. |
| *Long-Term Debt-to-Equity* | Long-Term Debt / Stockholders' Equity | Indicates the percentage of funds provided by long-term creditors as compared with owners. |
| **Performance Ratios** | | |
| *Gross Profit Margin* | Gross Profit / Total Revenue (i.e., Sales) | Measures company's efficiency during the production process. Substantial variations over time could suggest financial difficulties or possibly fraud. |
| *Return on Assets* | Net Income before Taxes / Total Assets | Measures the return on total assets employed. |
| *Return on Equity* | Net Profit after Taxes / Stockholders' Equity | Measures a firm's profitability in comparison to the total amount of shareholder equity. |
| *Return on Sales* | Net Operating Profit before Taxes / Net Sales | Indicates ratio of return on net sales. |

precise percentages are not always known, the principle of the curve can be accurately applied to most production environments.

The experience curve is based on three underlying concepts: learning, economies of scale, and capital-labor substitution possibilities.[26] **Learning** refers to the idea that employees become more efficient when they perform the same task many times. An increase in volume fuels this process, also increasing expertise. This reasoning can be applied to all jobs—line and staff, managerial and nonmanagerial—at the corporate, business unit, and functional levels. Economies of scale—the reductions in per unit costs as volume increases—can be great for businesses such as automobile manufacturers or Internet Service Providers. **Capital-labor substitution** refers to an organization's ability to substitute labor for capital, or vice versa as volume increases, depending on which combination minimizes costs and/or maximizes effectiveness. Certain U.S. manufacturers, for example, have shifted their assembly operations across the Mexican border where labor costs are much lower.

**Learning**
The increased efficiency that occurs when an employee performs a task repeatedly.

**Capital-Labor Substitution**
An organization's ability to substitute labor for capital or vice versa as production increases.

Recent developments in production technology have modified the traditional capital versus labor dichotomy. Many facilities have advanced to the point that products are manufactured while no workers are present, often during the night.

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## Case Analysis 8-2

### Step 13: What Is the Organization's Financial Position and Financial Strategy?

What is the organization's financial strategy? Is the organization financially sound? Ratio analysis is a systematic means for analyzing the financial condition of the organization. The purpose of financial ratio analysis is to determine the financial effects on a business based on current, past, and possible future managerial business decisions. Financial ratios—expressed either as a times multiple (x) or a percentage (%)—are computed by taking numbers from a business's financial statements and converting them into meaningful relationships and indicators of the firm's financial performance. Calculating financial ratios covering the current and past fiscal years or periods of a business and then comparing them to each other and to comparable industry averages for the same time period will provide an insight into the business's financial condition and operational performance.

Calculating only the ratios of the firm being analyzed is not sufficient. Industry norms must also be considered. Because of structural and competitive factors, a ratio that may appear normal in one industry may signal cause for concern in another. Therefore, one should compare each ratio to the industry norm (when available) and provide some degree of analysis. For example, it is not sufficient to note that the days of inventory is 47.5 without also identifying the industry norm and addressing why an organization is above or below that norm. One needs to compute all of the appropriate ratios while focusing on the most critical ratios, those that differ significantly from years past or from the industry norm.

If the company competes in multiple industries, comparisons should be made to the averages for industries in which the firm operates. Alternatively, when another company or a set of companies with similar characteristics exists (e.g., PepsiCo and Coca-Cola), direct company comparisons can also be made. The key is that a company's performance is compared to the most valid and reliable set(s) of standards available, although comparing is easier with some firms than with others.

If unique characteristics of the company do not permit the calculation of all relevant ratios (e.g., inventory turnover is irrelevant for corporations that do not hold inventory), then this fact should be stated in the report. In addition, certain Web sites (e.g., www.hoovers.com) provide detailed financial analysis for many publicly traded companies.

WILLIS KASSANDRA 2161TS

The role of the workers in such facilities is not to produce the products but to prepare them for delivery.[27]

Low-cost businesses with large market shares tend to benefit the most from the experience curve. Differentiated businesses often attempt to gain a similar advantage by charging higher than average prices, seeking to gain market share and ultimately lower costs by offering higher quality outputs. However, differentiators do not actively capitalize on the opportunities presented by low costs, whereas managers of businesses that compete with low-cost–differentiation do.[28]

Regardless of strategy, seeking to exploit the experience curve can be risky. Increases in volume often involve substantial investments in plant and equipment and a commitment to the prevailing technology. However, as technology changes and renders the plant's production processes obsolete, outdated capital equipment may have to be discarded. Balancing current investments in plant

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and equipment with the risk that current technology may become dated prompts particular firms to invest in flexible manufacturing systems that can be retooled quickly to respond to market changes.

*Source: Ablestock.com*

Enhancing efficiency in production is a key issue in restaurants, textile plants, and even airplane factories. In the mid-2000s, airplane producers Airbus and Boeing launched concerted efforts to simplify their production procedures and reduce assembly time. Airplane parts are now designed with a greater emphasis on how fast they can be assembled.[29]

Speed in developing, making, and distributing products and services can be the source of a significant competitive advantage.[30] In fact, an application of speed known as time-based strategy is a top priority in many organizations.[31] Companies that can deliver quality products in a timely fashion become problem solvers for their customers and are more likely to prosper. Motorola, for instance, cut the time needed to produce a cellular telephone from fourteen hours to less than two hours, while retail prices have fallen dramatically. Speed is equally important in customer service.

