

# CHAPTER 1

## WHAT IS STRATEGY AND WHY IS IT IMPORTANT?

### CHAPTER SUMMARY

Chapter 1 defines the concept of strategy and describes its many facets. The chapter explains what is meant by a competitive advantage, discusses the relationship between a company's strategy and its business model, and introduces the student to the kinds of competitive strategies that can give a company an advantage over rivals in attracting customers and earning above-average profits. The chapter examines what sets a winning strategy apart from others and why the caliber of a company's strategy determines whether it will enjoy a competitive advantage over other firms or be burdened by competitive disadvantage. By the end of this chapter, the student will have a clear idea of why the tasks of crafting and executing strategy are core management functions and why excellent execution of an excellent strategy is the most reliable recipe for turning a company into a standout performer over the long term.

### LECTURE OUTLINE

#### I. Introduction

Many factors enter into a full explanation of a company's performance, of course. Some come from the external environment; others are internal to the firm. But only one thing can account for the kind of long-lived success records that we see in the world's greatest companies—and that is a cleverly crafted and well executed *strategy*, one that facilitates the capture of emerging opportunities, produces enduringly good performance, is adaptable to changing business conditions, and can withstand the competitive challenges from rival firms.

#### II. What Do We Mean by Strategy?

1. A company's **strategy** is its action plan for outperforming its competitors and achieving superior profitability. In effect, it represents a managerial commitment to an integrated array of considered choices about how to compete.
2. Normally, companies have a wide degree of strategic freedom in choosing the “hows” of strategy:
  - How to attract and please customers.
  - How to compete against rivals.
  - How to position the company in the marketplace.
  - How best to respond to changing economic and market conditions.
  - How to capitalize on attractive opportunities to grow the business.
  - How to achieve the company's performance targets.

**CORE CONCEPT**

A company's **strategy** consists of the competitive moves and business approaches that managers are employing to compete successfully, improve performance, and grow the business.

3. Every strategy needs a distinctive element that attracts customers and produces a competitive edge. But there is no shortage of opportunity to fashion a strategy that both tightly fits a company's own particular situation and is discernibly different from the strategies of rivals.

**III. Strategy and the Quest for Competitive Advantage**

1. The heart and soul of any strategy is the actions and moves in the market place that managers are taking to improve the company's financial performance, strengthen its long-term competitive position, and gain a competitive edge over rivals.
2. A company achieves a competitive advantage whenever it has some type of edge over rivals in attracting buyers and coping with competitive forces.
3. Strategy is about competing differently from rivals or doing what competitors don't do or, even better, can't do. In this sense, every strategy needs a distinctive element that attracts customers and produces a competitive edge.
4. *Figure 1.1 – Identifying a Company's Strategy—What to Look For*, shows what to look for in identifying the substance of a company's overall strategy. These are the visible actions taken that signal what strategy the company is pursuing.

**ILLUSTRATION CAPSULE 1.1****McDonald's Strategy in the Quick-Service Restaurant Industry**

**Discussion Question:** 1. To what would you attribute McDonald's sales growth during the recent global economic downturn? Why?

**Answer:** The company's success can be attributed directly to both excellent strategy formulation and effective strategy execution. Their Plan to Win strategy improved the company's value proposition allowing sales growth in 2011 despite the economic slowdown experienced worldwide, as well as improved their business model to ensure profitability. This comprehensive strategy included initiatives to improve and streamline operations, maintain affordable prices, and maintain a wide menu selection. Their overall focus was on "being better, not just bigger," and this dual approach illustrates the importance of focusing on increasing revenue as well as decreasing costs in order to optimize profit.

5. What makes a competitive advantage **sustainable** (or durable), as opposed to temporary, are elements of the strategy that give buyers lasting reasons to prefer a company's products or services over those of competitors

**CORE CONCEPT**

A company achieves a **competitive advantage** when it provides buyers with superior value compared to rival sellers or offers the same value at a lower cost to the firm. The advantage is sustainable if it persists despite the best efforts of competitors to match or surpass this advantage.

4. Four of the most frequently used strategic approaches to setting a company apart from rivals and achieving a sustainable competitive advantage are:
  - a. Striving to be the industry's low-cost provider, thereby aiming for a cost-based competitive advantage over rivals – Low Cost Leader
  - b. Outcompeting rivals on the basis of differentiating features, such as higher quality, wider product selection, added performance, value-added services, more attractive styling, and technological superiority – Differentiation
  - c. Developing an advantage based on offering more value for the money – Best Cost Provider
  - d. Focusing on a narrow market niche within an industry – Niche Market

#### IV. Why a Company's Strategy Evolves over Time

1. Every company must be willing and ready to modify the strategy in response to changing market conditions, advancing technology, unexpected moves by competitors, shifting buyer needs, emerging market opportunities, and mounting evidence that the strategy is not working well.
2. Most of the time, a company's strategy evolves incrementally from management's ongoing efforts to fine-tune the strategy and to adjust certain strategy elements in response to new learning and unfolding events. 5??
3. Industry environments characterized by high velocity change require companies to repeatedly adapt their strategies.
4. The important point is that the task of crafting strategy is not a one-time event but always a work in progress.

