

WHAT IS STRATEGY AND WHY IS IT IMPORTANT?

CHAPTER SUMMARY

Chapter 1 explores the concepts surrounding organizational strategy. It begins with an explanation of the term strategy and offers a basis for how to identify a company's particular strategy. Next, it explores the importance of striving for competitive advantage in the marketplace and examines the role strategy plays in achieving this advantage. The chapter then explores the idea that strategy is partly proactive and partly reactive. Next, a discussion on strategy and ethics is given. This is followed by a close look at the relationship between a company's strategy and its business model. The chapter proceeds forward with a look at what makes strategy a winner and then presents reasons for why crafting and executing strategy are important. The chapter concludes with thoughts on the equation: good strategy + good strategy execution = good management.

LECTURE OUTLINE

I. Introduction

Managers at all companies face three central questions in thinking strategically about their company's present circumstances and prospects: What's the company's present situation? Where does the company need to go from here? How should it get there? "What's the company's present situation?" prompts managers to evaluate industry conditions and competitive pressures, the company's current performance and market standing, its resource strength and capabilities and its competitive weaknesses. "Where does the company need to go from here?" pushes managers to make choices about the direction the company should be headed—what new or different customer groups and customer needs it should endeavor to satisfy, what market positions it needs to be staking out, what changes in its business makeup are needed. "How should it get there?" challenges managers to craft and execute a strategy—a full-blown action plan—capable of moving the company in the intended direction, growing its business, and improving its financial and market performance.

II. What Do We Mean by Strategy?

1. A company's strategy is management's action plan for running the business and conducting operations. The crafting of a strategy represents a commitment to pursue a particular set of actions: how to attract and please customers, how to compete successfully, how to conduct operations, and how to improve the company's financial and market performance.
2. Normally, companies have a wide degree of strategic freedom in choosing the "hows" of strategy:
 - a. They can compete in a single industry.
 - b. They can diversify broadly or narrowly.
3. For companies intent on gaining sales and market share at the expense of competitors, managers typically opt for the offensive strategies while risk-avoiding companies prefer conservative or defensive strategies.

4. There is no shortage of opportunity to fashion a strategy that tightly fits a company's own particular situation and that is discernibly different from the strategies of rivals.
5. **Illustration Capsule 1.1, McDonald's Strategy in the Quick-Service Restaurant Industry**, offers a concrete example of the actions and approaches involved in crafting strategy..

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 2010 despite the economic meltdown 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.

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.

A. 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. What makes a competitive advantage sustainable as opposed to temporary are actions and elements in the strategy that cause an attractive number of buyers to have a lasting preference for a company's products or services as compared to the offerings of competitors.
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.

CORE CONCEPT

A company achieves sustainable competitive advantage when an attractive number of buyers prefer its products or services over the offerings of competitors and when the basis for this preference is durable.

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.

- 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.
 - c. Focusing on a narrow market niche and winning a competitive edge by doing a better job than rivals of serving the special needs and tastes of buyers in the niche.
 - d. Aiming to offer the lowest (best) prices for differentiated goods that at least match the features and performance of higher-priced rival brands.
5. The bigger and more sustainable the competitive advantage, the better the company's prospects for winning in the market place and earning superior long-term profits relative to its rivals.

B. Identifying a Company's Strategy

- 1. A company's strategy is reflected in its actions in the marketplace and the statements of senior managers about the company's current business approaches, future plans, and efforts to strengthen its competitiveness and performance.
- 2. 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.
- 3. Once it is clear what to look for, the task of identifying a company's strategy is mainly one of researching information about the company's actions in the marketplace and business approaches.
- 4. To maintain the confidence of investors and Wall Street, most public companies have to be fairly open about their actions which can allow us to determine the likely strategy.
- 5. Except for some about-to-be-launched moves and changes that remain under wraps and in the planning stage, there is usually nothing undiscoverable about what a company's present strategy is.

C. Why a Company's Strategy Evolves over Time

- 1. Every company must be willing and ready to modify its strategy in response to changing market conditions, advancing technology, competitive moves, shifting buyer needs and preferences, emerging market opportunities, new ideas for improving the strategy, 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 pieces of the strategy, but, on occasion, major strategy shifts are called for.
- 3. Industry environments characterized by high velocity change require companies to rapidly adapt their strategies.
- 4. Thus, a company's strategy at any given point in time is fluid.