## 8-3a Quality Considerations

In the late 1970s and early 1980s, strategic managers became interested in a concept borrowed from the Japanese known as quality circles, whereby managers and workers would meet to discuss and implement production changes that improved quality and efficiency. This interest evolved in the late 1980s and early 1990s into a heightening of interest in quality, broadly known as **total quality management (TQM)**.[32] Developed by W. Edwards Deming, TQM refers to the totality of features and characteristics of a product or service that bear on its ability to satisfy customer needs. Historically, quality has been viewed largely as a controlling activity that takes place at or near the end of the production process, an after-the-fact measurement of production success that occurs in the so-called quality control department. However, the notion that quality is measured *after* an output is produced has eroded, and quality is now seen as an essential ingredient of the product or service being provided and a concern of all members of the organization. Hence, from a production standpoint, producing a quality product lowers defects and minimizes rework time, thereby increasing productivity. In addition, making the operative employees responsible for quality eliminates the need for inspection.[33]

**Total Quality Management (TQM)**
A broad-based program designed to improve product and service quality and to increase customer satisfaction by incorporating a holistic commitment to quality, as seen through the eyes of the customer.

As an extension of the TQM philosophy, Six Sigma seeks to increase profits by eliminating variability in production, defects, and waste that undermine customer loyalty. Six Sigma is a systematic process that utilizes information and sophisticated statistical tools to improve production efficiency and quality. Practitioners receive training and advance to various levels of certification in Six Sigma concepts. Many companies began adopting the approach in the late 1990s and early 2000s and have reported substantial savings.[34]

Problems resulting in poor product or service quality can arise even in the best-managed businesses. Companies must guarantee an acceptable level of quality to instill confidence among buyers and avoid loss of business when such problems occur. The concept of the guarantee is both a quality and a marketing concern. Some companies even offer unlimited money-back guarantees.

In an effort to minimize short-term costs, however, many companies ignore this competitive advantage. Often, guarantees lapse after a short time or contain too many exceptional conditions to be effective competitive weapons. Managers must balance the costs associated with a superior guarantee with its benefits and tailor the package to the organization's strategy. Nonetheless, it

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has been suggested that the following five desirable characteristics be included in service guarantees.[35]

1. The guarantee should be unconditional, with no exceptions.
2. It should be easily understood and written in simple language.
3. The guarantee should be meaningful by guaranteeing what is important to the customer and making it worth the customer's time and effort to invoke the guarantee, should the customer be dissatisfied.
4. The guarantee should be convenient to invoke and not require the customer to appeal to several layers of bureaucracy.
5. The customer should be satisfied promptly, without a lengthy waiting period.

Changes in the competitive environment can even spark quality decisions from competitors within a given industry. For example, after 9/11, many airlines engaged in vigorous cost-cutting to help stop losses that were to follow. Although some airlines eliminated meals on domestic flights, Continental actually took steps to improve cabin comfort and retain quality meals on its flights. Hence, whereas most airlines moved to address critical short-term financial concerns, Continental perceived an opportunity to emphasize quality and seek to develop long-term competitive advantage.[36]

### 8-3b Research and Development

**Product/Service R&D**
Research and development activities directed toward improvements or innovations in the quality or uniqueness of a company's outputs.

Another function closely related to production is research and development (R&D). Differentiated businesses often—but not always—spend more on R&D than low-cost businesses. However, differentiated and low-cost businesses tend to pursue different types of R&D. **Product/service R&D** refers to efforts directed toward improvements or innovations in the quality or uniqueness of a company's outputs. For example, certain carmakers have been competing vigorously in the 2000s to develop high-performing and cost-competitive vehicles utilizing power sources other than gasoline.[37]

**Process R&D**
Research and development activities that seek to reduce the costs of operations and make them more efficient.

In contrast, **process R&D** seeks to reduce operational costs and make them more efficient. R&D is most important in rapidly changing industries where production modifications are most often required to remain competitive. Low-cost business units tend to emphasize process R&D to reduce their operations costs, whereas differentiators tend to place more importance on product/service R&D to produce improved and innovative outputs.

Product/service innovations can be risky. Once introduced, new products or services may not generate a level of demand sufficient to justify the R&D investment. RJR Nabisco, for example, has spent millions of dollars to develop and produce a smokeless cigarette. Although the new brands such as Premier and Eclipse were introduced with considerable fanfare, demand never materialized and the product was canceled after a short time.[38]

Interestingly, Japanese companies often abandon their new products as soon as they are introduced to force themselves to develop new replacement products immediately.[39] U.S. companies have responded by increasingly forming direct research links with their domestic competitors, asking their suppliers to participate in new-product design programs and taking ownership positions in small start-up companies that have promising technologies.[40]

## 8-4 Purchasing

All organizations have a purchasing function. In manufacturing firms, the purchasing department procures raw materials and parts so that the production department may process them into finished products. At the retail level, company buyers

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purchase items from manufacturers for resale to the consumer. Buyers must identify potential suppliers, evaluate them, solicit bids and price quotes, negotiate prices and terms of payment, place orders, manage the order process, inspect incoming shipments, and pay suppliers.

A business unit's purchasing strategy should be integrated with its competitive strategy. Generally speaking, low-cost businesses seek to purchase materials and supplies of basic quality at the lowest costs possible. Large organizations are able to lower costs further through their ability to demand quantity discounts. In addition, buyers that are larger than their suppliers and whose purchases represent a significant percentage of their suppliers' revenues may also possess considerable negotiating clout.

Small companies, however, can often attain low-cost purchasing through other means, such as working with other small businesses in the same industry to pool their purchasing requirements. Because of large quantities, industry networks are often able to wield as much power as a single large business in demanding quantity discounts and negotiating terms.

It is critical to note that low costs are not the only consideration in purchasing activities. Rather, low-cost businesses should seek the *best cost,* one that is as low as possible and consistent with basic quality standards of the purchased good or service. A low price is useless if the item breaks down in the production process or fails to meet customer demands. On the other hand, excessive quality unnecessarily raises costs and prices.[41]

Because their customers are willing to pay higher prices, differentiators tend to emphasize the procurement of high-quality inputs, even if they cost more than alternative offerings. In these cases, the quality of the parts or products takes precedence over cost considerations, although cost minimization is always desirable.