#### V. A Company's Strategy Is Partly Proactive and Partly Reactive

1. The evolving nature of a company's strategy means that the typical company strategy is a blend of (1) *proactive*, planned initiatives to improve the company's financial performance and secure a competitive edge, and (2) *reactive* responses to unanticipated developments and fresh market conditions.

#### CORE CONCEPT

**A company's deliberate strategy** consists of **proactive** strategy elements that are both planned and realized as planned; its **emergent strategy** consists of **reactive** strategy elements that emerge as changing conditions warrant.

2. The biggest portion of a company's current strategy flows from ongoing actions that have proven themselves in the marketplace and newly launched initiatives aimed at building a larger lead over rivals and further boosting financial performance. - Deliberate Strategy
3. Managers must always be willing to supplement or modify the proactive strategy elements with as-needed reactions to unanticipated conditions. – Emergent Strategy
4. In total, these two elements combine to form the company's Realized Strategy. **Figure 1.2, A Company's Strategy is a Blend of Proactive Initiatives and Reactive Adjustments**, illustrates the elements of strategy that become the Realized Strategy.

## VI. A Company's Strategy and its Business Model

### CORE CONCEPT

A company's **business model** sets forth the logic for how its strategy will create value for customers, while at the same time generate revenues sufficient to cover costs and realize a profit.

1. A business model is management's blueprint for delivering a valuable product or service to customers in a manner that will generate revenues sufficient to cover costs and yield an attractive profit.
2. The two elements of a company's business model are (1) its customer value proposition and (2) its profit formula.
3. The customer value proposition lays out the company's approach to satisfying buyer wants and needs at a price customers will consider a good value.
4. The profit formula describes the company's approach to determining a cost structure that will allow for acceptable profits, given the pricing tied to its customer value proposition.

### ILLUSTRATION CAPSULE 1.2

#### Sirius XM and Over-the-Air Broadcast Radio: Two Contrasting Business Models

**Discussion Question:** 1. What is the prominent difference between the business models of these two organizations?

**Answer:** While both provide essentially the same type of entertainment service, the business models employed by Sirius XM and Over-The-Air Broadcast Radio are completely different. In the area of value proposition (what the customer sees), Sirius XM provides commercial free entertainment with some local content based upon a monthly fee, while Broadcast Radio provides entertainment with some local content with interruptions for commercials without a fee. For profit, Sirius XM must attract a large enough customer base in order to cover costs and provide profit, while Broadcast Radio must attract a large enough advertiser base to cover costs and provide profit.

## VII. What Makes a Strategy a Winner?

1. Three questions can be used to test the merits of one strategy versus another and distinguish a winning strategy from a losing or mediocre strategy:

### a. The Fit Test:

How well does the strategy fit the company's situation? To qualify as a winner, a strategy has to be well matched to industry and competitive conditions, a company's best market opportunities, and other aspects of the enterprise's external environment. Unless a strategy exhibits a tight fit with both the external and internal aspects of a company's overall situation, it is likely to produce less than the best possible business results.

### b. The Competitive Advantage Test:

Can the strategy help the company achieve a sustainable competitive advantage? The bigger and more durable the competitive edge that a strategy helps build, the more powerful and appealing it is.

c. The Performance Test:

Is the strategy resulting in good company performance? Two kinds of performance improvements tell the most about the caliber of a company's strategy: (1) gains in profitability and financial strength and (2) gains in the company's competitive strength and market standing.

2. Strategies that come up short on one or more of the above questions are plainly less appealing than strategies passing all three test questions with flying colors.

### VIII. Why are Crafting and Executing Strategy Important?

1. Crafting and executing strategy are top priority managerial tasks for one very big reason: High-achieving enterprises are nearly always the product of astute, creative, and proactive strategy making.
2. Good Strategy + Good Strategy Execution = Good Management
  - a. Crafting and executing strategy are core management functions.
  - b. Among all the things managers do, nothing affects a company's ultimate success or failure more fundamentally than how well its management team charts the company's direction, develops competitively effective strategic moves and business approaches, and pursues what needs to be done internally to produce good day-to-day strategy execution and operating excellence.

### IX. The Road Ahead

1. Throughout the remaining chapters and the accompanying case collection, the spotlight is trained on the foremost question in running a business enterprise: What must managers do, and do well, to make a company a winner in the marketplace?
2. The mission of this book is to provide a solid overview of what every business student and aspiring manager needs to know about crafting and executing strategy.

## ASSURANCE OF LEARNING EXERCISES

1. Based on what you know about the quick-service restaurant industry, does McDonald's strategy as described in Concepts & Connections 1.1 seem to be well matched to industry and competitive conditions? Does the strategy seem to be keyed to a cost-based advantage, differentiating features, serving the unique needs of a niche, or some combination of these? What is there about McDonald's strategy that can lead to sustainable competitive advantage?