CORE CONCEPT

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

Changing circumstances and ongoing management efforts to improve the strategy cause a company's strategy to emerge and evolve over time—a condition that makes the task of crafting a strategy a work in progress, not a one-time event.

CORE CONCEPT

A company's business model sets forth the economic logic for making money in a business, given the company's strategy. It describes two critical elements; (1) the customer value proposition and (2) the profit formula.

D. A Company's Strategy Is Partly Proactive and Partly Reactive

1. A company's strategy is typically a blend of (1) proactive actions (deliberate strategy) on the part of managers to improve the company's market position and financial performance and (2) as-needed reactions (emergent strategy) to unanticipated developments and fresh market conditions.
2. **Figure 1.2, A Company's Strategy is a Blend of Proactive Initiatives and Reactive Adjustments**, depicts the typical blend found within a company's strategy.
3. The biggest portion of a company's current strategy flows from previously initiated actions and business approaches that are working well enough to merit continuation and newly launched managerial initiatives to strengthen the company's overall position and performance. This part of management's game plan is deliberate and proactive.
4. There will be occasions when market and competitive conditions take an unexpected turn that calls for some kind of strategic reaction or adjustment.
5. A portion of a company's strategy is always developed on the fly. It comes about as a reasoned response to unforeseen developments.
6. A company's strategy thus tends to be a combination of proactive and reactive elements.

III. The Relationship Between a Company's Strategy and Its Business Model**CORE CONCEPT**

A company's business model sets forth the economic logic for making money in a business, given the company's strategy. It describes two critical elements; (1) the customer value proposition and (2) the profit formula.

1. Closely related to the concept of strategy is the concept of a company's business model.
2. A company's business model is management's storyline for how and why the company's product offerings and competitive approaches will generate a revenue stream and have an associated cost structure that produces attractive earnings and return on investment.
3. The concept of a company's business model is consequently more narrowly focused than the concept of a company's business strategy. A company's strategy relates broadly to its competitive initiatives and business approaches while the business model zeros in on whether the revenues and costs flowing from the strategy demonstrate business viability.
4. **Illustration Capsule 1.2, Microsoft and Red Hat Linux: Two Contrasting Business Models**, discusses the contrasting business models of Microsoft and Red Hat Linux.

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.

V. 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.
3. Other criteria for judging the merits of a particular strategy include internal consistency and unity among all the pieces of strategy, the degree of risk the strategy poses as compared to alternative strategies, and the degree to which it is flexible and adaptable to changing circumstances.

CORE CONCEPT

A winning strategy must pass three test: (1) The Fit Test, (2) The Competitive Advantage Test, and (3) The Performance Test.

VI. Why are Crafting and Executing Strategy Important?

1. Crafting and executing strategy are top priority managerial tasks for two very big reasons:
 - a. There is a compelling need for managers to proactively shape or craft how the company's business will be conducted.
 - b. A strategy-focused organization is more likely to be a strong bottom-line performer.

A. Good Strategy + Good Strategy Execution = Good Management

1. Crafting and executing strategy are core management functions.
2. 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.
3. Good strategy and good strategy execution are the most trustworthy signs of good management.
4. The better conceived a company's strategy and the more competently it is executed, the more likely it is that the company will be a standout performer in the marketplace.
5. Being first off the starting block turns out to be competitively important only when pioneering early introduction of a technology or product delivers clear and substantial benefits to early adopters and buyers.

ASSURANCE OF LEARNING EXERCISES

1. Go to www.bestbuy.com, click on the investor relations section, and explore Best Buy's latest annual reports and 10-K filings to see if you can identify the key elements of Best Buy's strategy.

Students should provide an overview of Best Buy. It is a specialty retailer of consumer electronics, home office products, entertainment software, appliances and related services, operating 1,069 stores in 49 states, the District of Columbia and Puerto Rico at the end of fiscal 2010. Best Buy also has an international presence. The 2010 Annual Report states that Best Buy's business strategy is to treat customers as unique individuals, engaging and energizing our employees to serve customer needs with end-to-end solutions, while maximizing overall profitability. This strategy is based upon the core concepts of (1) offering consumers meaningful advantages in store environment (2) offering multi-channel shopping experiences, (3) providing product value and selection, and (4) offering a variety of in-store and in-home services related to the merchandise we offer. Taken together, these core concepts are designed to enhance the company's business model, gain market share, and improve profitability.