Purchasing is the first step in the materials management process. Indeed, purchasing also includes the operation of storage and warehouse facilities and the control of inventory.[42] Consequently, these related tasks can be efficiently and effectively conducted only if they are viewed as parts of a single operation, regardless of the business strategy employed.[43] The **just-in-time (JIT) inventory system** demonstrates the interrelationships. JIT was popularized by Japanese manufacturers to reduce materials management costs. Using this technique, the purchasing manager asks suppliers to ship parts at the precise time they are needed in production to hold inventory, storage, and warehousing costs to a minimum. As such, JIT has reduced costs for numerous large firms.

**just-in-time (JIT) inventory system**
An inventory system, popularized by the Japanese, in which suppliers deliver parts just at the time they are needed by the buying organization to use in its production process.

Although U.S. manufacturers have moved in the direction of JIT, this approach works particularly well in Japan where large manufacturers wield considerable bargaining power over their much smaller suppliers. Because JIT places great delivery demands on suppliers, it does not tend to work well when manufacturers do not possess great bargaining power, as is often the case in the United States. In addition, an occasional late supplier can cripple a firm's production process.[44]

A JIT system also makes a company highly vulnerable to labor strikes. For example, one of the plants that supplies parts to GM's Saturn manufacturing operations shut down for a short time due to a local labor dispute. Saturn, which uses the JIT system, suddenly found itself unable to produce any cars because it had no inventory of the more than three hundred metal parts that it purchased exclusively from the supplier whose plant was struck.[45]

Many large U.S. manufacturers seek a middle ground between traditional inventory systems and JIT. Most have reduced their number of suppliers from a

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> **Case Analysis 8-3**
>
> **Step 14: What Are the Organization's Production and Purchasing Strategies?**
>
> What approaches to production that support the current business-level strategy are in effect? Are these efforts successful? Why or why not? How does the firm's approach to production and purchasing differ from that of its competitors?

dozen or more to two or three to control delivery times and quality.[46] Companies are also strengthening their relationships with suppliers and providing them with detailed knowledge of their requirements and specifications. By working together, buyers and suppliers can improve the quality and lower the costs of the purchased items.[47]

## 8-5 Human Resources

The human resource management (HRM) functions include such activities as planning for future human resource (HR) needs, recruitment, placement, compensation, evaluation, and employee development. Strategic HRM seeks to build a workforce that enables the organization to achieve its goals.[48] A major detriment to effective HRM practices over the past two decades was an unprecedented wave of mergers and acquisitions. This massive restructuring of U.S. business has resulted in widespread layoffs and disillusioned, formerly loyal employees. Today, many workers no longer anticipate or even desire lifelong employment with a single firm.

Ineffective human resource policies can be detrimental to a firm, not only from a strategic perspective but also from a cost standpoint. As part of a labor agreement negotiated with the United Auto Workers, GM maintains a jobs bank where up to four hundred employees show up to work each day, do nothing, and earn wages and benefits that often exceed $100,000 annually. Collective costs of such programs to GM, Ford, and other manufacturers may be as high as $2 billion each year.[49] Such policies stifle productivity in an era when global competition demands that all of a firm's human resources work efficiently.

Strategy aside, all organizations are challenged to develop employee commitment to the company and to the job. Fostering commitment and developing a strong, competitive workforce require the creation and maintenance of attractive working conditions for employees that may include providing customized benefits, child day care, parental leave, and flexible working hours, as well as such traditional needs as training and development, job enrichment, and promotional opportunities for advancement.

In response to 9/11, numerous companies have heightened efforts to screen employees and investigate workers' history. Many argue that such efforts improve security at company facilities, whereas others cite examples of employees allegedly losing jobs over traffic violations or bounced checks. Nonetheless, today more than ever, security is a key strategy concern.[50]

An organization's strategy may be affected by the increasing diversity of the modern workforce. Women, Americans of African, Hispanic, and Asian descent, and persons with disabilities have already transformed the traditional white male image of many U.S. corporations. As a result, managers must learn to help persons from diverse backgrounds and functional areas work effectively as

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team members. The success of such cooperative endeavors as cross-functional teams, quality circles, and JIT inventory systems requires a unity of action that can be achieved only through the mutual respect and understanding of one's coworkers.

Although one might expect low-cost businesses to spend less on HR activities than their differentiated counterparts, this is not always the case, because attracting the best from the new workforce can support both strategies. Valuable human resources may enhance efficiency by lowering absenteeism and turnover and may promote differentiation by way of their innovative ideas and excellence in job performance.

The role played by human resources in an organization's strategic success is difficult to understate, especially in industries where turnover is historically high. Consider the fast-food industry in the United States, where it is not uncommon to experience turnover rates as high as 200 percent, compared to 10 to 15 percent at typical midsize and large organizations. Starting wages at fast-food companies generally hover around minimum wage. Some organizations have attempted to combat this problem by offering wages significantly higher than the minimum, whereas others, such as Domino's Pizza, have taken a more comprehensive approach. Domino's renamed its HR department "PeopleFirst" and started to focus more on attracting, training, and retaining exceptional store managers. The firm estimates HR costs of departing employees to be about $2,500 for hourly workers and $20,000 for managers. Domino's has experienced success with the program, reducing turnover significantly in the mid-2000s.[51]

Another key dimension of the HR strategy is that of benefits, specifically health care. Most organizations are struggling with the desire to provide health care as part of the compensation package while minimizing employment costs. To cut costs, some firms have even resorted to terminating workers who are disabled.[52] Needless to say, such decisions have strategic, legal, and ethical ramifications.