McDonald's market growth despite the recent global economic challenges is a clear indication that their strategy is well matched to both industry and competitive conditions. Total 2011 revenue of \$27.0B up from 2010's \$24.07B revenue demonstrates the effectiveness of their value proposition, while an operating income of \$8.5B demonstrates the efficiency of their operations.

Does the strategy seem to be keyed to having a cost-based-advantage, offering differentiating features, serving the unique needs of a narrow market niche, or being the best-cost provider?

McDonald's is moving towards a best-cost strategy. Their key initiatives include a strong value proposition aimed at providing better quality products and services while keeping strict price controls in place. Their affordable pricing is being made possible by strict cost control across the entire enterprise.

What is there about the action elements of McDonald's strategy that is consistent with its approach to competitive advantage?

Their competitive advantage is in delivering quality products and services at lower prices. Their action elements of (1) improved restaurant operations, (2) affordable pricing, and (3) wide menu variety and beverage choices all work together to provide competitive advantage.

From the information provided, which tests of a winning strategy does McDonald's strategy pass?

- (1) Fit Test – Yes, fits internally and externally.
  - (2) Competitive Advantage Test – Yes, market share and profit indicates competitive advantage.
  - (3) Performance Test – Yes, growth and profitability indicate performance.
2. Elements of Walmart's strategy have evolved in meaningful ways since the company's founding in 1962. Prepare a one- to two-page report that discusses how its strategy has evolved after reviewing all of the links at Walmart's About Us page, which can be found at [walmartstores.com/AboutUs/](http://walmartstores.com/AboutUs/). Your report should also assess how well Walmart's strategy passes the three tests of a winning strategy.

Walmart has staked out the low-cost leadership position in their market and are dominating the competition. Their gross profit margins continue to grow as a percentage of sales indicating a focus on cost control with 2010 gross profit margin of 24.8%. This is a steady yearly increase over the last five years starting with 23.1% in 2006. Walmart continues to maintain market growth despite the recent global economic challenges is a clear indication that their strategy is well matched to both industry and competitive conditions. Total 2010 revenue of \$405.0B up from 2009's \$401.17B revenue demonstrates the effectiveness of their value proposition, while an operating income of \$23.95B demonstrates the efficiency of their operations.

From the information provided, which tests of a winning strategy does McDonald's strategy pass?

- (1) Fit Test – Yes, fits internally and externally.
  - (2) Competitive Advantage Test – Yes, market share and profit indicates competitive advantage.
  - (3) Performance Test – Yes, growth and profitability indicate performance.
3. Go to [www.nytimes.com/investors](http://www.nytimes.com/investors) and check whether *The New York Times*' recent financial reports indicate that its business model is working. Does the company's business model remain sound as more consumers go to the Internet to find general information and stay abreast of current events and news stories? Is its revenue stream from advertisements growing or declining? Are its subscription fees and circulation increasing or declining?

The responses offered by the students may include information such as the following. The New York Times Company is a leading media company that includes The New York Times, the International Herald Tribune, The Boston Globe, 15 other daily newspapers and more than 50 Web sites. The company's core purpose is to enhance society by creating, collecting and distributing high-quality news, information and entertainment.

The student should note that the company's annual revenue has declined steadily over the last five reporting periods from \$2.32B in fiscal 2011 to \$3.18B in fiscal 2007, while net income has fluxuated greatly over the period with \$107M in 2010, a loss of \$57.8M in 2008, and a recent loss of \$39.67 in 2011. This illustrates a reducing value proposition (revenue) as well as an ineffective and unpredictable profit formula (earnings). The conclusion the student should reach is that the business model is not working effectively.

Can the company's business model remain sound as more consumers go to the Internet to find general information and stay abreast of current events and news stories? Is its revenue stream from advertisements growing or declining? Are its subscription fees and circulation increasing or declining?

Based on a review of the Web site, students should recognize there is evidence the company's business model is both changing and evolving. The company was proactive in assessing several changes in the media industry. For example, consumers are increasingly getting news and information from the Web, and advertisers are paying lower rates online than for print. When the print and digital operations of newspapers

in the U. S. are combined, audiences are growing. These changes were also complicated by the downturn in the U. S. economy. The company believes it has earned the trust of its readers by employing professional journalists to verify news for truth, for accuracy and for context. The company also believes that “newspapers play a critical role in the civic life of our country. Information is the lifeblood of our democracy, and the work that our journalists do enables citizens to make thoughtful decisions.” While newspapers will continue to be an important medium, the company recognizes it must provide high-quality journalism in an increasing number of ways.

Thus, the Times Company has embarked on transforming from a company focused primarily on print to one that is increasingly digital in focus and multiplatform in delivery. This strategy involves a four-pronged emphasis on the following: (1) introduce new products and services both in print and online (goal is to deliver high-quality journalism so consumers can access it wherever and whenever they want it); (2) strengthen digital research and development capability to support the development of new products and alliances; (3) aggressively restructure the cost base via expense reductions in several areas; and (4) rebalance the portfolio of businesses through both acquisitions and divestitures (sell assets that no longer fit well with the Company).