Use the framework provided in Figure 1.1 to help identify these key elements.

Utilizing the framework provided in Figure 1.1, examples of several key components that students are likely to identify are provided. Actions to gain sales and market share via various approaches: Four strategic priorities have been proposed for fiscal 2010. They are to (1) increase domestic market share based on specific product mix; (2) offer connected digital solutions to assist customers in transitioning to a connected digital lifestyle; (3) focus on international growth by applying the 'customer centricity' concept internationally; and (4) emphasize an efficient and effective enterprise by re-engineering the cost structure to deliver cost reductions or leverage across several revenue categories. Actions to respond to changing market conditions or other external factors: Best Buy outlines twenty 22 risk factors in the 2010 Annual Report which could negatively impact its operating results. Actions to enter new geographic or product markets or exit existing ones: During

the past decade Best Buy has expanded its operations to Canada, Europe (Best Buy Europe), China (Five Star), Mexico, and Turkey. Actions to capture emerging market opportunities and defend against external threats: As competitors (Circuit City) close their doors, Best Buy sees opportunities to attract additional customers. Online shopping (“clicks-and-mortar” strategy) was established in 2000. Geek Squad Inc. was acquired to provide technology support services to customers. Actions to strengthen market standing and competitiveness by acquiring or merging with other companies: Geek Squad Inc. was acquired in 2003, Speakeasy was acquired in fiscal 2008, and Napster was acquired in fiscal 2009. Actions to strengthen competitiveness via strategic alliances and collaborative partnerships: Based on the core hypothesis of combining technology, service, and local talent, Best Buy intends to pursue joint ventures in Europe, China, and Mexico. For example, The Carphone Warehouse is a European joint venture (2009). Actions and approaches used in managing R&D, production, sales and marketing, finance, and other key activities: The 2010 Annual Report identifies activities related to distribution, supplier strategy, and store development. For example, the company’s U.S. distribution strategy involves the majority of merchandise being shipped directly from manufacturers to its distribution centers.

What approach toward winning a competitive advantage does Best Buy seem to be pursuing?

Best Buy appears to be pursuing a competitive advantage based on providing specialized customer service keyed to meeting customers’ unique needs, end-to-end, by offering a variety of products and services in specialized store formats (for example, Best Buy Mobile).

2. On the basis of what you know about the quick-service restaurant industry, does McDonald’s strategy as described in Illustration Capsule 1.1 seem to be well matched to industry and competitive conditions?

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 2009 revenue of \$22.7B demonstrates the effectiveness of their value proposition, while earnings of \$6.8B demonstrate the efficiency of their operations. This position is further supported by an increase in earnings of 4 percent in the first quarter of 2010.

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.

3. Go to www.nytc.com/investors and check whether the New York Times Company's recent financial reports indicate that its business model is working.

The student should note that the company's annual revenue has declined steadily over the last five reporting periods from \$3.23B in fiscal 2008 to \$2.44B in fiscal 2009, while net income has declined from \$253M (7.83%) to \$19.89M (.82%). This illustrates a reducing value proposition (revenue) as well as a less effective 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?

The company's 2010 quarterly statement indicates a decline in overall advertising revenues of 1% and a decline in circulation revenue of 4.8%. The statement further indicates a decline in just print advertising revenues of 5.8%. The loss in the company's traditional revenue stream is offset by a sharp increase of 14.6% in digital advertising revenues. This would indicate that the company's efforts to reshape its revenue stream are beginning to gain traction.

Read the company's latest press releases. Is there evident that the company's business model is evolving?

Recent press releases highlight three specific items that provide evidence for an evolving business model. (1) Investment in products (comprehensive digital strategy) that reach a broader use base (2) Re-engineering of the company's cost base (3) A 15% increase in on-line advertising revenue, representing 27% of the company's total revenue in the third quarter of fiscal 2009.

To what degree does its strategic response to changing industry conditions seem proactive (deliberate) versus reactive and adaptive (emergent)?

The annual financial statements filed over the last five years indicate that revenue has been steadily declining along with a steady decline in net profit margin (% of sales). The student should note that if the refocus to digital media and re-engineering of the cost structure were largely the result of proactive strategy the statements would have shown a more consistent revenue stream with a change in the percentage from print media and digital media and the net profit margin would have remained more consistent. Therefore, the student should conclude that the changes appear to be largely adaptive.