In a more narrow sense, a business unit's generic strategy can also influence specific components of its HR program. For example, a company's reward system should be tied to employee behavior that helps the business attain its goals. Hence, low-cost business units should reward employees who help reduce operating costs, differentiators should establish reward systems that encourage output improvements or innovations, and all businesses should reward excellent customer service.

## 8-5a Human Capital and Knowledge Management

When organizations see their employees as expenses, they tend to *minimize* the cost. However, when they see their employees as investments, they tend to *maximize* the value by managing them more strategically. Following this logic, strategic managers have recently begun to assess the value of **human capital**—the sum of the capabilities of individuals in an organization—as a source of competitive advantage.[53] According to the **knowledge management** perspective, people and their skills and abilities represent the only resource that cannot readily be reproduced by a firm's competitors if it is deemed to be a source of competitive advantage.[54] As such, high-performing firms must leverage their human capital if they are to remain successful over the long term.[55] Human capital can be developed through organizational learning.[56] Table 8-3 identifies ten factors that can promote the development of learning capabilities in an organization.

**Human Capital**
The sum of the capabilities of individuals in an organization.

**Knowledge Management**
People and their skills and abilities (i.e., knowledge capital) represent the only resource that cannot readily be reproduced by a firm's competitors. Knowledge capital must be effectively leveraged if high-performing firms are to remain as such over the long term.

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**TABLE 8-3 Factors that Facilitate Organizational Learning Capabilities**

| Factor | Description |
|---|---|
| 1. Scanning imperative | Interest in external happenings and in the nature of one's environment. Valuing the processes of awareness and data generation. Curious about what is "out there" as opposed to "in here." |
| 2. Performance gap | Shared perception of a gap between actual and desired state of performance. Disconfirming feedback interrupts a string of successes. Performance shortfalls are seen as opportunities for learning. |
| 3. Concern for measurement | Spend considerable effort in defining and measuring key factors when venturing into new areas; strive for specific, quantifiable measures; discourse over metrics is seen as a learning activity. |
| 4. Experimental mindset | Support for trying new things: curiosity about how things work; ability to "play" with things. Small failures are encouraged, not punished. See changes in work processes, policies, and structures as a continuous series of graded tryouts. |
| 5. Climate of openness | Accessibility of information, relatively open boundaries. Opportunities to observe others; problems/errors are shared, not hidden; debate and conflict are acceptable. |
| 6. Continuous education | Ongoing commitment to education at all levels; support for growth and development of members. |
| 7. Operational variety | Variety exists in response modes, procedures, systems; significant diversity in personnel. Pluralistic rather than monolithic definition of valued internal capabilities. |
| 8. Multiple advocates | Top-down and bottom-up initiatives are possible; multiple advocates and gatekeepers exist. |
| 9. Involved leadership | Leadership at significant levels articulates vision and is very actively engaged in its actualization; takes ongoing steps to implement visions; "hands-on" involvement in educational and other implementation steps. |
| 10. Systems perspective | Strong focus on how parts of the organization are interdependent; seek optimization of organizational goals at the highest levels; see problems and solutions in terms of systemic relationships. |

*Source: From B. Moingeon and A. Edmondson,* Organizational Learning and Competitive Advantage *(Thousand Oaks, CA: Sage, 1996), 43. Reprinted by permission of Sage Publications Ltd.*

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Amazon.com makes effective use of its knowledge. As an Internet pioneer, the firm has a great deal of experience and Web savvy, enabling the firm to address new market opportunities ahead of competitors. Amazon.com also maintains a database of customer information, allowing the firm to suggest additional products that may be of interest to the consumer when shopping online. The company has even used its recommendations feature occasionally to make "faux suggestions," purchase recommendations that are not tied to a consumer's purchase history, but enable the firm to promote its new product lines to existing customers.[57]

### 8-5b Knowledge and Competitive Advantage

Regardless of the choice of generic strategy, the acquisition and development of knowledge can be a source of competitive advantage.[58] Five operating principles can help guide this process.[59]

1. Knowledge-based strategies begin with strategy, not knowledge. Knowledge can *support* the traditional mechanisms for serving customers and delivering value, but cannot replace them.
2. Knowledge-based strategies must be linked to traditional measures of performance. Quantifying the value of knowledge as a resource or an investment is difficult. However, performance can be evaluated only with quantifiable, objective measures.
3. Executing a knowledge-based strategy is about nurturing people with knowledge, not managing knowledge per se. Companies must develop cultures conducive to learning,

sharing, and personal growth; otherwise, its collective knowledge—housed within its people—will never be realized.

4. Organizations leverage knowledge through networks of people who collaborate, not networks of technology that interconnect. Technology cannot completely replace the need for the human interaction that transforms knowledge into market-viable innovations.
5. The engine that drives knowledge development comes from the workers' need for help in solving business problems. Company efforts to disseminate knowledge to its workers often lead to overload and frustration.

## 8-6 Information Systems Management

An effective information system (IS) can benefit all of a business unit's functional areas.[60] A computer-based decision support system can permit each functional area to access the information it needs and to improve coordination by communicating electronically with the other functional departments. Like HR, the link between the IS strategy and the business strategy is not always clear. An effective IS strategy can also cut internal costs while promoting differentiation and quality through a faster response to the market. Wal-Mart's system, for example, manages the reordering process on a real-time basis for the purchasing department while also providing critical data for the marketing department, such as which product combinations are most popular and the time of day certain products are likely to be purchased.

The value of quality information is not always easy to assess, but it can be great. Progressive online retailers such as Overstock.com, Delightful Deliveries, and Sierra Trading Posts collect extensive aggregate data about customer shopping habits and use it to craft personalized marketing approaches. A surfer's gender, location, or connection speed can determine whether this consumer is linked to a free shipping promotion or provided instant access to an online customer service representative. Internet searches using the words *cheap* and *discount* often pull up contextual advertisements targeted to bargain hunters. Creating a system to manage and utilize such data effectively can help retailers enhance their strategic effectiveness, regardless of business strategy.[61]

Whether an information system is conducted in-house or outsourced, it is deemed effective if it helps the business carry out its strategy. Far too many companies emphasize the hardware and software components of their functional system rather than the system's ability to satisfy customer needs.[62] Today, more than ever, the application of Internet technology to serve customers and support suppliers is typically a focal point of the IS strategy (see Case Analysis 8-4).

### Case Analysis 8-4

**Step 15: What Are the Current Strategies in Other Functional Areas Such as HR and Information Systems?**

What HR policies that support the current business-level strategy are in effect? Are these efforts successful? Why or why not? Is the organization poised to meet HR needs (changes in the workforce, etc.) in the future? How do the firm's human resources objectively compare to those of its competitors?

What is the current state of the organization's information system? Is it supporting the implementation of the organization's business and corporate strategies? Why or why not? Does the firm have a competitive presence on the Internet? How does this presence compare to those of its competitors?

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## 8-7 Summary

After corporate-level and business unit generic strategies are developed, top executives must align activities in the functional areas to ensure that the various departments are well coordinated and work together. Most notably, the functions of marketing, finance, production, purchasing, human resources, and information systems—including utilization of the Internet—should be considered.

In many instances, an organization's business strategy suggests appropriate characteristics of its functional strategies. Each organization should develop integrated functional strategies that support the uniqueness of its business and corporate strategies.

### *Key Terms*

capital-labor substitution
experience curve
functional strategies
human capital
just-in-time inventory system
knowledge management
learning
process R&D
product/service R&D
total quality management

### *Review Questions and Exercises*

1. What are the relationships among corporate-level, business unit, and functional strategies?
2. Why and how should the four Ps of marketing be aligned to support the organization's business strategy?
3. What is the difference between product and process R&D? How can each align with business strategies?
4. Relate the concept of the experience curve to the production operations of an automobile assembly plant.
5. Explain the role of business process reengineering in various functional strategies.
6. Explain the linkage that a just-in-time inventory system provides between the purchasing and production functions. What are the implications for quality?

### *Practice Quiz*

***True or False***

1. Because functional strategies should be designed to support corporate and business strategies, they should not be considered until corporate and business strategies have been formulated.
2. The most appropriate means of securing funds will depend heavily on the corporate and business strategies being pursued.
3. The reduction in per unit costs that occurs as an organization gains experience producing a product or service is known as economies of scale.
4. The purchasing department in a low-cost business should always purchase raw materials at the lowest possible cost.
5. The human resources department in a low-cost business should always attempt to hire managers and workers at pay rates below those of their competitors.
6. A key characteristic of an effective information system is its ability to serve and help integrate the other functional areas of the business.

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### *Multiple Choice*

**7.** Functional strategies should
- **A.** be integrated across the business unit.
- **B.** support the business strategy.
- **C.** support the corporate strategy.
- **D.** all of the above

**8.** Which of the following is not part of the marketing strategy?
- **A.** pricing
- **B.** distribution
- **C.** promotion
- **D.** none of the above

**9.** The experience curve is based on which of the following?
- **A.** potential for capital-labor substitutions
- **B.** economies of scale
- **C.** organizational learning
- **D.** all of the above

**10.** Efforts directed toward improvements or innovations in the quality or uniqueness of a company's outputs is known as
- **A.** product R&D.
- **B.** process R&D.
- **C.** product innovation.
- **D.** structural reorganization.

**11.** Reducing operational costs by making the production process more efficient is known as
- **A.** total quality management.
- **B.** process R&D.
- **C.** product innovation.
- **D.** structural innovation.

**12.** Which of the following is not a characteristic of the just-in-time (JIT) approach to inventory?
- **A.** JIT is difficult on suppliers.
- **B.** JIT reduces inventory costs.
- **C.** JIT is less risky than traditional inventory approaches.
- **D.** JIT is popular in Japan.

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READING 8-1

# Insight from *strategy+business*

*In some respects, larger firms have an edge over smaller firms. To exercise this advantage, however, its top managers must understand when and how firm size can be an asset. This chapter's strategy+business reading makes the case that scale economies, network efforts, and economies of scope offer an advantage for larger firms, but only in certain circumstances.*

## The Big, the Bad, and the Beautiful

***Size comes in three flavors–scale, scope, and network. Choose wisely from the menu.***

**By Tim Laseter, Martha Turner, and Ron Wilcox**

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Wal-Mart Stores Inc. dominates the retail industry. The Microsoft Corporation controls the market for PC software. General Electric Company has generated superior returns for decades. Each one ranks, on the basis of annual revenues, as the largest company of its type. Are they succeeding because they are large, or are they large because they are succeeding?

Consider three New Economy survivors: Amazon.com Inc., eBay Inc., and Cisco Systems Inc. During the Internet boom, companies pursued growth and size as key elements of their business strategy. Most failed in that pursuit. Were the few that succeeded simply lucky, or did they understand something that their competitors did not?

Size does matter, but only if you understand why and use that knowledge to create a competitive advantage. Three theories support the bigger-is-better argument: scale economies, network effects, and economies of scope. Each theory derives its logic from a different source and applies only in certain circumstances. Pursuit of size without a clear understanding of these concepts can lead to oblivion rather than dominance.

### Scale Economies

The theory of increasing returns to scale, or scale economies, dates to the beginning of the 20th century and a set of British economists, including Alfred Marshall, AC. Pigou, and Nicholas Kaldor. Building upon Adam Smith's original observations, these economists reasoned that larger companies would achieve productivity advantages due to greater opportunities for division of labor.

Technically, a scale curve measures production costs as a function of facility capacity. Plotted on a logarithmic scale, the slope of the curve shows the fixed percentage reduction in cost for each doubling of capacity. Businesses with operations that offer significant economies of scale, such as wafer fabrication for integrated circuits, have steep scale curves where costs drop significantly when facility capacity increases—which is why the Intel Corporation and other chip makers regularly invest upward of a billion dollars in new higher-capacity facilities.

Other businesses, such as apparel-producing plants, exhibit very limited scale economies. Since there is little opportunity to automate the process of sewing a dress or shirt, a larger apparel plant simply contains more sewing machines. A plant with 200 sewing machines run by individual operators doesn't produce shirts and dresses much more cheaply than one with only 100 machines. There is little value in having a bigger apparel factory.

Wal-Mart now ranks as the largest company on the planet. Although retailing, in general, has relatively limited opportunities to benefit from economies of scale, Wal-Mart has prospered by leveraging scale where it matters. For example, a Wal-Mart store building does not offer dramatic scale economies. A 100,000-square-foot store costs slightly less to build per square foot than a 50,000-square-foot store, but not enough less to provide a big competitive advantage. A retail distribution network, on the other hand, exhibits significant scale economies by enabling a business to exploit a lower cost trade-off among facility costs, inventory costs, and transportation. Wal-Mart's distribution network dwarfs its smaller retail competitors' networks and produces a 1 to

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2 percent margin advantage by our estimates. Given the thin margins in retail, this advantage is significant.

Amazon.com has sought, and in some cases achieved, scale economies. Its distribution network, although a fraction of the size of Wal-Mart's, ranks among the largest networks for fulfilling direct customer orders (rather than moving full cases and pallets as a traditional retailer does). But, frankly, the scale economies in fulfillment remain relatively marginal. Amazon's key source of scale has come from its ability to amortize its massive investment in the Web shopping engine across multiple categories and also across service contracts with partner companies like Toys "R" Us Inc., the Target Corporation, and Circuit City Stores Inc. The cost of building and maintaining a user-friendly online shopping interface has proved to be beyond the means of many Amazon competitors.

Pursuing size under an assumption that you will gain scale economies in businesses with flat scale curves offers no advantage and can in fact lead to decreasing margins if the incremental size is gained through lower prices. And even where a steep slope is possible, scale advantages don't just happen. A company must seek them out and exploit them. Examples like Wal-Mart and Amazon highlight the specific sources of scale and how companies have gained competitive advantage from it.

### Network Effects

Network effects came to the fore of business strategy during the height of the Internet boom to justify the phenomenal valuations of dot-com startups. Stock analysts applied the logic that the value of a network grows proportionately to the square of the number of users, a property of networks asserted by Bob Metcalfe, developer of Ethernet, a technology for connecting computers in a local area network, and the founder of the 3Com Corporation. Following what became known as Metcalfe's Law, a company's value quadrupled when the number of users doubled. Or if the number of users quadrupled, the value grew 16-fold. Given the exponential growth of the Internet population, the projected value gains were simply astronomical.

Unfortunately, even though a customer connects to a company's Web site via a computer network, the business itself does not necessarily exhibit network effects. To better understand why, we need to return to the economic arguments that predated the hype.

Economists noted the existence of "network externalities" in their research covering everything from ATMs to electricity to software. Formally, a network externality occurs when the value of participation in a network depends on how many other parties or which parties already belong to the network. Accordingly, a network effect is a demand-side argument for size versus the supply-side argument for scale economies.

Reflect on the early days of the telephone. In 1876, after participating in a demonstration call between Washington, D.C., and Philadelphia, President Rutherford B. Hayes commented: "That's an amazing invention, but who would ever want to use one?" President Hayes failed to understand the network possibilities of the nascent tool. A phone connecting a central user in one city to another offered little advantage over the existing telegraph technology. But unlike telegraphy, a telephone required no special training to use, and, accordingly, the network grew to encompass many individual users. And, as more individuals acquired telephones, the value of having a phone increased for everyone connected to the network. More recently, the Internet has produced the same effect.

Economists argue that a market leader can gain a monopolistic position from the network effect by erecting "switching barriers." A competitor with a smaller network has trouble enticing customers to join its alternative network because it offers lower network value. Microsoft's dominance of the market for personal computer operating systems and ultimately PC application software offers an excellent example. Although alternative operating systems such as Unix, Linux, and Apple OS have challenged Microsoft's DOS and Windows systems, none have displaced them—even though some proponents claimed their alternatives offered superior functionality. Why? Because PC users value the ability to exchange files with other users without risk of compatibility problems. The largest network (in this case a virtual one) offers more value to the user. Similarly, the large base of Windows users drives application developers to tailor their products to Microsoft first. This also creates greater value for the users of the dominant network.

Among Internet-based companies, eBay exhibits the most powerful network effect. As more people list items for sale on eBay, the site attracts more buyers. The more buyers who bid on an item, the greater its value to the seller. This, in turn, attracts more sellers. For comparison, consider that Amazon.com has the same number of customers as eBay, but its business model generates nominal network effects. Amazon customers benefit from the product ratings of other customers, and the acquisition of more customers improves Amazon's ability to mine its

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sales data to create customized purchasing recommendations, but the impact of this network effect is relatively small compared to eBay's.

As the early leader in creating an auction community, eBay built a network unmatchable by others. The site claims to have had 28 million active customers in 2002, and it offers about 16 million listings in its 27,000 categories on a typical day. UBid Inc., the second largest auction site, claims 3 million registered users bidding on its rotating stock of 12,000 branded products in 16 categories.

Even though uBid compares itself to eBay, its inherent business model offers less of a network effect. Since eBay primarily auctions used products, its customers tend to be both buyers and sellers. Competitor uBid auctions new branded products from a small base of dedicated sellers. This means the more customer-bidders there are joining the network, the higher the realized price will be on the network. This benefits the small population of sellers, but harms the disproportionately larger community of buyers.

In other words, sometimes a network, however large, produces little value. Many dot-coms focused on growth in customers as a key strategic tenet under the false assumption that size always translates into competitive advantage from scale economies and network effects. Such was the expectation of the ill-fated "last-mile delivery" companies Webvan, Kozmo, and UrbanFetch, but in reality their costs were largely variable and their customers didn't get incremental value from an increase in the customer base. (See 'The Last Mile to Nowhere: Flaws & Fallacies in Internet Home-Delivery Schemes," by Tim Laseter et al., *s+b*, Third Quarter 2000.) Here size added little advantage, and ill-advised pursuit of rapid growth led to their demise.

## Economies of Scope

The third theory supporting the size argument, economies of scope, concerns the benefits achieved by offering more than one product or service through the same organization. Economies of scope can affect both supply and demand.

General Electric captures demand-side benefits through its ability to bundle services from its financing unit with products from manufacturing units. For example, GE has long allowed its customers to finance the multimillion-dollar purchase of its jet engines via a leasing arrangement from GE Finance. More recently, GE has pursued a service strategy of selling "power by the hour" so that an airline doesn't buy a specific engine. Instead, a customer pays for access to a rotating stock of engines serviced and maintained by GE. On the supply side, GE Appliances combines with GE Motors and GE Aircraft Engines to purchase sheet steel in larger quantities for lower prices.

The most powerful economy of scope at General Electric, however, is probably the least tangible: Its vaunted management development system. The company can provide a breadth of experiences to its managers, who ultimately transfer best practices across disparate divisions. For example, Six Sigma, the analytical improvement process, was viewed largely as a tool for high-volume manufacturing operations until GE proved it could be applied across its wide range of businesses, including broadcast network NBC and finance arm GE Credit.

Cisco Systems offers a New Economy example of a strategy based on economies of scope. Originally a focused producer of Internet routers, Cisco launched what ultimately became a massive expansion of scope with its acquisition of Crescendo Communications in September 1993. From this initial expansion from routers to switches, Cisco made 39 additional acquisitions through 1999 and now boasts a full line of network equipment as varied as modems, wireless local area network equipment, and optical switches. Cisco thereby captured economies of scope by putting more products through the same organization. It loaded the new products into the plants of its existing contract manufacturers, and its sales organization could then offer complete solutions to its partner customers. These economies of scope helped Cisco build its dominant position as a supplier of the infrastructure of the Internet.

Such product line expansion does not necessarily lead to economies of scope. If Cisco had not consolidated the manufacturing activities of its acquisitions and enabled its sales forces to offer complete solutions, it would have captured little advantage from the broader product line.

In fact, economies of scope can be negative as well as positive. Empirical research has demonstrated the value of "focused factories," which were first described by Harvard Business School professor Steven Wheelwright in the early 1970s. Arguments for focusing on core competencies, or more colloquially "sticking to one's knitting," stem from a recognition that multi-line businesses suffer from "costs of complexity." (Sometimes described by the misnomer *diseconomies of scale,* the disadvantages of size are more appropriately viewed as diseconomies of scope.)

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The ill-fated diversification strategy of Sears, Roebuck and Company in the 1980s offers a prime example of a failed attempt to capture economies of scope. Sears, which had owned Allstate insurance since the 1930s, set out to build a consumer-oriented financial-services business by acquiring the real estate broker Coldwell Banker & Company and the stock brokerage firm Dean Witter. The company would accrue economies of scope by locating the stockbrokers within the Sears stores and by sharing information across business units. After all, the purchaser of a new home likely needs new appliances and homeowners insurance, too.

Unfortunately, the expansion led to what marketers call perceptual incongruity. Consumers accepted that Sears was a great source for appliances and power tools, but failed to accept that it could offer equal expertise in financial services. Furthermore, the added complexity of managing the disparate businesses drained the attention of Sears management. And the core department store business began to struggle. Ultimately, Sears reversed its diversification strategy and sold off its nonretail businesses in the early 1990s.

As these examples demonstrate, neither product line expansion nor business diversification automatically generates economies of scope. Economies of scope accrue only to companies that identify and capture synergies while simultaneously managing the risk of added complexity. Thus, scope expansion provides a powerful but double-edged sword. Broader scope can provide supply-side and demand-side advantage. But increased complexity can confuse consumers and distract management from the core value proposition of a company. Although a multiline company should seek synergies across unrelated business units, beware a company that tries to justify an expansion strategy purely on the basis of economies of scope.

## Defense vs. Offense

So, returning to our opening question, does size drive success or does success drive size? Although the three distinct theories described above propound solid arguments for the advantages of size, we believe that more often than not, success generates superior size rather than vice versa.

Although Wal-Mart posted $244 billion in revenues in 2002, its revenues in 1983 were a mere $4.7 billion, about one-eighth those of then-dominant retailer Sears. Not until 1990 and 1992, respectively, did Wal-Mart pass the Kmart Corporation and Sears in total revenues. Wal-Mart grew to a dominant position because it offered a superior customer proposition. As it grows, it certainly leverages its size for further advantage—but it didn't gain its dominance simply through the pursuit of size as a strategic objective.

In fact, size may offer a more effective defense than offense. The General Motors Corporation, Wal-Mart's predecessor in defining American business, provides ample evidence of the lingering, but continually fading, value of size. GM passed Ford Motor Company as the No. 1 global producer of automobiles in 1931 and became such an icon that Charles E. Wilson, a former GM executive, proclaimed before a congressional committee in 1952, "What is good for the country is good for General Motors, and what's good for General Motors is good for the country." Today, GM remains the largest producer of automobiles in the world by revenues, but ranks eighth in profits among vehicle producers, behind Toyota, Volkswagen, Daimnler-Chrysler, BMW, Peugeot, Renault, and Honda (rankings based on an average of 2001 and 2002). Toyota has less than half the sales of GM but nearly four times the profits. Size may provide an advantage, but size without profitability is of limited value.

Size certainly offers benefits to the companies that understand and exploit it. But size alone offers a relatively weak basis for a corporate strategy. A small company that executes well offers far more potential than a large, feeble one. In the end, it's not the size that matters, but how you use it.

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**Tim Laseter** (laseter@darden.virginia.edu) is the author of *Balanced Sourcing: Corporation and Competition in Supplier Relationships* (Jossey-Bass, 1998) and serves on the operations faculty at the Darden Graduate School of Business at the University of Virginia. Formerly a vice president with Booz Allen Hamilton, he has 20 years of experience in supply chain management and operations strategy.

**Martha Turner** (turner_Martha@bah.com) is a senior associate in Booz Allen Hamilton's New York office. She specializes in operations and supply chain management issues in a broad range of industries.

**Ron Wilcox** (wilcoxr@darden.virginia.com) is an associate professor of business with the Darden Graduate School of Business at the University of Virginia. He was formerly an economist at the Securities and Exchange Commission. His articles on business strategy have appeared in leading academic and industry journals.

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# *Real-Time Case 24: Papa John's*

Papa John's is the third-largest pizza chain in the United States behind Pizza Hut and Domino's. The company operates about 3,000 pizzerias in the United States and about thirty other countries. Papa John's typically offers delivery and carry-out options, but no restaurant seating. CEO John Schnatter founded Papa John's in 1985 at age twenty-three and owns 30 percent of the company.

Papa John's has always distinguished itself from the pizza crowd by using only fresh ingredients, concentrating on quality, and limiting the number of nonpizza items on the menu. The company frequently comes out on top in national taste tests and customer service surveys. Papa John's has received the top customer satisfaction rating among all national fast-food restaurant chains every year from 1999 to 2004, as measured by the American Customer Satisfaction Index.

Customer satisfaction successes notwithstanding, Papa John's has secured only about 7 percent of the quick-service pizza segment, behind Pizza Hut with 20 percent and Domino's with 12 percent. Other competitors include Pizza Inn, Little Caesar's, and Cici's, a rapidly growing pizza restaurant featuring a low-priced buffet offered around the clock. In addition, each location usually features independent pizzerias that have only one or a few locations.

In 2002, Papa John's initiated a move to close underperforming stores and open new ones only when prospects are very strong. For example, the company opened 103 franchised restaurants and 10 company-owned stores in 2002, while closing 76 franchised restaurants and 19 company-owned stores. As a result, revenues became stagnant in 2002 and 2003.

The Papa John's menu includes pizza with limited side items such as breadsticks and chicken strips. Bottled soft drinks are also available. Papa John's traditional pizza crust is made fresh, topped with 100 percent mozzarella cheese, meats with no fillers, and fresh vegetables. Locations abroad also emphasize pizza quality, but menus are adapted to local tastes.

During 2003 and 2004, Papa John's has closed unprofitable stores, while selling a number of units to franchisees. The firm has also emphasized global expansion as of late. Papa John's opened its first store in Russia in late 2003 and expanded its number of stores in Canada and the Bahamas in 2004. Papa John's appointed Blockbuster executive Nigel Travis as CEO in 2005.

Papa John's operates quality control (QC) centers that offer economies of scale and deliver fresh ingredients to stores twice weekly. Domestic franchises are required to purchase dough and spice mix from the QC centers or approved suppliers to ensure consistent quality. The firm consistently scores well in independent evaluations of quality, including consecutive top rankings in the *Restaurants & Institutions* survey of national take-out and delivery pizza chains in 2004 to 2006.

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## Perspectives

- White, J., "Come to papa," *Pizza Today*, 2004 September. Papa John's has experienced storybook growth since its inception in 1985. Today, the restaurant's emphasis on "better ingredients, better pizza" seems to keep it focused and successful.
- "Papa John's opens first Chinese pizza outlet in Shanghai," *Business Daily Update*, 27 October 2003. Papa John's opened its first pizza outlet in China, the beginning of an aggressive growth effort for the firm there.
- "Papa John's earns top rating among national take-out and delivery pizza chains in *Restaurants & Institutions'* survey," *Business Wire*, 4 December 2006. About 3,100 consumers rated 120 national and regional restaurant chains on eight customer satisfaction attributes. Papa John's earned the highest score in 2006 and its best score ever.

## Case Challenges

- Why does Papa John's seem to be pursuing a stability strategy in a market where some of its key competitors are expanding rapidly?
- To what extent do low-cost pizza providers such as Little Caesar's and Cici's pose a threat to Papa John's?
- Should Papa John's develop eat-in restaurants like Pizza Hut or stick to delivery and carry-out?



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## Internet Sites of Interest

- Corporate Web site: www.papajohns.com
- Web sites of key competitors: www.dominos.com, www.pizzahut.com, www.cicispizza.com
- Pizza Marketplace: www.pizzamarketplace.com
- *Pizza Today*: www.pizzatoday.com
- *Restaurants & Institutions*: www.rimag.com
- *Nation's Restaurant News*: www.nrn.com
- National Restaurant Association: www.restaurant.org
- Restaurant News Resource: www.restaurantnewsresource.com

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